



Public Service Commission

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RECORDS AND REPORTING

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DATE: AUGUST 5, 1999

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAY) *EM*

FROM: DIVISION OF WATER AND WASTEWATER (JOHNSON, MCCASKILL) *EM*
DIVISION OF LEGAL SERVICES (JAEGER) *EM*

RE: DOCKET NO. 990744-SU - DISPOSITION OF GROSS-UP ON CIAC COLLECTIONS BY FOUNTAIN LAKES SEWER CORPORATION *EM*

COUNTY: LEE

AGENDA: AUGUST 17, 1999 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\WAW\WP\990744.RCM

CASE BACKGROUND

Fountain Lakes Sewer Corporation (Fountain Lakes or utility) is a Class B utility providing service to approximately 503 wastewater customers in Lee County. As of December 31, 1997, the utility had annual operating revenues of \$266,281 and net operating income of \$48,758 for the wastewater system.

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

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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 gross-up.

On December 31, 1990, pursuant to Order No. 23541, Fountain Lakes filed for authority to continue grossing-up CIAC. Although the information as filed did not meet the filing requirements of Order No. 23541, subsequent information that was filed did meet the filing requirements. On December 17, 1991, this Commission issued Proposed Agency Action (PAA) Order No. 25500, which granted Fountain Lakes the authority to continue to gross-up CIAC.

However, on August 1, 1996, 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. The utility refunded all collections made after June 12, 1996 to the contributors and provided staff with canceled checks as verification.

The purpose of this recommendation is to address the amount of CIAC gross-up funds that should be refunded for the years 1990 through 1996.

DISCUSSION OF ISSUES

ISSUE 1: Should Fountain Lakes Sewer Corporation, be required to refund excess gross-up collections for the years 1990 through 1996?

RECOMMENDATION: Yes, the utility overcollected CIAC gross-up for the years 1990 through 1995 and should refund \$6,688 for 1990; \$6,358 for 1991; \$4,945 for 1992; \$2,233 for 1993; \$1,024 for 1994; and \$1,203 for 1995 for a total of \$22,451 plus accrued interest through the date of refund, for gross-up collected in excess of the tax liability resulting from the collection of CIAC. Further, staff recommends that the Commission accept Fountain Lakes' request that it be allowed to recover 50% of the legal and consulting expenses (\$3,050) that relate to the preparation of the gross-up refund report for 1996. If the Commission approves staff's recommendation, the overcollection of \$896 for 1996 should be reduced by the offset of \$896 of the \$3,050 of recoverable legal

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and consulting expenses. As a result, no refund would be required for 1996. In accordance with Orders Nos. 16971 and 23541, all amounts should be refunded on a pro rata basis to those persons who contributed the taxes. The refunds should be completed within six months. The utility should submit copies of canceled checks, credits applied to monthly bills or other evidence which verifies that the refunds have been made, within 30 days from the date of refund. Within 30 days from the date of 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. (JOHNSON)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, Fountain Lakes filed its 1990 through 1996 annual CIAC reports and tax returns regarding its collection of gross-up for each year. Staff's calculations and the utility's calculations are in agreement on the refund amounts for the years listed. With the inclusion of the preparation costs in the calculation of the refund for 1996, no refund is required. The utility did not request recovery of consultants fees for accounting and legal services for the years 1990 through 1995; therefore, none were included in staff's refund calculation for those years. However, a request for recovery of consultants fees for accounting and legal services was made for 1996.

RECOVERY OF LEGAL AND CONSULTING COSTS

The utility has provided documentation supporting legal and accounting fees of \$6,100 for the fiscal year ended 1996. Staff reviewed these costs and determined \$6,100 to be legitimate expenses. Fifty percent (50%) of this amount is \$3,050. The required gross-up for 1996 is \$40,460. The utility collected \$41,356 of gross-up for the fiscal year 1996. Therefore, staff calculates an overcollection of gross-up of \$896 for 1996. However, when \$896 of the recoverable legal and consulting fees are offset with the overcollection of \$896, no refund is required.

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. The Commission's actions have been consistent in over nine cases, including PAA Orders Nos. PSC-97-1349-FOF-SU, PSC-97-0648-FOF-SU, PSC-98-0031-FOF-WS, and PSC-97-0816-FOF-WS, by approving the offset of 50% of the legal and accounting costs associated with the preparation and filing of the utility's gross-up reports against the refund amounts. 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.

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Staff notes that it was the change in the tax laws and not the contributors that imposed a new cost on the utilities associated with CIAC. Further, staff believes that once the contributors have paid the gross-up taxes on the CIAC, the contributors have fulfilled their obligation under Orders Nos. 16971 and 23541. Since those orders also provide that gross-up in excess of the utility's actual tax liability should be refunded on a pro rata basis to those persons who contributed the taxes, staff believes that once the tax liability is determined, it is the responsibility of the Commission to ensure that excess payments of CIAC taxes are refunded in compliance with those Orders. Therefore, staff does not believe that a reduction in the amount of refund a contributor is entitled to receive as a result of his overpayment of gross-up taxes is appropriate. Staff acknowledges that those costs were incurred to satisfy regulatory requirements; however, staff does not believe that the contributors should be held responsible for the legal and accounting costs incurred to determine whether they are entitled to a refund. Staff views those costs as a necessary cost of doing business, and as such, staff believes it is appropriate for the utility to seek recovery of those amounts in a rate case proceeding. 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 should grant Fountain Lakes's request that it be allowed to recover 50% of the legal and accounting fees for 1996. The utility had legitimate legal and accounting fees of \$6,100. Half of this amount is \$3,050. When \$896 of this amount is offset with the overcollection of \$896, no refund is required.

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 reports and tax returns, are reflected on Schedule No. 1. A summary of the 1990 through 1996 refund calculations follows.

1990

The utility proposes a refund of \$6,688 for 1990 gross-up collections. Staff agrees that a refund of \$6,688 in gross-up collections for 1990 is appropriate.

Based upon our review of the utility's 1990 filing, the utility incurred an above-the-line loss of \$10,420 prior to the inclusion of taxable CIAC in income. As a result, all of the CIAC collected would not be taxed. Order No. 23541 requires that above-the-line losses be offset against CIAC income. Therefore, the above-the-line loss of \$10,420 must be netted with the taxable CIAC collected. The CIAC report indicates that the utility collected \$43,060 of taxable CIAC, with \$921 being deducted for the first year's depreciation. As a result, the amount of taxable CIAC is calculated to be \$34,719. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$13,065. 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 \$20,948. The utility collected \$27,636 in gross-up taxes. Based upon the foregoing, staff calculates the utility collected \$6,688 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1990, which must also be refunded through the date of the refund.

1991

The utility proposes a refund of \$6,358 for 1991 gross-up collections. Staff agrees that a refund of \$6,358 in gross-up collections for 1991 is appropriate.

Based upon our review of the utility's 1991 filing, the utility incurred an above-the-line loss of \$10,491 prior to the inclusion of taxable CIAC in income. As a result, all of the CIAC collected would not be taxed. Order No. 23541 requires that above-the-line losses be offset against CIAC income. Therefore, the above-the-line loss of \$10,491 must be netted with the taxable CIAC collected. The CIAC report indicates that the utility collected \$22,560 of taxable CIAC, with \$172 being deducted for the first

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year's depreciation. As a result, the amount of taxable CIAC is calculated to be \$11,897. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$4,477. 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 \$7,178. The utility collected \$13,536 in gross-up taxes. Based upon the foregoing, staff calculates the utility collected \$6,358 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1991, which must also be refunded through the date of the refund.

1992

The utility proposes a refund of \$4,945 for 1992 gross-up collections. Staff agrees that a refund of \$4,945 in gross-up collections for 1992 is appropriate.

Based upon our review of the utility's 1992 filing, the utility incurred an above-the-line loss of \$7,745 prior to the inclusion of taxable CIAC in income. As a result, all of the CIAC collected would not be taxed. Order No. 23541 requires that above-the-line losses be offset against CIAC income. Therefore, the above-the-line loss of \$7,745 must be netted with the taxable CIAC collected. The CIAC report indicates that the utility collected \$14,100 of taxable CIAC, with \$529 being deducted for the first year's depreciation. As a result, the amount of taxable CIAC is calculated to be \$5,826. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$2,192. 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 \$3,515. The utility collected \$8,460 in gross-up taxes. Based upon the foregoing, staff calculates the utility collected \$4,495 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1992, which must also be refunded through the date of the refund.

1993

The utility proposes a refund of \$2,233 for 1993 gross-up collections. Staff agrees that a refund of \$2,233 in gross-up collections for 1993 is appropriate.

Based upon our review of the utility's 1993 filing, the utility incurred an above-the-line loss of \$3,702 prior to the inclusion of taxable CIAC in income. As a result, all of the CIAC collected would not be taxed. Order No. 23541 requires that above-

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the-line losses be offset against CIAC income. Therefore, the above-the-line loss of \$3,702 must be netted with the taxable CIAC collected. The CIAC report indicates that the utility collected \$34,708 of taxable CIAC. As a result, the amount of taxable CIAC is calculated to be \$31,006. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$11,668. 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 \$18,707. The utility collected \$20,940 in gross-up taxes. Based upon the foregoing, staff calculates the utility collected \$2,232 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1993, which must also be refunded through the date of the refund.

1994

The utility proposes a refund of \$1,024 as appropriate and staff agrees with this proposed refund amount for 1994.

Based upon our review of the utility's 1994 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 \$62,720 in taxable CIAC was received, with \$1,869 being deducted for the first year's depreciation, resulting in net taxable CIAC of \$60,851. Staff has used the 37.63% combined marginal federal and state tax rates to calculate the tax effect of \$22,898. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be \$36,712. The utility collected \$37,736 in gross-up taxes; therefore, the utility collected \$1,024 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1994, which must also be refunded through the date of the refund.

1995

The utility proposes a refund of \$1,203 as appropriate and staff agrees with this proposed refund amount for 1995.

Based upon our review of the utility's 1995 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 also indicates that a total of \$78,400 in taxable CIAC was received, with \$2,054 being deducted for the first year's depreciation. As a result, net

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taxable CIAC was calculated to be \$76,346. Staff has used the 37.63% combined federal and state tax rate as provided in the CIAC report to calculate the tax effect of \$28,729. When \$28,729 is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be \$46,061. The utility collected \$47,264 in gross-up taxes; therefore, the utility collected \$1,203 more in gross-up than was required to pay the taxes. This amount does not include the accrued interest as of December 31, 1995, which must be refunded through the date of the refund.

1996

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

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 \$70,000 in taxable CIAC was received, with \$2,940 being deducted for the first year's depreciation, resulting in net taxable CIAC of \$67,060. Staff has used the 37.63% combined marginal federal and state tax rates to calculate the tax effect of \$25,235. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be \$40,460. The utility collected \$41,356 in gross-up taxes. Therefore, staff calculates an over collection of gross-up of \$896. As previously discussed, staff recommends that the utility be allowed to offset \$896 of the recoverable legal and consulting fees of \$3,050, with the \$896 overcollection of gross-up. With the inclusion of the preparation costs in the calculation of the refund for 1996, no refund is required.

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ISSUE 2: Should the docket be closed?

RECOMMENDATION: No. Upon expiration of the 21-day protest period, and upon issuance of the consummating order, this docket should remain open pending verification of the refunds. Staff should be given administrative authority to close the docket upon verification that the refunds have been completed. (JAEGER)

STAFF ANALYSIS: Upon expiration of the protest period, if a timely protest is not filed by a substantially affected person, and upon issuance of the consummating order, this docket should remain open pending completion and verification of the refunds. Staff recommends that administrative authority be granted to staff to close the docket upon verification that the refunds have been made.