

FLORIDA PUBLIC SERVICE COMMISSION  
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MEMORANDUM

SEPTEMBER 25, 1997

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FPSC - Records/Reporting

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

FROM: DIVISION OF WATER & WASTEWATER (JOHNSON)  
DIVISION OF LEGAL SERVICES (JAEGER)

RE: DOCKET NO. 970559-SU - DISPOSITION OF CONTRIBUTION IN AID  
OF CONSTRUCTION BY HUDSON UTILITIES, INC. D/B/A HUDSON  
BAY COMPANY  
COUNTY: PASCO

AGENDA: OCTOBER 7, 1997 - REGULAR AGENDA - PROPOSED AGENCY ACTION  
- INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\WAW\WP\970559.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 and 23541, issued December 18, 1986, and October 1, 1990, respectively, 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 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

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wishing to continue, to file a petition for approval with the Commission on or before October 29, 1990. On November 30, 1992, pursuant to Order No. 23541, Hudson Utilities, Inc. (Hudson or Utility) filed for initial authority to gross-up CIAC. The information as filed met the filing requirements of Order No. 23541. By Order No. PSC-93-0206-FOF-SU, issued February 9, 1993, the Commission allowed the utility's proposed tariff to become effective by operation of law on an interim basis for gross-up on CIAC. Order No. PSC-93-0962-FOF-SU, issued June 28, 1993, granted Hudson Utilities authority to gross-up.

On September 9, 1992, this Commission issued Proposed Agency Action Order No. PSC-92-0961-FOF-WS, which clarified the provisions 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 formula. 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 to determine any changes, 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. The purpose of this recommendation is to address the disposition of CIAC refunds for the year 1995.

Hudson is a Class B wastewater utility providing service to the public in Pasco County. As of December 31, 1996, the Utility served 1,337 wastewater customers. The Utility had gross operating revenues of \$714,244 for the wastewater system. The Utility reported a net operating income of \$101,919 for the wastewater system.

On July 10, 1997, Hudson submitted its 1995 CIAC Gross-up Report. In that report, Hudson suggested that it be allowed to offset any required refund with 50% of the accounting and legal expenses related to the preparation of the 1995 gross-up refund report as was allowed in Docket No. 961152-SU.

This recommendation addresses the amount of CIAC gross-up funds that should be refunded for 1995 and Hudson's request that it be allowed to offset 50% of the accounting and legal expenses related to the preparation of the 1995 gross-up refund report.

## DISCUSSION OF ISSUES

**ISSUE 1:** Should the Commission accept the settlement proposal of Hudson Utilities, Inc., and require the utility to refund excess gross-up collections plus accrued interest for the year 1995?

**RECOMMENDATION:** Yes. The Commission should accept Hudson's request that it be allowed to offset the refund amount with 50% of the accounting and legal expenses related to the preparation of the 1995 gross-up refund report. Based on this offset, the utility, for 1995, overcharged the contributors \$38,535, or \$141 per contributor. One hundred eighty four (184) customers paid the gross-up in full and 89 paid the gross-up in installments. Therefore, the utility should be required to refund \$25,944 or \$141 to each of the customers who paid the gross-up in full. In addition, \$12,591 of the \$38,535 overcharge related to customers who are paying the gross-up in installments. Therefore, the utility should reduce the amount of gross-up due from the installment customers and collect \$459 instead of \$600 from the 89 customers that are paying the gross-up in installments. However, to the extent that the utility has collected more than \$459 from those customers using the installment plan, the utility should be required to refund the difference in the \$459 that should have been collected and the amount actually collected in installments. In addition to the refund amount, the utility should refund accrued interest through the date of refund, for gross-up of CIAC collected in excess of the tax liability. In accordance with Orders Nos. 16971 and 23541, all refunds should be made on a pro rata basis to those persons who contributed the taxes. The refunds 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 refund, the utility also should file 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, Hudson filed its 1995 annual CIAC report regarding its collection of gross-up for the year. By correspondence dated June 23, 1997, staff submitted their preliminary refund calculation to the utility. By letter dated July 14, 1997 the utility amended its proposed refunds for 1995 to include the costs associated with filing refund reports. The utility has requested that 50% of the \$5,981 of legal and accounting costs incurred for filing the CIAC report be deducted from the amount of the refund. In the letter, Hudson indicated that it is willing to accept a similar arrangement with regard to a previous case (Docket No. 961152-SU). In Docket No. 961152-SU, which addressed the disposition of gross-up funds collected by Hudson in 1993-1994, the Commission voted to accept

Hudson's settlement proposal to offset 50% of the legal and accounting fees incurred in preparing the CIAC reports. The utility submitted its proposed offer of settlement in this proceeding, whereby it is proposing that 50% of the legal and accounting fees be offset against the refund calculated for 1995.

Staff notes that although the Commission has considered on several occasions, the question of whether an offset should be allowed pursuant to the orders governing CIAC gross-up, Orders No. 16971 and 23541 do not provide for the netting of costs incurred with filing refund reports with the excess gross-up collections. Those orders specifically state:

that all gross-up amounts in excess of a utility's actual tax liability resulting from its collection of CIAC should be refunded on a pro rata basis to those persons who contributed the taxes.

Therefore, staff believes that once the contributors have paid the gross-up taxes on the CIAC, the contributors have fulfilled their obligation under Orders Nos. 16971 and 23541. Further, since those orders also provide that gross-up in excess of the utility's actual tax liability should be refunded on a pro rata basis to those persons who contributed the taxes, staff believes that once the tax liability is determined, it is the responsibility of the Commission to ensure that excess payments of CIAC taxes are refunded in compliance with those Orders. Therefore, staff does not believe that a reduction in the amount of refund a contributor is entitled to receive as a result of his overpayment of gross-up taxes is appropriate. Staff acknowledges that those costs were incurred to satisfy regulatory requirements; however, staff does not believe that the contributors should be held responsible for the legal and accounting costs incurred to determine whether they are entitled to a refund. Staff views those costs as a necessary cost of doing business, and as such, staff believes it is appropriate for the utility to seek recovery of those amounts in a rate proceeding. Staff believes that this situation is similar to when a utility files for an increase in service availability charges. The costs of processing the utility's service availability case is borne by the general body of ratepayers, although the charges are set for future customers.

However, as in the other Hudson case (Docket No. 961152-SU), staff recognizes in this case that acceptance of the settlement proposal would avoid the substantial cost associated with a hearing, which may in fact exceed the amount of the legal and accounting cost to be recovered. Staff further notes that the actual costs associated with making the refunds have not been included in these calculations and will be absorbed by the utility.

Moreover, staff believes the utility's settlement proposal is a reasonable "middle ground". Therefore, staff recommends that while not adopting the utility's position, the Commission accept Hudson's settlement proposal that it be allowed to offset 50% of the legal and accounting cost incurred for filing the CIAC report, against the refund.

Staff has 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 has calculated the amount of refund which is appropriate. Our calculations, taken from the information provided by the utility in its gross-up report and tax return filed are reflected on Schedule No. 1. A summary of the 1995 refund calculation follows.

#### 1995

The utility proposes a base refund of \$43,929 and the recovery of \$2,991 in cost for preparing the refund report in 1995. Inclusion of the CIAC filing costs in the refund calculation resulted in a net total refund of \$40,938. Staff believes that a refund of \$38,535 for excess gross-up collections for 1995 is appropriate, and as previously stated, staff has included 50% of the accounting and legal costs for preparing the refund report in the refund calculation.

The utility reported \$177,450 of gross-up collections for 1995. This amount included \$13,650 of gross-up related to CIAC collections that were reported in 1994. As a result, only \$163,800 of the gross-up reported related to CIAC in 1995.

Order No. PSC-95-0376-FOF-SU, issued March 16, 1995, gave the utility authority to provide customers the option of paying the CIAC and the gross-up charge in installment payments. The installment payment plan allowed the contributor to pay the service availability charge of \$1,000 plus the gross-up taxes of \$600 in 24 monthly installment payments. In 1995 the utility collected CIAC and gross-up from 273 customers. One hundred and eighty four (184) customers paid the CIAC and gross-up in full and the remaining 89 customers signed notes to pay the CIAC and gross-up on the installment plan. For federal income tax purposes for 1995, the utility reported all of the CIAC and gross-up as income whether or not it was paid in full or in installments. Therefore, for 1995, the utility reported \$273,000 of CIAC income on its tax return (273 customers x \$1,000 service availability charge). Of this amount,

\$184,000 was collected from customers who paid the CIAC charge in full, and \$89,000 ( $\$1,000 \times 89$ ) was reported for those customers who paid the CIAC charge using the installment plan. In addition, the utility reported \$177,450 of gross-up collections as income on its tax return, of which \$13,650 related to CIAC reported in 1994 and \$163,800 related to CIAC reported in 1995. Of the \$163,800 of gross-up reported, \$110,400 ( $\$600 \times 184$ ) was collected from the customers who paid the gross-up in full, and \$53,400 was reported for customers who paid the gross-up in installments. It should be noted that although the utility reported \$53,400 on its tax return for gross-up collections from its installment customers, the utility had not actually collected the full \$53,400 because the installment customers were allowed to pay the gross-up over a 24 month period. Therefore, to the extent that these customers have not paid the required amount of gross-up, additional gross-up payments are due from them.

The 1995 CIAC report indicates that the utility had an above-the-line loss of \$66,359 prior to the inclusion of taxable CIAC in income. As a result, all of the CIAC collected would not be taxed. Order No. 23541 requires that above-the-line losses be offset against CIAC income. Therefore, the above-the-line loss of \$66,359 must be netted with the taxable CIAC collected. The CIAC report indicates that the utility collected \$273,000 of taxable CIAC, with \$3,978 being deducted for the first year's depreciation. As a result, the amount of taxable CIAC is calculated to be \$269,622. When this amount is offset with the above-the-line loss of \$66,359, net taxable CIAC is calculated to be \$202,663. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$76,262. 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 \$122,274.

As discussed earlier, the utility incurred accounting and legal costs that totaled \$5,981. Staff reviewed these costs and determined that all of the legal and accounting fees submitted by the utility are directly associated with preparing the required reports and calculating the tax effect and, thus, are considered to be legitimate expenses. In its settlement proposal, the utility requested to recover fifty percent of the legal and accounting costs incurred. If accepted the utility should be allowed to recover \$2,991 of legal and accounting costs. As a result, the utility should be allowed to recover \$125,265, to pay the tax effect on the CIAC and the legal and accounting charges. The gross-up funds were collected from 273 separate customers during 1995. Based on this amount, the utility should have collected \$459 ( $\$125,265/273$ ) of gross-up from each customer instead of \$600.

The utility reported \$163,800 ( $600 \times 273$ ) in gross-up for

1995. Therefore, staff calculates that the utility overcharged its contributors a total of \$38,535 (\$163,800 - 125,265), or \$141 per contributor. This amount does not include the accrued interest through the date of refund. Based on the total overcharged amount, each contributor that paid the gross-up in full should receive a refund of \$141. In addition, the utility should collect only \$459 instead of \$600 from the customers that paid in installments. However, to the extent that the utility has collected more than \$459 from those customers, using the installment plan, the utility should be required to refund the difference in the \$459 that should have been collected and the amount that was actually collected in installments.

If the Commission approves the refund, the refund should be completed within 6 months of the effective date of the order. Within 30 days from the date of the refund, the utility should submit copies of canceled checks, credits applied to the monthly bills or other evidence that verifies that the utility has made the refunds. Within 30 days from the date of the refund, the utility should also file a list of unclaimed refunds detailing contributor and amount, and an explanation of the efforts made to make the refunds.

ISSUE 2: Should the docket be closed?

RECOMMENDATION: No. Upon expiration of the 21-day 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)

STAFF ANALYSIS: 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.

**STAFF CALCULATED GROSS-UP REFUND**

**HUDSON UTILITIES, INC.**

SOURCE: (Line references are from CIAC Reports)

	<u>1995</u>
1 Form 1120, Line 30 (Line 15)	\$ 380,113
2 Less CIAC (Line 7)	(273,000)
3 Less Gross-up collected (Line 19)	(177,450)
4 Add First Year's Depr on CIAC (Line 8)	3,978
5 Add/Less Other Effects (Lines 20 & 21)	0
6	-----
7 Adjusted Income Before CIAC and Gross-up	\$ (66,359)
8 Taxable CIAC (Line 7)	273,000
9 Less first years depr. (Line 8)	(3,978)
10	-----
11 Taxable CIAC Resulting in a Tax Liability	\$ 202,663
12 Less: NOL Carrforward	0
13	-----
14 Net Taxable CIAC	\$ 202,663
15 Effective state and federal tax rate	37.63%
16	-----
17 Net Income tax on CIAC	\$ 76,262
18 Less ITC Realized	0
19	-----
20 Net Income Tax	\$ 76,262
21 Expansion Factor for gross-up taxes	1.603334937
22	-----
23 Gross-up Required to pay tax effect	\$ 122,274
24 Net Legal & Accounting Offset	2,991
25	-----
26 Total Cost Recoverable	\$ 125,265
27 Less CIAC Gross-up collected (Line 19)	(163,800)
28	-----
29 TOTAL OVERCHARGED	\$ (38,535)
30	=====
31	
32 TOTAL OVERCHARGED	\$ (38,535)
33	=====