

**New York State Electric & Gas Corporation**  
**Financial Statements**  
**For the Years Ended December 31, 2006 and 2005**

# New York State Electric & Gas Corporation

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**Report of Independent Auditors**

To the Shareholder and Board of Directors  
of New York State Electric & Gas Corporation:

In our opinion, the accompanying balance sheets and the related statements of income, of cash flows and of changes in common stock equity present fairly, in all material respects, the financial position of New York State Electric & Gas Corporation at December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, effective December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.



PricewaterhouseCoopers LLP  
February 28, 2007

**New York State Electric & Gas Corporation  
Statements of Income**

Year Ended December 31, (Thousands)	2006	2005
<b>Operating Revenues</b>		
Electric	\$1,703,031	\$1,646,245
Natural gas	440,303	477,744
<b>Total Operating Revenues</b>	<b>2,143,334</b>	<b>2,123,989</b>
<b>Operating Expenses</b>		
Electricity purchased	946,121	914,475
Natural gas purchased	280,462	317,511
Other operating expenses	256,590	237,432
Maintenance	114,240	99,057
Depreciation and amortization	115,475	104,853
Other taxes	110,709	109,721
<b>Total Operating Expenses</b>	<b>1,823,597</b>	<b>1,783,049</b>
<b>Operating Income</b>	<b>319,737</b>	<b>340,940</b>
<b>Other (Income)</b>	<b>(10,036)</b>	<b>(11,878)</b>
<b>Other Deductions</b>	<b>6,228</b>	<b>2,750</b>
<b>Interest Charges, Net</b>	<b>87,614</b>	<b>79,967</b>
<b>Income Before Income Taxes</b>	<b>235,931</b>	<b>270,101</b>
<b>Income Taxes</b>	<b>92,913</b>	<b>107,056</b>
<b>Net Income</b>	<b>143,018</b>	<b>163,045</b>
<b>Preferred Stock Dividends</b>	<b>396</b>	<b>396</b>
<b>Earnings Available for Common Stock</b>	<b>\$142,622</b>	<b>\$162,649</b>

The [notes](#) on pages 7 through 27 are an integral part of our financial statements.

**New York State Electric & Gas Corporation  
Balance Sheets**

<b>December 31,</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$18,394	\$19,171
Investments available for sale	20,000	99,825
Accounts receivable and unbilled revenues, net	337,850	317,477
Affiliated account receivable	7,337	2,976
Fuel and natural gas in storage, at average cost	61,917	68,868
Materials and supplies, at average cost	8,872	9,656
Deferred income taxes	56,443	-
Derivative assets	-	224,654
Prepayments and other current assets	69,349	53,853
<b>Total Current Assets</b>	<b>580,162</b>	<b>796,480</b>
<b>Utility Plant, at Original Cost</b>		
Electric	2,793,267	2,716,443
Natural gas	737,503	718,206
Common	246,816	161,640
	<b>3,777,586</b>	<b>3,596,289</b>
Less accumulated depreciation	1,368,743	1,277,238
<b>Net Utility Plant in Service</b>	<b>2,408,843</b>	<b>2,319,051</b>
Construction work in progress	24,424	88,015
<b>Total Utility Plant</b>	<b>2,433,267</b>	<b>2,407,066</b>
<b>Other Property and Investments</b>	<b>22,620</b>	<b>23,082</b>
<b>Regulatory and Other Assets</b>		
Regulatory assets		
Deferred income taxes	20,392	94,028
Environmental remediation costs	89,721	85,239
Unfunded future income taxes	39,679	48,869
Unamortized loss on debt reacquisitions	34,799	38,828
Gas hedge - losses	24,648	-
Pension and other postretirement benefits	136,745	-
Other	60,129	38,512
<b>Total regulatory assets</b>	<b>406,113</b>	<b>305,476</b>
Other assets		
Prepaid pension benefits	468,038	531,526
Derivative assets	34,784	59,941
Other	31,557	32,519
<b>Total other assets</b>	<b>534,379</b>	<b>623,986</b>
<b>Total Regulatory and Other Assets</b>	<b>940,492</b>	<b>929,462</b>
<b>Total Assets</b>	<b>\$3,976,541</b>	<b>\$4,156,090</b>

The notes on pages 7 through 27 are an integral part of our financial statements

**New York State Electric & Gas Corporation  
Balance Sheets**

December 31,	2006	2005
<b>(Thousands)</b>		
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Current portion of long-term debt	\$150,706	\$37,626
Accounts payable and accrued liabilities	45,384	40,795
Accounts payable to affiliates	14,370	18,267
Accounts payable, purchased gas	27,972	50,869
Accounts payable, purchased power	92,878	153,136
Interest accrued	10,333	8,689
Taxes accrued	2,768	-
Unfunded future income taxes	15,677	-
Deferred income taxes	-	83,595
Customer refund	61,439	-
Derivative liabilities	24,932	-
Other	85,015	77,920
<b>Total Current Liabilities</b>	<b>531,474</b>	<b>470,897</b>
<b>Regulatory and Other Liabilities</b>		
Regulatory liabilities		
Accrued removal obligation	363,686	346,918
Gain on sale of generation assets	9,285	60,142
Natural gas hedges	-	27,236
Other	22,505	51,603
Total regulatory liabilities	395,476	485,899
Other liabilities		
Deferred income taxes	570,145	599,140
Other postretirement benefits	242,623	221,485
Asset retirement obligation	17,480	6,387
Environmental remediation costs	112,387	107,904
Other	61,678	77,802
Total other liabilities	1,004,313	1,012,718
<b>Total Regulatory and Other Liabilities</b>	<b>1,399,789</b>	<b>1,498,617</b>
Other long-term debt	989,839	1,028,361
<b>Total Liabilities</b>	<b>2,921,102</b>	<b>2,997,875</b>
<b>Commitments and Contingencies</b>		
<b>Preferred Stock</b>		
Redeemable solely at the option of NYSEG	10,159	10,159
<b>Common Stock Equity</b>		
Common stock (\$6.66 2/3 par value, 90,000 shares authorized and 64,508 shares outstanding for 2006 and 2005)	430,057	430,057
Capital in excess of par value	267,154	266,800
Retained earnings	336,358	308,736
Accumulated other comprehensive income	11,711	142,463
<b>Total Common Stock Equity</b>	<b>1,045,280</b>	<b>1,148,056</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$3,976,541</b>	<b>\$4,156,090</b>

The notes on pages 7 through 27 are an integral part of our financial statements.

**New York State Electric & Gas Corporation  
Statements of Cash Flows**

Year Ended December 31,	2006	2005
<b>(Thousands)</b>		
<b>Operating Activities</b>		
Net income	<b>\$143,018</b>	\$163,045
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	<b>131,086</b>	124,886
Deferred income taxes and investment tax credits , net	<b>10,432</b>	37,966
Pension income	<b>(35,660)</b>	(34,687)
Changes in current operating assets and liabilities		
Accounts receivable and unbilled revenues, net	<b>(26,260)</b>	(1,805)
Inventory	<b>7,735</b>	(24,195)
Prepayments and other current assets	<b>(18,678)</b>	(7,267)
Accounts payable and accrued liabilities	<b>(79,948)</b>	86,366
Interest accrued	<b>1,644</b>	1,630
Taxes accrued	<b>4,520</b>	-
Other current liabilities	<b>(11,564)</b>	28,803
Other assets	<b>(17,965)</b>	(1,726)
Other liabilities	<b>(5,740)</b>	35,696
<b>Net Cash Provided by Operating Activities</b>	<b>102,620</b>	408,712
<b>Investing Activities</b>		
Utility plant additions	<b>(140,118)</b>	(164,474)
Maturities of current investments available for sale	<b>500,465</b>	262,800
Purchases of current investments available for sale	<b>(420,640)</b>	(362,025)
Investments	<b>434</b>	14,436
Other	<b>-</b>	236
<b>Net Cash Used in Investing Activities</b>	<b>(59,859)</b>	(249,027)
<b>Financing Activities</b>		
Long-term note issuances	<b>112,000</b>	65,000
Long-term note repayments	<b>(37,626)</b>	(65,559)
Notes payable	<b>-</b>	(57,967)
Book overdraft	<b>(2,516)</b>	2,428
Dividends on common and preferred stock	<b>(115,396)</b>	(100,396)
<b>Net Cash Used in Financing Activities</b>	<b>(43,538)</b>	(156,494)
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<b>(777)</b>	3,191
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>19,171</b>	15,980
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$18,394</b>	\$19,171

The [notes](#) on pages 7 through 27 are an integral part of our financial statements.

**New York State Electric & Gas Corporation**  
**Statements of Changes in Common Stock Equity**

(Thousands, except per share amounts)	Common Stock Outstanding \$6.66 2/3 Par Value		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive (Loss)	Total
	Shares	Amount				
<b>Balance, January 1, 2005</b>	64,508	\$430,057	\$277,748	\$246,087	\$9,749	\$963,641
Net income				163,045		163,045
Other comprehensive income, net of tax					132,714	132,714
Comprehensive income						295,759
Equity contribution from parent			250			250
Transfer of goodwill to RGS			(11,198)			(11,198)
Cash dividends declared						
Preferred stock (at serial rates)						
Redeemable - optional				(396)		(396)
Common stock				(100,000)		(100,000)
<b>Balance, December 31, 2005</b>	64,508	430,057	266,800	308,736	142,463	1,148,056
Net income				143,018		143,018
Other comprehensive (loss), net of tax					(130,046)	(130,046)
Comprehensive income						12,972
Adjustment to initially apply Statement 158					(706)	(706)
Equity contribution from parent			354			354
Cash dividends declared						
Preferred stock (at serial rates)						
Redeemable - optional				(396)		(396)
Common stock				(115,000)		(115,000)
<b>Balance, December 31, 2006</b>	64,508	\$430,057	\$267,154	\$336,358	\$11,711	\$1,045,280

The [notes](#) on pages 7 through 27 are an integral part of our financial statements.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 1. Significant Accounting Policies

**Background:** New York State Electric & Gas Corporation (NYSEG), is primarily engaged in electricity transmission and distribution operations and natural gas transportation, storage and distribution operations in upstate New York. We became a wholly-owned subsidiary of RGS Energy Group, Inc. (RGS Energy) as a result of a merger between Energy East Corporation (Energy East) and RGS Energy on June 28, 2002.

**Accounts receivable:** Accounts receivable include unbilled revenues of \$82 million at December 31, 2006, and \$131 million at December 31, 2005, and are shown net of an allowance for doubtful accounts of \$20 million at December 31, 2006, and \$12 million at December 31, 2005. Accounts receivable do not bear interest, although late fees may be assessed. Bad debt expense was \$28 million in 2006, \$22 million in 2005.

Unbilled revenues represent estimates of receivables for energy provided but not yet billed. The estimates are determined based on various assumptions, such as current month energy load requirements, billing rates by customer classification and delivery loss factors. Changes in those assumptions could significantly affect the estimates of unbilled revenues.

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable, determined based on experience for each service region and operating segment and other economic data. Each month we review our allowance for doubtful accounts and past due accounts over 90 days and/or above a specified amount, and review all other balances on a pooled basis by age and type of receivable. When we believe that a receivable will not be recovered, we charge off the account balance against the allowance. Changes in assumptions about input factors such as economic conditions and customer receivables, which are inherently uncertain and susceptible to change from period to period, could significantly affect the allowance for doubtful accounts estimates.

**Asset retirement obligation:** In accordance with Financial Accounting Standards Board (FASB) Statement 143, Accounting for Asset Retirement Obligations, and FASB Interpretation Number (FIN) 47, Accounting for Conditional Asset Retirement Obligations, we record the fair value of the liability for an asset retirement obligation and/or a conditional asset retirement obligation in the period in which it is incurred and capitalize the cost by increasing the carrying amount of the related long-lived asset. We adjust the liability to its present value periodically over time, and depreciate the capitalized cost over the useful life of the related asset. Upon settlement we will either settle the obligation at its recorded amount or incur a gain or a loss. We defer any timing differences between rate recovery and depreciation expense as either a regulatory asset or a regulatory liability.

FIN 47 clarifies that the term conditional asset retirement obligation as used in Statement 143 refers to an entity's legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 requires that if an entity has sufficient information to reasonably estimate the fair value of the liability for a conditional asset retirement obligation, it must recognize that liability at the time the liability is incurred. We began applying FIN 47 effective December 31, 2005. Our application of FIN 47 did not have a material effect on our financial position, and there was no effect on our results of operations or cash flows.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

Our asset retirement obligation (ARO) including our estimated conditional asset retirement obligation at December 31 was \$17.5 million for 2006 and \$6.4 million for 2005. The ARO primarily consists of obligations related to removal or retirement of: asbestos, polychlorinated biphenyl (PCB) contaminated equipment, gas pipeline and cast iron gas mains. The long-lived assets associated with our AROs are generation property, gas storage property, distribution property and other property.

The following table reconciles the beginning and ending aggregate carrying amount of the ARO for the years ended December 31, 2006 and 2005. The increase for 2006 is primarily for abandonment activities for bare steel mains and revisions to estimates for removal of asbestos and bare steel services. The increase for 2005 is primarily for disposal of PCB contaminated devices and removal of asbestos based upon the initial application of FIN 47.

<u>Year Ended December 31,</u> (Thousands)	<u>2006</u>	<u>2005</u>
ARO, beginning of year	6,387	\$216
Liabilities incurred during the year	8,521	6,339
Liabilities settled during the year	(228)	(181)
Accretion expense	354	13
Revisions in estimated cash flows	2,446	-
ARO, end of year	<b>\$17,480</b>	\$6,387

We have AROs for which we have not recognized a liability because the fair value cannot be reasonably estimated due to indeterminate settlement dates, including: the removal of hydro dams due to structural inadequacy; the removal of property upon termination of an easement, rights-of-way or franchise; and costs for abandonment of certain types of gas mains

Statement 143 provides that if the requirements for Statement 71, Accounting for the Effects of Certain Types of Regulations, are met, a regulatory liability should be recognized, for financial reporting purposes only, for the difference between removal costs collected in rates and actual costs incurred. We classify those amounts as accrued removal obligations.

**Statements of cash flows:** We consider all highly liquid investments with a maturity date of three months or less when acquired to be cash equivalents and those investments are included in cash and cash equivalents.

<u>Supplemental Disclosure of Cash Flows Information</u> (Thousands)	<u>2006</u>	<u>2005</u>
Cash paid during the year ended December 31:		
Interest, net of amounts capitalized	\$53,787	\$51,552
Income taxes, net of benefits received	\$63,062	\$69,808

The Company's book overdrafts are treated as a current liability by including them in accounts payable on the balance sheet.

The amount of capitalized interest was \$1 million in 2006 and less than \$1 million in 2005.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

**Depreciation and amortization:** We determine depreciation expense substantially using the straight-line method, based on the average service lives of groups of depreciable property, which include estimated cost of removal, in service at each operating company. The weighted-average service lives of certain classifications of property are: transmission property – 62 years, distribution property – 54 years, gas production and storage - 20 years, generation – 60 years and other property - 43 years. Our depreciation accruals were equivalent to 3.0% of average depreciable property for 2006 and 2005.

We charge repairs and minor replacements to operating expense, and capitalize renewals and betterments, including certain indirect costs. We charge the original cost of utility plant retired or otherwise disposed of to accumulated depreciation.

**Estimates:** Preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**FIN 48:** In July 2006 the FASB released FIN 48, Accounting for Uncertainty in Income Taxes, which clarifies uncertainty in income taxes recognized in financial statements in accordance with Statement 109, Accounting for Income Taxes, by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or to be taken in a tax return. The evaluation of a tax position is a two-step process. The first step is for an entity to determine if it is more likely than not that a tax position will be sustained upon examination. The second step involves measuring the amount of tax benefit to be recognized in the financial statements based on the largest amount of benefit that meets the prescribed recognition threshold. The difference between the amounts based on that position and the position taken in a tax return is generally recorded as a liability. FIN 48 is effective for fiscal years beginning after December 15, 2006. Upon adoption of FIN 48, the cumulative effect of applying the provisions of FIN 48 must be reported as an adjustment to the opening balance of retained earnings for that fiscal year. We are required to adopt FIN 48 on January 1, 2007. We are still in the process of measuring the effect of the adoption. We estimate that the adoption will not have a material effect on our results of operations or financial positions.

**Investments available for sale:** We held current investments of \$20 million at December 31, 2006, and \$100 million at December 31, 2005, which consisted of auction rate securities classified as available-for-sale. Our investments in these securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every 7 to 35 days. Despite the long-term nature of their stated contractual maturities, we have the ability to quickly liquidate such securities. As a result, we have no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from our current investments. All income generated from these current investments is recorded as interest income.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### *Other (Income) and Other Deductions:*

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
<b>(Thousands)</b>		
Interest and dividend income	<b>\$(4,765)</b>	\$(5,292)
Merger enabled gas savings	<b>(1,423)</b>	(238)
Allowance for funds used during construction	<b>(794)</b>	(1,091)
Gains from settlement of derivative contracts	<b>(2,675)</b>	(4,717)
Miscellaneous	<b>(379)</b>	(540)
<b>Total other (income)</b>	<b>\$(10,036)</b>	\$(11,878)
Losses from settlement of derivative contracts	<b>\$6,376</b>	\$1,385
Merger enabled gas savings	<b>(1,013)</b>	538
Donations, civic and political	<b>277</b>	-
Miscellaneous	<b>588</b>	827
<b>Total other deductions</b>	<b>\$6,228</b>	\$2,750

**Regulatory assets and liabilities:** Pursuant to Statement 71 we capitalize, as regulatory assets, incurred and accrued costs that are probable of recovery in future electric and natural gas rates. Substantially all regulatory assets for which funds have been expended are either included in rate base or are accruing carrying costs. We also record, as regulatory liabilities, obligations to refund previously collected revenue or to spend revenue collected from customers on future costs.

Unfunded future income taxes and deferred income taxes are amortized as the related temporary differences reverse. Unamortized loss on debt reacquisitions is amortized over the lives of the related debt issues. Other regulatory assets and other regulatory liabilities are amortized over various periods in accordance with our current rate plans.

At December 31, 2006 and 2005, our other regulatory assets and liabilities consisted of:

<b>(thousands)</b>	<b>2006</b>	<b>2005</b>
<b>Other regulatory assets</b>		
Deferred gas cost	<b>\$349</b>	\$2,677
Asset retirement obligation	<b>12,860</b>	5,256
Deferred pension cost	<b>24,648</b>	16,771
Site remediation	<b>12,295</b>	6,404
Other	<b>9,977</b>	7,404
<b>Total other regulatory assets</b>	<b>\$60,129</b>	\$38,512
<b>Other regulatory liabilities</b>		
Earnings sharing	<b>\$6,404</b>	\$27,600
Deferred gas cost	<b>3,752</b>	9,021
Economic development	<b>6,934</b>	4,213
Other	<b>5,415</b>	10,769
<b>Total other regulatory liabilities</b>	<b>\$22,505</b>	\$51,603

## Notes to Financial Statements

### New York State Electric & Gas Corporation

**Related party transactions:** Utility Shared Services Corporation and Energy East Management Corporation provide various administrative and management services to Energy East's operating utilities, including NYSEG, pursuant to service agreements. The cost for those services is allocated in accordance with methodologies set forth in the service agreements. The cost allocation methodologies vary depending on the type of service provided. The cost for services provided to NYSEG by Utility Shared Services Corporation and Energy East Managements Corporation was approximately \$51 million in 2006 and \$52 million in 2005.

**Revenue recognition:** We recognize revenues upon delivery of energy and energy-related products and services to our customers.

We enter into power purchase and sales transactions with the New York Independent System Operator (NYISO). When we sell electricity from owned generation to the NYISO, and subsequently repurchase electricity from the NYISO to serve our customers, we record the transactions on a net hourly basis in our statements of income.

**Risk management:** The financial instruments we hold or issue are not for trading or speculative purposes.

We use interest rate swap agreements to manage the risk of increases in variable interest rates and to maintain desired fixed-to-floating rate ratios. We record amounts paid and received under the agreements as adjustments to the interest expense of the specific debt issues. We also use derivative instruments to mitigate risk resulting from interest rate changes on anticipated future financings and we amortize amounts paid or received under those instruments to interest expense over the life of the corresponding financing.

We face risks related to counterparty performance on derivative contracts due to counterparty credit default. NYSEG in conjunction with Energy East has developed a matrix of unsecured credit thresholds that are dependent on a counterparty's Moody's or S&P credit rating. When Energy East's exposure to risk for a counterparty exceeds the unsecured credit threshold, the counterparty is required to post additional collateral or NYSEG will no longer transact with the counterparty until the exposure drops below the unsecured credit threshold.

We use electricity contracts, both physical and financial, to manage fluctuations in the cost of electricity. We include the cost or benefit of those contracts in the amount expensed for electricity purchased when the electricity is sold.

We have a purchased gas adjustment clause that allows us to recover through rates any changes in the market price of purchased natural gas, substantially eliminating our exposure to natural gas price risk. We use natural gas futures and forwards to manage fluctuations in the natural gas commodity prices and provide price stability to customers. We include the cost or benefit of natural gas futures and forwards in the commodity cost when the related sales commitments are fulfilled.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

We recognize the fair value of our financial electricity contracts, natural gas hedge contracts and interest rate agreements as current and noncurrent derivative assets or other current and noncurrent liabilities. At December 31, 2006, NYSEG had \$33 million of derivative assets, all of which were noncurrent and \$29 million of derivative liabilities, of which \$25 million were current. At December 31, 2005 it had \$285 million of derivative assets, of which \$225 million were current and \$7 million of noncurrent derivative liabilities. Our financial electricity contracts and interest swap agreements are designated as cash flow hedging instruments, except for our fixed-to floating interest swap, which is designated as a fair value hedge. We record changes in the fair value of the cash flow hedging instruments in other comprehensive income, to the extent they are considered effective, until the underlying transaction occurs. We record the ineffective portion of any change in fair value of cash flow hedges to the income statement as either Other (Income) or Other Deductions, as appropriate. We report changes in the fair value of the interest rate swap agreement on our statement of income in the same period as the offsetting change in the fair value of the underlying debt instrument. We record changes in the fair value of natural gas hedge contracts as regulatory assets or regulatory liabilities.

We use quoted market prices to determine the fair value of derivatives and adjust for volatility and inflation when the period of the derivative exceeds the period for which market prices are readily available.

As of December 31, 2006, the maximum length of time over which we had hedged our exposure to the variable in future cash flows for forecasted energy transactions was 36 months.

We have commodity purchases and sales contracts for both capacity and energy that have been designated and qualify for the normal purchases and normal sales exception in Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended.

**Statement 157:** In September 2006 the FASB issued Statement 157, Fair Value Measurements. Changes from current practice that will result from the application of Statement 157 relate to the definition of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. Statement 157 applies under other accounting pronouncements that require or permit fair value measurements in which the FASB previously concluded that fair value is the relevant measurement attribute. It does not require any new fair value measurements, but may change current practice for some entities. Statement 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with earlier application encouraged. The provisions are to be applied prospectively, with certain exceptions. A cumulative-effect adjustment to retained earnings is required for application to certain financial instruments. We will adopt Statement 157 effective January 1, 2008. We are currently assessing the effect Statement 157 would have on our results of operations, financial position and cash flows.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

**Statement 158:** In September 2006 the FASB issued Statement 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, which amends FASB Statements No. 87, 88, 106 and 132(R), and requires an employer to:

- recognize the overfunded or underfunded status of defined benefit pension and/or other postretirement plans as an asset or liability in its balance sheet;
- recognize changes in the funded status of such plans in the year in which the changes occur through comprehensive income;
- measure the funded status of a plan as of the date of its year-end balance sheet, and
- disclose in the notes to the annual financial statements certain effects that the delayed recognition of the gains or losses, prior service costs or credits and transition asset or obligation are expected to have on net periodic benefit cost for the next fiscal year.

The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation, which is the projected benefit obligation for a pension plan and the accumulated postretirement benefit obligation for any other postretirement benefit plan. As required by Statement 158, gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to Statement 87, Employers' Accounting for Pensions, or Statement 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, are recognized as a component of other comprehensive income, net of tax.

Gains or losses, prior service costs or credits and the transition asset or obligation remaining from the initial application of Statements 87 and 106 that subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. However, Energy East's operating companies are rate-regulated entities that meet the criteria to apply Statement 71. Based on our assessments of the facts and circumstances applicable to the jurisdiction and regulatory environment of each operating company, we have determined that all of our operating companies are allowed to defer as regulatory assets or regulatory liabilities the above indicated items. Other entities that are not rate-regulated would recognize those items as a component of other comprehensive income and/or include them in accumulated other comprehensive income.

We initially applied the recognition and disclosure provisions of Statement 158 as of December 31, 2006, which increased assets and liabilities, but had no effect on our results of operation or cash flows. Retrospective application of the recognition provisions and measurement provisions is not permitted. We measure our pension and other postretirement plan assets and benefit obligations as of the date of our fiscal year-end balance sheet and therefore have no need to change our measurement date.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

The incremental effect of applying Statement 158 for our qualified plans on individual line items in our balance sheet as of December 31, 2006, is:

	Before Application of Statement 158	Adjustments	After Application of Statement 158
<b>(Thousands)</b>			
<b>Regulatory and Other Assets</b>			
<b>Regulatory assets</b>			
Pension and other postretirement benefits	-	\$136,745	\$136,745
Other regulatory assets	\$269,368	-	269,368
<b>Other assets</b>			
Prepaid pension benefits	567,186	(99,148)	468,038
Total other assets	3,102,390	-	3,102,390
<b>Total Assets</b>	<b>\$3,938,944</b>	<b>\$37,597</b>	<b>\$3,976,541</b>
<b>Current Liabilities</b>			
Deferred income taxes	\$8,165	\$(8,165)	-
Other	64,539	20,476	\$85,015
All other current liabilities	446,459	-	446,459
<b>Regulatory liabilities</b>			
Deferred income taxes	(54,527)	54,527	-
Other regulatory liabilities	395,476	-	395,476
<b>Other liabilities</b>			
Deferred income taxes	616,507	(46,362)	570,145
Pension and other postretirement benefits	225,502	17,121	242,623
Long-term debt and other liabilities	1,181,384	-	1,181,384
<b>Total Liabilities</b>	<b>\$2,883,505</b>	<b>\$37,597</b>	<b>\$2,921,102</b>
<b>Preferred stock and common stock equity</b>			
Preferred stock	\$10,159	-	\$10,159
Total Common stock equity	1,045,280	-	1,045,280
<b>Total Preferred stock and Common Stock Equity</b>	<b>\$1,055,439</b>	<b>-</b>	<b>1,055,439</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$3,938,944</b>	<b>\$37,597</b>	<b>\$3,976,541</b>

**Statement 159:** In February 2007 the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (Statement 159), which will allow an entity to measure eligible financial instruments and certain other items at fair value at specified election dates on an instrument-by-instrument basis (the fair value option). The fair value option is irrevocable unless a new election date occurs. The fair value option will significantly expand an entity's ability to select the measurement attribute for certain key assets and liabilities, and allow it to mitigate potential mismatches that arise under the current mixed measurement attribute model. Statement 159 will be effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption permitted when specified conditions are met. Retrospective application to fiscal years preceding the effective date is not permitted unless the entity chooses early adoption. Application to eligible items existing at the effective date (or early adoption date) is permitted. We plan to adopt Statement 159 as of January 1, 2008. We are currently assessing the effect Statement 159 would have on our results of operations, financial position and cash flows.

## Notes to Financial Statements

### **New York State Electric & Gas Corporation**

**Taxes:** NYSEG computes its income tax provision on a separate return method. The determination and allocation of NYSEG's income tax provision and its components are outlined and agreed to in its tax sharing agreement with Energy East.

Deferred income taxes reflect the effect of temporary differences between the amount of assets and liabilities recognized for financial reporting purposes and the amount recognized for tax purposes. NYSEG amortizes Investment Tax Credits (ITCs) over the estimated lives of the related assets.

NYSEG accounts for sales tax collected from customers and remitted to taxing authorities on a net basis.

Energy East revised its Income Tax Allocation Agreement (Agreement) in 2006. The revised Agreement, which applies to income tax returns after 2004, and is accounted for at the time of the filing of the income tax returns in the subsequent year, eliminates the push-down requirements of PUHCA and better aligns the allocation of income taxes with the Cost of Service "stand alone" approach used in each of our regulated entities' rate structures.

If the revised agreement had been in place in 2005, NYSEG's income taxes would have been \$4.4 million higher.

**Variable interest entities:** FASB Interpretation No. 46 Consolidation of Variable Interest Entities, and interpretation of Accounting Research Bulletin No. 51 (FIN 46R), addresses consolidation of variable interest entities. A variable interest entity is an entity that is not controllable through voting interests and/or in which the equity investor does not bear the residual economic risks and rewards. FIN 46(R) requires a business enterprise to consolidate a variable interest entity if the enterprise has a variable interest that will absorb a majority of the entity's expected losses. As of March 31, 2004, we applied FIN 46(R) to all entities subject to the interpretation, as required.

We have power purchase contracts with nonutility generators (NUGs). However, we were not involved in the formation of and do not have ownership interest in any NUGs. We have evaluated all of our power purchase contracts with NUGs with respect to FIN 46(R) and determined that most of the purchase contracts are not variable interests for one of the following reasons: the contract is based on a fixed price or a market price and there is no other involvement with the NUG, the contract is short-term in duration, the contract is for a minor portion of the NUG's capacity or the NUG is a governmental organization or an individual. One of our NUG contracts expired in April 2006. We are not able to determine if we have variable interests with respect to power purchase contracts with two remaining NUGs because we are unable to obtain the information necessary to: (1) determine if any of the two NUGs is a variable interest entity, (2) determine if an operating utility is a NUG's primary beneficiary or (3) perform the accounting required to consolidate any of those NUGs. We routinely request necessary information from the two NUGs, and will continue to do so, but no NUG has yet provided the requested information. We did not consolidate any NUGs as of December 31, 2006, and 2005.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

We continue to purchase electricity from the two NUGs at above-market prices. We are not exposed to any loss as a result of our involvement with the NUGs because we are allowed to recover through rates the cost of our purchases. Also, we are under no obligation to a NUG if it decides not to operate for any reason. The combined purchases from the two NUGs totaled approximately \$338 million in 2006 and the combined purchases from the three NUGs totaled \$364 million in 2005.

#### Note 2. Income Taxes

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
Current		
Federal	<b>\$68,104</b>	\$58,268
State	<b>14,377</b>	10,822
Current taxes charged to expense	<b>82,481</b>	69,090
Deferred		
Federal	<b>8,099</b>	32,510
State	<b>3,013</b>	6,136
Deferred taxes charged to expense	<b>11,112</b>	38,646
ITC adjustments	<b>(680)</b>	(680)
<b>Total</b>	<b>\$92,913</b>	\$107,056

Our tax expense differed from the expense at the statutory rate of 35% due to the following:

<b>Year Ended December 31,</b>	<b>2006</b>	<b>2005</b>
(Thousands)		
Tax expense at statutory rate	<b>\$82,576</b>	\$94,536
Depreciation and amortization not normalized	<b>6,598</b>	6,934
ITC amortization	<b>(680)</b>	(680)
State taxes, net of federal benefit	<b>11,304</b>	11,022
Other, net	<b>(6,885)</b>	(4,756)
<b>Total</b>	<b>\$92,913</b>	\$107,056

The effective tax rate was 39% in 2006 and 40% in 2005.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

At December 31, 2006 and 2005, our deferred tax assets and liabilities consisted of:

	2006	2005
<b>(Thousands)</b>		
<b>Current Deferred Income Tax Assets (Liabilities)</b>		
Derivative assets (liabilities)	\$10,619	\$(89,581)
Other	45,824	5,986
<b>Total Current Deferred Income Tax Assets (Liabilities)</b>	<b>\$56,443</b>	<b>\$(83,595)</b>
<b>Noncurrent Deferred Income Tax Liabilities</b>		
Depreciation	\$381,144	\$412,460
Unfunded future income taxes	18,841	19,839
Accumulated deferred ITC	21,232	21,912
Pension	183,329	171,381
Postretirement benefits	(64,396)	(67,047)
Other	9,603	(53,433)
<b>Total Noncurrent Deferred Income Tax Liabilities</b>	<b>\$549,753</b>	<b>\$505,112</b>
Less amounts classified as regulatory liabilities		
Deferred income taxes	(20,392)	(94,028)
<b>Noncurrent Deferred Income Tax Liabilities</b>	<b>\$570,145</b>	<b>\$599,140</b>
Deferred Tax Assets	\$120,839	126,466
Deferred Tax Liabilities	614,149	715,173
<b>Net Accumulated Deferred Income Tax Liabilities</b>	<b>\$493,310</b>	<b>\$588,707</b>

We have no federal tax credit or loss carry forwards and no valuation allowances.

### Note 3. Long-term Debt

At December 31, 2006 and 2005, our long-term debt was:

	Maturity Dates	Interest Rates	2006	2005
<b>(Thousands)</b>				
Pollution control notes, fixed	2015 to 2034	3.245% to 6.00%	\$232,000	\$269,000
Pollution control notes, variable	2024 to 2029	3.50% to 3.85%	356,000	344,000
Long-term notes	2007 to 2023	4 3/8% to 5.75%	550,000	450,000
Obligations under capital leases			6,184	6,809
Unamortized premium and discount on debt, net			(3,639)	(3,822)
			<b>1,140,545</b>	<b>1,065,987</b>
Less debt due within one year, included in current liabilities			150,706	37,626
<b>Total</b>			<b>\$989,839</b>	<b>\$1,028,361</b>

NYSEG has no secured indebtedness. None of our debt obligations are guaranteed or secured by any of our affiliates.

At December 31, 2006, long-term debt and capital lease payments (in thousands) that will become due during the next five years are:

2007	2008	2009	2010	2011
\$150,706	\$761	\$840	\$768	\$303

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 4. Bank Loans and Other Borrowings

NYSEG participates in a joint borrowing with the other operating utilities under Energy East in a revolving credit facility providing to NYSEG maximum borrowings of \$200 million. Sublimits that total to the aggregate limit apply to each joint borrower and can be altered within the constraints imposed by maximum limits that apply to each joint borrower. This facility expires in 2011 and requires a fee on undrawn borrowing capacity.

In our revolving credit facility we covenant not to permit, without the consent of the lender, our ratio of consolidated indebtedness to consolidated total capitalization to exceed 0.65 to 1.00 at any time. The facility contains various other covenants, including a restriction on the amount of secured indebtedness Energy East may maintain. Continued unremedied failure to comply with those covenants for 15 days after written notice of such failure from the lender constitutes an event of default and would result in acceleration of maturity. Our ratio of consolidated indebtedness to consolidated total capitalization pursuant to the revolving credit facility was 0.52 to 1.00 at December 31, 2006. We are not in default at December 31, 2006.

We use short-term, unsecured notes to finance working capital needs and for other corporate purposes. There was no short-term debt outstanding at December 31, 2006, and 2005.

#### Note 5. Preferred Stock Redeemable Solely at the Option of NYSEG

At December 31, 2006 and 2005, our serial cumulative preferred stock was:

Series	Par Value Per Share	Redemption Price Per Share	Shares Authorized and Outstanding <sup>(1)</sup>	2006	Amount 2005
				(Thousands)	
3.75%	\$100	\$104.00	78,379	<b>\$7,838</b>	\$7,838
4 ½% (1949)	100	103.75	11,800	<b>1,180</b>	1,180
4.40%	100	102.00	7,093	<b>709</b>	709
4.15% (1954)	100	102.00	4,317	<b>432</b>	432
Total				<b>\$10,159</b>	\$10,159

<sup>(1)</sup> At December 31, 2006, NYSEG had 2,353,411 shares of \$100 par value preferred stock, 10,800,000 shares of \$25 par value preferred stock and 1,000,000 shares of \$100 par value preference stock authorized but unissued.

We had no redemptions or purchases of preferred stock during 2006 and 2005.

**Voting rights:** If preferred stock dividends on any series of preferred stock are in default in an amount equivalent to four full quarterly dividends, the holders of the preferred stock are entitled to elect a majority of the directors and their privilege continues until all dividends in default have been paid. The holders of preferred stock are not entitled to vote in respect of any other matters except those, if any, in respect of which voting rights cannot be denied or waived under some mandatory provision of law, and except that the charter contains provisions to the effect that such holders shall be entitled to vote on certain matters affecting the rights and preferences of the preferred stock.

## **Notes to Financial Statements**

### **New York State Electric & Gas Corporation**

Whenever holders of preferred stock shall be entitled to vote, they shall be entitled to cast one vote for each share of preferred stock held by them. Holders of our common stock are entitled to one vote per share on all matters, except in the election of directors with respect to which NYSEG common stock has cumulative voting rights.

#### **Note 6. Commitments and Contingencies**

**Capital spending:** We have commitments in connection with our capital spending program. Capital spending is expected to be paid for principally with internally generated funds. The program is subject to periodic review and revision. Our capital spending will be principally for necessary improvements to existing facilities, the extension of energy delivery service, compliance with environmental requirements and governmental mandates and an Infrastructure Replacement Program.

**Nonutility generator power purchase contracts:** We expensed approximately \$392 million for NUG power in 2006, and \$410 million in 2005. We have commitments to purchase NUG power contracts until 2020.

**NYISO billing adjustment:** The NYISO frequently bills market participants on a retroactive basis when it determines that billing adjustments are necessary. Such retroactive billings can cover several months or years and cannot be reasonably estimated. NYSEG records transmission or supply revenue or expense, as appropriate, when revised amounts are available. We have developed an accrual process that incorporates available information about retroactive NYISO billing adjustments as provided to all market participants. However, on an ongoing basis, we cannot fully predict either the magnitude or the direction of any final billing adjustments.

**NYPSC proceeding on NYSEG's accounting for OPEB:** On August 23, 2006, New York Public Service Commission(NYPSC) issued its decision in the NYSEG rate case. Among other things, the NYPSC instructed the Administrative Law Judge to open a separate proceeding regarding the NYPSC staff's position that NYSEG should have retained \$57 million of interest in its other post-employment benefit(OPEB) reserve and used it to reduce rate base. A proceeding has been opened and hearings on the issues raised by the NYPSC staff are currently scheduled for July 2007. NYPSC acceptance of its staff's position would result in NYSEG treating all or a portion of the \$57 million as an addition to its internal OPEB reserve, with a corresponding charge to income. While NYSEG is vigorously opposing staff on these issues, contending that the NYPSC staff is engaged in retroactive ratemaking, it cannot predict how this matter will be resolved.

#### **Note 7. Environmental Liability**

From time to time environmental laws, regulations and compliance programs may require changes in our operations and facilities and may increase the cost of electric and natural gas service.

## **Notes to Financial Statements**

### **New York State Electric & Gas Corporation**

The United States Environmental Protection Agency and the New York State Department of Environmental Conservation (NYSDEC), as appropriate, have notified us that we are among the potentially responsible parties who may be liable for costs incurred to remediate certain hazardous substances at 10 waste sites. The 10 sites do not include sites where gas was manufactured in the past, which are discussed below. With respect to the 10 sites, eight sites are included in the New York State Registry of Inactive Hazardous Waste Disposal Sites and four of the sites are also included on the National Priorities list.

Any liability may be joint and several for certain of those sites. We recorded an estimated liability of \$0.9 million related to three of the 10 sites. Remediation costs have been paid at the remaining seven sites, and we do not expect any additional liability to be incurred. The ultimate cost to remediate the sites may be significantly more than the accrued amount. Factors affecting the estimated remediation amount include the remedial action plan selected, the extent of site contamination and the portion attributed to us.

We have a program to investigate and perform necessary remediation at our sites where gas was manufactured in the past. In 1994 and 1996 we entered into Orders on Consent with the NYSDEC. Those Orders require us to investigate and, where necessary, remediate 35 of our 37 sites. Eight sites are included in the New York State Registry.

Our estimate for all costs related to investigation and remediation of the 37 sites ranges from \$112 million to \$198 million at December 31, 2006. That estimate is based on both known and potential site conditions and multiple remediation alternatives for each of the sites. The estimate could change materially based on facts and circumstances derived from site investigations, changes in required remedial action, changes in technology relating to remedial alternatives and changes to current laws and regulations.

The liability to investigate and perform remediation, as necessary, at the known inactive gas manufacturing sites was \$112 million at December 31, 2006, and \$107 million at December 31, 2005. We recorded a corresponding regulatory asset, net of insurance recoveries, since we expect to recover the net costs in rates.

Our environmental liability accruals, which are expected to be paid through the year 2017, have been established on an undiscounted basis. We received insurance settlements during the last three years, which we accounted for as reductions to our related regulatory asset.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 8. Fair Value of Financial Instruments

The carrying amounts and estimated fair values of our financial instruments are shown in the following table. The fair values are based on the quoted market prices for the same or similar issues of the same remaining maturities.

<b>December 31</b>	<b>2006</b>		<b>2005</b>	
	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>
<b>(Thousands)</b>				
Non current investments - classified as available-for-sale	<b>\$17,432</b>	<b>\$17,504</b>	\$17,823	\$17,823
Pollution control notes, fixed	<b>\$232,000</b>	<b>\$231,463</b>	\$269,000	\$274,832
Pollution control notes, variable	<b>\$356,000</b>	<b>\$356,000</b>	\$344,000	\$344,000
Long-term notes	<b>\$546,361</b>	<b>\$534,484</b>	\$446,178	\$451,757

The carrying amounts for cash and cash equivalents, current investments available for sale, derivative assets, derivative liabilities, notes payable and interest accrued approximate their estimated fair values.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 9. Accumulated Other Comprehensive Income (Loss)

	Balance December 31, 2004	Other Comprehensive Income (Loss) 2005	Balance December 31, 2005	Other Comprehensive Income (Loss) 2006	Adjustment to Initially Apply Statement 158	Balance December 31, 2006
<b>(Thousands)</b>						
Pension liability adjustment, net of income tax benefit (expense) of, \$7 for 2005 and \$169 for 2006 <sup>(1)</sup>	\$(431)	\$(11)	\$(442)	\$442	\$(706)	\$(706)
Unrealized gains (losses) on derivatives qualified as hedges: Unrealized gains (losses) during period on derivatives qualified as hedges, net of income tax (expense) of, \$(100,570) for 2005 and \$94,265 for 2006		151,266		(142,136)		
Reclassification adjustment for (gains) losses included in net income, net of income tax expense of \$12,386 for 2005 and \$(7,725) for 2006		(18,541)		11,648		
Net unrealized gains (losses) on derivatives qualified as hedges	10,180	132,725	142,905	(130,488)	-	12,417
<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>\$9,749</b>	<b>\$132,714</b>	<b>\$142,463</b>	<b>\$(130,046)</b>	<b>\$(706)</b>	<b>\$11,711</b>

<sup>(1)</sup>2006 Balance represents liability for nonqualified plans not included in regulatory assets.

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 10. Retirement Benefits

We sponsor defined benefit pension plans and postretirement benefit plans that cover substantially all of our employees. We use a December 31 measurement date for our pension and postretirement benefit plans.

Obligations and funded status:	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
(Thousands)				
<b>Change in benefit obligation</b>				
Benefit obligation at January 1	\$1,257,143	\$1,195,556	\$265,420	\$278,839
Service cost	21,072	20,702	2,724	2,894
Interest cost	68,085	68,153	14,526	15,227
Actuarial loss (gain)	(43,560)	39,587	(928)	(12,864)
Benefits paid	(67,692)	(66,855)	(19,767)	(18,676)
Federal Subsidy on benefits paid	-	-	1,125	-
Benefit obligation at December 31	\$1,235,048	\$1,257,143	\$263,100	\$265,420
<b>Change in plan assets</b>				
Fair value of plan assets at January 1	\$1,551,574	\$1,504,183	-	-
Actual return on plan assets	219,204	114,246	-	-
Employer contributions	-	-	\$19,767	\$18,676
Benefits paid	(67,692)	(66,855)	\$(19,767)	\$(18,676)
Fair value of plan assets at December 31	\$1,703,086	\$1,551,574	-	-
Funded status <sup>(1)</sup>	\$468,038	\$294,431	\$(263,100)	\$(265,420)
Unrecognized net actuarial loss <sup>(1)</sup>		204,229		25,363
Unrecognized net transition obligation <sup>(1)</sup>		-		47,600
Unrecognized prior service cost (benefit) <sup>(1)</sup>		32,866		(29,028)
Total unrecognized amounts		\$237,095		\$43,935
Prepaid (accrued) benefit cost		\$531,526		\$(221,485)

<sup>(1)</sup>December 31, 2006, these amounts for pension benefits and postretirement benefits are included in regulatory assets or regulatory liabilities, as appropriate, due to the application of Statement 158 and in accordance with Statement 71. See statement 158 disclosure in Note 1.

Amounts recognized on the balance sheet	Pension Benefits		Postretirement Benefits	
	2005		2006	2005
<b>2006</b>				
<b>Noncurrent asset</b>	\$468,038			
Current Liabilities			\$(20,477)	
Noncurrent Liabilities			(242,623)	
<b>Total Liabilities</b>			<b>\$(263,100)</b>	
Prepaid benefit cost	\$531,526		\$(221,485)	
Net amount recognized	\$531,526		\$(221,485)	

## Notes to Financial Statements

### New York State Electric & Gas Corporation

As explained in Note 1, we can defer as regulatory assets or regulatory liabilities items that would otherwise be recorded in accumulated other comprehensive income pursuant to Statement 158. Amounts recognized in regulatory assets or regulatory liabilities at December 31, 2006, consist of:

	Pension Benefits	Postretirement Benefits
<b>(Thousands)</b>		
Net loss	<b>\$69,872</b>	<b>\$19,668</b>
Prior service cost (benefit)	<b>\$29,276</b>	<b>\$(22,870)</b>
Transition obligation	-	<b>\$40,799</b>

Our accumulated benefit obligation for all defined benefit pension plans at December 31 was \$1,148 million for 2006 and \$1,159 million for 2005.

	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
<b>(Thousands)</b>				
<b>Components of net periodic benefit cost</b>				
Service cost	<b>\$21,072</b>	\$20,702	<b>\$2,724</b>	\$2,894
Interest cost	<b>68,085</b>	68,154	<b>14,526</b>	15,227
Expected return on plan assets	<b>(133,417)</b>	(128,426)	-	-
Amortization of prior service cost	<b>3,590</b>	3,880	<b>(6,157)</b>	(6,157)
Amortization of net actuarial gain	-	1,003	<b>4,767</b>	6,035
Amortization of transition obligation	<b>5,010</b>	-	<b>6,800</b>	6,800
Net periodic benefit cost	<b>\$(35,660)</b>	\$(34,687)	<b>\$22,660</b>	\$24,799

We include the net periodic benefit cost in other operating expenses. The net periodic benefit cost for postretirement benefits represents the amount expensed for providing health care benefits to retirees and their eligible dependents. There were no postretirement costs deferred as of December 31, 2006 or December 31, 2005. We are amortizing over 20 years the transition obligation for postretirement benefits that resulted from the adoption of Statement 106.

#### **Amounts expected to be amortized from regulatory assets or regulatory liabilities into net periodic benefit cost for the fiscal year ended December 31, 2007**

	Pension Benefits	Postretirement Benefits
<b>(Thousands)</b>		
Estimated net loss	\$5,255	\$4,442
Estimated prior service cost (benefit)	\$3,275	\$(6,157)
Estimated transition obligation	-	\$6,800

#### **Weighted-average assumptions used to determine benefit obligations at December 31,**

	Pension Benefits		Postretirement Benefits	
	2006	2005	2006	2005
Discount rate	<b>5.75%</b>	5.50%	<b>5.75%</b>	5.50%
Rate of compensation increase	<b>4.00%</b>	4.00%	<b>N/A</b>	N/A

## Notes to Financial Statements

### New York State Electric & Gas Corporation

As of December 31, 2006, we increased our discount rate from 5.50% to 5.75. The discount rate is the rate at which the benefit obligations could presently be effectively settled. We determined the discount rate developing a yield curve derived from a portfolio of high grade noncallable bonds that closely matches the duration of the expected cash flows of our benefit obligations.

**Weighted-average assumptions used  
to determine net periodic benefit cost  
Year ended December 31,**

	Pension Benefits		Postretirement Benefit	
	2006	2005	2006	2005
Discount rate	5.50%	5.75%	5.50%	5.75%
Expected return on plan assets	8.75%	8.75%	N/A	N/A
Rate of compensation increase	4.00%	4.00%	N/A	N/A

We developed our expected long-term rate of return on plan assets assumption based on a review of long-term historical returns for the major asset classes. That analysis considered current capital market conditions and projected conditions. Given the current low interest rate environment, we selected an assumption of 8.75% per year, which is lower than the rate that would otherwise be determined solely based on historical returns. We amortize unrecognized actuarial gains and losses over ten years from the time they are incurred .

**Assumed health care cost trend rates at December 31**

	2006	2005
Health care cost trend rate assumed for next year	9.0%	10.0%
Rate to which cost trend rate is assumed to decline (the ultimate rate trend rate)	5.0%	5.0%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amount reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	1% Increase	1% Decrease
(Thousands)		
Effect on total of service and interest cost components	\$400	\$(370)
Effect on postretirement benefit obligation	\$10,002	\$(8,896)

## Notes to Financial Statements

### New York State Electric & Gas Corporation

**Plan assets:** Our weighted-average asset allocations at December 31, 2006 and 2005, by asset category, are:

<b>Asset Category</b>	<b>Pension Benefits</b>		
	<b>Target Allocation</b>	<b>Actual Allocation 2006</b>	<b>2005</b>
Equity securities	58%	<b>64%</b>	64%
Debt securities	27%	<b>24%</b>	28%
Real estate	5%	<b>4%</b>	2%
Other	10%	<b>8%</b>	6%
Total	100%	<b>100%</b>	100%

Our pension benefits plan assets are held in a master trust with a trustee. Those assets are invested among and within various asset classes in order to achieve sufficient diversification in accordance with our risk tolerance. This is achieved through utilization of multiple asset managers and systematic allocation to investment management styles, providing a broad exposure to different segments of the fixed income and equity markets.

Equity securities did not include any Energy East common stock at December 31, 2006 and 2005.

**Contributions:** In accordance with our funding policy we make annual contributions of not less than the minimum required by applicable regulations. We do not anticipate any contributions to our pension benefit plans or our other postretirement benefit plans in 2007.

**Estimated future benefit payments:** Our expected benefit payments and expected Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) subsidy receipts, which reflect expected future service, as appropriate, are as follows:

	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>	<b>Medicare Act Subsidy Receipts</b>
(Thousands)			
2007	\$68,940	\$27,095	\$1,988
2008	\$73,152	\$29,595	\$2,288
2009	\$77,404	\$32,073	\$2,556
2010	\$81,159	\$34,416	\$2,801
2011	\$84,219	\$36,888	\$3,002
2012 – 2016	\$449,153	\$205,371	\$18,718

## Notes to Financial Statements

### New York State Electric & Gas Corporation

#### Note 11. Segment Information

Selected financial information for our operating segments is presented in the table below. Our electric delivery segment consists of our regulated transmission, distribution and generation operations. Our natural gas delivery segment consists of our regulated transportation, storage and distribution operations. We measure segment profitability based on net income.

	<b>Electric Delivery</b>	<b>Natural Gas Delivery</b>	<b>Total</b>
<b>(Thousands)</b>			
<b>2006</b>			
Operating Revenues	<b>\$1,703,031</b>	<b>\$440,303</b>	<b>\$2,143,334</b>
Depreciation and Amortization	<b>\$93,730</b>	<b>\$21,745</b>	<b>\$115,475</b>
Interest Charges, Net	<b>\$69,791</b>	<b>\$17,823</b>	<b>\$87,614</b>
Income Taxes	<b>\$73,125</b>	<b>\$19,788</b>	<b>\$92,913</b>
Net Income	<b>\$110,856</b>	<b>\$32,162</b>	<b>\$143,018</b>
Total Assets	<b>\$2,982,406</b>	<b>\$994,135</b>	<b>\$3,976,541</b>
Capital Spending	<b>\$105,089</b>	<b>\$35,029</b>	<b>\$140,118</b>
<b>2005</b>			
Operating Revenues	\$1,646,245	\$477,744	\$2,123,989
Depreciation and Amortization	\$84,855	\$19,998	\$104,853
Interest Charges, Net	\$63,485	\$16,482	\$79,967
Income Taxes	\$86,106	\$20,950	\$107,056
Net Income	\$135,285	\$27,760	\$163,045
Total Assets	\$3,117,067	\$1,039,023	\$4,156,090
Capital Spending	\$123,355	\$41,119	\$164,474