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# Niagara Mohawk Power Corporation

Financial Statements

For the years ended March 31, 2018, 2017, and 2016

**NIAGARA MOHAWK POWER CORPORATION**

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Niagara Mohawk Power
Corporation

We have audited the accompanying financial statements of Niagara Mohawk Power Corporation (the "Company"), which comprise the balance sheet and statement of capitalization as of March 31, 2018, and the related statements of income, comprehensive income, cash flows and changes in shareholders' equity for the year then ended, and the related notes to the financial statements.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditors' Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Niagara Mohawk Power Corporation as of March 31, 2018, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

**Predecessor Auditors' Opinion on 2017 and 2016 Financial Statements**

The financial statements of the Company as of and for each of the two years ended March 31, 2017, were audited by other auditors whose report, dated June 29, 2017, expressed an unmodified opinion on those statements.

Deloitte & Touche LLP

July 27, 2018

## NIAGARA MOHAWK POWER CORPORATION
## STATEMENTS OF INCOME
*(in thousands of dollars)*

| | Years Ended March 31, | | |
|---|---|---|---|
| | **2018** | 2017 | 2016 |
| **Operating revenues:** | | | |
| Electric services | **$ 2,452,486** | $ 2,336,955 | $ 2,371,789 |
| Gas distribution | **587,509** | 512,486 | 486,169 |
| Total operating revenues | **3,039,995** | 2,849,441 | 2,857,958 |
| **Operating expenses:** | | | |
| Purchased electricity | **729,002** | 678,500 | 671,304 |
| Purchased gas | **210,580** | 161,967 | 145,752 |
| Operations and maintenance | **1,078,544** | 1,044,431 | 1,112,644 |
| Depreciation | **256,995** | 253,819 | 243,631 |
| Other taxes | **276,089** | 263,347 | 253,292 |
| Total operating expenses | **2,551,210** | 2,402,064 | 2,426,623 |
| **Operating income** | **488,785** | 447,377 | 431,335 |
| **Other income and (deductions):** | | | |
| Interest on long-term debt | **(114,112)** | (106,833) | (105,095) |
| Other interest, including affiliate interest | **(39,756)** | (34,540) | (25,646) |
| Other income, net | **10,892** | 10,019 | 11,967 |
| Total other deductions, net | **(142,976)** | (131,354) | (118,774) |
| **Income before income taxes** | **345,809** | 316,023 | 312,561 |
| **Income tax expense** | **113,002** | 118,626 | 117,002 |
| **Net income** | **$ 232,807** | $ 197,397 | $ 195,559 |

The accompanying notes are an integral part of these financial statements.

**NIAGARA MOHAWK POWER CORPORATION**
**STATEMENTS OF COMPREHENSIVE INCOME**
*(in thousands of dollars)*

| | Years Ended March 31, | | |
|---|---|---|---|
| | **2018** | 2017 | 2016 |
| **Net income** | **$ 232,807** | $ 197,397 | $ 195,559 |
| **Other comprehensive income (loss), net of taxes:** | | | |
| Unrealized gains (losses) on securities | **283** | 549 | (984) |
| Change in pension and other postretirement obligations | **(3)** | 149 | 72 |
| **Total other comprehensive income (loss)** | **280** | 698 | (912) |
| **Comprehensive income** | **$ 233,087** | $ 198,095 | $ 194,647 |
| **Related tax (expense) benefit:** | | | |
| Unrealized (gains) losses on securities | **$ (260)** | $ (355) | $ 646 |
| Change in pension and other postretirement obligations | **(9)** | (96) | (47) |
| **Total tax (expense) benefit** | **$ (269)** | $ (451) | $ 599 |

The accompanying notes are an integral part of these financial statements.

## NIAGARA MOHAWK POWER CORPORATION
## STATEMENTS OF CASH FLOWS
*(in thousands of dollars)*

| | Years Ended March 31, | | |
|---|---|---|---|
| | **2018** | 2017 | 2016 |
| **Operating activities:** | | | |
| Net income | **$ 232,807** | $ 197,397 | $ 195,559 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | **256,995** | 253,819 | 243,631 |
| Regulatory amortizations | **23,949** | (2,578) | 7,102 |
| (Benefit from) provision for deferred income taxes | **(50,525)** | 13,843 | 92,670 |
| Bad debt expense | **36,221** | 49,290 | 41,260 |
| (Income) loss from equity investments, net of dividends received | **(7)** | 136 | (3) |
| Allowance for equity funds used during construction | **(12,483)** | (10,287) | (9,962) |
| Amortization of debt discount and issuance costs | **3,012** | 2,943 | 2,962 |
| Net postretirement benefits (contributions) expense | **(17,690)** | 2,133 | (1,468) |
| Net environmental remediation payments | **(10,238)** | (20,957) | (33,477) |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable, net, and unbilled revenues | **(79,111)** | (63,535) | 97,537 |
| Inventory | **(4,507)** | 13,523 | 167 |
| Regulatory assets and liabilities, net | **245,966** | 256,162 | 137,894 |
| Derivative instruments | **(5,905)** | (33,961) | 33,534 |
| Prepaid and accrued taxes | **119,583** | 68,818 | 14,210 |
| Other prepayments | **(31,202)** | 1,664 | 553 |
| Accounts payable and other liabilities | **41,944** | 114,834 | (80,893) |
| Renewable energy certificate obligations | **42,194** | - | - |
| Other, net | **(26,558)** | 1,154 | (14,467) |
| Net cash provided by operating activities | **764,445** | 844,398 | 726,809 |
| **Investing activities:** | | | |
| Capital expenditures | **(654,974)** | (566,575) | (572,187) |
| Proceeds from restricted cash and special deposits | **94,477** | 130,650 | 161,152 |
| Payments on restricted cash and special deposits | **(80,450)** | (125,734) | (187,327) |
| Intercompany money pool and affiliated receivables/payables, net | **477,833** | (221,935) | 5,185 |
| Cost of removal | **(46,914)** | (59,526) | (60,745) |
| Other | **(3,314)** | (1,080) | 488 |
| Net cash used in investing activities | **(213,342)** | (844,200) | (653,434) |
| **Financing activities:** | | | |
| Common stock dividends to Parent | **(550,000)** | - | - |
| Preferred stock dividends | **(1,060)** | (1,060) | (1,060) |
| Payments on long-term debt | - | - | (75,000) |
| Advance from affiliate | - | - | (25,000) |
| Parent tax loss allocation | - | - | 17,635 |
| Net cash used in financing activities | **(551,060)** | (1,060) | (83,425) |
| Net increase (decrease) in cash and cash equivalents | **43** | (862) | (10,050) |
| Cash and cash equivalents, beginning of year | **4,700** | 5,562 | 15,612 |
| Cash and cash equivalents, end of year | **$ 4,743** | $ 4,700 | $ 5,562 |
| **Supplemental disclosures:** | | | |
| Interest paid | **$ (103,148)** | $ (106,969) | $ (104,353) |
| Income taxes (paid) refunded | **(43,138)** | 1,457 | 110 |
| **Significant non-cash items:** | | | |
| Capital-related accruals | **21,067** | 27,845 | 21,447 |
| Parent tax loss allocation - previously reported in financing activities | **32,720** | - | - |
| Share based compensation | **20** | 304 | 240 |

The accompanying notes are an integral part of these financial statements.

**NIAGARA MOHAWK POWER CORPORATION**
**BALANCE SHEETS**
*(in thousands of dollars)*

| | March 31, | |
|---|---|---|
| | **2018** | 2017 |
| **ASSETS** | | |
| **Current assets:** | | |
| Cash and cash equivalents | **$ 4,743** | $ 4,700 |
| Restricted cash and special deposits | **21,548** | 35,575 |
| Accounts receivable | **596,645** | 571,977 |
| Allowance for doubtful accounts | **(150,189)** | (159,897) |
| Accounts receivable from affiliates | **14,953** | 20,573 |
| Intercompany money pool | **133,669** | 574,236 |
| Unbilled revenues | **109,565** | 101,051 |
| Inventory | **51,066** | 46,559 |
| Regulatory assets | **94,007** | 107,207 |
| Derivative instruments | **9,088** | 14,618 |
| Prepaid taxes | **19,747** | 18,173 |
| Other | **89,173** | 31,693 |
| Total current assets | **994,015** | 1,366,465 |
| **Equity investments** | **746** | 773 |
| **Property, plant and equipment, net** | **9,049,221** | 8,610,134 |
| **Other non-current assets:** | | |
| Regulatory assets | **611,414** | 929,912 |
| Goodwill | **1,289,132** | 1,289,132 |
| Derivative instruments | **1,585** | 1,533 |
| Postretirement benefits asset | **355,899** | 299,554 |
| Other | **71,231** | 68,330 |
| Total other non-current assets | **2,329,261** | 2,588,461 |
| **Total assets** | **$ 12,373,243** | $ 12,565,833 |

The accompanying notes are an integral part of these financial statements.

**NIAGARA MOHAWK POWER CORPORATION**
**BALANCE SHEETS**
*(in thousands of dollars)*

| | March 31, | |
|---|---|---|
| | **2018** | 2017 |
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current liabilities:** | | |
| Accounts payable | **$ 184,182** | $ 188,234 |
| Accounts payable to affiliates | **120,203** | 88,557 |
| Taxes accrued | **169,612** | 81,364 |
| Customer deposits | **31,630** | 30,333 |
| Interest accrued | **32,610** | 32,294 |
| Regulatory liabilities | **559,447** | 388,705 |
| Derivative instruments | **41,398** | 45,037 |
| Renewable energy certificate obligations | **42,194** | - |
| Other | **174,799** | 114,965 |
| Total current liabilities | **1,356,075** | 969,489 |
| **Other non-current liabilities:** | | |
| Regulatory liabilities | **1,790,227** | 982,282 |
| Asset retirement obligations | **14,546** | 15,187 |
| Deferred income tax liabilities, net | **928,484** | 1,889,991 |
| Postretirement benefits | **278,576** | 389,761 |
| Environmental remediation costs | **332,556** | 364,515 |
| Derivative instruments | **24,887** | 32,631 |
| Other | **403,844** | 394,584 |
| Total other non-current liabilities | **3,773,120** | 4,068,951 |
| **Commitments and contingencies (Note 13)** | | |
| **Capitalization:** | | |
| Shareholders' equity | **4,480,327** | 4,765,560 |
| Long-term debt | **2,763,721** | 2,761,833 |
| **Total capitalization** | **7,244,048** | 7,527,393 |
| **Total liabilities and capitalization** | **$ 12,373,243** | $ 12,565,833 |

The accompanying notes are an integral part of these financial statements.

**NIAGARA MOHAWK POWER CORPORATION**
**STATEMENTS OF CAPITALIZATION**
*(in thousands of dollars)*

| | | | March 31, | |
|---|---|---|---|---|
| | | | **2018** | 2017 |
| **Total shareholders' equity** | | | **$ 4,480,327** | $ 4,765,560 |
| **Long-term debt:** | Interest Rate | Maturity Date | | |
| *Unsecured notes:* | | | | |
| Senior Notes | 4.88% | August 15, 2019 | **750,000** | 750,000 |
| Senior Notes | 2.72% | November 28, 2022 | **300,000** | 300,000 |
| Senior Notes | 3.51% | October 1, 2024 | **500,000** | 500,000 |
| Senior Notes | 4.28% | October 1, 2034 | **400,000** | 400,000 |
| Senior Notes | 4.12% | November 28, 2042 | **400,000** | 400,000 |
| | | | **2,350,000** | 2,350,000 |
| *State Authority Financing Bonds:* | | | | |
| NYSERDA tax-exempt | Variable | December 1, 2023 - July 1, 2029 | **429,465** | 429,465 |
| | | | **429,465** | 429,465 |
| Total debt | | | **2,779,465** | 2,779,465 |
| Unamortized debt discount | | | **(7)** | (7) |
| Unamortized debt issuance costs | | | **(15,737)** | (17,625) |
| Long-term debt | | | **2,763,721** | 2,761,833 |
| **Total capitalization** | | | **$ 7,244,048** | $ 7,527,393 |

The accompanying notes are an integral part of these financial statements.

# NIAGARA MOHAWK POWER CORPORATION
## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
*(in thousands of dollars)*

| | | | | Accumulated Other Comprehensive Income (Loss) | | | | |
|---|---|---|---|---|---|---|---|---|
| | Common Stock | Cumulative Preferred Stock | Additional Paid-in Capital | Unrealized Gain (Loss) on Available-For-Sale Securities | Pension and Other Postretirement Benefits | Total Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
| **Balance as of March 31, 2015** | **$ 187,365** | **$ 28,985** | **$ 3,011,456** | **$ 2,655** | **$ (812)** | **$ 1,843** | **$ 1,127,110** | **$ 4,356,759** |
| Net income | - | - | - | - | - | - | 195,559 | 195,559 |
| Other comprehensive income (loss): | | | | | | | | |
| Unrealized losses on securities, net of $646 tax benefit | - | - | - | (984) | - | (984) | - | (984) |
| Change in pension and other postretirement obligations, net of $47 tax expense | - | - | - | - | 72 | 72 | - | 72 |
| Total comprehensive income | | | | | | | | 194,647 |
| Parent tax loss allocation | - | - | 17,635 | - | - | - | - | 17,635 |
| Share based compensation | - | - | 240 | - | - | - | - | 240 |
| Preferred stock dividends | - | - | - | - | - | - | (1,060) | (1,060) |
| **Balance as of March 31, 2016** | **$ 187,365** | **$ 28,985** | **$ 3,029,331** | **$ 1,671** | **$ (740)** | **$ 931** | **$ 1,321,609** | **$ 4,568,221** |
| Net income | - | - | - | - | | - | 197,397 | 197,397 |
| Other comprehensive income: | | | | | | | | |
| Unrealized gains on securities, net of $355 tax expense | - | - | - | 549 | - | 549 | - | 549 |
| Change in pension and other postretirement obligations, net of $96 tax expense | - | - | - | - | 149 | 149 | - | 149 |
| Total comprehensive income | | | | | | | | 198,095 |
| Share based compensation | - | - | 304 | - | - | - | - | 304 |
| Preferred stock dividends | - | - | - | - | - | - | (1,060) | (1,060) |
| **Balance as of March 31, 2017** | **$ 187,365** | **$ 28,985** | **$ 3,029,635** | **$ 2,220** | **$ (591)** | **1,629** | **$ 1,517,946** | **4,765,560** |
| Net income | - | - | - | - | | - | 232,807 | 232,807 |
| Other comprehensive income (loss): | | | | | | | | |
| Unrealized gains on securities, net of $260 tax expense | - | - | - | 283 | - | 283 | - | 283 |
| Change in pension and other postretirement obligations, net of $9 tax expense | - | - | - | - | (3) | (3) | - | (3) |
| Total comprehensive income | | | | | | | | 233,087 |
| Parent tax loss allocation | - | - | 32,720 | - | - | - | - | 32,720 |
| Share based compensation | - | - | 20 | - | - | - | - | 20 |
| Common stock dividends to Parent | - | - | - | - | - | - | (550,000) | (550,000) |
| Preferred stock dividends | - | - | - | - | - | - | (1,060) | (1,060) |
| **Balance as of March 31, 2018** | **$ 187,365** | **$ 28,985** | **$ 3,062,375** | **$ 2,503** | **$ (594)** | **$ 1,909** | **$ 1,199,693** | **$ 4,480,327** |

The Company had 187,364,863 shares of common stock authorized, issued and outstanding, with a par value of $1 per share and 289,848 shares of cumulative preferred stock authorized, issued and outstanding, with a par value of $100 per share at March 31, 2018 and 2017.

The accompanying notes are an integral part of these financial statements.

**NIAGARA MOHAWK POWER CORPORATION**
**NOTES TO THE FINANCIAL STATEMENTS**

## 1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Niagara Mohawk Power Corporation ("the Company"), a New York Corporation, is engaged principally in the regulated energy delivery business in New York State ("NYS"). The Company provides electric service to approximately 1.7 million customers in the areas of eastern, central, northern, and western New York and sells, distributes, and transports natural gas to approximately 0.6 million customers in the areas of central, northern, and eastern New York.

The Company is a wholly-owned subsidiary of Niagara Mohawk Holdings, Inc. ("NMHI"), which is a wholly-owned subsidiary of National Grid USA ("NGUSA" or the "Parent"), a public utility holding company with regulated subsidiaries engaged in the generation of electricity and the transmission, distribution, and sale of both natural gas and electricity. NGUSA is a direct wholly-owned subsidiary of National Grid North America Inc. ("NGNA") and an indirect wholly-owned subsidiary of National Grid plc, a public limited company incorporated under the laws of England and Wales.

The accompanying financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"), including the accounting principles for rate-regulated entities. The financial statements reflect the ratemaking practices of the applicable regulatory authorities.

The Company has evaluated subsequent events and transactions through July 27, 2018, the date of issuance of these financial statements, and concluded that there were no events or transactions that require adjustment to, or disclosure in, the financial statements as of and for the year ended March 31, 2018.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Use of Estimates

In preparing financial statements that conform to U.S. GAAP, the Company must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, and the disclosure of contingent assets and liabilities included in the financial statements. Actual results could differ from those estimates.

### Regulatory Accounting

The Federal Energy Regulatory Commission ("FERC") and the New York Public Service Commission ("NYPSC") regulate the rates the Company charges its customers. In certain cases, the rate actions of the FERC and NYPSC can result in accounting that differs from non-regulated companies. In these cases, the Company defers costs (as regulatory assets) or recognizes obligations (as regulatory liabilities) if it is probable that such amounts will be recovered from, or refunded to, customers through future rates. Regulatory assets and liabilities are reflected on the balance sheet consistent with the treatment of the related costs in the ratemaking process.

### Revenue Recognition

Revenues are recognized for energy service provided on a monthly billing cycle basis. The Company records unbilled revenues for the estimated amount of services rendered from the time meters were last read to the end of the accounting period.

As approved by the NYPSC, the Company is allowed to pass through commodity-related costs to customers and also bills for approved rate adjustment mechanisms. In addition, the Company has separate revenue decoupling mechanisms ("RDM") for gas and electric which allow for annual adjustments to the Company's delivery rates as a result of the reconciliation between allowed revenue and billed revenue. Any difference between the allowed revenue and the billed revenue is recorded as a regulatory asset or regulatory liability.

*Transmission Formula Rate*

The Company's wholesale transmission service charge ("TSC") rates are established based on a FERC-approved formula. The Company is required to make an informational filing annually to update certain components of the TSC formula rate. The revenue requirement component of the annual formula rate update is based on prior year actual costs and current year projected capital additions. The update also reconciles any differences between the revenue requirement in effect in the prior year and the actual revenue requirement for that year.

**Other Taxes**

The Company collects taxes and fees from customers such as sales taxes, other taxes, surcharges, and fees that are levied by state or local governments on the sale or distribution of gas and electricity. The Company accounts for taxes that are imposed on customers (such as sales taxes) on a net basis (excluded from revenues), while taxes imposed on the Company, such as excise taxes, are recognized on a gross basis. Excise taxes collected and paid for the years ended March 31, 2018, 2017, and 2016 were $37.7 million, $35.5 million, and $39.3 million, respectively.

The state of New York imposes on corporations a franchise tax that is computed as the higher of a tax based on income or a tax based on capital. To the extent the Company's state tax based on capital is in excess of the state tax based on income, the Company reports such excess in other taxes and taxes accrued in the accompanying financial statements.

The Company's policy is to accrue for property taxes on a calendar year basis, taking into account the assessment period. The Company had prepaid property taxes of $19.5 million and $18.1 million at March 31, 2018 and 2017, respectively.

**Income Taxes**

Federal and state income taxes have been computed utilizing the asset and liability approach that requires the recognition of deferred tax assets and liabilities for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. Deferred income taxes also reflect the tax effect of net operating losses, capital losses, and general business credit carryforwards. The Company assesses the available positive and negative evidence to estimate whether sufficient future taxable income of the appropriate tax character will be generated to realize the benefits of existing deferred tax assets. When the evaluation of the evidence indicates that the Company will not be able to realize the benefits of existing deferred tax assets, a valuation allowance is recorded to reduce existing deferred tax assets to the net realizable amount.

The effects of tax positions are recognized in the financial statements when it is more likely than not that the position taken, or expected to be taken, in a tax return will be sustained upon examination by taxing authorities based on the technical merits of the position. The financial effect of changes in tax laws or rates is accounted for in the period of enactment. Deferred investment tax credits are amortized over the useful life of the underlying property.

NGNA files consolidated federal tax returns including all of the activities of its subsidiaries. Each subsidiary determines its tax provision based on the separate return method, modified by a benefits-for-loss allocation pursuant to a tax sharing agreement between NGNA and its subsidiaries. The benefit of consolidated tax losses and credits are allocated to the NGNA subsidiaries giving rise to such benefits in determining each subsidiary's tax expense in the year that the loss or credit arises. In a year that a consolidated loss or credit carryforward is utilized, the tax benefit utilized in consolidation is paid proportionately to the subsidiaries that gave rise to the benefit regardless of whether that subsidiary would have utilized the benefit. The tax sharing agreement also requires NGNA to allocate its parent tax losses, excluding deductions from acquisition indebtedness, to each subsidiary in the consolidated federal tax return with taxable income. The allocation of NGNA's parent tax losses to its subsidiaries is accounted for as a capital contribution and is performed in conjunction with the annual intercompany cash settlement process following the filing of the federal tax return.

**Cash and Cash Equivalents**

Cash equivalents consist of short-term, highly liquid investments with original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value.

**Restricted Cash and Special Deposits**

Restricted cash consists of collateral paid to the Company's counterparties for outstanding derivative instruments. Special deposits primarily consist of a release of property account for mortgaged property under a mortgage trust indenture and a reserve for potential environmental violations. The Company had restricted cash of $9.8 million and $23.9 million and special deposits of $11.7 million at March 31, 2018 and 2017, respectively.

**Accounts Receivable and Allowance for Doubtful Accounts**

The Company recognizes an allowance for doubtful accounts to record accounts receivable at estimated net realizable value. The allowance is determined based on a variety of factors including, for each type of receivable, applying an estimated reserve percentage to each aging category, taking into account historical collection and write-off experience, and management's assessment of collectability from individual customers, as appropriate. The collectability of receivables is continuously assessed and, if circumstances change, the allowance is adjusted accordingly. Receivable balances are written off against the allowance for doubtful accounts when the accounts are disconnected and/or terminated and the balances are deemed to be uncollectible.

**Inventory**

Inventory is composed of materials and supplies as well as gas in storage. Materials and supplies are stated at weighted average cost, which represents net realizable value, and are expensed or capitalized as used. The Company's policy is to write-off obsolete inventory; there were no material write-offs of obsolete inventory for the years ended March 31, 2018, 2017, or 2016.

Gas in storage is stated at weighted average cost and the related cost is recognized when delivered to customers. Existing rate orders allow the Company to pass directly through to customers the cost of gas purchased, along with any applicable authorized delivery surcharge adjustments. Gas costs passed through to customers are subject to regulatory approvals and are audited annually by the NYPSC.

The Company had materials and supplies of $46.6 million and $43.9 million and gas in storage of $4.5 million and $2.7 million at March 31, 2018 and 2017, respectively.

**Derivative Instruments**

The Company uses various derivative instruments to manage commodity price risk. All derivative instruments, except those that qualify for the normal purchase normal sale exception, are recorded on the balance sheet at their fair value. All commodity costs, including the impact of derivative instruments, are passed on to customers through the Company's commodity rate adjustment mechanisms. Therefore, gains or losses on the settlement of these contracts are initially deferred and then refunded to, or collected from, customers consistent with regulatory requirements.

The Company has certain non-trading instruments for the physical purchase of electricity that qualify for the normal purchase normal sale exception and are accounted for upon settlement. If the Company were to determine that a contract no longer qualifies for the normal purchase normal sale exception, then the Company would recognize the fair value of the contract in accordance with the regulatory accounting described above.

The Company's accounting policy is to not offset fair value amounts recognized for derivative instruments and related cash collateral receivable or payable with the same counterparty under a master netting agreement, but rather to record and

present the fair value of the derivative instrument on a gross basis, with related cash collateral recorded within restricted cash and special deposits on the balance sheet.

**Power Purchase Agreements**

The Company enters into power purchase agreements to procure commodity to serve its electric service customers. The Company evaluates whether such agreements are leases, derivative instruments, or executory contracts. Power purchase agreements that do not qualify as leases or derivative instruments are accounted for as executory contracts and are, therefore, recognized as the electricity is purchased. In making its determination of the accounting for power purchase agreements, the Company considers many factors, including: the source of the electricity; the level of output from any specified facility that the Company is taking under the contract; the involvement, if any, that the Company has in operating the specified facility; and the pricing mechanisms in the contract.

**Natural Gas Long-Term Arrangements**

The Company enters into long-term gas contracts to procure commodity to serve its gas customers. Those contracts include Asset Management Agreements, Baseload, and Peaking gas contracts. Similar to the power purchase agreements noted above, the Company evaluates whether such agreements are derivative instruments or executory contracts and applies the appropriate accounting treatment.

**Fair Value Measurements**

The Company measures derivative instruments and available-for-sale securities at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The following is the fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value:

- Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities that a company has the ability to access as of the reporting date;
- Level 2: inputs other than quoted prices included within Level 1 that are directly observable for the asset or liability or indirectly observable through corroboration with observable market data;
- Level 3: unobservable inputs, such as internally-developed forward curves and pricing models for the asset or liability due to little or no market activity for the asset or liability with low correlation to observable market inputs; and
- Not categorized: certain investments are not categorized within the fair value hierarchy. These investments are measured based on the fair value of the underlying investments but may not be readily redeemable at that fair value.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. The Company uses valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

**Property, Plant and Equipment**

Property, plant and equipment is stated at original cost. The cost of repairs and maintenance is charged to expense and the cost of renewals and betterments that extend the useful life of property, plant and equipment is capitalized. The capitalized cost of additions to property, plant and equipment includes costs such as direct material, labor and benefits, and an allowance for funds used during construction ("AFUDC").

Depreciation is computed over the estimated useful life of the asset using the composite straight-line method. Depreciation studies are conducted periodically to update the composite rates and are approved by the NYPSC. The average composite rates for the years ended March 31, 2018, 2017, and 2016 are as follows:

| | Composite Rates | | |
|---|---|---|---|
| | Years Ended March 31, | | |
| | **2018** | 2017 | 2016 |
| Electric | **2.2%** | 2.3% | 2.2% |
| Gas | **2.1%** | 2.1% | 2.1% |
| Common | **3.2%** | 3.9% | 4.6% |

Depreciation expense includes a component for estimated future cost of removal, which is recovered through rates charged to customers. Any difference in cumulative costs recovered and costs incurred is recognized as a regulatory liability. When property, plant and equipment is retired, the original cost, less salvage, is charged to accumulated depreciation, and the related cost of removal is removed from the associated regulatory liability. The Company had cumulative costs recovered in excess of costs incurred of $304.4 million and $316.6 million at March 31, 2018 and 2017, respectively.

*Allowance for Funds Used During Construction*

The Company records AFUDC, which represents the debt and equity costs of financing the construction of new property, plant and equipment. AFUDC equity is reported in the accompanying statements of income as non-cash income in other income, net and AFUDC debt is reported as a non-cash offset to other interest, including affiliate interest. After construction is completed, the Company is permitted to recover these costs through their inclusion in rate base and corresponding depreciation expense. The Company recorded AFUDC related to equity of $12.5 million, $10.3 million, and $10.0 million and AFUDC related to debt of $4.3 million, $3.5 million, and $3.7 million for the years ended March 31, 2018, 2017, and 2016, respectively. The average AFUDC rates for the years ended March 31, 2018, 2017, and 2016 were 6.8%, 6.7%, and 6.5%, respectively.

*Impairment of Long-Lived Assets*

The Company tests the impairment of long-lived assets annually or when events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The recoverability of an asset is determined by comparing its carrying value to the future undiscounted cash flows that the asset is expected to generate. If the comparison indicates that the carrying value is not recoverable, an impairment loss is recognized for the excess of the carrying value over the estimated fair value. For the years ended March 31, 2018, 2017, and 2016, there were no impairment losses recognized for long-lived assets.

**Goodwill**

The Company tests goodwill for impairment annually on January 1, and when events occur or circumstances change that would more likely than not reduce the fair value of the Company below its carrying amount. The Company has early adopted ASU 2017-04, “Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment,” which eliminates step two from the two-step goodwill impairment test. The one-step approach requires a recoverability test performed based on the comparison of the Company’s estimated fair value with its carrying value, including goodwill. If the estimated fair value exceeds the carrying value, then goodwill is considered not impaired. If the carrying value exceeds the estimated fair value, the Company is required to recognize an impairment charge for such excess, limited to the allocated amount of goodwill.

Historically the fair value of the Company was calculated for the annual goodwill impairment test utilizing both the income and market based approaches. For the year ended March 31, 2018, the fair value of the Company was calculated utilizing solely the income approach. The Company believes that due to the recent rate order approved by the Company’s regulator this approach provides the most reliable information. See further details about the approved rate order in Note 4, “Rate

Matters." Based on the fair value resulting from the annual analyses performed, the Company determined that no adjustment to the goodwill carrying value was required at March 31, 2018 or 2017.

**Available-For-Sale Securities**

The Company provides certain executives with nonqualified retirement and deferred compensation benefits which have been partially secured through separate fund arrangements. As a result, the Company holds available-for-sale securities that include equities, municipal bonds, and corporate bonds. These investments are recorded at fair value and are included in other non-current assets on the balance sheet. Changes in the fair value of these assets are recorded within other comprehensive income.

**Asset Retirement Obligations**

Asset retirement obligations are recognized for legal obligations associated with the retirement of property, plant and equipment, primarily associated with the Company's distribution facilities. Asset retirement obligations are recorded at fair value in the period in which the obligation is incurred, if the fair value can be reasonably estimated. In the period in which new asset retirement obligations, or changes to the timing or amount of existing retirement obligations are recorded, the associated asset retirement costs are capitalized as part of the carrying amount of the related long-lived asset. In each subsequent period the asset retirement obligation is accreted to its present value. The Company applies regulatory accounting guidance and both the depreciation and accretion costs associated with asset retirement obligation are recorded as increases to regulatory assets on the balance sheet. These regulatory assets represent timing differences between the recognition of costs in accordance with U.S. GAAP and costs recovered through the ratemaking process.

The following table represents the changes in the Company's asset retirement obligations:

| | Years Ended March 31, | |
|---|---|---|
| | **2018** | 2017 |
| | *(in thousands of dollars)* | |
| Balance as of the beginning of the year | **$ 15,187** | $ 15,289 |
| Accretion expense | **621** | 619 |
| Liabilities settled | **(819)** | (721) |
| Balance as of the end of the year | **$ 14,989** | $ 15,187 |

The Company had a current portion of asset retirement obligations of $0.4 million included in other current liabilities on the balance sheet at March 31, 2018.

**Employee Benefits**

The Company has defined benefit pension plans and postretirement benefit other than pension ("PBOP") plans for its employees. The Company recognizes all pension and PBOP plans' funded status on the balance sheet as a net liability or asset with an offsetting adjustment to accumulated other comprehensive income ("AOCI") in shareholders' equity. The cost of providing these plans is recovered through rates; therefore, the net funded status is offset by a regulatory asset or liability. The Company measures and records its pension and PBOP funded status at the year-end date. Pension and PBOP plan assets are measured at fair value, using the year-end market value of those assets.

**Supplemental Executive Retirement Plans**

The Company has corporate assets included in other non-current assets on the balance sheet representing funds designated for Supplemental Executive Retirement Plans. These funds are invested in corporate owned life insurance policies and available-for-sale securities primarily consisting of equity investments and investments in municipal and corporate bonds. The corporate owned life insurance investments are measured at cash surrender value with increases and decreases in the value of these assets recorded in the accompanying statements of income.

**Going Concern**

Current U.S. GAAP guidance requires management to evaluate whether there is substantial doubt surrounding an entity's ability to continue as a going concern. If management concludes that substantial doubt exists additional disclosures relating to management's evaluation and conclusion are required. Management is not aware of any indicators giving rise to substantial doubt about the Company's ability to continue to operate and to meet its obligations as they become due.

**New and Recent Accounting Guidance**

**Accounting Guidance Recently Adopted**

*Measurement of Inventory*

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory." The new guidance requires that inventory be measured at the lower of cost and net realizable value (other than inventory measured using "last-in, first out" and the "retail inventory method"). The application of this guidance did not have a material impact on the results of operations, cash flows, or financial position of the Company since the Company's inventory was stated at cost upon adoption and the cost represents the net realizable value. The adoption of the guidance did not change the Company's methodology of measuring inventory.

*Employee Share-Based Payment Accounting*

In March 2016, the FASB issued ASU No. 2016-09, "Improvements to Employee Share-Based Payment Accounting (Topic 718)," which simplifies several aspects of the accounting for share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. Most notably, entities are required to recognize all excess tax benefits and shortfalls as income tax expense or benefit in the income statement within the reporting period in which they occur. The application of this guidance did not have a material impact on the results of operations, cash flows, or financial position of the Company.

*Goodwill*

In January 2017, the FASB issued ASU No. 2017-04, which eliminates Step 2 from the goodwill impairment test. For the Company, the requirements of the new standard will be effective for the fiscal year ended March 31, 2022, with early adoption permitted. The Company early adopted the ASU in the year ended March 31, 2018 for its annual goodwill impairment testing. Based on the resulting fair value from the annual analyses, the Company determined that no adjustment to the goodwill carrying value was required at March 31, 2018 or 2017.

*Derivatives and Hedging*

In March 2016, the FASB issued ASU No. 2016-05, "Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships." This update clarifies that a change in the counterparty to a derivative instrument that has been designated as a hedging instrument under Accounting Standards Codification ("ASC") 815, "Derivatives and Hedging," does not require dedesignation of that hedging relationship provided that all other hedge accounting criteria in accordance with ASC 815-20-35 through ASC 815-35-18 continue to be met. The application of this guidance did not have a material impact on the results of operations, cash flows, or financial position of the Company.

**Accounting Guidance Not Yet Adopted**

*Derivatives and Hedging*

In August 2017, the FASB issued ASU No. 2017-12, "Targeted Improvements to Accounting for Hedging Activities," which will be effective for the fiscal year ended March 31, 2020, with early adoption permitted. The amendments in this update expand and refine hedge accounting for both financial and nonfinancial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. This update also includes changes to certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. The Company is currently evaluating the impact of the new guidance on the results of its operations, cash flows, and financial position.

*Pension and Postretirement Benefits*

In March 2017, the FASB issued ASU No. 2017-07, "Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost," which changes certain presentation and disclosure requirements for employers that sponsor defined benefit pension and other postretirement benefit plans. The ASU requires the service cost component of the net benefit cost to be in the same line item as other compensation in operating income and the other components of net benefit cost to be presented outside of operating income on a retrospective basis. In addition, only the service cost component will be eligible for capitalization when applicable, on a prospective basis. For the Company, the requirements of the new standard will be effective for the fiscal year ended March 31, 2019, and interim periods within the reporting period, with early adoption permitted. The implementation of the ASU will not have a material impact on the net income of the Company since the Company defers the difference between actual pension costs and the amounts used to establish rates (See Note 7, "Employee Benefits" for additional details).

*Statement of Cash Flows*

In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)," which requires entities to show the changes in the total of cash, cash equivalents, restricted cash, and restricted cash equivalents in the statement of cash flows.

In August 2016, the FASB issued ASU No. 2016-15, "Classification of Certain Cash Receipts and Cash Payments (Topic 230)," which provides guidance about the classification of certain cash receipts and payments within the statement of cash flows, including debt prepayment or extinguishment costs, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims and policies, and distributions received from equity method investments.

For the Company, the requirements of the new standards will be effective for the fiscal year ended March 31, 2019, and interim periods therein, with early adoption permitted. The application of this guidance is not expected to have a material impact on the results of operations, cash flows, or financial position of the Company.

*Income Taxes*

In October 2016, the FASB issued ASU No. 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory," which eliminates the exception for all intra-entity sales of assets other than inventory. As a result, a reporting entity would recognize the tax expense from the sale of the asset in the seller's tax jurisdiction when the transfer occurs, even though the pre-tax effects of that transaction are eliminated in consolidation. For the Company, the requirements of the new standard will be effective for the fiscal year ended March 31, 2019, and interim periods thereafter, with early adoption permitted. The application of this guidance is not expected to have a material impact on the results of operations, cash flows, or financial position of the Company.

*Financial Instruments – Credit Losses*

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendment replaces the incurred loss impairment methodology in current U.S. GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. For the Company, the requirements of the new standard will be effective for the fiscal year ended March 31, 2022, and interim periods within, with early adoption permitted from the fiscal year ended March 31, 2020 and interim periods within. The Company is currently evaluating the impact of the new guidance on the presentation, results of its operations, cash flows, and financial position.

*Revenue Recognition*

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” The underlying principle of this ASU is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to, in exchange for those goods or services. For the Company, the new guidance is effective for the fiscal year ended March 31, 2019, including interim periods therein, and will be adopted using a modified retrospective approach.

The FASB has issued a number of additional recent ASUs related to revenue recognition, whose effective date and transition requirements are the same as those for ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” In March 2016, the FASB issued ASU No. 2016-08, “Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net),” which clarifies the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing," which provides guidance in the new revenue standard on identifying performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB issued ASU No. 2016-12, “Revenue from Contracts with Customers (ASC 606) Narrow-Scope Improvements and Practical Expedients,” providing additional clarity on various aspects of Topic 606, including a) Assessing the Collectability Criterion and Accounting for Contracts That Do Not Meet the Criteria for Step 1, b) Presentation of Sales Taxes and Other Similar Taxes Collected from Customers, c) Noncash Consideration, d) Contract Modifications at Transition, e) Completed Contracts at Transition, and f) Technical Correction. Lastly, in December 2016, the FASB issued ASU No. 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers." The amendments in this update cover a variety of corrections and improvements to the Codification related to the new revenue recognition standard (ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606)”).

The Company has undertaken detailed reviews of its revenue arrangements and is in the process of finalizing its assessment of the impact of the new standard. Based on work to date, the Company does not believe that the standard will have a material impact on the presentation of the results of its operations, cash flows, or financial position. However, the Company will be required to make significant additional qualitative and quantitative financial statement disclosures under ASC 606, “Revenue from Contracts with Customers,” pertaining to its revenue earning mechanisms.

*Leases*

In February 2016, the FASB issued a new lease accounting standard, ASU No. 2016-02, “Leases (Topic 842).” The key objective of the new standard is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Lessees will need to recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). For income statement purposes, a dual model has been retained, with leases to be designated as operating leases or finance leases. Expenses will be recognized on a straight-line basis for operating leases, and a front-loaded basis for finance leases. For the Company, the new standard is effective for the fiscal year ended March 31, 2020, and interim periods thereafter, with early adoption permitted. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. The Company is currently evaluating the impact of the new guidance on the results of its operations, cash flows, and financial position. The Company’s leases are discussed in Note 13, “Commitments and Contingencies” under “Operating Lease Obligations.”

*Financial Instruments – Classification and Measurement*

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities." The new guidance principally affects the accounting for equity investments and financial liabilities where the fair value option has been elected, as well as the disclosure requirements for financial instruments. For the Company, the new guidance is effective for the fiscal year ended March 31, 2019, and interim periods thereafter, with early adoption permitted for fiscal years or interim periods that have not yet been issued. The application of this guidance is not expected to have a material impact on the presentation, results of its operations, cash flows, and financial position.

*Stock Compensation*

In May 2017, the FASB issued ASU No. 2017-09, "Stock Compensation (Topic 718): Scope of Modification Accounting," which provides clarity on the application of modification accounting upon a change to the terms or conditions of a share-based payment award. For the Company, the requirements of the new standard will be effective for the fiscal year ended March 31, 2019, with early adoption permitted. The Company is currently evaluating the impact of the new guidance on the presentation, results of its operations, cash flows, and financial position.

**Reclassifications**

Certain reclassifications have been made to the financial statements to conform the prior period's balances to the current period's presentation. These reclassifications had no effect on reported income, total assets, stockholders' equity, or total operating, investing, or financing cash flows as previously reported.

## 3. REGULATORY ASSETS AND LIABILITIES

The Company records regulatory assets and liabilities that result from the ratemaking process. The following table presents the regulatory assets and regulatory liabilities recorded on the balance sheet:

| | March 31, | |
|---|---|---|
| | **2018** | 2017 |
| | *(in thousands of dollars)* | |
| **Regulatory assets** | | |
| Current: | | |
| Derivative instruments | **$ 55,612** | $ 61,518 |
| Gas costs adjustment | **20,408** | 12,594 |
| Rate adjustment mechanisms | **2,373** | 9,600 |
| Revenue decoupling mechanism | **15,229** | 23,495 |
| Other | **385** | - |
| Total | **94,007** | 107,207 |
| Non-current: | | |
| Dunkirk settlement deferral | **57,000** | 57,000 |
| Environmental response costs | **364,067** | 364,515 |
| Postretirement benefits | **117,462** | 255,442 |
| Regulatory tax asset, net | **-** | 93,793 |
| Storm costs | **-** | 106,925 |
| Other | **72,885** | 52,237 |
| Total | **611,414** | 929,912 |
| **Regulatory liabilities** | | |
| Current: | | |
| Energy efficiency | **407,582** | 270,001 |
| Gas costs adjustment | **3,858** | 8,700 |
| Rate adjustment mechanisms | **142,222** | 101,542 |
| Revenue decoupling mechanism | **2,564** | 1,147 |
| Other | **3,221** | 7,315 |
| Total | **559,447** | 388,705 |
| Non-current: | | |
| Carrying charges | **112,251** | 95,162 |
| Cost of removal | **304,440** | 316,583 |
| Economic development fund | **109,458** | 91,635 |
| Environmental response costs | **91,060** | 59,875 |
| Long-term debt true-up | **78,218** | 66,650 |
| Postretirement benefits | **78,003** | 64,641 |
| Regulatory tax liability, net | **806,078** | - |
| Storm costs | **58,637** | 148,389 |
| Other | **152,082** | 139,347 |
| Total | **1,790,227** | 982,282 |
| Net regulatory liabilities | **$ (1,644,253)** | $ (333,868) |

**Carrying charges:** The Company records carrying charges on regulatory balances for which cash expenditures have been made and are subject to recovery, or for which cash has been collected and is subject to refund. Carrying charges are not recorded on items for which expenditures have not yet been made.

**Cost of removal:** Represents cumulative amounts collected, but not yet spent, to dispose of property, plant and equipment. This liability is discharged as removal costs are incurred.

**Derivative instruments:** The Company evaluates open derivative instruments for regulatory deferral by determining if they are probable of recovery from, or refund to, customers through future rates. Derivative instruments that qualify for recovery are recorded at fair value, with changes in fair value recorded as regulatory assets or regulatory liabilities in the period in which the change occurs.

**Dunkirk settlement deferral:** The Company is allowed to defer up to $57 million to offset the Reliability Support Services ("RSS") associated with the Dunkirk generating plant and RSS agreements with other generators. This is an on-going deferral mechanism. The timing for disposition of any associated deferred balances will be determined by future NYPSC rulings.

**Economic development fund:** Represents a deferral mechanism for economic development discounts. Under this mechanism, the Company reconciles the economic discounts provided to customers to the amount reflected in rates for future refund to, or recovery from, customers. This is an on-going deferral mechanism. The timing for disposition of any associated deferred balances will be determined by future NYPSC rulings.

**Energy efficiency:** Represents the difference between revenue billed to customers through the Company's energy efficiency charge and the costs of the Company's energy efficiency programs as approved by the NYPSC.

**Environmental response costs:** The regulatory asset represents deferred costs associated with the Company's share of the estimated costs to investigate and perform certain remediation activities at sites with which it may be associated. The Company's rate plans provide for specific rate allowances for these costs at a level of $42 million per year, with variances deferred for future recovery from, or return to, customers. The Company believes future costs, beyond the expiration of current rate plans, will continue to be recovered through rates. The regulatory liability represents the excess of amounts received in rates over the Company's actual site investigation and remediation costs.

**Gas costs adjustment**: The Company is subject to rate adjustment mechanisms for commodity costs, whereby an asset or liability is recognized resulting from differences between actual revenues and the underlying cost being recovered or differences between actual revenues and targeted amounts as approved by the NYPSC. These amounts will be refunded to, or recovered from, customers over the next year.

**Long-term debt true-up:** The Company has a mechanism whereby it reconciles the actual interest expense and other debt costs related to its variable rate debt with the amount reflected in rates ($22 million for electric and $5.5 million for gas). The Company defers any over or under recoveries for future refund to, or recovery from, customers. This is an on-going deferral mechanism. The timing for disposition of any associated deferred balances will be determined by future NYPSC rulings.

**Postretirement benefits:** The regulatory asset represents the Company's deferral related to the underfunded status of its pension and PBOP plans. The regulatory liability primarily represents the excess of amounts received in rates over actual costs of the Company's pension and PBOP plans to be refunded in future periods.

**Rate adjustment mechanisms:** In addition to commodity costs, the Company is subject to a number of additional rate adjustment mechanisms whereby an asset or liability is recognized resulting from differences between actual revenues and the underlying cost being recovered or differences between actual revenues and targeted amounts as approved by the NYPSC.

**Regulatory tax asset/liability, net:** Represents over-recovered federal deferred taxes of the Company primarily as a result of regulatory flow through accounting treatment and excess federal deferred taxes as a result of the recently enacted Tax Cuts and Jobs Act ("Tax Act").

**Revenue decoupling mechanism**: As approved by the NYPSC, the Company has an electric RDM which allows for an annual adjustment to the Company's delivery rates as a result of the reconciliation between annual target revenue and actual billed delivery service revenue. Any difference between the annual target revenue and actual billed delivery service revenue is recorded as a regulatory asset or regulatory liability. The Company also has a gas RDM which allows for an annual adjustment to the Company's delivery rates as a result of the reconciliation between allowed revenue per customer and actual revenue per customer. Any difference between the allowed revenue per customer and the actual revenue per customer is recorded as a regulatory asset or regulatory liability.

**Storm costs:** The Joint Proposal (NMPC rate proceeding Case 12-E-0201) established an annual allowance for major storm recovery of $29 million in each of the three fiscal years ended March 31, 2016. The NYPSC allowed for the continuation of this allowance in Case 15-M-0744 for the two fiscal years ended March 31, 2018. The Company deferred the difference between the base rate allowance and actual major storm incremental costs for future refund to, or recovery from, customers. Under the new NMPC rate case (Case 17-E-0238), the annual allowance for major storm recovery will be $23 million for the three fiscal years ending March 31, 2021 and a per storm deferral threshold of $0.4 million was established. At March 31, 2017, the regulatory liability represents the cumulative storm reserve allowance/funding for major storm incremental costs and the regulatory asset represents the cumulative incremental costs incurred for qualified storm events. At March 31, 2018, these amounts have been reported net.

## 4. RATE MATTERS

### Electric and Gas Filing

On April 28, 2017, the Company filed a proposal to reset electric and natural gas delivery prices beginning in April 2018. On January 19, 2018, the Company reached a settlement agreement with the NYPSC Staff and other parties to the case and filed a Joint Proposal for a three-year rate plan. The proposal reflects the new federal tax law changes and provides a cumulative revenue requirement increase of $240.8 million and $60.8 million for the electric and gas business, respectively, based on a 9.0% return on equity and 48% common equity ratio. On March 15, 2018, the NYPSC issued a final order approving the Joint Proposal and the new rates took effect on April 1, 2018.

As of March 31, 2018, resulting from the Joint Proposal, a new electric rate plan settlement credit of $44.9 million and a new gas rate plan settlement credit of $28.4 million were established. These credits are included in other non-current regulatory liabilities in the preceding table within Note 3, “Regulatory Assets and Liabilities.” The Company applied $38.4 million of existing regulatory liabilities towards the creation of these credits.

### Tax Cuts and Jobs Act

In response to the Tax Act signed into law on December 22, 2017, the NYPSC issued an Order Instituting Proceeding under Case 17-M-0815 - Proceeding on Motion of the Commission on Changes in Law that May Affect Rates. This proceeding was instituted to solicit comments on the Tax Act’s implications and places the utilities on notice of the NYPSC’s intent to protect ratepayers’ interest and to ensure that any cost reductions from the changes in federal income taxes are deferred for future ratepayer benefit. On March 29, 2018, the NYPSC Staff released its proposal to address accounting and ratemaking related to the Tax Act. Comments on NYPSC Staff’s proposal were filed June 27, 2018.

On March 15, 2018 the FERC initiated multiple proceedings intended to adjust FERC-jurisdictional rates to reflect the corporate tax changes as a result of the passage of the Tax Act of 2017. Of the proceedings initiated relevant to the Company is the Notice of Inquiry (“NOI”) seeking comments on the effects of the Tax Act on all FERC-jurisdiction rates. This NOI will be used by the FERC to build a record on the tax issues affecting FERC-jurisdictional rates and will be used to determine whether additional action is needed.

**Operations Audit**

In August 2013, the NYPSC initiated an operational audit using a third party to review the accuracy of the customer service, electric reliability, and gas safety data reported by the investor owned utilities operating in New York, including the Company. On December 19, 2013, the NYPSC selected a third party to conduct the audit, which commenced in February 2014. On April 20, 2016, the NYPSC released the third party audit report publicly and adopted the majority of recommendations in the report. The audit report found that the Company, in general, is meeting its obligations to supply self-reported data. The report contains recommendations to improve internal controls and allow for greater consistency in reporting among the New York utilities. The recommendations do not affect current rate case performance targets or mechanisms and may be considered for potential implementation in future rate plans. The Company filed its plan to implement the audit recommendations with the NYPSC on May 19, 2016. On March 10, 2017, the NYPSC issued an Order approving the Company's implementation plan without modification, with quarterly updates to be made to the NYPSC on the status of implementation. On March 13, 2018, NYPSC Staff filed a letter indicating that the Company had implemented all recommendations and therefore the NYPSC was closing the audit.

**Operations Staffing Audit**

In January 2014, the NYPSC initiated an operational audit to review internal staffing levels and use of contractors for the core utility functions of the investor owned utilities operating in New York, including the Company. On June 26, 2014, the NYPSC selected a third party to conduct the audit. On February 21, 2017, the third party submitted its final report, which contained recommendations for all of National Grid's New York utilities designed to improve the staffing and workforce management processes. The report contained 26 recommendations for National Grid. The Company filed its implementation plan on March 23, 2017. On December 15, 2017, the NYPSC issued an Order approving the Company's implementation plan without modification, with quarterly updates to be made to the NYPSC on the status of implementation. The Company submitted its first update on April 16, 2018.

**New York Management Audit**

In 2018, the NYPSC will initiate a comprehensive management and operations audit of National Grid's three New York utilities. New York law requires periodic management audits of all utilities at least once every five years. National Grid last underwent a New York management audit in 2014/2015, when the NYPSC audited our New York gas business. The audit will be process oriented and forward looking, and presents opportunities to obtain feedback on how to improve service to customers and meet regulatory expectations. Areas of focus will likely include the traditional audit areas of corporate governance, budgeting and finance, customer, work management, and long-term planning, as well as organization design, information systems, and gas safety.

## 5. PROPERTY, PLANT AND EQUIPMENT

The following table summarizes property, plant and equipment at cost along with accumulated depreciation and amortization:

| | March 31, | |
|---|---|---|
| | **2018** | 2017 |
| | *(in thousands of dollars)* | |
| Plant and machinery | **$ 11,479,868** | $ 11,021,840 |
| Land and buildings | **623,054** | 589,774 |
| Assets in construction | **458,334** | 333,980 |
| Software and other intangibles | **7,895** | 6,888 |
| Total property, plant and equipment | **12,569,151** | 11,952,482 |
| Accumulated depreciation and amortization | **(3,519,930)** | (3,342,348) |
| Property, plant and equipment, net | **$ 9,049,221** | $ 8,610,134 |

## 6. DERIVATIVE INSTRUMENTS

The Company utilizes derivative instruments to manage commodity price risk associated with its natural gas and electricity purchases. The Company's commodity risk management strategy is to reduce fluctuations in firm gas and electricity sales prices to its customers.

The Company's financial exposures are monitored and managed as an integral part of the Company's overall financial risk management policy. The Company engages in risk management activities only in commodities and financial markets where it has an exposure, and only in terms and volumes consistent with its core business.

### Volumes

Volumes of outstanding commodity derivative instruments measured in dekatherms ("dths") and megawatt hours ("mwhs") are as follows:

| | Electric | | Gas | |
|---|---|---|---|---|
| | March 31, | | March 31, | |
| | **2018** | 2017 | **2018** | 2017 |
| | *(in thousands)* | | *(in thousands)* | |
| Gas option contracts (dths) | **-** | - | **1,360** | 1,850 |
| Gas purchase contracts (dths) | **-** | - | **5,403** | 4,226 |
| Gas swap contracts (dths) | **-** | - | **4,840** | 3,890 |
| Electric capacity (mwhs) | **550** | 651 | **-** | - |
| Electric option contracts (mwhs) | **151** | - | **-** | - |
| Electric swap contracts (mwhs) | **12,839** | 12,777 | **-** | - |
| Electric swaption contracts (mwhs) | **-** | 136 | **-** | - |
| Total | **13,540** | 13,564 | **11,603** | 9,966 |

**Amounts Recognized on the Balance Sheet**

| | Asset Derivatives | | | Liability Derivatives | |
|---|---|---|---|---|---|
| | March 31, | | | March 31, | |
| | **2018** | 2017 | | **2018** | 2017 |
| | *(in thousands of dollars)* | | | *(in thousands of dollars)* | |
| Current assets: | | | Current liabilities: | | |
| Rate recoverable contracts: | | | Rate recoverable contracts: | | |
| Gas option contracts | **$ -** | $ 25 | Gas option contracts | **$ 164** | $ 29 |
| Gas purchase contracts | **93** | 300 | Gas purchase contracts | **155** | - |
| Gas swap contracts | **32** | 846 | Gas swap contracts | **248** | - |
| Electric capacity contracts | **62** | 116 | Electric option contracts | **739** | - |
| Electric swap contracts | **8,901** | 13,331 | Electric swap contracts | **40,092** | 44,382 |
| Electric swaption contracts | **-** | - | Electric swaption contracts | **-** | 626 |
| | **9,088** | 14,618 | | **41,398** | 45,037 |
| Other non-current assets: | | | Other non-current liabilities: | | |
| Rate recoverable contracts: | | | Rate recoverable contracts: | | |
| Gas purchase contracts | **84** | 23 | Gas purchase contracts | **-** | - |
| Electric capacity contracts | **582** | 1,175 | Electric capacity contracts | **-** | - |
| Electric swap contracts | **919** | 335 | Electric swap contracts | **24,887** | 32,631 |
| | **1,585** | 1,533 | | **24,887** | 32,631 |
| Total | **$ 10,673** | $ 16,151 | | **$ 66,285** | $ 77,668 |

The changes in fair value of the Company’s rate recoverable contracts are offset by changes in regulatory assets and liabilities. As a result, the changes in fair value of those contracts had no impact in the accompanying statements of income. All of the Company’s derivative instruments are subject to rate recovery as of March 31, 2018 and 2017.

**Credit and Collateral**

The Company is exposed to credit risk related to transactions entered into for commodity price risk management. Credit risk represents the risk of loss due to counterparty non-performance. Credit risk is managed by assessing each counterparty’s credit profile and negotiating appropriate levels of collateral and credit support.

The credit policy for commodity transactions is managed and monitored by the Finance Committee to National Grid plc’s Board of Directors (“Finance Committee”), which is responsible for approving risk management policies and objectives for risk assessment, control and valuation, and the monitoring and reporting of risk exposures. NGUSA’s Energy Procurement Risk Management Committee (“EPRMC”) is responsible for approving transaction strategies, annual supply plans, and counterparty credit approval, as well as all valuation and control procedures. The EPRMC is chaired by the Vice President of U.S. Treasury and reports to both the NGUSA Board of Directors and the Finance Committee.

The EPRMC monitors counterparty credit exposure and appropriate measures are taken to bring such exposures below the limits, including, without limitation, netting agreements, and limitations on the type and tenor of trades. The Company enters into enabling agreements that allow for payment netting with its counterparties, which reduce its exposure to counterparty risk by providing for the offset of amounts payable to the counterparty against amounts receivable from the counterparty. In instances where a counterparty’s credit quality has declined, or credit exposure exceeds certain levels, the Company may limit its credit exposure by restricting new transactions with the counterparty, requiring additional collateral or credit support, and negotiating the early termination of certain agreements. Similarly, the Company may be required to post collateral to its counterparties.

The Company’s credit exposure for all commodity derivative instruments, normal purchase normal sale contracts, and applicable payables and receivables, net of collateral, and instruments that are subject to master netting agreements, was a liability of $45.8 million and $37.6 million as of March 31, 2018 and 2017, respectively.

The aggregate fair value of the Company's commodity derivative instruments with credit-risk-related contingent features that were in a liability position at March 31, 2018 and 2017 was $56.8 million and $64.5 million, respectively. The Company had $9.8 million and $23.9 million collateral posted for these instruments at March 31, 2018 and 2017, respectively. At March 31, 2018, if the Company's credit rating were to be downgraded by one, two, or three levels, it would be required to post additional collateral to its counterparties of $4.8 million, $14.2 million, or $47.6 million, respectively. At March 31, 2017, if the Company's credit rating had been downgraded by one, two, or three levels, it would have been required to post additional collateral to its counterparties of $2.9 million, $7.9 million, or $41.2 million, respectively.

**Offsetting Information for Derivative Instruments Subject to Master Netting Arrangements**

**March 31, 2018**
**Gross Amounts Not Offset in the Balance Sheets**
*(in thousands of dollars)*

| ASSETS: | Gross amounts of recognized assets *A* | Gross amounts offset in the Balance Sheets *B* | Net amounts of assets presented in the Balance Sheets *C=A+B* | Financial instruments *Da* | Cash collateral received *Db* | Net amount *E=C-D* |
|---|---|---|---|---|---|---|
| **Derivative instruments** | | | | | | |
| Gas purchase contracts | $ 177 | $ - | $ 177 | $ - | $ - | $ 177 |
| Gas swap contracts | 32 | - | 32 | - | - | 32 |
| Electric capacity contracts | 644 | - | 644 | - | - | 644 |
| Electric swap contracts | 9,820 | - | 9,820 | - | - | 9,820 |
| Total | $ 10,673 | $ - | $ 10,673 | $ - | $ - | $ 10,673 |

| LIABILITIES: | Gross amounts of recognized liabilities *A* | Gross amounts offset in the Balance Sheets *B* | Net amounts of liabilities presented in the Balance Sheets *C=A+B* | Financial instruments *Da* | Cash collateral paid *Db* | Net amount *E=C-D* |
|---|---|---|---|---|---|---|
| **Derivative instruments** | | | | | | |
| Gas option contracts | $ 164 | $ - | $ 164 | $ - | $ - | $ 164 |
| Gas purchase contracts | 155 | - | 155 | - | - | 155 |
| Gas swap contracts | 248 | - | 248 | - | - | 248 |
| Electric option contracts | 739 | - | 739 | - | - | 739 |
| Electric swap contracts | 64,979 | - | 64,979 | - | 9,800 | 55,179 |
| Total | $ 66,285 | $ - | $ 66,285 | $ - | $ 9,800 | $ 56,485 |

**March 31, 2017**
**Gross Amounts Not Offset in the Balance Sheets**
*(in thousands of dollars)*

| ASSETS: | Gross amounts of recognized assets<br>*A* | Gross amounts offset in the Balance Sheets<br>*B* | Net amounts of assets presented in the Balance Sheets<br>*C=A+B* | Financial instruments<br>*Da* | Cash collateral received<br>*Db* | Net amount<br>*E=C-D* |
|---|---|---|---|---|---|---|
| **Derivative instruments** | | | | | | |
| Gas option contracts | $ 25 | $ - | $ 25 | $ - | $ - | $ 25 |
| Gas purchase contracts | 323 | - | 323 | - | - | 323 |
| Gas swap contracts | 846 | - | 846 | - | - | 846 |
| Electric capacity contracts | 1,291 | - | 1,291 | - | - | 1,291 |
| Electric swap contracts | 13,666 | - | 13,666 | - | - | 13,666 |
| Total | $ 16,151 | $ - | $ 16,151 | $ - | $ - | $ 16,151 |

| LIABILITIES: | Gross amounts of recognized liabilities<br>*A* | Gross amounts offset in the Balance Sheets<br>*B* | Net amounts of liabilities presented in the Balance Sheets<br>*C=A+B* | Financial instruments<br>*Da* | Cash collateral paid<br>*Db* | Net amount<br>*E=C-D* |
|---|---|---|---|---|---|---|
| **Derivative instruments** | | | | | | |
| Gas option contracts | $ 29 | $ - | $ 29 | $ - | $ - | $ 29 |
| Electric swap contracts | 77,013 | - | 77,013 | - | - | 77,013 |
| Electric swaption contracts | 626 | - | 626 | - | 23,900 | (23,274) |
| Total | $ 77,668 | $ - | $ 77,668 | $ - | $ 23,900 | $ 53,768 |

## 7. FAIR VALUE MEASUREMENTS

The following tables present assets and liabilities measured and recorded at fair value on the balance sheet on a recurring basis and their level within the fair value hierarchy as of March 31, 2018 and 2017:

| | March 31, 2018 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | | (in thousands of dollars) | | |
| **Assets:** | | | | |
| Derivative instruments | | | | |
| Gas purchase contracts | $ - | $ - | $ 177 | $ 177 |
| Gas swap contracts | - | 32 | - | 32 |
| Electric capacity contracts | - | - | 644 | 644 |
| Electric swap contracts | - | 9,820 | - | 9,820 |
| Available-for-sale securities | 22,778 | 11,958 | - | 34,736 |
| Total | 22,778 | 21,810 | 821 | 45,409 |
| **Liabilities:** | | | | |
| Derivative instruments | | | | |
| Gas option contracts | - | - | 164 | 164 |
| Gas purchase contracts | - | 155 | - | 155 |
| Gas swap contracts | - | 248 | - | 248 |
| Electric option contracts | - | - | 739 | 739 |
| Electric swap contracts | - | 64,979 | - | 64,979 |
| Total | - | 65,382 | 903 | 66,285 |
| **Net assets (liabilities)** | $ 22,778 | $ (43,572) | $ (82) | $ (20,876) |

| | March 31, 2017 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | | (in thousands of dollars) | | |
| **Assets:** | | | | |
| Derivative instruments | | | | |
| Gas option contracts | $ - | $ - | $ 25 | $ 25 |
| Gas purchase contracts | - | 236 | 87 | 323 |
| Gas swap contracts | - | 846 | - | 846 |
| Electric capacity contracts | - | - | 1,291 | 1,291 |
| Electric swap contracts | - | 13,666 | - | 13,666 |
| Available-for-sale securities | 21,641 | 10,898 | - | 32,539 |
| Total | 21,641 | 25,646 | 1,403 | 48,690 |
| **Liabilities:** | | | | |
| Derivative instruments | | | | |
| Gas option contracts | - | - | 29 | 29 |
| Electric swap contracts | - | 77,013 | - | 77,013 |
| Electric swaption contracts | - | - | 626 | 626 |
| Total | - | 77,013 | 655 | 77,668 |
| **Net assets (liabilities)** | $ 21,641 | $ (51,367) | $ 748 | $ (28,978) |

**Derivative instruments***:* The Company's Level 2 fair value derivative instruments primarily consist of over-the-counter ("OTC") electric and gas swap contracts with pricing inputs obtained from the New York Mercantile Exchange and the Intercontinental Exchange ("ICE"), except in cases where the ICE publishes seasonal averages or where there were no transactions within the last seven days. The Company may utilize discounting based on quoted interest rate curves, including consideration of non-performance risk, and may include a liquidity reserve calculated based on bid/ask spread for

the Company's Level 2 derivative instruments. Substantially all of these price curves are observable in the marketplace throughout at least 95% of the remaining contractual quantity, or they could be constructed from market observable curves with correlation coefficients of 95% or higher.

The Company's Level 3 fair value derivative instruments consist of gas option and purchase, and electric option and capacity transactions, which are valued based on internally-developed models. Industry-standard valuation techniques, such as the Black-Scholes pricing model, Monte Carlo simulation, and Financial Engineering Associates libraries are used for valuing such instruments. A derivative is designated Level 3 when it is valued based on a forward curve that is internally developed, extrapolated, or derived from market observable curves with correlation coefficients less than 95%, where optionality is present, or if non-economic assumptions are made.

**Available-for-sale securities:** Available-for-sale securities are included in other non-current assets on the balance sheet and primarily include equity and debt investments based on quoted market prices (Level 1) and municipal and corporate bonds based on quoted prices of similar traded assets in open markets (Level 2).

**Changes in Level 3 Derivative Instruments**

| | Years Ended March 31, | |
|---|---|---|
| | **2018** | 2017 |
| | *(in thousands of dollars)* | |
| Balance as of the beginning of the year | **$ 748** | $ 1,496 |
| Net gains (losses) included in regulatory assets and liabilities | **2,870** | (344) |
| Settlements | **(3,700)** | (404) |
| Balance as of the end of the year | **$ (82)** | $ 748 |

A transfer into Level 3 represents existing assets or liabilities that were previously categorized at a higher level for which the inputs became unobservable during the year. A transfer out of Level 3 represents assets and liabilities that were previously classified as Level 3 for which the inputs became observable based on the criteria discussed previously for classification in Level 2. These transfers, which are recognized at the end of each period, result from changes in the observability of forward curves from the beginning to the end of each reporting period. There were no transfers between Level 1 and Level 2, and no transfers into or out of Level 3, during the years ended March 31, 2018, 2017, or 2016.

For valuations that include both observable and unobservable inputs, if the unobservable input is determined to be significant to the overall inputs, the entire valuation is categorized in Level 3. This includes derivative instruments valued using indicative price quotations whose contract tenure extends into unobservable periods. In instances where observable data is unavailable, consideration is given to the assumptions that market participants would use in valuing the asset or liability. This includes assumptions about market risks such as liquidity, volatility, and contract duration. Such instruments are categorized in Level 3 as the model inputs generally are not observable. The Company considers non-performance risk and liquidity risk in the valuation of derivative instruments categorized in Level 2 and Level 3.

**Quantitative Information About Level 3 Fair Value Measurements**

The following tables provide information about the Company's Level 3 valuations:

| Commodity | Level 3 Position | Fair Value as of March 31, 2018 | | | Valuation Technique(s) | Significant Unobservable Input | Range |
|---|---|---|---|---|---|---|---|
| | | Assets | (Liabilities) | Total | | | |
| | | | (in thousands of dollars) | | | | |
| Gas | Cross Commodity Contracts | $ 80 | $ - | $ 80 | Discounted Cash Flow | Forward Curve | $30.23 - $50.52/dth |
| Gas | Option contracts | - | (164) | $ (164) | Discounted Cash Flow | Forward Curve<br>Implied Volatility | $0.19 - $0.35/dth<br>22% - 28% |
| Gas | Purchase contracts | 97 | - | 97 | Discounted Cash Flow | Forward Curve | $5.43 - $9.93/dth |
| Electric | Capacity contracts | 644 | - | 644 | Discounted Cash Flow | Forward Curve | $0.25 - $2.59/MW |
| Electric | Option contracts | - | (739) | $ (739) | Discounted Cash Flow | Implied Volatility | 28% - 96% |
| | **Total** | $ 821 | $ (903) | $ (82) | | | |

| Commodity | Level 3 Position | Fair Value as of March 31, 2017 | | | Valuation Technique(s) | Significant Unobservable Input | Range |
|---|---|---|---|---|---|---|---|
| | | Assets | (Liabilities) | Total | | | |
| | | | (in thousands of dollars) | | | | |
| Gas | Option contracts | $ 25 | $ (29) | $ (4) | Discounted Cash Flow | Forward Curve<br>Implied Volatility | $0.30 - $0.42/dth<br>33% - 39% |
| Gas | Purchase contracts | 87 | - | 87 | Discounted Cash Flow | Forward Curve | $29.87 - $238.00/dth |
| Electric | Capacity contracts | 1,291 | - | 1,291 | Discounted Cash Flow | Forward Curve | $0.35 - $3.68/MW |
| Electric | Swaption contracts | - | (626) | (626) | Discounted Cash Flow | Implied Volatility | 12% - 63% |
| | **Total** | $ 1,403 | $ (655) | $ 748 | | | |

The significant unobservable inputs listed above would have a direct impact on the fair values of the Level 3 instruments if they were adjusted. The significant unobservable inputs used in the fair value measurement of the Company's gas option derivative instruments and electric option and swap derivative instruments are implied volatility and gas forward curves. A relative change in commodity price at various locations underlying the open positions can result in significantly different fair value estimates.

**Other Fair Value Measurements**

The Company's balance sheet reflects long-term debt at amortized cost. The fair value of the Company's long-term debt was based on quoted market prices when available, or estimated using quoted market prices for similar debt. The fair value of this debt at March 31, 2018 and 2017 was $2.8 billion.

All other financial instruments on the balance sheet such as accounts receivable, accounts payable, and the intercompany money pool are stated at cost, which approximates fair value.

## 8. EMPLOYEE BENEFITS

The Company participates in two non-contributory defined benefit pension plans (the “Pension Plans”) and two PBOP plans (the “PBOP Plans,” together with the Pension Plans, the “Plans”). The Company calculates benefits under these plans based on age, years of service and pay using March 31 as a measurement date. In addition, the Company also participates in a defined contribution plans for eligible employees. The plans are sponsored by National Grid USA Service Company.

Plan assets are maintained in commingled trusts. In respect of cost determination, plan assets are allocated to the Company based on the Company’s proportionate share of the Plan’s projected benefit obligation. The Plan’s costs are first directly charged to the Company based on the Company’s employees that participate in the Plan. Costs associated with affiliated service companies’ employees are then allocated as part of the labor burden for work performed on the Company’s behalf. The Company applies deferral accounting for pension and PBOP expenses associated with its regulated gas and electric operations. Any differences between actual pension costs and amounts used to establish rates are deferred and collected from, or refunded to, customers in subsequent periods. Pension and PBOP expense are included within operations and maintenance expense in the accompanying statements of income. Portions of the net periodic benefit costs disclosed below have been capitalized as a component of property, plant and equipment.

*Pension Plans*

The Pension Plans are comprised of both a qualified and a non-qualified plan. The qualified pension plan provides substantially all union employees, as well as all non-union employees hired before January 1, 2011, with a retirement benefit. The qualified pension plan is a cash balance pension plan design in which pay-based credits are applied based on service time and interest credits are applied at rates set forth in the plan. For non-union employees, effective January 1, 2011, pay-based credits are based on a combination of service time and age. The non-qualified pension plans provide additional defined pension benefits to certain eligible executives. The funding policy is determined largely by the Company’s rate agreements with the NYPSC. However, the contribution to the qualified pension plan for any year will not be less than the minimum amount required under Internal Revenue Service (“IRS”) regulations. During the years ended March 31, 2018, 2017, and 2016, the Company made contributions of approximately $30.9 million, $30.8 million, and $39.8 million, respectively, to the qualified pension plans. The Company does not expect to contribute to the Pension Plans during the year ending March 31, 2019.

Benefit payments to Pension Plan participants for the years ended March 31, 2018, 2017, and 2016 were approximately $127.9 million, $86.1 million, and $116.4 million, respectively.

*PBOP Plans*

The Company’s PBOP Plans provide health care and life insurance coverage to eligible retired employees. Eligibility is based on age and length of service requirements and, in most cases, retirees must contribute to the cost of their coverage. The PBOP Plans are funded based on rate agreements with the NYPSC. During the years ended March 31, 2018, 2017, and 2016, the Company made contributions of approximately $48.4 million, $49.1 million, and $43.7 million, respectively, to the PBOP Plans. The Company does not expect to contribute to the PBOP Plans during the year ending March 31, 2019.

Benefit payments to PBOP plan participants for the years ended March 31, 2018, 2017, and 2016 were approximately $71.0 million, $59.8 million, and $77.1 million, respectively.

*Defined Contribution Plan*

NGUSA has a defined contribution pension plan that covers substantially all employees. For the years ended March 31, 2018, 2017, and 2016, the Company recognized an expense in the accompanying statements of income of $9.4 million, $8.7 million, and $8.4 million, respectively, for matching contributions.

**Net Periodic Benefit Costs**

The Company's total pension cost for the years ended March 31, 2018, 2017, and 2016 are $32.0 million, $41.4 million, and $50.3 million, respectively.

The Company's total PBOP cost for the years ended March 31, 2018, 2017, and 2016 are $28.0 million, $72.9 million, and $70.9 million, respectively.

**Amounts Recognized in AOCI and Regulatory Assets**

The following tables summarize other pre-tax changes in actuarial gains/losses and prior service costs recognized primarily in regulatory assets and accumulated other comprehensive income for the years ended March 31, 2018, 2017, and 2016:

| | **Pension Plans** | | |
|---|---|---|---|
| | **Years Ended March 31,** | | |
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Net actuarial (gain) loss | **$ (7,179)** | $ (42,368) | $ 48,807 |
| Amortization of prior service cost, net | **(3,123)** | (3,123) | (3,719) |
| Amortization of net actuarial loss | **(46,964)** | (52,858) | (53,183) |
| Total | **$ (57,266)** | $ (98,349) | $ (8,095) |
| Included in regulatory assets | **$ (57,261)** | $ (98,104) | $ (7,976) |
| Included in AOCI | **(5)** | (245) | (119) |
| Total | **$ (57,266)** | $ (98,349) | $ (8,095) |

| | **PBOP Plans** | | |
|---|---|---|---|
| | **Years Ended March 31,** | | |
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Net actuarial gain | **$ (66,621)** | $ (258,040) | $ (42,177) |
| Amortization of prior service cost, net | **540** | 540 | (2,243) |
| Amortization of net actuarial loss | **(22,533)** | (49,786) | (46,142) |
| Total | **$ (88,614)** | $ (307,286) | $ (90,562) |
| Included in regulatory assets | **$ (88,614)** | $ (307,286) | $ (90,562) |
| Total | **$ (88,614)** | $ (307,286) | $ (90,562) |

**Amounts Recognized in AOCI and Regulatory Assets – not yet recognized as components of net actuarial loss**

The following tables summarize the Company's amounts in regulatory assets and other comprehensive income on the balance sheet that have not yet been recognized as components of net actuarial loss at March 31, 2018, 2017, and 2016:

| | Pension Plans | | |
|---|---|---|---|
| | Years Ended March 31, | | |
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Net actuarial loss | **$ 106,435** | $ 160,578 | $ 255,804 |
| Prior service cost | **8,030** | 11,153 | 14,276 |
| Total | **$ 114,465** | $ 171,731 | $ 270,080 |
| Included in regulatory assets | **$ 113,233** | $ 170,494 | $ 268,598 |
| Included in AOCI | **1,232** | 1,237 | 1,482 |
| Total | **$ 114,465** | $ 171,731 | $ 270,080 |

| | PBOP Plans | | |
|---|---|---|---|
| | Years Ended March 31, | | |
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Net actuarial (gain) loss | **$ (32,749)** | $ 56,405 | $ 364,231 |
| Prior service cost | **(516)** | (1,056) | (1,596) |
| Total | **$ (33,265)** | $ 55,349 | $ 362,635 |
| Included in regulatory assets | **$ (33,265)** | $ 55,349 | $ 362,635 |
| Total | **$ (33,265)** | $ 55,349 | $ 362,635 |

The NYPSC's statement of policy requires that prior service costs and gains and losses be amortized over a ten-year period calculated on a vintage year basis. The amount of net actuarial loss and prior service cost to be amortized from regulatory assets during the year ending March 31, 2019 for the Pension Plans is $54.2 million and $2.8 million, respectively, and net actuarial loss and prior service benefit to be amortized from regulatory assets during the year ending March 31, 2019 for the PBOP Plans is $15.6 million and ($0.1) million, respectively.

**Reconciliation of Funded Status to Amount Recognized**

| | Pension Plans | | PBOP Plans | |
|---|---|---|---|---|
| | Years Ended March 31, | | Years Ended March 31, | |
| | **2018** | 2017 | **2018** | 2017 |
| | *(in thousands of dollars)* | | | |
| Projected benefit obligation | **$ (1,374,041)** | $ (1,387,238) | **$ (1,706,164)** | $ (1,686,991) |
| Allocated fair value assets | **1,728,154** | 1,684,767 | **1,425,342** | 1,293,715 |
| Funded status | **$ 354,113** | $ 297,529 | **$ (280,822)** | $ (393,276) |
| Other non-current assets | **$ 355,899** | $ 299,554 | **$ -** | $ - |
| Current liabilities | **(332)** | (340) | **(3,700)** | (5,200) |
| Other non-current liabilities | **(1,454)** | (1,685) | **(277,122)** | (388,076) |
| Total | **$ 354,113** | $ 297,529 | **$ (280,822)** | $ (393,276) |

**Expected Benefit Payments**

Based on current assumptions, the Company expects to make the following benefit payments subsequent to March 31, 2018:

| *(in thousands of dollars)* Years Ending March 31, | Pension Plans | PBOP Plans |
|---|---|---|
| 2019 | $ 164,573 | $ 70,145 |
| 2020 | 159,106 | 73,836 |
| 2021 | 147,232 | 77,180 |
| 2022 | 137,026 | 80,192 |
| 2023 | 129,001 | 83,135 |
| 2024-2028 | 464,365 | 438,192 |
| Total | $ 1,201,303 | $ 822,680 |

**Assumptions Used for Employee Benefits Accounting**

| | Pension Plans | | |
|---|---|---|---|
| | Years Ended March 31, | | |
| | **2018** | 2017 | 2016 |
| **Benefit Obligations:** | | | |
| Discount rate | **4.10%** | 4.30% | 4.25% |
| Rate of compensation increase | **3.50%** | 3.50% | 3.50% |
| Expected return on plan assets | **6.00%** | 6.25% | 6.25% |
| **Net Periodic Benefit Costs:** | | | |
| Discount rate | **4.30%** | 4.25% | 4.10% |
| Rate of compensation increase | **3.50%** | 3.50% | 3.50% |
| Expected return on plan assets | **6.25%** | 6.25% | 6.00% |

| | PBOP Plans | | |
|---|---|---|---|
| | Years Ended March 31, | | |
| | **2018** | 2017 | 2016 |
| **Benefit Obligations:** | | | |
| Discount rate | **4.10%** | **4.30%** | 4.25% |
| Rate of compensation increase | **n/a** | **n/a** | n/a |
| Expected return on plan assets | **6.25%-6.75%** | **6.50%-6.75%** | 6.25%-6.75% |
| **Net Periodic Benefit Costs:** | | | |
| Discount rate | **4.30%** | **4.25%** | 4.10% |
| Rate of compensation increase | **n/a** | **n/a** | n/a |
| Expected return on plan assets | **6.50%-6.75%** | **6.25%-6.75%** | 6.25%-6.75% |

The Company selects its discount rate assumption based upon rates of return on highly rated corporate bond yields in the marketplace as of each measurement date. Specifically, the Company uses the Hewitt AA Above Median Curve along with the expected future cash flows from the Company retirement plans to determine the weighted average discount rate assumption.

The expected rate of return for various passive asset classes is based both on analysis of historical rates of return and forward looking analysis of risk premiums and yields. Current market conditions, such as inflation and interest rates, are evaluated in connection with the setting of the long-term assumptions. A small premium is added for active management of both equity and fixed income securities. The rates of return for each asset class are then weighted in accordance with the actual asset allocation, resulting in a long-term return on asset rate for each plan.

**Assumed Health Cost Trend Rate**

| | March 31, | |
|---|---|---|
| | **2018** | 2017 |
| Health care cost trend rate assumed for next year | | |
| Pre 65 | **7.50%** | 7.00% |
| Post 65 | **5.75%** | 6.00% |
| Prescription | **10.25%** | 10.25% |
| Rate to which the cost trend is assumed to decline (ultimate) | **4.50%** | 4.50% |
| Year that rate reaches ultimate trend | | |
| Pre 65 | **2028** | 2025 |
| Post 65 | **2026** | 2024 |
| Prescription | **2027** | 2025 |

**Plan Assets**

The National Grid Retirement Plan Committee is the fiduciary who manages the benefit plan investments to minimize the long-term cost of operating the Plans, with a reasonable level of risk. Risk tolerance is determined as a result of a periodic asset/liability study which analyzes the Plans' liabilities and funded status and results in the determination of the allocation of assets across equity fixed income securities and other investments. Equity investments are broadly diversified across U.S. and non-U.S. stocks, as well as across growth, value, and small and large capitalization stocks. Likewise, the fixed income portfolio is broadly diversified across market segments. Approximately ten percent of the total investment portfolio is approved for investments in private equity, real estate, and infrastructure with the objective of enhancing long-term returns while improving portfolio diversification. For the PBOP Plans, since the earnings on a portion of the assets are taxable, those investments are managed to maximize after tax returns consistent with the broad asset class parameters established by the asset allocation study. Investment risk and return are reviewed by the National Grid Retirement Plan Committee on a quarterly basis.

The Pension Plan is a trusted non-contributory defined benefit plan covering all eligible represented employees of the Company and eligible non-represented employees of the participating National Grid companies. The PBOP Plans are both a contributory and non-contributory, trusteed, employee life insurance and medical benefit plan sponsored by the Service Company. Life insurance and medical benefits are provided for eligible retirees, dependents, and surviving spouses of the Company.

The target asset allocations for the benefit plans as of March 31, 2018 and 2017 are as follows:

| | Pension Plans | | Union PBOP Plans | | Non-Union PBOP Plans | |
|---|---|---|---|---|---|---|
| | March 31, | | March 31, | | March 31, | |
| | **2018** | 2017 | **2018** | 2017 | **2018** | 2017 |
| U.S. equities | **20%** | 20% | **34%** | 34% | **45%** | 45% |
| Global equities (including U.S.) | **7%** | 7% | **12%** | 12% | **0%** | 0% |
| Global tactical asset allocation | **10%** | 10% | **17%** | 17% | **0%** | 0% |
| Non-U.S. equities | **10%** | 10% | **17%** | 17% | **25%** | 25% |
| Fixed income securities | **40%** | 40% | **20%** | 20% | **30%** | 30% |
| Private equity | **5%** | 5% | **0%** | 0% | **0%** | 0% |
| Real estate | **5%** | 5% | **0%** | 0% | **0%** | 0% |
| Infrastructure | **3%** | 3% | **0%** | 0% | **0%** | 0% |
| | **100%** | 100% | **100%** | 100% | **100%** | 100% |

**Fair Value Measurements**

The following tables provide the fair value measurements amounts for the pension and PBOP assets:

| | March 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Not categorized | Total |
| | *(in thousands of dollars)* | | | | |
| **Pension Assets:** | | | | | |
| Cash and cash equivalents | $ 356 | $ 36,556 | $ - | $ 1,244 | $ 38,156 |
| Accounts receivable | 84,635 | - | - | - | 84,635 |
| Accounts payable | (152,299) | - | - | - | (152,299) |
| Equity | 177,366 | - | - | 457,622 | 634,988 |
| Global tactical asset allocation | - | - | - | 144,987 | 144,987 |
| Fixed income securities | - | 641,932 | - | 271,958 | 913,890 |
| Preferred securities | - | 8,178 | - | - | 8,178 |
| Private equity | - | - | - | 109,225 | 109,225 |
| Real estate | - | - | - | 72,650 | 72,650 |
| Other | 1,052 | - | - | - | 1,052 |
| Total | **$ 111,110** | **$ 686,666** | **$ -** | **$ 1,057,686** | **$ 1,855,462** |
| **PBOP Assets:** | | | | | |
| Cash and cash equivalents | $ 15,707 | $ - | $ - | $ 604 | $ 16,311 |
| Accounts receivable | 2,293 | - | - | - | 2,293 |
| Accounts payable | (81) | - | - | - | (81) |
| Equity | 284,326 | - | - | 735,481 | 1,019,807 |
| Global tactical asset allocation | 38,824 | - | - | 86,119 | 124,943 |
| Fixed income securities | - | 293,793 | - | - | 293,793 |
| Other | (240) | - | - | - | (240) |
| Total | **$ 340,829** | **$ 293,793** | **$ -** | **$ 822,204** | **$ 1,456,826** |

| | March 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Not categorized | Total |
| | *(in thousands of dollars)* | | | | |
| **Pension Assets:** | | | | | |
| Cash and cash equivalents | $ 1,244 | $ 59,226 | $ - | $ 1,196 | $ 61,666 |
| Accounts receivable | 14,261 | - | - | - | 14,261 |
| Accounts payable | (58,646) | - | - | - | (58,646) |
| Equity | 208,341 | - | - | 435,492 | 643,833 |
| Global tactical asset allocation | - | - | - | 87,839 | 87,839 |
| Fixed income securities | - | 733,312 | - | 127,024 | 860,336 |
| Preferred securities | - | 6,713 | - | - | 6,713 |
| Private equity | - | - | - | 108,637 | 108,637 |
| Real estate | - | - | - | 82,430 | 82,430 |
| Other | 61 | - | - | | 61 |
| Total | $ 165,261 | $ 799,251 | $ - | $ 842,618 | $ 1,807,130 |
| **PBOP Assets:** | | | | | |
| Cash and cash equivalents | $ 20,345 | $ - | $ - | $ 895 | $ 21,240 |
| Accounts receivable | 1,815 | - | - | - | 1,815 |
| Accounts payable | (135) | - | - | - | (135) |
| Equity | 249,945 | - | - | 681,700 | 931,645 |
| Global tactical asset allocation | 36,188 | - | - | 79,310 | 115,498 |
| Fixed income securities | - | 264,872 | - | - | 264,872 |
| Other | 32 | - | - | - | 32 |
| Total | $ 308,190 | $ 264,872 | $ - | $ 761,905 | $ 1,334,967 |

The methods used to fair value pension and PBOP assets are described below:

**Cash and cash equivalents**: Cash and cash equivalents that can be priced daily are classified as Level 1. Active reserve funds, reserve deposits, commercial paper, repurchase agreements, and commingled cash equivalents are classified as Level 2. Cash and cash equivalents invested in commingled money market investment funds which have net asset value ("NAV") pricing per fund share are excluded from the fair value hierarchy.

**Accounts receivable and accounts payable:** Accounts receivable and accounts payable are classified as Level 1. Such amounts are short-term and settle within a few days of the measurement date.

**Equity and preferred securities:** Common stocks, preferred stocks, and real estate investment trusts are valued using the official close of the primary market on which the individual securities are traded. Equity securities are primarily comprised of securities issued by public companies in domestic and foreign markets plus investments in commingled funds, which are valued on a daily basis. The Company can exchange shares of the publicly traded securities and the fair values are primarily sourced from the closing prices on stock exchanges where there is active trading, in which case they are classified as Level 1 investments. If there is less active trading, then the publicly traded securities would typically be priced using observable data, such as bid and ask prices, and these measurements are classified as Level 2 investments. Mutual funds with publicly quoted prices and active trading are classified as Level 1 investments. For investments in commingled funds that are not publicly traded and have ongoing subscription and redemption activity, the fair value of the investment is the NAV per fund share, derived from the underlying securities' quoted prices in active markets, and they are excluded from the fair value hierarchy. Investments in commingled funds with redemption restrictions and that use NAV are excluded from the fair value hierarchy.

**Global tactical asset allocation:** Assets held in global tactical asset allocation funds are managed by investment managers who use both top-down and bottom-up valuation methodologies to value asset classes, countries, industrial sectors, and individual securities in order to allocate and invest assets opportunistically. Mutual funds with publicly quoted prices and

active trading are classified as Level 1 investments. For commingled funds that are not publicly traded and have ongoing subscription and redemption activity, the fair value of the investment is the NAV per fund share, and is excluded from the fair value hierarchy. Investments with redemption restrictions and that use NAV are excluded from the fair value hierarchy.

**Fixed income securities:** Fixed income securities (which include corporate debt securities, municipal fixed income securities, U.S. Government and Government agency securities including government mortgage backed securities, index linked government bonds, and state and local bonds) convertible securities, and investments in securities lending collateral (which include repurchase agreements, asset backed securities, floating rate notes and time deposits) are valued with an institutional bid valuation. A bid valuation is an estimated price at which a dealer would pay for a security (typically in an institutional round lot). Oftentimes, these evaluations are based on proprietary models which pricing vendors establish for these purposes. In some cases there may be manual sources when primary vendors do not supply prices. Fixed income investments are primarily comprised of fixed income securities and fixed income commingled funds. The prices for direct investments in fixed income securities are generated on a daily basis. Prices generated from less active trading with wider bid ask prices are classified as Level 2 investments. Mutual funds with publicly quoted prices and active trading are classified as Level 1 investments. For commingled funds that are not publicly traded and have ongoing subscription and redemption activity, the fair value of the investment is the NAV per fund share, and is excluded from the fair value hierarchy. Investments in commingled funds with redemption restrictions and that use NAV are excluded from the fair value hierarchy.

**Private equity and real estate:** Commingled equity funds, commingled special equity funds, limited partnerships, real estate, venture capital, and other investments are valued using evaluations (NAV per fund share) based on proprietary models, or based on the NAV. Investments in private equity and real estate funds are primarily invested in privately held real estate investment properties, trusts, and partnerships as well as equity and debt issued by public or private companies. The Company’s interest in the fund or partnership is estimated based on the NAV. The Company’s interest in these funds cannot be readily redeemed due to the inherent lack of liquidity and the primarily long-term nature of the underlying assets. Distribution is made through the liquidation of the underlying assets. The Company views these investments as part of a long-term investment strategy. These investments are valued by each investment manager based on the underlying assets. The funds utilize valuation techniques consistent with the market, income, and cost approaches to measure the fair value of certain real estate investments. The majority of the underlying assets are valued using significant unobservable inputs and often require significant management judgment or estimation based on the best available information. Market data includes observations of the trading multiples of public companies considered comparable to the private companies being valued. Investments in limited partnerships with redemption restrictions and that use NAV are excluded from the fair value hierarchy.

While management believes its valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the NAV as a practical expedient could result in a different fair value measurement at the reporting date.

**Other Benefits**

At March 31, 2018 and 2017, the Company had accrued workers compensation, auto, and general insurance claims which have been incurred but not yet reported (“IBNR”) of $12.5 million and $11.8 million, respectively. IBNR reserves have been established for claims and/or events that have transpired, but have not yet been reported to the Company for payment.

## 9. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table represents the changes in the Company's AOCI for the years ended March 31, 2018 and 2017:

| | Unrealized Gain (Loss) on Available-For-Sale Securities | Pension and Other Postretirement Benefits | Total |
|---|---|---|---|
| | *(in thousands of dollars)* | | |
| **Balance as of March 31, 2016** | $ 1,671 | $ (740) | $ 931 |
| Other comprehensive income (loss) before reclassifications: | | | |
| Unrecognized net actuarial gain (net of $54 tax expense) | - | 84 | 84 |
| Gain on investment (net of $564 tax expense) | 863 | - | 863 |
| Amounts reclassified from other comprehensive income (loss): | | | |
| Amortization of net actuarial loss (net of $42 tax expense)[1] | - | 65 | 65 |
| Gain on investment (net of $209 tax benefit) [1] | (314) | - | (314) |
| Net current period other comprehensive income | 549 | 149 | 698 |
| **Balance as of March 31, 2017** | **$ 2,220** | **$ (591)** | **$ 1,629** |
| Other comprehensive (loss) income before reclassifications: | | | |
| Unrecognized net actuarial loss (net of $24 tax benefit) | - | (69) | (69) |
| Gain on investment (net of $646 tax expense) | 1,068 | - | 1,068 |
| Amounts reclassified from other comprehensive income (loss): | | | |
| Amortization of net actuarial loss (net of $33 tax expense)[1] | - | 66 | 66 |
| Gain on investment (net of $386 tax benefit) [1] | (785) | - | (785) |
| Net current period other comprehensive income (loss) | 283 | (3) | 280 |
| **Balance as of March 31, 2018** | **$ 2,503** | **$ (594)** | **$ 1,909** |

[1] Amounts are reported as other income, net in the accompanying statements of income.

## 10. CAPITALIZATION

The aggregate maturities of long-term debt for the years subsequent to March 31, 2018 are as follows:

| *(in thousands of dollars)* Years Ending March 31, | |
|---|---|
| 2019 | $ - |
| 2020 | 750,000 |
| 2021 | - |
| 2022 | - |
| 2023 | 300,000 |
| Thereafter | 1,729,465 |
| Total | $ 2,779,465 |

The Company's debt agreements and banking facilities contain covenants, including those relating to the periodic and timely provision of financial information by the issuing entity and financial covenants such as restrictions on the level of indebtedness. Failure to comply with these covenants, or to obtain waivers of those requirements, could in some cases trigger a right, at the lender's discretion, to require repayment of some of the Company's debt and may restrict the

Company's ability to draw upon its facilities or access the capital markets. During the years ended March 31, 2018 and 2017, the Company was in compliance with all such covenants.

**Debt Authorizations**

Since January 12, 2015, the Company had regulatory approval from the FERC to issue up to $1 billion of short-term debt internally or externally. The authorization was renewed and is effective for a period of two years that expires on January 10, 2019. The Company had no external short-term debt as of March 31, 2018 and 2017. Refer to Note 14, "Related Party Transactions" under "Intercompany Money Pool" for short-term debt outstanding to associated companies.

Since May 19, 2016, the NYPSC authorized the Company to issue up to $2.1 billion of incremental long-term debt in one or more transactions through March 31, 2020. The Company can issue up to $429.5 million of the total authorization for optional refunding of existing debt.

**State Authority Financing Bonds**

The assets of the Company are subject to liens and other charges and are provided as collateral over borrowings of $429.5 million of State Authority Financing Bonds. These bonds were issued to secure a like amount of tax-exempt revenue bonds issued by the New York State Energy Research and Development Authority ("NYSERDA"). The bonds bear interest at short-term adjustable interest rates (with an option to convert to other rates, including a fixed interest rate) ranging from 0.66% to 4.69% for the year ended March 31, 2018 and 1.08% to 2.46% for the year ended March 31, 2017. The bonds are currently in auction rate mode and are backed by bond insurance. These bonds cannot be put back to the Company and, in the case of a failed auction, the resulting interest rate on the bonds would revert to the maximum auction rate which depends on the current appropriate, short-term benchmark rate and the senior unsecured rating of the Company or the bond insurer, whichever is greater. The effect on interest on long-term debt has not been material in any of the years ended March 31, 2018, 2017, or 2016.

**Dividend Restrictions**

The Company's debt and credit arrangements contain various financial and other covenants as described below. The Company was in compliance with all such covenants during the years ended March 31, 2018, 2017, and 2016.

The indenture securing the Company's mortgage debt provides that retained earnings shall be reserved and held unavailable for the payment of dividends on common stock to the extent that expenditures for maintenance and repairs plus provisions for depreciation do not exceed 2.25% of depreciable property as defined therein. These provisions have never resulted in a restriction of the Company's retained earnings.

The Company is limited by the various rate plans, NYPSC orders, and FERC orders with respect to the amount of dividends the Company can pay. If the Company's total debt exceeds 55% of its total capital excluding goodwill but does not exceed 57%, then the Company will be permitted to pay dividends up to an amount equal to but no greater than 50% of its net income for the previous twelve months until its average total debt for the most recent six month period is less than or equal to 55%. If the Company's total capital exceeds 57% then the Company may not pay dividends until the average total debt for the most recent six months ending is less than or equal to 55%. As long as the bond ratings on the least secure forms of debt issued by the Company and National Grid plc remain investment grade and do not fall to the lowest investment grade rating (with one or more negative watch downgrade notices issued with respect to such debt), the Company is allowed to pay dividends.

The Company's filed rate plan includes a ratemaking capital structure of approximately 52% debt and 48% equity through the combination of long-term debt issuance and dividend payments. In September 2017, the Company paid dividends on common stock of $550 million to NMHI to align the capital structure more closely to its filed rate plan.

**Cumulative Preferred Stock**

The Company has certain issues of non-participating cumulative preferred stock outstanding which can be redeemed at the option of the Company. There are no mandatory redemption provisions on the Company's cumulative preferred stock. A summary of cumulative preferred stock is as follows:

| | Shares Outstanding | | Amount | | |
|---|---|---|---|---|---|
| | March 31, | | March 31, | | Call |
| Series | **2018** | 2017 | **2018** | 2017 | **Price** |
| | *(in thousands of dollars, except per share and number of shares data)* | | | | |
| $100 par value - | | | | | |
| 3.40% Series | **57,524** | 57,524 | **$ 5,753** | $ 5,753 | $ 103.500 |
| 3.60% Series | **137,152** | 137,152 | **13,715** | 13,715 | 104.850 |
| 3.90% Series | **95,171** | 95,171 | **9,517** | 9,517 | 106.000 |
| Golden Share | **1** | 1 | **-** | - | Non-callable |
| Total | **289,848** | 289,848 | **$ 28,985** | $ 28,985 | |

In connection with the acquisition of KeySpan by NGUSA, the Company became subject to a requirement to issue a class of preferred stock, having one share (the "Golden Share"), subordinate to any existing preferred stock. The holder of the Golden Share would have voting rights that limit the Company's right to commence any voluntary bankruptcy, liquidation, receivership, or similar proceeding without the consent of the holder of the Golden Share. The NYPSC subsequently authorized the issuance of the Golden Share to a trustee, GSS Holdings, Inc. ("GSS"), who will hold the Golden Share subject to a Services and Indemnity Agreement requiring GSS to vote the Golden Share in the best interests of NYS. On July 8, 2011, the Company issued the Golden Share with a par value of $1.

The Company did not redeem any preferred stock during the years ended March 31, 2018, 2017, or 2016. The annual dividend requirement for cumulative preferred stock was $1.1 million for each of the years ended March 31, 2018, 2017 and 2016.

## 11. INCOME TAXES

**Components of Income Tax Expense**

| | Years Ended March 31, | | |
|---|---|---|---|
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Current tax expense (benefit): | | | |
| Federal | **$ 138,572** | $ 83,337 | $ 8,555 |
| State | **24,955** | 21,446 | 15,777 |
| Total current tax expense (benefit) | **163,527** | 104,783 | 24,332 |
| Deferred tax expense (benefit): | | | |
| Federal | **(44,716)** | 16,857 | 89,257 |
| State | **(4,003)** | (1,344) | 5,977 |
| Total deferred tax expense (benefit) | **(48,719)** | 15,513 | 95,234 |
| Amortized investment tax credits [1] | **(1,806)** | (1,670) | (2,564) |
| Total deferred tax expense (benefit) | **(50,525)** | 13,843 | 92,670 |
| Total income tax expense | **$ 113,002** | $ 118,626 | $ 117,002 |

(1) Investment tax credits ("ITC") are accounted for using the deferral and gross up method of accounting and amortized over the depreciable life of the property giving rise to the credits.

**Statutory Rate Reconciliation**

The Company's effective tax rates for the years ended March 31, 2018, 2017, and 2016 are 32.7%, 37.5%, and 37.4%, respectively. The following table presents a reconciliation of income tax expense at the federal statutory tax rate of 31.55%, 35%, and 35%, respectively, to the actual tax expense:

| | Years Ended March 31, | | |
|---|---|---|---|
| | **2018** | 2017 | 2016 |
| | *(in thousands of dollars)* | | |
| Computed tax | **$ 109,103** | $ 110,608 | $ 109,397 |
| Change in computed taxes resulting from: | | | |
| Equity-based compensation and dividends | **(4,112)** | (1,608) | (1,799) |
| Investment tax credits | **(1,806)** | (1,670) | (2,564) |
| State income tax, net of federal benefit | **14,297** | 13,066 | 14,140 |
| Temporary differences flowed through | **(3,981)** | (2,305) | (4,321) |
| Other items, net | **(499)** | 535 | 2,149 |
| Total changes | **3,899** | 8,018 | 7,605 |
| Total income tax expense | **$ 113,002** | $ 118,626 | $ 117,002 |

The Company is included in the NGNA and subsidiaries consolidated federal income tax return and New York unitary state income tax return. The Company has joint and several liability for any potential assessments against the consolidated group.

On December 22, 2017, the Tax Act was signed into law. The Tax Act includes significant changes to various federal tax provisions applicable to the Company, including provisions specific to regulated public utilities. The most significant changes include the reduction in the corporate federal income tax rate from 35% to 21% effective January 1, 2018 and the limitation of the net operating loss deduction for net operating losses generated in tax years starting after December 31, 2017 to 80% of taxable income with an indefinite carryforward period. The Tax Act provisions related to regulated public utilities eliminate bonus depreciation for certain property acquired or placed in service after September 27, 2017 and extend the normalization requirements for ratemaking treatment of excess deferred taxes.

In accordance with ASC 740, "Income Taxes," the effect of changes in tax law are required to be recognized in the period of enactment, which for the Company is the period ended March 31, 2018. Since the Company's fiscal year end is March 31, the statutory rate applicable for the Company's fiscal year ended March 31, 2018, is a blended tax rate of 31.55%. In subsequent periods, the federal income tax rate will be 21%. In addition, ASC 740 requires deferred income tax assets and liabilities to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. As a result, the Company remeasured its federal deferred income tax assets and liabilities using the newly enacted tax rate of 21%.

The Company recognized a decrease in its net deferred income tax liability in the amount of $685.2 million with $1.6 million recorded to deferred income tax expense and $686.8 million recorded as a regulatory tax liability for the refund of excess deferred income taxes to the ratepayers.

On December 22, 2017, the Securities Exchange Commission issued Staff Accounting Bulletin ("SAB") 118, which provides guidance on accounting for the effects of the Tax Act. The FASB staff subsequently issued guidance stating that private companies may apply SAB 118 to the financial statements. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date to complete the accounting under ASC 740. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete, a company can determine a reasonable estimate for those effects and record a provisional estimate in the financial statements. If a company cannot determine a

provisional amount, the company should continue to apply existing accounting guidance for income taxes based on provisions of the tax laws that were in effect immediately prior to the enactment of the Tax Act.

The Company has made a reasonable estimate for the measurement and accounting of the effects of the Tax Act which has been reflected in the March 31, 2018 financial statements based on management's interpretation of the Tax Act and information available. The items reflected as provisional amounts are related to accelerated depreciation for tax purposes of certain property placed in service after September 27, 2017, the allocation of excess deferred taxes between customers and shareholders, and certain property related temporary differences. The final impact may differ from the recorded amounts to the extent refinements are made as a result of changes in management's interpretations and assumptions, additional guidance or technical corrections that may be issued.

**Deferred Tax Components**

| | **March 31,** | |
|---|---|---|
| | **2018** | 2017 |
| | *(in thousands of dollars)* | |
| **Deferred tax assets:** | | |
| Allowance for doubtful accounts | **$ 41,302** | $ 66,357 |
| Environmental remediation costs | **100,118** | 151,274 |
| Future federal benefit on state taxes | **20,398** | 54,642 |
| Postretirement benefits and other employee benefits | **2,497** | 74,050 |
| Regulatory tax liability | **221,491** | - |
| Regulatory liabilities - other | **298,119** | 341,578 |
| Other items | **63,013** | 75,579 |
| Total deferred tax assets | **746,938** | 763,480 |
| **Deferred tax liabilities:** | | |
| Property-related differences | **1,513,220** | 2,308,092 |
| Regulatory assets - environmental response costs | **75,077** | 126,426 |
| Other items | **73,128** | 203,150 |
| Total deferred tax liabilities | **1,661,425** | 2,637,668 |
| Net deferred income tax liabilities | **914,487** | 1,874,188 |
| Deferred investment tax credits | **13,997** | 15,803 |
| **Deferred income tax liabilities, net** | **$ 928,484** | $ 1,889,991 |

**Net Operating Losses**

The amounts and expiration dates of the Company's net operating losses carryforward as of March 31, 2018 are as follows:

| **Expiration of net operating losses:** | **Carryforward Amount** | **Expiration Period** |
|---|---|---|
| | *(in thousands of dollars)* | |
| **Federal** | **$ 63,470** | **2029 - 2036** |

As a result of the accounting for uncertain tax positions, the amount of deferred tax assets reflected in the financial statements is less than the amount of the tax effect of the federal and state net operating losses carryforward reflected on the income tax returns.

The Company recognizes interest related to unrecognized tax benefits in other interest, including affiliate interest and related penalties, if applicable, in other income, net, in the accompanying statements of income. As of March 31, 2018 and 2017 the Company has accrued for interest related to unrecognized tax benefits of $27.4 million and $20.8 million, respectively. During the years ended March 31, 2018, 2017, and 2016 the Company recorded interest expense of $6.6 million, $6.6 million, and $3.4 million, respectively. No tax penalties were recognized during the years ended March 31, 2018, 2017 or 2016.

It is reasonably possible that other events will occur during the next twelve months that would cause the total amount of unrecognized tax benefits to increase or decrease. However, the Company does not believe any such increases or decreases would be material to its results of operations, financial position, or cash flows.

The Company is included in NGNA and subsidiaries' administrative appeal with the IRS related to the issues disputed in the examination cycles for the years ended August 24, 2007, March 31, 2008, and March 31, 2009. The Company is expecting to reach a settlement with the IRS in the next fiscal year. The Company does not believe that the outcome of the settlement will have a material impact to its results of operations, financial position, or cash flows. The IRS continues its examination of the next cycle which includes income tax returns for the years ended March 31, 2010 through March 31, 2012. The examination is not expected to conclude in the next fiscal year. The income tax returns for the years ended March 31, 2013 through March 31, 2018 remain subject to examination by the IRS.

During the period, the state of New York concluded its examination of NMHI & Combined Affiliates' income tax returns for the years ended March 31, 2009 through March 31, 2012. The examination resulted in a capital tax refund of $3.3 million. The income tax returns for the years ended March 31, 2013 through March 31, 2018 remain subject to examination by the state of New York.

The following table indicates the earliest tax year subject to examination for each major jurisdiction:

| Jurisdiction | Tax Year |
|---|---|
| Federal | March 31, 2010 |
| New York | March 31, 2013 |

**12. ENVIRONMENTAL MATTERS**

The normal ongoing operations and historic activities of the Company are subject to various federal, state, and local environmental laws and regulations. Under federal and state Superfund laws, potential liability for the historic contamination of property may be imposed on responsible parties jointly and severally, without regard to fault, even if the activities were lawful when they occurred.

The United States Environmental Protection Agency ("EPA"), and the New York State Department of Environmental Conservation ("DEC"), as well as private entities, have alleged that the Company is a potentially responsible party under state or federal law for the remediation of numerous sites. The Company's most significant liabilities relate to former Manufactured Gas Plant ("MGP") facilities formerly owned or operated by the Company. The Company is currently investigating and remediating, as necessary, those MGP sites and certain other properties under agreements with the EPA and the DEC. Expenditures incurred for the years ended March 31, 2018, 2017, and 2016 were $10.2 million, $21.0 million, and $33.5 million, respectively.

The Company estimated the remaining costs of environmental remediation activities were $364.1 million and $364.5 million at March 31, 2018 and 2017, respectively. The Company had a current portion of environmental remediation costs of $31.5 million included in other current liabilities on the balance sheet at March 31, 2018. These costs are expected to be incurred over approximately 42 years. However, remediation costs for each site may be materially higher than estimated, depending on changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. The Company has recovered amounts from certain insurers and potentially responsible parties,

and, where appropriate, the Company may seek additional recovery from other insurers and from other potentially responsible parties, but it is uncertain whether, and to what extent, such efforts will be successful.

By rate orders issued and effective March 15, 2013, the NYPSC has provided an annual rate allowance of $42 million ($35.7 million in electric base rates and $6.3 million in gas base rates). Any annual spend above the $42 million rate allowance is deferred for future recovery. Previous rate orders have provided for similar recovery mechanisms (with different rate allowances and thresholds). Accordingly, as of March 31, 2018 and 2017, the Company has recorded environmental regulatory assets of $364.1 million and $364.5 million, respectively, and environmental regulatory liabilities of $91.1 million and $59.9 million, respectively.

The Company believes that its ongoing operations, and its approach to addressing conditions at historic sites, are in substantial compliance with all applicable environmental laws. Where the Company has regulatory recovery, it believes that the obligations imposed on it because of the environmental laws will not have a material impact on its results of operations or financial position.

## 13. COMMITMENTS AND CONTINGENCIES

### Operating Lease Obligations

The Company has various operating leases relating to office space. Total rental expense for operating leases included in operations and maintenance expense in the accompanying statements of income was $4.4 million, $4.7 million, and $4.6 million for the years ended March 31, 2018, 2017, and 2016, respectively.

The future minimum lease payments for the years subsequent to March 31, 2018 are as follows:

| *(in thousands of dollars)*<br>Years Ending March 31, | | |
|---|---|---|
| 2019 | $ | 4,394 |
| 2020 | | 4,429 |
| 2021 | | 4,278 |
| 2022 | | 2,866 |
| 2023 | | 2,715 |
| Thereafter | | 13,102 |
| Total | $ | 31,784 |

### Purchase Commitments

The Company has several long-term contracts for the purchase of electric power. Substantially all of these contracts require power to be delivered before the Company is obligated to make payment. Additionally, the Company has entered into various contracts for gas delivery, storage, and supply services. Certain of these contracts require payment of annual demand charges, which are recoverable from customers. The Company is liable for these payments regardless of the level of service required from third-parties.

The Company's commitments under these long-term contracts for the years subsequent to March 31, 2018 are summarized in the table below:

| *(in thousands of dollars)* Years Ending March 31, | Energy Purchases |
|---|---|
| 2019 | $ 174,130 |
| 2020 | 167,964 |
| 2021 | 164,385 |
| 2022 | 118,983 |
| 2023 | 117,158 |
| Thereafter | 559,020 |
| Total | $ 1,301,640 |

The Company purchases additional energy to meet load requirements from independent power producers, other utilities, energy merchants or the NYISO at market prices.

**Legal Matters**

The Company is subject to various legal proceedings arising out of the ordinary course of its business. The Company does not consider any of such proceedings to be material, individually or in the aggregate, to its business or likely to result in a material adverse effect on its results of operations, financial position, or cash flows.

**Nuclear Contingencies**

As of March 31, 2018 and 2017, the Company had a liability of $170.4 million and $168.0 million, respectively, recorded in other non-current liabilities on the balance sheet, for the disposal of nuclear fuel irradiated prior to 1983. The Nuclear Waste Policy Act of 1982 provides three payment options for liquidating such liability and the Company has elected to delay payment, with interest, until the year in which Constellation Energy Group Inc., which purchased the Company's nuclear assets, initially plans to ship irradiated fuel to an approved Department of Energy ("DOE") disposal facility.

The 2010 Federal budget (which became effective October 1, 2009) eliminated almost all funding for the creation of the Yucca Mountain repository. A Blue Ribbon Commission ("BRC") on America's Nuclear Future, appointed by the U.S. Energy Secretary, released a report on January 26, 2012, detailing comprehensive recommendations for creating a safe, long-term solution for managing and disposing of the nation's spent nuclear fuel and high-level radioactive waste.

In early 2013, the DOE issued an updated "Strategy for the Management and Disposal of Used Nuclear Fuel and High-Level Radioactive Waste" in response to the BRC recommendations. This strategy included a consolidated interim storage facility that was planned to be operational in 2025. However, due to continued delays on the part of the DOE, and the amount of time required for DOE to select a site location and develop the necessary infrastructure for long-term spent nuclear fuel storage, the Company cannot predict the date at which the DOE will begin accepting spent nuclear fuel.

## 14. RELATED PARTY TRANSACTIONS

**Accounts Receivable from and Accounts Payable to Affiliates**

NGUSA and its affiliates provide various services to the Company, including executive and administrative, customer services, financial (including accounting, auditing, risk management, tax, and treasury/finance), human resources, information technology, legal, and strategic planning, that are charged between the companies and charged to each company.

The Company records short-term receivables from, and payables to, certain of its affiliates in the ordinary course of business. The amounts receivable from, and payable to, its affiliates do not bear interest and are settled through the intercompany money pool. A summary of net outstanding accounts receivable from affiliates and accounts payable to affiliates is as follows:

| | Accounts Receivable from Affiliates | | Accounts Payable to Affiliates | |
|---|---|---|---|---|
| | March 31, | | March 31, | |
| | **2018** | 2017 | **2018** | 2017 |
| | *(in thousands of dollars)* | | | |
| Massachusetts Electric Company | **$ 8,252** | $ 9,883 | **$ -** | $ - |
| National Grid Engineering Services, LLC | **6,104** | 6,092 | **-** | - |
| NGUSA | **-** | - | **5,953** | 6,912 |
| NGUSA Service Company | **-** | - | **113,530** | 80,925 |
| The Narragansett Electric Company | **9** | 1,099 | **-** | - |
| Other | **588** | 3,499 | **720** | 720 |
| Total | **$ 14,953** | $ 20,573 | **$ 120,203** | $ 88,557 |

**Advance from Affiliate**

The Company has board authorization to borrow up to $500 million from NGUSA and $450 million from NMHI as deemed necessary for working capital needs. At March 31, 2018 and 2017, the Company had no outstanding advance from affiliate.

**Intercompany Money Pool**

The settlement of the Company's various transactions with NGUSA and certain affiliates generally occurs via the intercompany money pool in which it participates. The Company is a participant in the Regulated Money Pool and can both borrow and invest funds. Borrowings from the Regulated Money Pool bear interest in accordance with the terms of the Regulated Money Pool Agreement. As the Company fully participates in the Regulated Money Pool rather than settling intercompany charges with cash, all changes in the intercompany money pool balance and accounts receivable from affiliates and accounts payable to affiliates balances are reflected as investing or financing activities in the accompanying statements of cash flows. In addition, for the purpose of presentation in the statements of cash flows, it is assumed all amounts settled through the intercompany money pool are constructive cash receipts and payments, and therefore are presented as such.

The Regulated Money Pool is funded by operating funds from participants. NGUSA has the ability to borrow up to $3 billion from National Grid plc for working capital needs including funding of the Regulated Money Pool, if necessary. The Company had short-term intercompany money pool investments of $133.7 million and $574.2 million at March 31, 2018 and 2017, respectively. The average interest rates for the intercompany money pool were 1.6%, 1.1%, and 0.7% for the years ended March 31, 2018, 2017, and 2016, respectively.

**Service Company Charges**

The affiliated service companies of NGUSA provide certain services to the Company at their cost. The service company costs are generally allocated to associated companies through a tiered approach. First and foremost, costs are directly charged to the benefited company whenever practicable. Secondly, in cases where direct charging cannot be readily determined, costs are allocated using cost/causation principles linked to the relationship of that type of service, such as number of employees, number of customers/meters, capital expenditures, value of property owned, and total transmission and distribution expenditures. Lastly, all other costs are allocated based on a general allocator determined using a 3-point formula based on net margin, net property, plant and equipment, and operations and maintenance expense.

Charges from the service companies of NGUSA, including but not limited to non-power goods and services, to the Company for the years ended March 31, 2018, 2017, and 2016 were $377.2 million, $495.6 million, and $478.4 million, respectively.