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MEMORANDUM

JANUARY 22, 1998

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)
FROM: DIVISION OF WATER & WASTEWATER (JOHNSON)
DIVISION OF LEGAL SERVICES (JAEGER) *[Handwritten initials]*
RE: DOCKET NO. 980076-SU - DISPOSITION OF CONTRIBUTION IN AID
OF CONSTRUCTION BY HUDSON UTILITIES, INC. D/B/A HUDSON
BAY COMPANY
COUNTY: PASCO
AGENDA: FEBRUARY 3, 1998 - REGULAR AGENDA - PROPOSED AGENCY
ACTION - INTERESTED PERSONS MAY PARTICIPATE
CRITICAL DATES: NONE
SPECIAL INSTRUCTIONS: S:\PSC\WAW\WP\980076.RCM

CASE BACKGROUND

Hudson is a Class B wastewater utility providing service to the public in Pasco County. As of December 31, 1996, the Utility served 1,337 wastewater customers. The Utility had gross operating revenues of \$714,244, and reported net operating income of \$101,919.

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

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

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FPSC-RECORDS/REPORTING

DOCKET NO. 980076-SU
JANUARY 22, 1998

In Order No. 23541, the Commission required any water and wastewater utility already collecting the gross-up on CIAC and wishing to continue, to file a petition for approval with the Commission on or before October 29, 1990. On November 30, 1992, pursuant to Order No. 23541, Hudson Utilities, Inc., D/B/A Hudson Bay Company (Hudson or Utility) filed for initial authority to gross-up CIAC. The information as filed met the filing requirements of Order No. 23541. By Order No. PSC-93-0206-FOF-SU, issued February 9, 1993, the Commission allowed the utility's proposed tariff to become effective by operation of law on an interim basis for gross-up on CIAC. Order No. PSC-93-0962-FOF-SU, issued June 28, 1993, granted Hudson Utilities authority to gross-up.

On September 9, 1992, this Commission issued Proposed Agency Action (PAA) Order No. PSC-92-0961-FOF-WS, which clarified the provisions of Orders Nos. 16971 and 23541 for the calculation of refunds of gross-up of CIAC. An amendatory PAA Order was issued on September 14, 1992. On October 12, 1994, PAA Order No. PSC-94-1265-FOF-WS revised the full gross-up formula. No protests were filed, and these Orders became final.

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

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

DOCKET NO. 980076-SU
JANUARY 22, 1998

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

On September 30, 1997, Hudson Utilities, Inc., submitted its 1996 CIAC Gross-up Report. In that report, Hudson suggested that it be allowed recovery of 50% of the accounting and legal expenses related to the preparation of the 1996 gross-up refund report as was allowed in Docket No. 961152-SU.

This recommendation addresses the amount of CIAC gross-up funds that should be refunded for 1996 and Hudson's request that it be allowed recovery of 50% of the accounting and legal expenses related to the preparation of the 1996 gross-up refund report.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission accept the settlement proposal of Hudson Utilities, Inc., and require the utility to refund excess gross-up collections plus accrued interest for the year 1996?

RECOMMENDATION: Yes. The Commission should accept Hudson's request that it be allowed recovery of 50% (\$3,044) of the accounting and legal expenses related to the preparation of the 1996 gross-up refund report. Based on the allowed recovery of 50 percent of the accounting and legal expenses, the utility should refund \$10,592. In addition to the refund amount, the utility should refund accrued interest through the date of refund, for gross-up of CIAC collected in excess of the tax liability. In accordance with Orders Nos. 16971 and 23541, all refunds should be made on a pro rata basis to those persons who contributed the taxes. The refunds should be completed within six months. The utility should submit copies of canceled checks, credits applied to monthly bills or other evidence which verifies that the refunds have been made, within 30 days from the date of refund. Within 30 days from the date of refund, the utility also should file a list of unclaimed refunds detailing contributor and amount, and an explanation of the efforts made to make the refunds. (JOHNSON)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, Hudson filed its 1996 annual CIAC report regarding its collection of gross-up for the year. The utility has requested that 50% of the \$6,088 of legal and accounting costs incurred for filing the CIAC report be deducted from the amount of the refund. Hudson indicated that it was willing to accept the same arrangement which it received in a previous case (Docket No. 961152-SU). In Docket No. 961152-SU, which addressed the disposition of gross-up funds collected by Hudson in 1993-1994, the Commission voted to accept Hudson's settlement proposal to allow recovery of 50% (\$3,044) of the legal and accounting fees incurred in preparing the CIAC reports. The utility submitted its proposed offer of settlement in this proceeding, whereby it is proposing that 50% of the legal and accounting fees be included in the refund calculated for 1996.

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

DOCKET NO. 980076-SU
JANUARY 22, 1998

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

Therefore, staff believes that once the contributors have paid the gross-up taxes on the CIAC, the contributors have fulfilled their obligation under Orders Nos. 16971 and 23541. Further, since those orders also provide that gross-up in excess of the utility's actual tax liability should be refunded on a pro rata basis to those persons who contributed the taxes, staff believes that once the tax liability is determined, it is the responsibility of the Commission to ensure that excess payments of CIAC taxes are refunded in compliance with those Orders. Therefore, staff does not believe that a reduction in the amount of refund a contributor is entitled to receive as a result of his overpayment of gross-up taxes is appropriate. Staff acknowledges that those costs were incurred to satisfy regulatory requirements; however, staff does not believe that the contributors should be held responsible for the legal and accounting costs incurred to determine whether they are entitled to a refund. Staff views those costs as a necessary cost of doing business, and as such, staff believes it is appropriate for the utility to seek recovery of those amounts in a rate proceeding. Staff believes that this situation is similar to when a utility files for an increase in service availability charges. The costs of processing the utility's service availability case is borne by the general body of ratepayers, although the charges are set for future customers.

However, as in the other Hudson case (Docket No. 961152-SU), staff recognizes in this case that acceptance of the settlement proposal would avoid the substantial cost associated with a hearing, which may in fact exceed the amount of the legal and accounting cost to be recovered. Staff further notes that the actual costs associated with making the refunds have not been included in these calculations and will be absorbed by the utility. Moreover, staff believes the utility's settlement proposal is a reasonable "middle ground". Therefore, staff recommends that while not adopting the utility's position, the Commission accept Hudson's settlement proposal that it be allowed to offset 50% (\$3,044) of the legal and accounting cost incurred for filing the CIAC report, against the refund.

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

ANNUAL GROSS-UP REFUND AMOUNTS

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

1996

The utility proposes a base refund of \$13,637 and the recovery of \$3,044 in cost for preparing the refund report in 1996. Inclusion of the CIAC filing costs in the refund calculation resulted in a net total refund of \$10,592. Staff believes that a refund of \$10,592 for excess gross-up collections for 1996 is appropriate, and as previously stated, staff has included 50% (\$3,044) of the accounting and legal costs for preparing the refund report in the refund calculation.

Based upon our review of the utility's 1996 filing, the utility incurred an above-the-line loss of \$20,287 prior to the inclusion of taxable CIAC and gross-up. The report indicates a total of \$32,400 in gross-up collections were received, with first year's depreciation of \$2,614 associated with \$54,000 in taxable CIAC. Order No. 23541 requires that CIAC income be netted against the above-the-line loss; therefore, staff has made a reduction to the total amount of taxable CIAC to reflect the loss. When the above-the-line loss of \$20,287 is netted with the total taxable CIAC of \$54,000; less the first year's depreciation of \$2,614 the amount of taxable CIAC resulting in a tax liability is \$31,099. Staff has used the reported 37.63% combined marginal federal and state tax rate applied to the net \$31,099 of taxable CIAC to calculate income taxes of \$11,703. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect of the CIAC is calculated to be \$18,764. However, as previously stated, Hudson requested that the Commission accept its settlement proposal to allow recovery of 50 percent (\$3,044) of the legal and accounting costs incurred (\$6,088) for preparation of the CIAC reports. Staff recommends that the Commission accept the utility's settlement proposal. Therefore, the total recoverable cost is \$21,808. The utility collected \$32,400 in gross-up taxes. Based upon the foregoing, staff calculates a refund of \$10,592 for 1996. This amount does not include the accrued interest which, also must be refunded from December 31, 1996 to the date of refund.

If the Commission approves the refund, the refund should be completed within 6 months of the effective date of the order.

DOCKET NO. 980076-SU
JANUARY 22, 1998

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

DOCKET NO. 980076-SU
JANUARY 22, 1998

ISSUE 2: Should the docket be closed?

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

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

STAFF CALCULATED GROSS-UP REFUND

HUDSON UTILITIES, INC.

SOURCE: (Line references are from CIAC Reports)

	<u>1996</u>
1 Form 1120, Line 30 (Line 15)	\$ 63,499
2 Less CIAC (Line 7)	(54,000)
3 Less Gross-up collected (Line 19)	(32,400)
4 Add First Year's Depr on CIAC (Line 8)	2,614
5 Add/Less Other Effects (Lines 20 & 21)	0
6	-----
7 Adjusted Income Before CIAC and Gross-up	\$ (20,287)
8 Taxable CIAC (Line 7)	54,000
9 Less first years depr. (Line 8)	(2,614)
10	-----
11 Taxable CIAC Resulting in a Tax Liability	\$ 31,099
12 Less: NOL Carrforward	0
13	-----
14 Net Taxable CIAC	\$ 31,099
15 Effective state and federal tax rate	37.63%
16	-----
17 Net Income tax on CIAC	\$ 11,703
18 Less ITC Realized	0
19	-----
20 Net Income Tax	\$ 11,703
21 Expansion Factor for gross-up taxes	1.603334937
22	-----
23 Gross-up Required to pay tax effect	\$ 18,764
24 Net Legal & Accounting Offset	3,044
25	-----
26 Total Cost Recoverable	\$ 21,808
27 Less CIAC Gross-up collected (Line 19)	(32,400)
28	-----
29 TOTAL OVERCHARGED	\$ (10,592)
30	=====
31	
32 TOTAL OVERCHARGED	\$ (10,592)
33	=====