

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition for) DOCKET NO. 910110-WS
Continuation of Gross-Up of) ORDER NO. PSC-93-1207-FOF-WS
Contributions-in-Aid-of-) ISSUED: August 18, 1993
Construction (CIAC) in Lee)
County by GULF UTILITY COMPANY.)
_____)

The following Commissioners participated in the disposition of this matter:

THOMAS M. BEARD
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On behalf of Commission Staff.

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FILED RECORDS SECTION

ORDER GRANTING AUTHORITY TO CONTINUE
GROSS-UP OF CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION

BY THE COMMISSION:

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 No. 16971 and 23541 also prescribed the accounting and regulatory treatments for the gross-up and required refunds of certain gross-up amounts collected. On February 1, 1991, pursuant to Order No. 23541, Gulf Utility Company (Gulf or utility) filed its request for continuation of 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.

On July 30, 1992, the Commission issued Order No. PSC-92-0742-FOF-WS, authorizing continued gross-up of CIAC and requiring submission of proposals by SFCC and a report evaluating such proposals by Gulf. On August 20, 1992, SFCC filed a protest of Order No. PSC-92-0742-FOF-WS and requested a formal hearing pursuant to Section 120.57(1), Florida Statutes. On March 30, 1993, the Florida Waterworks Association (FWWA) filed its Petition to Intervene which was granted by Order No. PSC-93-0653-PHO-WS, issued April 22, 1993.

A prehearing conference was held April 2, 1993, in Tallahassee, Florida, and the hearing was held May 5 and 6, 1993, in Tallahassee, Florida. At the hearing testimony was received from witnesses sponsored by Gulf, SFCC, and FWWA. At the hearing, Counsel for SFCC made an oral Motion to Deny Gulf's petition. This Motion is discussed below.

MOTION TO DENY GULF'S PETITION

At hearing, by motion SFCC requested that Gulf's petition be denied. In support of its motion, SFCC stated that: Gulf filed a petition and limited direct testimony; Gulf's key witnesses and those knowledgeable about the case, did not file testimony; a prima facie case must be made in the utility's direct testimony; to allow a case to be established on the basis of rebuttal testimony shifts the burden and requires the request to be disproved by the protestant; and since SFCC is not allowed to file rebuttal on rebuttal testimony, Gulf violated SFCC's procedural due process rights. It is SFCC's belief that Gulf had the burden in this case of proving it has a right to continue gross-up of CIAC using the full gross-up method. Further, Counsel for SFCC argued that the gross-up policy must be developed and proved up. It is SFCC's belief that the Commission may not rely on Order No. 23541.

We agree with SFCC that Gulf has the burden of proof in this proceeding. We also believe that the Commission should follow the generic policy as established by Order No. 23541 if the record supports that policy. We disagree, however, with SFCC that the non-rule Commission policy on gross-up was not "proved-up." In McDonald v. Dept. of Banking and Finance, 346 So.2d 569 (Fla. 1st DCA 1977), the Court recognized the appropriateness of non-rule policy in certain types of situations. The Court stated:

While the Florida APA thus requires rulemaking for policy statements of general applicability, it also recognizes the inevitability and desirability of refining incipient agency policy through adjudication of individual cases. Id. at 581.

The policy involving the gross-up of CIAC is still evolving as evidenced by this case. Although a "rule" is not in place at present, this case brings us closer to implementation of such a rule.

The case law regarding the requirements for the proving-up of non-rule policy appears consistent. In Ganson v. Dept. of Administration, 554 So.2d 516 (Fla. 1st DCA 1989) and Florida Cities Water Co. v. Florida Public Service Commission, 384 So.2d 1280 (Fla. 1980), the Court held that when an agency does not choose to document its policy by rule, there must be adequate support for its decision in the record of the proceeding. Ganson at 520. In Anheuser-Busch, Inc. v. Dept. of Business Regulation,

393 So.2d 1177 (Fla. 1st DCA 1981), the Court found that an agency must create a record foundation for the policy decisions in its orders, by expert testimony, documentary opinion or other evidence appropriate in form to the nature of the issues involved. Id. at 1183.

By Order No. 23541, the Commission set forth the criteria for establishing the need for gross-up of CIAC. The Order states:

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, cash flow statement, statement of interest coverage, statement of alternative financing, justification for gross-up, gross-up method selected, proposed tariffs. (Order pp. 11-13)

Contrary to SFCC's belief, Utility witness Mann provided direct testimony addressing all of the requirements of Order No. 23541. Mr. Mann's testimony regarding the requirements is set forth below:

The first requirement was a demonstration of an actual tax liability on the above-the-line basis. The second requirement was to provide a cash flow statement to the Public Service Commission. A statement of interest coverage. A statement of alternative financing. A statement of justification of gross-up. The gross-up method selected by the utility. And the proposed tariffs.

Mr. Mann testified that Gulf has, indeed, met the requirements of Order No. 23541. Gulf incurred an above-the-line tax liability by the receipt of taxable income with the collection of CIAC and Gulf will continue to receive substantial taxable income associated with CIAC in the future. Further, he testified that Gulf does not have the cash flow to fund CIAC taxes. In addition, he testified that the utility's times interest earned (TIE) ratio is below the standard of two times (2x) as established in Order No. 23541. He also testified that Gulf has a very limited capacity to borrow money on the financial market. Finally, he provided testimony regarding Gulf's need to gross-up and identified the full gross-up method as the method employed by Gulf.

We find that the record in this proceeding has, in fact, proved-up the Commission's non-rule policy by the testimony of expert witnesses and documentary evidence submitted by the parties, as well as official notice of Order No. 23541. The record supports each of the policy decisions made herein. Therefore, SFCC's Motion to Deny Gulf's Petition is denied. Upon consideration of the testimony and case law, we find that Gulf has met its burden, that the record does support the policy in Order No. 23541, and that Gulf has met the criteria establishing the need for gross-up.

CONTINUATION OF GROSS-UP AUTHORITY

Utility witness Mann testified that the criteria used for determination of the need to gross-up are set forth in Order No. 23541. The criteria which a utility must meet are: Demonstration of actual tax liability; presentation of cash flow statements; a statement of interest coverage (times interest earned ratio); statement of alternative financing; a statement in justification for gross-up; and the gross-up method selected.

Utility witness Mann's testimony indicates that the utility's projected income and cash flow statements showed a very limited capacity to borrow funds at reasonable rates of interest in order to fund the taxes on CIAC. Mr. Mann testified that the times interest earned ratios were 1.11 times in 1990, .63 times in 1991, and .97 times in 1992, and that this compares to the minimum times interest earned ratio of 2 times set forth in Order No. 23541. Utility witness Nixon testified that the utility's long-term debt exceeded rate base, and that the capital structure consisted of 94 percent debt and 6 percent equity in 1991, and 9 percent equity and 91 percent debt in 1990. Mr. Nixon also testified that the times interest earned ratios for those years were .63 times in 1991 and 1.11 times in 1990, that cash flow for both years decreased, and had the utility not been allowed to gross-up during that period, negative cash flow would have increased by approximately \$103,000 in 1991 and approximately \$827,000 in 1990.

It is SFCC's position that the Commission should reject full gross-up and allow Gulf the net present value method instead. SFCC also believes that the Commission should require a utility, whenever possible, to service a contributor through a homeowners' association, if requested by the contributor, or pursue alternative means of financing such as interest free loans, or interest free loans with some gross-up, to allow the refunding of the future tax benefit of the depreciation timing difference. FWWA's position is

that to the extent the utility complied with the requirements of Order No. 23541, it should be granted continued gross-up authority in accordance with that Order.

We have used and relied upon the criteria established by Order No. 23541. We believe that Gulf has met the criteria set forth in that Order and therefore, we find that it is appropriate to allow Gulf to continue to gross-up CIAC. Our analysis and findings are discussed below.

Demonstration of Actual Tax Liability

Order No. 23541 states that, as a threshold, a utility should be able to demonstrate the existence of an actual tax liability on a regulated, above-the-line basis. Utility witness Mann testified that the financial statements, federal income tax returns, and annual reports show an above-the-line taxable loss for 1987 and 1988, and an above-the-line taxable income of \$153,265 for 1989 and \$53,621 for 1990. Further, he testified that these income and loss amounts were calculated using the methodology in Exhibit 6, which reflects the calculation of the above-the-line income/loss for 1987 through 1991. Mr. Mann also testified that when including taxable CIAC, the utility has incurred substantial taxable income in 1987, 1988, 1989 and 1990 and should continue to incur substantial taxable income associated with CIAC in the future. In addition, he testified that Gulf's service area is located in Lee County, one of the highest growth areas of the state. With the announcement that Florida Gulf University, Florida's tenth state university, will locate in Gulf's service area and with the eventual rebounding of the southwest Florida economy, future growth rates should equal or exceed past growth, which would indicate that future amounts of CIAC collections should equal or exceed past amounts. Finally, Mr. Mann testified that Gulf's projected financial statements for 1990 through 1999 indicate that there will continue to be an above-the-line tax liability associated with Gulf's collection of CIAC.

While SFCC presented testimony that the net present value method or some other alternative to gross-up would be preferable to full gross-up, SFCC presented no testimony or evidence which indicated that Gulf did not incur, or would not incur, an actual above-the-line tax liability with the collection of CIAC.

Exhibit 6, the utility's calculation of taxable income/loss for 1987 through 1991, reflects that Gulf experienced an above-the-line loss for 1987 and 1988 of \$107,813 and \$76,885, respectively.

For 1989 and 1990, above-the-line taxable income was \$153,265 and \$53,621, respectively. Also, the exhibit indicates that the utility experienced an above-the-line loss of \$202,272 in 1991. Exhibit 3 reflects the utility's CIAC Summary for 1987 through 1991. Based on this exhibit, CIAC collections for 1987 through 1991 were \$522,602, \$2,452,906, \$2,249,953, \$1,754,296, and \$1,145,737, respectively. When CIAC is included in income, the utility has taxable income for each year 1987 through 1991. Based on the actual and projected information reviewed, we find that the utility had, and will continue to have, an actual above-the-line tax liability associated with the collection of CIAC.

Cash Flow Statement

Order No. 23541 required all Class A and B utilities to provide a cash flow statement. Gulf's projected income and cash flow statements for 1990 through 1999 are reflected in Exhibit 2. A cash flow statement shows whether liquid funds are available to pay taxes on CIAC.

Utility witness Mann testified that the cash flow statements reflect that Gulf should be able to generate sufficient cash over the projected years to cover interest on the existing bonds, to cover required principal reductions on the existing bonds, to contribute toward the financing of additional water and wastewater facilities, to begin building cash reserves necessary to ultimately repay the \$10,000,000 principal amount of the bonds by the year 2018, and to provide a margin of safety to the company, the company's customers, and the company's bondholders. Further, Mr. Mann testified that the cash flow statements indicate that the utility generates insufficient funds to also pay taxes associated with CIAC collected if not collected from contributors through the gross-up procedure. In addition, utility witness Nixon testified that cash flow for both 1990 and 1991 was negative and that cash decreased by \$397,420 in 1991 and \$583,650 in 1990. He further testified that if Gulf had not been allowed to gross-up during 1991 and 1990, the negative cash flow would have increased by \$103,319 in 1991 and \$826,820 in 1990.

SFCC witness Freeman testified that a review of Gulf's financial statements did not indicate a shortage of cash and liquid assets, especially for a company with the capital base that Gulf has. He testified that the 1992 audited financial statements show \$3.3 million of unrestricted cash, plus \$2.8 million of cash which is restricted under the bond issue. Mr. Mann testified that this

\$3,365,625 of cash and cash equivalents, short-term investments and long-term investments would be available to invest in plant. Further, the financial statements also indicate that approximately \$1.6 million of the unrestricted cash is currently in long-term investments. Since no testimony was given by either party as to the maturities of these long-term investments, it cannot be determined if these amounts would be readily available for investment in CIAC taxes. Since the utility testified that it has to build cash reserves to ultimately repay the principal amount of the bonds by the year 2018, it appears that these funds may not be available for payment of CIAC taxes.

A review of the cash projections in Exhibit 2 indicates that income from operations does not generate sufficient cash flows to provide for operations, servicing of debt and payment of CIAC taxes. Net operating cash available for debt service was projected as \$772,709 for 1991 and \$935,898 for 1992. Interest on debt was projected as \$955,794 for 1991 and 1992. Thus, interest on debt exceeds cash available in each year. When connection fees and the bond proceeds are included, the net cash available exceeds the amount needed to repay principal and interest on debt and fund construction projects for each of the projected years. However, it does not appear that cash flows are sufficient to provide for normal operations, fund principal and interest on debt, fund construction of additional water and wastewater facilities and pay taxes on CIAC collected. Further, Mr. Mann testified that all net revenues and connections fees have been pledged as collateral under the mortgage and security agreement. Since the bonds were issued for the construction of various water and wastewater facilities, it appears reasonable that the connection fees would be used to repay principal and interest on debt. Based on the evidence in the record, we believe that Gulf does not have the cash flow to fund the payment of CIAC taxes.

Statement of Interest Coverage

Order No. 23541 established a benchmark of 2x for the times interest earned (TIE) ratio. The TIE ratio indicates the number of times a utility is able to cover its interest. This ratio demonstrates the utility'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.

Utility witness Mann testified that the projected TIE ratio varied from .86x in 1990 to 3.3x in 1999, and that the bond coverage ratio varied from .64x in 1990 to 1.70x in 1999. Further, he testified that the actual TIE was .96x for 1990, .61x for 1991 and .93x for 1992. He also testified that the financial statements and interest coverages show that Gulf's operating cash flow was not sufficient to cover interest expense in 1990, 1991 or 1992. He further testified that the bond coverage ratios are expected to increase to over 1x in 1993 and gradually increase to 1.72x in 1999, and that the projections did not show a coverage in excess of 2x.

Our analysis of Gulf's projected income and cash flow statements indicates that the TIE ratio varied from .86x in 1990 to 1.74x in 1995. These TIE ratios are less than the benchmark of 2x established by Order No. 23541. Although the TIE is projected to increase from 2.03x to 3.3x for the period 1996 to 1999, the utility's projections indicate that the utility is not currently achieving the benchmark of 2x as established by Order No. 23541. Based on the evidence in the record and the standard of 2x established in Order No. 23541, we find 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

Order No. 23541 also required that the utility demonstrate it does not have an alternative source of financing available at a reasonable rate. Utility witness Mann testified that Gulf has a very limited capacity to borrow funds in the financial market at reasonable rates of interest. He testified that debt would not be a viable option because of several factors: (1) Gulf's IRB loan agreement prohibits the incurrence of additional debt until certain conditions have been met, for example, the utility's net revenues must exceed 1.2x for the fiscal year prior to the issuance of additional debt and the net revenues must be projected to exceed 1.2x for the following two years; (2) there is no readily identifiable or predictable source of cash flow associated with CIAC tax payments with which to repay the principal amount of the debt, the interest on the debt, or provide a margin of safety to the lender; and (3) there is no collateral available associated with CIAC tax payments to secure such debt.

Mr. Mann testified that Gulf requested financing for CIAC tax payments from Sun Bank, and that this request was ultimately denied. He also testified that Gulf requested an opinion from its bond underwriter, William R. Hough & Co. on the utility's ability to service additional debt incurred for payment of CIAC taxes, and their opinion was that Gulf does not currently have the capacity to borrow monies to pay tax liabilities associated with CIAC. The utility submitted with its original petition letters from Sun Bank and William R. Hough & Co., denying the request. However, Mr. Mann testified that no formal application was ever made for a loan or credit facility with Sun Bank. He further testified that he was aware of conversations with lenders and with Gulf's underwriters in regard to obtaining funds to pay the CIAC tax, all of which were not viewed favorably, but he was not aware of any written application to any lender or source of debt money to satisfy the tax on CIAC.

Utility witness Nixon testified that he believes it would be imprudent for the utility to incur substantial additional borrowings, even if available at a reasonable cost, to fund the taxes on CIAC because this would further reduce the utility's equity ratio.

SFCC witness Asmus testified that generally, he does not believe the factors cited by Mr. Mann would actually prevent the utility from borrowing the money to pay CIAC tax impact liability from a contributor. Mr. Asmus testified that while he has not had the opportunity to review the IRB trust indenture and other IRB documentation, he believes that a loan could be structured that would be subordinate to the IRB debt service obligations; that there is a reasonably predictable cash flow available to pay off such a loan, for example, the depreciation benefits created by the contributed assets; and finally, that the collateral argument is specious, given that SFCC would not demand collateral security, other than perhaps the prospective tax depreciation benefits to be realized as a result of SFCC's contribution to Gulf, for funds loaned to pay Gulf's CIAC tax impact liability.

Mr. Nixon testified that Mr. Asmus has not taken into account the utility's current debt-to-equity ratio or the impact on cash flow, and does not address the concerns that additional debt could jeopardize the utility's ability to borrow future construction funds, which are necessary to keep pace with growth in Gulf's service area. Mr. Nixon testified that with regard to zero interest loans from SFCC, Mr. Asmus did not consider the impact on

cash flow for out-of-pocket taxes on the original issue discounts, and did not consider the fact that cash outflows exceeded cash inflows for 1991 and 1992.

Based on the evidence in the record, we believe that Gulf has adequately shown that it may not have the ability to go into the open market and borrow monies to pay CIAC taxes at a reasonable rate. As demonstrated by the projected income and cash flow statements, the utility's TIE ratio is currently less than 2x; therefore, 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. Further, Mr. Mann testified that the utility's capital structure consists of approximately 6 percent equity and 94 percent debt in 1991 and 9 percent equity and 91 percent debt in 1990, which exceeds rate base by 41.92 percent and 36.54 percent for 1991, and 1990, respectively, which indicates that Gulf cannot service its long-term debt through operating income derived from its investment in rate base.

We also believe that any additional borrowings would further erode the capital structure by reducing the equity ratio of the company; thus, the utility may not be able to borrow funds at reasonable rates to pay CIAC taxes since there is no readily and predictably available source of cash flows associated with CIAC tax payments with which to repay the principal and interest amount on the debt. Further, Mr. Mann testified that all internally generated funds have been pledged to repay IRB debt. Because the mortgage and security agreement requires that all net revenues and connection fees be pledged for repayment of IRB debt, it appears that the utility may be restricted in its ability to use internally generated funds to repay principal and interest on additional debt borrowings. We do not believe that these restrictions alone, should preclude the utility from exploring other alternatives to gross-up. However, we cannot ignore the restrictions of the trust indenture in determining the cash flow needs of the utility. The utility made a business decision to issue the IRB bonds to finance plant expansion. The bonds have been included in the utility's capital structure, and no testimony has been given to indicate that this was an imprudent business decision, although there is testimony that the bonds have placed the utility in a highly leveraged position. Therefore, based on the foregoing, we find that Gulf's borrowing money in the open market is not a viable alternative.

Alternatives to Gross-Up

It is SFCC's position that Gulf does indeed have several alternatives to gross-up. These alternatives are discussed below in greater detail.

Net Present Value

Gulf argues that the net present value (NPV) gross-up method is not a viable alternative. Utility witness Mann testified that the NPV 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 20 years. Further, he testified that using this method would require a substantial use of the utility's cash flow, which has been pledged to repay IRB interest and debt, provide for the maintenance of existing plant and operations, and provide for future obligations and growth. Mr. Mann testified that had the utility used the NPV method during the period 1987 through 1992, the utility would have had to pay approximately \$1.5 million in related CIAC taxes. Mr. Mann also testified that if the utility had been operating under the NPV method from 1987 to 1992, CIAC tax payments would have consumed fully 100% of operating income. Mr. Nixon testified that the utility's financial position and circumstances do not allow it to invest in the up-front costs required by the NPV method.

SFCC argues that the NPV approach is far preferable to the full gross-up method. SFCC witness Freeman testified that the NPV is the fair method and it would not adversely affect anyone. Further, he testified that it is a win-win situation, and that Gulf would collect more money in gross-up than it would spend in tax and the contributors would spend significantly less money than tax-on-tax gross-up. In addition, he testified that the use of the NPV method would have saved approximately one-half of the cost associated with the taxes incurred with respect to the contributed facilities. However, SFCC did not present any evidence with regard to the savings calculation from using the NPV method.

Mr. Mann testified that the utility received \$1.1 million of CIAC in 1991. He further testified that the current contributors would have paid \$351,000 in gross-up under the NPV method. In addition, he testified that if the utility's marginal tax rate of 37.63 percent had been applied to line 30 of the utility's 1991 tax return, which was afforded confidential status by Order No. PSC-92-0773-CFO-WS, issued August 7, 1992, the resulting taxes due would

have been less than the \$351,000 of gross-up paid under the NPV method. However, Mr. Mann clarified that line 30 on the tax return was net taxable income, and that for purposes of calculating taxable income or taxable CIAC, we use the above-the-line taxable income.

We believe that the NPV method is conceptually sound. However, the evidence in the record is insufficient to determine the viability of this alternative for Gulf. Although SFCC argued that the NPV method would be preferable to full gross-up, SFCC did not provide testimony regarding the impact of the NPV method on Gulf, nor did it provide a comparison of the NPV method to the full gross-up method. SFCC attempted to show that if Gulf had used the NPV method, Gulf would have collected more money from the contributors than it paid in taxes. SFCC's tax amount was calculated on the net taxable income on line 30 of the utility's 1120 tax return, which includes above and below-the-line operations. However, in Order No. 23541 and Order No. PSC-92-0961-FOF-WS, we determined that the tax should be calculated on the utility's above-the-line taxable income because unless there is a stand-alone tax liability, there is no need for additional funds to pay the tax on CIAC. Further, although Gulf provided calculations showing the impact of the NPV method in Exhibit 13 which indicates that if Gulf had used the NPV method during the period 1987 through 1992, the utility's portion of the tax associated with the CIAC collected would have been approximately \$1.5 million, the utility's calculation assumes that all CIAC collected created a tax liability. However, Orders Nos. 23541 and PSC-92-0961-FOF-WS established that the utility's above-the-line losses should be netted against the CIAC collected. Therefore, since Exhibit 6 indicates that Gulf had a loss before CIAC consideration in 1987, 1988, and 1991, taxable CIAC would be less than that reported by the utility and thus, the utility's portion of the CIAC taxes would be less. Finally, Mr. Nixon testified that the utility's financial position and circumstances do not allow it to invest in the up-front costs required by the NPV method.

Our analysis of the utility's projected cash flow statements revealed that operations do not generate sufficient cash to provide for normal operations, repay principal and interest on debt and pay CIAC taxes. Further, there is no specific testimony in the record which addresses how the up-front CIAC taxes will be funded. As a result, we must find that the record does not support the viability of the NPV method for Gulf.

Interest Free Loan

SFCC offered to provide the utility an interest free loan to finance the cash flow needs of the utility for the tax on CIAC. Utility witness Mann testified that if the utility were to have borrowed the funds to pay the tax from all developers and customers subject to gross-up for the years 1987 through 1992, the utility would have incurred additional debt of approximately \$3,134,000. Further, he testified that this additional debt burden would serve to severely weaken and jeopardize the utility's financial integrity, would restrict its ability to maintain existing plant and operations, would inhibit its ability to fund its existing debt obligations, and would restrict its ability to obtain funds on a reasonable basis for future growth. He also testified that generation of future funds to repay developer and customer loans from the tax depreciation cannot be assured due to such factors as potential changes in marginal tax rates or changes in the utility's taxable income position. In addition, he testified that in order to administer a multitude of developer and customer loans for a period of up to 20 years, the utility would be forced to hire additional personnel and to invest in computer software and systems. Finally, Mr. Mann testified that if the interest free developer loan had been used from 1987 to 1992, the utility would have had to repay approximately \$638,000 of that debt and would have had to pay approximately \$610,000 in taxes related to the original issue discount on the interest free debt.

Utility witness Nixon testified that the interest free loan suffers from the same drawbacks as no gross-up or present value gross-up because there is a significant first year cost to the utility, which it cannot afford and which would jeopardize its financial position. Further, he testified, the utility would have cumulative 1992 out-of-pocket investments in tax of approximately \$3.744 million and an outstanding loan balance of approximately \$2.5 million, and that the cumulative taxes on the original issue discounts would be investments on which the utility could not earn a rate of return, unless specifically authorized by the Commission. Finally, Mr. Nixon testified that assuming the utility were in the financial position to enter into these transactions, he does not believe they could be offered to all developers as many are small, under-capitalized, and frequently go out of business. Also, he testified that it would create a risk for the utility if a developer goes out of business and the unpaid balance is treated as taxable income for forgiveness of debt.

Utility witness Freeman provided a calculation of the effects of an interest free loan on a CIAC property contribution. He testified that based on his calculation, the use of the interest free loan in the amount of the actual tax would cost the utility approximately 1.5 percent of the contribution, as opposed to costing the donor 60.33 percent of the contributions. However, although the schedule illustrates how an interest free loan would work, it does not reflect the effect on Gulf of an interest free loan. Therefore, while SFCC has established that the interest free loan may be an alternative, the record does not support the viability of this alternative for Gulf.

Homeowners Association

Gulf's position is that a homeowners' association cannot be utilized in order to avoid the tax imposed on Gulf when it receives CIAC. SFCC maintains that the contributed property would not be taxable either to Gulf or to the association. Utility witness Stoneburner testified that it is unlikely that a homeowners' association could be structured to avoid the imposition of tax on CIAC. SFCC witness Goldberg testified that the use of a separate utility operated by a homeowners' association or community development district could alleviate much of the tax burden. Further, he testified that utilizing the homeowners' association or community development district utility, the lines and certain other contributed property belong to the association utility, and would not subject Gulf to income on the property.

Utility witnesses Mann and Nixon testified that Gulf was concerned that routine maintenance and up-keep of the on-site facilities would suffer. Further, they testified that the utility was concerned that at some point in the future, the homeowners may decide to get out of the utility business and become customers of Gulf, and that at that point, receipt of the facilities by Gulf would trigger a tax. However, Mr. Mann testified that it would seem practical that as a part of the bulk service agreement the utility could require and name an independent engineer to guarantee that the facilities are being kept up to Gulf's standards. Further, Mr. Moore testified that Gulf could make an arrangement with the homeowners' association so that if the transfer of facilities triggered taxable CIAC, the homeowners would be responsible for paying that tax liability.

We do not believe that we can force the utility to form a homeowners' association. Further, Mr. Freeman testified that SFCC

does not need Gulf's help to form a homeowners association. Mr. Goldberg also testified that the homeowners', not Gulf, form the association. Further, with regard to a bulk service agreement, Mr. Moore testified that if there is an entity in Gulf's service area that applies for service, Gulf would have to give it service under its tariff. We, therefore, find it appropriate to take no action with regard to this alternative since a homeowners' association has not yet been formed.

Guaranteed Revenue Charge Method

Utility witness Mann testified that instituting guaranteed revenue charges on all developers would tend to shift the payment burden from a specific developer responsible for generating the tax to all developers and customers. Further, he testified that unless the utility were allowed to vary the amounts charged under the guaranteed revenue contracts, the collection under such contracts could be insufficient to cover the payment of the CIAC taxes, and a mismatch in collections and payments would occur. Upon consideration, we find that the record is insufficient to determine the viability of guaranteed revenue charges for Gulf.

Service by Lee County Utilities or Another Utility

Although utility witness Freeman testified that the northern portion of the SFCC project can be served by Lee County Utilities, SFCC did not provide testimony regarding this alternative. Therefore, we are unable to determine the viability of this alternative at this time.

Summary

Based upon the testimony and the evidence in the record, we find that the alternatives to gross-up of CIAC proposed by SFCC are not appropriate for Gulf.

GROSS-UP METHOD

Gulf requested that it be authorized to utilize the full gross-up method for all customers or developers within its service area. We believe the testimony and exhibits in the record establish that Gulf will incur an actual above-the-line tax liability with the collection of CIAC. The record also indicates that the utility's TIE ratio is below the threshold of 2x as established by Order No. 23541. Further, the record indicates

that, because the utility has pledged all net revenues for repayment of the existing IRB debt, cash flow may not be available to fund CIAC taxes. In addition, due to the level of debt and bond restrictions, the utility may not be able to incur additional debt to fund CIAC taxes or borrow funds at a reasonable rate.

Based upon the evidence in the record, we believe it is appropriate to authorize Gulf to continue to gross-up CIAC using the full gross-up method. While the record establishes that there are alternatives that may be preferable to full gross-up, we do not believe the record contains sufficient evidence for us to determine that these alternatives are viable for Gulf. Further, we find that it is appropriate that Gulf apply the full gross-up method to all CIAC contributions in accordance with its tariff.

INDUSTRIAL DEVELOPMENT REVENUE BOND

Utility witness Mann testified that the loan agreement places substantial controls and restrictions on the utility's activities, such as restrictions regarding the ability of the utility to enter into unsecured debt obligations, and the requirement that the utility maintain a bond coverage ratio of 1.2x prior to the issuance of additional debt, and for the following two years. However, Mr. Mann also testified that the loan agreement does not prohibit the utility from entering into short-term indebtedness, but restricts the amount of short-term debt the utility can incur. He further testified that the IRB would not specifically restrict the utility from entering into an unsecured loan with a developer such as SFCC for the purposes of funding the tax and gross-up, to the extent that the current portion of short-term debt does not exceed 50 percent of the current assets of the company.

SFCC argued that Mr. Mann also testified that failure to maintain a bond coverage ratio of 1.2x was not an event of default and that a coverage ratio of less than 1.2x only required the utility to hire an independent consultant to evaluate the utility's rate structure to make recommendations to the utility regarding rate relief. Thus, SFCC emphasized that the bond coverage ratio benchmark is not an impediment to the use of interest free loans for handling the tax on CIAC.

It is our finding that the IRB does not and cannot require the Commission to approve the full gross-up method. Although Mr. Mann testified that the IRB places substantial controls and restrictions on the utility's activities, no specific testimony was given which

proves that the IRB requires the Commission to approve the full gross-up method. We believe that the IRB is but one of many considerations that should be evaluated in determining Gulf's need to continue the gross-up of CIAC. It is certainly not the sole factor in our decision herein.

DEPRECIATION BENEFITS

It is Gulf's belief that the question of who should get the benefits of depreciation on contributed property was fully addressed by Order No. 23541. Further, Gulf argues that the Commission should not revisit the findings in Order No. 23541, as proposed by SFCC in this proceeding.

Utility witness Nixon testified that CIAC and gross-up is recovered by the developer from the purchaser of the home. He further testified that the developer is able to deduct the CIAC and gross-up on his tax return as units are sold. In addition, he testified that an unfair windfall would result for the developer if the developer received the tax benefits of the depreciation. He also testified that on Page 21 of Order No. 23541, the Commission found that the ultimate contributor and the ratepayer are one and the same, since the developer/contributor recovers his contribution and gross-up in the price of the homes sold. He testified that the Commission, therefore, made a specific finding that tax depreciation should be passed back to the utility ratepayer, not the original developer/contributor. Finally, Mr. Nixon testified that the tax depreciation benefits accrue to the benefit of the ratepayers through the normalization process whereby such benefits are included as cost-free capital in determining the utility's allowable rate of return.

SFCC proposes that the contributor should receive the benefits of the tax depreciation from CIAC. Further, SFCC argues in its brief that the pivotal question in determining who gets the benefit of depreciation should be "who bears the burden of the tax?" SFCC argues that, based on the evidence of record, it is clear that if full gross-up is retained in Gulf's territory, it is the contributor that bears the burden of funding all up-front costs, and it is the contributor that should get the benefit of the depreciation.

SFCC witness Wright testified that if the utility were allowed to collect full gross-up, to remain whole and yet treat the contributor fairly, the utility must at least refund or rebate to

the contributor the tax benefits that accrue over time as the contributed asset is depreciated for tax purposes. Further, he testified that otherwise, the contributor will be forced to subsidize either the utility or its general body of ratepayers because the future tax depreciation benefits will provide real cost savings to the utility, which it will either keep or apply to reduce the revenue burden of its general body of ratepayers. Thus, the utility or its general body of ratepayers will reap a benefit for which it did not pay.

SFCC witness Freeman testified that depending on the manner and method of paying for the tax, the contributor should receive the benefit of the depreciation for tax purposes if the contributor is required to pay the entire tax. Further, he testified that to handle this item in any other way would place the burden of the entire tax on the contributor, while taking an offset which directly results from this cost and allocating that benefit to a party that did not directly pay the tax, which is tantamount to taking the property of one and giving it to another. Mr. Freeman also testified that the utility has been allowed to book a significant dollar amount of depreciable property over the past number of years, apparently creating a windfall that was not present under the pre-1987 treatment of CIAC. Finally, he testified that the tax depreciation benefit is a windfall to the utility shareholders unless and until it's given back to the ratepayers. Mr. Freeman testified that SFCC pays the add-on tax on capacity charges, and that currently these charges are more than \$3,000 per unit. He testified that as a result, SFCC has had to absorb much of this cost in order to try to remain competitive in its market.

FWWA's position is that Order No. 23541 dealt specifically with the question of the appropriate allocation of tax depreciation benefits derived from depreciation of contributed property. FWWA argued that the Commission concluded in that Order that the depreciation benefits on such contributed property should accrue to the general body of ratepayers. Further, FWWA argues in its brief that while witnesses for SFCC allege that a failure of the Commission to return depreciation benefits to the contributor of CIAC would result in a windfall to the utility or its shareholders, no explanation whatsoever was provided to demonstrate the correctness of this conclusion. FWWA further argues that while SFCC presented detailed evidence of several witnesses to support a contention that depreciation benefits should theoretically be returned to the contributor of CIAC, no new evidence was presented

to justify such a position beyond that which has previously been presented to the Commission in Docket No. 860184-PU.

The Commission did address the issue of who should receive the benefits of tax depreciation of contributed property in Order No. 23541. The Commission's finding, on page 21 of the Order, was as follows:

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.
(emphasis added)

The operative word in the Commission's finding in Order No. 23541 is the word "generally." The Commission's finding was that developers "generally" recover their costs. This implies perhaps not in every particular instance, but as a rule, usually or ordinarily, developers recover their costs. Since the Commission does not regulate or audit the books of the developer, it cannot be determined with any degree of certainty whether developers are recovering their costs or the reason for any losses. Even Mr. Freeman testified that CIAC is not necessarily all of the loss. However, it is reasonable to conclude that generally, developers recover their costs. Further, the Commission found in Order No. 23541 that although market conditions may determine the selling price of a home, any time a developer has made a profit, it has recovered the costs of CIAC and the related taxes, and that if the costs are passed on to the ultimate ratepayer, the contributor and the ratepayer are one and the same. Based on that premise, we conclude that ultimately, the contributor and the ratepayer are one and the same. Therefore, consistent with the Commission's finding in Order No. 23541, we find here again that the tax depreciation benefits should be passed back to the utility ratepayer.

COMPLIANCE WITH TARIFF

Gulf's position is that it has complied fully with its tariff provisions. Mr. Nixon testified that all gross-up collections are kept in an interest bearing CIAC tax impact account, and that withdrawals are made only to make quarterly deposits for the estimated taxes on CIAC. Mr. Nixon further testified that the company has filed the required reports with the Commission, along

with copies of its tax returns and refund proposals for the years 1987 through 1991. In addition, he testified that as required by the Company's tariff, and as clarified in Order No. 23541, the reports filed by the utility apportion page 1 of the 1120 tax return into above-the-line and below-the-line income or loss on a regulated basis for each year reported. Mr. Mann testified that Gulf's financial statements, federal income tax returns, and annual reports show a refund of CIAC gross-up taxes collected of \$10,823 for 1987 and \$16,945 for 1988. However, Mr. Nixon testified that the refunds noted in Mr. Mann's testimony were only proposed refund amounts, and that the Commission had not made a final determination of the refund amounts.

SFCC witness Asmus testified that the utility's tariff does not allow it to collect amounts in excess of the net tax liability generated by the contributions. He further testified that based on the language in the utility's original tariffs, Original Sheet No. 36.0 and 36.1 for water and 25.0 for wastewater, any amounts collected in excess of the actual tax liability for any year should be refunded to the contributors responsible for the CIAC and the CIAC tax. However, utility witness Nixon testified that the term net tax liability was not used in the portion of the tariff quoted by Mr. Asmus.

Although Mr. Nixon testified that the utility's revised proposals result in refunds for the respective years 1987 through 1991 totalling \$223,031, and Mr. Asmus testified that the utility's own tariff provides that any amounts collected in excess of the actual tax liability for any year should be refunded to the contributors responsible for the CIAC and CIAC tax, the final determination of refund amounts will be made separately in Docket No. 930216-WS. Further, Order No. PSC-92-0961A-FOF-WS, issued September 14, 1992, sets forth the formula to be used in the refund calculation. Finally, although Mr. Mann testified that he was not sure whether the utility had filed a detailed statement of the CIAC tax impact account with its annual report, the testimony of Mr. Nixon indicates that in accordance with its tariffs, CIAC gross-up collections are kept in an interest bearing CIAC tax impact account. Further, the utility has filed the required annual CIAC reports with the Commission, along with copies of its tax returns, and refunds are pending, subject to determination in a separate docket. In consideration of the foregoing, we do not believe that the testimony in the record supports SFCC's contention that Gulf has not complied with its gross-up tariff provisions relating to the collection, escrow, and refunding of the CIAC tax impact

ORDER NO. PSC-93-1207-FOF-WS
DOCKET NO. 910110-WS
PAGE 22

monies. Further, since the refund amounts are currently being addressed in Docket No. 930216-WS, it is not appropriate for us to make a finding with regard to the refund at this time.

Upon consideration of the evidence in the record, we find that Gulf has established the need to continue to gross-up CIAC using the full gross-up method. All gross-up collections are to be made in accordance with the provisions of Orders Nos. 16971 and 23541, which are incorporated herein by reference. Gulf shall submit revised tariff sheets to reflect our decision herein. The tariff sheets will be approved upon Staff's verification that the tariff sheets are consistent with our decision. This docket shall be closed upon Staff's verification that the revised tariff sheets are consistent with our decision herein.

Based on the foregoing, it is, therefore,

ORDERED by the Florida Public Service Commission that approval is granted for Gulf Utility Company to continue collecting the gross-up on CIAC. It is further

ORDERED that all gross-up collections are to be made in accordance with the provisions of Orders Nos. 16971 and 23541, which are incorporated herein by reference. It is further

ORDERED that Gulf Utility Company shall submit revised tariff sheets which reflect the decision herein. The tariff sheets will be approved upon Staff's verification that the tariff sheets are consistent with our decision. It is further

ORDERED that this docket shall be closed upon Staff's verification of the tariff sheets.

By ORDER of the Florida Public Service Commission this 18th day of August, 1993.

STEVE TRIBBLE, Director
Division of Records and Reporting

(S E A L)
LAJ

by: 
Chief, Bureau of Records

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 Civil Procedure. The notice of appeal must be in the form specified in Rule 9.900 (a), Florida Rules of Appellate Procedure.