BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Request by FLORIDA WATERWORKS ASSOCIATION for investigation of proposed repeal of Section 118(b), Internal Revenue Code [Contributions-in-aid-of-construction]	)	DOCKET NO. 860184-PU ORDER NO. 23541 ISSUED: 10-1-90

The following Commissioners participated in the disposition of this matter:

MICHAEL McK. WILSON, Chairman
BETTY EASLEY
GERALD L. GUNTER

APPEARANCES:

B. KENNETH GATLIN, Esquire, Gatlin, Woods, Carlson & Cowdery, 1709-D Mahan Drive, Tallahassee, Florida 32308
On behalf of the Florida Waterworks Association

ROBERT M. C. ROSE, Esquire, Rose, Sundstrom & Bentley, 2548 Blair Stone Pines Drive, Tallahassee, Florida 32301
On behalf of Aloha Utilities, Inc., Canal Utilities, Inc., Clay Utility Company, Eagle Ridge Utilities, Inc., El Agua Corporation, and Martin Downs Utilities, Inc.

F. MARSHALL DETERDING, Esquire, Rose, Sunstrom & Bentley, 2548 Blair Stone Pines Drive, Tallahassee, Florida 32301
On Behalf of Alafaya Utilities, Inc., Aloha Utilities, Inc., Canal Utilities, Inc., Clay Utility Company, Eagle Ridge Utilities, Inc., El Agua Corporation, Kingsley Service Company, Lehigh Utilities, Inc., Martin Downs Utilities, Inc., Neighborhood Utilities, Inc., North Fort Myers Utility, Inc., Rolling Oaks Utilities, Inc, Royal Utility Company, and Southside Utilities, Inc.

PATRICK K. WIGGINS, Esquire, Wiggins & Villacorta, P. A., 501 East Tennessee Street, P. O. Drawer 1657, Tallahassee, Florida 32302
On behalf of Southwest Florida Capital Corporation and the Florida Home Builders Association

ROBERT J. PIERSON, Esquire, Florida Public Service Commission, 101 East Gaines Street, Tallahassee, Florida 32399-0863
On behalf of the Commission Staff

PRENTICE P. PRUITT, Esquire, Florida Public Service Commission, 101 East Gaines Street, Tallahassee, Florida 32399-0862
Counsel to the Commission

ORDER AUTHORIZING CONTINUED USE OF THE GROSS-UP OF CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION, SUBJECT TO PRIOR COMMISSION APPROVAL, PRESCRIBING ACCOUNTING AND REGULATORY TREATMENTS FOR THE GROSS-UP, AND REQUIRING REFUNDS OF CERTAIN GROSS-UP AMOUNTS COLLECTED

BY THE COMMISSION:

CASE BACKGROUND

On February 13, 1986, the Florida Waterworks Association (FWWA) requested that we investigate a proposed repeal of Section 118(b), Internal Revenue Code (I.R.C.), under which certain contributions to the capital of a corporation were excludable from gross income. Ultimately, Section 118(b), I.R.C., was repealed by the Tax Reform Act of 1986 (ACT) and, effective January 1, 1987, contributions-in-aid-of-construction (CIAC) became both gross income and depreciable for federal tax purposes.

By Order No. 16971, issued December 18, 1986, on an emergency basis, this Commission authorized corporate utilities subject to our jurisdiction to amend their service availability policies to gross-up CIAC in order to meet the tax impact resulting from the inclusion of CIAC as gross income. Since then, 44 water and/or wastewater utilities have elected to implement that gross-up. Of these, only 37 remain subject to our jurisdiction.

By Order No. 21266, issued May 22, 1989, this Commission proposed to establish certain guidelines to control the collection

of the gross-up. On June 12, 1989, Order No. 21266 was protested by FWWA and 14 water/wastewater utilities.

On June 13, 1989, South Florida Capital Corporation (SFCC), under the misnomer of Florida Home Development Corporation, purported to file a petition protest to Order No. 21266. The protest was, however, untimely; accordingly, we treated it as a petition to intervene and granted SFCC intervenor status by Order No. 21921, issued September 19, 1989. On April 5, 1990, the Florida Home Builders Association (FHBA) petitioned to intervene in this proceeding. Its petition was granted by Order No. 22859, issued April 26, 1990.

By Order No. 21436, issued June 26, 1989, we also proposed to require a number of utilities to refund amounts of the gross-up collected or make adjustments to their depreciation reserves. On or about July 17, 1989, Order No. 21436 was protested by six water/wastewater utilities.

Based upon the protests of Orders Nos. 21266 and 21436, we conducted a hearing on April 27, 1990. We were not able to complete all of the testimony on that date, however, and the hearing was, accordingly, continued on April 30, 1990.

FINDINGS OF FACT, LAW, AND POLICY

Having heard the evidence presented at hearing, and having reviewed the briefs of the parties and the recommendations of Staff, we enter our findings of fact, law, and policy as follows.

RETENTION OF GROSS-UP

Purpose of Gross-up

Some of the Petitioners expressed concern that there is language in Order No. 21266 that implies that Order No. 16971, which originally authorized the gross-up, was issued solely for the purpose of alleviating cash flow problems. Although Order No. 21266 has been protested and is, therefore, a legal nullity, we note that neither FWWA's original petition nor Order No. 16971 specifically mention cash flow as a consideration. Order No. 16971 merely discusses the change in Section 118(b), I.R.C., FWWA's proposal, and our modifications to its proposal. It does not state that the gross-up was allowed solely for the purpose of alleviating

cash flow problems nor, for that matter, any other reason. Although we believe that cash flow is a consideration in the overall gross-up picture, it is only one of many.

Avoidance of Taxes on CIAC

The first question that should be addressed is whether there is any way for utilities to avoid taxes on CIAC. The IRS issued Notice 87-82 to provide guidance to taxpayers regarding the application of the tax accounting rules related to CIAC. Notice 87-82 states, in part, that "a transaction will be treated as CIAC if such treatment is in accordance with the substance of the transaction, regardless of the form in which such transaction is conducted".

Witness Elliott testified that, since the IRS generally considers any contribution of funds received by a utility related to its future provision of service to be CIAC, it is clear that if the transaction is CIAC in substance, it will be treated as CIAC for tax purposes. Witnesses Elliott and Martin also testified that they and other experts in the areas of taxation, utility law, and accounting had made diligent searches to determine whether there are any methods of avoidance of taxation on CIAC. Witness Martin's conclusion was that the Tax Reform Act of 1986 closed all loopholes to exempt CIAC from taxable income and that only new legislation from Congress could alter that position. Witness Elliott testified that he was not aware of any methods of avoiding the taxation of CIAC. However, he did not preclude the possibility of such a method.

Witness Causseaux testified that General Development Utilities, Inc. (GDU) had managed to avoid taxes on CIAC. However, she admitted that GDU's method was quite complicated, and that it probably would not be within the reach of those utilities that are most in need of the gross-up.

Although GDU's plan probably would not be within the reach of those utilities who would be most in need of the gross-up, it does indicate that there are ways to avoid taxes on CIAC. Accordingly, we hereby encourage the water and wastewater industry to continue to search for viable methods.

Who Should Bear the Burden?

If the taxation of CIAC is not generally avoidable, the next question is who should be responsible for the taxes? In their brief, SFCC and FHBA argue that the utility (i.e., the general body of ratepayers) should be responsible for paying the taxes irrespective of the source of income. They argue that to do otherwise would misidentify the contributor as the cost causer.

Witnesses Elliott and Nixon believe that the contributor is the cost causer. However, under cross-examination, Mr. Elliott agreed that measuring the extent to which any contributor is the cost causer is a very subjective determination. Mr. Elliott further stated that the decision whether to collect the taxes from the contributor should be up to each utility, based upon its particular facts and circumstances.

Witness Nixon testified that, if utilities do not gross-up, their payment of taxes on CIAC will, eventually, result in increased revenue requirements. Witnesses Martin, Elliott and Causseaux agreed. Witnesses Martin and Nixon testified that the required revenue increases may be significant, especially in high growth areas. Mr. Nixon also testified that utilities making regular and significant investments in taxes on CIAC may require regular and significant rate relief. He also argued that, due to "regulatory lag", a utility may never be able to actually earn its authorized rate of return.

Under cross-examination, however, Witness Nixon admitted that, depending upon a utility's particular circumstances, its investment in taxes on CIAC could result in either no increase or a very minimal increase in rates. Witness Causseaux also testified that a utility with prior tax losses may use them to offset current taxable income. It might, therefore, not feel the impact of the tax on CIAC for years.

We agree that high growth could result in increased revenue requirements. However, such growth would probably cause the utility to file a rate increase anyway, due to factors such as increased rate base and operating and maintenance expenses. Accordingly, we do not believe that this particular piece of the regulatory puzzle should be viewed in isolation. We believe that all of the facts and circumstances of the utility should go into determining who should bear the responsibility of paying the tax

impact of CIAC. 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.

Debt Financing for CIAC Taxes

If a utility pays the taxes associated with CIAC itself, it must obtain the cash to pay those taxes. Witnesses Martin, Nixon, and O'Steen testified that it would be difficult to obtain debt financing for the tax liability associated with the receipt of CIAC. Witness O'Steen argued that it is not a sound practice to finance a tax paid annually over a longer period of time. In fact, he argued that it may not even be possible due to the inability to collateralize such loans and the fact that the period during which the utility would recover the taxes through depreciation would be much longer than the term of the loan.

Witness O'Steen also testified that, over the long-run, investing in taxes can "damage the soundness of a utility's capital structure, thereby making it much more difficult for a utility to obtain needed funds for plant construction, renovation, and major maintenance when those funds are needed." He believes that, as utilities borrow more and more to pay such taxes, they will appear more risky to lenders, which will further restrict the availability of funds, and make those funds that are available more costly. Upon cross-examination, however, Witness O'Steen agreed that lenders place great reliance on cash flow projections.

Witness Nixon testified that most of the companies he deals with generally provide for plant expansion through debt. He argued that anything that would decrease a utility's ability to borrow funds jeopardizes its ability to serve its customers.

Witness Martin argued that the water and wastewater industry is already highly leveraged, and he expressed concern over these utilities increasing their levels of debt. He was also concerned whether funds would be available with reasonable terms and cost rates for the payment of taxes or for other purposes. He expressed particular concern about utilities that are experiencing significant growth and would have to make substantial investment in taxes every year. On cross-examination, however, Witness Martin agreed that a well-managed utility should be able to foresee and plan for such growth and increased taxes. He also agreed that a utility can petition for increased rates to improve its debt

service capability or for the gross-up if it foresees substantial growth coming.

Finally, we note that utilities do not always borrow funds for specific purposes. For instance, a company can often secure a line of credit by merely demonstrating a cash flow and paying a small fee or percentage at the front end. These funds can be used to finance anything from plant expansion to operating expenses, including the payment of taxes.

Based upon the evidence of record and the discussion above, we find that debt financing may be available for the payment of taxes related to CIAC. However, we also find that a utility's payment of taxes on CIAC may lessen its cash flow, which may, in turn, impair its ability to borrow funds for the payment of taxes or for other purposes.

Use of Cash CIAC to Pay Taxes

In her testimony, Witness Causseaux suggested that a utility in a strong cash position could use a portion of the cash CIAC to pay the taxes associated with the receipt of CIAC. However, she also stated that using cash CIAC for such a purpose will mean that there is less cash available for current or future construction or to repay the utility for its past investment in plant.

Witness Nixon testified that it would be imprudent for most utilities to use cash CIAC to meet their tax liabilities. He also stated that it defeats the very purpose for collecting CIAC, under general regulatory theory, because CIAC is primarily a financing vehicle used to construct new plant or repay debt or equity invested to construct plant. In his opinion, it should be used only for the above-mentioned purposes since CIAC must be deducted from rate base, which reduces the return available for funding debt or equity costs.

Witness Nixon also testified that many utilities' loan agreements require them to assign or pledge cash CIAC to service debt and, for that reason, cash CIAC is unavailable to meet the tax liability. Witness Deterding expressed many of the same concerns in his testimony.

Based upon the evidence of record, we find that a utility can use cash CIAC for any purpose that it deems appropriate. However,

this may mean that the cash will not be available for its intended use. Further, in a rate proceeding, all CIAC will be considered in the reduction of the utility's rate base.

Cash Versus Property CIAC

In Order No. 21266, we made the assertion that property CIAC was typically collected from developers, while cash CIAC was typically collected from individuals. In his testimony, Witness Nixon stated that cash CIAC is generally paid by developers and homebuilders. He stated that cash CIAC is less often collected directly from individual homebuyers.

Mr. Nixon also prepared an exhibit to demonstrate that the donation of cash CIAC varies between utilities. According to Mr. Nixon's exhibit, during 1987, Rolling Oaks Utilities, Inc. received $327,324 in cash contributions from individual homeowners and no cash from developers. Clay Utility Company, on the other hand, received no cash from individual homeowners and $886,745 in cash from developers. This same situation can be observed between other utilities during 1988.

In her testimony, Witness Causseaux stated that she had no knowledge of any utilities that typically collected cash CIAC from individuals as opposed to developers.

Based upon the evidence of record, we find that a utility's collection of CIAC can vary between cash and property depending upon that utility's particular facts and circumstances.

Gross-up cause Competitive Disadvantage?

This issue addresses whether implementing the gross-up of CIAC may place a utility at a competitive disadvantage with utilities that do not gross-up, or convince developers to utilize septic tanks instead of connecting to the utility's system. During the hearing, Jacksonville Suburban Utility Corporation was the only company specifically mentioned that chose not to gross-up because of competitive pressures.

Witness Nixon testified that he was not aware of any case in which a utility had chosen to gross-up but was later forced to stop due to competitive pressures. However, during cross examination,

he did admit that competition was one reason that he did not urge a mandatory gross-up.

Witness Elliott, on the other hand, testified that the water and wastewater industry in Florida is subject to competitive pressures due to the large number of both municipal and investor-owned water and wastewater utilities. He also stated that a significant difference in rates or CIAC charges can cause growth to shift into a lower-cost utility's service areas.

As for the suggestion that the gross-up may force developers to begin utilizing septic tanks, Witness Causseaux stated that she had no personal knowledge of any utilities that have had a developer switch to use of septic tanks because of gross-up costs. Although SFCC and FHBA stated that they have actual knowledge of projects utilizing septic tanks because of the CIAC gross-up cost, their position is not supported by the record. Further, Witness Nixon provided the results of a questionnaire sent to all utilities utilizing the gross-up. All of the utilities that responded stated that they were not aware of any cases in which septic tanks had been utilized or utilities had found themselves at a competitive disadvantage because of the gross-up.

Based on the evidence discussed above, we find that, although the use of the gross-up may place a utility at a competitive disadvantage, it is not a widespread problem in Florida.

Retention of Gross-up/Requirement of Pre-approval

All parties and the Staff of this Commission (Staff) agreed that the gross-up should be retained. The only real point of contention appears to be whether the gross-up should be allowed solely at the discretion of the utilities or only upon the prior approval of this Commission. All of the utility witnesses believe that whether to gross-up should be a management decision. According to witness Elliott, "management has the experience and knowledge of the facts and circumstances of the utility..." and is, therefore, in the best position to determine the needs of the utility."

We do not agree. Generally, we do not insert ourselves into the day-to-day decision-making processes of a utility. In fact, we normally do not review the management decisions of a utility unless it has applied for a rate increase or we have initiated an

overearnings investigation. In the case of the gross-up, however, the dollar amounts are quite large and there are other persons involved, such as developers and home purchasers. If we wait until a utility's next rate proceeding to review its decision whether to gross-up, it may be too late to undo what has already been done.

In addition to the above, we believe that requiring pre-approval of the gross-up is reasonable for a number of other reasons. First, out of the approximately 700 water and wastewater utilities regulated by this Commission, only 44 have ever requested to gross-up. Although a number of the utilities that we regulate are partnerships and sole proprietorships, the fact that so few have elected to implement the gross-up indicates that the vast majority of water and wastewater utilities do not need the gross-up.

The evidence also indicates that some of the utilities that are collecting the gross-up may not actually need it. For instance, Witness Nixon stated that one company, Southern States Utilities, Inc., appears to have enough resources to cover the tax impact of CIAC, and that it intends to discontinue the gross-up. Witness Nixon stated that Florida Cities Water Company is another company that "will not fight for continued authority to gross-up."

Second, the use of a gross-up creates a new tax, and expense, that did not previously exist. This is what has been referred to as the "tax-on-tax." A tax-on-tax is created when taxes are contributed. The contributed taxes are considered gross income which are, in turn, taxable. Because of this tax-on-tax effect, the gross-up can be as high as 60.3 percent, as compared to a maximum combined federal and state tax rate of 37.63 percent, if the utility pays the tax on CIAC itself.

Witness Elliott stated that this "tax-on-tax" effect does not only exist in the case of a gross-up. He stated that, when a utility does not gross-up, it must use equity to invest in the CIAC-related taxes. Since the equity component is grossed-up for taxes, he argues that there is a "tax-on-tax." Although a portion of the CIAC tax investment would be supported by equity, we do not believe that Witness Elliott's analysis considers that we generally do pro rata reconciliations, assuming that funds cannot be traced. Witness Elliott's analysis also assumes that equity would be the only source available for financing. Although funds cannot be specifically traced, we believe that there are other sources for

these funds, such as operating revenues, debt, and deferred taxes.

Witness Causseaux argued that the tax on CIAC is a cost of doing business. Witness Elliott agreed. He also stated his belief that "the change in the tax laws have imposed a new cost on the utilities associated with CIAC." An observation was also made at the hearing that, if Congress had wanted to tax the contributor, it would have done so. Over the long-run, however, it is probably the homeowner/ratepayer who bears the burden anyway.

Upon consideration of the above, we believe that the gross-up should be retained, but that it should only be allowed upon the prior approval of this Commission.

Determination of Need

We believe that the need for a gross-up should be determined on a case-by-case basis, based upon the facts and circumstances peculiar to each utility. According to Witness Elliott, utility management is in the best position to evaluate all of these facts and circumstances, and to determine whether a gross-up is needed and, if so, what methodology to use. If that is the case, once management determines that a gross-up is necessary, it should be able to provide the same information that it relied upon to make such a determination in a petition to this Commission. Accordingly, we find it appropriate to require all utilities that wish to collect the gross-up to file a petition for approval to collect the gross-up with this Commission. Any utility that is already collecting the gross-up may continue to do so pending our approval of its petition, provided that it files such a petition on or before October 29, 1990.

There is, of course, no need determination policy that will cover the entire water and wastewater industry. Our requirements must, therefore, remain flexible. However, at a minimum, each utility should be able to demonstrate that a tax liability exists and that sources of funds are not available at a reasonable cost. Generally speaking, a utility may demonstrate such need by filing the following information:

Demonstration of Actual Tax Liability - As a threshold, a utility should be able to demonstrate the existence of an actual tax liability on a regulated, above-the-line basis. Unless there

is a stand-alone tax liability, there is no need for additional funds to pay for the tax on CIAC.

Cash Flow Statement - All Class A and B utilities ought to be able to provide a cash flow statement. Witness O'Steen stated that a prudent utility would have cash flow statements for a number of years. He also stated that in his experience as a banker he "zeroed in on the cash flow." A cash flow statement would show whether liquid funds are available to pay taxes on CIAC. We will not require cash flow statements from Class C utilities, however, due to the expense associated with them.

Statement of Interest Coverage - The utility should also provide a statement of its times interest earned (TIE) ratio. The TIE ratio indicates the number of times a utility is able to cover its interest. The ratio is an indicator of the relative protection of the bondholders. It is also indicative of a utility's ability to go into the financial market to borrow money or issue stock at a reasonable rate. A utility should demonstrate that its TIE ratio is no more than 2x. We have selected a TIE ratio of 2x because the testimony indicates that it is a conservative ratio that maintains a utility's financial integrity without unduly burdening the ratepayers. We also note that 2x is within the range of Moody's Baa guidelines. Witness Elliott testified that 2x was too low; however, he did not present an alternative. Although we believe that a TIE ratio of 2x should be used as a benchmark, it should not be viewed in isolation. A utility may be able to show adequate interest coverage, but not have enough cash on hand.

Statement of Alternative Financing - A utility should also be able to demonstrate that it does not have an alternative source of financing available at a reasonable rate. As discussed above, some utilities may not be able to obtain financing at a reasonable rate to pay for taxes on CIAC. However, certain situations may exist where an alternative source is available at a reasonable rate. For instance, under cross-examination, Witness Elliott admitted that, given the choice between giving or lending the funds to pay taxes on CIAC, there was a strong incentive for a contributor to lend them.

Justification for Gross-up - The utility should also provide a statement regarding why it needs the gross-up, including the particular facts and circumstances that led to that conclusion. As stated by Witness Causseaux, "the utility is intimately aware of

its own unique circumstances ... [and] should be able to articulate its reasons for requesting a gross-up."

Gross-up Method Selected - The utility should also indicate the gross-up method selected and the reasons why. As discussed below, there are two methods of calculating the gross-up, each with its own advantages and disadvantages. Since the utility knows its unique circumstances leading to the decision to request the gross-up, it should also determine which gross-up method is better in its situation.

Proposed Tariffs - Finally, the utility should submit proposed tariffs for the gross-up in its filing.

Frequency of Demonstration of Need

One of the concerns of the utilities is whether the gross-up need determination will be one-time or periodic. In his testimony, Witness Nixon argued that an annual review of the need for the gross-up could cost anywhere between $5,000 to $8,000 a year for accounting services alone. He believes that it would be an unwarranted additional expense to pass on to the ratepayers. Mr. Nixon also stated that any fluctuations in need from year to year could result in discriminatory rates being applied to new connections. Upon cross-examination, however, he agreed that, once a utility has an approved gross-up, it should be simple for it to advise this Commission on an annual basis whether its circumstances had changed.

Witness Martin also argued that an annual determination of need would be expensive. He also testified that it will be difficult for utilities to forecast their cash flow for ten or 15 years if they face the prospect of losing the gross-up each and every year. Mr. Martin stated that this "unstabilizing event" could be looked upon unfavorably by lenders, bond buyers, or bond rating agencies. He also argued that a change in the gross-up for any future year could cause changes in the utility's debt service coverage and could harm the utility's ability to obtain low-cost, long-term financing.

Witness Elliott testified that it would be appropriate for us to require utilities to file a periodic statement whether any circumstances surrounding their need for the gross-up have changed. He believes that utilities should periodically review their needs

anyway, particularly if the facts and circumstances attending their decision to request the gross-up have changed. Mr. Elliott cautioned, however, that frequent changes in any annual filing requirements could be detrimental.

We agree with Mr. Elliott. We believe that a prudent utility should monitor its need for the gross-up and periodically determine if it is still warranted under that utility's particular circumstances. If circumstances have changed, it should be the utility's responsibility to notify this Commission. Accordingly, we find it appropriate to require those utilities that have received approval to use the gross-up to file a sworn statement with their annual reports stating whether circumstances have changed and whether the gross-up is still required. If it is later discovered that the circumstances are not as reported by the utility, we can address the matter in a rate case or a separate investigation.

CALCULATION OF GROSS-UP

There are basically two methods of grossing-up, the full gross-up and the net present value (NPV) gross-up. The formulae for these methods are as follows:

Full Gross-up:

Depreciable Plant	(CP-(CP*(1/TL)*AR*.5)) * (1/(1-CTR))
Land	(CL*(1/(1-CTR)))

NPV Gross-up:

All CIAC	(CTR/(1-CTR))*((C+CP+CL)-((((C+CP)/TL)*(1-(1+ROR)-tl))/ROR)*(CTRi/CTR))

Where:

CP	=	Contributed plant
TL	=	Tax life for contributed plant
AR	=	Accelerated tax rate
CTR	=	Combined federal and state income tax rate
C	=	Contributed cash
CL	=	Contributed land
ROR	=	Utility's last allowed rate of return

-tl = Negative exponent of the tax life of the contributed asset
CTRi = Tax rate expected to be in effect when the depreciation is taken on the tax return

The full gross-up allows a utility to collect the full tax impact associated with CIAC, including the "tax-on-tax." The NPV gross-up allows a utility to collect the taxes associated with the gross-up less the present value of the tax depreciation that will be received in the future. By the very nature of the calculations, the full gross-up will provide more cash flow than the NPV method.

Both methods have advantages and disadvantages. The full gross-up would provide a ready source of cash to pay the maximum tax liability that would be associated with CIAC. However, the full gross-up method fails to take into account future depreciation that will be taken on the contributed assets. The NPV method takes into account the benefit of the future tax depreciation, but may not provide enough relief for a utility in a poor cash position. The NPV formula is also considered bulky, cumbersome, not easily understood, and subject to error.

We note that the formula for the full gross-up of depreciable plant takes into account the first year's tax depreciation using a half-year convention. We agree with Witness Elliott that, for purposes of the NPV gross-up, it should be assumed that utilities would utilize the most liberal method of tax depreciation allowed by the tax law and that, if they choose to use a method less favorable, it's simply to their detriment.

Based upon the evidence of record and the discussion above, we believe that both methods should be available to the utilities. However, we note that, out of the 44 utilities that requested the gross-up, only one implemented a NPV gross-up.

ACCOUNTING/REGULATORY TREATMENT - NO GROSS-UP

Taxes as Investment

All of the witnesses who addressed this issue agreed that, when a utility pays taxes associated with its collection of CIAC, it has, essentially, made an investment in such taxes. Witnesses

Elliott and Nixon testified that, if a utility does not gross-up, but pays the taxes related to its receipt of CIAC itself, we should include the full amount of its investment in such taxes in rate base, without regard to any used and useful considerations. Mr. Nixon also argued that any utility that is not authorized to gross-up is required to invest in taxes on CIAC. Accordingly, he argued that this places the utility and its customers at risk for the success of the development. Upon cross-examination, however, Mr. Nixon admitted that tax benefits follow the asset.

As mentioned above, there are certain tax benefits that flow from a utility's investment in taxes related to CIAC. Further, as discussed by Witness Elliott under cross examination, there are methods under which a utility may recover its carrying costs and earn a return on nonused and useful property, such as guaranteed revenue and allowance for funds prudently invested charges. Accordingly, we do not find it appropriate to allow utilities to earn a return on taxes related to nonused and useful CIAC.

Finally, we note Witness Nixon's concern that the debit-deferred balance will not be recognized in rate base, since we are moving to the formula (one-eighth of operating and maintenance expenses) method of calculating working capital. Accordingly, due to the long-lived nature of the assets involved, we find that debit-deferred taxes should be recognized separately from the working capital calculation.

Normalization

All witnesses who testified in this regard agreed that, if a utility does not gross-up, the tax effects of a its collection of CIAC should be normalized. By normalizing, the tax effects are recognized over the lives of the assets acquired.

Witness Causseaux testified that there are different methods to normalize. She recommends the method required by the IRS pursuant to Notice 87-82. Under Notice 87-82, debit deferred taxes should be treated as the regulatory body usually treats deferred taxes. In Florida, the norm is to offset debit deferred taxes against credit deferred taxes in the capital structure. If the net of the credit and debit deferred tax amounts is a debit, the amount is included in rate base.

Notwithstanding the above, Witness Causseaux stated that a more simplistic approach would be to recognize the full debit deferred tax balance in rate base. Witness Elliott, however, argued that the accounting treatment should follow the regulatory treatment, and not vice-versa. We agree. Although the proposed rate base treatment would be easier to administer, we believe that the appropriate method of normalization is the capital structure method. This would keep the treatment in total compliance with Notice 87-82.

ACCOUNTING/REGULATORY TREATMENT WITH GROSS-UP

All witnesses who testified regarding this issue also agreed that normalization accounting should be followed when a utility does gross-up. The IRS has no normalization requirements associated with CIAC that is grossed-up. However, we still believe that full normalization accounting should be utilized. This would result in consistent treatment between utilities that are not grossing-up and those that are. In addition, those utilities that switch from grossing-up to not grossing-up will maintain the same normalization methodology.

As discussed above, normalization involves offsetting debit-deferred taxes against credit-deferred taxes in the capital structure with any net debit-deferred balance included in rate base. Under the full gross-up method, the debit-deferred taxes would be fully offset by the contributed taxes. Under the NPV gross-up method, however, the utility would have an investment in the present value of the future tax depreciation.

Under either method of gross-up, a tax-on-tax will exist. Witnesses Elliott and Causseaux disagreed on how this should be treated. Witness Causseaux contended that the tax-on-tax is a permanent difference. As a permanent difference, it would flow through tax expense the year it is received. Witness Elliott, however, argued that the tax-on-tax is not a permanent difference. He argued that the tax-on-tax reverses over the useful life of the plant and that it reduces future tax expense.

We do not believe that it is important whether the tax-on-tax is a permanent difference or a timing difference by definition; what is important is who should receive the benefits. Based upon the evidence of record, we believe that the benefits should be passed back to the ratepayers over the lives of the related assets,

consistent with the theory of normalization. However, in order to identify the different contributions and to properly normalize, utilities will have to, and we find it appropriate to require them to, record the gross-up in a separate subaccount.

Offset of CIAC Income Against Net Operating Losses (NOLs)

By Order No. 21436, we proposed to require utilities to offset the tax impact of their collection of CIAC by their NOLs. Without exception, the utility witnesses argued that NOLs should not be used to offset the tax impact of CIAC.

The utilities argue that the collection of CIAC cannot create NOLs and that we should not, therefore, require them to offset CIAC-related taxes with losses generated by activities unrelated to their collection of CIAC. The utilities also argue that the NOLs should be reserved for those who bore the cost when the NOL was generated. Witness Deterding further argued that, since this Commission does not recognize NOLs as an investment, it should not recognize the tax benefits of NOLs either.

Witness Causseaux, on the other hand, argued that current tax expense is based upon jurisdictional operations and that, if a utility has NOLs, it will have no tax liability, regardless of the elements of revenues or expenses considered. Witness Elliott agreed that CIAC is not considered in isolation, but with all other transactions that occur. He also agreed that, no matter what our decision is in this docket, utilities will use their NOLs on their tax returns. In fact, according to Witness Deterding, when a gross-up is allowed, NOLs are or will be consumed more rapidly.

Based upon the evidence of record, we find it appropriate to require utilities to offset CIAC income against their NOLs. The purpose of this docket is to determine the treatment of the additional tax burden caused by the change in tax laws regarding CIAC. Until a tax liability is incurred, there is no additional tax burden. By requiring utilities to offset CIAC income with NOLs, we are only recognizing what they are actually doing on their tax returns. Further, such treatment is in keeping with the entire "tax picture", without isolating one piece - the taxation of CIAC.

Notwithstanding the above, we believe that a utility should only have to offset jurisdictional, above-the-line NOLs, and not below-the-line NOLs. This is consistent with our policy of

calculating taxes on a stand-alone basis. Below-the-line items would include, but not be limited to, the impact of disallowed expenses, nonused and useful plant depreciation, other expenses associated with nonused and useful plant, revenues associated with nonused and useful plant and interest associated with debt not included in the capital structure.

In addition to the above, the utilities also argue that, to the extent that their NOLs result from below-the-line losses, any required offset would be in violation of Section 367.081, Florida Statutes. Under Section 367.081(2)(a), Florida Statutes, in setting rates for utility service, "the commission shall consider the value and quality of the service and the cost of providing the service, which shall include, but not be limited to ... a fair return on the investment of the utility in property used and useful in the public service." (Emphasis added) Based upon the language just quoted, we believe that, although generally only above-the-line losses should be used to offset income from above-the-line operations, if an occasional below-the-line loss crept into the equation, we would not be in violation of Section 367.081, Florida Statutes.

Offset of CIAC Income Against Investment Tax Credits (ITCs)

The utility witnesses also do not believe that the tax liability resulting from the gross-up should be offset by ITCs. Witness Elliott argued that ITCs are economic assets, that ITC carry-forwards represent contingent receivables to the utility from the U.S. Treasury, and that it would, therefore, be inappropriate for us to deprive utilities of their use.

Witness Elliott also argued that the utility's collection of CIAC could not have given rise to the ITCs. Mr. Elliott explained that, prior to the tax law change, CIAC could not generate an ITC. Along with the changes in the tax laws, ITCs have effectively been eliminated. Mr. Elliott further argued that, to assign the benefit of an ITC carry-forward to the contributor creates an inequitable mismatch by giving the benefit to a party clearly not responsible for such benefit.

According to Witness Causseaux, however, utilities will use their ITCs to reduce taxable income from any source, including the receipt of CIAC or contributed taxes, without regard to the outcome of this docket, in order to minimize their actual tax liabilities.

As we have already stated, until there is an actual tax liability, we do not believe that there is any tax burden created by the collection of CIAC or contributed taxes. Our treatment will simply recognize what is actually transpiring.

Based upon the evidence of record, we find it appropriate to recognize, for regulatory purposes, the treatment afforded by the utilities themselves, by requiring them to offset CIAC income against ITCs. However, as with our decision regarding NOLs, we believe that only above-the-line ITCs should be used as an offset.

Offset of NOLs and ITCs a Normalization Violation?

Witnesses Bowen, Deterding, Jackson and Wintz each testified that I.R.C. normalization requirements would be violated if the tax liability related to CIAC or the gross-up was offset by NOLs or ITCs. Witness Causseaux, however, did not believe that the requirements of Sections 46, 167, or 168, I.R.C., would be violated if NOLs and ITCs were used as an offset, so long as the appropriate normalization procedures are followed.

Witness Elliott testified that he did not believe that a refund of gross-up amounts due to the existence of NOLs or ITCs would violate the I.R.C. or the related regulations. In fact, he stated that, "[a]lthough the normalization requirements of the IRS are subject to the IRS' interpretation, I concur with Ms. Causseaux that refunding previously contributed taxes based upon the utilization of an NOL or ITC carry-forward would not represent a normalization violation if the investment in taxes is properly handled in the regulatory process."

Based upon the testimony of regulatory tax experts Causseaux and Elliott, we find that the normalization requirements of the I.R.C. and related regulations will not be violated by offsetting the tax liability associated with CIAC by regulatory NOLs and ITCs, if the utility properly records the transaction.

Tax Depreciation Benefits

Witnesses Elliott, Nixon, and Deterding each testified that, theoretically, the benefits of tax depreciation on CIAC should be passed back to the contributors of CIAC. These witnesses further testified, however, that because of practical considerations, such as prohibitive recordkeeping requirements, the benefits cannot be

returned to the contributors and must, therefore, be passed back to the general body of ratepayers. Although they did not sponsor any witnesses to support their position, SFCC and FHBA argued in their brief that, to the extent that a contributor pays the tax, the depreciation benefits should be passed back to him.

In her testimony, Witness Causseaux suggested that CIAC and the related taxes are ultimately borne by the homebuyer. Witness Elliott also testified to his belief that most developers treat CIAC costs as a cost of development, which is included in the total cost of the project. Witness Nixon does not agree.

Mr. Nixon testified that the prices which developers charge for homes are dictated by such factors as competition, area growth, interest rates and the resale market. He argued that, although developers presumably attempt to recover their costs and a profit through the purchase price, due to market conditions, the payment of CIAC-related taxes may actually reduce their profit margins. In support of this argument, he pointed out that a number of developers have objected to or complained about the gross-up.

We do not agree. Although market conditions may determine the selling price of a home, we believe that any time a developer has made a profit, it has recovered the costs of CIAC and the related taxes. Further, if the costs are passed on to the ultimate ratepayer, the contributor and the ratepayer are one and the same.

Since the practical considerations militate against passing the tax depreciation benefits back to developers and, since we believe that developers generally recover their costs, we find that the tax depreciation benefits should be passed back to the utility ratepayer. However, we note that, to the extent that utilities use the NPV method of grossing-up, they are passing the tax depreciation benefits of the gross-up back to developers, since the effect of that method is to offset the current taxes by the net present value of the future depreciation.

REFUND OF GROSS-UP AMOUNTS

The utilities do not believe that it would be fair and reasonable for this Commission to require refunds of the gross-up occasioned by the consumption of NOLs and ITCs. Witness Elliott

listed five reasons why he believes that this would be inappropriate.

First, Mr. Elliott argued that NOLs and ITCs are, for tax purposes, more or less equivalent to cash. Accordingly, he argues that it would be arbitrary for this Commission to treat them differently than it treats other economic assets.

We do not agree. The offset against NOLs and ITCs is merely a reflection of the way that the utilities will treat them for tax purposes. What Petitioners really object to here is that requiring them to refund all gross-up amounts collected in excess of their actual tax liabilities will deny them the opportunity to turn NOLs and ITCs into cash on hand.

Second, Mr. Elliott argues that the receipt of CIAC cannot create an NOL or ITC and that, to require refunds will assign such benefits to CIAC contributors, resulting in an inappropriate mismatch. We do not agree that the refund will assign the benefits to the contributors. The tax benefits are being used by the utilities to offset income. Again, what the utilities object to is the loss of the opportunity to cash-in on their NOLs and ITCs.

Third, Mr. Elliott argues that normalization must be followed when there is no gross-up or when excess amounts must be refunded, and that the refund of previously contributed taxes will result in increased revenue requirements. In fact, whenever NOLs or ITCs are consumed normalization will occur, whether or not there is a refund requirement. In addition, a refund requirement will only result in increased revenue requirements to the extent that a utility is earning below its last authorized rate of return.

Fourth, Mr. Elliott argues that a refund would be a windfall to those receiving it, at the expense of increased revenue requirements. We believe that, in fact, it is more likely a windfall to the utilities if they are not required to refund excess gross-up amounts, since they will receive cash now and the benefit of increased cash flow through depreciation over the lives of the assets. Further, we do not believe that it would be a windfall to the contributors if the refund is required, since both the utilities and the contributors were put on notice that a refund would be required by Order No. 16971, as follows:

> Monies in the CIAC Tax Impact Account may be withdrawn periodically for the purpose of paying that portion of the estimated Federal and State income tax expense which can be shown to be directly attributable to the repeal of Section 118(b) of the Internal Revenue Code and the inclusion of CIAC in taxable income. Annually, following the preparation and filing of the utility's annual, Federal and State income tax returns, a determination shall be made as to the actual Federal and State income tax expense that is directly attributable to the inclusion of CIAC in taxable income for the tax year. CIAC tax impact monies received during the tax year that are in excess of the actual amount of tax expense that is attributable to the receipt of CIAC, together with interest earned on such excess monies held in the CIAC Tax Impact Account must be refunded on a pro rata basis to the parties which made the contribution and paid the tax impact amounts during the tax year. (Order No. 16971, at page 3.)

This could be interpreted to mean that we will look at the receipt of CIAC as an isolated tax event, or that a tax liability must be incurred on the overall jurisdictional return. However, since the taxation of CIAC in isolation can only produce a tax liability, the former interpretation makes no sense because there is no way that a refund could occur. Accordingly, we believe that the intent was to consider the entire tax picture.

Fifth, Mr. Elliott argued that the application of a refund policy could become discriminatory due to potential fluctuations in CIAC collections from year to year. We agree that the potential for such "discrimination" exists. However, we do not find that any such discrepancies are either likely or likely to be "unfairly discriminatory," especially since any refunds will be based upon a rational and measurable basis - the utility's tax liability.

Finally, we note that the testimony of Mr. Charles deMenzes in this regard. Mr. deMenzes is the owner of Tradewinds Utilities, Inc. (Tradewinds), a small utility with NOLs that collects the gross-up. It appears from Mr. deMenzes' testimony that Tradewinds has a large percentage of nonused and useful plant and is having difficulty borrowing from banks. Mr. deMenzes was unequivocal about his desire to retain the gross-up as a trade-off for

Tradewinds' NOLs, in order to pay for operating expenses and expansion. Although we are sympathetic to Mr. deMenzes' plight, the gross-up does have a specific purpose - payment of the tax liability associated with the collection of CIAC. There are other mechanisms available from this Commission to allow utilities in poor financial condition to earn a fair rate of return.

Based upon the evidence of record and our discussion above, we find 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. Since a number of the utilities referred to in Order No. 21436 had NOLs and/or ITCs to offset CIAC-related income for 1987, they must refund gross-up amounts collected for 1987.

Notwithstanding the above, it appears from the record that some of the NOLs and ITCs used to offset taxes by Order No. 21436 were below-the-line items. These amounts were taken from the CIAC gross up reports required by Order No. 16971. Accordingly, to the extent these utilities can demonstrate that their losses or ITCs were below the line items, they should not be used to offset CIAC income. These utilities should, therefore, file amended reports to reflect only above-the-line NOLs and ITCs, with a reconciliation to the amounts originally filed. This suggestion would also hold true for 1988 and 1989 gross-up reports that have been filed. We also grant Staff administrative authority to process refunds of the gross-up based upon NOLs and ITCs for those years.

As for El Agua Corporation, Petitioners argue that its tax losses resulted from book/tax timing differences and that, to require it to refund contributed taxes would transfer the benefits of these book/tax timing differences from the ratepayers to the contributor. We do not agree. The book/tax timing difference would be accounted for through deferred tax accounting, regardless of whether or not a refund was required. Accordingly, it is not the book/tax timing difference, but the immediate benefit of converting the loss into cash that is actually being transferred from the utility back to those who contributed the cash.

With regard to Canal Utilities, Inc., Petitioners argue that its tax credits derive from ITC carry-forwards and that requiring it to offset CIAC-related taxes against the ITCs would transfer the benefits of the ITCs from the ratepayers to the contributors. This argument belies the fact that, as with the book/tax timing

differences discussed above, the ITCs would be normalized, for regulatory purposes, regardless of whether the refund is required or not. Again, the only benefit being transferred is the ability to convert ITCs into cash on hand.

Confiscation Without Due Process?

Finally, Petitioners argue that Order No. 21436 confiscates their property without due process of law. In this regard, we first point out that Order No. 21436 was protested and that the matter was considered at a Section 120.57(1), Florida Statutes, hearing. Since Order No. 21436 was protested, it became a legal nullity and cannot confiscate Petitioners' property. In addition, since it was considered in the context of an evidentiary hearing, Petitioners' due process rights have been protected.

Further, in a broader sense, offsetting CIAC income by NOLs and/or ITCs does not confiscate Petitioners' property. Petitioners will use these tax benefits on their tax returns regardless of the Commission's treatment. All we are doing by requiring a refund is recognizing this fact.

As already discussed, we believe that Petitioners really object to the fact that, by recognizing the actual tax transaction, they will be denied the opportunity to convert their losses and ITCs into cash on hand. Although our treatment will result in the consumption of these tax benefits for regulatory purposes, since contributions are now depreciable in any event, these benefits will be returned to the utilities as increased cash flow through depreciation over time. This would be recognized in ratemaking through deferred taxes. Accordingly, we do not believe that requiring the offset of NOLs and ITCs confiscates Petitioners' property in any sense of the term.

CONCLUSIONS OF LAW

1. This Commission is vested with jurisdiction over the gross-up of CIAC by the provisions of Sections 367.081, .091, .101, and .121, Florida Statutes.

2. The gross-up charges and conditions established herein are just and reasonable.

3. The requirements that utilities offset CIAC income against above-the-line NOLs and ITCs, and refund all amounts of gross-up collected in excess of their actual, jurisdictional tax liabilities resulting from their collection of CIAC, do not confiscate their property without just or fair compensation or violate their rights to due process.

Upon consideration of the foregoing, it is, therefore,

ORDERED by the Florida Public Service Commission that each of the findings contained in the body of this Order are approved in every respect. It is further

ORDERED that all matters discussed in the body of this Order are expressly incorporated herein by reference. It is further

ORDERED that no utility may gross-up CIAC without first obtaining the approval of this Commission. It is further

ORDERED that any utility that is currently grossing-up CIAC shall file a petition, in accordance with the provisions of this Order, for continued authority to gross-up no later than October 29, 1990. It is further

ORDERED that utilities shall follow the accounting procedures prescribed in the body of this Order whether they gross-up or not. It is further

ORDERED that utilities that do gross-up shall record the gross-up in a separate subaccount. It is further

ORDERED that all utilities that had below-the-line losses or ITCs for 1987, 1988, or 1989 shall file amended gross-up reports to reflect only above-the-line NOLs and ITCs, with a reconciliation to the amounts originally filed. It is further

ORDERED that any gross-up amounts collected in excess of a utility's actual tax liability resulting from its collection of CIAC, as set forth in the body of this Order, shall be refunded on a pro rata basis to the contributors of those amounts. It is further

ORDERED that Staff is hereby granted administrative authority to process refunds of the gross-up related to NOLs and ITCs for the years 1987, 1988, and 1989.

By ORDER of the Florida Public Service Commission, this 1st day of OCTOBER, 1990.

STEVE TRIBBLE, Director
Division of Records and Reporting

(S E A L)

RJP

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.

Any party adversely affected by the Commission's final action in this matter may request: 1) reconsideration of the decision by filing a motion for reconsideration with the Director, Division of Records and Reporting within fifteen (15) days of the issuance of this order in the form prescribed by Rule 25-22.060, Florida Administrative Code; or 2) judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or the First District Court of Appeal in the case of a water or sewer 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 after the issuance 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.