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REPLY TO: Tallahassee

August 12, 1991

ORIGINAL
FILE COPY

HAND DELIVERED

Mr. Steve Tribble, Director
Division of Records and Reporting
Florida Public Service Commission
101 East Gaines Street
Tallahassee, Florida 32399-0850

Re: Docket No. 900876-WS; Palm Coast Utility CIAC Gross-up.

Dear Mr. Tribble:

Enclosed for filing are an original and 15 copies of the supplemental information of Palm Coast Utility Corporation ("PCUC") requested by the Commission Staff in connection with PCUC's petition to continue its CIAC gross-up. The attached information was supplied to Staff on May 3, 1991 in draft form. Since Staff has not requested any corrections or further information, we are now filing this as part of the official Docket No. 900876-WS file.

If you have any questions regarding this matter, please advise. Thank you for your assistance.

Sincerely,

Floyd R. Self
For the Firm

FRS:sct
Enclosures

cc: Ms. Connie McCaskill
Ms. Ann Causseaux
Ms. Beth Salak
Ms. Rhonda Hicks
Mr. Brian Bilinsky

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ARTHUR ANDERSEN & CO.

133 PEACHTREE STREET, N.E.
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April 30, 1991

ORIGINAL FILE COPY

Mr. Roy W. Likins
President
Palm Coast Utility Corporation
Two Utility Drive
Palm Coast, Florida 32137

Dear Mr. Likins:

This letter is written in response to your request that we review and document certain matters associated with Palm Coast Utility Corporation's ("PCUC") petition filed in response to Florida Public Service Commission ("FPSC") Order No. 23541 in Docket No. 860184-PU for continued authority to gross up contributions in aid of construction ("CIAC") for income taxes using the net present value ("NPV") method. This letter supersedes my previous letter dated October 23, 1990 and is solely for use by PCUC in petitioning the FPSC for continued authority to gross up CIAC using the NPV method and is not to be used, referred to, or distributed for any other purpose or to any other party.

As you are aware, I am a partner in Arthur Andersen & Co., a firm of independent public accountants, at 133 Peachtree Street, N.E., in Atlanta, Georgia. I am currently a partner in the energy and telecommunications practice of the Atlanta office of Arthur Andersen & Co. I have previously presented testimony in Docket No. 860184-PU, under which Order No. 23541 was issued.

In this letter, I will discuss certain facts and circumstances of PCUC, as management has presented them to me, and the application and relevance of these facts and circumstances to management's decision to request continued authority to gross up CIAC within the guidelines discussed in Order No. 23541 and the considerations I identified in my earlier testimony related to this docket. The information provided to me has not been audited, although we have performed certain limited testing of PCUC's forecasting system discussed later in this letter.

Order No. 23541 states that "the need for gross-up should be determined on a case-by-case basis, based upon the facts and circumstances peculiar to each utility." The important factors which must be considered in making the decision to gross up include:

1. Fairness of the charge to the customer, the contributor, and the utility.

2. Effect of the decision on long-run customer revenue requirements.

3. Rate stability.

4. Assignment of costs to cost causes, including cost of new growth policies.

5. The utility's cash flow and availability of alternative financing sources.

6. Competitive pressures, including potential bypass issues.

Following is a brief discussion of each of these considerations as they relate to PCUC and the information you have provided me.

Fairness of the Charge

Fairness is, of course, a subjective determination. In the case of CIAC tax funding, the fairness to the customer, the contributor, and the utility must be considered. You have stated that in your opinion, the NPV gross-up is the most fair method in the case of PCUC, as it achieves what you believe to be the best balance of the interests of all three parties (the customer, the contributor, and PCUC) affected by the decision.

I understand you have selected the NPV method because you believe it to be a fair method of collecting the cost of taxes attributable to CIAC. As I stated in my testimony in Docket No. 860184-PU, the NPV gross-up method is a fair method to the customer, the contributor, and PCUC. As a revenue-neutral method, NPV gross-up is fair to the customers. Since only the carrying costs associated with the taxes on CIAC are collected from the contributor, NPV is fair to the contributor. As I testified in the Docket No. 860184-PU hearing, the carrying cost of financing the taxes on CIAC are the true economic costs since the taxes are recouped through future tax depreciation benefits. PCUC is made whole on the carrying costs of financing the CIAC taxes, and the financing of those taxes is not an unreasonable burden on PCUC; therefore, the NPV gross-up is fair to PCUC. In the case of PCUC, the relative importance of CIAC to the customer and the Company is magnified, since, based upon data you have supplied to me, PCUC collects more CIAC than any other FPSC-regulated water and wastewater utility which grosses up (Exhibit I).

Customer Revenue Requirements and Rate Stability

As was discussed by me and other witnesses during the hearing related to Docket No. 860184-PU, the NPV gross-up method of funding CIAC taxes is revenue neutral and the no gross-up method creates a future customer revenue requirement. The issue then is the higher customer revenue requirements in the no gross-up environment compared to what they will be if PCUC continues its present policy of NPV gross-up. Due to the relative importance of CIAC to PCUC, if PCUC were not allowed to gross up, customer revenue requirements will be cumulatively $921,000 higher over the next five years. This is graphically illustrated by Exhibit II. This represents an increase in customer revenue requirements of 3.4% per ERC in 1995. You have stated that PCUC believes that not grossing up results in imposing on existing customers' costs associated with new growth, and I concur with your analysis. PCUC management does not wish to impose these costs on existing customers.

As Exhibit II illustrates, this revenue requirement continues to increase over time as more and more new growth occurs. This will have the effect of leading to higher rates and less rate stability.

Assignment of Costs

You have stated that PCUC believes, and I concur, that the tax costs of CIAC should be assigned in a manner consistent with the CIAC itself. As previously discussed, the NPV method assigns the true economic costs of CIAC taxes to the contributor, giving the contributor the benefit of the future tax depreciation benefits.

Cash Flow and Financing

Order No. 23541 requests certain information concerning cash flow and financing. Specifically, the order requests demonstration of an actual tax liability, a demonstration that sources of funds are not available at a reasonable cost, a cash flow statement, and a statement of interest coverage. Under my supervision, we have prepared two schedules which present this information based on amounts projected by PCUC for the years 1991 through 1995. The source of this data and the related notes are PCUC's projected financial data for the years 1991 through 1995. The first schedule (Exhibit III) projects the data assuming PCUC is able to utilize the NPV gross-up method to fund CIAC taxes. The second schedule (Exhibit IV) projects the data assuming PCUC is not able to utilize NPV gross-up and uses the no gross-up method.

We have performed limited testing procedures related to PCUC's forecasting system from which the data in Exhibit III and Exhibit IV was obtained. The scope of our work was not designed to enable us to issue a report under the

reporting standards as established by the American Institution of Certified Public Accountants ("AICPA") for review of forecasts and projections. As you are aware, the scope of testing which would be required in order to allow us to comply with the AICPA standards and issue an examination report covering projected data derived from PCUC's forecasting system is extensive, and you and I decided that such a level of testing would not be cost-effective within the requirements of this docket. Accordingly, we have not issued any form of report related to PCUC's forecasting system.

Both Exhibit III (NPV gross-up) and Exhibit IV (no gross-up) reflect an overall tax liability for PCUC in each of the years 1991 through 1995. PCUC, therefore, is projected to satisfy the order's minimum requirement that utilities grossing up CIAC actually have an "above the line" tax liability.

Following the determination of tax liability, a projected summarized cash flow statement is presented. Sources of cash (excluding debt) are net cash flow from operations and CIAC. Uses of cash (excluding debt) are capital additions, CIAC placed in trust, and prepaid taxes and other.

The net difference between sources and uses is borrowings or repayments of debt. PCUC's current debt facility consists of a long-term revolving line of credit, and this type of facility is assumed to continue through 1995.

Interest Coverage

The effect of PCUC's extensive capital program is also evident in the times-interest-earned ("TIE") ratio. If not allowed to gross up through 1993, PCUC's TIE ratio would significantly remain below the FPSC's prescribed threshold of 2.00 (Exhibit IV). Only after the forecasted rate increase in late 1993 does the TIE rise slightly above 2.00 in 1994 and 1995. If allowed to gross up CIAC (Exhibit III), the gross-up funds collected significantly reduce required debt financing, resulting in an improvement in the TIE ratio. Although the TIE ratio is projected at 2.01 in 1991 and lower in 1992, the ratio is stronger than under the no gross-up projection. This also demonstrates that if allowed to gross up CIAC, PCUC's debt borrowings do not exceed currently available facilities until 1995, when the TIE ratio will be significantly above 2.00.

As I discussed in my testimony in this docket, use of a TIE ratio test is only one measure of a company's overall financial health. However, it does provide an indication of a company's ability to service its debt. As can be seen in Exhibits III and IV, if PCUC is not allowed to gross up CIAC for taxes, its debt borrowings are significantly increased and its TIE ratio is significantly reduced. PCUC is projecting a TIE ratio below 2.00 even if allowed to gross up CIAC, with the projected TIE ratio significantly deteriorating if the gross-up is not allowed. This indicator supports PCUC's decision to gross up.

Alternative Financing

Under both the NPV gross-up and no gross-up cases, the effect of PCUC's high level of capital additions in 1991 is evident, resulting in significant additional debt requirements. PCUC management has anticipated this financing requirement and maintained total debt facilities of $12 million. However, under the no gross-up case, PCUC's available debt facilities would be exceeded in 1995 by over $4 million due entirely to the requirement to finance taxes on CIAC. You have stated to me that sources of financing to pay these CIAC-related taxes have not been obtained.

You have stated that a majority of PCUC's CIAC is received from individuals, not developers. Therefore, you have not considered developer financing to be a viable borrowing source for funds to pay CIAC taxes. In addition, I agree with you that the record-keeping requirements related to numerous homeowner loans are generally onerous and not cost-effective. Even if debt financing from developers or homeowners were obtained, the customer rate effects of the no gross-up method would still apply.

Based upon the above projections and analysis, I understand that PCUC management believes that continued authority to gross up CIAC is critical to the financial health of the company. Based upon my review of these same projections, I agree that CIAC gross-up funds represent an important and material source of funds during the projected period and that PCUC's overall financial health would be harmed if CIAC gross-up is not allowed and the corresponding required rate increases to cover the carrying costs of financing the CIAC taxes are not granted.

Competitive Pressures

You have stated to me that the issue of competitive pressures was considered in the development of PCUC's conclusion that it needs to gross up, but it was not a significant factor in making that determination.

Summary

After having considered and evaluated the previously described facts and circumstances of PCUC and in view of the current service availability policies in Florida, I concur with your position that a NPV gross-up of CIAC is needed for PCUC and I believe your position is well supported and consistent with the guidelines described in Order No. 23541. I understand your selection of the NPV gross-up over a full gross-up is based on management's position that the NPV method more appropriately balances the interests of all parties, particularly the contributors, and I concur with this position. Again, my

conclusions are based upon the particular facts and circumstances of PCUC as described herein and do not represent a general endorsement by me of the need for all utilities to gross up or the preferability in all cases of one gross-up method over another.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Thomas L. Elliott

Thomas L. Elliott III

ARTHUR ANDERSEN & CO.

ATLANTA, GEORGIA

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Trustees of
ZF Steering Gear (U.S.), Inc./
Lemforder Corporation
Retirement and Savings Plan:

We were engaged to audit the accompanying statement of net assets available for plan benefits of the ZF STEERING GEAR (U.S.), INC./LEMFORDER CORPORATION RETIREMENT AND SAVINGS PLAN as of December 31, 1990, the related statement of changes in net assets available for plan benefits for the year then ended, and the supplemental schedules of investments and reportable transactions as of and for the year ended December 31, 1990. These financial statements and schedules are the responsibility of the Plan's management.

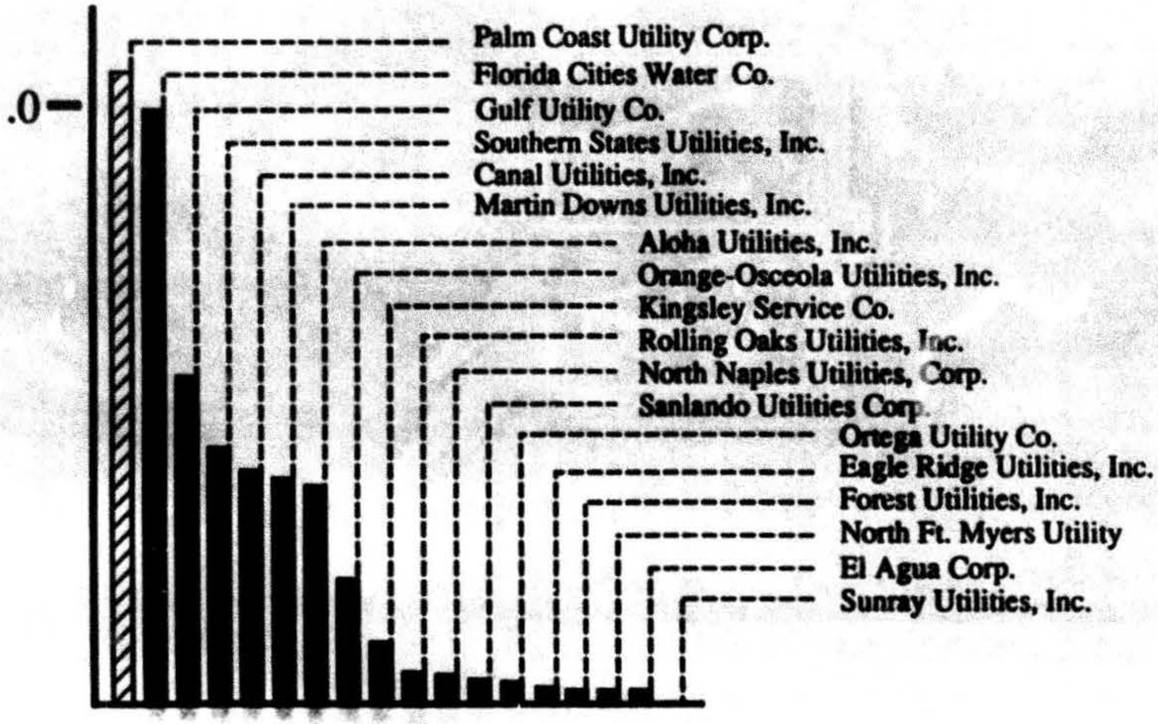
As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note 4, which was certified by Fleet Bank of Maine and Sovran Bank, N.A., the custodians of the Plan, except for comparing the information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the custodians hold the Plan's investment assets and execute investment transactions. The plan administrator has obtained a certification from the custodians as of and for the year ended December 31, 1990 that the information provided to the plan administrator by the custodians is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the custodians, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Arthur Andersen & Co.

June 6, 1991

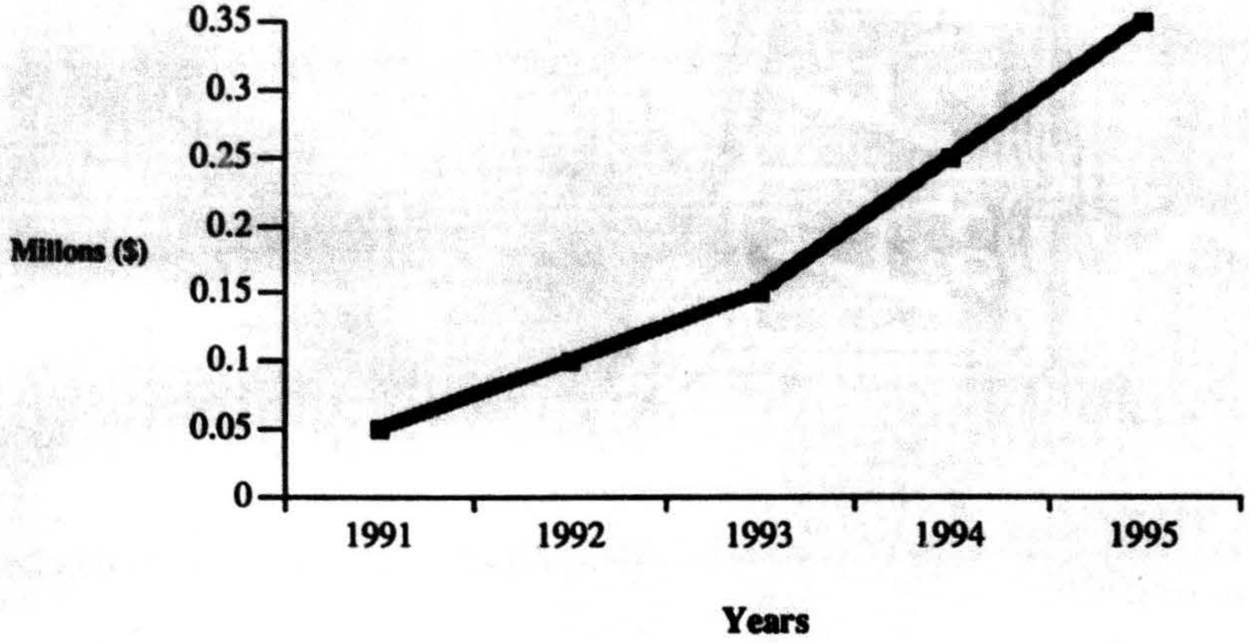
1989 TAXABLE INCOME FROM CIAC AND GROSS-UP AMOUNTS



The above data was derived by the Company.

PALM COAST UTILITY CORPORATION

Difference in Customer Revenue Requirements: No Gross-Up Over NPV Gross-Up



SOURCE: The above graph was developed from PCUC projected financial data for the years 1991 through 1995.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NET PRESENT VALUE GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual 1990	Projected Year Ended December 31 1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Contributions subject to gross-up	2,282	3,147	3,366	4,318	3,115	4,302
Other contributions	1,523	1,962	2,056	2,120	2,143	2,109
Gross-up contributions	480	1,013	1,084	1,391	1,003	1,385
Other timing differences, net	695	(1,617)	(1,823)	(2,178)	(2,686)	(3,410)
TAXABLE INCOME	$5,934	$ 5,775	$5,179	$7,064	$ 6,064	$ 7,385
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 2,173	$1,949	$2,658	$ 2,282	$ 2,779
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ 1,013	$1,084	$1,391	$ 1,003	$ 1,385
Net cash flow from operations	2,978	1,797	1,351	1,852	2,551	2,984
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	7,919	7,857	9,681	8,812	10,780
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(1,239)	(1,717)	(1,820)	(990)	(1,314)
Total uses	(7,767)	(14,797)	(6,157)	(8,332)	(10,155)	(13,181)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(6,878)	$1,700	$1,349	$(1,343)	$(2,401)
YEAR-END DEBT BALANCE	$4,500	$11,401	$9,722	$8,402	$ 9,772	$12,210
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	962	445	1,374	2,348	2,646
Add debt interest	364	954	1,267	1,087	1,090	1,319
EARNINGS BEFORE INTEREST AND TAXES	$1,156	$ 1,916	$1,712	$2,461	$ 3,438	$ 3,965
DEBT INTEREST	$ 364	$ 954	$1,267	$1,087	$ 1,090	$ 1,319
"TIMES INTEREST EARNED" RATIO	3.18	2.01	1.35	2.26	3.15	3.01

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NET PRESENT VALUE GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming gross-up of contributions in aid of construction for income taxes using the net present value gross-up method ("NPV gross-up"). Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the Florida Public Service Commission as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has not received authorization of the FPSC to gross up CIAC for income taxes during the projection period. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.
- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993, resulting in a rate increase of 13% for water taking effect as an interim increase in September 1993. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

8. LONG-TERM DEBT

Long-term debt consists of a revolving long-term facility with interest based on projected LIBOR rates.

9. CONTRIBUTIONS

Contributions not subject to gross-up include prepaid sewer CIAC placed in trust and prepaid water CIAC which relate to amounts collected prior to the time homesite purchasers connect to the water and sewer system by the company's affiliate, ITT Community Development Corporation.

CIAC gross-up is computed in accordance with the net present value gross-up method as specified in FPSC Order No. 23541.

10. SIGNIFICANT VARIATION EXPLANATIONS

The following explains the cause of significant variations which occur in the projected years:

- The decrease in pretax book income from 1991 to 1992 is the result of the termination of the collection of guaranteed revenues in mid-1991 (Note 5) and a significant increase in interest expense, net of allowance for funds used during construction ("AFUDC"), upon construction of a 2 million-gallon-per-day ("MGD") water treatment facility during 1991 (Note 7).

- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).

- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).

- The large amount of 1994 and 1995 capital additions is a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NO GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual	Projected Year Ended December 31				
	1990	1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Contributions subject to gross-up	2,282	-	-	-	-	-
Other contributions	1,523	5,109	5,422	6,438	5,258	6,411
Gross-up contributions	480	-	-	-	-	-
Other timing differences, net	695	(1,697)	(1,883)	(2,233)	(2,669)	(3,397)
TAXABLE INCOME	$5,934	$ 4,637	$ 3,877	$ 5,365	$ 4,773	$ 5,586
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 1,745	$ 1,459	$ 2,019	$ 1,796	$ 2,102
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ -	$ -	$ -	$ -	$ -
Net cash flow from operations	2,978	1,740	1,248	1,711	2,426	2,798
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	6,849	6,670	8,149	7,684	9,209
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(786)	(1,241)	(1,221)	(582)	(740)
Total uses	(7,767)	(14,344)	(5,681)	(7,733)	(9,747)	(12,607)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(7,495)	$ 989	$ 416	$(2,063)	$(3,398)
YEAR-END DEBT BALANCE	$4,500	$12,020	$11,055	$10,673	$12,771	$16,215
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	917	287	1,121	2,043	2,219
Add debt interest	364	991	1,384	1,303	1,406	1,739
AVAILABLE EARNINGS	$1,156	$ 1,908	$ 1,671	$ 2,424	$ 3,449	$ 3,958
DEBT INTEREST	$ 364	$ 991	$ 1,384	$ 1,303	$ 1,406	$ 1,739
"TIMES INTEREST EARNED" RATIO	3.18	1.93	1.21	1.86	2.45	2.28

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NO GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming no gross-up of contributions in aid of construction for income taxes. Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were not grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the FPSC as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has decided or been required to gross up CIAC for income taxes. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies, except for the accounting treatment for the effects of not grossing up CIAC for income taxes, are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of not grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.
- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993 resulting in a rate increase of 15% for water, taking effect as an interim increase in September 1993 and a final increase in 1994. The effect of not grossing up CIAC for income taxes results in 2% of the above water rate increase. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

8. LONG-TERM DEBT

Long-term debt consists of a revolving long-term facility with interest based on projected LIBOR rates.

9. SIGNIFICANT VARIATION EXPLANATIONS

The following explains the cause of significant variations which occur in the projected years:

- The decrease in pretax book income from 1991 to 1992 is the result of the termination of the collection of guaranteed revenues in mid-1991 (Note 5) and a significant increase in interest expense, net of AFUDC, upon construction of a 2 MGD water treatment facility during 1991 (Note 7).

- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).

- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).

- The large amount of 1994 and 1995 capital additions are a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.

ARTHUR ANDERSEN & CO.

133 PEACHTREE STREET, N.E.
ATLANTA, GEORGIA 30303
(404) 658-1776

April 30, 1991

Mr. Roy W. Likins
President
Palm Coast Utility Corporation
Two Utility Drive
Palm Coast, Florida 32137

Dear Mr. Likins:

This letter is written in response to your request that we review and document certain matters associated with Palm Coast Utility Corporation's ("PCUC") petition filed in response to Florida Public Service Commission ("FPSC") Order No. 23541 in Docket No. 860184-PU for continued authority to gross up contributions in aid of construction ("CIAC") for income taxes using the net present value ("NPV") method. This letter supersedes my previous letter dated October 23, 1990 and is solely for use by PCUC in petitioning the FPSC for continued authority to gross up CIAC using the NPV method and is not to be used, referred to, or distributed for any other purpose or to any other party.

As you are aware, I am a partner in Arthur Andersen & Co., a firm of independent public accountants, at 133 Peachtree Street, N.E., in Atlanta, Georgia. I am currently a partner in the energy and telecommunications practice of the Atlanta office of Arthur Andersen & Co. I have previously presented testimony in Docket No. 860184-PU, under which Order No. 23541 was issued.

In this letter, I will discuss certain facts and circumstances of PCUC, as management has presented them to me, and the application and relevance of these facts and circumstances to management's decision to request continued authority to gross up CIAC within the guidelines discussed in Order No. 23541 and the considerations I identified in my earlier testimony related to this docket. The information provided to me has not been audited, although we have performed certain limited testing of PCUC's forecasting system discussed later in this letter.

Order No. 23541 states that "the need for gross-up should be determined on a case-by-case basis, based upon the facts and circumstances peculiar to each utility." The important factors which must be considered in making the decision to gross up include:

1. Fairness of the charge to the customer, the contributor, and the utility.

2. Effect of the decision on long-run customer revenue requirements.

3. Rate stability.

4. Assignment of costs to cost causes, including cost of new growth policies.

5. The utility's cash flow and availability of alternative financing sources.

6. Competitive pressures, including potential bypass issues.

Following is a brief discussion of each of these considerations as they relate to PCUC and the information you have provided me.

Fairness of the Charge

Fairness is, of course, a subjective determination. In the case of CIAC tax funding, the fairness to the customer, the contributor, and the utility must be considered. You have stated that in your opinion, the NPV gross-up is the most fair method in the case of PCUC, as it achieves what you believe to be the best balance of the interests of all three parties (the customer, the contributor, and PCUC) affected by the decision.

I understand you have selected the NPV method because you believe it to be a fair method of collecting the cost of taxes attributable to CIAC. As I stated in my testimony in Docket No. 860184-PU, the NPV gross-up method is a fair method to the customer, the contributor, and PCUC. As a revenue-neutral method, NPV gross-up is fair to the customers. Since only the carrying costs associated with the taxes on CIAC are collected from the contributor, NPV is fair to the contributor. As I testified in the Docket No. 860184-PU hearing, the carrying cost of financing the taxes on CIAC are the true economic costs since the taxes are recouped through future tax depreciation benefits. PCUC is made whole on the carrying costs of financing the CIAC taxes, and the financing of those taxes is not an unreasonable burden on PCUC; therefore, the NPV gross-up is fair to PCUC. In the case of PCUC, the relative importance of CIAC to the customer and the Company is magnified, since, based upon data you have supplied to me, PCUC collects more CIAC than any other FPSC-regulated water and wastewater utility which grosses up (Exhibit I).

Customer Revenue Requirements and Rate Stability

As was discussed by me and other witnesses during the hearing related to Docket No. 860184-PU, the NPV gross-up method of funding CIAC taxes is revenue neutral and the no gross-up method creates a future customer revenue requirement. The issue then is the higher customer revenue requirements in the no gross-up environment compared to what they will be if PCUC continues its present policy of NPV gross-up. Due to the relative importance of CIAC to PCUC, if PCUC were not allowed to gross up, customer revenue requirements will be cumulatively $921,000 higher over the next five years. This is graphically illustrated by Exhibit II. This represents an increase in customer revenue requirements of 3.4% per ERC in 1995. You have stated that PCUC believes that not grossing up results in imposing on existing customers' costs associated with new growth, and I concur with your analysis. PCUC management does not wish to impose these costs on existing customers.

As Exhibit II illustrates, this revenue requirement continues to increase over time as more and more new growth occurs. This will have the effect of leading to higher rates and less rate stability.

Assignment of Costs

You have stated that PCUC believes, and I concur, that the tax costs of CIAC should be assigned in a manner consistent with the CIAC itself. As previously discussed, the NPV method assigns the true economic costs of CIAC taxes to the contributor, giving the contributor the benefit of the future tax depreciation benefits.

Cash Flow and Financing

Order No. 23541 requests certain information concerning cash flow and financing. Specifically, the order requests demonstration of an actual tax liability, a demonstration that sources of funds are not available at a reasonable cost, a cash flow statement, and a statement of interest coverage. Under my supervision, we have prepared two schedules which present this information based on amounts projected by PCUC for the years 1991 through 1995. The source of this data and the related notes are PCUC's projected financial data for the years 1991 through 1995. The first schedule (Exhibit III) projects the data assuming PCUC is able to utilize the NPV gross-up method to fund CIAC taxes. The second schedule (Exhibit IV) projects the data assuming PCUC is not able to utilize NPV gross-up and uses the no gross-up method.

We have performed limited testing procedures related to PCUC's forecasting system from which the data in Exhibit III and Exhibit IV was obtained. The scope of our work was not designed to enable us to issue a report under the

reporting standards as established by the American Institution of Certified Public Accountants ("AICPA") for review of forecasts and projections. As you are aware, the scope of testing which would be required in order to allow us to comply with the AICPA standards and issue an examination report covering projected data derived from PCUC's forecasting system is extensive, and you and I decided that such a level of testing would not be cost-effective within the requirements of this docket. Accordingly, we have not issued any form of report related to PCUC's forecasting system.

Both Exhibit III (NPV gross-up) and Exhibit IV (no gross-up) reflect an overall tax liability for PCUC in each of the years 1991 through 1995. PCUC, therefore, is projected to satisfy the order's minimum requirement that utilities grossing up CIAC actually have an "above the line" tax liability.

Following the determination of tax liability, a projected summarized cash flow statement is presented. Sources of cash (excluding debt) are net cash flow from operations and CIAC. Uses of cash (excluding debt) are capital additions, CIAC placed in trust, and prepaid taxes and other.

The net difference between sources and uses is borrowings or repayments of debt. PCUC's current debt facility consists of a long-term revolving line of credit, and this type of facility is assumed to continue through 1995.

Interest Coverage

The effect of PCUC's extensive capital program is also evident in the times-interest-earned ("TIE") ratio. If not allowed to gross up through 1993, PCUC's TIE ratio would significantly remain below the FPSC's prescribed threshold of 2.00 (Exhibit IV). Only after the forecasted rate increase in late 1993 does the TIE rise slightly above 2.00 in 1994 and 1995. If allowed to gross up CIAC (Exhibit III), the gross-up funds collected significantly reduce required debt financing, resulting in an improvement in the TIE ratio. Although the TIE ratio is projected at 2.01 in 1991 and lower in 1992, the ratio is stronger than under the no gross-up projection. This also demonstrates that if allowed to gross up CIAC, PCUC's debt borrowings do not exceed currently available facilities until 1995, when the TIE ratio will be significantly above 2.00.

As I discussed in my testimony in this docket, use of a TIE ratio test is only one measure of a company's overall financial health. However, it does provide an indication of a company's ability to service its debt. As can be seen in Exhibits III and IV, if PCUC is not allowed to gross up CIAC for taxes, its debt borrowings are significantly increased and its TIE ratio is significantly reduced. PCUC is projecting a TIE ratio below 2.00 even if allowed to gross up CIAC, with the projected TIE ratio significantly deteriorating if the gross-up is not allowed. This indicator supports PCUC's decision to gross up.

Alternative Financing

Under both the NPV gross-up and no gross-up cases, the effect of PCUC's high level of capital additions in 1991 is evident, resulting in significant additional debt requirements. PCUC management has anticipated this financing requirement and maintained total debt facilities of $12 million. However, under the no gross-up case, PCUC's available debt facilities would be exceeded in 1995 by over $4 million due entirely to the requirement to finance taxes on CIAC. You have stated to me that sources of financing to pay these CIAC-related taxes have not been obtained.

You have stated that a majority of PCUC's CIAC is received from individuals, not developers. Therefore, you have not considered developer financing to be a viable borrowing source for funds to pay CIAC taxes. In addition, I agree with you that the record-keeping requirements related to numerous homeowner loans are generally onerous and not cost-effective. Even if debt financing from developers or homeowners were obtained, the customer rate effects of the no gross-up method would still apply.

Based upon the above projections and analysis, I understand that PCUC management believes that continued authority to gross up CIAC is critical to the financial health of the company. Based upon my review of these same projections, I agree that CIAC gross-up funds represent an important and material source of funds during the projected period and that PCUC's overall financial health would be harmed if CIAC gross-up is not allowed and the corresponding required rate increases to cover the carrying costs of financing the CIAC taxes are not granted.

Competitive Pressures

You have stated to me that the issue of competitive pressures was considered in the development of PCUC's conclusion that it needs to gross up, but it was not a significant factor in making that determination.

Summary

After having considered and evaluated the previously described facts and circumstances of PCUC and in view of the current service availability policies in Florida, I concur with your position that a NPV gross-up of CIAC is needed for PCUC and I believe your position is well supported and consistent with the guidelines described in Order No. 23541. I understand your selection of the NPV gross-up over a full gross-up is based on management's position that the NPV method more appropriately balances the interests of all parties, particularly the contributors, and I concur with this position. Again, my

onclusions are based upon the particular facts and circumstances of PCUC as described herein and do not represent a general endorsement by me of the need for all utilities to gross up or the preferability in all cases of one gross-up method over another.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Thomas L. Elliott III

Thomas L. Elliott III

ARTHUR ANDERSEN & CO.

ATLANTA, GEORGIA

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Trustees of
ZF Steering Gear (U.S.), Inc./
Lemforder Corporation
Retirement and Savings Plan:

We were engaged to audit the accompanying statement of net assets available for plan benefits of the ZF STEERING GEAR (U.S.), INC./LEMFORDER CORPORATION RETIREMENT AND SAVINGS PLAN as of December 31, 1990, the related statement of changes in net assets available for plan benefits for the year then ended, and the supplemental schedules of investments and reportable transactions as of and for the year ended December 31, 1990. These financial statements and schedules are the responsibility of the Plan's management.

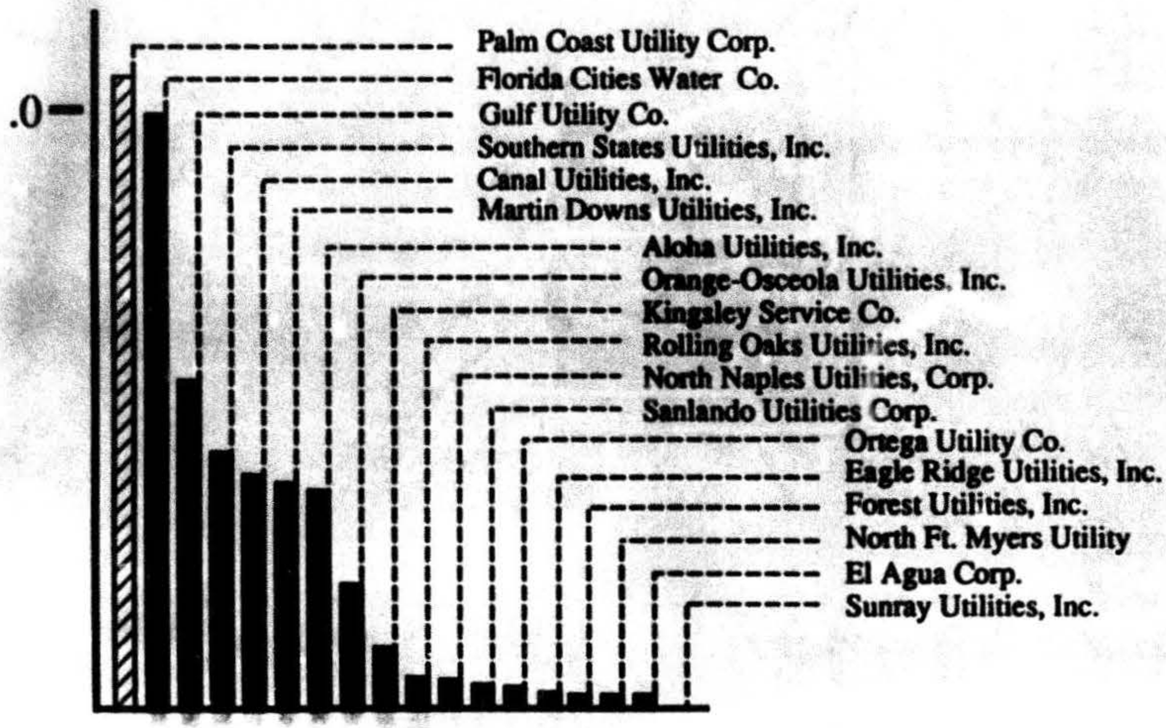
As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note 4, which was certified by Fleet Bank of Maine and Sovran Bank, N.A., the custodians of the Plan, except for comparing the information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the custodians hold the Plan's investment assets and execute investment transactions. The plan administrator has obtained a certification from the custodians as of and for the year ended December 31, 1990 that the information provided to the plan administrator by the custodians is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the custodians, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Arthur Andersen & Co.

June 6, 1991

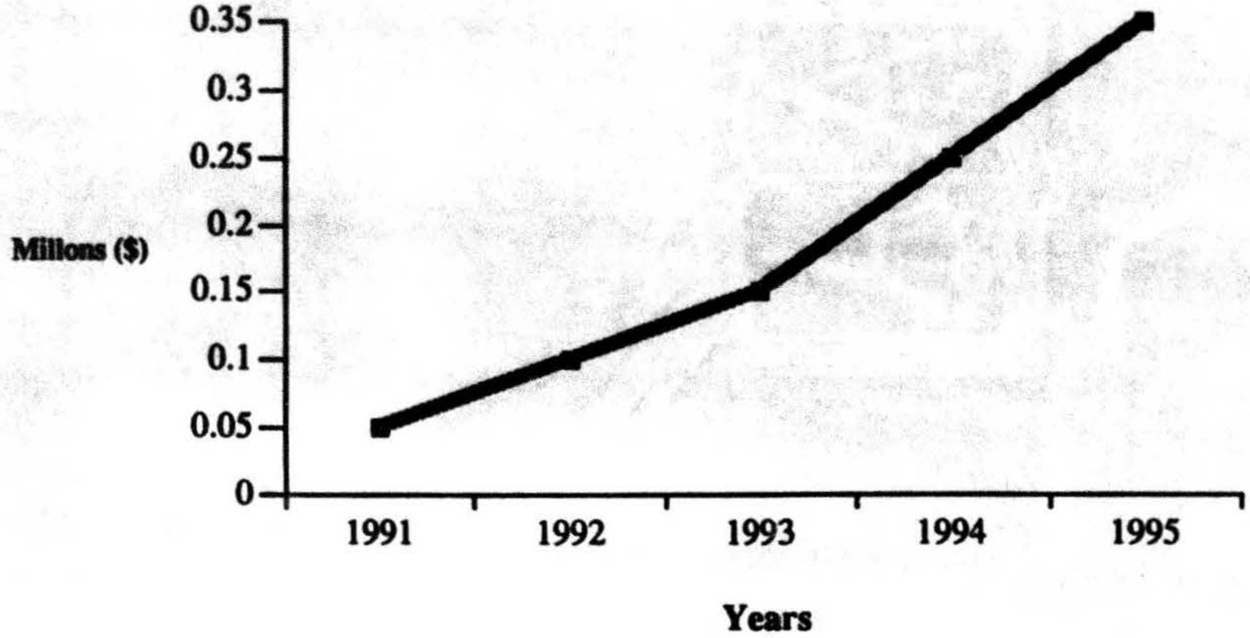
1989 TAXABLE INCOME FROM CIAC AND GROSS-UP AMOUNTS



The above data was derived by the Company.

PALM COAST UTILITY CORPORATION

Difference in Customer Revenue Requirements: No Gross-Up Over NPV Gross-Up



SOURCE: The above graph was developed from PCUC projected financial data for the years 1991 through 1995.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NET PRESENT VALUE GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual	Projected Year Ended December 31				
	1990	1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Contributions subject to gross-up	2,282	3,147	3,366	4,318	3,115	4,302
Other contributions	1,523	1,962	2,056	2,120	2,143	2,109
Gross-up contributions	480	1,013	1,084	1,391	1,003	1,385
Other timing differences, net	695	(1,617)	(1,823)	(2,178)	(2,686)	(3,410)
TAXABLE INCOME	$5,934	$ 5,775	$5,179	$7,064	$ 6,064	$ 7,385
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 2,173	$1,949	$2,658	$ 2,282	$ 2,779
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ 1,013	$1,084	$1,391	$ 1,003	$ 1,385
Net cash flow from operations	2,978	1,797	1,351	1,852	2,551	2,984
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	7,919	7,857	9,681	8,812	10,780
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(1,239)	(1,717)	(1,820)	(990)	(1,314)
Total uses	(7,767)	(14,797)	(6,157)	(8,332)	(10,155)	(13,181)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(6,878)	$1,700	$1,349	$(1,343)	$(2,401)
YEAR-END DEBT BALANCE	$4,500	$11,401	$9,722	$8,402	$ 9,772	$12,210
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	962	445	1,374	2,348	2,646
Add debt interest	364	954	1,267	1,087	1,090	1,319
EARNINGS BEFORE INTEREST AND TAXES	$1,156	$ 1,916	$1,712	$2,461	$ 3,438	$ 3,965
DEBT INTEREST	$ 364	$ 954	$1,267	$1,087	$ 1,090	$ 1,319
"TIMES INTEREST EARNED" RATIO	3.18	2.01	1.35	2.26	3.15	3.01

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NET PRESENT VALUE GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming gross-up of contributions in aid of construction for income taxes using the net present value gross-up method ("NPV gross-up"). Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the Florida Public Service Commission as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has not received authorization of the FPSC to gross up CIAC for income taxes during the projection period. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.
- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993, resulting in a rate increase of 13% for water taking effect as an interim increase in September 1993. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

8. LONG-TERM DEBT

Long-term debt consists of a revolving long-term facility with interest based on projected LIBOR rates.

9. CONTRIBUTIONS

Contributions not subject to gross-up include prepaid sewer CIAC placed in trust and prepaid water CIAC which relate to amounts collected prior to the time homesite purchasers connect to the water and sewer system by the company's affiliate, ITT Community Development Corporation.

CIAC gross-up is computed in accordance with the net present value gross-up method as specified in FPSC Order No. 23541.

10. SIGNIFICANT VARIATION EXPLANATIONS

The following explains the cause of significant variations which occur in the projected years:

- The decrease in pretax book income from 1991 to 1992 is the result of the termination of the collection of guaranteed revenues in mid-1991 (Note 5) and a significant increase in interest expense, net of allowance for funds used during construction ("AFUDC"), upon construction of a 2 million-gallon-per-day ("MGD") water treatment facility during 1991 (Note 7).

- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).

- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).

- The large amount of 1994 and 1995 capital additions is a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NO GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual	Projected Year Ended December 31				
	1990	1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Contributions subject to gross-up	2,282	-	-	-	-	-
Other contributions	1,523	5,109	5,422	6,438	5,258	6,411
Gross-up contributions	480	-	-	-	-	-
Other timing differences, net	695	(1,697)	(1,883)	(2,233)	(2,669)	(3,397)
TAXABLE INCOME	$5,934	$ 4,637	$ 3,877	$ 5,365	$ 4,773	$ 5,586
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 1,745	$ 1,459	$ 2,019	$ 1,796	$ 2,102
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ -	$ -	$ -	$ -	$ -
Net cash flow from operations	2,978	1,740	1,248	1,711	2,426	2,798
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	6,849	6,670	8,149	7,684	9,209
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(786)	(1,241)	(1,221)	(582)	(740)
Total uses	(7,767)	(14,344)	(5,681)	(7,733)	(9,747)	(12,607)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(7,495)	$ 989	$ 416	$(2,063)	$(3,398)
YEAR-END DEBT BALANCE	$4,500	$12,020	$11,055	$10,673	$12,771	$16,215
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	917	287	1,121	2,043	2,219
Add debt interest	364	991	1,384	1,303	1,406	1,739
AVAILABLE EARNINGS	$1,156	$ 1,908	$ 1,671	$ 2,424	$ 3,449	$ 3,958
DEBT INTEREST	$ 364	$ 991	$ 1,384	$ 1,303	$ 1,406	$ 1,739
"TIMES INTEREST EARNED" RATIO	3.18	1.93	1.21	1.86	2.45	2.28

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NO GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming no gross-up of contributions in aid of construction for income taxes. Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were not grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the FPSC as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has decided or been required to gross up CIAC for income taxes. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies, except for the accounting treatment for the effects of not grossing up CIAC for income taxes, are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of not grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.

- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993 resulting in a rate increase of 15% for water, taking effect as an interim increase in September 1993 and a final increase in 1994. The effect of not grossing up CIAC for income taxes results in 2% of the above water rate increase. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

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The following explains the cause of significant variations which occur in the projected years:

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- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).

- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).

- The large amount of 1994 and 1995 capital additions are a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.

ARTHUR ANDERSEN & CO.

133 PEACHTREE STREET, N.E.
ATLANTA, GEORGIA 30303
(404) 658-1776

April 30, 1991

Mr. Roy W. Likins
President
Palm Coast Utility Corporation
Two Utility Drive
Palm Coast, Florida 32137

Dear Mr. Likins:

This letter is written in response to your request that we review and document certain matters associated with Palm Coast Utility Corporation's ("PCUC") petition filed in response to Florida Public Service Commission ("FPSC") Order No. 23541 in Docket No. 860184-PU for continued authority to gross up contributions in aid of construction ("CIAC") for income taxes using the net present value ("NPV") method. This letter supersedes my previous letter dated October 23, 1990 and is solely for use by PCUC in petitioning the FPSC for continued authority to gross up CIAC using the NPV method and is not to be used, referred to, or distributed for any other purpose or to any other party.

As you are aware, I am a partner in Arthur Andersen & Co., a firm of independent public accountants, at 133 Peachtree Street, N.E., in Atlanta, Georgia. I am currently a partner in the energy and telecommunications practice of the Atlanta office of Arthur Andersen & Co. I have previously presented testimony in Docket No. 860184-PU, under which Order No. 23541 was issued.

In this letter, I will discuss certain facts and circumstances of PCUC, as management has presented them to me, and the application and relevance of these facts and circumstances to management's decision to request continued authority to gross up CIAC within the guidelines discussed in Order No. 23541 and the considerations I identified in my earlier testimony related to this docket. The information provided to me has not been audited, although we have performed certain limited testing of PCUC's forecasting system discussed later in this letter.

Order No. 23541 states that "the need for gross-up should be determined on a case-by-case basis, based upon the facts and circumstances peculiar to each utility." The important factors which must be considered in making the decision to gross up include:

1. Fairness of the charge to the customer, the contributor, and the utility.

2. Effect of the decision on long-run customer revenue requirements.

3. Rate stability.

4. Assignment of costs to cost causes, including cost of new growth policies.

5. The utility's cash flow and availability of alternative financing sources.

6. Competitive pressures, including potential bypass issues.

Following is a brief discussion of each of these considerations as they relate to PCUC and the information you have provided me.

Fairness of the Charge

Fairness is, of course, a subjective determination. In the case of CIAC tax funding, the fairness to the customer, the contributor, and the utility must be considered. You have stated that in your opinion, the NPV gross-up is the most fair method in the case of PCUC, as it achieves what you believe to be the best balance of the interests of all three parties (the customer, the contributor, and PCUC) affected by the decision.

I understand you have selected the NPV method because you believe it to be a fair method of collecting the cost of taxes attributable to CIAC. As I stated in my testimony in Docket No. 860184-PU, the NPV gross-up method is a fair method to the customer, the contributor, and PCUC. As a revenue-neutral method, NPV gross-up is fair to the customers. Since only the carrying costs associated with the taxes on CIAC are collected from the contributor, NPV is fair to the contributor. As I testified in the Docket No. 860184-PU hearing, the carrying cost of financing the taxes on CIAC are the true economic costs since the taxes are recouped through future tax depreciation benefits. PCUC is made whole on the carrying costs of financing the CIAC taxes, and the financing of those taxes is not an unreasonable burden on PCUC; therefore, the NPV gross-up is fair to PCUC. In the case of PCUC, the relative importance of CIAC to the customer and the Company is magnified, since, based upon data you have supplied to me, PCUC collects more CIAC than any other FPSC-regulated water and wastewater utility which grosses up (Exhibit I).

Customer Revenue Requirements and Rate Stability

As was discussed by me and other witnesses during the hearing related to Docket No. 860184-PU, the NPV gross-up method of funding CIAC taxes is revenue neutral and the no gross-up method creates a future customer revenue requirement. The issue then is the higher customer revenue requirements in the no gross-up environment compared to what they will be if PCUC continues its present policy of NPV gross-up. Due to the relative importance of CIAC to PCUC, if PCUC were not allowed to gross up, customer revenue requirements will be cumulatively $921,000 higher over the next five years. This is graphically illustrated by Exhibit II. This represents an increase in customer revenue requirements of 3.4% per ERC in 1995. You have stated that PCUC believes that not grossing up results in imposing on existing customers' costs associated with new growth, and I concur with your analysis. PCUC management does not wish to impose these costs on existing customers.

As Exhibit II illustrates, this revenue requirement continues to increase over time as more and more new growth occurs. This will have the effect of leading to higher rates and less rate stability.

Assignment of Costs

You have stated that PCUC believes, and I concur, that the tax costs of CIAC should be assigned in a manner consistent with the CIAC itself. As previously discussed, the NPV method assigns the true economic costs of CIAC taxes to the contributor, giving the contributor the benefit of the future tax depreciation benefits.

Cash Flow and Financing

Order No. 23541 requests certain information concerning cash flow and financing. Specifically, the order requests demonstration of an actual tax liability, a demonstration that sources of funds are not available at a reasonable cost, a cash flow statement, and a statement of interest coverage. Under my supervision, we have prepared two schedules which present this information based on amounts projected by PCUC for the years 1991 through 1995. The source of this data and the related notes are PCUC's projected financial data for the years 1991 through 1995. The first schedule (Exhibit III) projects the data assuming PCUC is able to utilize the NPV gross-up method to fund CIAC taxes. The second schedule (Exhibit IV) projects the data assuming PCUC is not able to utilize NPV gross-up and uses the no gross-up method.

We have performed limited testing procedures related to PCUC's forecasting system from which the data in Exhibit III and Exhibit IV was obtained. The scope of our work was not designed to enable us to issue a report under the

reporting standards as established by the American Institution of Certified Public Accountants ("AICPA") for review of forecasts and projections. As you are aware, the scope of testing which would be required in order to allow us to comply with the AICPA standards and issue an examination report covering projected data derived from PCUC's forecasting system is extensive, and you and I decided that such a level of testing would not be cost-effective within the requirements of this docket. Accordingly, we have not issued any form of report related to PCUC's forecasting system.

Both Exhibit III (NPV gross-up) and Exhibit IV (no gross-up) reflect an overall tax liability for PCUC in each of the years 1991 through 1995. PCUC, therefore, is projected to satisfy the order's minimum requirement that utilities grossing up CIAC actually have an "above the line" tax liability.

Following the determination of tax liability, a projected summarized cash flow statement is presented. Sources of cash (excluding debt) are net cash flow from operations and CIAC. Uses of cash (excluding debt) are capital additions, CIAC placed in trust, and prepaid taxes and other.

The net difference between sources and uses is borrowings or repayments of debt. PCUC's current debt facility consists of a long-term revolving line of credit, and this type of facility is assumed to continue through 1995.

Interest Coverage

The effect of PCUC's extensive capital program is also evident in the times-interest-earned ("TIE") ratio. If not allowed to gross up through 1993, PCUC's TIE ratio would significantly remain below the FPSC's prescribed threshold of 2.00 (Exhibit IV). Only after the forecasted rate increase in late 1993 does the TIE rise slightly above 2.00 in 1994 and 1995. If allowed to gross up CIAC (Exhibit III), the gross-up funds collected significantly reduce required debt financing, resulting in an improvement in the TIE ratio. Although the TIE ratio is projected at 2.01 in 1991 and lower in 1992, the ratio is stronger than under the no gross-up projection. This also demonstrates that if allowed to gross up CIAC, PCUC's debt borrowings do not exceed currently available facilities until 1995, when the TIE ratio will be significantly above 2.00.

As I discussed in my testimony in this docket, use of a TIE ratio test is only one measure of a company's overall financial health. However, it does provide an indication of a company's ability to service its debt. As can be seen in Exhibits III and IV, if PCUC is not allowed to gross up CIAC for taxes, its debt borrowings are significantly increased and its TIE ratio is significantly reduced. PCUC is projecting a TIE ratio below 2.00 even if allowed to gross up CIAC, with the projected TIE ratio significantly deteriorating if the gross-up is not allowed. This indicator supports PCUC's decision to gross up.

Alternative Financing

Under both the NPV gross-up and no gross-up cases, the effect of PCUC's high level of capital additions in 1991 is evident, resulting in significant additional debt requirements. PCUC management has anticipated this financing requirement and maintained total debt facilities of $12 million. However, under the no gross-up case, PCUC's available debt facilities would be exceeded in 1995 by over $4 million due entirely to the requirement to finance taxes on CIAC. You have stated to me that sources of financing to pay these CIAC-related taxes have not been obtained.

You have stated that a majority of PCUC's CIAC is received from individuals, not developers. Therefore, you have not considered developer financing to be a viable borrowing source for funds to pay CIAC taxes. In addition, I agree with you that the record-keeping requirements related to numerous homeowner loans are generally onerous and not cost-effective. Even if debt financing from developers or homeowners were obtained, the customer rate effects of the no gross-up method would still apply.

Based upon the above projections and analysis, I understand that PCUC management believes that continued authority to gross up CIAC is critical to the financial health of the company. Based upon my review of these same projections, I agree that CIAC gross-up funds represent an important and material source of funds during the projected period and that PCUC's overall financial health would be harmed if CIAC gross-up is not allowed and the corresponding required rate increases to cover the carrying costs of financing the CIAC taxes are not granted.

Competitive Pressures

You have stated to me that the issue of competitive pressures was considered in the development of PCUC's conclusion that it needs to gross up, but it was not a significant factor in making that determination.

Summary

After having considered and evaluated the previously described facts and circumstances of PCUC and in view of the current service availability policies in Florida, I concur with your position that a NPV gross-up of CIAC is needed for PCUC and I believe your position is well supported and consistent with the guidelines described in Order No. 23541. I understand your selection of the NPV gross-up over a full gross-up is based on management's position that the NPV method more appropriately balances the interests of all parties, particularly the contributors, and I concur with this position. Again, my

conclusions are based upon the particular facts and circumstances of PCUC as described herein and do not represent a general endorsement by me of the need for all utilities to gross up or the preferability in all cases of one gross-up method over another.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Thomas L. Elliott

Thomas L. Elliott III

ARTHUR ANDERSEN & CO.

ATLANTA, GEORGIA

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Trustees of
ZF Steering Gear (U.S.), Inc./
Lemforder Corporation
Retirement and Savings Plan:

We were engaged to audit the accompanying statement of net assets available for plan benefits of the ZF STEERING GEAR (U.S.), INC./LEMFORDER CORPORATION RETIREMENT AND SAVINGS PLAN as of December 31, 1990, the related statement of changes in net assets available for plan benefits for the year then ended, and the supplemental schedules of investments and reportable transactions as of and for the year ended December 31, 1990. These financial statements and schedules are the responsibility of the Plan's management.

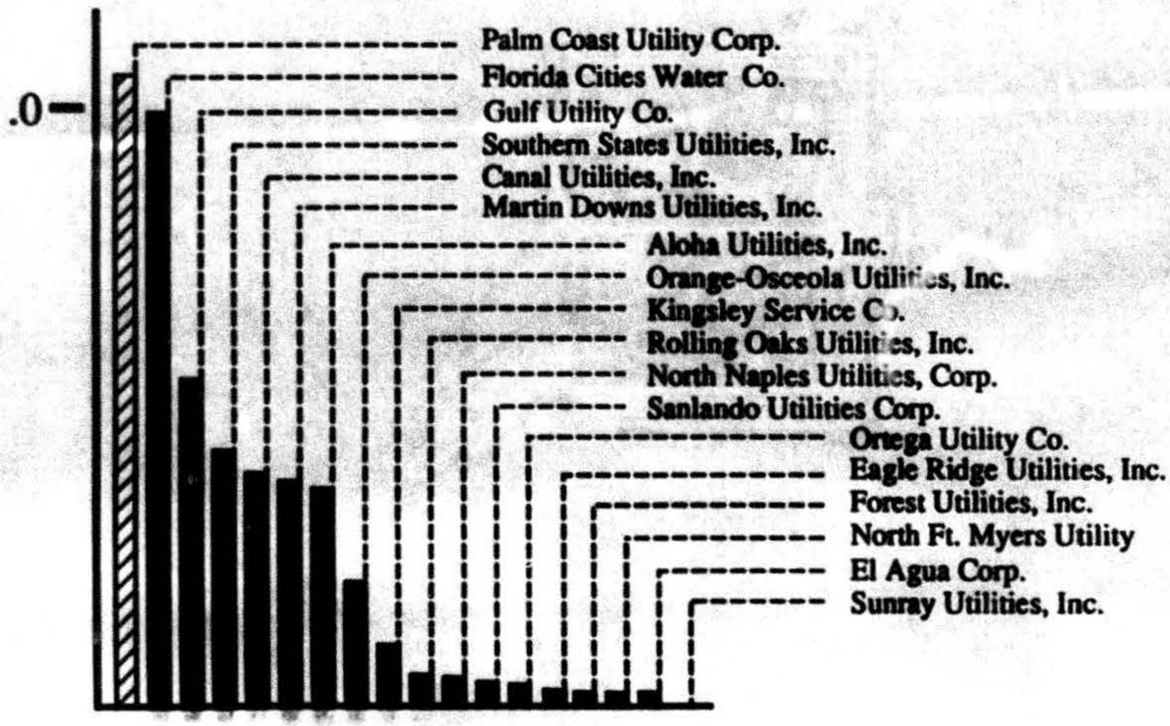
As permitted by Section 2520.103-8 of the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note 4, which was certified by Fleet Bank of Maine and Sovran Bank, N.A., the custodians of the Plan, except for comparing the information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the custodians hold the Plan's investment assets and execute investment transactions. The plan administrator has obtained a certification from the custodians as of and for the year ended December 31, 1990 that the information provided to the plan administrator by the custodians is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the custodians, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Arthur Andersen & Co.

June 6, 1991

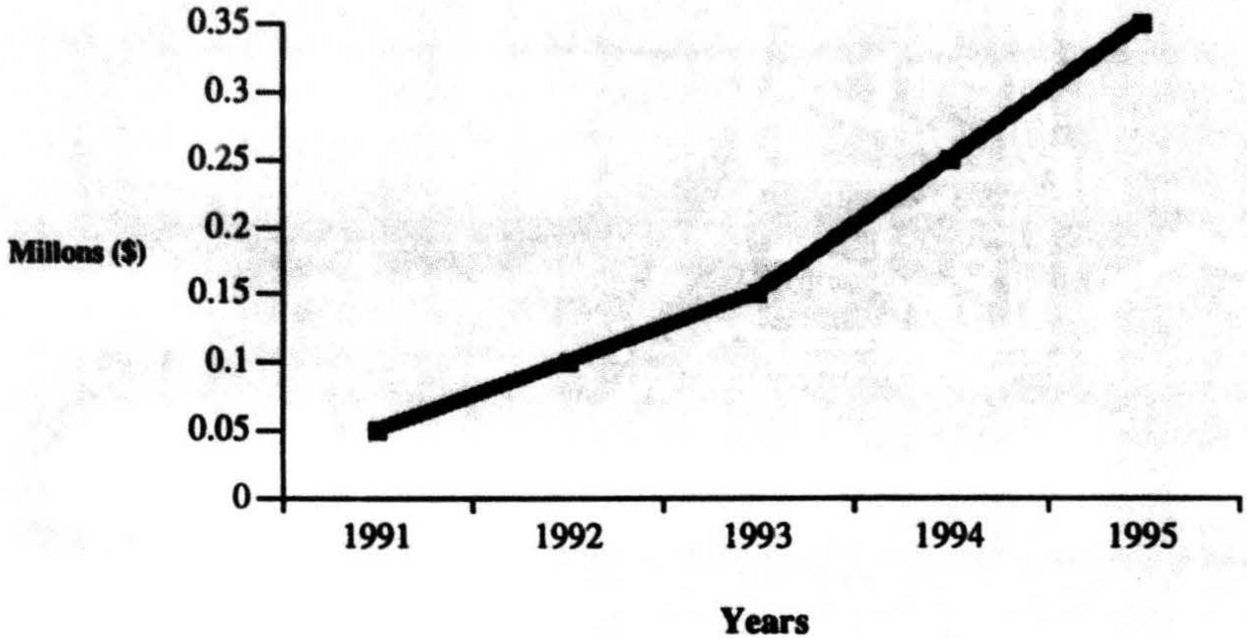
1989 TAXABLE INCOME FROM CIAC AND GROSS-UP AMOUNTS



The above data was derived by the Company.

PALM COAST UTILITY CORPORATION

Difference in Customer Revenue Requirements: No Gross-Up Over NPV Gross-Up



SOURCE: The above graph was developed from PCUC projected financial data for the years 1991 through 1995.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NET PRESENT VALUE GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual	Projected Year Ended December 31				
	1990	1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Contributions subject to gross-up	2,28[illegible]	3,147	3,366	4,318	3,115	4,302
Other contributions	1,523	1,962	2,056	2,120	2,143	2,109
Gross-up contributions	480	1,013	1,084	1,391	1,003	1,385
Other timing differences, net	695	(1,617)	(1,823)	(2,178)	(2,686)	(3,410)
TAXABLE INCOME	$5,934	$ 5,775	$5,179	$7,064	$ 6,064	$ 7,385
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 2,173	$1,949	$2,658	$ 2,282	$ 2,779
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ 1,013	$1,084	$1,391	$ 1,003	$ 1,385
Net cash flow from operations	2,978	1,797	1,351	1,852	2,551	2,984
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	7,919	7,857	9,681	8,812	10,780
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(1,239)	(1,717)	(1,820)	(990)	(1,314)
Total uses	(7,767)	(14,797)	(6,157)	(8,332)	(10,155)	(13,181)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(6,878)	$1,700	$1,349	$(1,343)	$(2,401)
YEAR-END DEBT BALANCE	$4,500	$11,401	$9,722	$8,402	$ 9,772	$12,210
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,270	$ 496	$1,413	$ 2,489	$ 2,999
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	962	445	1,374	2,348	2,646
Add debt interest	364	954	1,267	1,087	1,090	1,319
EARNINGS BEFORE INTEREST AND TAXES	$1,156	$ 1,916	$1,712	$2,461	$ 3,438	$ 3,965
DEBT INTEREST	$ 364	$ 954	$1,267	$1,087	$ 1,090	$ 1,319
"TIMES INTEREST EARNED" RATIO	3.18	2.01	1.35	2.26	3.15	3.01

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NET PRESENT VALUE GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming gross-up of contributions in aid of construction for income taxes using the net present value gross-up method ("NPV gross-up"). Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the Florida Public Service Commission as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has not received authorization of the FPSC to gross up CIAC for income taxes during the projection period. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.
- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993, resulting in a rate increase of 13% for water taking effect as an interim increase in September 1993. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

8. LONG-TERM DEBT

Long-term debt consists of a revolving long-term facility with interest based on projected LIBOR rates.

9. CONTRIBUTIONS

Contributions not subject to gross-up include prepaid sewer CIAC placed in trust and prepaid water CIAC which relate to amounts collected prior to the time homesite purchasers connect to the water and sewer system by the company's affiliate, ITT Community Development Corporation.

CIAC gross-up is computed in accordance with the net present value gross-up method as specified in FPSC Order No. 23541.

10. SIGNIFICANT VARIATION EXPLANATIONS

The following explains the cause of significant variations which occur in the projected years:

- The decrease in pretax book income from 1991 to 1992 is the result of the termination of the collection of guaranteed revenues in mid-1991 (Note 5) and a significant increase in interest expense, net of allowance for funds used during construction ("AFUDC"), upon construction of a 2 million-gallon-per-day ("MGD") water treatment facility during 1991 (Note 7).

- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).

- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).

- The large amount of 1994 and 1995 capital additions is a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.

PALM COAST UTILITY CORPORATION

SELECTED FINANCIAL DATA

ASSUMING NO GROSS-UP OF CONTRIBUTIONS IN AID OF CONSTRUCTION

(In Thousands, Except Ratios)

	Actual	Projected Year Ended December 31				
	1990	1991	1992	1993	1994	1995
CURRENT TAX LIABILITY:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Contributions subject to gross-up	2,282	-	-	-	-	-
Other contributions	1,523	5,109	5,422	6,438	5,258	6,411
Gross-up contributions	480	-	-	-	-	-
Other timing differences, net	695	(1,697)	(1,883)	(2,233)	(2,669)	(3,397)
TAXABLE INCOME	$5,934	$ 4,637	$ 3,877	$ 5,365	$ 4,773	$ 5,586
INCOME TAXES AT 37.63% (ROUNDED)	$2,233	$ 1,745	$ 1,459	$ 2,019	$ 1,796	$ 2,102
SUMMARIZED CASH FLOW STATEMENT:						
Sources (excluding debt):						
Gross-up contributions	$ 480	$ -	$ -	$ -	$ -	$ -
Net cash flow from operations	2,978	1,740	1,248	1,711	2,426	2,798
Contributions received	3,805	5,109	5,422	6,438	5,258	6,411
Total receipts	7,263	6,849	6,670	8,149	7,684	9,209
Uses (excluding debt):						
Capital additions	(5,461)	(12,743)	(3,608)	(5,661)	(8,308)	(11,029)
Contributions placed in trust	(693)	(815)	(832)	(851)	(857)	(838)
Prepaid taxes and other	(1,613)	(786)	(1,241)	(1,221)	(582)	(740)
Total uses	(7,767)	(14,344)	(5,681)	(7,733)	(9,747)	(12,607)
(BORROWINGS) REPAYMENTS OF DEBT	$ (504)	$(7,495)	$ 989	$ 416	$(2,063)	$(3,398)
YEAR-END DEBT BALANCE	$4,500	$12,020	$11,055	$10,673	$12,771	$16,215
INTEREST COVERAGE:						
Pretax book income	$ 954	$ 1,225	$ 338	$ 1,160	$ 2,184	$ 2,572
Less AFUDC	(162)	(308)	(51)	(39)	(141)	(353)
	792	917	287	1,121	2,043	2,219
Add debt interest	364	991	1,384	1,303	1,406	1,739
AVAILABLE EARNINGS	$1,156	$ 1,908	$ 1,671	$ 2,424	$ 3,449	$ 3,958
DEBT INTEREST	$ 364	$ 991	$ 1,384	$ 1,303	$ 1,406	$ 1,739
"TIMES INTEREST EARNED" RATIO	3.18	1.93	1.21	1.86	2.45	2.28

The above selected data were derived from projections developed by the company. See accompanying summary of significant projection assumptions.

PALM COAST UTILITY CORPORATION

SUMMARY OF SIGNIFICANT PROJECTION ASSUMPTIONS

YEARS ENDED DECEMBER 31, 1991 THROUGH 1995

NO GROSS-UP

This projected selected financial data represents, to the best of management's knowledge and belief, the company's projected results for the selected data presented during the projection period, assuming no gross-up of contributions in aid of construction for income taxes. Accordingly, the projected data reflects management's judgment as of October 23, 1990, the date of this projected data, of the expected conditions and its expected course of action if CIAC were not grossed up for income taxes, as revised for the effects of 1990 actual results. The projected data is designed to provide information to the FPSC as required under Order No. 23541. Accordingly, this projected data should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected data; however, management has decided or been required to gross up CIAC for income taxes. There will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies, except for the accounting treatment for the effects of not grossing up CIAC for income taxes, are the same as those disclosed in the company's financial statements for the year ended December 31, 1990. Those financial statements should be read for additional information (Exhibit V).

The accounting treatment for the effects of not grossing up CIAC for income taxes are the same as those required by the FPSC in Order No. 23541, except that prepaid deferred income taxes resulting from CIAC are treated as a component of rate base. On October 16, 1990, the company filed a motion requesting the FPSC to reconsider the capital structure normalization provisions of the order.

2. INCOME TAXES

Income taxes are computed at the statutory rates in effect at October 23, 1990.

3. CUSTOMER RATES

For 1991 and 1992, customer rates are forecast using rates currently in effect plus an annual operating and maintenance indexing factor approximating 2%. Usage is forecast based on management's estimates of future customer usage as follows:

- Usage per residential customer is constant at 139 gallons per ERC per day.

- New customer growth is forecast based on forecasts provided by the company's affiliate, ITT Community Development Corporation.

The projections assume a rate case in 1993 resulting in a rate increase of 15% for water, taking effect as an interim increase in September 1993 and a final increase in 1994. The effect of not grossing up CIAC for income taxes results in 2% of the above water rate increase. This would result in fully compensatory rates for water service. No increase is projected for sewer rates.

Usage, customer growth, and the annual operating and maintenance indexing factor are expected to continue the trends from 1991 and 1992, as discussed above with the 1993 rate case rates as a base.

4. OPERATING AND MAINTENANCE EXPENSES

Operating and maintenance expenses are forecast to increase as warranted by the demands of customer growth to provide safe and adequate service. Inflation is expected to increase costs at 5% per year.

5. GUARANTEED REVENUES

Guaranteed revenues are in effect through June 1991, the date the underlying agreement, as amended, terminates.

6. USED AND USEFUL PERCENTAGES

Used and useful percentages of cost of service and rate base are forecast consistent with the methodology used in Order No. 22843, the company's most recent rate order.

7. CAPITAL ADDITIONS

Capital expenditures for additional water and wastewater treatment capacity are forecast to provide approximately a six-month lead time in excess treatment capacity. Capital additions in 1991 include construction of the first two-million-gallon-per-day phase of a water treatment facility and appurtenances totaling approximately $7 million.

Expenditures for system strengthening and/or main extensions to serve additional general service requirements are forecasted based as demands placed upon the water and sewer system are brought about by customer growth.

8. LONG-TERM DEBT

Long-term debt consists of a revolving long-term facility with interest based on projected LIBOR rates.

9. SIGNIFICANT VARIATION EXPLANATIONS

The following explains the cause of significant variations which occur in the projected years:

- The decrease in pretax book income from 1991 to 1992 is the result of the termination of the collection of guaranteed revenues in mid-1991 (Note 5) and a significant increase in interest expense, net of AFUDC, upon construction of a 2 MGD water treatment facility during 1991 (Note 7).
- The increase in pretax book income from 1992 to 1993 and from 1993 to 1994 is a result of a projected interim rate increase in 1993 and a final rate increase in 1994 (Note 3).
- The large amount of 1991 capital additions is due to construction of a 2 MGD water treatment facility to meet capacity requirements (Note 7).
- The large amount of 1994 and 1995 capital additions are a result of projected construction of a 1 MGD wastewater treatment facility, including effluent disposal in order to meet projected capacity requirements.