(ii) NONRECURRING REVENUES

Staff annualized nonrecurring local revenue and charges assessed customers for changing designated preferred interexchange carriers (PICs) using the same September times twelve method, while SWB relied upon the average charge per access line method. Ex.7,p.39-40 Ms. Martin explained that local nonrecurring charges (such as new connect charges) run at a higher level in July, August and September due to school activity, and PIC charges fluctuate from month to month. Thus, relying upon only September produces a higher result than can be expected annually. Ex.7,p.40 Ms. Rucker's surrebuttal confirms that July, August and September do indeed tend to have higher results than others in the test period series.[159] Ex.28HC,Sch.4 Staff's annualization thus overstates expected revenue for the test period.

(iii) NO DISCERNABLE TREND (MISC)

Staff used several methods for these types of revenues where no discernable trend was noted; i.e., 1991 data, nine months average data, or September times twelve.[160] Ex.7,p.41 SWB proposes using the actual results for the twelve months ending September, 1992. This captures any test period change and assures that a representative period is used relative to rate base expense. Ex.7,p.41 Ms. Rucker's surrebuttal analysis confirms that her

[159]Ms. Rucker makes no attempt to rebut Ms. Martin's point that because of school new connects, nonrecurring charges occur in higher proportion during September.

[160]Ms. Rucker really offers no compelling reason why 1991 data is appropriate or representative. Indeed, Ms. Rucker seemingly contradicts herself by arguing in her surrebuttal that there is a discernable trend for these revenues. Ex.28,p.15

proposal not only doesn't correspond to actual 1992 results, but will not be achieved by SWB until 1993 or later. Ex.28,Sch.5 Again, Ms. Rucker relies upon "growth" as her touchstone, but fails to recognize those additional revenues will be accompanied by higher expense and rate base levels which are not part of Staff's proposal. Thus, Ms. Rucker's revenues are not representative of Mr. Meyer's test period expenses and rate base.

(iv) UNCOLLECTIBLE REVENUES

Both Staff and SWB recognize that uncollectible revenues must be included. The principal difference is due to the revenue level selected, the higher the revenues in the analysis, the greater the uncollectible offset. Ex.7,p.42 While Staff may disagree how "direct" the relationship is, higher revenues do result in higher uncollectibles also.

B. NONWAGE EXPENSE

While Staff adjusted many expense account balances from December 31, 1991 to twelve months ending September 30, 1992, it ignored changes to non-wage expense balances.[161] SWB witness Wepfer testified that nonwage expenses[162] have materially changed since December 31, 1991 and that the update to September 30, 1992 is needed to properly match the revenues, rate base and other expenses in the test period.[163] Ex.43,p.59 Ms. Wepfer further

[161]As it did with access/billing & collection expense.

[162]Examples are office supplies, gasoline, advertising, paper products, etc. Ex.43,p.57;T.660

[163]"Material change" was the principle basis for Staff's adjustment to revenues, wage/salary expense and rate base. Ex.2,p.2-7;T.150-153,157-158,163-166

annualized those account balances using the GNP-IPD, which represents the price movement in the economy and is an appropriate measure of price behavior for these SWB expenses. Ex.43,p.61

Staff principally opposes the GNP annualization factor, arguing that the GNP relationship to SWB expense is "unsupported and unverifiable." Ex.31,p.28 However, during cross- examination, Ms. Wepfer was asked about this relationship and introduced a study performed by SWB which correlated the GNP factor to SWB expense changes. T.660, 664-65 Staff's objection is therefore without foundation.

Staff also argues that the adjustment does not "consider" offsetting cost reductions. Ex.31,p.28 However, since Ms. Wepfer used September 30, 1992 results, all offsets reflected in expenses are included -- indeed, this is the same year ending method Staff used to adjust its other expense accounts to the September 30, 1992 test period balances.[164] T.165-6

As a last defense. Staff says that these adjustments "cannot even be isolated." Ex.31,p.29 This statement is confusing -- Staff witness Boczkiewicz, in his CWC adjustment work papers, was certainly able to isolate nonwage expense for his computation. Ex.189 If nonwage expense is considered in one part of Staff's proposed adjustment (CWC), what reason would Staff have to ignore this same expense for the year ending process?

---

[164]Staff also complains that "all the adjustment" for nonwage expense does is restate the balance at September 30, 1992. This, of course, is precisely "all that Staff's adjustments" do with respect to wage, depreciation, rate base, and revenues. Ex.5,p.9;Ex.7,p.11-15;T.149,157,163,166,498-499

(i) ACCESS/BILLING & COLLECTION EXPENSE

SWB updated Access/Billing & Collection (B&C) expense to September 30, 1992 levels; Staff failed to mention this adjustment.[165] SWB, as a primary toll carrier, pays access charges (and B&C) to other local exchange companies for IntraLATA toll service SWB provides. These access charges relate directly to toll revenues included in SWB's September 1992 test period amount. Staff proposed an annualized toll revenue increase (from 1991 to September 30, 1992), but, it failed to reflect the corresponding increase in expense related to the higher toll revenue in its case. Ex.7,p.93-94 Staff's proposal, therefore, does not maintain the "appropriate revenue, expense, rate base" that Mr. Meyer discusses. Ex.2,p.2-3;Ex.7,p.93-94

III. INCENTIVE REGULATION

Incentive regulation is working in Missouri. SWB's current incentive plan is promoting the efficiencies, the investments, the reasonable prices and the revenue growth it was designed to promote. As Mr. Wilk, former President of the California Public Utilities Commission, pointed out, as the industry changes so must its regulation. Ex.56,p.8 In today's environment of growing competition in the telecommunications industry, efforts to exercise the "typical" total regulatory control of the industry (through traditional regulation) will cause numerous problems and likely frustrate the achievement of important public policy goals, such as the goal of insuring quality, modern and affordable service in the rural as well as urban areas of the state. Ex.56,p.9

---

[165]Indeed, Staff does not rebut the proposal at all.

The need to move away from traditional regulation was recognized early on by this Commission in approving the Company's current plan. Most states, (twenty-nine states and the District of Columbia), have now adopted some form of incentive regulation as a way to balance the ongoing need for regulatory oversight with the complications resulting from the introduction of competition into the telecommunications industry. Ex.56,p.29 In addition, there are currently six additional states where alternative regulation proposals are being considered. Ex.61,p.2,Sch.1

One of the key benefits inherent in many incentive plans is accelerated or increased infrastructure modernization. Many incentive plans today have been designed to encourage investment in the state's telecommunications infrastructure. Ex.61,p.2,Sch.1 In order to bring about this investment, many plans have incorporated incentives to encourage companies to accelerate or increase the level of investment in the state. Id. SWB's current plan did just that. It offered incentives for accelerated investment in the network infrastructure through an opportunity for improved earnings. Absent the current plan, rural Missouri customers simply would not have the additional services and quality of service available to them today. Traditional regulation has not readily fostered aggressive infrastructure development, as evidenced by the need for a Commission rulemaking to define minimum parameters for basic local service in this state. Ex.61,p.3-4

Given the relationship of network modernization to incentive regulation, several plans adopted in other states have included a quid pro quo of infrastructure development in return for specified incentives. Ex.61,p.4 These agreements were premised upon the belief that if proper incentives are provided, then there is an impetus for companies to undertake accelerated or additional infrastructure development that would expand the availability of advanced telecommunications capabilities to broader markets, including rural markets. Ex.61,p.4-5

These agreements make business sense. There should be no doubt that a relationship exists between SWB's management decision to invest in infrastructure projects and the expected profitability of the Company as a result of such investment. Ex.49,p.9 While SWB will continue to meet its franchise obligation to provide quality service in Missouri, discretionary investment decisions are based upon the likelihood and timing of capital recovery and the likelihood and level of the return to be obtained from such investments. Any suggestion otherwise wholly ignores prudent business realities. The bottom line is that SWB has an obligation to shareholders to invest discretionary capital where it will receive the best return. The returns SWB would realize under Staff's proposed $150M rate reduction equates to approximately 7.0% after Commission adjustments (including Yellow Pages results) and only 4.1% on its actual books. Such results would make any such investments by SWB in Missouri imprudent. Ex.69,p.6

1. CURRENT PLAN

The current incentive regulation plan was a negotiated agreement among the parties to the appeals of Case Nos. TC-89-14 and TO-90-1, including the Commission itself. T.1278 The agreement called for substantial rate reductions (approximately

$82M), a freeze of basic local exchange rates, and significant network upgrades ($180M) including 100 central office upgrades, upgrades of approximately 750 miles of interoffice facilities, and the elimination of approximately 60,000 party lines. Ex.48,p.5-6;Ex.49,p.8;Ex.125,p.2

In return for its willingness to make those agreements and investments, SWB was given the opportunity to retain all earnings up to 14.1% return on equity (ROE) and to share earnings over that level up to a cap of 17.25% ROE, after which all earnings would be returned automatically to customers. Ex.48,p.13 The cap has not been reached and the amount shared under the Plan totals approximately $45M to date. SWB's after-sharing earnings under the plan were 11.7% in 1990, 11.5% in 1991, and 11.7% in 1992. After Commission adjustments, including the imputation of Yellow Pages earnings, the Company's earnings were 16.0% in 1990, 15.9% in 1991, and 12.9% in 1992. Ex.69,p.3,18

SWB believes the plan has been a success. For example, the network modernization plans filed by the next two largest Missouri LECs in response to the Commission's new rule defining basic local service (4 CSR 240.32-100) indicate that SWB's investments have resulted in its customers receiving the benefits of an upgraded network and many new services on a significantly expedited basis and without rate increases. Ex.76,p.37-38 SWB's plan resulted in increased and expedited investment in the state's telecommunications network which in turn has and will continue to have a positive impact on economic development in the State. Ex.76,p.23-30,Ex.125,126 SWB's actual earnings have remained relatively stable because of significant cost cutting, growth in current services and introduction of new services. Ex.69,p.9-32 At the same time, the quality of service delivered to consumers has been maintained at high levels. Ex.93,Sch.1-68-1-76;Ex.125;Ex.126

Since SWB, its customers and the State have all derived benefits over the duration of the plan, the Company believes the plan was positive and should be continued. Several parties, including Staff and OPC, take the position that the success or failure of the plan cannot be ascertained because neither the plan itself nor the order approving it contained any standard or criteria for evaluating the results of the plan.

In fact, Section 392.530 RSMo. states that all the provisions of Chapter 392 under which the Commission takes its authority to regulate telephone companies should be construed to accomplish the listed goals, which are as follows:

1) Promote universally available and widely affordable telecommunications services;

2) Maintain and advance the efficiency and availability of telecommunications services;

3) Promote diversity in the supply of telecommunications services and products throughout the State of Missouri;

4) Ensure that customers pay only reasonable charges for telecommunications service;

5) Permit flexible regulation of competitive telecommunications companies and competitive telecommunications services; and

6) Allow full and fair competition to function as a substitute for regulation when consistent with the protection of ratepayers and otherwise consistent with the public interest.

The Commission should look to such goals in assessing the success or failure of its regulation under the statute in whatever format such regulation takes, including its evaluation of the achieved benefits under the current plan and the merits of SWB's proposal for continuing the plan.

Measured against such criteria, the current plan was a clear success. Customers received reduced and stable prices and also received a share of SWB's earnings (goals 1 and 4). The network was upgraded making new and improved services available throughout the state, including rural areas (goals 2 and 3). Competition for SWB's services grew and expanded at an increasing rate (goal 6). Ex.65,66,67 And, the Company had a reasonable opportunity to increase its earnings.[166]

Other criticisms of the plan lacked substance. On the one hand, the plan was criticized because in the first two years there were credits which were characterized as indicating overearnings, even though SWB's earnings never reached the cap agreed to in the plan.[167] On the other hand, the plan was criticized because there were no credits in the third year. T.842

---

[166]Mr. Wilk also offered some criteria for the Commission's consideration based upon his own experiences. He testified that a good alternative plan must 1) protect customers from abusive pricing; 2) address infrastructure development realistically; 3) deal constructively with the issue of competition; and 4) provide meaningful and stable incentives. Ex.56,p.19-20 Whether this fourth criteria is met will be determined in this case.

[167]Earning within the range of return agreed to in the plan should not be viewed as excessive, including that portion which can result in sharing. Otherwise, any incentives to increase earnings are illusory. T.879-80,916

Staff and OPC also took the position that they could see no link between investment made under the plan and SWB's ability to earn well under the plan. But, Mr. Robertson made it clear that the network upgrades under the current plan were directly related to the parameters of the plan which gave SWB the opportunity to earn well. Ex.49,p.2-9 Likewise, it was made clear that the incremental investment included in SWB's proposal for extending the plan is also directly related to a rejection of Staff's earnings complaint and continuation of the current plan without major changes in SWB's earnings opportunities.[168] Id.,p.17

2. PROPOSALS FOR CONTINUING WITH ALTERNATIVE REGULATION

A. SWB'S PROPOSAL

SWB's TF2 proposal would continue to link SWB's opportunity to grow earnings with substantial additional discretionary investments and significant customer benefits, over both the short- and long-term. TF2 would extend the provisions of the current incentive plan with certain modifications regarding the monitoring procedures and the sharing grid; reduce customer rates by an additional $22M per year (Ex.89); significantly expand the eligibility for LifeLine service and simplify the administration of the eligibility process for that service (Id.); and invest approximately $140M to $150M of incremental capital, over and above its normal construction budget,

[168]Mr. Wilk testified that in order for an alternative plan to truly provide proper investment, earnings and cost reduction incentives, it must be viewed by the utility as reasonably stable and ongoing in nature. Otherwise, the utility will view such plans as little different from traditional regulation. Ex.56,p.33-35,47

in network projects in Missouri during the next three years.[169] See discussion in next subsection. If the proposed projects end up costing more to complete than estimated, SWB is still committed to completing the projects. T.792,826

(i) MODERNIZATION PROPOSAL

The Company originally proposed to invest an estimated $82M in a digital DS3 fiber optic infrastructure for Missouri within the first three years of an extended plan. The proposal will create a digital fiber optic telecommunications link to virtually every community served by SWB in Missouri. As originally proposed, the network would connect all interested public middle schools, high schools, colleges and hospitals served by SWB to permit the offering of Distance Learning and TeleMedicine services. Ex.75,p.5 During the hearings, SWB committed to extend the proposal to all interested private schools at an estimated additional capital cost of $35-$45M. T.860 SWB also committed to include for public schools the cost of the expensive on-premise CODEC equipment needed for Distance Learning applications.[170] This constituted an additional $10M capital commitment. T.855,859-60

SWB also agreed during the hearing to accelerate party line elimination in order to conclude the program by 1995 instead

---

[169]Mr. Robertson testified that what SWB spends on such projects would be tracked and reported to the Commission. T.826 He further testified that if there is insufficient demand or costs are underestimated, SWB would work with Staff and OPC to insure committed investments would be made in other worthwhile projects. T.792

[170]This commitment would also extend to participating private schools. The CODEC equipment is included in the estimated $45M capital commitment for private schools.

of 1997, as currently scheduled. The capital cost of this commitment was $11M. T.395-94 Finally, SWB's proposal also includes a $2M commitment to accelerate compliance with the remaining requirements of Rule 4 CSR 240-32.100. which defines contemporary basic local service requirements.[171] Ex.75,p.28-32 SWB's TF2 proposal, as modified, gives this Commission the opportunity to foster significant advances in education, health care and economic development in Missouri. Rather than allowing this state to fall behind in these areas, this proposal has the potential to make Missouri a leader.

The fiber optic network proposed by SWB holds the promise of a wide range of benefits and applications for a general cross section of the public facilitating the transmission of high quality interactive video. The most notable applications can be found in educational opportunities (Distance Learning), and health care (TeleMedicine). Ex.75,p.25-26;Ex.168,p.1-2 With Distance Learning, the instructor can see and hear the students, and at the same time, the students are able to see and hear the instructor as well as the other students. The students can ask questions and receive answers just as if they were all in one classroom. Ex.75,p.17 The instructor can control the camera to change views due to demonstrations, writing on the blackboard or using an overhead projector, etc.

---

[171]The acceleration would complete SWB compliance with this portion of the rule within 18 months of the plan's extension.

This network will support educational delivery for many age groups and individual educational needs.[172] In addition to classroom instruction, the network will facilitate other applications such as in-service training sessions, "field trips by fiber", and adult education. Ex.75,p.23 Health care applications include remote physician and specialist consultations, second opinions, remote exams, nursing training, Teleradiology, and continuing medical education. Ex.75,p.23 The health care industry is now ready to utilize the benefits of communication to assist in controlling spiralling health costs and improving the quality of care. As doctors and hospitals form alliances to address the high cost of new medical technology, this network will allow early remote diagnoses to permit sharing of the costly medical resources. Ex.85,p.24;T.99-105

OPC and the Attorney General contend that Distance Learning and TeleMedicine applications can effectively be provided over a copper-based network. Ex.1,p.66,71 This position demonstrates both a lack of understanding of the quality aspects of copper as well as the live interactive applications anticipated to be demanded on this network. A copper-based network provides significantly less video quality than the Company's fiber proposal to support interactive applications. OPC witness Dunkel argues that technologies are under development which can transmit a "VCR-

---

[172]The Intervenors for Independence Options support the development of a fiber optics network to fully open the network to all potential users, including people with disabilities and older adults. The technologies proposed by SWB, for example, would permit interactive video communications for hearing impaired consumers to sign to one another. Ex.1,p.73-74

like" quality. Ex.121,p.29 This contention is a red herring. Even Mr. Dunkel recognizes that today such quality cannot be achieved with live interactive video applications, admitting that VCR-like quality can only be achieved at the current time with pre-recorded signals. Ex.121,p.29,n.12 Distance Learning, however, involves live interaction between teacher and student and between students in different locations. Teachers will use this application not simply to lecture, but to perform science experiments, use a chalkboard or overhead projector, show a videotape, perform signing for a hearing impaired student, etc. For all of these live applications, speed of transmission and quality of picture are essential. T.1213;Ex.76,p.16;Ex.168,p.2

Company witness Dr. Jackson Tung disagreed with Mr. Dunkel's suggestion that ADSL and HDSL compression technologies would make copper effective for TeleMedicine and Distance Learning. Dr. Tung testified that he had previously interfaced with the Bellcore staff in the development of the ADSL and HDSL algorithms. Those compression technologies were designed to achieve a minimum acceptable standard to view prerecorded entertainment video; they were never intended for specialized applications such as health care or Distance Learning.[173] Ex.84,p.6 Finally, Dr. Tung

---

[173]This is further evidenced by the fact that ADSL is solely a one-way technology, not appropriate for any type of interactive application. Similarly, Attorney General witness Cooper's suggestion that copper-based ISDN can effectively provide interactive video has no merit. It provides significantly less video quality than fiber and is difficult to adapt to the full-presence, multi-location requirements of Distance Learning. Ex.76,p.13 Moreover, the Company has a significant number of digital switches particularly in the outstate areas that do not have ISDN serving capability because the vendor has not yet (continued...)

explained that the increased bandwidth and the resultant increased quality and precision achieved with fiber are necessary for an effective medical application. Ex.84,p.5 And, SWB witness Crossley emphasized that the future of the network rests in fiber, not copper. Ex.76,p.15

Finally, some parties have questioned whether sufficient demand exists to justify the development of this network. SWB is firmly convinced that such demand is present. As Mr. Huser confirmed "the real interest in Distance Learning is literally coming out of the woodwork." T.1206 The Company is receiving inquiries throughout the State seeking information on the availability of these services. Thirteen Missouri schools are now participating in a Distance Learning trial coordinated by the Interactive Video Programming (IVP) Advisory Council, a group formed following a joint IVP Task Force and Commission recommendation to coordinate the Distance Learning trials in Missouri. Ex.85,p.8 In addition, there are over one hundred Distance Learning networks in operation in the United States today. Ex.85,p.13 This Commission now has the opportunity to ensure that Missouri, and particularly its rural schools, has the opportunity to take advantage of a Distance Learning network covering the majority of the State. Absent SWB's TF2 proposal, deployment of such technology will continue to be limited to isolated trials and

---

[173](...continued)
developed such capability for these switches. Even with the switches that have such capability, significant investment would be required to utilize ISDN. Ex.76,p.14

never the standard operating environment. Each case will be an island, never a comprehensive educational program.

Hospitals and the medical community also look forward to a greater deployment of fiber networks for TeleMedicine applications. As noted by hospital participants in this case supporting the Company's proposal, "TeleMedicine addresses the key critical issues driving the evolution of health care into the next century." T.100 Public mandate is motivating health care providers to find ways to broaden access to quality care while at the same time reducing costs. One clearly available way to achieve this is using SWB's proposal to provide state of the art TeleMedicine applications. Id. Dr. Tung also confirmed the desire of managed care organizations to take advantage of this technology, including the introduction of new health care management organizations into the state. T.1188-91

(ii) RATE REDUCTIONS

In connection with the extension of the current plan, SWB also has proposed $22M in rate reductions. These reductions, which do not include the approximately $6M in revenue requirement associated with SWB's implementation of expanding calling plans as directed by the Commission in Case No. TO-92-306,[174] are as follows:

> Expansion of LifeLine Program ($2.0M) SWB proposes to replace the existing program with a new offering that would expand upon the eligibility criteria (roughly

---

[174]Under the Commission's December, 23, 1992 Order in that case, SWB is entitled to revenue neutrality for implementing such services. If SWB forgoes revenue neutrality, the value of its proposed rate reductions in this case actually becomes $28M. Additionally, SWB is seeking implementation of FAS 106 which would increase SWB's revenue requirement by approximately $30M but without any offsetting rate increases. T.861

14,000 existing customers currently have Lifeline services) so that approximately 180,000 customers would be eligible. SWB also would assume responsibility for administering and promoting the LifeLine Program.

Merge Touchtone with Basic Local Service ($5.3M) SWB proposes to merge the Touchtone service rate with the basic local exchange service rate, which would result in a rate reduction for existing customers with Touchtone service ($.20 decrease for residence, $.53 decrease for business). In addition, customers placing orders for new basic local exchange service or customers transferring their existing service would receive a basic local exchange access line equipped with Touchtone signalling at a lower rate than the current rate design. Existing customers without Touchtone service would be grandfathered at their existing locations.

Reduced Switched Access Rates ($7.7M) SWB recommends rate reductions for local switching ($2.1M), local transport ($4.5M), and access directory assistance ($1.1M). Reductions in this area would be appropriate due to the increasing risk of competition in the switched access market.

Reduction in Long Distance Message Telecommunications Service Rates ($6.5M) SWB recommends reducing rates for SWB's intraLATA toll service. Decreases in this area will improve SWB's ability to compete in the market and offer savings to its customers. The proposed reductions target medium- and long-haul mileage bands in order to extend savings to customer calling patterns not covered by the new expanded calling services established in Case No. TO-92-306.

Expand the Calling Scope for Third and Fourth Tier Coin Telephones ($0.5M) SWB is proposing to expand the calling scope of coin phones in the existing Kansas City and St. Louis third and fourth tier exchanges and in the Billings and Clever exchanges in the Springfield area. This will make the coin calling scope consistent with the local exchange service calling scope purchased by the majority of residential and business customers in these exchanges. Coin Operated Pay Telephone Service (COPTS) customers will maintain their existing rate and will be offered the option of selecting the expanded local calling scope or remaining with their existing calling scope.

Although SWB's earnings declined in the third year of the plan and no sharing occurred, the $22M in rate reductions approximate the level of credits which were returned to customers in the first two years of the plan.[175] Ex.48,p.22

(iii) SHARING GRID

If the Commission determines that the incentive regulation plan should be extended, SWB has proposed that the Commission either continue to use the current sharing grid, or adjust the current grid by reducing each of the various sharing points down by 3.4 percentage points (i.e., initial sharing would begin at 10.7% ROE rather than 14.1% ROE), and eliminating Yellow Pages earnings results from the way earnings are calculated under the plan. Ex.1,p.57-58;Ex.48,p.13-16,22-26;Ex.49,p.15-17,19-22 This 340 basis point reduction in ROE is equivalent to the frozen 1985 adjusted level of Yellow Pages imputation used in the current plan. Ex.48,p.13-14

Thus, under this proposal, the level of sharing would be unaffected and the 1985 adjusted level of Yellow Pages earnings would remain embedded in the Company's rates for the duration of the plan. Ex.48,p.5;Ex.49,p.19-20 The earnings cap, which, under the current plan already excludes Yellow Pages earnings from its calculation, would remain at 17.25% ROE and be based on the Company's actual capital structure. Ex.48,p.13-14 The 10.7% ROE initial sharing point is within Staff's recommended ROE range of 10.11% to 11.21%. Approval of this proposal would not prevent the

---

[175]It also approximates the revenue requirement associated with the decline in capital costs which the Staff alleges has occurred since the current plan was implemented (12.61% ROE v. 10.11%-11.21% ROE).

Commission from imputing Yellow Pages earnings in future proceedings.[176]

(iv) PROPOSED RATE FREEZE

If SWB's TF2 proposal is approved, SWB proposes to continue to freeze basic local exchange rates at current levels for the duration of time the plan remains in place. Other rates could be increased, but only upon Commission approval.

(v) DURATION OF ANY EXTENDED PLAN

SWB proposes that any extended incentive regulation plan have no automatic termination point. However, parties could seek changes in the plan after the third year. No change would be effective until after the third year of the plan. As a result, after the third year, the plan would continue without change until the Commission, on its own motion or at the request of others, determines the plan should be changed or terminated.

(vi) COMPETITION

No party took a position that SWB does not currently face some level of competition. Competition within the telecommunications industry directly impacts SWB today and such competition will continue to grow and expand. These rapid developments are important to the Commission's decision because the risks the Company faces are critical to the determination of the appropriate regulatory plan and suitable returns on equity for the Company. Ex.59,p.7-18;Ex.18,p.7-16

---

[176]See Section II.20 of this brief for further discussion of imputation of Yellow Pages earnings in this case, whether or not the Commission chooses to continue with alternative regulation.

The record establishes that competition for SWB's services has grown significantly, even since the current plan was implemented. For example, five years ago, only 15 companies were certificated to provide intrastate Message Telecommunications Service (aka MTS, toll or long distance). Today, there are over 74 certified firms. Ex.65,p.5 Consumers are using these alternatives in many ways. The use of one competitive dialing procedure (10XXX) alone more than doubled in 1992, representing over $6M lost in intraLATA toll revenues. Ex.65,p.6 At that rate of growth, SWB will see increasingly significant portions of its toll revenues disappear in only a few years.

Competitive losses of this magnitude already have occurred with other services provided by the Company. Since 1987, over 40 companies have received certification and tariff approval to provide WATS and/or 800 services. During this same period, SWB's WATS and 800 revenues have dropped by over 80 percent, from $17.6M in 1987 to less than $3.0M in 1992. Ex.65,p.9

In the operator services market, the number of certificated providers has grown from 13 companies in 1988 to over 35 companies today. Ex.65,p.10 During this same time, SWB's operator assisted revenues in Missouri have dropped by nearly 30 percent, from $14.7M in 1988 to $10.4M in 1992. Ex.65,p.12

Dedicated private line alternatives, which are virtually identical to the Company's offering, are offered by at least 19 certificated companies in addition to a number of alternate technology providers (e.g., satellite, microwave, radio). Ex.65,p.12 Moreover, many of Missouri's largest consumers are utilizing these alternatives to SWB's services. Ex.65,p.13-14 These bypass technologies all are real forms of competition. T.907

The FCC's recent orders and decision regarding collocation, both special and switched, likely will have a dramatic effect on SWB's access and toll revenues. CC Docket No. 91-141, 7 FCC Rcd. 7369 (October 19, 1992) Implementation of its special access decision alone will increase the pressures immediately on SWB's existing intrastate transport revenues, (approximately $20.4M in 1992). Any company or customer will have the ability to collocate in the Company's switching offices, including well-funded Competitive Access Providers (CAPs) such as Kansas City Cable Partners, MWR Fibercom and Metropolitan Fiber Systems (MFS). Ex.65,p.16 With the FCC's adoption of the switched collocation rule,[177] and if this Commission also adopts a collocation rule, the competitive impact will be much greater.

The significance of the FCC decision can best be illustrated by the statement of the president of MFS, who concluded that it "signals the beginning of the end of the local exchange monopoly." Ex.65,p.15 In addition, the cable industry, proclaiming that it passes over 96% of all existing homes and businesses within this state, has expressed its clear intentions and plans to provide telecommunications services. Ex.65,p.18-20;T.1331,1333-36

The emergence of wireless technologies (such as Personal Communications Services) and the growing use of cellular service results in viable substitutes for even basic local service that are

---

[177] Second Report and Order and Third Notice of Proposed Rulemaking, CC Docket No. 91-141, Adopted August 3, 1993 (not yet released)

beyond the Commission's certification and regulatory jurisdiction. Ex.65,p.17 The recent flourish of partnerships, acquisitions and investment announcements (e.g., AT&T/McCaw, Time Warner/U.S. West, MCI/British Telecom and many others) clearly manifests the vision that competitive inroads within the incumbent LEC's service area will continue to broaden at rapid speed. T.1019,1036-38

In short, SWB faces increasing competition in virtually all of its markets (Ex.65,66,67), and, as Mr. Wilk noted, going back to traditional regulation is therefore not a viable option. Ex.57,p.10 The growth of competitive alternatives and the increasing risks to SWB's financial viability should be recognized by the Commission as it addresses the appropriate regulatory plan for SWB, as well as the appropriate rate of return associated with these heightened risks to the Company's revenues and earnings.

(vii) ADDITIONAL EARNINGS ADJUSTMENTS

SWB proposes to continue monitoring reports and sharing calculations under the current agreement which is based on the use of Case No. TC-89-14 adjustments. Ex.7,p.107 SWB is not opposed to the use of CAM methods to quantify the deregulated service costs included in each month's monitoring results; however, there is no need for special "earnings adjustments." Ex.7,p.106-11

(viii) EXOGENOUS FACTORS

SWB supports Staff's proposal that the Commission consider the addition of an exogenous factor provision to an extended incentive regulation plan, particularly since the plan could run longer than three years. Staff's proposal covers the Commission's implementation of expanded calling scopes in connection with Case

No. TO-92-306, and any future Commission consideration of intraLATA presubscription. SWB has suggested also including tax increases or decreases,[178] changes in accounting rules, natural disasters,[179] and other increases or reductions in costs or earnings directly related to regulatory decisions, including, for example, changes in separation rules. Such an exogenous factor provision would prevent SWB from being either unduly benefitted or harmed under the plan by major events that are beyond the Company's control. A $5M aggregate materiality standard should apply. Ex.7,p.112-15

(ix) ADDITIONAL MONITORING REPORTS

Both Staff and the OPC have suggested that additional reports be provided by the Company in regard to monitoring of the Company's earnings under the plan. While clarification is needed as to the format and timing of the suggested reports, if the plan is extended, SWB is generally agreeable to supplementing the additional monitoring reports as requested by OPC and Staff. Ex.7,p.104-06

(x) INTEREST ON SHARING CREDITS

Staff has proposed that the incentive or alternative regulation plan be changed to require the payment of interest on credits to customers. Except under the terms of the plan itself,

---

[178]It is already known that federal income taxes paid by SWB will increase in 1993 as a result of recent federal legislation. This increase, which is not reflected in Staff's accounting case or its rate of return analysis, will increase SWB's annual revenue requirement in excess of $4M.

[179]Mr. Robertson estimated the current flooding in Missouri could have an adverse revenue and expense impact to SWB-Missouri operations of as much as $40M. T.2087 This impact is not reflected in Staff's accounting case or its risk and return analysis either.

customers have no claims to a credit at any particular point in time. The timing of the credits is specified in the plan, and unless the Company unreasonably delays implementation of such credits beyond the specified time, no interest should be assessed. Ex.7,p.111-12 To the extent SWB's earnings fall below the threshold for filing for rate relief under the plan, it earns no interest and gets no surcharge for the shortfall that occurs during regulatory lag. Id.

B. STAFF'S PROPOSAL

Staff's proposal is that the Commission first reduce SWB's rates by $150M and then continue with an "alternative" regulation plan in which sharing would begin at 12.61% ROE, including the 1985 level of Yellow Pages earnings in the calculation of SWB's earnings. That would mean sharing on SWB's actual telephone related investment would begin at approximately 9.21% ROE. However, the proposed $150M rate reduction would lower the Company's earnings to 4.11% ROE on its actual books or 7.09% ROE with Commission adjustments.[180] Ex.69,p.6

If the Commission chooses to base its decision on Staff's complaint, SWB cannot proceed with incentive regulation, as proposed by either Staff or the Company. Under such a

---

[180]Mr. Wilk noted that Staff's proposal essentially involves traditional rate case regulation interspersed with periods of shared earnings, and he characterized the use of the term "alternative" to describe such a proposal as "something of a stretch." Ex.57,p.3 He also noted that it would strain the Commission's own credibility to put itself in the position of alternatively adopting incentive plans followed by traditional rate cases. Ex.48,p.47 The benefits of incentive regulation depend on the regulated entity being able to count on the incentives being real and ongoing.

circumstance, SWB requests that after any ordered rate reduction, it merely be permitted to operate under the forbearance type of regulation accorded to most other LECs in this state (i.e., if the Company does not file for revenue increases, the Staff and the Commission will not review its earnings level). T.284-85

Even if the Commission rejects Staff's complaint, SWB is unwilling to continue with alternative regulation as suggested by Staff with sharing beginning at 12.61% ROE, including Yellow Pages earnings. T.838 The Company would agree to begin sharing at 10.7% ROE if Yellow Pages earnings are not included. Sharing at 12.61% ROE with Yellow Pages earnings included would mean sharing at 9.21% ROE on SWB's investment. It would not be prudent for SWB management to proceed with its proposed incremental TF2 investments for such a return opportunity. T.885

C. OPC PROPOSAL

OPC supports a continuation of sharing with periodic and ongoing rate reductions. Under traditional regulation there could be periodic rate proceedings, but SWB would be entitled to retain all earnings between such proceedings and would not be required to share anything. OPC even proposes that sharing begin at a specific cost of capital (OPC recommends 10.5% ROE), rather than at some point above such figure, as is the case under the current plan. Under traditional regulation, SWB would be able to retain all earnings within a zone of reasonableness above an authorized return. Regulatory lag under traditional regulation would offer more "incentives" than OPC's plan and, therefore, SWB would not agree to it.

D. POSITIONS OF OTHER PARTIES

CompTel and The Missouri Cable TV Association (MCTA) take the position SWB's proposed plan to place fiber to schools and hospitals could be offered by others at possibly less cost and more ubiquitously. However, neither offered any commitment to actually offer such services at less cost on a statewide basis or within SWB's service area. T.1328;Ex.117,118

SWB also opposes the suggestions of Attorney General (and OPC) that the proposed Distance Learning and TeleMedicine network be developed by using technology facilities such as copper and ISDN over copper. If the network is to be built, SWB and Staff agree it should be built with fiber. T.1272 Incredibly, the witness for the Attorney General, Dr. Cooper did not even discuss or review his testimony or positions with anyone in any State agency or the Office of Administration, even though those are the very entities which the Attorney General purports to represent in this case.[181] T.1173 Nor was Dr. Cooper aware that the State's Highway

---

[181]Not only did Dr. Cooper, a doctor of sociology (T.1167-68), not check with anyone in any state agency about whether they agreed with his opinions and testimony, he admitted he 1) had not read the Commission's Order in Case No. TC-89-14 (T.1166-67), 2) had not read the Commission's decision in Case No. TO-93-116 classifying certain Southwestern Bell services as transitionally competitive (T.1167), 3) had not read the Commission's decision in Case No. TO-89-56 establishing cost standards for pricing services classified as transitionally competitive (Id.,p.4), had not read the Commission's proposed collocation rule (Id.,p.5), had not read the Commission's Order in Case No. TO-88-142 regarding classification of interexchange services (Id.,p.6), was not an expert in engineering (T.1168), and 7) had done no study on the level of competition being experienced in telecommunications markets in Missouri, but instead based his conclusions on national averages and his review of "broad literature" about what "typically takes place".

Department itself is considering taking bids on a fiber network along State highways. T.1078,1173

Several parties, including the Missouri Industrial Development (MIDC), the Jefferson Memorial Hospital, Freeman Hospital in Joplin, St. Louis Children's Hospital, Intervenors for Independence Options and the Regional Consortium for Education and Technology of Southwest Missouri supported SWB's TF2 fiber-based proposal as one that would further both education and health care in the State and aid in economic development. Additionally, several participants without intervention supported the fiber-based proposal for similar reasons. These included St. Louis County League of Chambers of Commerce and the Economic Development Director for Jackson County.

E. SUMMARY

This case presents the Commission with a unique opportunity to accomplish several important goals. By extending the current incentive regulation plan as proposed by SWB, the Commission can achieve:

1) A reasonable level of additional rate reductions;

2) Ongoing rate stability for local exchange service;

3) The ongoing opportunity for customers to automatically share in Company earnings;

4) Significant accelerated network infrastructure improvements with positive results for education, health care and economic development in rural as well as urban areas;

5) Realistic depreciation rates;

6) Implementation of FAS 106 according to GAAP and consistent with the vast majority of other regulatory jurisdictions, without adverse rate consequences to customers;

7) A sharing point of 10.7% ROE, if the Commission will agree to not utilize Yellow Pages earnings in calculating SWB's earnings under the plan, thereby allowing the 1985 adjusted level of Yellow Pages earnings to be "locked in" to both current rates and the sharing grid; and

8) An opportunity for SWB to achieve a reasonable level of earnings.

None of these objectives, which are positive for the Company, its customers and the State, can be achieved under the proposals made by Staff and OPC.

IV. RATE DESIGN

1. STIPULATION

In the event the Commission does not adopt SWB's proposal to continue with the incentive regulation plan under the TF2 proposal including its associated rate reductions and rate design, a Stipulation was submitted by SWB, Staff, OPC, AT&T, MCI, CompTel and the Attorney General on a recommended rate design for any rate reductions ordered by the Commission in conjunction with the Staff's earnings complaint. Ex. 159 SWB does not recommend or support any other proposed modifications to the Company's services or rates in this proceeding.

Respectfully submitted,

SOUTHWESTERN BELL TELEPHONE COMPANY

By ______________________________
ALFRED G. RICHTER, JR.
ANN E. MEULEMAN
MICHAEL C. CAVELL
MARK P. ROYER
DARRYL W. HOWARD
JOSEPH F. JEDLICKA, III
KATHERINE C. SWALLER

Attorneys for
Southwestern Bell Telephone Company
100 N. Tucker, Room 630
St. Louis, Missouri 63101-1976
(314) 247-5224

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing document were served to all parties on the Service List by first-class postage prepaid, U.S. Mail.

Dated at St. Louis, Missouri, the 10th day of September, 1993.

Attorney

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 91-M-0890 - In the Matter of the Development of a Statement of Policy Concerning the Accounting and Ratemaking Treatment for Pensions and Postretirement Benefits Other than Pensions.

NOTICE SOLICITING COMMENTS

(Issued March 19, 1992)

NOTICE is hereby given that the Commission, at its session of February 20, 1992, decided to seek comments from interested parties regarding a proposed Statement of Policy concerning the Accounting and Ratemaking treatment for Pensions and Postretirement Benefits Other than Pensions. The proposed Statement is discussed briefly in the attached February 12, 1992 staff memorandum to the Commission. The attached Appendices A and B, with the addition of the provisions listed below, contain the detail of the proposed Statement and an explanation of the reasons for its advocacy. Appendix C is a request to Class A and B jurisdictional companies for additional information.

ADDITION TO APPENDIX A

The pension plans of most New York State utilities are currently funded to a level that is very near, if not above, the maximum level allowed by the Internal Revenue Code (approximately 150% of the current pension liability). In almost all of these cases, when SFAS No. 87 is adopted, the fair market value of these assets will exceed the projected benefit obligation, as determined under SFAS No. 87, of the related pension plan(s).

There is no requirement for any company to fund its pension plan to the maximum level allowed by the IRC and such level may not be desirable. To the extent that current pension funding exceeds the SFAS No. 87 full funding level, the Commission desires to explore the possible use of the excess to mitigate the revenue requirement impact of adopting SFAS No. 106. Although this subject is addressed in Section 2(E)(a) of Appendix B, the Commission seeks more extensive comments on this matter including, but not limited to, making changes to the proposals contained in Appendix A.

Class A and B utilities are requested to comment on this matter and to explain how companies that are fully funded under SFAS No. 87 can maximize the use of excess pension fund assets and existing pension rate allowances to reduce the rate impact of SFAS No. 106. The responses should consider any logical and prudent means whereby these like items can be viewed jointly so as to minimize rate impacts. At the minimum, the Commission requests companies to comment on the following:

a. methods available to effectively transfer, or otherwise use, excess pension fund assets to defray the cost of OPEB,

b. ratemaking or accounting approaches to reduce pension expense rate allowances and apply this difference to rate allowances for OPEB funding, and

c. itemize the company-specific possibilities, with pros and cons, of settling a part of the pension plan liability and using the resulting gain (as determined under the guidelines of SFAS No. 88) as an offset to the OPEB liability.

ADDITION TO APPENDIX B

1. Addition to Section 10

Any plan submitted in accordance with Section 10 of Appendix B is to include a full explanation and justification of:

a. the provisions, features, etc. of the company's OPEB plan(s),

b. its proposed plan for recovery, or other disposition, of OPEB expenses,

c. use of pension funds and excess pension related rate allowance to mitigate the rate impact of adopting SFAS No. 106, and

d. what OPEB cost control measures the company has adopted, what cost control measures it is in the process of investigating, and the current stage of that investigation.

If approval of the submitted plan, or a modification thereof, is not granted by the Commission, or its designee, by the mandatory effective date of SFAS No. 106,[1] the company, in the interim and until approval is granted, shall follow the provisions of this statement regarding deferral (and accrual of interest) of the differences between:

a. the amount of the OPEB rate allowance,

b. the amount booked for the OPEB expense, and

c. the amount deposited in tax-effective OPEB dedicated funds.

The company shall apply interperiod tax allocation to any book/tax timing differences resulting from this accounting.

---

1. SFAS No. 106 is effective for fiscal years commencing after December 15, 1992, however, for nonpublic enterprises with no more than 500 plan participants it is effective for fiscal years beginning after December 15, 1994.

2. Review of Overall Compensation

In current and future rate proceedings jurisdictional companies will have to substantiate that their OPEB plans and expenses are a part of an overall compensation package that is reasonable, necessary, and comparable to those provided by other utilities and nonregulated employers of comparable size within the area and the state. The Commission will also be looking to ascertain that appropriate cost control measures have been, or are being, investigated and/or implemented by each company.

3. Early Retirement Programs

Certain fringe benefits, such as health insurance, are provided to employees currently as well as after retirement. During active employment, the projected cost of these benefits to be delivered after retirement is included in the OPEB accrual, but the cost of benefits being provided currently is an operating expense that is recorded separately and is being recovered through rates.

In the case of early retirement, the cost of providing these benefits to the early retiree is shifted from a current operating cost to the OPEB fund. This shift will cause:

a. an increase in the OPEB liability which will commence being amortized and recovered over future periods. The company will be kept whole for the resulting increase in annual OPEB expense by the deferral requirements proposed in Section 4 of Appendix B,

b. the employer will cease recording the cost of currently provided benefits as a separate expense since it is now being paid by the OPEB fund. This will cause a corresponding increase in the company's net income.

The above increase in net income, or "savings," is actually revenue that was provided to cover a cost which was not eliminated, but merely shifted to future ratepayers. Therefore, it appears inappropriate for regulated industries to flow these "savings" through to net income. Accordingly, we propose to require that:

> If an early retirement program is enacted between rate cases or rate changes, and the financial impacts of that program have not been accurately forecasted and included in their entirety in the revenue requirement determined in a rate proceeding, the company shall defer an amount equal to the portion of the savings related to the fringe benefits of the early retirees which have not been recognized in rates. This deferral shall be credited to the internal OPEB fund described in Appendix B or deposited into the company's external OPEB fund. Documentation must be maintained to allow verification of these transactions, their justification, and all related calculations.

COMMENT DEADLINE

Parties wishing to comment should submit 5 copies of their comments to John J. Kelliher, Secretary, New York State Public Service Commission, Three Empire State Plaza, Albany, New York 12223 by no later than 60 days from the date of this Notice. Additional information may be obtained from James R. Palmer of the Office of Accounting and Finance at (518) 486-2841.

JOHN J. KELLIHER
Secretary

Attachment

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

February 12, 1992

TO: THE COMMISSION

FROM: OFFICE OF ACCOUNTING AND FINANCE

SUBJECT: CASE 91-M-0890 In the matter of the development of a Statement of Policy concerning the Accounting and Ratemaking treatment for Pensions and Postretirement Benefits Other than Pensions.

* * *

Memorandum Soliciting Comments Regarding Proposed Accounting for Pensions and Postretirement Benefits Other Than Pensions

* * *

<u>RECOMMENDATION</u>: The attached Appendices A, B, and C be sent to all Class A and B jurisdictional companies, and any other interested parties, for comment.

<u>Summary</u>

The Financial Accounting Standards Board (FASB) recently issued new rules governing the accounting for pensions.[1] These new rules have impacted the amount of pension expense reported for financial accounting purposes and the rate impact will be similar if they are adopted for ratemaking purposes.

In December 1990, during the course of our analysis of

1. Statement Of Financial Accounting Standards (SFAS) Number 87 - <u>Employers' Accounting for Pensions</u> and Number 88 - <u>Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits</u>. Both of these statements became effective in 1987 (1989 for companies with fewer than 100 plan participants.

these new pension rules, the FASB issued SFAS No. 106[2] which establishes new rules on a related item, Postretirement Benefits Other Than Pensions (OPEB).[3] Many of the provisions of the new OPEB accounting are the same as, or similar to, those established for pensions. However, the financial impact of SFAS No. 106 will be substantially greater than the new rules for pensions. Because of this, we decided the three accounting pronouncements should be addressed in a unified manner in one policy proposal.

A detailed discussion of the issues and our preliminary recommendation for a Commission policy statement are contained in Appendices A and B. Appendix C is a request to Class A and B jurisdictional companies for additional information. We recommend the three appendices be sent to all Class A and B jurisdictional companies, and any other interested party, for their comment. The responses we receive will be considered when we formulate our final recommendation. The policy issues discussed herein are: 1) use of the new rules for ratemaking purposes, 2) use of excess pension allowances in current rates to begin funding for OPEB liabilities, and 3) actions utilities should be taking now in relation to their OPEB plans.

---

2. SFAS No. 106 - Employers' Accounting for Postretirement Benefits Other Than Pensions.
3. OPEB includes all benefits, other than retirement income, provided by an employer to its retirees. Some examples of OPEB are: health insurance, life insurance, tuition assistance, legal services, financial advisory services and housing subsidies. The most controversial of these items, and the item with by far the largest financial impact, is retiree health care.

Background

Pensions

Prior to September 1987, Commission policy for pension costs was the same as prescribed for pensions under generally accepted accounting principles (GAAP). GAAP permitted broad flexibility in both the measurement and allocation of employers' costs for pensions. The amount utilities reported for pensions for both financial accounting purposes and for ratemaking purposes was normally based on the same methods and assumptions used to determine contributions made to their pension funds. These contributions were determined by actuaries and were generally calculated so as to take maximum advantage of liberal federal income tax allowances. This policy has been effected by recent tax legislation which severely curtailed, and in many cases eliminated, the amount utilities may contribute to their pension plans and still deduct on their tax returns.

In response to the new accounting rules for pensions issued by the FASB,[4] a Commission order was issued in September 1987 informing jurisdictional companies that they may adopt the new rules for recording pension costs only if the change was implemented in conjunction with a rate filing or if the variation between actual pension expense under the new procedure and the amount reflected in rates was preserved for future disposition.

---

4. The Financial Accounting Standards Board is the private sector's independent rulemaking body for the accounting profession. Although the Securities and Exchange Commission (SEC) has statutory authority to establish financial and reporting standards, the FASB's standards are officially recognized as authoritative by the SEC and the American Institute of Certified Public Accountants.

The order was an interim measure made "pending the completion of a staff inquiry into the impact of the revised accounting for pensions". A survey of pension plans and the related accounting was also taken at that time. This revealed that the new rules have been adopted by all of the major jurisdictional companies for financial accounting purposes and that the amount of pension expense calculated under the provisions of SFAS No. 87 has generally been lower than what it would have been under the method previously used.

OPEB

Currently, Postretirement Benefits Other Than Pensions (OPEB) are recorded on a pay-as-you-go basis for both accounting and ratemaking purposes.[5] In the past, the cost of these benefits have been relatively small and therefore this treatment was not an issue. More recently these costs have become signigicant, as has their expected rate of increase. These are the principal reasons SFAS No. 106 was issued.

SFAS No. 106, which becomes effective in 1993, will require companies to estimate the future cost of their promised OPEB and to recognize that cost on their financial statements over the working lives of the covered employees. It has been estimated that, for most companies, these new rules will increase the OPEB expense recorded for accounting purposes by between two to six times what is being paid presently to current retirees.

5. A few companies have begun accruing for future OPEB liabilities but this is only to a limited extent and generally does not equal the liability that would be required under the new FASB rules.

The resulting revenue requirement increase will be significant for all of the Class A and B companies.

By far, the major cost component of OPEB is the cost of health care. The estimated revenue requirement impact of SFAS No. 106 accounting on the projected health care expense of some of the major NY State utility companies is as follows:

IMPACT OF SFAS No. 106 ON HEALTH CARE COSTS
AT MAJOR NEW YORK STATE UTILITIES
(dollar amounts in thousands)

COMPANY	(a) INCREASE IN REVENUE REQUIREMENT FOR 1993	(b) COLUMN (a) AS A % OF 1990 OPERATING REVENUES

In order to avoid conflicts with the Securities and Exchange Commission's public disclosure requirements, the confidential data originally presented on this table has been deleted.

Discussion

Use of the new rules for ratemaking purposes

Pensions

The pre-1987 policy for pensions was advantageous in that it has allowed utilities to maximize their federal income tax deductions for pension costs. However, it has also been shown to have left companies with a great deal of discretion in the determination of pension expense which in turn left the door open for manipulation to the detriment of customers. The new accounting rules are complex, but are an improvement over prior rules because they provide a more objective and defined basis for determining pension expense.

Since most, if not all, pension plans of jurisdictional companies have been well funded, we do not expect adoption of SFAS No. 87 for ratemaking purposes to have a major impact on revenue requirement. In addition, even though the Commission has not issued a generic policy regarding SFAS No. 87, many of our larger utilities have already been allowed to adopt SFAS No. 87 for ratemaking purposes on a case-by-case basis.

Our pension proposal recommends that SFAS Nos. 87 and 88 be adopted, with certain restrictions, for ratemaking purposes. These restrictions limit some of the options available under SFAS Nos. 87 and 88 in order to make them more appropriate for regulated utilities and to protect the interests to ratepayers. We have also proposed adoption of certain deferral mechanisms to assure pension rate allowances are either dedicated to that purpose or preserved for future Commission disposition. In 3 to

5 years we will review these procedures for effectiveness and continued applicability.

OPEB

OPEB, like pensions, are a form of deferred compensation. In exchange for the employee's current services the employer promises both current benefits (e.g. wages) and deferred benefits (e.g. OPEB). Since today's customers receive the benefits of the employees' services, it is reasonable that they pay for the cost of the employees benefits at the time service is rendered. This philosophy would include benefits paid at a later date, such as during retirement. The alternative is to allow the companies to build a liability beyond the $3.4 billion owed by the customers to date[6] and recover those amounts from future customers. The latter approach could be of particular concern to industries where competitive inroads are likely to reduce the number of customers from which OPEB liabilities might be recovered. There is also a question of fairness to future generations which weighs on the side of current recovery. Moreover, the Securities and Exchange Commission (SEC) is looking closely at regulated companies with regard to utilities' liabilities and the regulators' history of recognizing such items in rates. The SEC is also very concerned about the regulators' ability to guarantee future recovery of OPEB liabilities for certain industries that are coming under

6. The companies listed in the table on page 5 of this memo currently owe a total of $3.4 billion OPEB liability for the past services rendered by their employees and retirees. The 20-year amortization of this amount is included in the revenue requirement impact shown in column (a) of that table.

increased competitive pressure and which may cease to operate in a regulated environment.

The lack of historical data, and the margin of error in some of the projections required by SFAS No. 106, render the estimates of OPEB costs imprecise and subject to manipulation. This, along with other reasons, leads us to propose the use of certain deferral mechanisms to assure OPEB allowances are either dedicated to that purpose or preserved for future Commission disposition. Also, due to the increase in revenue requirement in certain instances, we believe that adoption of SFAS No. 106 for rates should be phased-in over several years.

The major provisions of our OPEB proposal are:

1. SFAS No. 106, with certain restrictions, should be phased-in for ratemaking purposes.

   .. The pace of the phase-in would be determined on a case-by-case basis and would depend upon its revenue requirement impact on the subject company.

   .. Until the phase-in is completed, the annual increase for OPEBs would equal the lesser of:

      a. the total annual OPEB expense, or
      b. an amount equal to approximately 1% of the company's gross operating revenue.

   .. Our stated goal is to complete the phase-in within 5 years. However, for most companies the revenue requirement impact is less than 1 1/2% of gross operating revenues. Therefore, full recognition of OPEB should be accomplished within a few years. The exception to this is the New York Telephone Company, for which the projected revenue impact is significant and the estimated liability is much higher than other companies after adjusting for size.[7]

---

7. NY Tel's estimated level of OPEB cost, as filed with our Office of Accounting and Finance, is significantly greater than the norm. We have not made any study to ascertain the reasons for this, nor have we formed any opinion as to the

(Footnote continues on next page)

.. This proposal provides the Commission with maximum flexibility in the amount it allows for OPEB and provides some control over the size of the overall rate increase.

.. The guarantee of a minimum level of recovery, and a ratcheting up of that level in subsequent rate cases, is necessary to demonstrate to the financial community that the Commission is sincere about full and timely rate recognition of OPEB expense.

2. OPEB funding

.. Companies are encouraged to deposit OPEB rate allowances in tax effective funding vehicles, dedicated exclusively to OPEB purposes.[8]

.. Because of the very limited availability of tax effective funding vehicles, companies most likely will not be able to deposit 100% of their OPEB allowances into such funds. In that event, companies are required to set-up a reserve account, similar to that used for nuclear decommissioning funds, until such time as a tax deductable deposit can be made.

3. We will review this procedure in 3 to 5 years for effectiveness and continued applicability.

Actions utilities should be taking now for OPEB

Studies taken in anticipation of the issuance of SFAS No. 106 found that there were actions companies should take immediately which could not only reduce the impact of the new rules but could result in lower ultimate OPEB payments. Our

---

(Footnote continued from previous page)

reasonableness of the benefit plans. However, we believe this matter warrants close review by the company. It will be up to the company to substantiate in future rate proceedings that its overall compensation package (including OPEB, pensions, and wages) is reasonable and necessary.

8. An OPEB fund is "tax-effective" if 1) contributions made to the fund can be taken as a current tax deduction by the company making the contribution, 2) the income earned on the fund balance accumulates tax free, and 3) the employee is not taxed until the benefit is actually received or not taxed at all.

recommendations include a requirement that utilities explore the feasibility of implementing these actions.

Public Opposition to Adoption of SFAS No. 106

Some consumer advocacy groups are urging state regulators to reject the new OPEB accounting. A January 7, 1992 article in the New York Times newspaper reported on the reasons given by these groups in support of their position. The major arguments, and our responses to them, are summarized below.

1. Ratepayers will receive little or no advantage in paying for OPEB now. "It is cheaper for ratepayers to keep the money now, rather than to pay it up front."

OPEB are a form of deferred compensation. In exchange for the employee's current services, the employer promises a deferred benefit in the form of OPEB. Since today's customers receive the employees' services, it is reasonable that they pay the full cost of the employees' benefits, including the cost of benefits which will be paid out after retirement (similar to pensions).

Unless accrual accounting for the OPEB expense is adopted for ratemaking purposes there will be no prefunding of the OPEB liability. Without that prefunding, the OPEB liability will continue to grow without earnings on the funded assets accumulating to help offset the liability growth.

2. It is impossible to forecast medical costs accurately.

Forecasting the cost of future medical costs is an evolving science which, with the passage of time, will become more accurate. However, no matter how inaccurate it may be at the present time, it is more accurate than the current pay-as-you-go method which, in effect, estimates this cost as "zero".

B. <u>The government will eventually assume more responsibility for health care insurance, thereby shifting the costs for future retirees to taxpayers.</u>

What the government will eventually do is an unknown, but it is unlikely to decrease the burden on major corporations. Most national health plans being discussed today involve special assessments on employers or increases in other employer paid costs in order to provide coverage to people who currently have none. Whatever the case, employers will end up paying a portion of the costs for these other people in addition to the costs applicable to their own workforce. This translates into an increase in cost, not a decrease.

If national health insurance is enacted, and it covers the company's employees, the company would still have a need for its OPEB fund to pay the cost of national health insurance after the employees' retirement. It is unlikely that national health insurance would significantly decrease the company's overall insurance costs since the company would most likely have to purchase additional health insurance to augment the national coverage.

<u>Conclusion and recommendation</u>

Staff has completed its preliminary investigation of the new accounting rules and is recommending a change in policy for the accounting and rate treatment of pension and other postretirement benefit costs. A detailed description and discussion of our findings and recommendations is provided in Appendices A and B. Another appendix (Appendix C) is a request for the filing of additional pension and OPEB information by Class A and B jurisdictional utilities. It is requested that these three appendices be sent to the Commission's Class A and B jurisdictional companies, and any other interested parties, for their comment. All replies received in response to this request for comments will be considered when we formulate our final recommendations.

Respectfully submitted,

JAMES R. PALMER
Public Utilities Auditor II

CHARLES REUBENS
Public Utilities Auditor III

Approved by:

GEORGE E. TRAHAN
Acting Deputy Director,
Office of Accounting & Finance

PROPOSED ACCOUNTING AND RATE TREATMENT

FOR

PENSIONS

TABLE OF CONTENTS

END OF TABLE

PENSIONS

1. PRE-SFAS NO. 87 POLICY FOR PENSIONS

Prior to SFAS No. 87,[1] the amount allowed in rates for pensions generally equaled the amount the utility funded in a trust for its pension plan(s). As will be elaborated on further in this appendix, the amount funded was determined by independent actuaries and was normally based on federal regulations (mainly relating to federal income taxes) and the financial characteristics of the company. Even though federal regulations for pensions have become more strict in recent years, utilities still have grea: latitude in funding their pension plans.

A. Analysis of Issue

Federal regulations allow actuaries to chose any one of several methods when determining the amount a utility must fund to comply with the regulations and still be able to deduct the fund payment on its federal income tax return. Each of these methods requires the selection of certain assumptions by the actuary and for each assumption there exits a range from which the actuary may choose. As a result, the amount a utility chooses to fund for its pension plan is extremely subjective. If this subjectively determined expense level is allowed for rates, there exits the opportunity to manipulate the pension expense allowance for the enhancement of stockholders and to the detriment of ratepayers. For example, one of the assumptions used to calculate the annual

1. Statement of Financial Accounting Standards (SFAS) No. 87 - Employer's Accounting for Pensions was issued by the Financial Accounting Standards Board (FASB) in December 1985.

pension expense is the return expected to be earned on fund assets. There exists a variety of sources from which an acceptable assumption for this component may be chosen. When projecting the pension expense in a rate proceeding, the actuary could easily select a low expected return on plan assets. This would, in turn, indicate that the utility needs a rate allowance for pension expense higher than is actually necessary. As a result, the company's actual deposit to its pension could be lower than the rate case projection, and the company would, in turn, earn a higher rate of return than the Commission intended.

Another concern with the current policy is that as long as the rate allowance for pensions is based on the amount funded, and the utilities are basing the amount they fund on federal regulations, the objectives for the federal regulations become the basis upon which rates are set. This may not be desirable. For example, Congress may pass laws restricting the amount a company may deduct on its federal income tax return for pensions in order to reduce the federal budget deficit. As a result, a utility would have to reduce the amount it funds. Since rates are set on the amount funded, in the interim between tax law changes and the next rate case, companies could retain the difference and realize a windfall. It is not practicable for the Commission to adjust rates simultaneous with individual tax law changes, unless they are extremely wide-ranging and material.

A third concern is that current procedures have resulted in overfunding. A survey taken in 1985 showed that about 90 percent of large corporate pension plans were overfunded.[2] A survey we made in July 1987, showed this trend continues for New York State utilities. This means customers have paid more in rates for pensions than the estimated projected liability of the related plan. The main reason for this overfunding is liberal tax allowances for prefunding pension costs.

Finally, because current federal income tax rules are liberal and the choices of assumptions are numerous, it is difficult for staff to closely monitor pension costs. Also, staff's expertise in the actuarial area is limited and it would be costly to bring it up to the level that would be necessary to effectively monitor pension costs under the current rules.

A consideration favoring current policy is that severing pension funding from the allowance in rates for pensions will result, in certain cases, in the customer paying more in rates for pensions than the utility expends in that year.

B. Recommendation

Pre-SFAS No. 87 policy and procedures should be replaced with more strict and objective requirements for pension expense recognition.

2. SFAS NO. 87 AS RATE POLICY

In December 1985, the FASB issued SFAS No. 87. This accounting pronouncement provides more uniform accounting methods for computing and reporting annual pension costs. On September 22, 1987 the Commission ordered that any Class A or B utility

---

2. "1985 Executive Report on Large Corporate Pension Plans," and "Industry Profiles Developed from the 1985 Executive Report on Large Corporate Pension Plans," Johnson and Higgins, New York, 1985.

electing to adopt SFAS No. 87 must either make the accounting change in the context of a rate proceeding or must defer, for subsequent disposition by the Commission, the difference between the allowance in current rates for pension costs and costs recorded according to SFAS No. 87.

The recommendation to implement deferral accounting procedures was based on concerns about certain actuarial assumptions required by the statement, potential volatility of pension expense, the severing of the accounting and ratemaking for pensions from the actual funding of pensions, and certain provisions that permitted too much flexibility in assigning future costs to current periods. On July 28, 1987 a questionnaire regarding the impacts of using SFAS No. 87 was mailed to all Class A and B utilities under the Commission's jurisdiction.

Responses to the pension questionnaire were received from all but one company.[3] All but four of the responses indicated the company adopted SFAS No. 87 for reporting purposes in either 1986 or 1987.[4] Unfortunately, many of the responses were incomplete because the companies were unable to provide current pension expense using their pre-SFAS No. 87 method, and/or projected pension costs beyond 1987. Also, only a select few chose to comment on the issues discussed in the survey, despite the invitation to do so.

. No response was received from Rochester Telephone Corporation.

4. Three utilities responded that the type of pension plan they employed was not subject to the provisions of SFAS No. 87. The fourth indicated that it was exempt until 1989 due to its small size.

Based on the survey responses and actual experience to date, the amount of pension expense calculated under the provisions of SFAS No. 87 has generally been lower than what it would have been under the previously used method. The main reason for this, as mentioned previously, is that the utilities are in an overfunded position because past rate allowances were based on the amount funded, which in turn was based on obtaining the maximum benefit from the liberal federal income tax laws related to pensions.

A. Analysis of Issue

Perhaps the main advantage for adopting SFAS 87 for rate purposes is that it provides a more objective tool for measuring and evaluating rate allowances for pensions. For example, the July 1987 survey showed pension expense allowances calculated using SFAS No. 87 were lower than they would have been under the prior method. This demonstrates that the utilities were in an overfunded position at this time. Under prior pension rules, this overfunding would not have been clear because the the amount charged to expense for pensions would simply have matched the amount funded for the pension plan.

Another advantage of adopting SFAS No. 87 for ratemaking purposes is that it is part of Generally Accepted Accounting Principles (GAAP). That is, it is now part of the common set of accounting concepts, standards, procedures, and conventions recognized by the accounting profession as a whole and upon which most nonregulated enterprises base their external financial reporting. While this in itself does not demonstrate that the

SFAS No. 87 is the most appropriate method for ratemaking purposes, compliance with GAAP has clear advantages.

First, following GAAP makes the comparison with both regulated and non-regulated companies' pension expense more meaningful. Prior to SFAS No. 87, GAAP permitted a variety of actuarial methods for determining pension expense. Since pension expense between companies was often based on different actuarial methods, a strict comparison of the dollars charged to expense did not necessarily inform the financial statement user of the actual difference between the plans. SFAS No. 87 reduces the variance resulting from using different methods and, thus, makes the comparison between companies more meaningful.

Second, utility operations, especially in the communications industry,[5] are diversifying or becoming less regulated. As regulated operations transition to non-regulated status, they must follow GAAP and, if GAAP is already being followed on the regulated side, the transition can be accomplished more smoothly. There is also less chance that pension funds will have become overfunded, at the expense of ratepayers, before they are transferred to the non-regulated portion of the business.

Third, acquisitions, mergers, etc., will be easier to effectuate, and their impacts easier to quantify, if all the parties involved follow GAAP.

A fourth consideration is that there are many acceptable methods for calculating pension costs under current PSC accounting

---

5. For example, see Opinion 89-12, Case 29469 - Proceeding on Motion of the Commission to Review Regulatory Policies for Segments of the Telecommunications Industry Subject to Competition, issued May 16, 1989.

rules. Each method, the results of which can vary widely, requires the selection and use of numerous assumptions. SFAS No. 87 requires the use of one standard method. Narrowing the manner in which pension costs must be calculated, improves staff's monitoring of pension costs by reducing the number of methods with which staff must become familiar.

A fifth reason for adopting SFAS No. 87 is that by now almost all companies have adopted SFAS No. 87 for reporting purposes, but they are still deferring the difference between rate allowances under the old formula and financial accounting amounts under SFAS No. 87. Requiring companies to switch back to the previous method would be costly, cumbersome, and confusing. Also, switching back and forth between methods might lead the more sophisticated investor and rating agencies to question the integrity of the financial statements.

Finally, the Omnibus Budget Reconciliation Act of 1987 (OBRA) placed an additional cap on the maximum amount of pension costs a company may d-duct for federal income tax purposes. This budget improving act has tended to decrease, and in many cases eliminate, the amount being funded for pensions. Some NY State utilities' rate allowances for pension expense are still based on the earlier level of funding. Requiring SFAS No. 87 for rate purposes, coupled with our proposed requirement that the entire difference between pension expense allowed in rates and actual deposit in the pension fund be deferred for future disposition, will capture for customers the effect of this lower pension funding level. The current deferral requirement only captures the impact of SFAS No. 87 on pension expense. The impacts of OBRA will be elaborated upon subsequently.

We have found three potential disadvantages of adopting SFAS No. 87 for rate purposes. First, one of the primary concerns against using SFAS No. 87 was that it could result in undue volatility in pension expense. It was believed that the increased volatility would result from:

1) Changing the discount rate assumptions from those based on expected long-term projections that fluctuate infrequently and moderately to assumptions based on point-in-time interest rates.

2) Changing from the current method of prior service cost amortization, which provides a level amount representing the sum of prior service cost and interest, to a method that generally accelerates amortization over a shorter period.

SFAS No. 87 allows companies some latitude in the mechanics of applying the new rules, the objective being to moderate pension expense volatility. Analysts of the firm of Bear, Stearns & Co. stated in a report dated May 12, 1987, that "We believe it is well within the ability of management to minimize fluctuations in expense under SFAS No. 87." This conclusion was confirmed in the February 23, 1987 issue of Pension and Investment Age where it was stated "Corporate executives completed their second year of compliance with FASB's rules for pension accounting were able to minimize volatility of pension expense that some had feared would result from the new rules." We conclude that there exists sufficient evidence to question the "volatility argument", however, actual experience with the standard is needed to effectively evaluate this concern.

Another argument against adopting SFAS No. 87 for rates is that severing the link between the rate allowance for pension expense and the company's actual funding of pensions decreases the incentive to fund pension plans properly. The utilities also pointed out that the failure to allow the additional financing costs due to higher funding requirements could also prove to be a disincentive to proper pensions funding. We disagree with these arguments. The FASB noted the following in the "Summary" section of SFAS No. 87:

> "net pension cost for a period is not necessarily determined by the amount the employer decides to contribute to the plan for that period. Many factors (including tax considerations, as well as, the availability of both cash and alternative investment opportunities) that effect funding decisions should not be allowed to dictate accounting results if the accounting is to provide useful information."

Similarly, the factors that determine pension funding are not the same as those determining the proper amount of pension expense to be collected in rates. There are other regulatory forces that mandate proper funding levels and we are also proposing the utilities be made whole for the higher or lower financing costs that will result because of the differences between rate allowances and funding. This issue is discussed below as a separate issue (Section 4).

A final argument against adopting SFAS No. 87 for rate purposes is that, when compared to the method most commonly used previously, SFAS No. 87 assigns lower costs to the early years of an employee's career and higher costs as the employee approaches retirement age. It was argued this could result in an undesirable rate impact. The problem with this argument is that it assumes that pension costs result from employees who are all the same age. If the employees are all currently young, then the argument is valid and the dramatic increase in expense will occur. However, it is doubtful this is the actual situation. The workforce of the major utilities are made up of employees of various ages. While pension costs are lower for the younger employees, they are correspondingly higher for older employees using the method required by SFAS No. 87. This could be a problem for some of the smaller utilities since there are only a small number of employees available to even-out age differences. However, other rate moderating techniques could be employed to eliminate an undesirable affect on rates.

B. Recommendation

SFAS No. 87, subject to certain stipulations described in the remainder of this appendix, should be adopted for rate purposes.

C. SUBSIDIARY ISSUES

a. Optional Provisions of SFAS No. 87

SFAS No. 87 allows companies some latitude in the mechanics of applying the new rules, the objective being to control pension expense volatility. Included in this category are some elective options that we could require to be used. These options have the ability to mitigate short-term fluctuations in pension expense and thereby allow companies to plan future expenditures more accurately. This would, in turn, provide customers with more predictable and stable rates. The provisions which need to be addressed are: (a) delayed recognition of gains and losses; (b) use of the "corridor approach" to determine if gains or losses should be recognized; and (c) use of the market-related value approach, based on a three or five year average, to value plan assets.

1. Delayed Recognition of Gains and Losses.

Gains and losses result from changes in the projected benefit obligation caused by changes in the assumptions used in the SFAS No. 87 calculations. They also result from changes in the value of plan assets caused by experience being different from that originally assumed.

SFAS No. 87 permits the option of electing to use either immediate or delayed recognition of gains or losses. If delayed recognition is elected, gains and losses are not recognized as they occur but are recognized in a systematic and gradual manner over subsequent accounting periods. If, however, there is a settlement or curtailment, these unrecognized gains or losses are immediately reflected in income.

We are aware of several New York utilities that are using the delayed recognition option and that currently have large unrecognized gains which they claim to be due to better than anticipated financial market conditions.

Analysis of Issue

The FASB included the "delayed recognition" provisions because it concluded that

> the difference in periodic measures of the pension liability (and therefore the funded status of the Plan) results partly from the inability to predict accurately for a period (or over several periods) compensation levels, length of employee service, mortality, retirement ages, and other pertinent events. As a result, actual experience often differs significantly from that which was

> estimated and that leads to changes in the estimates themselves. Recognizing the effects of revisions in estimates in full in the period in which they occur may result in volatility of the reported amounts that does not reflect actual changes in the funded status of the of the plan in that period. (SFAS No. 87, paragraph 175)

The FASB's logic for not recognizing gains and losses immediately is reasonable and is appropriate logic for setting rates. If the long-term assumptions prove to be accurate, gains and losses in one year will be offset by losses or gains in subsequent periods. The "delayed recognition" provisions provide a reasonable opportunity for gains and losses to offset each other without affecting annual pension expense.

On the other hand, the FASB's logic for delaying recognition of gains and losses is based on the assumption that they are temporary. This may not turn out to be the case and, therefore, adoption of "delayed recognition" could result in the ratepayers not receiving the benefit of the gains for a considerable period of time.

Recommendation

We believe the benefits of delayed recognition outweigh the disadvantages. Therefor, companies should use the "delayed recognition" provisions of SFAS No. 87 to recognize gains and losses for regulatory accounting and rate purposes. Immediate recognition shall be prohibited.

2. The "corridor approach"

As stated above, in order to recognize the long term nature of the various assumptions SFAS No. 87 allows delayed (deferred) recognition of gains and losses. SFAS No. 87 also defines the method companies are to use to determine the minimum rate at which gains and losses must be recognized. This <u>minimum rate of amortization</u>, referred to as the "corridor approach", allows companies to postpone recognition of gains or losses until the net cumulative variance exceeds 10% of the greater of (1) the market related value of the plan assets, or (2) the projected benefit obligation. Even if the 10% level is reached, the amount that exceeds the corridor may be amortized over the average remaining service period of active employees expected to receive benefits under the plan. For most of our large jurisdictional companies that period is approximately 20 years.

Gains and losses may be recognized more rapidly than is required under the corridor approach. Paragraph 33 of SFAS No. 87 states

> Any systematic method of amortization of unrecognized gains and losses may be used in lieu of the minimum specified in the previous paragraph [the corridor approach] provided that (a) the minimum is used in any period in which the minimum amortization is greater (reduces the net balance by more), (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed.

The "corridor approach" is founded on the premise that the relevant assumptions are based on long-term projections which can be expected to vary from year to year. Since variances between the assumptions and actual results should, in theory, cancel each other out, the FASB reasoned that these continuing but offsetting variances should not be recognized until the variance reaches such a high level that it is no longer likely that it is temporary.

<u>Analysis of Issues</u>

The duration of pension obligations is long term in nature. Thus, for rate setting purposes it is illogical to immediately recognize gains and losses that reflect short-term market fluctuations and that are likely to cancel each other out in the long run. Therefore, using the corridor approach, in conjunction with the market-related value approach for valuing pension assets, warrants consideration.

A potential disadvantage of adopting the corridor approach is that it could result in a failure to recognize permanent gains. Gains, or losses, which may in fact be permanent, may never reach the 10% corridor threshold and therefore may never be recognized. To put the magnitude of this problem into perspective, the fair market value of the assets held in Consolidated Edison's pension fund on December 31, 1990 was $3 billion.[6] This means the corridor could contain a net gain or loss of $300 million which would remain unrecognized for accounting and rate purposes.

Although we support delayed recognition for gains and losses, we do not support permanent non-recognition for significant amounts. We also believe using the average remaining service period of active employees (approximately 20 years for many utilities) for the amortization period of gains and losses is somewhat excessive.

We propose to prohibit use of the corridor approach. Instead, any gains or losses, which would have gone into the corridor, should be placed into a deferral account and amortized, on a vintage year basis, over 10 years. Ten years is sufficient to normalize any cyclical fluctuations in the market value of assets or variations of actual experience from assumptions;

6. December 31, 1990 Annual Report to the Public Service Commission.

especially if this approach is used in conjunction with the "market-related value" method of valuing fund assets. The use of any longer amortization period, or use of a "corridor", would result in either "masking" permanent gains or losses or in flowing them through to ratepayers over too long a period of time.

It may be argued that by requiring certain provisions of SFAS No. 87 be followed the Commission is not really adopting SFAS No. 87 for rate purposes. However, the options we are requiring are within the standard and thus the manner in which we are requiring pension expense be calculated and recognized is in compliance with SFAS No. 87.

Recommendation

The "corridor approach" should not be used to recognize gains and losses for accounting and rate purposes. Instead, any gains or losses, which would have gone into the corridor, should be placed into a deferral account and amortized, on a vintage year basis, over 10 years. For ratemaking purposes the amount in this account will be included in ratebase.

Some companies have already adopted SFAS No. 87 and are using the corridor approach. Those companies, on the effective date of this policy statement, shall transfer the amount then deferred in the corridor to the deferral account and are to commence the 10-year amortization. Since this amortization will be part of the companies' annual pension expense, any difference it causes between the booked expense and the then current rate allowance for pension expense will be captured for subsequent disposition by the Commission by the deferral requirements described in Section 3 of this appendix.

Some NY State utilities are a part of a larger organization (as an affiliate, subsidiary, operating division etc.) and the remainder of the organization is not subject to the jurisdiction of this Commission. In many of these instances there is only one pension plan which covers the entire organization. It may be awkward for the utility portion regulated by the Commission to use one of the "optional provisions" of SFAS No. 87 while the remainder of the organization uses a different option to account for the same plan(s). We request respondents to specifically address this problem in their comments.

3. Valuation of Plan Assets

Plan assets are defined as investments that have been segregated and restricted (usually in a trust) to provide benefits. The value of the pension plan's assets is used to determine how much more a company must accrue or fund to meet its pension obligation and is thus a key factor in the calculation of pension expense. In determining the value of pension plan assets, SFAS No. 87 allows the use of either a point in time value, referred to as the Fair Value, or an averaging method referred to as the Market-Related Value of Assets approach. This averaging approach requires that plan assets be valued as "a calculated value that recognizes changes in fair value in a systematic and rational manner over no more than five years."[7]

7. Different ways of calculating the market-related value may be used for different classes of assets, but the manner of determining the market-related value is required to be applied consistently from year to year for each asset class.

Analysis of Issues

Use of the market-related value approach enables employers to smooth the short-term volatility inherent in the financial markets. Since the pension obligation is long-term in nature, eliminating short-term swings in the value of pension fund assets would result in a more accurate reflection of the funded status of the plan. Therefore, use of this valuing method should be required; but there still remains controversy over the number of years which should be included in the averaging period.

When viewed in conjunction with the 10-year amortization of gains and losses we are proposing, a three-year averaging would probably be sufficient. Five years would obviously smooth the volatility more, but that advantage may be outweighed by the probability that the longer period would delay recognition of the general trend in the value of the fund assets (e.g. the overall long-term upwards trend of the value of stocks). This would cause an understatement of the value of the funds which would, in turn, cause an increase in the amount of pension expense to be recognized by the company.

Recommendation

Plan assets should be valued using a calculated value that recognizes changes in fair value in a systematic and rational manner over three years.

We request that respondents specifically address whether a period of 3, 4, or 5 years should be used, and that they fully explain the reasons for their preference. We also ask that they state what method they are currently using to value their pension fund assets.

b. Choice of Assumptions

Three of the key assumptions used to calculate pension expense under SFAS No. 87 are the discount rate, the rate of return on plan assets, and the salary progression rate. A change in any of these rates will result in an immediate change in the amount of pension expense being recognized on the income statement.[8]

There is a considerable difference between the rates being used by various companies. The previously referenced survey by Buck Consultants showed the discount rates used by those surveyed varied by more than five percentage points. The responses we received to our July 1987 survey showed that, for each of the three rates, the variances between companies was as much as two or three percentage points.

Since selection of the rates to be used for each of these three assumptions is up to management, there is an opportunity for manipulation of pension expense. If this manipulation occurs between rate cases it could result in the enhancement of corporate profits at the expense of ratepayers. One possible remedy for this potential problem is for the Commission to specify the rates to be used. The July 1987 questionnaire requested comments on this remedy and all respondents opposed it.

1. Analysis of Issue

Each pension plan and fund is unique and the assumptions related to them should be based on the individual characteristics

8. A change in any one assumption may not produce as great a change in the pension expense as one might initially expect. This is because the three assumptions are interlinked and a change in any one should result in a somewhat offsetting change in the others.

of that particular plan and fund. The utility, in conjunction with its actuary, should be the best party for selecting these assumptions since it formed and manages the plan and fund. If the Commission required use of generic assumptions, their use would, in all likelihood, result in larger variances between the assumptions and actual results than if the assumptions were selected by the utility and considered the uniqueness of the plans and funds. Also, use of generic assumptions would complicate matters for any utility whose pension plan is part of a larger group that is not entirely regulated by this Commission.

The FASB reviewed this problem and concluded it was not reasonable for it to specify generic assumptions. Paragraphs 193 and 194 of SFAS No. 87 state:

> The Board concluded that requiring all employers to use the same assumptions is inappropriate. Concepts Statement 2 defines comparability as "the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena." The Board noted that requiring employers to use the same turnover assumption, for example, would reduce comparability to the extent that the assumption would otherwise reflect real differences in expected turnover among employers.
>
> The Board considered a requirement that all employers use common benchmark discount rates, such as those published by the Pension Benefit Guaranty Corporation (PBGC).[9] One reason for that consideration was its concern that rates previously used for disclosure purposes varied among employers over an unreasonable range. In spite of that concern, however, the Board concluded that requiring use of benchmark rates would be inappropriate, in part because no readily available rates seemed fully suitable. Instead, the Board decided that the Statement should describe more clearly the objective of selecting the discount rates with the expectation that a narrower range of rates used would result. Although the Board concluded that it should not require use of PBGC rates, it noted that certain of those rates, as currently determined,

---

9. PBGC is a federal agency that serves to insure plan participants against the loss of vested benefits. It is funded by premiums paid by all companies with qualified pension plans.

are one source of readily available information that might be considered in estimating the discount rates required by this statement.

Our analysis of SFAS No. 87 included studies of SFAS No. 87 made by other regulatory agencies. These studies all concluded that it was not reasonable or proper for the regulatory agency to specify the rates which must be used for these assumptions.

In view of the above, it does not appear that generic assumptions should be mandated. Consequently, there remains our concern regarding management's possible manipulation of the rates for the purpose of enhancing corporate profit. Although this may be a problem in the long-term, it is adequately addressed for the near-term by our proposed deferral requirements.

Under SFAS No. 87, variances between assumptions and actual results are considered to be gains or losses. Under the accounting we are proposing here,[10] these gains and losses will flow through to ratepayers over a 10-year period. If a the change in assumptions occurs between rate cases, the amortization of the resulting gain or loss would, ordinarily, flow through to the stockholders. However, as discussed in Section 3 below, we are recommending deferral accounting be applied to the difference between the rate allowance for pension expense and the amount of expense actually booked. Therefore, even if the utility did manipulate its pension expense between rate cases the resulting benefit would be deferred and its disposition addressed by the Commission in a future rate proceeding. In other words, as long as deferral accounting is required, the customer cannot be harmed

10. Section 2(C)(a)(1) of this appendix

by the selection of a particular assumption. However, deferral of the difference between rates allowance and book expense is being proposed for a trial period only. When we review this policy statement in three to five years we will determine if this deferral requirement should continue.

2. Recommendation

We continue to be concerned about the amount of discretion utilities have in the selection of the assumptions used in the SFAS No. 87 calculation as it provides the opportunity for manipulation. However, this concern does not fully offset advantages of adopting the standard. In view of our recommended deferral accounting and restrictions on the optional provisions of SFAS No. 87, we believe that, with the exception of the restriction discussed below concerning calculation of the "assumed discount rate", each utility should continue to select its own assumptions. We will reevaluate this issue when we review this policy statement in approximately three to five years.

c. Assumed Discount Rate

The discount rate is the interest rate used to adjust for the time value of money when determining the present value of the Projected Benefit Obligation. The rules related to the selection of an assumed discount rate are minimal. However, in order to give some consistency in the method of developing the rate, and at the same time allowing the rate to reflect the inherent differences in each individual plan, SFAS No. 87 states the assumed discount rate should be based on information concerning rates of return implicit in current prices of annuity contracts that could be used to settle the obligation. It also states that when estimating the discount rate employers may also look to rates of return on high-quality, fixed-income investments that are currently available and that are expected to be available during the period to maturity of the pension benefits.

In spite of the FASB's efforts to give guidance in developing the appropriate rate, considerable variance exists between the rates used by different companies. The survey by Buck Consultants found that discount rates averaged 8.73% in 1987 and ranged from 6% to 11.25%. While we do not know if this variance is justified by differences between the plans, we are concerned that it may not be.

1. Analysis of Issues

Although SFAS No. 87 states the discount rate should reflect the rates of return implicit in current prices of annuity contracts that can be used to effect settlement of the obligation, caution must be exercised regarding the use of these rates.

Often when an insurance company offers to settle a portion of a pension fund's obligation (usually that portion applicable to employees who are already retired), the contract it offers will reflect the rate of return on a specific investment available at that specific time (e.g., a specific new issuance of bonds the insurance company has committed to purchase at a stated price). Thus, the contract it offers may not reflect the average rates available on the open market.

Another factor is that since the insurance company has a much larger investment pool than will the employer's pension fund, the insurance company may be willing to purchase unrated corporate bonds or other somewhat lower quality investment vehicles (with their commensurately higher rate of return) than would be prudent for the employer's pension fund.

Since any settlement being offered at any one specific time may not reflect the returns available from investment vehicles available to, and appropriate for, the pension fund, the rate of return inherent in such a contract is probably not the most appropriate source of information for determining the discount rate unless the company is going to settle the obligation in the very near future.

2. Recommendation

The assumed discount rate should be based on the rates of return currently available on high-quality bonds, and other market indicators which are of similar duration and risk, whose cash flows match the timing and amount of expected benefit payments. If settlement of the obligation with third-party insurers is possible, the rate of return inherent in the amount at which the obligation can be settled is relevant in determining the discount rate, but should not be a major factor unless a settlement is imminent.

d. Requirements for Changes in Methods or Assumptions

Section 48 of the Commission's Rules of Procedure specifies certain requirements which must be complied with when a utility wishes to make a change in its method of accounting. SFAS No. 87 consists of many provisions, assumptions, etc. and it may not be clear if Section 48 applies if a utility changes any of these items in its pension expense computation.

1. Analysis of Issue

Section 48 was established to protect customers from any utility making a change between rate cases in the manner in which it accounts for an event when such a change will be detrimental to ratepayers. If Commission approval is not required for changes related to SFAS No. 87 accounting, a utility may change the manner in which it calculates a component of pension expense between rate cases for the sole purpose of lowering pension expense. This manipulation will cause the resulting gain to flow through to shareholders' equity. The company could easily rationalize that it was not required to report this gain and it could go undetected by staff and the Commission. Therefore, notification of any changes appears to be warranted. Also, given the technical nature of pensions and the SFAS No. 87 accounting, it might be easier to resolve any differences of opinion between Staff and the company in a Section 48 forum rather than to await the filing of a formal rate proceeding.

On the other hand, the changes at issue here are changes in assumptions or estimates, not changes in accounting method as covered in Section 48. Requiring utilities to get permission for almost all actions they take related to their pension funds would result in Commission intrusion into matters that are primarily management's responsibility. Such oversight should not be necessary since the companies' outside auditors, as part of their normal audit process, will be checking to ensure the changes are proper. A requirement to obtain Commission approval would be a duplication of effort and could result in a waste of time, money and effort.

Concerns regarding the overrecovery or underrecovery of pension costs will be alleviated for the near term by our proposed temporary requirement to defer any variance between pension expense rate allowances and the actual expense booked; however, a long term solution is also needed. Moreover, some changes could be controversial and should not be implemented, and possibly remain in effect for years, before they are reviewed by staff. Therefore, in order to balance the above conflicting concerns, we will require companies to notify the Director of the Office of Accounting and Finance of any changes in assumptions and options. If there is an item upon which the Director and the company cannot come to an agreement, the matter may be referred to the Commission for resolution. This procedure should also reduce the possibility that changes in the makeup of pension expense will be an issue in rate proceedings.

2. Recommendation

If the company changes the method or manner in which it selects an assumption or determines the value of plan assets or liabilities, it is not considered a change in accounting subject to Section 48. The selection of a different option, where there is a choice, is also not a change in accounting subject to Section 48. However, in both of these instances the utilities should inform the Director of the Office of Accounting and Finance of any such change 60 days in advance of its effective date if its impact on annual pension expenses is greater than 10% of the latest rate allowance for pensions. If there is more than one change being enacted, it is the total effect of all changes, when added together, which should be used to determine it the effect meets the 10% threshold. If the impact is less that the 10%, the change need not to be reported until its effective date.

Any change due to an event completely outside the control of the utility, such as a change in the assumed discount rate due to changes in current market or economic conditions, is not a change in accounting subject to Section 48 but shall be reported on the appropriate schedule in the first Annual Report to the this Commission filed after the effective date of such change.

e. Treatment of Transition Amount

As part of the implementation process, firms were required to compute the impact of SFAS No. 87 at the implementation date. This amount, referred to as the Transition Asset (or Obligation),[11] is required to be amortized on a straight-line basis, over the average remaining service period of active employees expected to receive a benefit under the plan, except that (1) the firm may elect to use a 15-year period if this average remaining period is less than 15 years and (2) if almost all of a plan's participants are inactive, the firm must use the average remaining life expectancy of the inactive participants.

1. Analysis of Issue

Preliminary analysis has revealed that the vast majority of NY State utilities had a transition asset upon implementation: in other words, they were overfunded. The amortization period for

11. The difference, existing at the beginning of the fiscal year in which SFAS No. 87 is first applied, between (a) the projected benefit obligation and (b) the fair value of plan assets plus previously recognized unfunded accrued pension cost or less previously recognized prepaid pension cost. An unrecognized net asset is a Transition Asset and an unrecognized net obligation is a Transition Obligation.

the transition asset specified in SFAS No. 87 is somewhat lengthy but still results in the customer receiving the full benefit of the lower pension cost resulting from the adoption of SFAS No. 87. Also, as discussed in Section 2(E) of the attached Appendix B, amortization of the pension transition asset will help offset amortization of the OPEB transition obligation.

Requiring utilities to comply with SFAS No. 87 would result in every utility amortizing the transition asset/obligation in the same manner. This would improve comparability. The Commission could adopt a shorter amortization period but some of the benefits of adopting the standard for rate purposes, such as comparability with utility companies in other states and with non-regulated firms, would be diminished.

Requiring a shorter amortization period than that specified by SFAS No. 87 would be a violation of SFAS No. 87, but would not be a violation of GAAP. A different statement, SFAS No. 71 - Accounting for the Effects of Certain Types of Regulation, permits regulated utilities to deviate from a standard issued by the FASB, if the utility accounts for an item using the same method the regulatory agency uses to set rates.

2. Recommendation

Utilities should continue to amortize the transition asset (or obligation) over the same period they have adopted to date. This period should be in accordance with SFAS No. 87. For utilities which have not adopted SFAS No. 87 awaiting the Commission policy, the amortization period should comply with the provision of SFAS No. 87 as it applies to the company.

f. Treatment of Prior Service Costs

SFAS No. 87 states that if a company has a history of regularly making amendments to its pension plan, a shorter amortization period for prior service costs may be warranted. This is based on the theory that the regularity of the amendments indicates a shortening of the period during which the company expects economic benefits from the amendment.

1. Analysis of issue

SFAS No. 87 provides little guidance on what constitutes "a history of plan amendments". Thus, the provision is extremely judgmental and provides the utility the opportunity to reduce the amortization period of prior service costs that was assumed in its last rate case, without the requirement of substantiating its reasons. Shortening the amortization period would cause an increase in the company's revenue requirement in its next rate proceeding. Also, if the company is currently subject to an earnings threshold whereby excess earnings are required to be passed back to ratepayers, those ratepayers may end up paying for the entire amount of the increased amortization until the company has its next rate proceeding.

If a utility adopts this provision, it may feel obligated to periodically improve its pension plan in order to continue to justify a shorter amortization period. Such action could, in the long-run, be quite costly as well as making comparison of pension expense between companies less meaningful.

Unlike some of the optional provisions of SFAS No. 87 that we are recommending be required, this provision is not optional. If we ignore, or adopt a revised version of it, we are somewhat negating the benefits of strictly following the provisions of SFAS No. 87.

In actuality, compliance with this provision should not present much of a problem. Since SFAS No. 87 requires that there be a history of plan amendments before amortization of prior service costs is accelerated, the utility's outside auditors, as part of their examination of the company's financial statements, should establish that there exits a valid basis for the conclusion that there is such a history. In addition, the Commission could require our jurisdictional companies to obtain approval from the Director of the Office of Accounting and Finance before implementing the accelerated amortization. This would insure that there is agreement by staff that there is a basis for invoking the provision before the company does so unilaterally.

2. Recommendation

Approval by the Director of the Office of Accounting and Finance should be required before a company may shorten the amortization period for prior service costs based on the contention that "it has a history of plan amendments."

3. DEFERRAL OF VARIANCE BETWEEN EXPENSE AND RATE ALLOWANCE

Calculating pension expense utilizing SFAS No. 87 promotes consistency in the measurement of pension expense and provides specific guidelines for tracking pension costs. However, as previously discussed, there is still room for manipulation due to the various assumptions used in the SFAS No. 87 calculations and it does not appear feasible for the Commission to establish generic assumptions. For all Class A and B utilities that have adopted SFAS No. 87 outside of a rate case, we currently require deferral accounting for the difference between the allowance in current rates for pension expense and expense recorded according to SFAS No. 87. The Commission must decide if it wants to continue, modify, or eliminate the current deferral accounting requirements.

A. Analysis of Issue

As previously discussed, we are proposing to prohibit use of the "corridor approach" for the recognition of gains and losses. In its place, we are proposing to adopt a 10-year amortization plan [see Section 2(C)(a)(2)]. Each year this amortization will cause a change in the amount recognized for pension expense. The effect of this change will be magnified for companies currently using SFAS No. 87 and the corridor approach since the switch-over from the corridor to the 10-year amortization will cause the amount currently deferred in the corridor to immediately commence being amortized. Whether this will cause an increase or decrease in expense depends on whether the company has a net gain or net loss in the corridor at the time of the switch-over. It is our understanding that currently most have net gains.

Unless the 10-year amortization commences within the context of a rate proceeding the annual amortization will flow through to shareholders. Therefore, at least in the near term, there should be a deferral mechanism in place to capture the amount of amortization that has not been considered for rates. This will keep the company whole for losses and will pass back to ratepayers any gain. In the long term, as more years of gains and losses are included in the amortization program and companies have this amortization projected in their revenue requirements, future experience may indicate continuance of this deferral mechanism is not necessary.

SFAS No. 87 has only been effective for a few years and it is a very complex standard. While we feel its objectivity provides an improvement over prior pension procedures, we are unsure of what its ultimate impacts will be. Requiring deferral of all the difference between actual and the rate case projection of pension expense, at least for a trial period, would protect the customer from the potential manipulation that still exists, despite our attempts at curtailing such opportunities. However, if full deferral accounting is implemented, and the utility is guaranteed to be made whole for losses while it can under no circumstances realize a gain, then it may ignore or neglect its pension fund in order to allocate its resources to other potentially profitable areas.

B. Recommendation

The entire difference between the amount allowed in rates for pension expense and the actual amount recorded on the books as pension expense should be deferred in a separate subaccount of the appropriate deferral account. Interperiod tax allocation should be applied to this deferral and the resulting amount should be deferred in a separate subaccount of the appropriate tax deferral account.

This deferral program should be instituted, on a trial basis, commencing with the effective date of this policy statement. When we review this policy statement in three to five years, we will reexamine this issue to determine if the deferral accounting procedures proposed here should be modified. We remain concerned about the lack of incentive this creates for utilities to manage their pension funds effectively and we request suggestions.

The rate treatment of this deferral is integrated with that accorded another deferral -- deferral of the difference between the recorded pension expense and the amount actually deposited in an externally held pension fund. This second item is addressed in Section 4 of this appendix. The rate treatment to be accorded both of these deferrals is addressed in Section 5.

4. PENSION FUNDING - COMMISSION INPUT AND DEFERRAL OF VARIANCE FROM RATE ALLOWANCE

The amount a company deposits in its pension plan fund may not be the same as what it must report as pension expense for accounting purposes nor what would be proper for rate setting purposes. Funding policy generally refers to management's decisions (in line with labor negotiations and contracts) as to how much to transfer to the pension trust fund. Federal regulations and the financial characteristics of the firm are two key factors used to determine the amount to be funded. Other factors, such as matching the pension cost with the service rendered by the employee, will determine how to account for the cost and when it should be collected from the customer, but should not determine funding policy.

A. Federal Regulations

a. ERISA

The key federal regulations for pension plans are provided through the Employee Retirement Income Security Act (ERISA) filed; and (d) a potentially smaller tax burden to the plan participants upon receiving timely plan distributions.

To accomplish these, and other tax advantages, the retirement plan must be qualified under ERISA. In other words, it must meet the numerous and at times intricate statutory requirements of ERISA which includes benefit limitations, participation requirements, vesting rules, anti-discrimination rules, and minimum (discussed above), as well as maximum, funding rules.

2. Maximum Funding Limitation

Prior to OBRA 87, the amount an employer could contribute to its retirement plan fund and still deduct on its federal income tax return was limited to the "full-funding limitations" provided in Section 404 of the IRC. Specifically, deductible contributions were limited to the greater of (1) the amount necessary to fund the remaining unfunded past and current service costs of all participants over the remaining service lives of those participants at a rate equal to either a level amount or a level percent of compensation of those participants, or (2) an amount equal to the normal cost of the plan plus the amount necessary to amortize all past service costs evenly over ten years. Any contribution not currently deductible could be carried over and deducted in a future year. However, the amount deductible in the future years was subject to the deduction limitations for the year in which the deduction was sought.

3. Summary

A pension contribution is "tax effective" if 1) it can be taken as a current tax deduction by the company making the contribution; 2) the income earned on the contribution is accumulated tax free; and 3) the employee is not taxed until the benefit is actually received or not taxed at all. If a company has a sound funding policy, it will fund its pension plan on a tax effective basis. This means the company will fund at least enough to meet the minimum requirements of ERISA but will fund no more than it can deduct on its tax return. In sum, federal regulations provide a minimum and maximum range that a taxpayer/employer should consider when depositing funds in the pension trust. The amount actually selected in this range is left to the management of the company and should be made based on the financial characteristics of the company and other relevant factors.

d. Impact of OBRA 87

1. Minimum Funding Standards

OBRA 87 increased the minimum amount an employer must contribute to its pension fund for plan years beginning in 1988. The amortization period for experience gains and losses was reduced from 15 years to 5 years, and the amortization period for gains and losses due to changes in actuarial assumptions was reduced from 30 years to 10 years. OBRA 87 also imposed more strict minimum funding requirements for underfunded plans (i.e., plans with assets less than 100% of current liabilities). This included a new requirement that all plans must fund certain unpredictable event-contingent benefits (e.g. shutdown benefits). OBRA 87 also eliminated an IRS regulation that permitted asset valuations to be based on a range between 85% and 115% of the average value, as well as requiring that each actuarial assumption be reasonable rather than only in aggregate as was previously allowed. Finally, the use of specific, yet often different, interest rates were required for a variety of plan purposes and the rate of the excise tax was doubled from 5% to 10%.

In the January 19, 1988 issue of Actuarial, Benefits & Compensation - Information Release, Coopers & Lybrand (C&L) noted:

> These changes not only added to the complexity of the computation of pension expense, but taken together with the changes in the full funding limitations described below, generally will result in more volatility in required pension contributions.

2. Employer Deductions

Effective 1988, OBRA 87 limited the amount of deductible contributions to defined pension plans to the lesser of prior law funding or 150% of the current liability of the plan. In its January 19, 1988 Information Release C&L stated "this additional constraint was apparently made to curtail the tax-free accumulation of excess assets, on a plan termination basis, under plans that fund for projected benefits" and that "this change has tended to decelerate pension funding and will lead to more variability in pension contributions (and deductions) for plans that are close to this limitation and thus likely to swing in and out of this limitation from year to year."

A survey performed by Buck Consultants showed that over 53% of corporate-defined benefit pension plans exceeded OBRA 87's full funding limitations for 1988 and were thus not allowed tax deductions for pension plan contributions. Many NY State utilities are also in an overfunded position and were unable to contribute to their pension fund on a tax-effective basis.

The impact of not making tax-effective contributions to its pension fund is even greater for those companies that have been taking the additional deduction for payments made subsequent to the tax year, the benefit of which has been generally flowed through to ratepayers. These companies not only face the temporary loss of their current pension deduction, but also face the immediate recapture by the IRS of additional tax benefits previously recognize.[13]

OBRA 87 also included the following changes to employer deductions for pension costs:

a. Prior law allowed a deduction for contributions necessary to amortize past service or other supplementary credits in equal amounts over a period of no less than 10 years nor more than 30 years (40 years for plans in existence on January 1, 1974). Effective for years beginning after 1987, OBRA 87 states that the amortizable base in determining an employer's maximum deduction for past service liability equals only the unfunded costs attributable to such liability.

b. Under prior law, due to statutory deduction limits, an employer's contribution to a defined benefit plan may not have been deductible even though plan assets plus the contribution did not exceed the plan's termination liability for the year. Under OBRA 87, effective for years beginning after 1987, the maximum deduction limit for contributions is not less than the unfunded current (termination) liability of the plan. This rule applies only if the plan has more than 100 participants

c. OBRA 87 requires that companies subject to the uniform capitalization rules,[14] must include past service pension costs in the basis of property that is produced or held for resale. Prior law allowed all past service costs to

13. As OBRA will likely result in companies making deductible contributions in some years, but not in others, the existence and amount of the additional deduction (in some years it will actually be an addition to taxable income) will be extremely volatile. Thus, it is recommended that all companies defer rather than flow through its impacts effective with this policy statement.
14. Uniform capitalization rules govern the inclusion in inventory or capital accounts of all costs incurred in manufacturing, construction and other activities.

be deducted currently. This provision was made effective for self-constructed assets for costs incurred after 1987, long term contracts for costs incurred after 1987 with respect to contracts entered into after February 28, 1986, and inventory for tax years beginning after 1987.

3. Other Provisions

OBRA 87 also included important changes affecting Pension Benefit Guaranty Corporation premiums, the ability of a company to terminate a plan, controlled group liability for pension costs, the reversion of excess assets on plan termination, quarterly contribution requirements, tighter funding waiver requirements and other changes.

4. Summary

OBRA 87 substantially closed the gap between the minimum and maximum amount a company could deduct on a tax effective basis. It has resulted in many NY State utilities with overfunded plans (as defined by OBRA 87) making no contributions to their pension plans.

e. Relationship with OPEB

We mentioned earlier that OPEB, pensions and the related Federal income tax regulations should be looked at as a total package. One reason for this is the following IRC provisions for funding OPEB, which themselves commingle the three items:

1. 401(h) Account

This is a separate account kept in conjunction with a pension plan to which an employer may make tax-deductible contributions for medical benefits for retirees and their dependents. Various limitations apply to the funding of such accounts, including prohibition of benefit reduction, vesting of benefits before retirement, and the requirement that the contribution for medical benefits cannot exceed 25% of pension plan contributions.[15] The investment income accumulates tax free, and the retiree is not taxed when he receives the benefit.

The Omnibus Budget Reconciliation Act of 1990 provides for restrictive transfers of excess pension assets in defined benefit plans to Section 401(h) accounts of such plans. The transfer must be a "qualified transfer." A qualified transfer is one that occurs in a taxable year beginning after 1990 and before 1996, which does not contravene any other provision of law (i.e., a collective bargaining agreement under relevant law) and which meets certain use, vesting, and minimum cost requirements. The amount transferred in a qualified transfer may not exceed an amount which is reasonably estimated to be the amount the employer maintaining the plan will pay (directly or through reimbursement) out of the 401(h) account during the taxable year for qualified retiree health liabilities. In addition, generally, no more than one transfer per plan per taxable year may be treated as a qualified transfer, however that transfer may be made at anytime during the tax year. An exception is made for certain transfers attributed to the 1990 taxable year but made after the close of

15. Under Section 401(h), pension or annuity plans can be used to fund post-retirement medical benefits, provided annual contributions to the plan for medical benefits do not exceed 25 percent of the total contributions including the amount deposited in the 401(h) account (e.g. if $75 is deposited in the pension retirement account, $25 can be deposited in the 401(h) account). Recent tax legislation overturned a previous IRS ruling that allowed plans to use a theoretical aggregate pension cost rather than the actual dollar contribution to pass this test. This new legislation makes Section 401(h) plans less attractive because many companies have reached the maximum funding level for pensions and they will not be able to fund their 401(h) plan.

such year and before the due date, including extensions, for filing the tax return for such year.

Before any company elects to make use of this transfer option there are three restrictions which must be carefully evaluated. The impact of these restrictions may be so severe as to render use of the transfer option inadvisable for most collectively bargained benefit plans. These restrictions are:

a. Use requirement - Any asset transferred to the 401(h) account may be used only to pay qualified current retiree health liabilities for the taxable year of the transfer (qualified current retiree health liabilities does not include amounts provided for health benefits to key employees). Amounts not used to pay for health benefits must be transferred back to the transferor plan. Such amounts are not includable in the gross income of the employer for such taxable year but are treated as an employer reversion and subject to the 20% penalty.

b. Vesting requirement - The plan must generally provide that the accrued pension benefits of any participant or beneficiary under the plan become nonforfeitable (i.e. vested) as if the plan had terminated immediately before the qualified transfer.

c. Minimum cost requirement - Each group health plan or arrangement under which applicable health benefits are provided provides that the applicable employer cost for each taxable year during the year of the transfer and the following four years will not be less than the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the year of the qualified transfer.

2. Pension Benefit Enhancement

A defined benefit pension plan can be revised to increase benefits with the intent that the employees use the increase in pay for medical insurance after retirement. The insurance could be provided through private policies or through a group policy sponsored (but not paid for) by the employer.

This would allow excess pension assets to be used to fund the additional benefit with no accounting or tax effect. It would also put the retiree, rather than the company, at risk with regard to healthcare inflation. In essence, this substitutes a "defined contribution" plan for a "defined benefits" plan.

There are also certain limitations or drawbacks to this procedure:

a. the retiree is taxed when he receives the benefits,

b. the maximum tax-deductible contribution is limited if the pension plan has reached the full funding limits under the tax law, and

c. participants become vested in accrued benefits, based on vesting schedules for qualified retirement plans. The effect of vesting may be to increase the employer's cost because ERISA mandates vesting in retirement income programs, but not for health or other welfare programs.

The importance of these provisions is emphasized by the fact that the IRC currently contains only one other provision which is intended to provide for funding OPEB, and that is with a VEBA.

3. VEBA

Current tax law (IRC Section 501(c)(9)) permits employers to fund qualified postemployment benefits through a Voluntary Employee Benefit Association (VEBA) regardless of the funded status of the employer's pension plans. Employer contributions to the such funds are tax deductible in the year made and the retiree is not taxed when he receives the benefit. However, use of a VEBA generally has certain disadvantages and limitations. Briefly, these are:

a. investment income is taxed at trust rates,

b. the maximum tax deductible contribution is computed based solely on current costs without allowance for inflation, and

c. excess pension assets can't be transferred to a VEBA without paying an excise tax.

However, the first two of these disadvantages can be avoided with the establishment of a "collectively bargained" VEBA.

A collectively bargained VEBA can be established for a company's current and retired employees who are employed (or were employed immediately before retiring) under a collectively bargained labor agreement. These labor agreements must have been established pursuant to arm's length negotiation over benefits between employee representatives and the company, and only if at least 90% of the employees covered by the VEBA are represented employees. For this type of VEBA, the company's tax-deductible contributions can include an element for inflation and the income earned on the plan's investments is allowed to accumulate tax-free.[16]

4. Funding OPEB With Life Insurance

Although the use of life insurance to fund OPEB is not related to pensions, it is presented here in order to complete the list of possible methods to fund OPEB. It is our understanding that under current New York State law the use of life insurance for this purpose

16. This opinion is based on a "finding of fact" in Decision 91-07-006 issued July 2, 1991 by the Public Utilities Commission of the State of California, a private ruling from the IRS concerning the VEBA established by one of our jurisdictional companies to provide postretirement benefits for its unionized employees, and our own reading of the IRS tax codes. Companies are advised to consult with their own tax experts before acting on this information. The pertinent Sections of the IRC are: 419A(f)(5); 1.419A-2T, Q&A-2; 501(c)(9); 505(a)(1); 505(a)(2); 511; 512(a)(1); 512(a)(3)(A); 512(a)(3)(B); 512(a)(3)(E); and 7701(a)(46).

by an employer or OPEB fund is illegal, however, as noted below, there is a possibility that the law may be changed.

Corporate-Owned Life Insurance

The tax results of funding health benefits with employer owned insurance on the lives of retirees are as follows:

1. The employer cannot deduct premium payments.

2. If the employer has an insurable interest in the employee, increases in the policy's cash surrender value and proceeds payable at death are not subject to regular income tax, although the company may pay alternative minimum tax on these. State insurance laws generally require an insurable interest to be based on an economic loss that would be suffered as result of the employee's death. since the death of an employee included in a retiree health program may eliminate a significant financial obligation for the employer, many observers feel that the insurable interest question presents serious tax concerns, as well as state law issues.

3. The employer's interest deduction on debt to carry these policies may be limited.

4. Payments to retirees to pay medical expenses are tax-free.

Under SFAS No. 106, the policies would not meet the definition of plan assets. Therefore, their value would not reduce the OPEB liability required to be recorded on the Balance Sheet. However, the valueof the ploicies could be recognized on the Balance Sheet as an asset dedicated to the payment of OPEB.

A company considering this funding method should carefully evaluate the cash-flow requirements, since both premium and medical benefits must be paid well in advance of receipt of death proceeds. Insurance companies have been working on developing plans which would be economical funding plans for OPEB and would still meet the legal and IRC definitions of life insurance. Reportedly such plans have been developed, but still the legality and economics of such funding must be carefully examined before entering into such a contract, including an evaluation of the insurer's stability and operating efficiency.

Companies should also be aware that the build-up of cash surrender values in life insurance policies has been targeted by many in Congress as a source of revenue because it is presently untaxed. Many observers believe that this targeting will continue as Congress attempts to cope with the national budget deficit.

VEBA-Owned Life Insurance

Since a significant disadvantage of funding retiree health benefits with corporate-owned life insurance is the non-deductibility of premium payments, companies may wish to explore the possibility of having VEBA-owned insurance on the lives of retirees. Some considerations relating to these arrangements are as follows:

1. The employer can deduct contributions to the VEBA, which the VEBA then uses to pay insurance premiums.

2. If the VEBA does not have an insurable interest in the employee, the trust would likely pay tax on the increases in cash surrender value and on death benefits. Because no employment relationship exists between the VEBA and the employee, the insurable interest issue is even more tenuous than with corporate-owned life insurance. However, a couple of states have revised their insurance laws to allow a trust fund, such as a VEBA, to use life insurance for this purpose. Other states have also been looking at this option and may change their laws. Also, as stated above, some insurance companies have reportedly developed plans which are economical funding plans for OPEB and still meet the legal and IRC definitions of life insurance. The economics of such funding must be carefully examined before entering into such a contract, including an evaluation of the insurer's stability and operating efficiency.

3. Payments to the retirees are tax-free.

Unless the provisions of the VEBA are very carefully worded, the value of the policies would not meet the definition of plan assets under SFAS No. 106. If they did not meet that definition, their value would not reduce the OPEB liability required to be recorded on the Balance Sheet, however, it would be recognized on the Balance Sheet as an asset dedicated to the payment of OPEB.

B. <u>Analysis of Issue</u>

The input the Commission should have on the funding of OPEB is discussed in the attached Appendix B.

As for pensions, funding the retirement plan on a tax effective basis represents good financial management and should occur without additional Commission inducements. However, due to differences in the way the SFAS No. 87 and the Internal Revenue Code (IRC) measure pension liabilities and the value of assets in pension funds, it is possible that some companies will be forced to recognize pension expense on their books while, at the same time, they are at the maximum funding limit for IRC purposes. Therefore, using SFAS No. 87 to set rates could provide companies with pension allowances they have no way of funding on a tax effective basis. The net result of this would a build up of a liability (a long-term account payable to the pension fund) and an enhancement of the company's cash flow. Another scenario with same results would be if a company simply chose not to deposit in its pension fund the full amount it records as pension expense.

To remedy this situation and assure that the ratepayers receive the benefit of this enhanced cash flow we could require:

(1) deferral of the difference between the deposit in the pension fund and the rate allowance granted for pension expense, and (2) accrual of interest on this deferral. This deferral and interest accrual would be made to an internal reserve dedicated to the payment of pension benefits. While this addresses the above problem, it does not discourage the overfunding allowed by the liberal ERISA and tax laws[17] and most companies' desire to maximize tax savings from tax deductions for pension contributions. Overfunding can be disadvantageous to both the company and the ratepayers because once assets are placed in the pension fund, it is practically impossible to legally get them out should cash flow needs arise outside the pension fund.

C. Recommendation

Contributions to pension funds should be made only if they are tax effective. Accordingly, we shall require that contributions to externally held pension funds be made only to accounts or trust arrangements that: (1) will allow such payments to qualify as a current federal income tax deduction, (2) the income earned on the fund balance accumulates tax free, and (3) the employee is not taxed until the benefit is actually received or not taxed at all. The assets held by such funds must be dedicated to the payment of pension benefits (Management fees for the fund may also be paid from these assets. Transfers to a 401(h) account, or similar fund, for payment of OPEB should be

17. Current laws permit funding 150% of the pension liability, an amount which may be considered excessive.

permitted if the company can demonstrate such transfers are advantageous to its ratepayers).

There is no requirement for any company to fund its pension plan to the maximum level allowed by the IRC (approximately 150% of its pension liability), and such level may not even be desirable. Also, most companies, pension funds are currently very near, if not above, the maximum funding levels. With these two factors in mind, coupled with the fact that fairly accurate projections of the level of mandatory fund payments are readily available for use in rate proceedings, we do not expect companies to be forced to make pension fund payments in excess of rate allowances. As for the other side of the funding question, sufficient regulations already exist to ensure that pension plans are adequately funded. Therefore, at this time, we believe the Commission should not stipulate what level of outside funding should be maintained for pensions.

Although there is no need to stipulate the level of outside funding, there is a need to ensure that all revenues granted for pension expenses are dedicated to that purpose or are returned to the ratepayers. Therefore, if a company's total annual contributions to external pension funds differ from its rate allowance for pension expense, the company should defer the difference in a separate internal reserve account.[18] This reserve

---

18. e.g., Class A and B electric utilities should use Account 263, Pensions and Benefits Reserve. The accounting detail as to whether a portion of this amount should be recorded as a current liability with the remainder being credited or debited to this
(Footnote continues on next page)

is to be dedicated to the payment of pension benefits[19] (or other disposition ordered by the Commission should a portion of the reserve no longer be needed for pension purposes). Interperiod tax allocation should be applied to this deferral and the resulting amounts should be deferred in a separate subaccount of the appropriate tax deferral account. The rate treatment to be applied to this deferral is discussed immediately below.

5. RATE TREATMENT OF DEFERRALS PROPOSED IN SECTIONS 3(B) AND 4(C)

Section 3(B) above proposed deferring the difference between the pension expense rate allowance and the amount of pension expense actually booked. Section 4(C) above proposed deferring, in an internal reserve, the difference between the amount of pension expense rate allowance and the amount actually deposited in an external pension fund. For rate making purposes these two deferrals should not be used as a ratebase addition or subtraction, but instead should be used to determine if the company has realized a net cash inflow (positive cash flow) or an outflow (negative cash flow). If there is a positive cash flow, an interest factor should be applied to the deferral representing

(Footnote continued from previous page)

reserve account is not critical to this issue and can be addressed at a later date if necessary. For the purposes of this policy statement (including the accrual of interest addressed in Section 5) it is the total of this amount which is being addressed, regardless of whether it is recorded as a current liability or an internal reserve.

19. Although SFAS No. 87 will not allow this internal fund to be netted against the pension obligation for financial disclosure purposes, it will be recorded on the balance sheet and can be included in the notes to the financial statements.

that cash flow and the result added to the internal reserve. If there is a negative cash flow, no interest should be calculated.

A. Analysis of Issue

The deferral made in accordance with Section 3(B) is a regulatory asset (deferred expense) booked in accordance with SFAS Nos. 71 and 87. It represents a Commission promise to allow recovery of the expense sometime in the future, but until that recovery is provided it does not represent a cash flow item. The liability which this regulatory asset counterbalances also does not represent a cash flow item since the liability remains unpaid on the company's books. Although interperiod tax allocation will be applied to this deferral, the resulting deferred tax is likewise a non-cash-flow item. This is because the tax deduction is tied to the pension fund payments, not to the level of expense booked.

The second deferral item -- the internal reserve created in accordance with Section 4(C) above and representing the difference between the amount of pension expense rate allowance and the amount actually deposited in an external pension fund -- obviously is a cash flow item, and so is its related deferred income tax effect.

A credit balance in this reserve indicates the ratepayers have supplied the company with more funds than the company expended for pension funding. This means the company is in a net positive cash flow position. Since the company is free to use of these extra funds for general corporate purposes, the ratepayers should be recompensed for this advance provision of funds. We propose to do this through requiring accrual of interest on the internal reserve.

If the the reserve has a debit balance, indicating a negative cash flow, <u>no</u> interest should be accrued. The reason for this uneven treatment is that there is no reason a negative cash flow should occur. As explained in Section 4(C) above, the ability to avoid a negative cash flow position should be completely within the control of the company. Even if such a situation should occur, the company is still being kept whole for the fund payment; its only loss would be the time value of that excess payment from the date it is made to the date the company brings itself back to a neutral or positive cash flow position.

B. <u>Recommendation</u>

For rate making purposes, the deferral made in accordance with Section 3(B) above, the related unpaid pension liability, and the deferred income tax effect, should not be used as a ratebase addition or subtraction nor should an interest factor be applied to the net deferrals. Disposition of this item will be considered in future rate proceedings.

For rate making purposes, the deferral made in accordance with Section 4(C) above should not be used as a ratebase addition or subtraction, but should be used to determine if the company has realized a net positive or negative cash flow. If there is a net positive cash flow, an interest factor should be applied to the net deferral[20] and the result added to the internal reserve. If

20. For the purpose of this calculation the deferral should be reduced by its related income tax effect.

there is a negative cash flow, no interest should be calculated.

The interest rate used for this purpose should, when compounded, should equal the company's last allowed pre-tax rate of return[21] (unless otherwise directed by the Commission). The interest so calculated should be maintained in a separate subaccount within the reserve and should compound monthly using the same rate of interest.

The funds represented by this internal reserve may be used by the company for general utility purposes until such time as the funds are actually paid out for pension benefits[22] or transferred to an externally held pension fund. Because of this, and in order to ensure that this interest expense will not inadvertently be included in the revenue requirement determined in future rate proceedings, the contraentry for the interest accrual will be a debit to a below-the-line expense account (Account 431, Other Interest Expenses).

Interperiod tax allocation shall be applied to the above deferrals.[23]

---

21. Use of the pre-tax rate of return is consistent with that which has been ordered on other major deferrals (e.g., the deferred tax savings resulting from the Tax Reform Act of 1986).
22. Current payment of pension benefits for which no external fund has been established shall be debited to this internal reserve. If an external reserve has been established it will be up to the company's discretion, barring specific directions from the Commission to the contrary, as to whether the benefits will be paid from the internal fund, the external fund, or a combination of both.
23. We are presuming the FASB's Statement No. 96, which is currently under review by the FASB, will allow booking of the deferred tax asset. We will not address the effect of SFAS No. 96 here, but will address it in a separate preceeding if necessary.

This deferral program should be instituted, on a trial basis, commencing with the effective date of this policy statement. When we review this policy statement in three to five years, we will reexamine this issue to determine if the deferral accounting procedures proposed here should be modified.

6. POLICY FOR PENSION SETTLEMENTS AND CURTAILMENTS

In conjunction with SFAS No. 87, the FASB issued SFAS No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. For an event defined as a "settlement"[24] SFAS No. 88 requires immediate recognition of previously unrecognized (actuarial) gains and losses[25] (including any remaining unrecognized net asset existing at the date of initial application of SFAS No. 87) but does not require acceleration of prior service cost.

Fc a "curtailment"[26] SFAS No. 88 requires the immediate recognitior of a gain or loss composed of the following two factors:

---

24. A settlement is an action taken by the plan sponsor that has the effect of relieving the company of the responsibility to make certain future benefit payments. The action must be (1) irrevocable, (2) relieve the employer (or the plan) of the primary responsibility for a pension benefit obligation, and (3) it must eliminate significant risks related to the obligation and the assets used to effect the settlement.
25. Gains and losses are changes in the amount of either the projected benefit obligation or plan assets resulting from (1) experience different from that assumed and (2) from changes in assumptions. Gains and losses include amounts that have been realized (e.g. by sale of a security) as well as amounts that are unrealized.
26. A curtailment is an event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services.

(1) a portion of the previously unrecognized prior service cost (including the cost of retroactive plan amendments and any remaining unrecognized net obligation existing at the date of initial application of SFAS No. 87) and

(2) any increase or decrease in the pension benefit obligation caused by the curtailment.

Before the portion of the curtailment gain or loss applicable to the change in the pension benefit obligation is recognized, it is first offset against any unrecognized (actuarial) gain or loss.[27]

SFAS No. 88 also changed the method of computing gains or losses recognized on asset reversions and specifies special transition rules for companies that have undergone previous asset reversions. SFAS No. 88 has not previously been addressed by staff or the Commission.

A. Analysis of Issue

The rationale employed by the FASB in SFAS No. 87 for delaying recognition of gains and losses is that when using long-range assumptions fluctuations in experience can be expected to occur even if the assumptions prove to be accurate in the long run. Thus, over time, gains and losses can be expected to offset each other. If a "settlement" or "curtailment" occurs, this "offsetting process" will not take place since the liability is settled or terminated. Therefore, the gains and losses are no

27. For the purpose of applying this provision, any remaining unrecognized net asset that existed at the date of initial application of SFAS No. 87 is treated as an unrecognized gain and combined with the net gain or loss arising subsequent to transition to SFAS No. 87.

longer temporary and SFAS No. 88 requires their immediate recognition.

The same rationale that supports immediate recognition of "settlement" or "curtailment" gains and losses for accounting purposes also applies to recognizing the gains and losses for rate purposes -- assuming the settlement or curtailment was a prudent action (which is the reason we are recommending approval be required to defer a loss). Also, the advantages of complying with GAAP that were described for SFAS No. 87 apply equally to SFAS No. 88.

If SFAS No. 88 is adopted for rate purposes, any gains recognized due to the settlement, curtailment or similar action related to a pension plan should be deferred for reflection in a future rate case. It can be argued that since all gains are to be deferred and passed back to the customer in a future rate case, the utility has no incentive to make expenditures to determine if one of the actions covered by SFAS No. 88 would be cost beneficial.

B. Recommendation

Utilities should follow SFAS No. 88 to determine gains or losses resulting from the transactions covered by the standard. The Director of the Office of Accounting and Finance must be notified, in writing, 60 days prior to the consumation of all such proposed transactions. This notification shall include the nature of the transaction, the details and specifics of the transaction, quantification of amounts, computation of the gain or loss, the proposed disposition of the gain or loss, and the economic justification for making the transaction.

Any gains recognized due to an actual settlement, curtailment or similar action related to a pension plan shall be deferred for future disposition by the Commission. The disposition of such deferrals are to be settled in a rate proceeding within two years of the action, otherwise the company must file a petition with the Commission seeking approval of its proposed disposition.

If a utility wishes to defer any losses incurred due to a transaction covered by SFAS No. 88, it must petition the Commission for approval in a timely manner and provide proof why the transaction was beneficial to ratepayers.

Reviewing the pension plan and its related funding to determine if a pension settlement would be beneficial is part of prudent pension management and companies should not need additional incentive. However, there is a requirement in the OPEB portion of this policy statement that requires companies to review the feasibility of using pension settlements made under the guidelines of SFAS No. 88 as a possible source for offsetting OPEB liabilities [see attached Appendix B, Section 2(D)(a)].

7. IMPLEMENTATION DATE

As previously discussed, companies began implementing SFAS Nos. 87 and 88 for reporting purposes between 1986 and 1988. In many instances, the manner in which pension expense was calculated is not in compliance with one or more of the requirements described above. Thus, there is an issue as to when the pension provisions of this policy statement should become effective.

SFAS No. 106, which is discussed in detail in Appendix B, does not have to be implemented until after December 15, 1992.[28] Although the Statement does permit earlier adoption, to date none of our jurisdictional companies have made that election and we are proposing to prohibit early adoption for regulatory accounting purposes.

A. Analysis of Issue

Requiring companies to implement the pension accounting proposals contained herein retroactive to the date they adopted SFAS No. 87 and 88 for regulatory accounting accounting purposes could constitute retroactive ratemaking. Therefore, the provisions should be applied in a prospective manner.

Since the accounting and ratemaking proposals contained in this document treat the effects of SFAS Nos. 87, 88 and 106 in an integrated manner, it is reasonable to adopt a uniform effective date for both the pension and OPEB provisions of this policy statement. Although we could adopt an earlier effective date for the pension portion, the impact of delaying adoption to a later date has been substantially negated by a Commission order issued on September 22, 1987. That order required any Class A or B utility electing to adopt SFAS No. 87 either to make the

---

28. SFAS No. 106 is effective for fiscal years commencing after December 15, 1992, however, for nonpublic enterprises with no more than 500 plan participants it is effective for fiscal years beginning after December 15, 1994.

accounting change in the context of a rate proceeding or to defer, for subsequent disposition by the Commission, the difference between the allowance in current rates for pension expense and the expense recorded in accordance with SFAS No. 87.

B. Recommendation

The new policy statement as it applies to SFAS Nos. 87 and 88 shall be effective for fiscal years commencing after December 15, 1992. Previous policy, including deferral requirements, shall continue to be applied through that date.

8. Conclusion

Our analysis indicates there is no absolute right or wrong method to compute pension expense. One could make an argument for several methods that would provide a wide range of results. SFAS Nos. 87 and 88 provide more objective, but still not perfect, standards. Some potentially valid arguments have been raised against their use for rate purposes, but these arguments do not outweigh the advantages of adopting them. However, we believe these accounting standards should only be adopted with certain stipulations that make SFAS Nos. 87 and 88 more suitable for rate purposes.

In view of the amount of discretion still available in the selection of the assumptions required under SFAS Nos. 87 and 88, there continues to exist the possibility of manipulation of pension expense. Therefore, deferral accounting procedures are to be employed, at least for the next several years, for the entire difference between the amount of pension expense allowed in rates and the actual amount recorded on the company's books. A similar deferral will be required for the difference between the amount of pension expense allowled in rates and the amount deposited in a tax-effective pension fund. This second deferral requirement is expected to be a permanent requirement.

SFAS Nos. 87 and 88, as well as pension regulations in general, are so complex and diffuse, it is difficult to fully assess the impact of the new standards at this time. As additional experience is is gained, the Office of Accounting and Finance expects to periodically review this policy statement to determine if it needs to be revised.

PROPOSED ACCOUNTING AND RATE TREATMENT

FOR

OPEB

TABLE OF CONTENTS

END OF TABLE

I. OPEB - BACKGROUND

A. Introduction

Postretirement Benefits Other Than Pensions, known by the acronym "OPEB", comprises all forms of benefits, other than retirement income, provided by an employer to its retirees. In addition to health care insurance and life insurance, OPEB includes such benefits as tuition assistance, legal services, financial advisory services, and housing subsidies provided during retirement. However, retiree health care is the central issue that gives the topic its impact.

When utilities initially offered OPEB, health care costs were relatively low and the ratio of covered retirees to active workers was small. Since cash payments for these costs were generally immaterial, cash-basis expense recognition -- pay-as-you-go -- was deemed acceptable for accounting purposes and was adopted for ratemaking purposes. But a combination of escalating health care costs and changing demographics has altered the postretirement landscape.

In December 1990, the FASB issued SFAS No. 106.[1] This Accounting Standard requires companies to switch from pay-as-you-go to accrual accounting for OPEB's. This means corporate entities will now recognize in expense not only the current pay outs for these benefits, but also recognize as a current expense

---

1. Statement of Financial Accounting Standards No. 106 - Employers' Accounting for Postretirement Benefits Other Than Pensions issued by the Financial Accounting Standards Board (FASB).

amounts being set aside for future payments. The FASB concluded that the rendering of employees' service pursuant to a postretirement benefit plan creates a significant obligation and that the cost of promised postretirement benefits should be recognized in financial statements during the working lives of the covered employees. In deciding how companies should account for OPEB, the FASB paid particular attention to its pension standards because of the similarities between pensions and OPEB, (e.g., both are deferred compensation payable after retirement, and the obligation to provide the benefits arises as employees render the services). As a result, the provisions of SFAS No. 106, are very similar to those of SFAS Nos. 87 and 88.[2]

The purpose of the SFAS No. 106 accounting is not to encourage or discourage companies from offering benefits, rather it is to provide reasonable information for decision making. Accrual accounting does not change the nature or extent of the postretirement benefit promise. However, it will require employers to reflect their existing commitments in their financial statements. Because of this improved disclosure, the company, as well as its investors, creditors, employees, and others, can better evaluate those commitments and the likelihood that the company can fulfill them.

Our analysis of the financial impact of SFAS No. 106 is in the early stages, however it is anticipated that the impact will

2. Statement of Financial Accounting Standards (SFAS) Number 87 - Employers' Accounting for Pensions and Number 88 - Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.

be substantial. Estimates of the potential liability vary widely. The Employee Benefit Research Institute estimated the total unfunded employer liability, including that of the public sector, to be about $280 billion; the private sector's share is estimated to be about $169 billion. The U.S. General Accounting Office estimated the private sector's liability to be $221 billion. The primary difference between the two estimates is medicare benefits. Although these two estimates are somewhat close, many other estimates have been considerably higher.

B. Field Test Study of Financial Impact

In an effort to help the FASB the Financial Executives Research Foundation sponsored a field test study, conducted by Coopers & Lybrand, Certified Public Accountants (C&L), to assess the impact of requiring accrual accounting for retiree health benefits. The field test studied 26 companies[3] and determined that the increased expense recognition resulting from the proposed accrual accounting would cause the subject companies to experience decreases in pretax income ranging from 2% to 20%. For two-thirds of these companies the predicted increase in expense equated to an increase of two to six times the pay-as-you-go cost they currently incur for health coverage for retirees.

Because of the potential impact on earnings of these new accounting rules, in conjunction with the fact that companies

---

3. Initially the study was to include a larger number of companies. However, even though all or the companies seeking to be included in the study were large and well organized, a significant number of them had to be excluded because they were unable to provide even the minimum level of data need for the field test.

need to do considerable research to develop data and systems to measure their OPEB liabilities under accrual accounting, the FASB delayed the effective date for SFAS No. 106 to fiscal years beginning after December 15, 1992. However, nonpublic enterprises, with no more than 500 plan participants in the aggregate, have until fiscal years beginning after December 15, 1994. Early adoption is permitted.

One of the findings of C&L's field test was that many employers had little idea how much their retiree costs might be in the future because record keeping for these costs has been poor and many of the benefit packages do not define when, how much, and what postretirement benefits are covered. C&L also noted that of those companies that were able to quantify their OPEB liability, many were stunned at its magnitude.

The longer a company ignores the severity of the impact of the OPEB it has promised employees, the more difficult and costly it becomes to take action. For example, a company may have a large potential obligation due to one of its OPEB benefits that can be easily altered or at least reduced to a more reasonable level. The longer a company waits to make the alteration, the more the obligation builds and the more difficult it becomes to make a modification, since retirees are relying more and more on the benefit.

Another fact that must be considered in the adoption of SFAS No. 106 is that it is new and covers territory where there exists very little historical data. The initial conclusions of the Actuarial and Accounting professions, the utility industry, and this Commission may change once experience has been gained.

C. Financial Impact on N.Y. Utilities

In order to quantify the impact of SFAS No. 106 on our jurisdictional companies, we sent a questionnaire to the 13 largest on February 27, 1991. Not all companies were able to provide the information requested, however, those which could are presented in the table below. The table presents the data relating only to health care plans. The impact of the new accounting on the cost of OPEB plans other than health care are excluded from the table for two reasons: (1) the bulk of the financial impact of the new accounting relates to the health care plans and (2) since most of the financial impact relates to health care plans, many companies have not made detailed studies of the impact of SFAS No. 106 on their other plans; therefore reliable data is not available.

Table 1

IMPACT OF SFAS No. 106 ON HEALTH CARE COSTS AT MAJOR NEW YORK STATE UTILITIES

(dollar amounts in thousands)

COMPANY	(a) TRANSITION OBLIGATION AT 1/1/93[1]	(b) INCREASE IN ANNUAL COST FOR 1993	(c) COLUMN (b) AS A % OF 1990 OPERATING REVENUES	(d) EFFECT OF 1% CHANGE IN HEALTH CARE TREND RATE	(e)
				TRANSITION OBLIGATION	ANNUAL COST

In order to avoid conflicts with the Securities and Exchange Commission's public disclosure requirements, the confidential data originally presented on this table has been deleted.

D. Income Tax Issues

To the extent the increase in annual expense reported in column (b) above is tax deductable, any amount allowed for OPEB in rates will cause a dollar-for-dollar increase in revenue requirement. To the extent the OPEB expense is not deductable, the revenue requirement could be greater; how much greater will depend upon the ratemaking treatment accorded the tax effect (i.e., either recovered in rates as an expense or deferred and added to rate base). Unfortunately, there is a dearth of tax - effective funding vehicles available where employers can deposit OPEB contributions and, because of the current federal budget deficits, this situation is not likely to improve in the near future. Therefore, the majority of this expense increase probably will not be tax deductable until it is actually paid out in the form of employee benefits.

E. Observations

As can be seen in columns (d) and (e) of Table 1, both the transition obligation and the amount of annual expense are highly sensitive to changes in the Health Care Cost Trend Rate.[4] This cost trend rate is company specific and is also one of the most

4. The Health Care Cost Trend Rate is an assumption about the annual rate(s of change in the cost of health care benefits currently provided by the OPEB plan, due to factors other than changes in the composition of the plan population by age and dependency status, for each year from the measurement date until the end of the period in which benefits are expected to be paid. The Health Care Cost Trend Rates implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of the plan participants. Differing types of services, such as hospital care and dental care, may have different trend rates.

difficult to predict inputs in the SFAS No.106 formula. Most actuaries are projecting the Health Care Cost Trend Rate will be high in the near future but will taper off over time to something closer to the general inflation rate. The responses to our February 27, 1991 questionnaire show that while some companies are using this declining rate, others are using a single percentage representing an average rate. Both of these methods are valid and, at the present time, we are not postulating a preference for either.

The following table shows the Health Care Cost Trend Rates used by some of companies which responded to our February 27, 1991 questionnaire. Since each company's health plans differ from those of the other companies', we would not expect to see the exact same Health Care Cost Trend Rate used by each company. However, the size of the variances in the rates reported is indicative of the problems inherent in making an accurate projection.

Table 2

HEALTH CARE COST TREND RATES
(All rates represent per annum increases)

In order to avoid conflicts with the Securities and Exchange Commission's public disclosure requirements, the confidential data originally presented on this table has been deleted.

When the potential for variation in the Health Care Cost Trend Rate is considered in conjunction with other projections required by the SFAS No. 106 accounting, it is clear that we, as regulators, must protect against the likelihood of providing revenues to cover overaccruals of these costs. At the same time we should strive to maintain intergenerational equity by providing revenues and funding to cover reasonable estimates of the OPEB costs. Our specific proposals are discussed in detail in the remainder of this appendix.

F. Proposals

The potential magnitude of the liability for the promises utilities may have made under existing OPEB plans is an issue that requires immediate attention regardless of the rate treatment accorded OPEB costs. Since OPEB is intertwined with pensions and the federal income tax regulations related to pensions, we have examined the three items as an integrated package. Our proposals for the accounting and ratemaking treatment of OPEB are detailed in the remainder of this Appendix. Our proposals for the accounting and ratemaking treatment of pensions is detailed in Appendix A.

2. RATE TREATMENT OF OPEB COSTS

The decision NY State utilities will make relative to implementing SFAS No. 106 will be highly influenced by how the Commission decides to treat OPEB costs for rate purposes. The decision is not an easy one.

A. Recognition of SFAS No. 106 for Rates is Not Required

In SFAS No. 106, the FASB recognized the practical concerns of utilities but concluded the cost of a promise to provide postretirement benefits to qualifying employees is not changed by the rate treatment accorded OPEB and that SFAS No. 106 should include no special provisions for utilities. However, SFAS No. 106 specifically recognizes that the accounting to be applied to certain regulated industries is subject to a special standard - - FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation. SFAS No. 71 permits regulated utilities to deviate from a standard issued by the FASB if the utility accounts for an item using the same method the regulatory agency uses to set rates.

As a result of this provision and SFAS No. 71, if the current cash-basis policy is continued for OPEB for rate purposes the utility will not have to recognize the higher SFAS No. 106 expense on its income statement. Instead, the increase in expense would be recorded as a deferred expense (a deferred expense is a "regulatory asset" which represents a promise from the regulatory agency to allow future recovery of the amount deferred). Although this removes the effect of SFAS No. 106 from the Income Statement, it does not alter the fact that the company will still have to recognize the substantial OPEB liability on its Balance Sheet. The Balance Sheet "asset" which counter-balances this liability is the deferred expense.

D. Pros and Cons of Adopting SFAS No. 106 for Ratemaking

One advantage of adopting SFAS No. 106 is that it is now part of Generally Accepted Accounting Principals. As we stated in our discussion on SFAS NO. 87, it is desirable to follow the FASB's rules whenever possible.

If one accepts the FASB's logic that OPEB are similar to pensions, then it would seem logical to use SFAS 106 for rate purposes. OPEB, like pensions, are a form of deferred compensation. In exchange for the employee's current services, the employer promises a deferred benefit in the form of OPEB. Since today's customers receive the employees' services, it is only fair that they pay the full cost of the employees, including the cost of benefits which will be paid out at a later date. The alternative is to allow the companies to build a liability beyond the $3.4 billion owed by ratepayers to date.[5] This is of particular concern to industries where competition inroads are likely to reduce the number of customers from which OPEB liabilities might be recovered. There is also a question of fairness to future generations which weighs on the side of current recovery.

Unless accrual accounting for the OPEB expense is adopted for ratemaking purposes there will be no prefunding of the OPEB liability. Without that prefunding, the OPEB liability will continue to grow without earnings on the funded assets accumulating to help offset the liability growth.

There are, however, several aspects of SFAS No. 106 that would support not using it for rate purposes. First, as shown by the Table 1 on page 9, reflecting the full impact of SFAS No. 106 accounting in rates could, by itself, result in substantial rate increases.

Second, even the FASB concedes that the ability to measure the obligation for postretirement health care benefits and the

5. As shown in column (a) of Table 1 on page 9 of this appendix, the companies listed therein currently owe a total OPEB liability of $3.4 billion for the past services rendered by their employees and retirees. The 20-year amortization of this amount is included in the revenue requirement impact shown in column (c) of that table.

recognition of that obligation are subjects of controversy. Historical data about per capita claims cost are limited and actuarial practice in this area is still developing. The task is even further complicated by the uncertainties surrounding the cost of health care in the future. In order to develop a reasonable estimate of future health care costs it is necessary to project such diverse items as the health care inflation rate, health care delivery methods, utilization levels, technological advancements in medical knowledge, and demographic information. It has been argued that these unknowns render the estimated amounts for the health care portion of OPEB unreliable.

Third, because of the tremendous impact of the above subjective estimates, the resulting OPEB expense to be recorded in any one year, or series of years, is highly vulnerable to manipulation.

Fourth, basing rates on SFAS No. 106 would result in utilities receiving large amounts of cash from customers for a liability that will not have to be paid until many years in the future. However, this situation is akin to that of nuclear plant decommissioning, nuclear fuel disposal, pensions, etc. for which rate allowances are being provided currently even though the cash outlay is much later.

Finally, and perhaps most important, the additional costs recognized under SFAS No. 106 accounting is expected to be tax deductible only to a limited extent. To the extent it is not tax deductible, either the company's revenues must be increased to provide for the increased taxes, or the tax effect must be deferred. Since deferred taxes are a rate base addition, such a deferral will also cause an increase in the revenue requirement. Thus, if SFAS No. 106 is adopted for rate purposes, customers will not only pay the higher expense recognized by the new accounting, but they could also end up paying either the associated federal income tax expense or a return on the rate base increase. This is not the situation that existed for pensions, for which extremely generous tax deductions were previously allowed (recent federal tax reduction acts have significantly reduced pension tax deductions).

C. Rate Treatment - Various Possibilities

As we discussed previously, the provisions of SFAS No. 71 give regulatory agencies a wide latitude in how OPEB expenses can be reflected in rates; regulators do not have to adopt SFAS No. 106 for ratemaking purposes. However, we recommend adoption of SFAS No. 106, subject to certain restrictions which address the "softness" of the projected amounts and other regulatory concerns. While these restrictions eliminate certain options otherwise available under SFAS No. 106, they in no way violate the express provisions of, or the intent of, that accounting pronouncement.

While there are numerous methods which could be applied to determine the appropriate OPEB rate allowances, there are seven methods presented below to which we have given consideration. We request respondents to comment on and critique these methods. Suggestions of alternative methods will also be considered.

a. Adopt SFAS No. 106 for Rates

The merits and drawbacks of this option have been discussed above.

b. Allow SFAS No. 106 Expense - Use the Net-of-Tax Balance as a Rate Base Offset

Provide a rate allowance to cover the full annual expense determined in accordance with SFAS No. 106, but without provision for any tax effect. The after-tax amount of the portion of the allowance which cannot be tax-effectively funded[*] would be deferred and treated as ratebase offset, thereby, saving ratepayers the before-tax rate of return times the amount in the internal fund. Although this will cause a significant revenue requirement increase, it helps maintain intergenerational equity and starts funding for payment of a very real and significant cost.

c. Allow SFAS No. 106 Expense - Accrue Interest on the Net-of-Tax Balance

Use the same method as Item b above except the deferred amount would not be used as a rate base offset. Instead, an interest accrual equivalent to the company's last allowed pre-tax rate of return would be imputed on the deferred amount, net of its tax effect. Since this deferral is expected to accumulate rapidly, and to amount to a considerable balance, accrual of interest will accurately reflect the benefit the company is receiving from these ratepayer provided funds; much more so than would a rate base reduction promulgated in sporadically filed rate proceedings.

d. Calculate Expense Using the Benefit/Compensation Approach

Use an allocation method which distributes the OPEB obligation over the employee's service life at a rate which is equal to a constant percentage of the employee's expected annual salary. Stated more technically, this approach attributes the amount of the expected obligation at retirement to each year of service in the attribution period based on the proportion of the employee's compensation in each year to the expected aggregate compensation earned over the employee's career. Service cost in each year is the actuarial present value of the amount of benefit attributed to that year. The accumulated benefit obligation measured at any point in time is the sum of the cumulative current year's and prior years'

---

[*] An OPEB fund is "tax-effective" if 1) contributions made to the fund can be taken as a current tax deduction by the company making the contribution, 2) the income earned on the fund balance accumulates tax free, and 3) the employee is not taxed until the benefit is actually received or not taxed at all.

service cost and interest accrued thereon. (It is also the actuarial present value of benefits attributed to the current and prior years.)

This method results in lower accruals in the earlier years, and higher accruals in later years, than would SFAS No. 106. The main reasons for this disparity are:

1. Under SFAS No. 106 the projected obligation is allocated on a benefit/years of service basis, whereas under benefit/compensation approach it is allocated on a percent of expected salary including anticipated salary increases. This results in a slower accrual of the employees' service cost.

2. Because of the slower accrual of the service cost the annual interest costs are lower.

This method of attribution was discussed in paragraph 182 of the OPEB Exposure Draft. Although it has an intuitive appeal, it also has several flaws. The FASB rejected this method on the basis that it less faithfully represents how the benefits are earned under the plan. Therefore, its use would not conform to the requirements of SFAS No. 106. In addition, this method double counts the effect of inflation. This is because projected inflation is factored into into both the expected salary increases and the discount rate used to quantify the service cost and interest components of the net periodic postretirement benefit cost.

e. Allow Tax-effective Funding Only

Allow rate recovery for only the amount of OPEB expense which can be tax-effectively funded. This would mitigate the rate impact of adopting SFAS No. 106.

On the other hand, tax-effective funding is expected to be available only to a limited extent and it is probable that all companies will find it impossible to fund their entire annual OPEB expense. Some companies may be unable, or find it economically unjustifiable, to establish any tax-effective OPEB funding program (e.g. the administrative fees for a VEBA may make it uneconomic to establish one for a small employer). Therefore, for most companies, a rapidly growing, unprovided for liability, would have to be recognized on their books and our goal of intergenerational equity would not be met. Also this plan would provide no consistency between companies regarding the proportion of OPEB expense being provided for through rates. This only exacerbates the intergenerational equity problem and would be confusing to financial statement users.

f. Phase-In Adoption of SFAS No. 106 - Method 1

Allow rate recovery for the amount of OPEB expense which can be tax-effectively funded in the rate year, plus a percentage of the difference between that amount and the net periodic cost for the year as calculated under SFAS No. 106. Tentatively, that percentage would be set at 50% at the time of the initial adoption of this policy statement. There would be subsequent reviews to determine when that percentage should be raised. The first such review would be approximately three to five years after issuance of the final policy statement and would consider raising the percentage to 75%, or possibly higher if companies can demonstrate they have developed reasonably accurate cost projections and have taken strong and decisive actions towards reducing, or at least restraining the growth of, their OPEB obligations.

Some of the factors supporting use of this phase-in approach are:

1. The SFAS No. 106 method may result in an overaccrual of expense for several reasons, one of which is it does not allow companies to factor in cost containment strategies which they may institute in the future. On the other hand, we do not believe the amount that can be tax-effectively funded under the current tax code is sufficient to provide for a reasonable estimate of the future obligation. Therefore, adoption of a target allowance somewhere between these two amounts is desirable.

2. Providing current recovery for at least a portion of the cost of future OPEB benefits should commence as soon as possible since the current pay-as-you-go method results in charging future ratepayers the cost of services being rendered to current customers.

3. A phase-in will mitigate rate impact.

4. In the future, the IRS may revise the tax codes to allow funding the accrued OPEB liability on a tax-effective basis (similar to what it did for nuclear plant decommissioning costs). In that situation, the internal reserve for OPEB which would have built up under this plan could be deposited in a tax-effective fund without affecting rates.

Since this plan does not provide full recovery of the OPEB expense as calculated under SFAS No. 106, there would be some build-up of unprovided for OPEB liability on the balance sheet, along with an offsetting regulatory asset (deferred debit). However, it is not expected that this liability will have the same impact on the companies' bond ratings as would similar amounts of more conventional liabilities. The rating agencies have stated they will factor into their decisions the timing of these liabilities, the "softness" of the estimates, the projected future revenue levels of the company, etc.

Support of this method is based on the assumption that most of the OPEB liability cannot be tax-effectively funded. If this plan were adopted and tax regulations were subsequently changed to allow significantly increased tax-effective funding for OPEB, or if there were other developments which would have similar effects,* we would recommend modification to achieve more current recovery. In the near term, we would not expect to provide current rate recovery in excess of 65% of any company's net periodic postretirement benefit cost unless there were extenuating circumstances (e.g. the company's plan is a defined contribution plan that does not require projecting future increases in the cost of benefits). For companies with such extenuating circumstances, the actual amounts to be allowed for rate recovery would be decided in the context of rate proceedings on a case-by-case basis. The 65% bench mark would be tentative and there would be subsequent reviews to determine when that percentage should be raised. The first such review would be approximately three to five years after issuance of the final policy statement.

g. <u>Phase-In Adoption of SFAS No. 106 - Method 2</u>

Phase-in, over several of years, rate recovery for the full amount of the annual OPEB expense. The pace of the phase-in would depend upon the revenue requirement impact of the new accounting and would commence with the first rate proceeding following the company's adoption of SFAS No. 106 for regulatory accounting purposes (or, at the Commission's discretion, an earlier proceeding).

Because recognition of the full amount of annual OPEB expense would, by itself, cause rate increases from 0.5% to 1.5% for most of our major utilities, the Commission should reserve for itself the ability to set the OPEB rate allowance at a level that balances the need for cost recovery with its concerns about rate impacts. Accordingly, initial rate allowances should be set at amounts that are between the full annual OPEB cost and a minimum level (discussed below). The relative size of these allowances would depend upon the size of the overall rate increase that accompanies OPEB implementation. In each subsequent year, the previous allowance would be increased, by at least this minimal amount, until the full annual OPEB expense is provided for.

---

* For example, it now appears that the entire OPEB obligation for unionized employees can be tax-effectively funded through use of "collectively bargained" VEBAs. See Section 4(A)(e)(3) of the attached Appendix A for more detail.

For example, if full OPEB expense recognition, when combined with other cost increases, would cause a rate increase that is deemed to be onerous on ratepayers, the Commission may allow a minimum amount for OPEB to mitigate the overall impact. The portion of the annual OPEB expense in excess of the OPEB rate allowance would be deferred for disposition in subsequent rate proceedings. On the other hand, if a rate change is not going to be significant, the Commission may allow the full OPEB expense. Our goal is to phase-in full recovery of the annual expense within approximately five years.

This proposal provides the Commission with maximum flexibility in the amount it allows for OPEB and provides some control over the size of the overall rate increase. At the same time, this guarantee of a minimum level of recovery, and a ratcheting up of that level in subsequent rate cases, is necessary to demonstrate to the financial community that the Commission is sincere about full rate recognition of OPEB expense.

The initial OPEB rate allowance would be set at an amount equal to the lesser of: (1) the total net periodic postretirement expense, or (2) an amount equal to approximately 1% of the company's gross operating revenue. This target amount of 1% could be reduced if the Commission decides the overall revenue requirement increase will be onerous. However, the minimum rate of phase-in would be 0.25% of operating revenues, increasing by at least that amount in each subsequent year until the full net periodic postretirement expense is provided for. On the other hand, the Commission may grant an OPEB allowance in excess of the 1% target if it deems such action will not cause an unacceptable increase in the revenue requirement.

For most companies the projected revenue requirement impact of the new accounting is less than 1.5% of their gross operating revenues. Therefore, under this proposal, rate recovery of the full level of annual OPEB expense should be accomplished within a few years. The exception to this is the New York Telephone Company, for[a] which the projected revenue impact is significantly greater.

Use of this phase-in plan has many of the attributes and advantages discussed or referenced by items (a) and (f) above.

---

[a] NY Tel's estimated level of OPEB cost, as filed with our Office of Accounting and Finance, is significantly greater than the norm. We have not made any study to ascertain the reasons for this, nor have we formed any opinion as to the reasonableness of the benefit plans. However, we believe this matter warrants close review by the company. It will be up to the company to substantiate in future rate proceedings that its overall compensation package (including OPEB, pensions, and wages) is reasonable and necessary.

However, the possibility of over-accrual referenced in Item (f)(1) above needs further comment.

As will be discussed later, revisions of estimates and enactment of changes in OPEB plans (e.g. revisions made for cost control purposes) will result in "actuarial gains or losses." If we do not limit the options available under SFAS No. 106 for recognizing such gains and losses, it might result in over-accruals or significant swings in the net periodic postretirement benefit cost. However, as discussed in Section 2(E)(b) below, we are proposing all gains and losses be amortized, on a vintage year basis, over 10 years. We believe this rolling 10-year amortization will sufficiently mitigate the affects of possible future plan revisions and the "softness" of current cost projections so that rate allowances for 100% of the net periodic postretirement benefit cost are justifiable.

D. Recommendation

Our preference is the accounting and ratemaking described in Item g coupled with the interest accrual proposal of Item c. Nonetheless, we recommend that the public, including the utilities, be allowed 60 days to comment on the proposals. Regardless of the option eventually selected, we believe rate recovery should be subject to the following conditions. We ask parties to comment on the suitability of these provisions as well.

a. The company must demonstrate that it has explored the feasibility of using the following sources to mitigate the impact of the additional OPEB costs:

1. excess pension costs currently in rates due to (a) the adoption of SFAS No. 87 or (b) an inability to tax-effectively fund the full amount of the pension allowance.

2. gains calculated under the guidelines provided in SFAS No. 88.

3. the balance of the unamortized transition asset arising from implementing SFAS No. 87, if one exits.

4. the use of excess pension funds to fund a Section 401h account for the provision of health care to retirees. As described in Section 4(A)(e)(1) of the attached Appendix A, there are several restrictions to such a transfer of

assets that must be carefully evaluated before electing this option.

b. If a company fails to take advantage of tax-effective funding of OPEB rate allowances to the maximum extent possible, it must be prepared to defend its actions.

c. Contributions to externally held OPEB funds may be made only to accounts or trust arrangements that: (1) will allow such payments to qualify as a current federal income tax deduction, (2) the income earned on the fund balance accumulates tax free, and (3) the employee is not taxed until the benefit is actually received or not taxed at all. The assets held by such funds must be dedicated to the payment of OPEB benefits (reasonable management fees for the fund may also be paid from these assets).

d. If a company's total annual contributions to external funds dedicated to the payment of OPEB benefits differ from the sum of its OPEB rate allowance plus any pension related funds or other funds used for OPEB purposes,[9] the company must defer the difference in a ~~separate~~ internal reserve (liability) account. This OPEB dedicated internal reserve[10] would not be used as a ratebase addition or subtraction, but would be used to determine if the company has realized a net positive or negative cash flow. If there is a net positive cash flow, an interest factor should be applied to the net deferral[11] and the result added to the internal reserve. If there is a negative cash flow, no interest should be calculated. This deferral, its cash-flow aspects, and its rate treatment are discussed in more detail in Sections 5 and 6 below.

The interest rate used for this purpose should, when compounded, equal the company's last allowed pre-tax rate of return[12] (unless otherwise directed by the Commission). The interest so calculated should be maintained in a separate subaccount within the reserve and should compound monthly using the same rate of interest.

---

9. For example, use of excess pension rate allowances for for OPEB purposes or the transfer of excess pension funds to a 401(h) plan as described in Section 2(D)(a)(4) above.
10. Although the internal fund will not be netted against the obligation for financial disclosure purposes, it will be recorded on the balance sheet and can be included in the notes to the financial statements.
11. For the purpose of this calculation the deferral should be reduced by its related income tax effect.
12. Use of the pre-tax rate of return is consistent with that which has been ordered on other major deferrals (e.g., the deferred tax savings resulting from the Tax Reform Act of 1986).

The funds represented by this internal reserve may be used by the company for general utility purposes until such time as the funds are actually paid out for OPEB benefits[13] or transferred to an externally held OPEB fund. Because of this, and in order to ensure that this interest expense will not inadvertently be included in the revenue requirement determined in future rate proceedings, the contraentry for the interest accrual would be a debit to a below-the-line expense account (Account 431, Other Interest Expenses).

e. The difference between the amount a company records on its books for OPEB expense using SFAS No. 106, and the rate allowance it is provided for that expense, shall be deferred in a separate subaccount. This deferral is the "regulatory asset", recorded in accordance with SFAS Nos. 71 and 106, which offsets the liability booked under SFAS No. 106 for the portion of the OPEB expense that has not yet been provided for in rates. To put it another way, it is a long term receivable which offsets a long term payable. As such, this deferral does not represent a cash flow item and, accordingly, shall not have an interest accrual applied to it nor will it be added to rate base for ratemaking purposes (the same as the liability it offsets will not be used to adjust rate base or the working capital allowance). This issue is discussed in more detail in Sections 4 and 6 below.

The method of recovery for this deferral (or pass-back to ratepayers should the net deferral be negative) will be considered in future rate proceedings. We expect to commence amortizing or providing other recovery (e.g. offsetting with existing credits of refunds) for this deferral commencing in the year immediately following that in which rate recovery of the full annual OPEB expense is allowed. Our goal is that the net deferral, made to this subaccount prior to the granting of rate allowances for the full annual OPEB expense, be recovered within 10 years of the company's adoption of SFAS No. 106 for regulatory accounting purposes.

f. Interperiod tax allocation shall be applied to (1) any non-tax-effective funding allowed and (2) any deferrals made in compliance with items d. and e. above.[14]

---

13. Current payment to or for retirees of OPEB benefits for which no external fund has been established shall be debited to this internal reserve. If an external reserve has been established it will be up to the company's discretion, barring specific directions from the Commission to the contrary, as to whether the benefits will be paid from the internal fund, the external fund, or a combination of both.
14. We are presuming the FASB's Statement No. 96, which is currently under review by the FASB, will allow booking of the deferred tax asset. We will not address the effect of SFAS No. 96 here, but will address it in a separate preceeding if necessary.

g. If OPEB is funded through a 401(h) plan (as part of the pension provisions) Section 404(a)(6) of the Internal Revenue Code permits the taxpayer to deduct, on its current tax return, payments to a qualified OPEB fund made subsequent to the end of the tax year but before the earlier of (a) the due date of the tax return (including filing extensions) or (b) the date on which it is paid. Any company using this "reach-out" provision shall apply interperiod tax allocation to the "reach-out" amount.

E. SUBSIDIARY ISSUES

a. Use of pension and other credits for OPEB costs

Regardless of the rate treatment accorded OPEB costs, there is little dispute that a large, unrecognized OPEB liability exists. One possible source of funding for this liability is pension related credits. We discussed in Appendix A that (a) some companies pension costs calculated using SFAS No. 87 would be lower than amounts currently in rates for pensions, (b) in many cases implementing SFAS No. 87 resulted in a transition asset which must be amortized over a period based on the average service life of the employees (per SFAS No. 87) or at the discretion of the Commission (per FASB No. 71), and (c) a company may recognize a gain from such actions as settling a portion of its pension plan under the guidelines provided in SFAS No. 88. Since pensions and OPEB are both deferred compensation, are payable only after retirement, and the new accounting rules for both are very similar, it seems reasonable that excess pension assets should be used as a source to prefund OPEB, thereby mitigating the impact of recognizing the liability for OPEB plans. There may also exist other unused credits, (e.g., excess earnings, mirror CWIP, property tax refunds, and deferrals relating to the Tax Reform Act of 1986) which can be used to prefund OPEB costs without dramatically affecting rates.

1. Analysis of Issue

It is basic financial planning to establish a funding plan to meet the expected large payments for OPEB. When formulating this plan all potential sources should be considered. If a company has a refund or credit available to it, especially when the credit results from something as similar as OPEB and pensions, it is only logical that the credit or refund be used as a source of revenue to cover the expected expenditures.

The offsetting of the pension transition asset against the OPEB transition obligation will occur to a substantial extent without the need for Commission intervention. The provisions of SFAS No. 87 and 106 both require the amortization of the transition asset or obligation and, except for the optional minimum amortization period of 15 year for pensions versus 20 years for OPEB, the accounting for the transition amounts by both of these standards are identical.[15] Thus the amortization of the pension transition asset will partially offset the amortization of the OPEB transition obligation. Other than the relative size of the amounts, the only difference in their amortization will be that which results from the different implementation dates and the optional minimum amortization periods if such are elected.

15. We are proposing the immediate recognition of the OPEB Transition obligation be prohibited and SFAS No. 87 did not allow immediate recognition for the pension transition asset/obligation.

2. Recommendation

Amortization of the pension transition asset will automatically offset a portion of the OPEB transition obligation without further intervention by this Commission. Any other credits that exist related to pensions should be used to partially offset the OPEB liability. Other unused credits should also be strongly considered for this use.

b. Optional provisions of SFAS No. 106

SFAS No. 106 allows companies some latitude in the mechanics of applying the new rules, the objective being to control volatility. Some of these provisions are the same as those contained in SFAS No. 87. These provisions are: (a) delayed recognition of gains and loses, (b) use of the "corridor approach" to determine if gains or losses should be recognized, and (c) use of the market related value approach, based on a three or five year average, to value plan assets. The recommendations made for these items in connection with SFAS No. 87 should be adopted for SFAS No. 106 also.

Two additional provisions of SFAS No. 106 which need to be addressed are: (a) election of immediate recognition of the transition obligation and (b) election of the minimum amortization period of 20 years for the transition obligation.

Immediate Recognition of Transition Obligation

An employer's transition obligation or asset may be recognized either on a delayed basis or immediately, subject to certain constraints. Immediate recognition is permitted only at the date of initial application of SFAS No. 106.

Amortization of Transition Obligation

If delayed recognition of the transition obligation or asset is elected, the amount is required to be amortized on a straight-line basis over the average remaining service period of active plan participants, except that (a) if the average remaining service period is less than 20 years, the employer may elect to use a 20-year period, and (b) if all or almost all of the plan participants are inactive, the employer is required to use the average remaining life expectancy period of those participants. However, phasing-in recognition of a transition obligation may not be done at a rate that would result in slower recognition of the obligation than would result from continuation of the pay-as-you-go (cash basis) method.

1. Analysis of Issue

Immediate recognition of the transition obligation may be the simplest method of recognition and it could be argued that it would provide the more significant improvement in financial reporting. However, it is unlikely that regulated utilities will elect this option without seeking either current recovery or a separate deferral with accelerated amortization in rates.

Another consideration is that the actuarial techniques for measuring postretirement health care benefit obligations are still developing and should become more sophisticated and reliable with time and experience. Therefore, any near-term measures of the accumulated postretirement obligation, from which the transition obligation is derived, will reflect the deficiencies of insufficient data collection in the past and the evolving actuarial practice in this area. Adoption of immediate recognition would capture these inaccuracies on the income statement and balance sheet at the time of transition while, incongruously, any subsequent adjustments to measures of the accumulated obligation will be recognized in income through the gain or loss component of the net periodic postretirement benefit cost which provides for delayed recognition of gains and losses.

The above argues for prohibiting both immediate recognition of the transition obligation and early adoption of SFAS No. 106. Likewise it argues for a long amortization period for the transition obligation so that its amortization may be partially offset by he amortization of gains resulting from refinements in the c s originally used to project the transition obligation or changes made to the OPEB plans for cost control purposes.

2. Recommendation

a. Delayed Recognition of Gains and Losses
Companies should use the "delayed recognition" provisions of SFAS No. 106 to recognize gains or losses resulting from changes in the accumulated postretirement benefit obligation or in the value of plan assets resulting from experience being different from that originally assumed or from changes in assumptions. Immediate recognition shall be prohibited.

b. The "Corridor Approach"
The "corridor approach" should not be used to recognize gains and losses for accounting and rate purposes. Instead, any gains or losses, which would have gone into the corridor, should be placed into a deferral account and amortized, on a vintage year basis, over 10 years. For ratemaking purposes the amount in this account will be included in rate base.

Some NYS utilities are a part of a larger organization (as an affiliate, subsidiary, operating division etc.)

and the remainder of the organization is not subject to the jurisdiction of this Commission. In many of these instances there is only one health plan which covers the entire organization. It may be awkward for the utility portion regulated by the Commission to use one of the "optional provisions" of SFAS No. 106 while the remainder of the organization uses a different option to account for the same plan(s). We request respondents to specifically address this problem in their comments.

c. Valuation of Plan Assets
Plan assets should be valued using a calculated value that recognizes changes in fair value in a systematic and rational manner over three years.

We request that respondents specifically address whether a period of 3, 4, or 5 years should be used, and that they fully explain the reasons for their preference. We also ask that they state what method they are currently using to value their pension fund assets.

d. Immediate Recognition of Transition Obligation
Election of immediate recognition of the transition obligation or asset should be prohibited.

e. Amortization of Transition Obligation
A minimum amortization period of 20 years should be required for amortization of the transition obligation or asset. However, as required by SFAS No. 106, amortization of the transition obligation shall be accelerated if the cumulative benefit payments made subsequent to the transition date to all plan participants exceed the cumulative postretirement benefit cost accrued subsequent to the transition date.

c. Choice of Assumptions

Three of the key assumptions used in the calculation of OPEB expense using SFAS No. 106 are the discount rate, the rate of return on plan assets and the health care cost inflation rate. Generally speaking, changes in any of these rates results in a change in the amount of OPEB expenses.

1. <u>Analysis of Issue</u>

In Section 2(c)(b) of the attached Appendix A, we discussed whether the Commission should require companies to use generic assumptions for SFAS No. 87 accounting requirements, or if each utility should be allowed to select its own assumptions. The conclusions reached in that Section are equally applicable to the accounting requirements of SFAS No. 106.

2. <u>Recommendation</u>

We continue to be concerned with the amount of discretion utilities have in the selection of the assumptions used in the SFAS No. 106 calculation as it provides the opportunity for manipulation. However, this concern does not fully offset advantages of adopting the standard. In view of our recommended deferral accounting and restrictions on the optional provisions of SFAS No. 106 we believe that, with the exception of the restriction discussed below concerning calculation of the "assumed discount rate", each utility should continue to select its own assumptions. We will reevaluate this issue when we review this policy statement in approximately three to five years.

d. <u>Assumed Discount Rate</u>

The discount rate is the interest rate used to adjust for the time value of money when determining the present value of the expected Postretirement Benefit Obligation.

1. <u>Analysis of Issue</u>

This subject, as it applies to SFAS No. 87, was discussed in detail in Section 2(C)(c) of the attached Appendix A. The method for determining the discount rate under SFAS No. 106

requirements and SFAS No. 87 requirements are the same except SFAS No. 106 places much less emphasis on the rate of return inherent in settlements. This down-playing of the importance of settlements in determining the SFAS No. 106 discount rate is because settlements of OPEB obligations are generally unavailable, whereas such settlements are available for pensions obligations. In view of this, the comments made on this subject in Appendix A are equally valid here.

2. Recommendation

The assumed discount rate should be required to be based on the rates of return currently available on high-quality bonds, and other market indicators which are of similar duration and risk, whose cash flows match the timing and amount of expected benefit payments. If settlement of the obligation with third-party insurers is possible, the rate of return inherent in the amount at which the obligation can be settled is relevant in determining the discount rate, but should not be a major factor unless a settlement is imminent.

e. Treatment of Prior Service Costs

SFAS No. 106 states that a shorter amortization period for prior service costs may be warranted if a company has a history of regular plan amendments. This is based on the theory that the regularity of the amendments indicates a shortening of the period during which the company expects economic benefits from the amendment.

1. Analysis of issue

SFAS No. 87 contains this same provision and the discussion on this subject in Section 2(C)(f) of Appendix A for SFAS No. 87 pertains here also.

2. Recommendation

Approval by the Director of the Office of Accounting and Finance should be required before a company may shorten the amortization period for prior service costs based on the contention that "it has a history of plan amendments."

f. Requirements for Changes in Methods or Assumptions

Section 48 of the Commission's Rules of Procedure specifies certain requirements which must be complied with when a utility wishes to change its method of accounting. SFAS No. 106 consists of many provisions, assumptions, etc. and it may not be clear if Section 48 applies if a utility changes any of these items in its OPEB expense computation.

1. Analysis of Issue

This issue, as it pertains to SFAS No. 87, was discussed at length in Section 2(C)(d) of Appendix A. The same discussion and conclusions pertain to SFAS No. 106 also.

2. Recommendation

If the company changes the method or manner in which it selects an assumption or determines the value of plan assets or liabilities, it is not considered a change in accounting subject to Section 48. The selection of a different option, where there is a choice, is also not a change in accounting subject to Section 48. However, in both of these instances the utility should inform the Director of the Office of Accounting and Finance of any such change 60 days in advance of its effective date if its impact on annual OPEB expenses is greater than 10% of the latest rate allowance for OPEB. If there is more than one change being enacted, it is the total effect of all changes, when added together, which should be used to determine if the effect meets the 10% threshold. If the impact is less that the 10%, the change need not to be reported until its effective date.

Any change due to an event completely outside the control of the utility, such as a change in the assumed discount rate due to changes in current market or economic conditions, is not a change in accounting subject to Section 48 but shall be reported on the appropriate schedule in the first Annual Report to this Commission filed after the effective date of such change.

3. POLICY FOR OPEB SETTLEMENTS AND CURTAILMENTS

SFAS No. 106 defines a settlement as a transaction that: (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a postretirement obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement.[16]

A curtailment is an event that significantly reduces the expected years of future service of active plan participants or eliminates the accrual of defined benefits for some or all of the future services of a significant number of active plan

---

16. For example, if an insurance contract is purchased from an insurance company controlled by the employer, the purchase of the contract does not constitute a settlement.

participants. Under the provisions of SFAS No. 106 the occurrence of either of these events will result in the immediate recognition of a gain or loss.

A. Analysis of Issue

Although the calculation of the gain resulting from a settlement under SFAS No. 106 is slightly different than that specified by SFAS No. 88,[17] the discussion regarding settlements and curtailments made in Section 6 of Appendix A for SFAS No. 87 and 88 pertains here also.

B. Recommendation

Utilities should follow SFAS No. 106 to determine gains or losses resulting from settlements and curtailments. The Director of the Office of Accounting and Finance must be notified, in writing, 60 days prior to the consumation of all such proposed transactions. This notification shall include the nature of the transaction, the details and specifics of the transaction, quantification of amounts, computation of the gain or loss, the proposed disposition of the gain or loss, and the economic justification for making the transaction.

Any gains recognized due to an actual settlement, curtailment or similar action related to an OPEB plan shall be deferred for future disposition by the Commission. The

---

17. Under Statement 88, a gain resulting from settlement of a pension obligation is measured without regard to any remaining unrecognized transition obligation. However, in recognition that the Transition Obligation for OPEB is likely to be significant, whereas it generally wasn't for pensions, SFAS No. 106 requires that any gain arising from a settlement be reduced by any remaining unrecognized transition obligation; only the excess is recognized as a settlement gain.

disposition of such deferrals are to be settled in a rate proceeding within two years of the action, otherwise the company must file a petition with the Commission seeking approval of its proposed disposition.

If a utility wishes to defer any losses incurred due to a settlement or curtailment, it must petition the Commission for approval in a timely manner and provide proof why the transaction was beneficial to ratepayers.

4. DEFERRAL OF VARIANCE BETWEEN EXPENSE AND RATE ALLOWANCE

SFAS No. 106 is a very complex standard and its passage has focused attention on the potential costs of retirement benefit plans as they are structured today. While we believe SFAS No. 106 is an improvement over the current pay-as-you-go procedure, we are unsure of what its ultimate impact will be. We are are proposing a 10-year amortization of gains and losses partially because the potential inaccuracies of the assumptions and estimates required by SFAS No. 106 renders the OPEB expense estimate unreliable. These same assumptions and estimates also provide significant opportunity for manipulation of the amount of expense to be recognized. At the same time it does not appear feasible for the Commission to require generic assumptions be used.

Another concern, at least for the near term, is the underrecovery of expense caused by our proposed phase-in of SFAS No. 106 for rate making purposes (see Section 2(D)). Since companies should eventually be made whole for this short-fall, a deferral mechanism needs be in place during the phase-in period.

A. Analysis of Issue

In view of the above, some procedure needs to be in place to safeguard ratepayers from overcharges and the companies from serious underrecorery. Requiring deferral of the differences between actual OPEB expense and the rate case allowance would accomplish these ends. On the other hand, if the utility is guaranteed to be made whole, and can under no circumstances realize a gain because full deferral accounting is implemented, it could lead to companies placing less emphases on developing methods of cost control or making plan changes in an effort to minimize their OPEB expenses.

B. Recommendation

The entire difference between the amount allowed in rates for OPEB expense, and the actual amount recorded on the books as OPEB expense, should be deferred in a separate subaccount of the appropriate deferral account. Interperiod tax allocation should be applied to this deferral and the resulting amount should be deferred in a separate subaccount of the appropriate tax deferral account.

This deferral program should be instituted, on a trial basis, commencing with the effective date of this policy statement. When we review this policy statement in three to five years, we will reexamine this issue to determine if the deferral accounting procedures proposed here should be modified. We remain concerned about the lack of incentive this creates for utilities to manage their OPEB funds effectively and we request suggestions.

The rate treatment of this deferral is integrated with that of another -- the deferral of the difference between the OPEB rate allowance and the amount actually deposited in an externally held OPEB fund(s). This second item is addressed in Section 5 below. The rate treatment to be accorded both of these deferrals is addressed in Section 6.

5. DEFERRAL OF VARIANCE BETWEEN RATE ALLOWANCE AND FUNDING

The amount a company deposits in an external OPEB fund may not be the same as what it must report as OPEB expense for accounting purposes nor what would be proper for rate setting purposes. Funding policy generally refers to management's decisions (in line with labor negotiations and contracts) as to how much to transfer to the OPEB trust fund. Federal regulations and the financial characteristics of the firm are two key factors used to determine the amount to be funded. Other factors, such as matching the OPEB cost with the service rendered by the employee, will determine how the cost should be accounted for and when it should be collected from ratepayers; but they should not determine funding policy.

A. Analysis of Issue

Funding OPEB on a tax effective basis represents good financial management and should occur without additional Commission inducements. However, the Internal Revenue Code (IRC) does not contain provisions which will allow the tax effective funding of the entire annual OPEB expense determined under SFAS No. 106. Therefore, using SFAS No. 106 to set rates could provide companies with OPEB allowances they have no way of funding on a tax effective basis. The net result of this would a build up of a liability (a long-term account payable to the OPEB fund) and an enhancement of the company's cash flow. Another scenario with same results would be if a company simply chose not to deposit in its OPEB fund the full amount it records as OPEB expense.

On the other hand, since we are proposing to phase-in SFAS No. 106 for rate purposes, we expect that for several years the rate allowance will be less than the booked expense. However, this should not create a cash flow problem since we do not expect companies to be forced to make OPEB fund payments in excess of rate allowances. There is no requirement for any company to fund its OPEB plan to the maximum level allowed by the IRC. Also, in view of the costs involved in establishing and managing a trust fund, it may not be desirable to establish such a fund for a small amount of assets.

To remedy this situation and assure that the ratepayers receive the benefit of this enhanced cash flow we could require: (1) deferral of the difference between the deposit in the OPEB fund and the rate allowance granted for OPEB expense, and (2) accrual of interest on this deferral. This deferral and interest accrual would be made to an internal reserve dedicated to the payment of OPEB benefits.

B. Recommendation

Contributions to OPEB funds should be made only if they are tax effective. Accordingly, we shall require that contributions to externally held OPEB funds be made only to accounts or trust arrangements that: (1) will allow such payments to qualify as a current federal income tax deduction, (2) the income earned on the fund balance accumulates tax free, and (3) the employee is not taxed until the benefit is actually received or not taxed at all. The assets held by such funds must be dedicated to the payment of OPEB benefits (Management fees for the fund may also be paid from these assets).

Although there is no need for the Commission to stipulate what level of outside funding should be maintained for OPEB, there is a need to ensure that all revenues granted for OPEB expenses are dedicated to that purpose or are returned to the ratepayers. Therefore, if a company's total annual contributions to external OPEB funds differ from its rate allowance for OPEB expense, plus any pension related or other funds used for OPEB purposes,[18] the company should defer the difference in a separate internal reserve account.[19] This reserve is to be dedicated to the payment of OPEB benefits[20] (or other disposition ordered by the Commission should a portion of the reserve no longer be needed for OPEB purposes).

---

18. For example, use of excess pension rate allowances for for OPEB purposes or the transfer of excess pension funds to a 401(h) plan as described in Section 2(D)(a)(4) above.
19. e.g., Class A and B electric utilities should use Account 263, Pensions and Benefits Reserve. The accounting detail as to whether a portion of this amount should be recorded as a current liability with the remainder being credited or debited to this reserve account is not critical to this issue and can be addressed at a later date if necessary. For the purposes of this policy statement (including the accrual of interest addressed in Section 6) it is the total of this amount which is being addressed, regardless of whether it is recorded as a current liability or an internal reserve.
20. Although SFAS No. 106 will not allow this internal fund to be netted against the OPEB obligation for financial disclosure purposes, it will be recorded on the balance sheet and can be included in the notes to the financial statements.

Interperiod tax allocation should be applied to this deferral and the resulting amounts should be deferred in a separate subaccount of the appropriate tax deferral account. The rate treatment to be applied to this deferral is discussed in Section 6 below.

6. RATE TREATMENT OF DEFERRALS PROPOSED IN SECTIONS 4(B) AND 5(B)

Section 4(B) above proposed deferring the difference between the OPEB expense rate allowance and the amount of OPEB expense actually booked. Section 5(B) above proposed deferring, in an internal reserve, the difference between the amount of OPEB expense rate allowance and the amount actually deposited in an external OPEB fund. For rate making purposes these two deferrals should not be used as a ratebase addition or subtraction, but instead should be used to determine if the company has realized a net cash inflow (positive cash flow) or an outflow (negative cash flow). If there is a positive cash flow, an interest factor should be applied to the deferral representing that cash flow and the result added to the internal reserve. If there is a negative cash flow, no interest should be calculated.

A. Analysis of Issue

The deferral made in accordance with Section 4(B) is a regulatory asset (a deferred expense) booked in accordance with SFAS Nos. 71 and 106. It represents a Commission promise to allow recovery of the expense sometime in the future, but until that recovery is provided it does not represent a cash-flow item. The liability which this regulatory asset counterbalances also does not represent a cash-flow item since the liability remains unpaid on the company's books. Although interperiod tax allocation will be applied to this deferral, the resulting deferred tax is likewise a non-cash-flow item. This is because the tax deduction is tied to the OPEB fund payments, and/or the cost of benefits actually paid to (or for) current retirees in that year, not to the level of expense booked.

The second deferral item -- the internal reserve created in accordance with Section 5(B) above -- obviously is a cash-flow item, and so is its related deferred income tax effect. A credit balance in this reserve indicates the ratepayers have supplied the company with more funds than the company expended for OPEB funding. This means the company is in a net positive cash flow position. Since the company is free to use of these extra funds for general corporate purposes, the ratepayers should be recompensed for this advance provision of funds. We propose to do this through requiring accrual of interest on the internal reserve.

If the the reserve has a debit balance, indicating a negative cash flow, no interest should be accrued. The reason for this uneven treatment is that there is no reason a negative cash flow should occur. As explained in Section 5(A) above, the ability to avoid a negative cash flow position should be completely within the control of the company. Even if such a situation should occur, the company is still being kept whole for the fund payment; its only loss would be the time value of that excess payment from the date it is made to the date the company brings itself back to a neutral or positive cash flow position.

B. Recommendation

The deferral made in accordance with Section 4(B) . the "regulatory asset", recorded in accordance with SFAS Nc and 106, which offsets the liability that SFAS No. 106 requ -- be booked. To put it another way, it is a long term receivable which offsets a long term payable. It is a not a cash-flow item. There fore, this deferral, and its related tax effect, shall not have an interest accrual applied to it, nor will it be added to rate base for ratemaking purposes (the same as the liability it offsets will not be used to adjust rate base or the working capital allowance).

The method of recovery for this deferral (or pass-back to ratepayers should the net deferral be negative) will be considered in future rate proceedings. We expect to commence amortizing or providing other recovery (e.g. offsetting with existing credits of refunds) for this deferral commencing in the year immediately following that in which rate recovery of the full annual OPEB expence is allowed. Our goal is for the net deferral, made to this subaccount prior to the granting of rate allowances for the full annual OPEB expense, to be recovered within 10 years of the company's adoption of SFAS No. 106 for regulatory accounting purposes. The timing for the disposition of the deferrals made subsequent to the granting of rate allowances for the full annual OPEB expense will be addressed at a later date, probably on a case-by-case basis within the context of rate proceedings.

For rate making purposes, the deferral made in accordance with Section 5(B) above should not be used as a ratebase addition or subtraction, but should be used to determine if the company has realized a net positive or negative cash flow. If there is a net positive cash flow, an interest factor should be applied to the net deferral[21] and the result added to a separate subaccount in the internal reserve. If there is a negative cash flow, no interest should be calculated.

The interest rate used for this purpose should, when compounded, equal the company's last allowed pre-tax rate of return[22] (unless otherwise directed by the Commission). The interest so calculated should be maintained in a separate subaccount of the internal reserve and should compound monthly using the same rate of interest.

The funds represented by this internal reserve may be used by the company for general utility purposes until such time as the funds are actually paid out for OPEB benefits[23] or transferred to an externally held OPEB fund. Because of this, and in order to ensure that this interest expense will not inadvertently be included in the revenue requirement determined in future rate proceedings, the contraentry for the interest accrual will be a

---

21. For the purpose of this calculation the deferral should be reduced by its related income tax effect.
22. Use of the pre-tax rate of return is consistent with that which has been ordered on other major deferrals (e.g., the deferred tax savings resulting from the Tax Reform Act of 1986).
23. Current payment of pension benefits for which no external fund has been established shall be debited to this internal reserve. If an external reserve has been established it will be up to the company's discretion, barring specific directions from the Commission to the contrary, as to whether the benefits will be paid from the internal fund, the external fund, or a combination of both.

debit to a below-the-line expense account (Account 431, Other Interest Expenses).

Interperiod tax allocation shall be applied to the above deferrals.[24]

This deferral program should be instituted, <u>on a trial basis</u>, commencing with the effective date of this policy statement. When we review this policy statement in three to five years, we will reexamine this issue to determine if the deferral accounting procedures proposed here should be modified.

7. <u>ACTIONS UTILITIES SHOULD BE TAKING</u>

Regardless of the accounting and ratemaking decided for OPEB, there are various actions being recommended by accounting and actuarial firms that each company should be considering regarding its OPEB liability. Some of these recommendations are that each company: (a) analyze and quantify the short and long-term effects SFAS No. 106, (b) review its OPEB plan to ensure that it is part of an employee compensation and benefit package that is reasonable and necessary to maintain a reliable and competent workforce, and (c) analyze the feasibility of changes to plan design, plan administration, funding, computer and claims processing systems and other appropriate areas to mitigate the impact of the new standard.

---

24. We are presuming the FASB's Statement No. 96, which is currently under review by the FASB, will allow booking of the deferred tax asset. We will not address the affect of SFAS No. 96 here, but will address it in a separate preceeding if necessary.

A. Analysis of Issue

The actions described above represent conduct that a responsible company should be taking to control its expenditure. By performing them, company may find ways it can reduce its OPEB liability without cutting back on benefits. These actions should be performed on an ongoing basis so that the company will be aware of any new developments relating to funding or cost for OPEB plans, or any new laws, or revisions to old existing laws, relating to their OPEB plans. The company will then be in a position to measure the impacts of any changes and to take expeditious action to lessen or negate detrimental impacts while taking maximum advantage of any beneficial changes.

B. Recommendation

Each utility must demonstrate in the first rate case or PSC annual report[25] it files after this policy statement is issued that they have, at a minimum, taken the actions described above.

8. IMPLEMENTATION DATE

SFAS No. 106 does not have to be implemented until after December 15, 1992.[26] Although the Statement does permit earlier adoption, to date none of our jurisdictional companies have made that election.

25. Reporting schedules will be developed and included in future reports.

26. SFAS No. 106 is effective for fiscal years commencing after December 15, 1992, however, for nonpublic enterprises with no more than 500 plan participants it is effective for fiscal years beginning after December 15, 1994.

A. Analysis of Issue

Any measures of the estimated postretirement benefit obligation made in the near future will reflect the lack of historical data on which to base projections and the fact that actuarial practice in this area is still at an early evolutionary stage. Thus, early adoption of SFAS No. 106 would capture these inaccuracies in the transition obligation. In fact, it was these very concerns which led the FASB to postpone the effective date for SFAS No. 106 to December 15, 1992. The FASB recognized that delaying the effective date would allow companies more time to quantify their obligations, develop more accurate projections, and to institute any cost containment measures they deem necessary. The necessity for as much accuracy as possible in these estimates at the time SFAS No. 106 is adopted is exemplified by the manner in which SFAS No. 106 accounts for changes in assumptions.

Under SFAS No. 106 accounting, changes in assumptions produce actuarial gains or losses. Some of these gains and losses will relate to the transition obligation. If the transition obligation and any subsequently realized actuarial gains and losses related to the transition obligation were being amortized over the same period they would offset each other; however that is not the case.

The transition obligation is being amortized over a period of approximately 20 years commencing with the company's adoption of SFAS No. 106, whereas we are proposing gains and losses be amortized over a rolling 10-year period (see Section 2(E)(b) of this appendix). This difference in amortization will cause a mismatch between these two related items and will, therefore, cause a distortion of the OPEB expense being recognized on the books of the company. This problem will become less significant with the passage of time and the resulting amortization of the transition obligation. However, the more accurate the calculation of the transition obligation at the time of adoption of SFAS No. 106 the smaller will be this problem.

B. Recommendation

Companies should adopt SFAS No. 106 for regulatory accounting purposes as of the mandatory effective date of SFAS No. 106 for companies of their size and type, but not earlier (i.e. for fiscal years commencing after either December 15, 1992, or December 15, 1994, as applicable). The other provisions of this policy statement, as it applies to OPEB, shall be effective on the same date.

If, prior to its adoption of SFAS No. 106 for regulatory accounting purposes, a company is granted a rate allowance to provide for accrual accounting of OPEB, it should follow the provisions of this statement regarding deferral (and accrual of interest) of the differences between:

1. the amount of the OPEB rate allowance,

2. the amount booked for the OPEB expense, and

3. the amount deposited in tax-effective OPEB dedicated funds.

The company shall also apply interperiod tax allocation to any book/tax timing differences resulting from this accounting.

9. TAX-EFFECTIVE FUNDING PLANS

At the present time we are aware of only three tax-effective vehicles that are appropriate for funding OPEB obligations: (1) IRC Section 401(h) Accounts, (2) Pension Benefit Enhancement, and (3) IRC Section 501(c)(9) - voluntary employee's beneficiary association (VEBA). Two other vehicles which have been discussed, but which we understand are presently illegal in New York State, are corporate owned life insurance and VEBA owned life insurance. Since these five items were discussed in detail in Section 4(A)(e) of the attached Appendix A, we will not elaborate on them here except to point out a recent development concerning VEBAs.

For current and retired employees who are/were employed under collectively bargained labor agreements it may be possible to fund through a VEBA, and deduct as a current expense on the company's tax return, the entire present value of the OPEB liability; including the portion applicable to projected inflation. In addition, the income earned by these collectively bargained VEBAs will accumulate tax-free. This is discussed in more detail in Section 4(A)(e)(3) of the attached Appendix A.

We remain concerned about the lack of tax-effective funding vehicles for OPEB. Therefore, we request respondents to provide suggestions if they are aware of other tax-effective vehicles that are appropriate for this purpose.

10. PLAN FOR RECOVERING OPEB COSTS - MANDATED FILING DATE

Any company for which accrual of OPEB costs in a manner consistent with this policy statement has not been reflected in its rates, or included in a then active rate filing, is to submit a proposed plan for recovery, or other disposition, of such costs that would take effect on the date of its adoption of SFAS No. 106 for regulatory accounting purposes.

11. COMPANIES SUBJECT TO LIMITED SECOND STAGE RATE FILINGS

Some companies are subject to rate orders or settlement agreements that provide for second or third stage rate increases for limited amounts or specified items. The expense increase occasioned by the change to accrual accounting for OPEB, made in accordance with the provisions of this policy statement, may be included in those subsequent filings. Such requests for recovery should be made in the context of a plan which considers or proposes the use of credits available to help offset the revenue requirement impact of the new accounting (i.e. Mirror CWIP, tax refunds, effects of adopting SFAS No. 87, etc).

12. CONCLUSION

The current cash-basis approach to accounting for OPEB costs is misleading because of its implication that no liabilities for future retiree benefits exist. Therefore, it is better accounting, and more financially responsible, to move in the direction of accrual-basis recognition for OPEB. At the same time, the SFAS No. 106 accounting is so complex and dependent upon imprecise estimates and projections that we are concerned about the possible overestimation of OPEB expense for ratemaking purposes and of rateshock on customers if SFAS No. 106 is adopted in its entirety for ratemaking purposes. Also, because of the lack of data and imprecise nature of the estimates and projections required for the accrual of health case costs under SFAS No. 106 accounting, there exists a possibility of manipulation of OPEB expense projections used for ratemaking purposes.

We believe SFAS No. 106 should be adopted for accounting purposes, but only with certain conditions that make the statement more suitable for use by regulated utilities. While we should be moving toward SFAS No. 106 accounting for rate purposes, we also believe a phase-in for such accounting is necessary. Therefore, we have described in this proposal several possible methods and are requesting comments on them.

The ability to project future OPEB costs accurately will be an evolving science. In view of this, and the likelihood of significant changes in company health plans, available government health programs, and tax laws, the Office of Accounting and Finance expects to periodically review this policy statement to determine if it needs to be revised.

REQUEST TO CLASS A AND B UTILITIES

FOR INFORMATION AND COMMENTS

In addition to any other comments or suggestions filed .n response to the proposed policy statement described in Appendices A and B, we request all New York State Class A and B utilities to provide the following information.

---

1. For each year, from the date of your company's adoption of SFAS No. 87 thru December 31, 1992, please quantify the impact that SFAS No. 87 has had on the company's annual pension expense.

2. Describe in detail how and by whom all assumptions, including the following, were developed for the fiscal years since SFAS No. 87 was implemented:

   a. the expected growth rate of plan assets.
   b. the settlement or discount rate.
   c. projected wage increases.
   d. employee turnover and mortality assumptions.

3. How is the company monitoring the accuracy of the four assumptions listed in item 2 above?

4. Provide any criteria that has been established that will be used to determine at what point an assumption should be changed. If no criteria exists, how will it be decided when an assumption should be changed?

5. What impact did the rates published by the PBGC have on your interest rate and discount rate assumptions? If the PBGC rates were ignored when determining your assumptions, please explain why they were not considered given paragraph 196 of SFAS 87.

6. Provide the following for the transition amount determined at the time SFAS No. 87 was implemented:

   a. the date the transition amount is based on.
   b. the amount and a supporting detailed calculation.
   c. the assumptions used.
   d. how each assumption was selected or determined (include the source and any supporting calculations).
   e. the amortization period used and how it was determined.
   f. the amount of the annual amortization.

7. If a transition obligation resulted, please describe why, given that SFAS No. 87 requires the use of the "unit credit method" which normally results in a lower Accumulated Benefit Obligation than if other methods are used.

8. a. Is your company accelerating amortization of prior service cost because of a history of plan amendments?

   b. If yes, describe and quantify the impacts. Include the criteria used to determine that there was a history of plan amendments.

9. Since adopting SFAS No. 87, has your company made any changes in the method it uses to calculate pension expense or the manner in which it determines any of the SFAS No. 87 assumptions?

10. If the answer to 9 is yes, please describe and quantify.

11. Are there any other specific types of changes that you might want to make under certain situations related to pensions that we have not specifically mentioned? If yes, please describe.

12. Please describe in detail any actions specified, or similar to the ones specified, in SFAS No. 88 which have been explored or implemented by your company. Also, please explain the reasons why the action was implemented or rejected.

13. Please describe the procedures employed to determine if it is advisable or advantageous to settle or curtail all, or a part of, the company's pension plan and what options and terms are available for such actions.

14. Please provide the amounts deferred for pensions to date as a result of the Commission's September 1987 order requiring deferral of the difference between the annual pension expense recorded in accordance with SFAS No. 87 and the amount reflected in rates. Also please provide the amount that would have been deferred if the <u>entire</u> difference between pension costs actually paid out (e.g. amounts actually paid to pension funds or paid directly to beneficiaries) and the amount allowed in rates had been required to be deferred. Please describe, <u>in detail</u>, the reason(s) for any difference between these 2 amounts.

15. Please provide any suggestions that will help staff and the Commission ensure that each NY State utility company is efficiently managing its pension plan.

16. Please provide the factors, with a discussion of their relative importance, used to determine the amount which was

funded for pensions and OPEB for years 1988 thru 1991. This should also address the impact of OBRA 87.

17. Please provide any regulations or factors, other than those described in Appendix A, which might impact the way a company funds its pension plan.

18. Please list and describe each of the company's OPEB plans.

19. How much has been charged to expense for each OPEB plan for each of the years in the 4 year period ending December 31, 1991? Was any of this expense for prefunding the company's expected future OPEB liability? If so, please quantify explain fully.

20. For each of your company's OPEB plans, please describe what steps, if any, that have been taken to quantify its accrued and projected liability. Do these methods conform with the requirements of SFAS No. 106? If they do not conform, please describe how they deviate and quantify the effects of the deviations.

21. Please provide the results of any actions described in the preceding question.

22. For each of your company's OPEB plans, please describe the conditions which employees must meet in order to qualify for the benefit.[1] We encourage all companies to review these requirements carefully since, in the application of SFAS No. 106, this criteria is used to determine the attribution period over which the expected postretirement obligation must be recognized and the result for some companies may be supprising. To illustrate, assume the only criteria that must be met to receive health care coverage is that the employee has retired from the company and is receiving payment of pension benefits. Assume also employees' pension rights vest after 6 months of employment but in order to receive benefits the employee must have retired and have attained the age of 55 years. Under this scenario, each employee's estimated health care benefit cost must be <u>fully accrued within 6 months of his hire</u>.

1. For example, health care coverage is provided to all former employees who have retired and who are either (1) currently receiving pension benefits or (2) have vested their pension benefits but are not yet receiving those benefits. To vest pension benefits the person must must have been employed by the company for 10 consecutive years and have attained age of 55 years while working for the company. To receive pension benefits the person must meet the preceeding criteria plus have attained the age of 65 years.

23. Please describe the problems you have incurred trying to determine the OPEB liability.

24. Please comment of the 7 possible methods of rate recovery for OPEB costs described in Section 2(C) of Appendix B.

25. Please state whether you are in favor of, or oppose, the recommended rate treatment for OPEB expenses as detailed in Section 2(D) of Appendix B. Explain fully your reasons for support or opposition to this method. If you propose an alternative method, or have a suggestion for improvement of our recommended method, please explain your recommendation in detail and explain fully the reasoning behind your proposal.

26. Are you aware of any sources that could be used to fund OPEB costs other than those addressed in Section 9 of Appendix B?

27. Are you aware of any federal tax provisions, other than those listed in Section 4(A)(e) of Appendix A, that allow tax-effective funding, or other tax incentives, for the accrual or funding of future OPEB costs? If so, please give a detailed explanation, including the applicable section numbers of the Internal Revenue Code.

28. Please describe in what actions your company has taken related to the funding of its current OPEB plan or why no action has been taken.

.9. Please list and explain what actions your company has taken decrease or to mitigate increases in its current and/or future OPEB costs. If no action has been taken please explain why.

30. Please provide the projected impact on 1993 net income of the changes recommended in Appendix A.

31. Please provide the projected impact on 1993 net income of adopting SFAS No. 106. All companies which responded to our February 27, 1991 OPEB questionnaire should explain fully any deviation in this amount from that which was reported for the same thing in their response to the questionnaire.

32. Please state the SFAS No. 106 options, assumed discount rate, and expected long-term rate of return on plan assets used to calculate the amount reported is response to the preceeding question.

33. Please provide the projected impact of the changes recommended in Appendix B on the amount reported in response to question 31 above.

34. Some NY State utilities are a part of a larger organization (e.g. a subsidiary or operating division, etc.) and the

remainder of the organization is not subject to the jurisdiction of this Commission. In many of these instances there is only one pension plan and one health plan which covers the entire organization. It may be awkward for the utility portion regulated by the Commission to use one of the "optional provisions" of SFAS Nos. 87 or 106 while the remainder of the organization uses a different option to account for the same plans. Please state how serious a problem your company believes this to be and explain the reasons.

35. Please list and explain any actions which could be taken by this Commission, the companies, or their affiliates to mitigate the problem described in the preceeding question and/or your response to that question.

36. We are recommending that assets of pension and OPEB dedicated funds be valued using a calculated value that recognizes changes in fair value in a systematic and rational manner over 3 years (Sections 2(C)(a)(3) and 2(E)(b)(2) of Appendices A and B respectively). Please address whether a period of 3, 4, or 5 years should be used, and explain fully the reasons for your preference. Please also state what method(s) you are currently using to value assets of your pension and OPEB funds.

37. For both pensions and OPEB we are recommending that use of the "corridor approach" for recognition of gains and losses be prohibited. In its place, all gains and losses will be amortized, on a vintage year basis, over 10 years (Section 2(C)(a)(2) and 2(E)(b)(2) of Appendices A and B respectively). Please state whether you are in favor of, or oppose, this recommendation and explain fully your reasons.

38. For pensions, please state the amount of unamortized net gains and losses remaining in the 10% corridor at the end of each year for the 4-year period ending December 31, 1991. Was there any amortization of gains and/or losses in this 4-year period? If so, please itemize by year and explain the reasons for the amortization.

to carry his burden of showing that his present bail is excessive. Accordingly, we affirm the judgment of the trial court.

CITIES OF ABILENE, et al., Appellants,

v.

PUBLIC UTILITY COMMISSION OF TEXAS, et al., Appellees.

No. 3-92-065-CV.

Court of Appeals of Texas, Austin.

May 5, 1993.

Rehearing Overruled July 7, 1993.

Judicial review was sought of final order of Public Utility Commission in telephone rate case. The 250th Judicial District Court, Travis County, Joe B. Dibrell, J., affirmed, and appeal was taken. The Court of Appeals, Carroll, C.J., held that while Commission's order was mostly correct, Commission did not correctly apply the law as to income tax savings resulting from expenses disallowed for rate-making purposes.

Reversed and remanded with instructions.

1. Administrative Law and Procedure ⇐763, 791, 793

In reviewing agency order, Court of Appeals may not substitute its discretion or judgment for that of agency; court may reverse agency's decision only if it is not supported by substantial evidence, is arbitrary, or results from abuse of discretion.

2. Administrative Law and Procedure ⇐763

Agency's decision is arbitrary or results from abuse of discretion if agency failed to consider factor legislature directed it to consider, or relied upon irrelevant factor, or weighed only relevant factors that legislature directed it to consider but still reached completely unreasonable result.

3. Public Utilities ⇐165

Public Utility Commission may consider nonunanimous stipulation as basis for final order, unless it is arbitrary, unreasonable, abuse of discretion, or involves consideration of factors other than those legislature has directed Commission to consider.

4. Public Utilities ⇐165

Public Utility Commission properly discharged its statutory duties in adopting nonunanimous stipulation as basis for its order; all parties presented evidence and Commission made findings of fact on relevant issues.

5. Administrative Law and Procedure ⇐791

In reviewing sufficiency of evidence to support agency order, Court of Appeals applies substantial evidence test.

6. Telecommunications ⇐330

Nonunanimous stipulation and testimony offered to support a finding that telephone rates were just and reasonable under the stipulation constituted substantial evidence, as required to support order of Public Utilities Commission.

7. Constitutional Law ⇐298(4)
Telecommunications ⇐334

Public Utilities Commission's use of nonunanimous stipulation as basis for its order on telephone rates did not violate due process rights of stipulation opponent, where opponents were given opportunity to present entirety of their case. U.S.C.A. Const.Amend. 14.

8. Telecommunications ⇐334

Nonunanimous stipulation used by Public Utilities Commission as basis for its order on telephone rates did not violate public policy; stipulation was not a Mary Carter agreement and did not promote litigation.

9. Telecommunications ⟸330

Public Utility Commission's finding that nonunanimous stipulation, used as basis for its order on telephone rates, set reasonable rate of return was supported by substantial evidence, despite potential of future events which could result in returns greater than reasonable rate of return.

10. Telecommunications ⟸330

Nonunanimous stipulation entered by telephone company, Public Utility Commission staff and 24 other parties constituted evidence in stipulation hearing.

11. Telecommunications ⟸330

Public Utility Commission's finding that adjusted test-year expenses represented reasonable operating expenses for telephone company was supported by substantial evidence, where opponents were given opportunity to examine evidence supporting stipulation through discovery and to present evidence and argument against its adoption.

12. Telecommunications ⟸347

Public Utility Regulatory Act (PURA) authorized Public Utility Commission to order "earnings sharing" plan, whereby telephone company would return to consumers 50% of earnings within the specified range and 100% of earnings above that range; plan fell within the type of innovative regulation authorized by PURA and was based on consideration of proper factors. Vernon's Ann.Texas Civ.St. art. 1446c, § 18(a).

13. Telecommunications ⟸347

Section of Public Utility Regulatory Act (PURA) requiring Public Utility Commission to fix overall revenues at level that would permit utility a reasonable opportunity to earn reasonable return did not require Commission to fix exact rate of return or prohibit "earnings sharing" plan whereby telephone company would return to consumers 50% of earnings within specified range and 100% of earnings above that range. Vernon's Ann.Texas Civ.St. art. 1446c, § 39(a).

14. Telecommunications ⟸334

Stipulation providing that telephone company could not raise rates on certain basic services for four years and could not bring major rate case until its rate of return fell below 10.49% for a full year did not improperly limit Public Utility Commission's power to inquire into unreasonable rates. Vernon's Ann.Texas Civ.St. art. 1446c, § 42.

15. Telecommunications ⟸161

Implementation of procedural provisions for nonmajor rate cases is within Public Utility Commission's discretion. Vernon's Ann.Texas Civ.St. art. 1446c, § 43(b).

16. Telecommunications ⟸336

Approval of telephone company's application for nonmajor rate increases without full rate-filing package was not an improper advisory opinion by Public Utility Commission. Vernon's Ann.Texas Civ.St. art. 1446c, § 43(b).

17. Public Utilities ⟸128

Standard for inclusion of utility's income tax expense in cost of service is whether utility actually incurred the expense, i.e., amount of taxes actually paid.

18. Telecommunications ⟸313

Public Utility Commission reasonably concluded that no adjustment in telephone company's income tax expense was necessary to account for consolidated return filed by its parent and that telephone company had received its fair share of resulting tax savings. Vernon's Ann.Texas Civ. St. art. 1446c, § 41(c)(2).

19. Telecommunications ⟸313

If telephone company realized tax savings from deductions relating to disallowed expenses, these savings had to apply to reduced rates, even if underlying deduction could not be included as expenses in telephone company's cost of service.

20. Public Utilities ⟸167

Points of error not urged in motions for rehearing in Public Utility Commission were waived. Vernon's Ann.Texas Civ.St. art. 6252-13a, § 16(e).

21. Telecommunications ⇐336

Public Utility Regulatory Act (PURA) and Administrative Procedure and Texas Register Act (APTRA) did not require Public Utilities Commission to set forth findings of fact in support of its rejection of hearing examiner's recommendation for disallowance of portion of expenses. Vernon's Ann.Texas Civ.St. art. 6252-13a, § 19.

22. Telecommunications ⇐336

Public Utility Commission made all required findings to support its determination that expenses of telephone company's transactions with affiliated companies were reasonable and necessary; Commission found that each of four allocation methods used by company's parent resulted in costs no higher to company than costs to other affiliates, and that each of the methods produced reasonable result based on cost causation and benefit received. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(1).

23. Telecommunications ⇐336

Public Utility Commission made required findings to support allowance of expenses telephone company incurred in transaction with a subsidiary, finding that each project of subsidiary was reasonable and necessary and that charges to telephone company were no higher than charges to other co-owners of affiliate or unaffiliated third parties. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(1).

24. Telecommunications ⇐336

Public Utility Commission was not required to make findings of fact as to imputation of yellow pages revenue to telephone company, where company purchased no goods or services in connection with publication of yellow pages directories. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(1).

25. Telecommunications ⇐330

Substantial evidence supported Public Utility Commission's finding that telephone company's yellow pages expenses were reasonable and necessary. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(1).

26. Telecommunications ⇐336

Public Utility Commission made adequate findings of fact to support its conclusion that telephone company's existing extended metropolitan service (EMS) rates were just, reasonable, and not discriminatory. Vernon's Ann.Texas Civ.St. art. 6252-13a, § 16(b).

27. Public Utilities ⇐194

Absent showing that complained-of rates were unreasonably discriminatory, Court of Appeals will not overturn Public Utility Commission's approval of rate design.

28. Telecommunications ⇐330

Substantial evidence supported Public Utility Commission's finding that telephone company's existing extended metropolitan service (EMS) rates were just, reasonable and not unduly discriminatory, and that application of existing rates to particula exchange was just and reasonable.

29. Telecommunications ⇐330

Substantial evidence supported Publ Utility Commission's conclusion that diffe ential between Tier I and Tier II rates fc extended metropolitan service (EMS) wa reasonable and not discriminatory.

30. Telecommunications ⇐330

Substantial evidence supported Pub Utility Commission's finding that ra group reclassifications proposed in stipu tion were supported by evidence and we reasonable.

31. Telecommunications ⇐330

Substantial evidence supported Put Utility Commission's approval of extend metropolitan service (EMS) rates for fc local telephone companies.

Barbara Day, Butler, Porter, Gay & D Austin, for City of Abilene, et al.

Jesus Sifuentes, Susan C. Gentz, Bick staff, Heath & Smiley, Austin, for City McKinney.

Walter Washington, Austin, for Office Public Utility Counsel.

Dan Morales, Atty. Gen., Steven Baron, Norma K. Scogin, Asst. Attys. Gen., Austin, for Public Utility Com'n of Texas, et al.

Brook B. Brown, McGinnis, Lochridge & Kilgore, Austin, for Central Telephone Co. of Texas and Lufkin-Conroe Telephone Exchange, Inc.

Anthony P. Gillman, Austin, for GTE Southwest Inc. and Contel of Texas, Inc.

Robert J. Hearon, Jr., Graves, Dougherty, Hearon & Moody, Austin, for Southwestern Bell Telephone Co.

Before CARROLL, C.J., and JONES and KIDD, JJ.

ON MOTION FOR REHEARING

CARROLL, Chief Justice.

The opinion and judgment of the Court in this cause handed down on February 3, 1993, are withdrawn and the following opinion is substituted therefor.

Appellants [1] sought judicial review of the Public Utility Commission's (the "Commission") final order in a rate case concerning Southwestern Bell Telephone Company ("SW Bell") and other entities.[2] The district court affirmed the Commission's order, and the appellants seek reversal of the district court's judgment. While the Commission's order is predominantly correct, we conclude the Commission did not correctly apply the law as to income-tax savings resulting from expenses disallowed for ratemaking purposes. We will reverse the district court's judgment and remand the cause to the district court with instructions that it be remanded to the Commission for proceedings consistent with our opinion.

PROCEDURAL BACKGROUND

The Commission initiated the agency proceeding as an inquiry into the reasonableness of SW Bell's existing rates pursuant to section 42 of the Public Utility Regulatory Act ("PURA"), Tex.Rev.Civ.Stat.Ann. art. 1446c, § 42 (West Supp.1993). The primary impetus for this rate case was consumer group concern that utility tax savings resulting from the Tax Reform Act of 1986 were not being passed through to ratepayers and that SW Bell was realizing excessive profits.

In January 1989, the Commission initiated the rate case as *Inquiry of the General Counsel Into the Reasonableness of the Rates and Services of Southwestern Bell Telephone Company*, Docket No. 8585.[3] The Commission directed SW Bell to file a "rate-filing package" based on 1988 as the test year. SW Bell also submitted a proposal for resolution of the rate case, its "Texas First Plan." The parties conducted

1. Appellants are the Office of Public Utility Counsel, the City of McKinney (appealing on separate points), and the following Texas cities: Abilene, Alamo, Allen, Alvin, Amarillo, Amherst, Arlington, Balcones Heights, Bay City, Big Wells, Benbrook, Blue Mound, Borger, Brackettsville, Breckenridge, Canadian, Cameron, Canyon, Carrizo Springs, Cisco, Clute, Columbus, Converse, Cotulla, Crane, Crowley, Crystal City, Dalworthington Gardens, Denison, Double Oak, Eagle Pass, Eagle Lake, Earth, East Mountain, Eastland, Edcouch, Edgecliff Village, Edinburg, Edna, El Campo, El Paso, Farmersville, Forest Hill, Floydada, Fort Stockton, Friendswood, Fritch, Garland, Goliad, Gordon, Grand Prairie, Groves, Gruver, Hackberry, Hallsburg, Happy, Harlingen, Hedwig Village, Hereford, Hollywood Park, Hudson Oaks, Kenefick, Kermit, Kingsville, Lake Tanglewood, Laredo, La Villa, Longview, Lorenzo, Luling, Marlin, McAllen, Meadow, Mercedes, Mesquite, Midland, Missouri City, Monahans, Mount Pleasant, New Deal, Noonday, Olton, Palmhurst, Pampa, Pantego, Paris, Pearsall, Pecan Hill, Plainview, Pharr, Rancho Viejo, Richmond, Rio Hondo, Rockwall, Rosenberg, San Antonio, San Juan, Schertz, Seminole, Sinton, Slaton, Stagecoach, The Colony, Thompsons, Timbercreek Canyon, Tiki Village, Tye, Tyler, University Park, Uvalde, Vega, Waco, White Settlement, and Woodsboro.

2. Appellees are the Public Utility Commission of Texas, Southwestern Bell Telephone Company, and the following intervenors: AT & T Communications of the Southwest, Inc., Lufkin-Conroe Telephone Exchange, Inc., Central Telephone, General Telephone Company of the Southwest, Contel of Texas, Inc., Fort Bend Telephone Cooperative, Guadalupe Valley Telephone Cooperative, MCI Telecommunications, State Purchasing & General Services, and Texas Statewide Telephone Cooperative, Inc.

3. In February 1989, this rate case was consolidated with another rate case involving SW Bell, the *Inquiry of the General Counsel Into the WATS Prorate Credit*, Docket No. 8212.

PURA § 40(b); *Suburban Util. Corp. v. Public Util. Comm'n*, 652 S.W.2d 358, 366 (Tex.1983). The establishment of just and reasonable rates requires consideration of three factors: (1) the utility's reasonable operating expenses; (2) the utility's rate base; and (3) the reasonable rate of return. PURA § 39. A regulated utility is entitled to rates that provide a "reasonable opportunity to earn a reasonable return on its invested capital...." PURA § 39(a); *see Suburban Util. Corp.*, 652 S.W.2d at 362.

Rates are set in a two-step process. First, the overall revenue the utility is entitled to recover is set, a process often referred to as setting "revenue requirements." Second, a "rate design" of individual rates for classifications of customers and services is determined. *See Texas Alarm & Signal Ass'n v. Public Util. Comm'n*, 603 S.W.2d 766, 768 n. 2 (Tex. 1980). The Cities and OPC complain of the operating-expense and rate-of-return elements of the revenue-requirement determination, while McKinney complains of the rate design as applied to its residents.

[1, 2] In reviewing an agency order, we may not substitute our discretion or judgment for that of the agency; we may reverse the agency's decision only if it is not supported by substantial evidence, is arbitrary, or results from an abuse of discretion. *Railroad Comm'n v. Continental Bus Sys., Inc.*, 616 S.W.2d 179, 181 (Tex. 1981). An agency's decision is arbitrary or results from an abuse of discretion if the agency has (1) failed to consider a factor the legislature directed it to consider, (2) relied upon an irrelevant factor, or (3) weighed only relevant factors that the legislature directed it to consider but still reached a completely unreasonable result. *Gerst v. Nixon*, 411 S.W.2d 350, 360, n. 8 (Tex.1966); *Statewide Convoy Transp., Inc. v. Railroad Comm'n*, 753 S.W.2d 800, 804 (Tex.App.—Austin 1988, no writ).

Adoption of the Non-Unanimous Stipulation

The Cities' first point of error and OPC's first and eighth points of error complain of the Commission's adoption of the non-unanimous stipulation. The Cities and OPC argue that the Commission (1) failed to consider the statutory factors in setting rates; (2) considered irrelevant nonstatutory factors in setting rates; (3) failed to make an evaluation of SW Bell's reasonable and necessary expenses; (4) made improper implied adjustments to test-year data; and (5) in considering the stipulation, used a procedure that was not proper under PURA and that violated due-process principles.

[3] We recently considered the adoption of a non-unanimous stipulation in a rate case. *See City of El Paso v. Public Util. Comm'n*, 839 S.W.2d 895 (Tex.App.—Austin 1992, writ requested). In *City of El Paso* we determined that a non-unanimous stipulation could be considered as a basis for a final order in a rate case as long as nonstipulating parties had an opportunity to be heard on the merits of the stipulation and the Commission made an independent finding on the merits, supported by substantial evidence in the record, that the stipulation set just and reasonable rates. *Id.* at 903. The consideration of a non-unanimous stipulation as a basis for the final order is proper unless it is "arbitrary, unreasonable, an abuse of discretion, or involves consideration of factors other than those the legislature has directed the Commission to consider." *Id.* at 904.

[4] In their arguments that the Commission failed to consider statutory factors, considered irrelevant factors, failed to analyze SW Bell's operating expenses, and made improper adjustments to test-year data, the Cities and OPC essentially contend, that in adopting the stipulation, the Commission did not conduct the analysis PURA requires in rate cases. In *City of El Paso* we stated:

> [A]ppellants impliedly urge us to *presume* that, by basing its final order partially on stipulated matters, the Commission completely abdicated its responsibility to determine disputed issues. We may not so presume; indeed, the law compels a contrary presumption. In reviewing a challenged administrative order, we must presume its validity. The

extensive discovery and filed written testimony supporting their various positions in advance of any hearing.[4]

Before the date set for the cost-of-service hearing, SW Bell, the Commission staff, and twenty-four other parties entered into a non-unanimous stipulation. This stipulation provided, in part, for rate reductions of approximately $73 million annually and upgrades in SW Bell services and facilities. The signatory parties presented the stipulation to the Commission for consideration as the basis for setting the rates at issue and filed written testimony in support of the stipulation provisions. The Office of Public Utility Counsel ("OPC"), a group of one hundred and fourteen Texas cities ("Cities"), the City of McKinney ("McKinney"), and several other intervenors opposed adoption of the stipulation.

To establish the procedure for the consideration of the stipulation, the Commission ordered that an initial hearing be conducted solely on the issue whether the stipulation should be adopted. If the Commission rejected the stipulation, the order provided that a full cost-of-service hearing would be held to set just and reasonable rates and that the parties to the stipulation would be free to pursue their previous positions. The Commission allowed all parties to conduct additional discovery and file additional written testimony before the stipulation hearing. At the conclusion of the stipulation hearing, the administrative law judge recommended that the Commission reject the stipulation because of SW Bell's failure to present evidence on its cost of service and invested capital. The Commission, however, adopted the stipulation with some minor modifications in its final order.

After exhausting their administrative remedies, the appellants sought judicial review in the district court of Travis County pursuant to section 69 of PURA and section 19 of the Administrative Procedure and Texas Register Act ("APTRA"), Tex. Rev.Civ.Stat.Ann. art. 6252-13a, § 19 (West Supp.1993). The trial court affirmed the final order of the Commission adopting the stipulation. The Cities, OPC, and McKinney appeal the judgment of the trial court.

THE STIPULATION PLAN

The stipulation, as adopted by the Commission, provided for a mix of rate reductions and other benefits to consumers. Under the stipulation, SW Bell would (1) provide a one-time credit to residential customers, (2) reduce certain other rates, including long distance access charges, and (3) upgrade SW Bell facilities and services. The stipulation also set up an "earnings sharing" plan, whereby SW Bell would return to consumers fifty percent of earnings within a specified range and one hundred percent of earnings above that range. Additionally, certain SW Bell rates were subject to a four-year "rate cap."

THE DISPUTE

On appeal, the Cities and OPC complain of (1) the adoption of the non-unanimous stipulation as the basis for the Commission's order; (2) the sufficiency of the evidence to support the finding of a reasonable rate of return; (3) the consideration of the test-year cost-of-service data in setting rates; (4) the implementation of the "earnings sharing" plan; (5) the inclusion of a hypothetical federal income tax expense in cost of service; and (6) the inclusion of inappropriate affiliate expenses in cost of service. By separate points, McKinney complains of the "extended metropolitan service" rates set by the stipulation and the Commission's order.

DISCUSSION AND HOLDING

In Texas, utility rates are set by the same test whether a utility seeks a rate increase or outside entities seek a rate decrease. *See* PURA §§ 42, 43. In both instances, the utility bears the burden of proof to show just and reasonable rates.

4. The Cities argued for approximately $738 million in rate reductions annually; the OPC for approximately $595 million in rate reduction annually; and the Commission staff for rate reductions of approximately $392 million annually. SW Bell's rate filing package asserted that a rate increase of approximately $139 million annually was appropriate.

> challenger bears the burden of showing error.

Id. at 902 (citations omitted). We believe this statement applies equally in the immediate case. The Cities and OPC complain that the Commission did not conduct a line-by-line cost-of-service analysis in setting SW Bell rates. However, the record reflects that all parties presented evidence and that the Commission made findings of fact on the relevant issues. We find nothing in the record to compel the conclusion that the Commission failed to properly discharge its statutory duties.

The Cities and OPC argue that the Commission findings were not based on any real evidence. Rather than rely on the prefiled testimony and SW Bell's rate-filing package, the signatory parties to the stipulation jointly offered new written testimony to support the stipulation. The Cities and OPC argue that this evidence reflects artificial numbers generated to support the stipulation. However, that contention, if assumed true, does not negate the probative value of the evidence. It would be as artificial to require the stipulating parties to argue their prior extreme positions in support of compromise numbers. The Commission recognized this situation and ordered that the signatory parties be grouped as one party for briefing, presentation of witnesses, and cross-examination at the stipulation hearing. The opponents to the stipulation were given a full opportunity to present evidence to contradict the stipulation and to refute the evidence presented to support its adoption.

[5, 6] In reviewing the sufficiency of the evidence to support an agency order, we apply the substantial-evidence test. This Court has extensively discussed the substantial evidence test in *Lone Star Salt Water Disposal Co. v. Railroad Commission*, 800 S.W.2d 924, 928 (Tex.App.—Austin 1990, no writ):

> To determine whether an agency's decision is supported by substantial evidence, as APTRA § 19(e)(5) requires, we must determine whether, in considering the record upon which the decision is based, the evidence as a whole is such that reasonable minds could have reached the conclusion which the Commission must have reached in order to justify its action. In determining whether there is substantial evidence to support the order, the reviewing court may not substitute its judgment for the Commission's, and must consider only the record upon which the decision is based. The evidence in the agency record may actually preponderate against the Commission's decision, but still amount to substantial evidence supporting it. The burden is on the complaining party to demonstrate an absence of substantial evidence.
>
> Final orders of the Commission are presumed to be valid. Where the evidence in the record before an agency will support either an affirmative or a negative finding, the agency order must be upheld. Any conflict in the evidence must be resolved in favor of the agency's decision. (Citations omitted.)

The stipulation itself and the testimony offered to support a finding that rates were just and reasonable under the stipulation constitute substantial evidence. *City of El Paso*, 839 S.W.2d at 907. Evidence was presented supporting either adoption or rejection of the stipulation. We may not substitute our judgment on the weight and credibility of the evidence for that of the Commission. APTRA § 19(e).

[7] The Cities also complain that the procedure the Commission used in considering the stipulation denied the stipulation opponents due process. Appellants argue that the hearing, being limited to the issue of whether to accept or reject the stipulation, denied the opponents the opportunity to present their proposals for consideration.

The adoption of a non-unanimous stipulation raises several due-process concerns. The most obvious is the possibility that opposing parties may be denied an opportunity to present evidence against acceptance of the stipulation. A more subtle problem is the possibility of an unintentional shift of the burden of proof from the utility to the opponents of the stipulation. There is a danger that when presented with a ready-made solution, the Commission might unconsciously require that the opponents refute the agreement, rather than require the utility to prove affirmatively that the proposed rates are just and reasonable. This danger is increased when the Commission staff is a signatory party and is in a position of advocating the stipulation.

In *City of El Paso* and in *Mobil Oil Corp. v. Federal Power Commission*, 417 U.S. 283, 94 S.Ct. 2328, 41 L.Ed.2d 72 (1974), the procedural facts are somewhat distinguishable from the instant case. In both *City of El Paso* and *Mobil*, the stipulations were negotiated only after extended litigation, and extensive hearings on the merits preceded the hearings for adoption of the stipulations. In *City of El Paso*, the rate case was initially divided into three phases—revenue requirement, prudence review of a nuclear project, and rate design. In that case, a fourth phase was later added to consider the stipulation. In the immediate case, however, the chronology was reversed; the stipulation hearing was a preliminary matter. The Commission's order provided that in the event that the stipulation was rejected, the parties would return to their pre-stipulation positions and the hearing would begin anew as an ordinary rate case. Nonetheless, the opponents had a full opportunity to present evidence on all issues at the hearing on the stipulation. We conclude that in the immediate case the procedural distinction does not compel a result different from our decision in *City of El Paso*.

The Cities cite a Missouri case for the proposition that the limited hearing violates due process. *See State ex rel. Fisher v. Public Serv. Comm'n*, 645 S.W.2d 39 (Mo. Ct.App.1982). The *Fisher* case presents a similar procedural history of a preliminary hearing to consider a non-unanimous stipulation in a rate case. That hearing was also limited to a determination of acceptance or rejection of the stipulation. The court determined that the opponents did not have an opportunity to present any positions which could be adopted at the stipulation hearing and, thus, were denied due process. We do not find this rationale compelling. Clearly, in the immediate cause, the opponents to the stipulation were able to present their positions that the stipulation should be rejected and greater rate reductions ordered fully. The opponents were given the opportunity to present the entirety of their case at the stipulation hearing. Only the scope of the Commission's *decision* was limited. The procedure used in this case offered adequate opportunity for all parties to present their positions for the Commission's consideration. We reject the rationale in *Fisher* and reaffirm our test in *City of El Paso*.

[8] In their motion for rehearing, the Cities cite a recent Texas Supreme Court case finding a Mary Carter agreement void as violative of public policy and argue that the stated policy disfavoring agreements which promote rather than discourage further litigation should apply to the stipulation in this cause.[5] *See Elbaor v. Smith*, 845 S.W.2d 240, 247–52 (Tex.1992). We disagree. The stipulation in this cause is not a Mary Carter agreement. Nor do we believe the stipulation promoted litigation in this cause. We conclude that the policy considerations set out in *Elbaor* do not require that the stipulation be rejected.

The test for the procedural propriety of the consideration of a non-unanimous stipulation is set out in *City of El Paso*. The nonsignatory parties must be afforded an opportunity "to be heard on the merits of the stipulation," and the Commission's order should be based on an independent finding of just and reasonable rates based on the statutory factors and substantial evidence. *City of El Paso*, 839 S.W.2d at 903. In this case after a separate hearing on the stipulation was set, all parties were allowed additional discovery. At the hearing, the Cities and OPC presented unrestricted evidence and contentions and were provided the procedural safeguards mandated by APTRA. The Commission made

5. A Mary Carter agreement is defined as an agreement whereby a "settling defendant retains a financial stake in the plaintiff's recovery *and* remains a party at the trial of the case. *Elbaor*, 845 S.W.2d at 247.

extensive findings of fact and conclusions of law to support its ultimate determination that the stipulation resulted in just and reasonable rates. We conclude that the procedure complied with the *City of El Paso* criteria. We find nothing in the record to indicate that the Commission shifted the burden of proof from SW Bell to the stipulation opponents. The Cities' first point of error and OPC's first and eighth points of error are overruled.

Rate of Return

[9] The Cities' third point of error complains of the sufficiency of the evidence to support the Commission's finding of a reasonable rate of return. The Cities complain that there was not substantial evidence in the record to support the entire range of return the Commission awarded. The Commission found that SW Bell's current cost of equity was in a reasonable range between 11.5 and 13.0 percent and that the range of SW Bell's overall cost of capital between 10.49 percent and 11.36 percent was reasonable. By alternative calculation methods, the Commission found SW Bell's rate of return on investment under the stipulation to be either 10.86 or 11.20 percent, both within the range found reasonable. The earning-sharing provisions of the stipulation stated that SW Bell would retain all return on investment up to 12.06 percent (14.2 percent return on equity); would refund 50 percent of return on investment between 12.06 and 14.5 percent (14.2 and 18.41 percent return on equity) to consumers; and would refund 100 percent of any return on investment greater than 14.5 percent (18.41 percent return on equity) to consumers.

The Cities argue that, under the stipulation, SW Bell may earn a return on equity of up to 16.3 percent [6] (13.28 percent return on investment), a rate that exceeds both the adopted reasonable range ceiling of 13.0 percent and any evidence in the record. This argument ignores the pro forma nature of ratemaking in which a hypothetical reasonable rate of return is determined based on adjusted test-year data and future rates set to produce approximately that return. In a conventional rate case there is no consideration of future changes in the actual rate of return. If consumer use exceeds projections or operational costs are reduced to create a greater return from the set rates, the utility retains the entire windfall until the next rate case adjusts the rate of return and individual rates. The potential of future events which may result in a return greater than the reasonable rate of return does not make the finding of the reasonable rate of return erroneous or unsupported by evidence. In the immediate case, the rate of return on investment was set at a rate the Commission found reasonable, 10.86 or 11.20 percent, depending on the calculation method. However, the Commission went on to provide a distribution to the consumers in the event of a greater return.

[10] The stipulation itself constitutes evidence. *City of El Paso*, 839 S.W.2d at 907. The signatory parties also presented testimony and evidence to support a finding that the stipulation provided for just and reasonable rates. We conclude that substantial evidence exists in the record to support the finding that the stipulation set a reasonable rate of return. We will not substitute our judgment on the weight of that evidence for that of the Commission. Accordingly, we overrule the Cities' third point of error.

Test-Year Expenses

[11] In its second point of error, the OPC complains that in adopting the 1988 test-year expenses and in assuming that the stipulation included implied adjustments to these expenses, the Commission did not properly analyze the expenses as PURA required. The OPC cites *Coalition of Cities for Affordable Utility Rates v. Public Utility Commission*, 798 S.W.2d 560, 563 (Tex.1990), for its holding that "book" expenses carry no presumption that

6. The Cities calculate this rate as the greatest potential return on equity to SW Bell under the earnings sharing provisions—all earnings up to 14.2 percent plus 50 percent of earnings between 14.2 and 18.41 percent.

they are reasonable and necessary and the utility did not carry its burden of proof by merely "opening its books to inspection." The OPC argues that the Commission could not properly rely on SW Bell's actual 1988 expenses and that, in doing so, the Commission failed to hold SW Bell to its burden of proof. We disagree.

The record reflects that the Commission did not blindly accept SW Bell's book expenses. The Commission examined the evidence and testimony presented on cost of service, including portions of the rate-filing package, and made adjustments to the book expenses to conform with the requirements of PURA and to account for the effects of the stipulation. The opponents were given an opportunity to examine the evidence supporting the stipulation through discovery and to present evidence and argument against adoption of the stipulation at the hearing. We conclude that substantial evidence exists in the record to support the Commission's finding that the adjusted 1988 test-year expenses represent reasonable SW Bell operating expenses. Accordingly, we overrule OPC's second point of error.

Earnings Sharing Plan

[12] The Cities' fourth point of error and OPC's fifth, sixth, and seventh points of error complain of the Commission's implementation of an "earnings sharing plan." The Cities and OPC argue that the plan is not authorized under PURA and that the elements of the plan are not supported by substantial evidence. The Cities additionally argue that the plan provides for illegal retroactive refunds, illegally fixes rates for four years, improperly substitutes monitoring for conventional regulation, and constitutes an advisory opinion in that it allows SW Bell to file for nonmajor future rate increases without a full rate-filing package. OPC also complains that in adopting the plan the Commission failed to consider statutory factors and, instead, considered irrelevant factors.

The initial question the Cities and OPC raise under these points of error is whether PURA authorizes the Commission to order an "earning sharing plan." The Cities and OPC characterize this type of ratemaking as "incentive regulation," and argue that it conflicts with the cost-of-service-based regulation under PURA and is not authorized. The Cities and OPC rely on the statement in section 18(e)(1) that "nothing in this section is intended to change the burden of proof of the local exchange company under Sections 38, 39, 40, and 41...."

The policy underlying the earning sharing plan is to promote increased efficiency in SW Bell's operations. Faced with frozen rates, SW Bell may increase profits by making its operations more cost efficient. Section 39(b) of PURA authorizes the Commission to consider, among other factors, "the efficiency of the utility's operations" in setting a reasonable rate of return on invested capital. Section 18(a) authorizes the Commission to carry out the policies of protecting "the public interest in having adequate and efficient telecommunications service available to all citizens ... at just, fair, and reasonable rates" by nontraditional "regulatory rules, policies, and principles" as necessitated by the growing and increasingly competitive telecommunications industry. Additionally, PURA section 2 mandates a balancing of consumer and utility interests in setting rates.

We conclude that nothing in the plan or this proceeding has relieved SW Bell of its burden to show that the proposed rates are just and reasonable. The Commission found that SW Bell met that burden, and we will not substitute our judgment for that of the Commission.

OPC argues that the Commission improperly considered nonstatutory factors in adopting the earnings-sharing provisions. OPC contends that the Commission improperly considered factors set out in its findings of fact 147 and 150 in adopting the earnings sharing plan.[7] OPC contends that

7. These findings of fact state:
147. The earnings thresholds set forth in the Stipulation are reasonable because they were negotiated by parties having opposing interests, because they are comparable to the thresholds in similar plans adopted by other

consideration of these factors violated PURA section 39(b). Section 39(b) sets out factors for the Commission to consider in setting a reasonable return on invested capital.[8] However, this section does not purport to set out exclusive factors for ratemaking consideration. Section 39(b) only lists factors to be considered "in addition to other applicable factors." The Commission made several other findings of fact indicating consideration of operational efficiency. The Commission found that the earning-sharing provisions would promote greater efficiency by SW Bell. We believe that the Commission properly considered these factors.

[13] The Cities and OPC argue that the Commission failed to "fix" a rate of return as PURA section 39(a) requires. By providing for a range in the earnings sharing plan, the Cities contend that the Commission failed to fix the reasonable rate of return at an exact point. We do not believe that section 39(a) requires the Commission to fix an exact rate of return. Section 39(a) requires that the Commission fix overall revenues at a level that will permit the utility a reasonable opportunity to earn a reasonable return.[9] The Commission met this requirement by finding that SW Bell's rate of return on investment was either 10.86 or 11.20 percent under the two calculation methods, numbers within both the range of evidence and the range of return on investment the Commission found reasonable. *See Public Util. Comm'n v. GTE-SW*, 833 S.W.2d 153, 159 (Tex.App.—Austin 1992, writ denied). That the Commission also made provision for sharing of prospective excess profits does not make this determination invalid. We conclude that the Commission has satisfied the requirements of section 39(a).

The Cities contend that the Commission authorized unlawful retroactive ratemaking by providing for consumer refunds of excess profits. The Cities failed to preserve this error in its motion for rehearing before the Commission. *See* APTRA § 16(e); *United Sav. Ass'n v. Vandygriff*, 594 S.W.2d 163, 168-70 (Tex.Civ.App.—Austin 1980, writ ref'd n.r.e.).

[14] The Cities contend that the Commission unlawfully fixed rates for four years. The stipulation provides that SW Bell could not raise rates on certain basic services for four years and could not bring a major rate case unless its rate of return on investment fell below 10.49 percent for a full year. This provision is an integral part of the earnings sharing plan in that it provides the necessary protection for consumers and fixes a significant portion of SW Bell's revenues so as to provide an incentive for long-term increases in operational efficiency. The Cities argue that the stipulation also limits the Commission's power to inquire into unreasonable rates pursuant to PURA section 42. In making this argument, the Cities refer to paragraph 27 of the stipulation which provides "[i]f both unforeseen and unusual events act to cause the Stipulation and Agreement to function in a manner which is contrary to the public interest, the [Commission] or the parties may seek modification to the

jurisdictions, and because they are well within the range of actual earnings of similar businesses.

150. What might not be reasonable in the context of a traditional rate case resulting in the prescription of a new, fixed rate schedule may well be reasonable under a sharing formula whereby basis [sic] rates are frozen, any improvement in earnings must be the product of improved efficiency and any gains beyond specified levels must be shared with customers, thereby resulting in lower overall rates.

8. Section 39(b) provides: "In fixing a reasonable return on invested capital, the regulatory authority shall consider, in addition to other applicable factors, efforts to comply with the statewide energy plan, the efforts and achievements of such utility in the conservation of resources, the quality of the utility's services, the efficiency of the utility's operations, and the quality of the utility's management." Tex.Rev.Civ.Stat.Ann. art. 1446c, § 39(b) (West Supp.1993).

9. Section 39(a) provides: "In fixing the rates of a public utility the regulatory authority shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses." Tex.Rev.Civ.Stat.Ann. art. 1446c, § 39(a) (West Supp.1993).

Stipulation and Agreement or may initiate a general inquiry into the reasonableness of [SW Bell's] rates or earnings." [10] Paragraph 27 further states that the stipulation "will not be modified absent notice, hearing, and a Commission determination that such modification is in the public interest." The Cities contend that the language "unforeseen and unusual acts" creates an unlawful threshold to initiation of a section 42 action. We do not read such a requirement into the provision. Paragraph 27 operates only as an affirmation of the Commission's authority. The Commission retains full authority to initiate an inquiry into SW Bell's rates at any time. Additionally, the Cities, OPC, or any other nonsignatory to the stipulation could bring a PURA section 42 complaint at any time.

The Cities contend that the Commission improperly substituted monitoring for regulation and that this allows SW Bell to recover automatically any cost changes during the term of the stipulation.[11] This argument ignores the situation in the immediate case and in rate cases in general. In this case, as in ordinary rate cases, rates are fixed until the next rate case. The inquiry into reasonable operating costs is a "snapshot" inquiry based on the test year. It is not intended to account for future cost changes. Adjustment for these changes will be made in future rate cases. While SW Bell is free to incur any additional costs it chooses, it may not recover any of these additional costs through higher rates absent a proceeding under PURA section 43 and a Commission order. Additionally, as discussed above, the Commission retains full authority to initiate an inquiry into the reasonableness of SW Bell's rates pursuant to PURA section 42. We conclude that the monitoring provisions are in addition to, and do not infringe upon, the Commission's regulatory powers.

[15, 16] The Cities argue that the approval of SW Bell's application for nonmajor rate increases without a full rate-filing package is an improper advisory opinion by the Commission. However, the stipulation also authorizes the Commission to require a rate-filing package in any proceeding if good cause is shown. The distinction between "major" and "nonmajor" rate cases is supported by PURA section 43(b). We believe that the implementation of procedural provisions for nonmajor rate cases is within the Commission's discretion. Nothing in the stipulation or the Commission's order abrogates SW Bell's burden of proof in such cases or operates as a pre-approval of nonmajor rate changes. We conclude that this provision does not constitute an advisory opinion.

We believe that the earnings sharing plan the Commission approved falls within the type of innovative regulation section 18(a) authorizes and was based on consideration of proper factors. Given that we have concluded that the Commission properly considered the statutory factors, we see no conflict between the earnings sharing plan and traditional ratemaking. Additionally, we conclude that substantial evidence exists in the record to support each of the individual elements of the plan. We overrule the Cities' fourth point of error and OPC's fifth, sixth, and seventh points of error.

Federal Income Tax Expense

The Cities' second point of error and OPC's third point of error complain of the Commission's inclusion of a hypothetical federal income tax expense in SW Bell's cost of service. The Cities and OPC argue that this tax expense did not reflect the actual tax paid by SW Bell in that it failed to account for tax savings resulting from (1) the consolidated tax return Southwestern Bell Corporation ("SBC") filed on behalf of SW Bell and other subsidiaries and (2) deductions actually taken for expenses the Commission disallowed for ratemaking

10. This language of paragraph 27 is essentially duplicated in Commission finding of fact number 30(y).

11. During the term of the stipulation, SW Bell is required to file monthly, quarterly, semiannual, and annual reports with the Commission and OPC. These reports are used to monitor SW Bell's performance and to determine whether earnings sharing is required.

purposes. The Cities also argue that the Commission erred in assuming that the stipulated income tax expense implicitly accounted for SW Bell's tax expense savings resultng from the Tax Reform Act of 1986.

[17] The standard for the inclusion of a utility's income tax expense in cost of service is whether the utility actually incurred the expense, *i.e.*, the amount of taxes actually paid. *Public Util. Comm'n v. Houston Lighting & Power Co.*, 748 S.W.2d 439, 442 (Tex.1987); *GTE-SW*, 833 S.W.2d at 163.

SBC is the parent company of SW Bell. SBC files a consolidated income tax return for its subsidiary companies, not all of which are regulated utilities. If some of the unregulated utilities post a net loss, then the total SBC tax bill is reduced. In *GTE-SW* we held that, under PURA section 41(c)(2), the Commission must compute the utility's tax savings under a consolidated tax return to determine if a savings would result and, if so, calculate the utility's "fair share" of the savings. *GTE-SW*, 833 S.W.2d at 163. The utility's share of the savings must be passed on to the ratepayers in lower rates. *Id.* at 165.

[18] To support a conclusion, as the Commission made in this case, that no adjustment to income tax expense is necessary under PURA section 41(c)(2), the Commission is required to find either (1) that it was not advantageous for the utility to consolidate returns, or (2) that the Commission has computed taxes as though a consolidated return were filed and the utility had received its fair share of the savings from the consolidated return. *GTE-SW*, 833 S.W.2d at 168. In *GTE-SW* we held that the general finding that "no adjustment for a consolidated tax return was necessary," was insufficient. However, in the immediate case, the Commission went beyond such a general finding. The Commission made specific underlying fact find ings that SBC actually filed a consolidate return and that SW Bell had received it fair share of the resulting tax savings pur suant to the tax allocation agreemen among the SBC subsidiaries. This indi cates that the Commission reviewed th consolidated return, SW Bell's tax expense and the tax allocation agreement and foun that SW Bell received its "fair share" o any tax savings. We find substantial evi dence in the record to support this finding These determinations essentially satisf the *GTE-SW* test, and in any event, w should not be "hypertechnical" in requirin a precise form of findings of underlyin fact. *Allied Bank Marble Falls v. Stat Banking Bd.*, 748 S.W.2d 447, 448-49 (Te 1988). In *GTE-SW* we held that sectio 41(c)(2) required that the Commission in pute to the utility its "fair share" of an tax savings resulting from a consolidate return. "Fair share" is not defined b PURA. Therefore we must conclude th the legislature left this determination t the discretion of the Commission. Th Commission may determine that the uti ty's "fair share" is zero, as it did in th proceeding, that the utility is entitled to a tax savings, or any allocation betwee these extremes.[12] We do not construe se tion 41(c)(2) to require any set allocation (these tax savings. If the Commission determination is supported by substanti evidence, there is no error. Therefore, th Commission could reasonably conclude th no adjustment to SW Bell's income t expense was necessary to account for th consolidated return.

The Texas Supreme Court has held th when a utility claims income tax deductior for all expenses it has incurred, includi expenses disallowed for ratemaking p poses, the resulting tax savings should i ure to the benefit of ratepayers. *Houst Lighting & Power*, 748 S.W.2d at 442. *GTE-SW* we rejected an argument th

12. We contrast consolidated return tax savings under section 41(c)(2) with tax savings for disallowed expenses under section 41(c)(3). Tax savings resulting from the utility's disallowed expenses directly apply to the utility's tax bill. Tax savings resulting from a consolidated return attributable to losses posted by unregulat entities, however, require a Commission det mination of the connection of the unregulat entity to the utility and an allocation of the t savings based on this connection.

consideration of the savings resulting from deductions disallowed for ratemaking purposes would violate section 41(c)(3). *GTE-SW*, 833 S.W.2d at 169. We concluded that section 41(c)(3) forbids only the passing along disallowed *expenses* to ratepayers, not passing through resulting tax *savings*, and that *Houston Lighting & Power* required that all tax savings go to ratepayers, pursuant to section 39 of PURA. *Id.*

[19] In the immediate case, the Commission found that an adjustment to income tax expenses for deductions relating to disallowed expenses would involve an impermissible consideration of expenses that are excluded from ratemaking as unreasonable or unlawful. This finding is virtually identical to the reasoning we rejected in *GTE-SW*. Under the "actual taxes paid" test, any utility tax savings must benefit ratepayers. Therefore, if SW Bell realized tax savings resulting from deductions, these savings must apply to reduce rates, even if the underlying deduction could not be included as expenses in SW Bell's cost of service.

The appellees have argued that, in the event the Commission erred in calculating income tax expenses, such error is harmless because the total "benefits" to consumers under the stipulation plan would far exceed any additional rate reductions necessary to correct the error.[13] Appellees contend that the language of APTRA section 19(e) that a cause may be reversed or remanded "if substantial rights of the appellant have been prejudiced" requires that appellants show that any error is not offset by the total benefits to ratepayers under the stipulation. We do not find this argument persuasive, as it presumes that the effect of any error in calculating cost of service can be weighed against the total benefits of the stipulation on an incremental basis. Although the Commission found that it would require at least an annual rate reductions of $418 million to exceed the stipulation benefits, we do not believe that consumer's rights may be prejudiced only if the Commission's error in applying the law causes a rate miscalculation in excess of this amount.

SW Bell and the Commission have stated that the effect of any error in the Commission's application of section 41(c)(3) is to overstate SW Bell's tax expense by approximately $3.23 million ($9.5 million in disallowed expenses multiplied by SW Bell marginal tax rate of 34%). In its motion for rehearing, SW Bell has urged that this error is harmless because its return on investment after adjustment for this error will remain within the range the Commission found reasonable. Whether the error causes the overall rates to be unreasonable is initially a question for the Commission. In any event, consumers are entitled to rates that reflect a proper application of the law. Accordingly, a remand to the Commission is proper to determine what, if any, further rate reductions are due consumers.

We overrule the Cities' second point of error and OPC's third point of error as to consolidated tax return savings, but we sustain these points of error as to tax savings resulting from deductions for disallowed expenses.

Affiliate Expenses

The Cities' fifth point of error and OPC's fourth point of error complain of the Commission's inclusion of expenses of SW Bell's transactions with its affiliated companies in its cost of service. Specifically, the Cities and OPC complain of the inclusion of the costs of SW Bell's transactions with SBC and Bell Communications Research, Inc. ("Bellcore"). SW Bell is a wholly-owned subsidiary of SBC, which provides certain centralized services to its subsidiaries. SW Bell is a co-owner with other SBC subsidiaries of Bellcore, which conducts research and development work for its owners and other affiliated companies. The Cities also complain that SW

13. SW Bell and the Commission have also urged this harmless-error/lack-of-substantial-prejudice argument as to each of the Commission's alleged errors in calculating the cost-of-service errors. Because we resolve these issues on other grounds, we do not reach this argument under the other points of error.

Bell has failed to prove the reasonableness and necessity of its yellow pages expenses.

[20, 21] As to SBC and Bellcore expenses, the Cities and OPC complain that the Commission failed to make underlying findings of fact to support its ultimate findings that the prices SW Bell paid were no greater than the prices charged to other affiliates. The Cities and OPC failed to urge this error in their motions for rehearing in the Commission; therefore, this complaint is waived. *See* APTRA § 16(e); *United Sav. Ass'n*, 594 S.W.2d at 168–70. The Cities also argue that the Commission should have gone further in setting out its rationale for rejecting the hearing examiner's recommendation for disallowance of a portion of the expenses.[14] We are aware of no requirement under PURA or APTRA for such findings of fact. The Commission is within its discretion to accept or reject recommendations of its hearing examiners.

[22] PURA section 41(c)(1) requires that payments to an affiliate be reasonable and necessary. In determining that the expenses of transactions with affiliated companies are reasonable and necessary, the Commission must make subsidiary findings that (1) each item or class of items is "reasonable and necessary" and (2) the price paid by the utility is no higher than the prices charged to other affiliates or unaffiliated persons. *GTE–SW*, 833 S.W.2d at 160. The Cities and OPC contend that the Commission failed to make these findings.

The Cities and OPC contend, as to the SBC expenses, that (1) the Commission failed to make a finding that the allocation of costs among SBC subsidiaries reflects the costs and the relative benefits to each subsidiary, (2) the Commission included in the SBC allocation expenses which could not be allowed for ratemaking, and (3) the Commission failed to make a finding that each item of SBC expenses is reasonable and necessary.

SBC expenses are allocated to affiliates by four methods: direct billing, employee-factor allocation, investment-factor allocation, and general-factor allocation. The Commission made a finding of fact that each of the allocation methods resulted in costs no higher than costs to other affiliates. The Commission also found that each of the methods produced "a reasonable result based on cost causation and benefit received" and that the services provided by SBC were charged to its subsidiaries at cost.

The Commission found that the SBC expenses had been adjusted by the removal of legislative advocacy, advertising, and membership expenses. The Commission found that the majority of services SBC provided were nondiscretionary and that economies of scale produced benefits by grouping these activities in a central entity. These findings could reasonably lead to the Commission's conclusion of law that SW Bell had met its burden of proof that its SBC expenses were reasonable and necessary. We conclude that, as to the SBC expenses, the Commission made all findings required by section 41(c)(1).

[23] As to Bellcore, the Cities and OPC argue that the Commission failed to make the required findings to support allowance of these expenses. The Commission made findings of fact that each of Bellcore's projects was "reasonable and necessary" and that charges to SW Bell were no higher than the charges to the other co-owners of Bellcore or unaffiliated third parties. We conclude that the Commission satisfied the requirements of section 41(c)(1). *See GTE–SW*, 833 S.W.2d at 160–61.

[24] Additionally, the Cities complain that SW Bell failed to prove the reasonableness and necessity of its yellow pages expenses. Pre-tax revenues of yellow pages affiliates are imputed to the regulated utility for ratemaking purposes. Generally, the Commission has required this adjustment to avoid the possibility of advertising profits being protected in an unregulated

14. The Cities also make this argument as to the hearing examiner's recommendation that yellow pages income imputed to SW Bell be increased.

subsidiary. The Cities allege that the amount of yellow pages income imputed to SW Bell should have been greater and that the Commission failed to comply with the findings requirement of PURA section 41(c)(1). By its terms, section 41(c)(1) applies only to transactions whereby the utility purchases "services, ... property, right or thing ..." from an affiliate. *See General Tel. Co. of the S.W. v. Public Util. Comm'n*, 628 S.W.2d 832, 840 (Tex.App.—Austin 1982, writ ref'd n.r.e.). While SW Bell does purchase other services from its yellow pages affiliate, Southwestern Bell Publications ("Yellow Pages"),[15] none of the services purchased are those complained of on appeal. SW Bell does not purchase any goods or services in connection with the publication of yellow pages directories. Therefore, the section 41(c)(1) requirements do not apply to the internal expenses of Yellow Pages. We conclude that it was not necessary for the Commission to make the findings of fact otherwise required by section 41(c)(1) as to the imputation of Yellow Pages revenue to SW Bell.

[25] The Cities also argue that SW Bell failed to present sufficient evidence to support a finding on the reasonableness of Yellow Pages expenses. The record reflects substantial evidence that Yellow Pages expenses were reasonable and necessary. We will not substitute our judgment on this evidence for that of the Commission. For the above reasons, we overrule the Cities' fifth point of error and OPC's fourth point of error.

McKinney Extended Metropolitan Service

McKinney complains by five separate points of error of the provisions of the Commission's order setting SW Bell rates applicable to McKinney residents for extended metropolitan service ("EMS"). EMS is an optional service whereby customers in outlying exchanges surrounding a large metropolitan area may pay a fixed rate for what would otherwise be long-distance calls within that metropolitan area.[16] McKinney complains of the failure of the Commission to state underlying findings of fact and the sufficiency of the evidence to support the Commission's findings (1) that existing SW Bell EMS rates were just and reasonable and not discriminatory; (2) that the application of the existing SW Bell EMS rates to McKinney and other exchanges was just and reasonable; (3) that the EMS rates set out in the stipulation were not unreasonably discriminatory; and (4) that identical EMS rates should be set for companies other than SW Bell.[17] McKinney also complains of the sufficiency of the evidence to support the Commission's rate group reclassification of the McKinney exchange. Each of McKinney's complaints attack the rate-design portion of the Commission's decision.

15. SW Bell contracted with its yellow pages affiliate for the production, publication, and delivery of its white pages directories during the 1988 test year. SW Bell also contracted with Yellow Pages for the sale of white pages bold listings for the 1988 test year. Appellants have not complained of the inclusion of these expenses in cost of service.

16. This service is similar to Extended Area Service ("EAS") under 16 Tex.Admin.Code § 23.49 (1992).

17. The Commission's conclusions of law on rate design and EMS issues include the following:

44. The rate design and rates resulting from the Stipulation do not grant an unreasonable preference or advantage, or establish unreasonable differences as to rates or service between localities or between classes of service.

45. The rates resulting from the Stipulation are just and reasonable and not unreasonably discriminatory, and are in the public interest.

. .

64. [SW Bell's] current EMS rates are just and reasonable and are not discriminatory.

65. The application of the current EMS rates to the 22 [SW Bell] exchanges to receive EMS pursuant to the Stipulation is just and reasonable.

66. The approval of the EMS provisions of the Stipulation is in the public interest.

67. The differential between the Tier I and Tier II EMS rates is reasonable and not unreasonably discriminatory.

68. As shown in Finding of Fact Nos. 410–437, making EMS service available on an optional basis to customers in the ten independent company exchanges surrounding the [SW Bell] metro exchanges is reasonable and in the public interest.

[26, 27] In its first two points of error, McKinney argues that the Commission failed to make underlying findings of fact to support its conclusions that SW Bell's existing EMS rates were just, reasonable, and not discriminatory, and that it was just and reasonable to apply these rates to twenty-two additional exchanges, including McKinney, as set out in the stipulation. When an ultimate finding of fact is set forth in statutory language, it must be accompanied by a statement of underlying facts. APTRA § 16(b); *Texas Health Facilities Comm'n v. Charter Medical-Dallas, Inc.*, 665 S.W.2d 446, 452 (Tex.1984). Assuming, without deciding, that the findings McKinney complains of are ultimate findings of fact, we conclude that the Commission made adequate underlying findings. In *Charter Medical-Dallas*, the Texas Supreme Court set out the criteria to examine findings of underlying fact:

1. the findings must be clear, specific, non-conclusory, and supportive of the findings of ultimate facts on the statutory criteria;
2. mere recitals of testimony or references to or summations of the evidence are improper;
3. the findings must be stated as the agency's findings; and
4. the findings must relate to material basic facts and relate to the findings of ultimate fact that they accompany.

Charter Medical-Dallas, 665 S.W.2d at 451–52. However, in applying these standards we should not be "hypertechnical" in requiring a precise form of findings of underlying fact. *Allied Bank Marble Falls*, 748 S.W.2d at 448–49. To support its conclusions of law on the EMS rate design, the Commission made numerous findings of underlying fact including the following:

231. The rate design objectives of promoting universal service, encouraging further development of the Information Age in Texas and promoting equal opportunities for competitors were utilized by the Staff in evaluating the Stipulation rate design.

....

234. The Commission Staff has thoroughly reviewed the rate design proposals contained in the Stipulation in light of the major policy provisions of PURA and the rate design goals of the Staff.

....

412. There is a strong demand for expanding calling scopes as evidenced by the numerous requests pending before the Commission for Extended Area Service (EAS).

413. The EMS provisions of the Stipulation allow the Commission to address a number of EAS issues and significantly reduce the backlog of EAS requests pending before the Commission.

414. The expansion of optional, two-way, flat rate calling in the metropolitan areas will promote both the economic and social interests of the communities.

415. The Stipulation will provide EMS to the following 22 [SW Bell] exchanges ... *Tier II* ... McKinney....

....

418. The rates for the 22 [SW Bell] exchanges receiving EMS pursuant to the Stipulation will be identical to the rates for the 19 [SW Bell] exchanges that are currently receiving EMS. These rates are as follows:....

419. Establishing rates at such levels will promote rate uniformity for customers in similarly situated exchanges.

420. Tier I exchanges are contiguous to a Metropolitan calling area while Tier II are not. There is a proportionate relationship between the distances of the Tier I and Tier II exchanges to their respective metropolitan exchange and the EMS rate levels for the Tier I and Tier II exchanges.

421. There is insufficient evidence in the record to permit the Commission to set exchange-specific or metropolitan-specific rates in accordance with Section 23.49 of the Substantive Rules for the 22 [SW Bell] exchanges that will receive EMS pursuant to the Stipulation, or for the 19 [SW Bell] exchanges that presently have EMS.

The Commission enjoys broad discretion in determining whether a rate design results in just, reasonable, nondiscriminatory rates. *City of El Paso*, 839 S.W.2d at 932. As stated in *Texas Alarm & Signal*:

> In general, § 38 requires rate structures to be just, reasonable, and not unreasonably discriminatory. This broad standard allows the Public Utility Commission discretion to determine the method of rate design. It also gives the Commission the discretion to consider factors other than cost and adjusted values of property. Rate design is a complex matter that involves many factors.

603 S.W.2d at 772. Absent a showing that the complained-of rates are unreasonably discriminatory, we will not overturn the Commission's approval of a rate design. *Public Util. Comm'n v. AT & T Communications of the S.W.*, 777 S.W.2d 363 (Tex. 1989); *City of El Paso*, 939 S.W.2d at 932. McKinney argues that the Commission improperly failed to consider cost factors in setting EMS rates, as allegedly required by the policy set out in Rule 23.49. *See* 16 Tex.Admin.Code § 23.49 (1992). The Texas Supreme Court has rejected the argument that rate design and individual rates must be based on cost analysis. *Texas Alarm & Signal*, 603 S.W.2d at 772; *see also City of El Paso*, 839 S.W.2d at 933–34. In making a determination of rate design, "the Commission may consider factors in addition to the cost of providing service, keeping in mind the overriding considerations of consistency and the utility's burden of proving that its proposed rates are just and reasonable." *City of El Paso*, 839 S.W.2d at 932. We conclude that, empowered with this broad discretion, the Commission could properly base its rate-design decision on the factors set out in its findings of fact. Additionally, the enumerated findings of fact reasonably support the Commission's conclusions in setting EMS rates applicable to McKinney and otherwise satisfy the *Charter Medical-Dallas* criteria.

[28] McKinney also complains of the sufficiency of the evidence to support these findings. Under the substantial-evidence test set out above, we conclude that, based on the evidence in the record, the Commission could reasonably have found that existing EMS rates were just, reasonable, and not unduly discriminatory, and that application of the existing rates to McKinney was just and reasonable. We overrule McKinney's first and second points of error.

[29] McKinney's third point of error complains that there were no underlying findings of fact and insufficient evidence to support the placement of the McKinney exchange in Tier II for EMS rate purposes. McKinney argues that the only evidence in the record supports placing it in Tier I. The criteria used in placing exchanges in Tiers I or II was contiguity with a metro exchange. By placing McKinney in Tier II, the Commission impliedly found it was not contiguous to a metro exchange. The record shows a factual dispute whether McKinney meets the criteria for a Tier I exchange. This issue was resolve by the Commission. McKinney also complains that the Commission's finding that the differential between Tier I and Tier II rates was reasonable and not unreasonably discriminatory is not supported by substantial evidence. We note that "[e]xisting classification schemes previously approved by the Commission are, prima facie, not unreasonably discriminatory, and the complaining party has the burden of proving that the classification produces unreasonably discriminatory rates." *City of El Paso*, 839 S.W.2d at 932–33. We find substantial evidence in the record to support the conclusion that the Tier I–Tier II differential is reasonable and not discriminatory. We overrule McKinney's third point of error.

[30] In its fourth point of error, McKinney complains of the sufficiency of the evidence to support the rate group reclassification of the McKinney exchange. The exchange rate group classification determines local exchange rates and is based upon the number of subscribers within the local exchange. The Commission found that the "rate group reclassifications proposed in this Stipulation are supported by the evidence and are reasonable." We conclude that substantial evidence exists in the record to support this finding. Accordingly, we overrule McKinney's fourth point of error.

[31] In its fifth point of error, McKinney complains that the Commission's approval of EMS rates for four local telephone companies [14] other than SW Bell was not supported by underlying findings of fact and substantial evidence. We conclude that the Commission made underlying findings of fact that satisfy the *Charter Medical-Dallas* criteria and that substantial evidence exists in the record to support the application of the SW Bell EMS rates to other companies. We overrule McKinney's fifth point of error.

CONCLUSION

We overrule the appellants' points of error with the sole exception of the complaint that the Commission did not correctly apply the law as to income-tax savings resulting from expenses disallowed for ratemaking purposes, which we sustain. We therefore reverse the district court's judgment and we remand the cause to the district court with instructions that the cause be remanded to the Commission for further proceedings consistent with our opinion.

KEY NUMBER SYSTEM

AMARILLO INDEPENDENT SCHOOL DISTRICT,

v.

Lionel R. MENO, the State Commissioner of Education in His Official Capacity, and the Texas Education Agency, et al.

No. 3-92-435-CV.

Court of Appeals of Texas, Austin.

May 12, 1993.

Rehearing Overruled July 7, 1993.

Teachers' contracts were not renewed by school district, and teachers appealed to the State Commissioner of Education. The Commissioner reversed, ordering that each teacher be reinstated, and school district appealed. The 200th District Court, Travis County, Paul R. Davis, J., affirmed the Commissioner's order, and school district appealed. The Court of Appeals, Powers, J., held that the Commissioner exceeded his statutory authority by engrafting on the Term Contract Nonrenewal Act the requirement that teachers' current year evaluations had to be considered before decision could be made whether to renew their contracts.

Commissioner's order reversed; remanded to trial court with directions.

1. Constitutional Law ⇐251.6

The qualification of meaningful notice is an essential aspect of due process of law. U.S.C.A. Const.Amend. 14.

2. Statutes ⇐206

Cardinal rule of statutory construction is to seek out legislative intent from general view of whole enactment; once that has been ascertained, meaning must be assigned accordingly to any questioned part of the statute.

3. Statutes ⇐188, 206

In process of seeking out legislative intent from general view of whole statutory enactment, words of the act must be given interpretation that is neither forced, nor strained, nor exaggerated.

4. Statutes ⇐188

Words of statutory enactment must be assigned meaning suggested affirmatively by statutory text and one that the text will fairly sanction and clearly sustain.

5. Statutes ⇐212.7

When assigning meaning suggested by statutory text, one may impute implication

14. GTE Southwest Inc., Lufkin-Conroe Telephone Exchange, Guadalupe Valley Telephone Cooperative, and Central Texas Telephone Co.

Quantification of Staff's Alleged Voucher Errors and Alleged Incorrect Charges

		Mo. Intrastate
1.	Ex. 29, Sch. 4-7. Re: Gulf. 807,863 - 759,280 = 45,583 45,583 x .1545 x .75[1] =	5,282
2.	Ex. 29P, Sch. 4-46. Re: Communitel. $6,351 x .1545 x .75 =	1,360
3.	Ex. 29, Sch. 4-47. Re: Group President. $1,579 x .1545 x .75 =	183
4.	Ex. 218HC, p. 33. Re: Strategic Business Development. $258,000 x .1545 x .75 =	33,024
5.	Ex. 218HC, p. 34. Re: Project Prizm. $73,500 x .1545 x .75 =	8,517
6.	Ex. 218HC, p. 35. Re: Clarion Consulting Fee. $13,675 x .1545 x .75 =	1,585
7.	Ex. 218HC, p. 35. Re: Ernst & Young Services. $19,915 x .1545 x .75 =	2,308
8.	Ex. 218HC, p. 37. Re: Philadelphia trip.[2] $1,125 x .1545 x .75 =	130
9.	Ex. 218HC, p. 42. Re: Metropolitan Publishing v. SWBT. 108,333 x .1545 x .75 =	12,553
10.	Ex. 218HC, p. 43. Re: Great Western, Metropolitan and Mesquite.[3] $720,366 x .1545 x .75 =	83,472
	Total	154,414

---

[1].1545 represents the Missouri total percentage and .75 represents the intrastate percentage.

[2]SWB concedes that this one voucher was coded in error, and would offer the explanation that it was a mistake made by a temporary employee.

[3]This quantification assumed 100% of the costs were allocated to SWBT when, in actuality, approximately 70% of SBC's total direct and allocated costs are charged to SWBT. Therefore, the quantification is overstated and represents the greatest amount that could have been assigned to SWBT-Mo. intrastate.