

State of Florida



Public Service Commission

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RECORDS SECTION

DATE: DECEMBER 3, 1998

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

FROM: DIVISION OF WATER AND WASTEWATER (GILCHRIST) *OGM*
 DIVISION OF AUDITING AND FINANCIAL ANALYSIS (CAUSSEAU) *AS*
 DIVISION OF LEGAL SERVICES (JAEGER) *JA*

RE: DOCKET NO. 971179-SU - DISPOSITION OF CIAC GROSS-UP FUNDS
 COLLECTED BY NORTH FORT MYERS UTILITY, INC. IN LEE COUNTY.
 COUNTY: LEE

AGENDA: DECEMBER 15, 1998 - REGULAR AGENDA - PROPOSED AGENCY
 ACTION (EXCEPT FOR ISSUE NO. 1) - INTERESTED PERSONS MAY
 PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\LEG\WP\971179C.RCM

CASE BACKGROUND

North Ft. Myers Utility, Inc. (NFMU or utility) is a Class A wastewater utility providing service to approximately 5,360 customers in Lee County. According to its 1997 annual report, the utility reported gross operating revenues of \$1,958,553 and net operating income of \$446,362.

As a result of the repeal of Section 118(b) of the Internal Revenue Code, effective January 1, 1987, contributions-in-aid-of-construction (CIAC) became gross income and were depreciable for federal tax purposes. Therefore, by Order No. 16971, issued December 18, 1986, the Commission authorized corporate utilities to collect the gross-up on CIAC in order to meet the tax impact resulting from the inclusion of CIAC as gross income.

Order No. 16971 and Order No. 23541, issued December 18, 1986 and October 1, 1990, respectively, require that utilities annually file information which would be used to determine the actual state

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and federal income tax liability directly attributable to the CIAC. The information would also determine whether refunds of gross-up would be appropriate. These orders also required that all gross-up collections for a tax year, which are in excess of a utility's actual tax liability for the same year, should be refunded on a pro rata basis to those persons who contributed the taxes.

However, the Small Business Job Protection Act of 1996 (The Act), which became law on August 20, 1996, 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, in Docket No. 960965-WS, Order No. PSC-96-1180-FOF-WS, issued September 20, 1996, revoked 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. Although NFMU did not request a variance, it explained in a letter dated January 10, 1997, that it did not believe that the continued collection of the installment payments constituted a variance, but merely a payment of a debt over a period of time. Since there was no longer a need to review the Commission's policy on the gross-up of CIAC, Order No. PSC-96-1253-FOF-WS, issued October 8, 1996, closed 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.

NFMU provides wastewater service to several subdivisions (Forest Park, Lake Arrowhead, Carriage Village, Tamiami Village, and Lazy Days) formerly receiving service through package plants. In each case, under the authority granted in its tariff, NFMU allowed each customer to either pay the plant capacity charge and applicable gross-up at the time of connection onto the utility's central wastewater system or pay by installment payments over a seven-year period for the total amount owed. This installment arrangement was undertaken and authorized for the convenience of the customers who could not or chose not to pay their plant capacity fees and gross-up at the time of connection.

Although the Act provided for the non-taxability of CIAC collected by water and wastewater utilities for amounts received after June 12, 1996, several of the contractual agreements between the customers and the utility continue to be outstanding and require payments after June 12, 1996. As a result, on November 18, 1996, staff received a call from the Office of Public Counsel (OPC), advising staff that several customers had contacted OPC regarding the status of the customer's obligation to continue paying the gross-up amount of the installment payment to NFMU.

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From March 17, 1997, through March 25, 1997, staff received approximately seventeen letters and numerous telephone calls from customers of NFMU, wanting to know why NFMU continued to collect gross-up from its customers when the Commission had canceled the utility's authority to collect gross-up. Staff advised the customers that the utility could continue to collect gross-up if it had not collected all of the gross-up it was entitled to receive from those customers who were paying by installment. Further, staff assured the customers that this matter would be investigated thoroughly and a recommendation to the Commission would be made accordingly. On November 12, 1997, OPC filed its Notice of Intervention in this docket and by Order No. PSC-97-1474-PCO-SU, the Commission acknowledged OPC's intervention.

Subsequent to filing its recommendation on October 23, 1997, staff realized that since, the utility was not treating the installment payments received after June 12, 1996, as taxable income on its tax return, treating the installment contracts as "income" in the year the contracts were entered into, would have given the utility gross-up on CIAC which may not have been taxable income. Therefore, the gross-up refund calculations appearing in staff's recommendation of October 23, 1997, were revised to remove the installment contracts as being taxable income and the utility was advised accordingly. As a result, staff's recommendation of October 23, 1997, was deferred from the November 4, 1997, Agenda Conference. By letter dated November 14, 1997, revised refund calculations were submitted to the utility. In response to staff's letter, the utility advised staff that it would be filing amended tax returns to reflect as taxable income, the CIAC and gross-up due from customers paying by installment.

On December 12, 1997, the utility filed a certified copy of the amended tax returns with this Commission along with a copy of the return receipt from the Internal Revenue Service (IRS). Staff's recommendation has been revised accordingly.

The purpose of this recommendation is to address the utility's request for a variance from Order No. PSC-96-1180-FOF-WS, to address the disposition of gross-up funds collected by the utility in 1994, 1995, and 1996, including the concerns of Mr. Pete Longjohn, President of Tamiami Village Homeowners Association, and the concerns expressed in the letters and telephone calls received from customers of NFMU, to address the utility's request that 50% of its legal and accounting costs be offset against the refund amounts, and to address the utility's informal Settlement Offer that was filed on October 2, 1998, and OPC's response, which was filed on October 21, 1998, to the informal Settlement Offer filed by the utility.

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DISCUSSION OF ISSUES

ISSUE 1: Should North Ft. Myers Utility's request for a variance from Order No. PSC-96-1180-FOF-SU, be granted?

RECOMMENDATION: Yes, North Ft. Myers Utility, Inc.'s request for a variance from Order No. PSC-96-1180-FOF-WS, should be granted. If the Commission approves staff's recommendation, NFMU's tariffs for gross-up authority should not be canceled. The utility should file revised tariffs to allow for the continued collection of gross-up taxes on CIAC that is paid in installments from customers that entered into installment contracts prior to June 12, 1996. Once the Utility has collected the entire amount of taxes it is entitled to receive from the customers paying by installment, NFMU should submit canceled tariff sheets to the Commission. Also, the provision allowing customers in Forest Park, Lake Arrowhead, Carriage Village, Lazy Days Village and Tamiami Village, the option of paying the system capacity charges in monthly installments over a seven-year period at 10% interest should be removed from the utility's tariff and a revised tariff sheet should be submitted accordingly. (GILCHRIST, CAUSSEAU, JAEGER)

STAFF ANALYSIS: Order No. PSC-96-1180-FOF-WS, revoked the authority of utilities to collect gross-up of CIAC and required the cancellation of the respective tariffs unless, within 30 days of the issuance of the order, affected utilities requested a variance. In its letter of January 10, 1997, the utility explains why its request for a variance was not filed in a timely manner. The utility explains that it was not aware that the Commission considered the installment contracts as somehow requiring a variance from Commission Order No. PSC-96-1180-FOF-WS. The utility goes on to say that it has always taken the position that the installment contract arrangement which is authorized pursuant to the provisions of the utility's tariff (other than the gross-up provisions) simply was allowing the customers to pay a debt for service availability charges and gross-up fees over an extended period of time, and, that it is not now and has never been considered by the utility to be continued collection of gross-up.

Although NFMU does not believe that this situation constitutes one in which a variance from Commission Order No. PSC-96-1180-FOF-WS is necessary, to the extent the Commission deems it to be necessary, by letter dated February 28, 1997, the utility requested such a variance from the order. In its letter of February 28, 1997, the utility reiterates that the debt owing originally represented CIAC and gross-up, and, for those customers who chose to pay the amount owing over time, it became simply an installment debt authorized by

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tariff from the date that those individuals became customers of NFMU and agreed to make the installment payments.

As mentioned previously, the utility charges its mobile home customers a service availability charge of \$462, and in accordance with its tariff, the utility allows customers residing in Forest Park, Lake Arrowhead, Carriage Village, Lazy Days Village, and Tamiami Village the option of paying system capacity charges in monthly installments over a seven-year period at 10% interest. By letter dated January 10, 1997, the utility indicated that the gross-up tax due from the customers residing in these parks is \$278. Staff believes that the request for a variance is necessary because in the absence of a variance, the authority of NFMU to collect gross-up of CIAC is revoked and the respective tariffs are canceled. Upon revocation, staff believes that a portion of the installment payment constitutes CIAC gross-up which is no longer authorized and is not in its tariff. The utility states that it views the payments as installment loan payments, not as payments of gross-up.

Nonetheless, in staff's opinion, the utility's collection of the payments as installment loan payments does not alter the fact that a portion of the payment collected from the customers paying by installment is used to pay the gross-up tax related to CIAC. Although the utility has not technically timely requested a variance (Order No. PSC-96-1180-FOF-WS, issued September 20, 1996, canceled gross-up authority unless affected utilities requested a variance within 30 days of the issuance of the order), staff believes that there was a valid question as to whether the utility had to apply for a variance. Therefore, staff believes that the utility's failure to timely request a variance is excusable. See, Rothblatt v. Department of Health and Rehabilitative Services, 520 So. 2d 644 (Fla. 4th DCA 1988), and Hamilton County Board of County Commissioners v. Department of Environmental Protection, 587 So. 2d 1378 (Fla. 1st DCA 1991)

Based on the above, NFMU should be allowed to collect from the customers, the gross-up portion of the installment payment that it was entitled to receive prior to the change in the tax law. Therefore, staff recommends that the request by NFMU for a variance from Order No. PSC-96-1180-FOF-WS, be granted. If the Commission approves staff's recommendation, NFMU's tariffs for gross-up authority should not be canceled. The utility should file revised tariff sheets to allow for the continued collection of gross-up taxes on CIAC that is paid in installments from customers that entered into the installment contracts prior to June 12, 1996. Once the utility has collected the entire amount of taxes on the CIAC installment agreements it is entitled to receive, the utility should submit canceled tariff sheets to the Commission and the utility's service availability policy should be revised also. Specifically,

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the provision allowing customers in Forest Park, Lake Arrowhead, Carriage Village, Lazy Days Village and Tamiami Village, the option of paying the system capacity charges and gross-up in monthly installments over a seven-year period at 10% interest would no longer be necessary, once the entire amount owed to the utility has been collected. Therefore, this provision should be removed from the utility's service availability policy, and a revised tariff sheet should be submitted accordingly.

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ISSUE 2: Should North Ft. Myers Utility, Inc. be required to refund excess gross-up collections for fiscal year 1994(ended May 31, 1995), fiscal year 1995(ended May 31, 1996), and fiscal year 1996 (ended May 31, 1997)?

RECOMMENDATION: Based on past stipulations, staff recommends that the Commission accept NFMU's request that it be allowed to offset 50% of the legal and accounting fees incurred in processing the refund of CIAC gross-up over collections. If the Commission approves staff's recommendation, the over collection of \$322,070 should be reduced by the offset of \$8,048, for a refund of \$314,022 for fiscal year 1994 (ended May 31, 1995). For fiscal year 1995 (ended May 31, 1996) the over collection of \$229,958 should be reduced by the offset of \$9,101, for a refund of \$220,857. For those contributors who have paid the full amount of the gross-up, the utility should make a cash refund based on their pro rata share of the \$314,022 and \$220,857 overcharged amounts. The utility should also refund interest accrued from May 31, 1995, and May 31, 1996, to the date of the refund.

However, for those contributors who are paying by installment, but have not paid the full amount of gross-up that the utility is entitled to collect for fiscal years 1994 and 1995, the utility should reduce (credit) the principal amount due on their installment contracts by their pro rata share of the gross-up overcharge for 1994 and 1995, and collect the reduced amount of gross-up from the contributor. Further, for those contributors who are paying by installment, and have paid the full amount of the gross-up that the utility is entitled to collect for fiscal years 1994 and 1995, the utility should make a cash refund of any excess gross-up and associated interest payments, and discontinue gross-up collections from those contributors. In addition, the utility should also refund interest accrued on the excess gross-up and associated interest payments, at the escrow rate, from May 31, 1995, and May 31, 1996, to the date of refund.

The refunds should be completed within 6 months of the effective date of the order. Within 30 days from the date of the refund, the utility should submit copies of canceled checks, credits applied to the monthly bills or other evidence that verifies that the utility has made the refunds. Within 30 days from the date of the refund, the utility should also provide a list of unclaimed refunds detailing contributor and amount, and an explanation of the efforts made to make the refunds. Further, on October 1, 1996, the utility refunded \$2,753.82 it collected for the period of June 1

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through June 12, 1996, and no refund is recommended for the fiscal year 1996 (ended May 31, 1997). (GILCHRIST, CAUSSEAU)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, NFMU filed its 1994 and 1995 annual CIAC reports regarding its collection of gross-up for fiscal years 1994 and 1995, respectively. On October 23, 1997, staff filed a recommendation addressing the disposition of CIAC gross-up collected by the utility. Subsequent to filing its recommendation on October 23, 1997, staff realized that since the utility was not treating the installment payments received after June 12, 1996, as taxable income on its tax return, staff's treating the installment contracts as "income" in the year the contracts were entered into, would have given the utility gross-up on CIAC which may not have been taxable income. Therefore, the gross-up refund calculations appearing in staff's recommendation of October 23, 1997, were revised to remove the installment contracts as being taxable income.

By letter dated November 14, 1997, revised refund calculations were submitted to the utility. In response to staff's letter, the utility advised staff that it would be filing amended tax returns to reflect as taxable income, the CIAC and gross-up due from the customers paying by installment. On December 12, 1997, the utility filed a certified copy of the amended tax returns with this Commission along with a copy of the return receipt from the Internal Revenue Service (IRS). The amended tax returns showed that the utility reported as taxable income, the total amount due under the installment contracts.

By letter dated February 20, 1998, revised refund calculations based on the utility's amended tax returns, and revised CIAC gross-up reports and schedules were sent to the utility. On March 20, 1998, the utility filed its response to staff's letter of February 20, 1998. In its letter of March 20, 1998, the utility indicated that it does not agree with staff's above-the-line allocation of operating and maintenance expenses, with staff's above-the-line allocation of the legal expenses relating primarily to the litigation over an agreement with a consulting firm for its assistance in refinancing the company's industrial development revenue bonds, and with staff's above-the-line allocation of amortization expense for retired plant.

At the request of the utility, staff met informally with the utility and OPC on May 19, 1998 to further discuss the adjustments referenced in staff's letter of February 20, 1998 and to resolve as many differences as possible prior to the agenda conference. Based on the discussions held on May 19, 1998, the utility submitted additional information on June 11, 1998, that staff has been asked to consider.

In the meeting held on May 19, 1998, and in its letter of June 11, 1998, the utility argues that staff did not make an above-the-line allocation of expenses in the previous NFMU gross-up cases filed and approved by this Commission, and for staff to make an above-the-line-allocation of expenses in the present case reflects a change in "Commission Policy". Staff acknowledges that an allocation of above the-line-expenses were not made in the previous gross-up cases filed with the Commission. However, for this case, and as further explained below, staff's above-the-line allocation of officer's compensation, engineering & testing (which includes the General Manager's salary) and legal expenses is based on the amount reported on the utility's tax return. We realize that we may have erred by not making an above-the-line allocation of expenses in the previous gross-up cases filed and approved by this Commission. However, staff does not view the corrective measures taken in this case as a change in "Commission Policy". Because those previous cases have long since become final, staff does not believe the Commission can go back and correct what has happened in the previous cases. However, staff believes that the Commission must go forward and do what it believes is proper. A more detailed discussion of staff's adjustments follows below.

Also, in its letter of June 11, 1998, the utility contends that \$437,968 and \$374,019 of operating and maintenance expenses shown in the utility's 1994 and 1995 annual reports should be reclassified as below-the-line expenses for gross-up purposes. Although Mr. Nixon's calculations show that the utility's achieved rate of return would be less than from the top of its authorized rate of return on equity if expenses that the utility contends should have been reported below-the-line in its annual report, were properly reflected below-the-line, staff does not believe that it is appropriate to now include those expenses below-the-line. Upon first consideration, it was thought that if the inclusion of these expenses below-the-line would not result in the utility exceeding its last authorized rate of return on equity, then perhaps the expenses could be included below-the-line for gross-up refund purposes. However, upon further consideration, staff believes that even though the utility would not exceed its last authorized rate of return on equity, it would not be appropriate to now include these expenses below-the-line because the utility has received, through indexing, the benefit of their above-the-line treatment in the annual report. As a result, the utility has realized additional revenues that are currently embedded in its rates. Therefore, staff does not believe it would be appropriate or equitable to make the adjustments that the utility requests.

On October 2, 1998, the utility filed an informal settlement agreement for staff to consider. The utility proposed to:

1. Treat, solely for the purposes of gross-up, certain expenses as below-the-line which were originally reported on the utility's annual reports as above-the-line expenses.
2. To the extent the utility is required to refund overpayments of gross-up funds to those who paid by installment, the utility is willing to apply those refunds as credits including interest at the installment contract rate.
3. To forego the implementation of indexing expenses for the years 1997, 1998, and 1999.
4. The utility will not seek to recover the additional gross-up costs which it has incurred since February, 1998.

On October 21, 1998, OPC filed a response to the utility's informal settlement agreement. In summary, OPC stated, that the Commission should reject the settlement offer proposed by the utility because the offer is fraught with errors and is wholly inconsistent with sound ratemaking practices and principles. OPC stated that the settlement should be rejected because of the following reasons:

1. The expenses in question cannot be considered reasonable for rate purposes, but not for CIAC gross-up purposes.
2. NFMU's calculation of the gross-up amounts owed to customers is severely understated. OPC disagrees with the expenses which have been suggested by the utility as being below-the-line for purposes of determining taxable income. If the utility's position is accepted, the Commission must immediately open an investigation into the earnings of this utility. If the expenses the utility claims are nonutility and more appropriately recorded below-the-line, OPC believes the utility's achieved return on rate base to be substantially in excess of any reasonable authorized rate of return on equity.

3. The Commission should reject the utility's suggestion that for those customers paying by installment, any refund of CIAC gross-up monies should be treated as a credit to monies owed under the contract.
4. The utility's offer to forego rate indexing increases for the years 1997, 1998, and 1999 should be rejected, because the expenses in question should be recorded above-the-line, nullifying the need for any refunds or rate reductions.
5. OPC urges the Commission to reach a quick and final resolution of these gross-up monies owed to NFMU's customers.

Staff is in agreement with OPC on points 1 and 4 and agrees that the utility's calculations of refunds are understated. The informal settlement offer by the utility should be rejected for all of these reasons. However, staff found that even if the expenses that have been allocated above-the-line, were placed below-the-line, the utility would not exceed its authorized rate of return on equity. Also, staff believes the utility should be allowed to collect from the customers, the gross-up portion of the installment payment that it was entitled to receive prior to the change in the tax law.

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

ANNUAL GROSS-UP REFUND AMOUNTS

Based upon the foregoing, staff calculated the amount of refund per year which is appropriate. The calculations, taken from the information provided by the utility in its revised gross-up reports for fiscal years 1994 and 1995, respectively, are reflected on Schedule No. 1. A summary of each year's refund calculation follows.

1994

If the Commission votes to offset the refund by 50% of the legal and accounting costs, the utility proposes a refund of \$73,367, for fiscal year 1994 (ended May 31, 1995). Staff believes

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a refund of \$314,022 is appropriate for fiscal year 1994(ended May 31, 1995).

In its letter of June 11, 1998, the utility allocated \$115,529 of engineering & testing (which includes \$46,807 for testing, \$45,987 or 40% of the General Manager's salary, and \$22,735 for plant supplies) above-the-line. Staff allocated \$184,511 above-the-line (which includes \$46,807 for testing, \$114,969 or 100% of the General Manager's salary, and \$22,735 for plant supplies). Staff recognizes that the reporting period for the annual report is based on a calendar year and the utility's tax return is based on a fiscal year. Nonetheless, the utility reported these expenses in its annual report and on its tax return. The utility's 1994 and 1995, annual reports show \$217,766 and \$153,214, respectively, as the amounts for Contractual Services-Other (which includes testing, the General Manager's salary, and Other contract maintenance services). Therefore, staff has allocated these expenses above-the-line and the allocation is based on the amount reported on the utility's tax return. By correspondence dated July 1, 1998, staff asked, and to date, the utility has not advised us of any expenses reported on the tax return that were not reported in the annual report. Therefore, staff has allocated the entire amount of engineering & testing above-the-line.

In its revised filing, the utility placed \$199,940 of Officer's Compensation below-the-line. Staff recognizes that the reporting periods for the annual report and the utility's tax return are different. Nonetheless, the utility's annual reports for 1994 and 1995, show \$178,734 and \$173,907, respectively, as the amounts for Officer's Compensation. Therefore, Staff has allocated the entire amount of Officer's Compensation above-the-line and the allocation is based on the amount reported on the utility's tax return. Staff has not been advised of any expenses reported on the tax return that were not reported in the annual report. Therefore, staff has allocated the entire amount of Officer's Compensation above-the-line.

Also, the utility allocated depreciation in the amount of \$268,395, below-the-line. Staff adjusted this amount by \$22,120 to reflect first year's depreciation, above-the line.

Further, the utility allocated "Other deductions" in the amount of \$161,218, below the line. Of this amount, \$128,509 is for legal expenses which staff has allocated above-the-line. Staff's above-the-line allocation is based on the amount reported on the utility's tax return. Although the reporting periods for the annual report and the utility's tax return are different, the utility's annual reports for 1994 and 1995 do show legal expenses of \$152,480 and \$136,417. Staff has not been advised of any expenses reported on

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the tax return that were not reported in the annual report. Therefore, staff has allocated \$128,509 of legal expenses above-the-line.

Based on the adjustments above, taxable income for the utility is calculated to be \$412,187 for fiscal year 1994 (ended May 31, 1995).

The utility's revised 1994 CIAC report reveals that the utility received taxable CIAC of \$619,015 for fiscal year 1994 (ended May 31, 1995); and staff deducted \$22,120 for the first year's depreciation, resulting in net taxable CIAC of \$596,895. The utility's revised 1994 CIAC report also indicates that the utility was operating at a loss before the inclusion of CIAC in income. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, not all of the CIAC collected would create a tax liability. When CIAC in the amount of \$596,895 is netted against staff's calculated loss of \$541,601, the amount of taxable CIAC resulting in a tax liability is \$55,294. Staff used the 37.63% combined marginal federal and state tax rates as provided in the revised 1994 CIAC Report to calculate net income taxes of \$20,807. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect on the CIAC is calculated to be \$33,361. The utility collected \$355,431 of gross-up monies. Therefore, staff calculates a refund of \$322,070. If the Commission votes to offset the refund by 50% (\$8,048) of the legal and accounting costs, the net refund is calculated to be \$314,022.

1995

If the Commission votes to offset the refund by 50% of the legal and accounting costs, the utility proposes a refund of \$51,131, for fiscal year 1995 (ended May 31, 1996). Staff believes a refund of \$220,857, is appropriate for fiscal year 1995 (ended May 31, 1996).

In its letter of June 11, 1998, the utility allocated \$101,745 of engineering & testing (which includes \$26,996 for testing, \$56,645 or 40% of the General Manager's salary, and \$18,104 for plant supplies) above-the-line. Staff allocated \$186,807 above-the-line (\$26,996 is for testing, \$141,613 or 100% of the General Manager's salary, \$18,104 for plant supplies and \$94 for security). Staff recognizes that the reporting period for the annual report is based on a calendar year and the utility's tax return is based on a fiscal year. Nonetheless, the utility's annual reports for 1995 and 1996, do show \$153,214 and \$182,977, respectively, as the amounts for Contractual Services-Other, (which includes testing, the

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General Manager's salary, and Other contract maintenance services). Therefore, staff has allocated these expenses above-the-line and the allocation is based on the amount reported on the utility's tax return. By correspondence dated July 1, 1998, staff asked, and to date, the utility has not advised us of any expenses reported on the tax return that were not reported in the annual report. Therefore, staff has allocated the entire amount of engineering & testing above-the-line.

In its revised filing, the utility placed \$224,952 of Officer's Compensation below-the-line. Staff recognizes that the reporting period for the annual report and the utility's tax return are different. Nonetheless, the utility's annual reports for 1995 and 1996, show \$173,907 and \$205,854, respectively, as the amounts for Officer's Compensation. Therefore, staff has allocated \$224,952 of Officer's Compensation above-the-line and the allocation is based on the amount reported on the utility's tax return. The utility has not advised staff of any expenses reported on the tax return that were not reported in the annual report. Therefore, staff has allocated the entire amount of Officer's Compensation above-the-line.

Also, the utility allocated depreciation in the amount of \$326,800, below-the-line. Staff adjusted this amount by \$25,196 to reflect first year's depreciation, above-the line.

Further, the utility allocated "Other deductions" in the amount of \$317,615, below-the-line. Of this amount, \$151,518 is for legal expenses, which staff has allocated above-the-line. Staff's above-the-line allocation is based on the amount reported on the utility's tax return. Although the reporting periods for the annual report is based on a calendar year and the utility's tax return is based on a fiscal year, the utility's annual reports for 1995 and 1996 do show legal expenses of \$136,417 and \$40,936. The utility has not advised staff of any expenses reported on the tax return that were not reported in the annual report. Therefore, staff has allocated \$151,518 of legal expenses above-the-line.

Based on the adjustments above, taxable income for the utility is calculated to be \$1,368,582 for fiscal year 1995 (ended May 31, 1996).

The utility's revised 1995 CIAC report reveals that the utility received taxable CIAC of \$1,434,249 for fiscal year 1995 (ended May 31, 1996); and staff deducted \$25,196 for the first year's depreciation and \$296,184 for CIAC associated with the purchase of existing systems not grossed up, resulting in net taxable CIAC of \$1,112,869. The utility's revised 1995 CIAC report also indicates that the utility was operating at a loss before the inclusion of

CIAC in income. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, not all of the CIAC collected would create a tax liability. When CIAC in the amount of \$1,112,869 is netted against staff's calculated loss of \$588,871, the amount of taxable CIAC resulting in a tax liability is \$523,998. Staff used the 37.63% combined marginal federal and state tax rates as provided in the revised 1995 CIAC Report to calculate net income taxes of \$197,180. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect on the CIAC is calculated to be \$316,146. The utility collected \$546,104 of gross-up monies. Therefore, staff calculates a refund of \$229,958. If the Commission votes to offset the refund with 50% (\$9,101) of the legal and accounting costs, the net refund is calculated to be \$220,857.

1996

By correspondence dated February 20, 1998, staff advised NFMU that the disposition of gross-up collected for 1996 (ended May 31, 1997) would be addressed in this docket and requested the utility to file its tax return and CIAC Gross-up report for 1996. In response to staff's request, by letter dated June 24, 1998, the utility advised staff that during the period of June 1 through June 12, 1996, it collected service availability and the related gross-up charges totaling \$2,753.82 from five contributors. On October 1, 1996, refunds in the amount of \$2,753.82 were made to the five contributors and the utility submitted canceled checks as proof that the refunds were made. Since the refunds to the five contributors have been made, staff agrees with the company that filing a tax return for 1996 (ended May 31, 1997) and filing a 1996 CIAC Gross-up Report will not be necessary.

The utility provided documentation requesting legal and accounting fees of \$19,389.52 for fiscal year 1994 and \$21,496.52 for fiscal year 1995, for a total of \$40,886.04. Staff reviewed these costs and believes the cost incurred to file the amended tax returns should be disallowed. Staff believes that filing tax returns is a normal cost of operations, therefore, this cost should not be passed directly to the contributors of the gross-up.

Based upon its review, staff has determined that \$34,298 of the legal and accounting fees submitted by the utility are the legitimate costs for preparing the required reports, calculating the tax effect and the proposed refunds, \$16,096 of these expenses were incurred in fiscal year 1994 and \$18,202 of the expenses were incurred in fiscal year 1995. Fifty percent (50%) of these amounts are \$8,048 and \$9,101, respectively. Staff believes only one-half (½) of the cost of filing the revised CIAC gross-up reports and

schedules should be allowed because the contributors of the gross-up did not have any control over the utility's decision to file amended tax returns; however, because the revised CIAC gross-up reports and schedules were filed to satisfy regulatory requirements, staff believes the cost incurred should be shared equally between the utility and the contributors of the gross-up. Therefore, for fiscal year 1994 (ended May 31, 1995), staff recommends that \$8,048 of legal and accounting fees be used to offset the proposed refund amount of \$322,070 and for fiscal year 1995 (ended May 31, 1996), \$9,101 of legal and accounting fees should be used to offset the proposed refund amount of \$229,958. As a result, staff recommends refunds of \$314,022 and \$220,857 for fiscal years 1994 and 1995 (ended May 31, 1995 and 1996, respectively).

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. In Docket Nos. 961076-WS, and 970275-WS, by Order Nos. PSC-97-0657-AS-WS and PSC-97-0816-FOF-WS, respectively, the Commission accepted the utility's settlement proposals that 50% of the legal and accounting costs be offset against the refund amount. In general, the utility argues that the legal and accounting costs should be deducted from the amount of the contributors' refund, as the contributors are the cost-causers and as such, those costs should be recovered from the cost-causers.

Staff believes that Orders Nos. 16971 and 23541 did not provide for or contemplate an offset as requested by the utility. Therefore, staff does not believe that a reduction in the amount of refund a contributor is entitled to receive as a result of his overpayment of gross-up taxes is appropriate. Staff acknowledges that those costs were incurred to satisfy regulatory requirements; however, staff does not believe that the contributors should be held responsible for the legal and accounting costs incurred to determine whether they are entitled to a refund. Staff views those costs as a necessary cost of doing business. Finally, staff believes that this situation is similar to when a utility files for an increase in service availability charges. The costs of processing the utility's service availability case is borne by the general body of ratepayers, although the charges are set for future customers, only.

However, as in the other cases referenced herein, staff recognizes in this case that acceptance of the utility's request 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 implementing the refunds have not been included in these calculations and will be absorbed by the utility. Moreover, staff believes the utility's request is a reasonable "middle ground". Therefore, staff recommends that while not adopting the utility's position, the Commission grant NFMU's request that it be allowed to offset 50% of the legal and accounting fees against the refund amounts. As previously stated, staff believes that for fiscal years 1994 and 1995, \$17,149 of the legal and accounting expenses incurred by the utility are appropriate. Therefore, for fiscal year 1994(ended May 31, 1995), staff recommends that \$8,048 of legal and accounting fees be used to offset the proposed refund amount of \$314,022. For fiscal year 1995 (ended May 31, 1996), staff recommends that \$9,101 of legal and accounting fees be used to offset the proposed refund amount of \$229,958. As a result, refunds of \$314,022 and \$220,857 are being proposed for fiscal years 1994 and 1995(ended May 31, 1995 and 1996, respectively). For those contributors who have paid the full amount of the gross-up, the utility should make a cash refund based on their pro rata share of the \$314,022 and \$220,857 overcharged amounts. The utility should also refund interest accrued from May 31, 1995, and May 31, 1996, to the date of the refund.

However, for those contributors who are paying by installment, but have not paid the full amount of gross-up that the utility is entitled to collect for fiscal years 1994 and 1995, the utility should reduce (credit) the principal amount due on their installment contracts by their pro rata share of the gross-up overcharge for 1994 and 1995, and collect the reduced amount of gross-up from the contributor. Further, for those contributors who are paying by installment, and have paid the full amount of the gross-up that the utility is entitled to collect for fiscal years 1994 and 1995, the utility should make a cash refund of any excess gross-up and associated interest payments, and discontinue gross-up collections from those contributors. In addition, the utility should also refund interest accrued on the excess gross-up and associated interest payments, at the escrow rate, from May 31, 1995, and May 31, 1996, to the date of refund.

The utility proposes, and staff agrees that each of these customers would be notified that the principal amount owing under their installment contract would be reduced by their pro rata share of the refund amount. The utility has indicated that it is willing to make the appropriate calculations for the customer depending

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upon the year of the installment contract and notify the customers in accordance with that revision. Staff believes this is a reasonable approach because the customers would get full benefit of the lower amount of gross-up owed, and the utility would not be required to make refunds to customers before payments are received from those customers.

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

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ISSUE 3: Should the docket be closed?

RECOMMENDATION: No. Upon expiration of the protest period, the docket should remain open pending verification of the refunds. Staff should be given administrative authority to close the docket upon verification that the refunds have been completed. (JAEGER)

STAFF ANALYSIS: Upon expiration of the protest period, the docket should remain open pending completion and verification of the refunds. Staff recommends that administrative authority be granted to staff to close the docket upon verification that the refunds have been made.

STAFF CALCULATED GROSS-UP REFUND

North Fort Myers Utility

SOURCE: (Line references are from Amended CIAC Reports)

	1994		1995
	-----		-----
1 Form 1120, Line 30 (Line 15)	\$ 412,187	\$	1,368,582
2 Less CIAC (Line 7)	(619,015)		(1,434,249)
3 Less Gross-up collected (Line 19)	(355,431)		(546,104)
4 Add First Year's Depr on CIAC (Line 8)	22,120		25,196
5 Add/Less Other Effects (Lines 20 & 21)	\$ (1,462)		(2,296)
6	-----		-----
7 Adjusted Income Before CIAC and Gross-up	\$ (541,601)	\$	(588,871)
8			
9 Taxable CIAC (Line 7)	\$ 619,015	\$	1,434,249
10 Less first years depr. (Line 8)	\$ (22,120)	\$	(25,196)
11 Adjusted Income After CIAC	\$ 55,294	\$	820,182
12 Less CIAC associated with purchase of existing systems not grossed-up			(296,184)
13 Less: NOL Carry Forward	0		0
14	-----		-----
15 Net Taxable CIAC	\$ 55,294	\$	523,998
16 Combined Marginal state & federal tax rates	37.63%		37.63%
17	-----		-----
18 Net Income tax on CIAC	\$ 20,807	\$	197,180
19 Less ITC Realized	0		0
20	-----		-----
21 Net Income Tax	\$ 20,807	\$	197,180
22 Expansion Factor for gross-up taxes	1.6033349		1.6033349
23	-----		-----
24 Gross-up Required to pay tax effect	\$ 33,361	\$	316,146
25 Less CIAC Gross-up collected (Line 19)	\$ (355,431)		(546,104)
26	-----		-----
27 (OVER) OR UNDER COLLECTION	\$ (322,070)	\$	(229,958)
28	=====		=====
29 TOTAL YEARLY REFUND	\$ (322,070)	\$	(229,958)
30	=====		=====
31 OFFSET OF LEGAL AND ACCOUNTING FEE	\$ 8,048		9,101
32	-----		-----
33 PROPOSED REFUND (excluding interest)	\$ (314,022)		(220,857)
	=====		=====