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JAN 21 1998
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MEMORANDUM

January 22, 1998

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

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

RE : DOCKET NO.: 971658-SU DISPOSITION OF CONTRIBUTION-IN-AID-OF-CONSTRUCTION GROSS-UP FUNDS COLLECTED BY FOREST UTILITIES, INC.
COUNTY: LEE

AGENDA : FEBRUARY 3, 1998 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\WAW\WP\971658.RCM

CASE BACKGROUND

Forest Utilities is a Class B wastewater utility providing service to the public in Lee County. As of December 31, 1996, the utility served 1,922 wastewater customers. The utility had gross operating revenues of \$559,096, and reported a net operating loss of \$38,523.

As a result of the repeal of Section 118(b) of the Internal Revenue Code (I.R.C.), contributions-in-aid-of-construction (CIAC) became gross income and were depreciable for federal tax purposes. In Order No. 16971, issued December 18, 1986, the Commission authorized corporate utilities to collect the gross-up on CIAC in order to meet the tax impact resulting from the inclusion of CIAC as gross income.

Orders Nos. 16971, issued December 18, 1986, and 23541, issued October 1, 1990, required that utilities annually file information which would be used to determine the actual state and federal income tax liability directly attributable to the CIAC. The information would also determine whether refunds of gross-up would be appropriate. These orders require that all gross-up collections for a tax year, which are in excess of a utility's actual tax liability for the same year, should be refunded on a pro rata basis to those persons who contributed the taxes.

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In Order No. 23541, the Commission required any water and wastewater utility already collecting the gross-up on CIAC and wishing to continue, to file a petition for approval with the Commission on or before October 29, 1990. On December 27, 1990, pursuant to Order No. 23541, Forest Utilities, Inc. (Forest Utilities or utility) filed for authority to continue to gross-up CIAC. The information as filed met the filing requirements of Order No. 23541. Order No. 25299, issued November 5, 1991, granted Forest Utilities authority to continue to gross-up using the full gross-up formula.

On September 9, 1992, this Commission issued Proposed Agency Action Order No. PSC-92-0961-FOF-WS, which clarified the provision of Orders Nos. 16971 and 23541 for the calculation of refunds of gross-up of CIAC. On September 14, 1992, Amendment Order No. PSC-92-0961A-FOF-WS was issued. This Order included attachment A which is the generic calculation form. On October 12, 1994, Order No. PSC-94-1265-FOF-WS, revised the full gross-up method generic calculation form. No protests were filed, and these Orders became final.

On March 29, 1996, Docket No. 960397-WS was opened to review the Commission's policy concerning the collection and refund of CIAC gross-up. Workshops were held and comments and proposals were received from the industry and other interested parties. By Order No. PSC-96-0686-FOF-WS, issued May 24, 1996, staff was directed to continue processing CIAC gross-up and refund cases pursuant to Orders Nos. 16971 and 23541; however, staff was also directed to make a recommendation to the Commission concerning whether the Commission's policy regarding the collection and refund of CIAC should be changed upon staff's completion of its review of the proposals and comments offered by the workshop participants. In addition, staff was directed to consider ways to simplify the process and determine whether there were viable alternatives to the gross-up.

However, on August 1, 1996, The Small Business Job Protection Act of 1996 (The Act) passed congress and was signed into law by President Clinton on August 20, 1996. The Act provided for the non-taxability of CIAC collected by water and wastewater utilities effective retroactively for amounts received after June 12, 1996. As a result, on September 20, 1996, in Docket No. 960965-WS, Order No. PSC 96 1180 FOF-WS was issued to revoke the authority of utilities to collect gross-up of CIAC and to cancel the respective tariffs unless, within 30 days of the issuance of the order, affected utilities requested a variance. Since, there was no longer a need to review the Commission's policy on the gross-up of

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CIAC, on October 8, 1996, Order No. PSC-96-1253-FOF-WS was issued, closing Docket No. 960397-WS. However, as established in Order No. PSC-96-0686-FOF-WS, all pending CIAC gross-up refund cases are being processed pursuant to Orders Nos. 16971 and 23541.

On August 15, 1997, Forest Utilities, Inc., submitted its 1996 CIAC Gross-up Report. In that report, Forest suggested that it be allowed to offset any required refund with 50% of the accounting and legal expenses related to the preparation of the 1996 gross-up refund report as was allowed in Docket No. 961152-SU.

The purpose of this recommendation is to address the amount of CIAC gross-up funds that should be refunded for 1996 and Forest's request that it be allowed to offset 50% of the accounting and legal expenses related to the preparation of the 1996 gross-up refund report.

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DISCUSSION OF ISSUES

ISSUE 1: Should Forest Utilities, Inc. be required to refund excess gross-up collections plus accrued interest for the year 1996?

RECOMMENDATION: No refund is necessary for 1996. The utility overcharged its customers \$263; however staff recommends that the commission accept Forest's request to offset 50% of the legal and accounting fees incurred (\$2,325) against the refund amount of \$263. When this offset is made, no refund is required. (JOHNSON)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, Forest Utilities filed its 1996 annual CIAC report. The utility has requested that 50% of the \$4,650 of legal and accounting costs incurred for filing the CIAC report be deducted from the amount of the refund. In the letter, Forest indicated that it was willing to accept a similar arrangement which it received in a previous case (Docket No. 961237-SU). In Docket No. 961237-SU, which addressed the disposition of gross-up funds collected by Forest in 1990-1995, the Commission voted to accept Forest's settlement proposal to offset 50% of the legal and accounting fees incurred in preparing the CIAC reports. The utility submitted its proposed offer of settlement, whereby it is proposing that 50% of the legal and accounting fees be offset against the refund calculated for 1996.

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

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

Further, staff does not believe that the contributors should be held responsible for the accounting costs incurred to determine the amount of each customer's refund. Staff acknowledges that these costs were incurred to satisfy regulatory requirements; however staff views those costs as a necessary cost of doing business and as such, staff does not believe that a reduction of the amount of the refund that the contributor is entitled to receive as a result of his overpayment in taxes is appropriate. Staff believes it is

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appropriate for the utility to seek recovery of those amounts in a rate case proceeding.

However, as in the other Forest case (Docket No. 961237-SU), staff recognizes in this case that acceptance of the settlement proposal would avoid the substantial cost associated with a hearing, which may in fact exceed the amount of the legal and accounting cost to be recovered. Staff further notes that the actual costs associated with making the refunds have not been included in these calculations and will be absorbed by the utility. Moreover, staff believes the utility's settlement proposal is a reasonable "middle ground". The utility proposes fifty percent of the total cost incurred for filing the CIAC report be used to offset the final refund amount. This request is consistent with orders from past cases. Therefore, staff recommends that while not adopting the utility's position, the Commission accept Forest's settlement proposal.

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

ANNUAL GROSS-UP REFUND AMOUNTS

Based upon the foregoing, staff has calculated the amount of refund which is appropriate. Our calculations, taken from the information provided by the utility in its gross-up report and tax return filed are reflected on Schedule No. 1. A summary of the 1996 refund calculation follows.

1996

The utility proposes that no refund is appropriate. Staff agrees that a refund of gross-up collections for 1996 is not appropriate.

The 1996 CIAC report indicates that a total of \$5,083 in gross-up collections were received. Based upon our review of the utility's 1996 filing, the utility was in a taxable position on an above-the-line basis prior to the inclusion of taxable CIAC in income. Therefore, all taxable CIAC received would be taxed. The report indicates a total of \$9,415 in taxable CIAC was received, with \$1,428 being deducted for the first year's depreciation, resulting in net taxable CIAC of \$7,987. Staff has used the 37.63% combined marginal federal and state tax rates to calculate the tax effect of \$3,006. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay

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the tax effect of the CIAC is calculated to be \$4,820. The utility collected \$5,083 in gross-up taxes; therefore, the utility over collected the gross-up by \$263. However, as previously stated, Forest requested that the Commission accept its settlement proposal to offset 50 percent (\$2,325) of the legal and accounting costs incurred (\$4,650) against the refund amount. Staff recommends that the Commission accept the utility's settlement proposal. Therefore, staff has offset \$263 of the legal and accounting fees of \$2,325 against the over collection of \$263 and no refund is required.

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ISSUE 2: Should the docket be closed?

RECOMMENDATION: Yes. Upon expiration of the protest period this docket should be closed. (JAEGER)

STAFF ANALYSIS: Upon expiration of the protest period, if a timely protest is not filed by a substantially affected person, this docket should be close.

STAFF CALCULATED GROSS-UP REFUND

FOREST UTILITIES - INC.

SOURCE: (Line references are from CIAC Reports)

	<u>1996</u>
1 Form 1120, Line 30 (Line 15)	\$ 73,847
2 Less CIAC (Line 7)	(9,415)
3 Less Gross-up collected (Line 19)	(5,083)
4 Add First Year's Depr on CIAC (Line 8)	1,428
5 Add/Less Other Effects (Lines 20 & 21)	<u>0</u>
6	
7 Adjusted Income Before CIAC and Gross-up	\$ 60,777
8 Taxable CIAC (Line 7)	9,415
9 Less first years depr. (Line 8)	<u>(1,428)</u>
10	
11 Taxable CIAC Resulting in a Tax Liability	\$ 7,987
12 Less: NOL Carrforward	0
13	
14 Net Taxable CIAC	\$ 7,987
15 Effective state and federal tax rate	37.63%
16	
17 Net Income tax on CIAC	\$ 3,006
18 Less ITC Realized	0
19	
20 Net Income Tax	\$ 3,006
21 Expansion Factor for gross-up taxes	<u>1.603334937</u>
22	
23 Gross-up Required to pay tax effect	\$ 4,820
24 Less CIAC Gross-up collected (Line 19)	<u>(5,083)</u>
25	
26 (OVER) OR UNDER COLLECTION	(283)
27 Offset of Legal & Accounting fees	<u>263</u>
28	
29 Proposaed refund (exluding interest)	\$ <u>0</u>
30	