



Public Service Commission

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RECORDS AND REPORTING
BAY
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JAEG

DATE: AUGUST 20, 1998

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

FROM: DIVISION OF WATER AND WASTEWATER (GILCHRIST)
DIVISION OF AUDITING AND FINANCIAL ANALYSIS (CAUS)
DIVISION OF LEGAL SERVICES (JAEG)

RE: DOCKET NO. 980695-WS - DISPOSITION OF GROSS-UP FUNDS
COLLECTED BY LAKE GROVES UTILITIES, INC.
COUNTY: LAKE

AGENDA: SEPTEMBER 1, 1998 - REGULAR AGENDA - PROPOSED AGENCY
ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\WAW\WP\980695.RCM

CASE BACKGROUND

Lake Groves Utilities, Inc. (LGU or utility), is a Class C utility providing service to approximately 484 water and 483 wastewater customers in Lake County. According to its 1997 annual report, the utility reported gross operating revenues of \$187,063 and \$151,481 for water and wastewater, respectively, and net operating income of \$82,887 for water and net operating income of \$80,330 for wastewater.

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

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Order No. 16971 and Order No. 23541, issued December 18, 1986 and October 1, 1990, respectively, require that utilities annually file information which would be used to determine the actual state and federal income tax liability directly attributable to the CIAC. The information would also determine whether refunds of gross-up would be appropriate. These orders also required that all gross-up collections for a tax year, which are in excess of a utility's actual tax liability for the same year, should be refunded on a pro rata basis to those persons who contributed the taxes.

However, the Small Business Job Protection Act of 1996 (The Act), which became law on August 20, 1996, provided for the non-taxability of CIAC collected by water and wastewater utilities effective retroactively for amounts received after June 12, 1996.

The disposition of gross-up funds collected by the utility for 1995 was handled in Docket No. 970113-WS, Order No. PSC-97-0255-FOF-WS, issued March 7, 1997. The purpose of this recommendation is to address the disposition of gross-up funds collected by the utility for 1996.

DISCUSSION OF ISSUES

ISSUE 1: Should Lake Groves Utilities, Inc. be required to refund excess gross-up collections for 1996?

RECOMMENDATION: Yes, the utility should refund \$16,654 for 1996 plus accrued interest through the date of refund, for gross-up collected in excess of the above-the-line tax liability resulting from the collection of taxable CIAC. According to Orders Nos. 16971 and 23541, all amounts should be refunded on a pro rata basis to those persons who contributed the taxes. The refunds should be completed within 6 months of the effective date of the order. Within 30 days from the date of the refund, the utility should submit copies of canceled checks, credits applied to 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 also should provide a list of unclaimed refunds detailing the contributor and amount, and an explanation of the efforts made to make the refunds. (GILCHRIST, CAUSSEAU)

STAFF ANALYSIS: In compliance with Orders Nos. 16971 and 23541, Lake Groves filed its 1996 annual CIAC report regarding its collection of gross-up. By letter dated April 22, 1998, staff submitted preliminary refund calculation numbers to the utility. On June 4, 1998, the utility filed a response to staff's preliminary calculation. The utility stated it disagreed with staff's above-the-line allocation of operation and maintenance (O&M) expenses. Staff's above-the-line allocation of O&M expenses is based upon the expenses reported in the utility's annual report. By correspondence dated June 25, 1998, the utility informed staff that the O&M expenses reported in its 1996 annual report were overstated by approximately \$44,000 and an amended 1996 annual report was submitted accordingly. Allowing the utility to amend its annual report to reflect O&M expenses in the amount of \$44,000 below-the-line will not cause the utility to earn outside of its authorized rate of return. Also, the utility did not file for a 1997 price index, therefore, customers will not be harmed by this action. Based upon the information contained in the amended 1996 annual report, staff calculated, and the utility agrees that a refund of \$16,654 is appropriate for 1996.

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

ANNUAL GROSS-UP REFUND AMOUNT

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 is reflected on Schedule No. 1.

The utility's 1996 CIAC report indicates that the utility had an above-the-line-loss before the inclusion of taxable CIAC in income. Order No. 23541 requires that CIAC income be netted against the above-the-line-loss; therefore, not all of the CIAC collected would create a tax liability. The utility's CIAC report indicates a total of \$426,511 in taxable CIAC was received, with \$5,458 being deducted for the first year's depreciation, resulting in net taxable CIAC of \$421,053. When this amount is netted against the above-the-line-loss of \$38,644, the amount of taxable CIAC resulting in a tax liability is \$382,409. Staff used the 37.63% combined marginal federal and state tax rate as provided in the 1996 CIAC Report to calculate net income taxes of \$143,901 on the taxable CIAC. When this amount is multiplied by the expansion factor for gross-up taxes, the amount of gross-up required to pay the tax effect on the CIAC is calculated to be \$230,722. The utility collected \$247,376 of gross-up monies; therefore, staff calculates a refund of \$16,654. This amount does not include accrued interest which must be refunded from December 31, 1996 through the date of the refund.

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

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ISSUE 2: Should this docket be closed?

RECOMMENDATION: No. Upon expiration of the protest period, this docket should remain open pending staff's verification of refunds. Staff should be given administrative authority to close the docket upon verification that the refunds have been completed, and there are no unclaimed refunds. (JAEGER)

STAFF ANALYSIS: Upon expiration of the protest period, if a timely protest is not received from 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, and there are no unclaimed refunds.

STAFF CALCULATED GROSS-UP REFUND

Lake Groves Utilities, Inc.

SOURCE: (Line references are from CIAC Reports)

	1996
1 Form 1120, Line 30 (Line 15)	\$ 631,376
2 Less CIAC (Line 7)	(426,511)
3 Less Gross-up collected (Line 19)	(247,376)
4 Add First Year's Depr on CIAC (Line 8)	5,458
	0
5 Add/Less Other Effects (Lines 20 & 21)	(1,591)
6	-----
7 Adjusted Income Before CIAC and Gross-up	\$ (38,644)
8	
9 Taxable CIAC (Line 7)	\$ 426,511
10 Less first years depr. (Line 8)	\$ (5,458)
11	-----
12 Adjusted Income After CIAC	\$ 382,409
13 Less: NOL Carry Forward	\$ 0
14	-----
15 Net Taxable CIAC	\$ 382,409
16 Combined Marginal state & federal tax rates	37.63%
17	-----
18 Net Income tax on CIAC	\$ 143,901
19 Less ITC Realized	0
20	-----
21 Net Income Tax	\$ 143,901
22 Expansion Factor for gross-up taxes	1.6033349
23	-----
24 Gross-up Required to pay tax effect	\$ 230,722
25 Less CIAC Gross-up collected (Line 19)	(247,376)
26	-----
27 (OVER) OR UNDER COLLECTION	\$ (16,654)
28	=====
29	
30 TOTAL YEARLY REFUND	\$ (16,654)
31	=====
32	
33 PROPOSED REFUND (excluding interest)	\$ (16,654)
34	=====