FLORIDA PUBLIC SERVICE COMMISSION
Capital Circle Office Center ● 2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

MEMORANDUM

December 5, 1996

TO : DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM : DIVISION OF WATER AND WASTEWATER (JOHNSON)
DIVISION OF AUDITING AND FINANCIAL ANALYSIS (CAUSSEAUX)
DIVISION OF LEGAL SERVICES (JAEGER)

RE : DOCKET NO.: 961237-SU DISPOSITION OF CONTRIBUTION-IN-AID-OF-CONSTRUCTION GROSS-UP FUNDS COLLECTED BY FOREST UTILITIES, INC.
COUNTY: LEE

AGENDA : DECEMBER 17, 1996 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\WAW\WP\961237.RCM

CASE BACKGROUND

As a result of the repeal of Section 118(b) of the Internal Revenue Code (I.R.C.), contributions-in-aid-of-construction (CIAC) became gross income and were depreciable for federal tax purposes. In Order No. 16971, issued December 18, 1986, the Commission authorized corporate utilities to collect the gross-up on CIAC in order to meet the tax impact resulting from the inclusion of CIAC as gross income.

Orders Nos. 16971, issued December 18, 1986, and 23541, issued October 1, 1990, required that utilities annually file information which would be used to determine the actual state and federal income tax liability directly attributable to the CIAC. The information would also determine whether refunds of gross-up would be appropriate. These orders require that all gross-up collections for a tax year, which are in excess of a utility's actual tax liability for the same year, should be refunded on a pro rata basis to those persons who contributed the taxes.

In Order No. 23541, the Commission required any water and wastewater utility already collecting the gross-up on CIAC and wishing to continue, to file a petition for approval with the Commission on or before October 29, 1990. On December 27, 1990, pursuant to Order No. 23541, Forest Utilities, Inc. (Forest

Utilities or utility) filed for authority to continue to gross-up CIAC. The information as filed met the filing requirements of Order No. 23541. Order No. 25299, issued November 5, 1991, granted Forest Utilities authority to continue to gross-up using the full gross-up formula.

On September 9, 1992, this Commission issued Proposed Agency Action Order No. PSC-92-0961-FOF-WS, which clarified the provision of Orders Nos. 16971 and 23541 for the calculation of refunds of gross-up of CIAC. On October 12, 1994, Order No. PSC-94-1265-FOF-WS, revised the full gross-up method generic calculation form. No protests were filed, and the Order became final.

On March 29, 1996, Docket No. 960397-WS was opened to review the Commission's policy concerning the collection and refund of CIAC gross-up. Workshops were held and comments and proposals were received from the industry and other interested parties. By Order No. PSC-96-0686-FOF-WS, issued May 24, 1996, staff was directed to continue processing CIAC gross-up and refund cases pursuant to Orders Nos. 16971 and 23541; however, staff was also directed to make a recommendation to the Commission concerning whether the Commission's policy regarding the collection and refund of CIAC should be changed upon staff's completion of its review of the proposals and comments offered by the workshop participants. In addition, staff was directed to consider ways to simplify the process and determine whether there were viable alternatives to the gross-up.

However, on August 1, 1996, The Small Business Job Protection Act of 1996 (The Act) passed congress and was signed into law by President Clinton on August 20, 1996. The Act provided for the non-taxability of CIAC collected by water and wastewater utilities effective retroactively for amounts received after June 12, 1996. As a result, on September 20, 1996, in Docket No. 960965-WS, Order No. PSC-96-1180-FOF-WS was issued to revoke the authority of utilities to collect gross-up of CIAC and to cancel the respective tariffs unless, within 30 days of the issuance of the order, affected utilities requested a variance. Since, there was no longer a need to review the Commission's policy on the gross-up of CIAC, on October 8, 1996, Order No. PSC-96-1253-FOF-WS was issued, closing Docket No. 960397-WS. However, as established in Order No. PSC-96-0686-FOF-WS, all pending CIAC gross-up refund cases are being processed pursuant to Orders Nos. 16971 and 23541. Therefore, the purpose of this recommendation is to address the disposition of refunds for the years 1990 through 1995.

Forest Utilities is a Class B wastewater utility providing service to the public in Lee County. As of December 31, 1995, the utility served 1,901 wastewater customers. The utility had gross operating revenues of $522,259, and reported a net operating loss of $16,704.

DISCUSSION OF ISSUES

ISSUE 1: Should Forest Utilities, Inc. be required to refund excess gross-up collections plus accrued interest for the years 1990 through 1995?

RECOMMENDATION: Yes, the utility should refund $3,372 for 1990; $2,183 for 1991; $16,946 for 1993; and $3,287 for 1994; for a total of $26,337 plus accrued interest through the date of refund, for gross-up collected in excess of the tax liability resulting from the collection of CIAC. In 1992, $549 should be credited to CIAC, instead of refunding it to the contributors. No refund is necessary for 1995, because the utility undercollected. In accordance with Orders Nos. 16971 and 23541, all amounts should be refunded on a pro rata basis to those persons who contributed the taxes. The refund should be completed within six months. The utility should submit copies of canceled checks, credits applied to monthly bills or other evidence which verifies that the refunds have been made, within 30 days from the date of refund. Within 30 days from the date of the refund, the utility also should provide a list of unclaimed refunds detailing contributor and amount, and an explanation of the efforts made to make the refunds. (JOHNSON)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, Forest Utilities filed its 1990 through 1995 annual CIAC reports. By correspondence dated October 22, 1996, staff submitted their preliminary refund calculation to the utility. On November 18, 1996 the utility responded that although it disagrees with certain adjustments made by staff, it accepts staff's computation for 1990 through 1995. The difference between staff and the utility's calculation were due to the following three items:

1. The administrative cost incurred for accounting and legal expenses (administrative processing costs).
2. The imputation of first years's depreciation for 1991 and 1992.
3. The allocation of above-the-line treatment of total salary expense.

ADMINISTRATIVE PROCESSING COSTS FOR REFUNDS

The utility amended its proposed refunds for the years 1990 through 1995 to include the total cost associated with filing refund reports. The cost incurred for filing the CIAC reports was netted with the total proposed refund amount. The utility reported $12,700 in accounting fees and $7,099 in legal fees, for a total cost of $19,799. The utility proposed a total refund amount of $14,052. The filing costs of $19,799 were deducted from the total amount of the refund. The results would be a $5,747 remaining outlay for the utility.

The utility contends that the cost causer should bear the cost of the tax impact on CIAC and should also bear the administrative expenses related to the collection and disposition of gross-up. Staff disagrees that the contributors of the gross-up should bear the cost of processing the refunds. The full gross-up formulas in Orders Nos. 16971 and 23541 provide a mechanism for the utility to collect the maximum taxes associated with the collection of CIAC. As such, the customer bears the cost of the tax impact on CIAC to the extent that the utility has a tax liability resulting from its collection of CIAC. In addition, those orders provide that any excess collections of gross-up should be refunded to the contributor. However, staff believes it would be inappropriate for the utility to charge the contributors for refunding excess gross-up taxes collected from them.

Orders Nos. 16971 and 23541 do not require the proposed refund amount to be offset with the costs incurred for filing refund reports with the excess gross-up collections. Those orders specifically require that all gross-up amounts in excess of a utility's actual tax liability should be refunded on a pro rata basis to those persons who contributed the taxes. Further, staff does not believe that the contributors should be held responsible for the accounting costs incurred to determine the amount of his refund. Staff acknowledges that these costs were incurred to satisfy regulatory requirements, but a reduction of the contributors' refund amount is not the appropriate place to seek recovery of administrative processing costs. It's Commission practice that in no instance should maintenance and administrative costs associated with any refund be borne by the customers. The costs are the responsibility of, and should be borne by, the utility. Therefore, staff has removed the cost for preparing the refund reports from the utility's proposed refund amount.

CALCULATION OF FIRST YEAR'S DEPRECIATION

The utility reported the collection of cash and property CIAC. The utility's calculation of first year depreciation expense is calculated based on the contributed property, and not capacity fees. The utility did not include the cash in their calculation of depreciation, because cash isn't depreciable property.

Rule 25-30.515(3), Florida Administrative Code defines CIAC as:

> any amount or item of money, services, or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement, or construction costs of the utility's property, facilities, or equipment used to provide utility services to the public. The term includes...system capacity charges, main extension charges and customer connection charges.

By definition, CIAC charges are intended for plant and are to be utilized for the acquisition, or construction of utility property; therefore, staff believes it is appropriate to assume the cash CIAC was convert into property in determining the amount of depreciation expense.

To further support the conversion of cash to property, staff used the annual reports to determine the annual additions of depreciable plant. Staff then removed the amount of property CIAC received in each year to arrive at the amount of net additions after property CIAC. Staff then removed the amount of cash CIAC collected to determine if the amount of property additions exceeded both the amount of cash and property CIAC received. Based upon this analysis, it appears that the utility has plant additions for each year 1990 through 1995 that significantly exceed the amount of property and cash CIAC collections. Because plant additions for each year exceeded the amount of CIAC collections, staff believes it is appropriate to assume that the cash CIAC (the capacity fees) was converted to plant. The Commission also used this method of calculating depreciation on capacity fees assumed to be converted to cash in the gross-up disposition case of Florida Cities Water Company, Docket No. 921240-WS; Order No. PSC-94-0213-WS-FOF, issued February 23, 1994. Therefore, staff calculated first year's depreciation expense based on the total collected CIAC for the year. The depreciation rate used was .042127 which is the average of the depreciation rate used for the years 1992 through 1995.

ABOVE-THE-LINE TREATMENT FOR OFFICER SALARIES EXPENSE

The utility states that it disagrees with staff's classification of total officer salaries expense as an above-the-line expense. In its filing, the utility classified a portion of its officer salaries as a below-the-line expense. The utility explains that a portion of the officers' salaries should be classified below-the-line because that portion of the expense has never been recognized in the current rates of the utility.

However, staff would like to note that the utility's annual report for years 1990-1995 shows total officer and employee salaries as an above the line expense. When staff reviewed the utility's annual report to determine whether it was overearning, the entire amount of officers salaries was considered to be utility related and used and useful. The utility's officer attest to the accuracy of the annual reports by signing them each year. Therefore, for annual report review purposes, the entire amount of officers' salaries were included and considered when determining the utility's net income, and earned rate of return.

In addition, the full amount of these expenses were included in the calculation of the utility's 1995 price index rate increase. Staff, therefore, believes that for purposes of calculating the CIAC gross-up refund, the entire amount of officers' salaries should be given the same above-the-line treatment they were given in the utility's annual report review and price index application. Therefore, staff believes that total officer salaries expense amount should be included as an above-the-line expense.

ANNUAL GROSS-UP REFUND AMOUNTS

Based upon the foregoing, staff has calculated the amount of refund per year which, is appropriate. Our calculations, taken from the information provided by the utility in its gross-up reports filed each year is reflected on Schedule No. 1. A summary of each year's refund calculation follows.

1990

The utility proposes a refund of $2,159 for 1990 excess gross-up collections. Staff calculates a refund of $3,372 for 1990.

The 1990 CIAC report indicates that the utility was in an above-the-line taxable position before the inclusion of taxable CIAC in income. Therefore, all taxable CIAC received during the year would be taxed, net of the first year's depreciation. Although the CIAC report indicates a total of $19,375 in taxable CIAC was received, the utility did not make a deduction for first year's depreciation. According to the utility, none of the CIAC received in 1990 was used for plant additions or debt service. The utility contends that plant additions were funded by monies from a bank loan obtained in 1989 and cash flow from the utility operations; therefore, no adjustment for first year's depreciation should be made.

As discussed above, staff assumed cash CIAC was converted to plant, which is consistent with Order No. PSC-94-0213-FOF-WS. This results in the staff's depreciation expense being different from the utility's. Staff believes that to the extent cash CIAC is used and useful, there is first year's depreciation since the cash either pays for a prior investment made by the utility or it provides for new plant in the year it is received by the utility. In addition, the annual CIAC reports filed by the utility detail the amount of depreciation per year. Order No. 23541 states that the full gross-up formula takes into account the first year's depreciation using a half-year convention. The depreciation is an expense item which reduces the amount of CIAC which is taxable. Based on the foregoing, staff has included first year's depreciation in its calculation of the net taxable amount of CIAC. Staff's calculation of first year's depreciation is based on total CIAC received (cash CIAC/capacity fees and property CIAC). Staff determined the depreciation rate by taking the average of the rates used for 1992 through 1995. This average depreciation rate was applied to the total CIAC collected. As a result, staff's first year's depreciation was calculated to be $816, instead of $0 as determined by the utility.

The utility received taxable CIAC of $19,375 and staff deducted $816 for the first year's depreciation. Staff used the 32.04% combined marginal federal and state tax rates as provided in the 1990 CIAC Report to calculate the tax effect. The reported 32.04% combined marginal federal and state tax rate applied to the net $18,559 results in the tax effect of $5,946. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be $8,749. The utility collected $12,121 of gross-up monies. Based upon the foregoing, staff calculates a refund of $3,372 for 1990. This amount does not include the accrued interest which also must be refunded from December 31, 1990 to the date of refund.

1991

The utility proposes a refund of $1,436 for 1991 excess gross-up collections. Staff calculates a refund of $2,183 for 1991.

The 1991 CIAC report indicates that the utility was in an above-the-line taxable position before the inclusion of taxable CIAC in income. Therefore, all taxable CIAC received during the year would be taxed, net of the first year's depreciation. Although the CIAC report indicates a total of $29,375 in taxable CIAC was received, the utility did not make a deduction for first year's depreciation. According to the utility, none of the CIAC received in 1991 was used for plant additions or debt service. The utility contends that plant additions were funded by monies from a bank loan and cash flow from the utility operations. Therefore, no adjustment for first year's depreciation should be made.

As discussed above, staff assumed cash CIAC was converted to plant, which is consistent with Order No. PSC-94-0213-FOF-WS. This results in the staff's depreciation expense being different from the utility's. Staff believes that to the extent cash CIAC is used and useful, there is first year's depreciation since the cash either pays for a prior investment made by the utility or it provides for new plant in the year it is received by the utility. In addition, the annual CIAC reports filed by the utility detail the amount of depreciation per year. Order No. 23541 states that the full gross-up formula takes into account the first year's depreciation using a half-year convention. The depreciation is an expense item which reduces the amount of CIAC which is taxable. Based on the foregoing, staff has included first year's depreciation in its calculation of the net taxable amount of CIAC. Staff's calculation of first year's depreciation is based on total CIAC received (cash CIAC/capacity fees and property CIAC). Staff determined the depreciation rate by taking the average of the rates used for 1992 through 1995. This average depreciation rate was applied to the total CIAC collected. As a result, staff's first year's depreciation was calculated to be $1,237, instead of $0 as determined by the utility.

The utility received taxable CIAC of $29,375 and staff deducted $1,237 for the first year's depreciation. Staff used the 37.63% combined marginal federal and state tax rates as provided in the 1991 CIAC Report to calculate the tax effect. The reported 37.63% combined marginal federal and state tax rate applied to the net $28,138 results in the tax effect of $10,588. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be $16,976. The utility collected $19,159 of gross-up monies. Based upon the foregoing, staff calculates a refund of $2,183 for 1991. This amount does not include the accrued interest which also must be refunded from December 31, 1991 to the date of refund.

1992

The utility proposes a refund of $549 for 1992 excess gross-up collections. Staff agrees that a refund of $549 in gross-up collections for 1992 is appropriate.

The 1992 CIAC report indicates that a total of $7,038 in gross-up collections were received. Based upon our review of the utility's 1992 filing, the utility was in a taxable position on an above-the-line basis prior to the inclusion of taxable CIAC in income. Therefore, all taxable CIAC received would be taxed. The report indicates a total of $7,038 in gross-up collections were received, with first year's depreciation of $[illegible]96 associated with $11,250 in taxable CIAC. Staff has used the 37.63% combined marginal federal and state tax rates as provided in the 1992 CIAC Report to calculate the tax effect. Based upon the foregoing, staff calculates the utility collected $549 more in gross-up than required to pay the taxes. This amount does not include the accrued interest which also must be refunded from December 31, 1992 to the date of refund.

The utility requested that it be allowed to book the excess gross-up collections as CIAC. The utility believes the refund amount to be immaterial and the cost of processing the refund would be more costly. The gross-up funds were collected from 18 separate individuals or entities during 1992. Based on the total refund amount, each contributor would receive about $30.50 each. The net CIAC level is 85.00% contributed. Staff agrees that the administrative costs could more than likely exceed the individual refund amounts, and recommends the utility credit CIAC for the excess collections.

1993

The utility proposes a refund of $9,581 for 1993 excess gross-up collections.

Staff calculates a refund of $16,946 for 1993. Based upon our review of the utility's 1993 filing, the utility incurred an above-the-line loss of $12,211 prior to the inclusion of taxable CIAC and gross-up. The report indicates a total of $82,747 in gross-up collections were received, with first year's depreciation of $4,652 associated with $125,924 in taxable CIAC. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, staff has made a reduction to the total amount of taxable CIAC to reflect the loss. When the above-the-line loss of $12,211 is netted with the total taxable CIAC of $125,924, the amount of taxable CIAC resulting in a tax liability is $113,713. As a result, net taxable CIAC has been calculated to be $109,061. Staff has used the reported 37.63% combined marginal federal and state tax rate applied to the net $109,061 of taxable CIAC to calculate income taxes of $41,040. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be $65,801. Based upon the foregoing, staff calculates a refund of $16,946 for 1993. This amount does not include the accrued interest which, also must be refunded from December 31, 1993 to the date of refund.

1994

The utility proposes a refund of $327 for 1994 excess gross-up collections. Because of the immaterial amount of excess gross-up collected, the utility proposes to book this amount as CIAC instead of making a refund. The utility states that the administrative costs of processing the refund would likely exceed the amount of the refund.

Staff calculates a refund of $3,287 for 1994. Based upon our review of the utility's 1994 filing, the utility incurred an above-the-line loss of $45,055 prior to the inclusion of taxable CIAC in income. The report indicates a total of $3,287 in gross-up collections were received, with first year's depreciation of $258 associated with $5,164 in taxable CIAC. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, staff has made a reduction to the total amount of taxable CIAC to reflect the loss. When the above-the-line loss of $45,055 is netted with the total taxable CIAC of $5,164, the loss exceeds the CIAC income. Therefore, all CIAC gross-up collections should be refunded. Based upon the foregoing, staff calculates a refund of $3,287 for 1994. This amount does not include the accrued interest which, also must be refunded from December 31, 1994 to the date of refund.

As stated above, the utility requested that it be allowed to book the excess gross-up collections as CIAC. The utility calculated a refund of $327 and considers this amount to be immaterial. The utility asserts that the cost of processing the refund would be too costly. The gross-up funds were collected from 4 separate individuals or entities during 1994, and based on the utility's refund, each contributor would receive $81.75 each. However, based on Staff's total refund amount of $3,287, each contributor would receive about $822 each. Therefore, staff disagrees with the utility's request for booking the gross-up as CIAC.

1995

The utility proposes that no refund is appropriate.

Staff agrees that a refund of gross-up collections for 1995 is not appropriate. Based upon our review of the utility's 1995 filing, the utility incurred an above-the-line loss of $1,690 prior to the inclusion of taxable CIAC in income. The report indicates a total of $3,128 in gross-up collections were received, with first year's depreciation of $973 associated with $25,936 in taxable CIAC. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, staff has made a reduction to the total amount of taxable CIAC to reflect the loss. When the above-the-line loss of $1,690 is netted with the total taxable CIAC of $25,936, the amount of taxable CIAC resulting in a tax liability is $24,963. As a result, net taxable CIAC has been calculated to be $23,273. Staff has used the reported 37.63% combined marginal federal and state tax rate applied to the net taxable CIAC of $23,273 to calculate income taxes of $8,758. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be $14,042. The utility collected $3,128 in gross-up monies; the utility required more in gross-up to pay the tax impact than the utility collected, therefore, no refund is necessary.

<u>ISSUE 2</u>: Should the docket be closed?

<u>RECOMMENDATION</u>: No. Upon expiration of the protest period this docket should remain open pending verification of the refunds. Staff should be given administrative authority to close the docket upon verification that the refunds have been completed. (JAEGER)

<u>STAFF ANALYSIS</u>: Upon expiration of the protest period, if a timely protest is not filed by a substantially affected person, this docket should remain open pending completion and verification of the refunds. Staff recommends that administrative authority be granted to staff to close the docket upon verification that the refunds have been made.

FOREST UTILITIES, INC.
DOCKET NO. 961237-SU

STAFF CALCULATED GROSS-UP REFUND
05-Dec-96

	1990	1991	1992	1993	1994	1995
1 Form 1120, Line 30 (Line 15)	$ 76,865	$ 104,074	$ 39,446	$ 191,808	$ (36,862)	$ 26,401
2 Less CIAC (Line 7)	(19,375)	(29,375)	(11,250)	(125,924)	(5,164)	(25,936)
3 Less Gross-up collected (Line 19)	(12,121)	(19,159)	(7,038)	(82,747)	(3,287)	(3,128)
4 Add First Year's Depr on CIAC (Line 8)	816	1,237	496	4,652	258	973
5 Add/Less Other Effects (Lines 20 & 21)	(1,134)	(344)	(186)	0	0	0
6						
7 Adjusted Income Before CIAC and Gross-up	$ 45,051	$ 56,433	$ 21,468	$ (12,211)	$ (45,055)	$ (1,690)
8						
9 Taxable CIAC (Line 7)	$ 19,375	$ 29,375	$ 11,250	$ 125,924	$ 5,164	$ 25,936
10 Less first years depr. (Line 8)	$ (816)	$ (1,237)	$ (496)	$ (4,652)	$ (258)	$ (973)
11						
Adjusted Income After CIAC	$ 18,559	$ 28,138	$ 10,754	$ 109,061	$ (40,149)	$ 23,273
Less: NOL Carry Forward	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
14						
15 Net Taxable CIAC	$ 18,559	$ 28,138	$ 10,754	$ 109,061	$ 0	$ 23,273
16 Combined Marginal state & federal tax rates	32.04%	37.63%	37.63%	37.63%	37.63%	37.63%
17						
18 Net Income tax on CIAC	$ 5,946	$ 10,588	$ 4,047	$ 41,040	$ 0	$ 8,758
19 Less ITC Realized	0	0	0	0	0	0
20						
21 Net Income Tax	$ 5,946	$ 10,588	$ 4,047	$ 41,040	$ 0	$ 8,758
22 Expansion Factor for gross-up taxes	1.471453796	1.603334937	1.603334937	1.603334937	1.603334937	1.603334937
23						
24 Gross-up Required to pay tax effect	$ 8,749	$ 16,976	$ 6,489	$ 65,801	$ 0	$ 14,042
25 Less CIAC Gross-up collected (Line 19)	(12,121)	(19,159)	(7,038)	(82,747)	(3,287)	(3,128)
26						
27 (OVER) OR UNDER COLLECTION	$ (3,372)	$ (2,183)	$ (549)	$ (16,946)	$ (3,287)	$ 10,914
28						
29						
30 TOTAL YEARLY REFUND	$ (3,372)	$ (2,183)	$ (549)	$ (16,946)	$ (3,287)	$ 0
31						
PROPOSED REFUND (excluding interest)	(26,337)					
34						