

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for) DOCKET NO. 910110-WS
continuation of gross-up of) ORDER NO. PSC-92-0742-FOF-WS
contributions-in-aid-of-) ISSUED: 07/30/92
construction (CIAC) in Lee)
County by GULF UTILITY COMPANY.)
_____)

The following Commissioners participated in the disposition of this matter:

THOMAS M. BEARD, Chairman
J. TERRY DEASON
BETTY EASLEY
LUIS J. LAUREDO

NOTICE OF PROPOSED AGENCY ACTION

ORDER AUTHORIZING CONTINUED GROSS-UP OF
CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION
AND REQUIRING SUBMISSION OF PROPOSALS BY
SOUTHWEST FLORIDA CAPITAL CORPORATION
AND A REPORT EVALUATING SUCH PROPOSALS BY
GULF UTILITY COMPANY

BY THE COMMISSION:

NOTICE IS HEREBY GIVEN by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are adversely affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code.

I. BACKGROUND

By Order No. 16971, issued December 18, 1986, the Commission granted approval for water and wastewater utilities to amend their service availability policies to meet the tax impact on contributions-in-aid-of-construction (CIAC) resulting from the amendment of Section 118(b) of the Internal Revenue Code. Order No. 23541, issued October 1, 1990, ordered utilities currently grossing-up CIAC to file a petition for continued authority to gross-up and also ordered that no utility may gross-up CIAC without first obtaining the approval of this Commission. Orders Nos. 16971 and 23541 also prescribed the accounting and regulatory treatments for the gross-up and required refunds of certain gross-up amounts collected.

DOCUMENT NUMBER-DATE

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On February 1, 1991, pursuant to Order No. 23541, Gulf Utility Company (Gulf or utility) filed its request for authority to continue CIAC gross-up. On June 14, 1991, Southwest Florida Capital Corporation (SFCC) filed a petition for leave to intervene in this Docket pursuant to Rule 25-22.039, Florida Administrative Code. By Order No. 24808, issued July 12, 1991, SFCC's petition to intervene was granted.

Gulf is a Class A water and wastewater utility. Based on the 1991 Annual Report on file with the Commission, the utility served approximately 5,513 water and 1,507 wastewater customers at the end of December 31, 1991. Gross operating revenues for 1991 were reported as \$1,484,296 for the water system and \$660,570 for the wastewater system. Net operating income for 1991 was reported as \$44,650 and \$98,479 for water and wastewater, respectively. The utility's reported achieved rate of return for the combined water and wastewater systems is 2.77%.

II. GULF AUTHORIZED TO CONTINUE CIAC GROSS-UP

Order No. 23541 states that each utility must demonstrate that an actual above-the-line tax liability exists and that alternate sources of funds are not available at a reasonable cost. Utilities are required to file the following information to demonstrate the need to gross-up: Demonstration of Actual Tax Liability, Cash Flow Statement (except for Class C Utilities), Statement of Interest Coverage, Statement of Alternative Financing, Justification for Gross-up, Gross-up Method Selected and Proposed Tariffs.

Demonstration of Actual Tax Liability

Our review of the financial statements filed by Gulf indicates that Gulf will incur an actual above-the-line tax liability with the collection of CIAC. The utility submitted schedules of taxable income on an above-the-line basis for the years ended December 31, 1987, through 1990. In 1987 and 1988, the utility experienced an above-the-line loss before CIAC was included in income. However, in each of the four years, the utility had taxable income after the inclusion of CIAC in income. The utility also filed federal income tax returns for 1987 through 1990, which indicate that the utility had taxable income. In addition, the utility's 1991 annual report reflects above-the-line taxable income without CIAC collections. Further, the utility's projection of income for the years 1990 through 1999 in connection with the offering of \$10,000,000 of 30

year industrial development revenue bonds (IDRB) indicates that the utility will have taxable income before and after the inclusion of CIAC in income for each of the projected years 1993 through 1999. In 1991 through 1992, the utility projects a net loss without the inclusion of CIAC in income. However, when CIAC income is included, the utility will have taxable income. Based upon the information reviewed, it appears that the utility will continue to have an actual above-the-line tax liability associated with the collection of CIAC.

Cash Flow Statement

The company prepared cash flow projections for the years 1990 through 1999, in connection with the offering of \$10,000,000 of 30 year IDRBs. The purpose of our review of the cash flow statement is to determine whether liquid funds are available to pay taxes on CIAC. Our review of the cash flow projections filed by the utility indicates that ending cash balances are projected for each of the projected years. However, use of the ending cash balances is restricted by the IDRB bond indenture and is required to be used to replace and maintain the existing plant and operations, to repay principal and interest on the bond issue, and to provide for adequate reserves for these payments. In addition, our review of the cash projections indicates that operations do not generate sufficient cash flows to provide for servicing of debt and payment of CIAC taxes. When connection fees are included, adequate cash flows are provided; however, the connection fees, as well as the net revenues of the company, have been pledged as collateral under the mortgage indenture of the IDRBs. A large portion of the cash balance at the end of the year appears to be from proceeds of the bond issue. However, the company has agreed to use the proceeds of the bonds and funds otherwise available to finance the acquisition, construction and installation of the project. In consideration of the above, it appears that cash may not be available to fund the payment of taxes on CIAC.

Statement of Interest Coverage

The times interest earned (TIE) ratio indicates the number of times a utility is able to cover its interest. This ratio demonstrates the company's ability to service its debt. It is also an indicator of the relative protection of the bondholders, and the utility's ability to go into the financial market to borrow money

or issue stock at a reasonable rate. Order No. 23541 established a TIE ratio of 2x as a benchmark.

In connection with the cash flow projections, coverage ratios were also calculated. Based on the data submitted by the utility, it does not meet the standard of 2x established in Order No. 23541. Although the utility projects an increase in the TIE ratio from .64x in 1990 to 1.70x in 1999, the utility's projections indicate that the times interest coverage ratio will be less than 2x throughout the 10 year projection period. Based on the standard of 2x established in Order No. 23541, it appears that the utility does not have adequate interest coverage and may not be able to adequately service its existing debt. This factor might impair the utility's ability to borrow money at a reasonable rate.

Statement of Alternative Financing

Gulf has stated that there are only two sources of funds available for CIAC tax payments other than gross-up, internally generated funds and debt. Gulf stated that all internally generated funds are committed by the bond indenture to pay principal and interest on Gulf's currently outstanding IDRBS. Further, Gulf states that in analyzing debt, any debt incurred, for whatever reason, would require a source of repayment. Unless customer rates were increased to the level necessary to provide a source of funds to repay CIAC tax borrowings, the carrying cost on those borrowings, and a margin of safety to repay borrowings, no lender would consider such a loan. Additionally, Gulf states that a waiver from the trustee of the IDRBS would also be required for that portion of any rate increase specifically related to funding repayment of CIAC tax loans. Finally, the utility states that it requested that Sun Bank of Lee County establish a credit facility for the company for the purpose of funding the taxes related to CIAC, and that the facility was denied by the bank. Therefore, Gulf asserts that it has no alternative source of funding of CIAC taxes at a reasonable cost.

We note that equity, as a source of funding, was omitted from Gulf's list. Gulf's 1991 annual report indicates that Gulf has \$665,444 in common equity and paid in capital, in addition to the \$10 million of debt, the proceeds of which are being used to fund the construction of new water and wastewater treatment facilities. These support gross total company plant, land and equipment of approximately \$24 million, of which approximately \$16 million is

CIAC. Thus, equity supports less than 3% of the utility's gross plant investment. The water rate base was found to be virtually 100% used and useful by Order No. 24735, issued July 1, 1991. Similarly, the wastewater plant was found to be virtually 100% used and useful by Order No. 20272, issued November 7, 1988. A review of the utility's annual reports indicates that the average annual amount of connection fees, excluding capacity charges, received by this utility in the last five years is \$90,305. These fees are not subject to gross-up, and Gulf now finds the funds to pay the taxes on these fees. In addition, by letter dated January 17, 1992, SFCC states that it has offered Gulf several alternatives to grossing-up which the utility has rejected. By letter dated February 10, 1992, our staff requested that Gulf provide explanations of the utility's reason for rejecting each of the alternatives. The utility provided a written response by letter dated April 30, 1992, which we will discuss below.

In conclusion, it appears that borrowing funds in the open market to pay CIAC taxes may not be an alternative for Gulf because the bond indenture places a restriction on the amount and type of additional debt Gulf will be allowed to incur. Equity, as an alternative source of funding, was not discussed by the utility, although the utility's 1991 annual report indicates that less than 3% of the utility's gross plant investment is supported by equity capital. Therefore, it appears that unless the utility is able to invest additional equity capital for the overall funding of CIAC taxes, Gulf may not have an alternative to grossing-up CIAC to pay CIAC taxes.

Justification for the Gross-Up

Gulf states that its request to gross-up is justified for several reasons. First, in connection with the IDRB issue, the company has covenanted that all net revenues will be used for repayment of existing IDRB debt. Second, the inability to gross-up could cause greater uncertainties as to the timing and magnitude of the company's cash flow. The utility states that these greater uncertainties could severely jeopardize and diminish its financial integrity. And finally, the utility states that it is in a very high growth area of the state, and that funds not appropriated for the existing debt are needed to finance future growth.

Our review of the information filed by the utility indicates that the utility will incur an actual above-the-line tax liability

with the collection of CIAC. The information also indicates that the company's TIE ratio is below the threshold of 2x as established in Order No. 23541. Further, because the utility has covenanted that all net revenues would be used for repayment of existing IDRB debt, cash flows may not be available to fund CIAC taxes. In addition, due to bond restrictions, the utility may not be able to incur additional debt to fund CIAC taxes. Therefore, we find there is justification for this utility to continue to gross-up CIAC and we, hereby, authorize Gulf to continue to utilize the full gross-up method.

Gross-Up Method Selected

The utility stated that it selected the full gross-up method because the full gross-up method provides a ready source of cash to pay the maximum tax liability that is associated with the CIAC and because it is in a financial position and growth posture that requires this ready source of cash to pay the maximum tax liability. Also, the utility stated that the full gross-up method is a much easier method to apply from an internal administrative and accounting standpoint.

Gulf states that the net present value method requires that the utility make a substantial up-front investment for CIAC tax payments with a return on the investment over a period of up to 45 years. The utility states that using this method would require a substantial use of the utility's cash flow, which as previously stated, has been pledged to repay IDRB interest and debt, provide for the maintenance of existing plant and operations, and for future obligations and growth. Gulf states that forcing the utility to make this investment in the development partially transfers the risk of the development to the utility and its customers. We do not believe that this factor, alone, should preclude the utility from using the net present value gross-up method. This Commission determined in Order No. 23541 that the burden of who should bear the responsibility for CIAC taxes should not be viewed in isolation. We found that all of the facts and circumstances of the utility should be considered when determining who should bear the tax impact of CIAC and that, depending upon its particular facts and circumstances, it may be appropriate for the utility to collect the taxes from the contributor or invest in them itself. However, because the bond indenture places restrictions on the use of Gulf's cash, we believe that the utility may not have

the upfront cash to make the investment in CIAC taxes. Therefore, the net present value method may not be viable for this utility.

Conclusion

Based on the foregoing, we find it appropriate to authorize Gulf to continue the gross-up of CIAC utilizing the full gross-up method, subject to the provisions in Section III below. In Section III, we permit Gulf to continue its gross-up of CIAC from SFCC, subject to refund, pending our final determination of the appropriateness of the alternatives proposed by SFCC.

Orders Nos. 16971 and 23541 prescribe the accounting and regulatory treatments and record keeping for the gross-up, and require refunds of certain gross-up amounts collected. The utility shall make all CIAC collections in accordance with those Orders and all matters discussed in the body of those Orders is expressly incorporated herein by reference.

In accordance with Order No. 23541, the utility has submitted proposed tariffs for the full gross-up method as requested in its filing. The tariffs are hereby approved as filed and shall become effective upon the expiration of the protest period, if no timely protests are received.

III. SFCC TO SUBMIT PROPOSALS FOR ALTERNATIVES AND GULF TO SUBMIT A REPORT EVALUATING SUCH PROPOSALS

SFCC has offered the utility alternatives to grossing-up CIAC which we believe merit consideration by the utility. SFCC states that its alternatives would work to avoid either triggering the tax on the CIAC in the first instance, or to fund the CIAC in a manner that avoids triggering a tax on the tax.

One of the alternatives SFCC proposed to Gulf is for the homeowners association to form a not-for-profit homeowners' association utility (homeowners' utility) that could purchase bulk service from Gulf. The idea would be to place responsibility for the consequences of the CIAC on the homeowners' utility. SFCC believes that, as a not-for-profit utility, the homeowners' utility would not have to pay taxes on the CIAC. Gulf argues that a not-for-profit homeowners association which would receive the CIAC

would not avoid the tax on CIAC, but would merely shift the burden to the association.

Another alternative SFCC has posed is a loan from SFCC to Gulf of the money necessary to pay the tax on the CIAC. SFCC states that this loan would be for all purposes an arms-length transaction. SFCC proposes that Gulf could repay the loan with the tax benefits derived in the future from the contributed property. Gulf has said that no lender would consider a loan until customers' rates are increased to the level necessary to provide a source of funds to repay CIAC tax loans and the cost of carrying those loans. Further, Gulf maintains that the entire proceeds would be taxable as CIAC. SFCC has said that there will be positive cash flow for repayment of the CIAC tax loan as a result of the depreciation to be taken on the contributed assets on future tax returns of Gulf. Gulf states that it is not certain that there will be any future benefits from the depreciation and that keeping track of the benefits and the developers is not feasible over 45 years and would require the addition of personnel and an investment in computer software and systems.

SFCC states that it also suggested to Gulf that it use a guaranteed revenue charge to fund the taxes. Gulf says that this alternative is unacceptable because guaranteed revenues would be applicable to all developers and would shift the burden of one developer to all developers and customers. SFCC counters that it is not a guaranteed revenue charge and would not be applicable to all developers.

SFCC also has suggested that Gulf charge a gross-up based on the net present value method. SFCC states that, mathematically, the amounts paid under the net present value method should equal the amounts paid under an approach where SFCC loans the money to the utility. Gulf maintains that it does not have the ability to fund its share of the taxes under the net present value method.

SFCC states that there may be other viable methods to avoid the tax-on-tax effect of the full gross-up, and that SFCC is willing to cooperate with any reasonable approach. SFCC states that Gulf has rejected every suggestion SFCC has made to avoid either triggering the tax in the first place or to avoid a tax-on-tax effect assuming that some gross-up is needed.

By Order No. 23541, we encouraged the water and wastewater industry to continue to search for viable methods to avoid taxes on CIAC. If there are other viable alternatives in this situation, we find that neither SFCC nor Gulf has identified those alternatives or demonstrated why they would or would not be viable. Therefore, we find it appropriate to authorize Gulf to continue its gross-up of CIAC from SFCC, subject to refund, pending our final determination of the appropriateness of the alternatives posed by SFCC. We find it appropriate to require Gulf to consider the alternatives offered by SFCC. Therefore, within 15 days of the effective date of this Order, SFCC shall submit formal proposals for each of the alternatives it wishes Gulf to review and consider. These proposals shall detail terms, conditions, proposed manner of implementation, cost, rates and other pertinent information necessary to evaluate the viability of each alternative. Within 30 days of the receipt of the formal proposals, Gulf shall submit a detailed evaluation of each proposal and provide justification for the utility's acceptance or rejection of each proposal. If we determine that Gulf should be required to accept any of the alternatives offered by SFCC, Gulf will be required to refund, with interest, the difference in the amount collected using full gross-up and the amount that would have been collected under the alternative method selected.

This docket shall remain open until our final disposition of Gulf's authority to gross-up CIAC.

Based on the foregoing, it is, therefore,

ORDERED by the Florida Public Service Commission that Gulf Utility Company's petition for authority to continue gross-up of contributions-in-aid-of-construction is hereby granted as set forth in the body of this Order. It is further

ORDERED that Southwest Florida Capital Corporation shall submit within 15 days of the effective date of this Order, formal proposals for each of the alternatives it wishes Gulf to consider. It is further

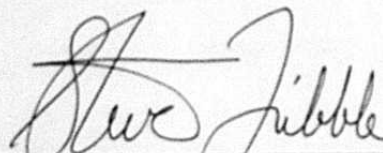
ORDERED that Gulf Utility Company shall, within 30 days of the receipt of the formal proposals from Southwest Florida Capital Corporation, submit an evaluation of each such proposal as set forth in the body of this Order. It is further

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ORDERED that the provisions of this Order are issued as proposed agency action and will become final unless an appropriate petition is filed with the Division of Records and Reporting, 101 East Gaines Street, Tallahassee, Florida 32399-0870, by the close of business on the date indicated in the Notice of Further Proceedings or Judicial Review. It is further

ORDERED that this docket shall remain open pending our final disposition of Gulf Utility Company's authority to continue gross-up of contributions-in-aid-of-construction.

By ORDER of the Florida Public Service Commission, this 30th day of July, 1992.



STEVE TRIBBLE, Director
Division of Records and Reporting

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NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.59(4), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

The action proposed herein is preliminary in nature and will not become effective or final, except as provided by Rule 25-22.029, Florida Administrative Code. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, as provided by Rule 25-22.029(4), Florida Administrative Code, in the form provided by Rule 25-22.036(7)(a) and (f), Florida Administrative

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Code. This petition must be received by the Director, Division of Records and Reporting at his office at 101 East Gaines Street, Tallahassee, Florida 32399-0870, by the close of business on August 20, 1992.

In the absence of such a petition, this order shall become effective on the day subsequent to the above date as provided by Rule 25-22.029(6), Florida Administrative Code.

Any objection or protest filed in this docket before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.

If this order becomes final and effective on the date described above, any party adversely affected may request judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or by the First District Court of Appeal in the case of a water or wastewater utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days of the effective date of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.