

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

M E M O R A N D U M

December 5, 1996

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

FROM: DIVISION OF WATER & WASTEWATER (GILCHRIST) *BW*
DIVISION OF LEGAL SERVICES (O'SULLIVAN) *JS* *OK* *mo* *ft*

RE: DOCKET NO. 961263-SU - DISPOSITION OF GROSS-UP FUNDS
COLLECTED BY NORTH FT. MYERS UTILITY, 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\961263.RCM

CASE BACKGROUND

North Ft. Myers Utility, Inc. (NFMU or utility) is a Class A wastewater utility providing service to approximately 4,966 customers in Lee County. According to its 1995 annual report, the utility reported gross operating revenues of \$1,493,279 and a net operating loss of \$131,325.

As a result of the repeal of Section 118(b) of the Internal Revenue Code, 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.

Order No. 16971 and Order No. 23541, issued October 1, 1990, require 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 also required 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.

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FPSC-RECORDS/REPORTING

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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. NFMU filed for authority to continue to gross-up on December 27, 1990. By Order No. 25532, issued December 24, 1991, NFMU was granted 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 September 14, 1992, Order No. PSC-92-0961A-FOF-WS was issued. This order included Attachment A which reflects the 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 Order 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, the Small Business Job Protection Act of 1996 (The Act) 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-0686-FOF-WS, all pending CIAC gross-up refund cases are being processed pursuant to Order Nos. 16971 and 23541. The purpose of this recommendation is to address the disposition of gross-up funds collected by the utility in 1992 and 1993.

DISCUSSION OF ISSUES

ISSUE 1: Should North Ft. Myers Utility, Inc. be required to refund excess gross-up collections for 1992 and 1993?

RECOMMENDATION: No, the utility does not owe refunds for 1992 and 1993. (GILCHRIST)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, NFMU filed its 1992 and 1993 annual CIAC reports regarding its collection of gross-up for each year. By letter dated June 18, 1996, staff submitted preliminary refund calculation numbers to the utility. By letter dated June 27, 1996, the utility indicated that although it agrees with the end result of staff's computations, for the record, it strongly disagrees with certain conclusions and assumptions contained in staff's calculations. Specifically, the utility disagrees with staff's imputation of first year's depreciation for 1993.

Staff calculated the gross-up required to pay the tax liability resulting from the collection of taxable CIAC by grossing-up the net taxable CIAC amount, in accordance with the method adopted in Order No. PSC-92-0961-FOF-WS.

ANNUAL GROSS-UP REFUND AMOUNTS

Based upon the foregoing, staff 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, are reflected on Schedule No. 1. A summary of each year's refund calculation follows.

1992

The utility proposes that no refund is appropriate.

Staff agrees that a refund of gross-up collections for 1992 is not appropriate. The 1992 CIAC report indicates the utility was in a taxable position on an above-the-line basis prior to the inclusion of taxable CIAC and gross-up. Therefore, all of the taxable CIAC received would be taxed. The report indicates a total of \$1,129,778 in taxable CIAC was received, with \$5,794 being deducted for the first year's depreciation. Staff used the 37.63% combined marginal federal and state tax rates as provided in the 1992 CIAC Report to calculate the tax effect. The reported 37.63% combined marginal federal and state tax rate applied to the net \$1,123,984 results in the income tax effect of \$422,955. When this amount is multiplied by the expansion factor for gross-up taxes,

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the amount of gross-up required to pay the tax effect on the CIAC is calculated to be \$678,139. The utility collected \$563,410 of gross-up monies. The utility required more in gross-up to pay the tax impact than the utility collected; therefore, no refund is necessary.

1993

The utility proposes that no refund is appropriate.

Staff agrees that a refund of gross-up collections for 1993 is not appropriate. In its filing, the utility did not make a deduction for first year's depreciation. According to the utility, staff's adjustment imputes a tax benefit for depreciation on CIAC which does not exist. Also, the utility indicated that it did not add any depreciable contributed property to its assets in the fiscal year, and that plant additions were funded by the company's line of credit and Industrial Development Revenue Bonds. Further, the utility indicated that such sources of financing bear interest and associated carrying costs and that under IRS regulations, construction of assets with these borrowings results in a tax basis, which entitles the company to the depreciation, irrespective of any reimbursement of investment through cash CIAC collections.

The utility goes on to say that payments on debt are applied first to interest and then to principal and that the amount of cash CIAC collected in fiscal years 1993 and 1994 would not pay the interest, much less the principal, on the utility's debt in these years. Moreover, the utility states that there is no Commission rule or requirement that cash CIAC is to be used for any specific purpose and that staff is well aware that cash CIAC is used for all kinds of purposes, including the payment of current operating expenses.

In response to the utility's statements, staff notes that depreciation is an allowable deduction for federal tax purposes, which the utility claimed on its federal tax returns in determining taxable income. Depreciation is an integral part of the determination of taxable income, which should be calculated by reducing the amount of taxable CIAC collected in each year by the amount of first year's depreciation deduction taken by the utility. By definition, CIAC charges are intended for plant and are to be utilized for the acquisition, or construction of utility property, and therefore, staff believes the CIAC collected will be converted into property and, thus, depreciated. Staff believes to the extent that cash CIAC is used and useful, first year's depreciation exists because the cash either pays for a prior investment made by the

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utility or it provides for new plant in the year it is received by the utility. Based on the foregoing, staff has included first year's depreciation in its calculation of the net taxable amount of CIAC.

The utility received taxable CIAC of \$409,690 and staff deducted \$20,008 for the first year's depreciation, resulting in net taxable CIAC of \$389,682. The utility's 1993 CIAC report indicates that the utility was operating at a loss before the inclusion of CIAC in income. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, not all of the CIAC collected would create a tax liability. When CIAC in the amount of \$389,682 is netted against staff's calculated loss of \$56,189, the amount of taxable CIAC resulting in a tax liability is \$333,493. Staff used the 37.63% combined marginal federal and state tax rates as provided in the 1993 CIAC Report to calculate net income taxes of \$125,493. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect on the CIAC is calculated to be \$201,207. The utility collected \$191,017 of gross-up monies. The utility required more in gross-up to pay the tax impact than the utility collected, therefore, no refund is necessary.

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ISSUE 2: Should the docket be closed?

RECOMMENDATION: Yes, upon expiration of the protest period, if a timely protest is not received from a substantially affected person, the docket should be closed. (O'SULLIVAN)

STAFF ANALYSIS: If a timely protest is not filed, upon expiration of the protest period, processing of this docket is complete and the docket should be closed.

STAFF CALCULATED GROSS-UP REFUND

North Fort Myers Utility

SOURCE: (Line references are from CIAC Reports)

	1992	1993
	-----	-----
1 Form 1120, Line 30 (Line 15)	\$ 1,746,547	\$ 528,810
2 Less CIAC (Line 7)	(1,129,778)	(409,690)
3 Less Gross-up collected (Line 19)	(563,410)	(191,017)
4 Add First Year's Depr on CIAC (Line 8)	5,794	20,008
5 Add/Less Other Effects (Lines 20 & 21)	(8,478)	(4,300)
6	-----	-----
7 Adjusted Income Before CIAC and Gross-up	\$ 50,675	\$ (56,189)
8		
9 Taxable CIAC (Line 7)	\$ 1,129,778	\$ 409,690
10 Less first years depr. (Line 8)	\$ (5,794)	\$ (20,008)
11	-----	-----
12 Adjusted Income After CIAC	\$ 1,174,659	\$ 333,493
13 Less: NOL Carry Forward	\$ 0	\$ 0
14	-----	-----
15 Net Taxable CIAC	\$ 1,123,984	\$ 333,493
16 Combined Marginal state & federal tax rates	37.63%	37.63%
17	-----	-----
18 Net Income tax on CIAC	\$ 422,955	\$ 125,493
19 Less ITC Realized	0	0
20	-----	-----
21 Net Income Tax	\$ 422,955	\$ 125,493
22 Expansion Factor for gross-up taxes	1.6033349	1.6033349
23	-----	-----
24 Gross-up Required to pay tax effect	\$ 678,139	\$ 201,207
25 Less CIAC Gross-up collected (Line 19)	(563,410)	(191,017)
26	-----	-----
27 (OVER) OR UNDER COLLECTION	\$ 114,729	\$ 10,190
28	=====	=====
29		
30 TOTAL YEARLY REFUND	\$ 0	\$ 0
31	=====	=====
32		
33 PROPOSED REFUND (excluding interest)	0	
34	=====	