REQUEST OF FLORIDA WATERWORKS ASSOCIATION FOR INVESTIGATION OF PROPOSED REPEAL OF SECTION 118(b), INTERNAL REVENUE CODE CONTRIBUTIONS IN AID OF CONSTRUCTION

DOCKET NUMBER 860184-PU

DIRECT TESTIMONY OF ANN P. CAUSSEAUX

ON BEHALF OF

THE STAFF OF THE FLORIDA PUBLIC SERVICE COMMISSION

DIVISION OF AUDITING AND FINANCIAL ANALYSIS

FILED: FEBRUARY 23, 1990

DIRECT TESTIMONY OF ANN P. CAUSSEAUX

Q. What is your name and business address?

A. My name is Ann P. Causseaux and my business address is 101 E. Gaines Street, Tallahassee, Florida 32399-0865.

Q. By whom are you employed and in what capacity?

A. I am employed by the Florida Public Service commission as Chief of Tax in the Division of Auditing and Financial Analysis.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present the Commission with alternatives in regard to the tax effect of contributions in aid of construction (CIAC).

Q. What alternatives are available to the Commission in regard to the amount of taxes related to CIAC that are collected?

A. The Commission can allow:

1. all related taxes to be collected,
2. a portion of the related taxes to be collected,
3. none of the related taxes to be collected, or
4. a case-by-case determination of the amount of related taxes to be collected.

Q. What advantage does the first alternative have?

A. It provides the utility with a ready source of cost free cash. Further, it converts that cost free source of cash into net income to the utility. However, the advantage most often stated is that it requires growth to pay for itself.

Q. Do you agree that it requires growth to pay for itself?

A. Not necessarily. CIAC charges are not normally set on a customer-by-customer basis. Because of the way the CIAC charges are determined, CIAC may pay for existing plant serving existing customers. If the CIAC paid for only new construction or future construction, then it could be said to be entirely growth related.

System demand cannot usually be determined on a customer-by-customer basis yet that is the effect of this premise. Contributions are collected from those causing increased demand on the system. Thus, the contributions pay the costs associated with that increased demand.

Q. What disadvantages does this alternative have?

A. The first alternative recognizes the initial impact of receiving CIAC. However, it fails to address the impact of future depreciation that may be taken on the tax return. This is the mechanism whereby the cost free source of cash is converted into income of the utility.

The first alternative may price some potential home buyers out of the market. It may also affect the ability of some pure utilities to grow when they are surrounded by utilities who do not gross-up CIAC.

Q. What advantages does the second alternative have?

A. This alternative allows different types of CIAC to be treated differently. For example, it allows a utility in strong cash position to use a portion of that cash to pay

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The first alternative may price some potential home buyers out of the market. It may also affect the ability of some pure utilities to grow when they are surrounded by utilities who do not gross-up CIAC.

Q. What advantages does the second alternative have?

A. This alternative allows different types of CIAC to be treated differently. For example, it allows a utility in a strong cash position to use a portion of that cash to pay the

taxes that may be associated with receipt of CIAC. It allows a utility with the ability to borrow to do so to pay the taxes that may be associated with the receipt of CIAC. It allows the utility with the ability to increase its equity holdings to do so in order to pay the taxes that may result from the receipt of CIAC. It also recognizes the effect of the future depreciation that will be taken on the tax return. It allows use of cash contributions to pay the taxes that may be associated with the receipt of CIAC. This alternative also allows the utilities to be competitive with others that may be adjacent or near-by. It also makes homes in the service area competitive with those in nearby areas where there is no gross-up or where the gross-up is lower.

Q. Can a utility mortgage or bond the prepaid taxes?

A. No, it cannot. However, if the financial community becomes aware of the fact that the utility will be allowed the opportunity to earn a return on the prepaid taxes, the ability of the utilities to borrow should be enhanced.

Q. Does the second alternative have disadvantages?

A. Yes, this alternative does not recognize that use of some of the cash CIAC received will mean that there is less cash available for current or future construction or to repay the utility for its past investment in existing plant.

Q. Does the third alternative have any merit?

A. The third alternative does not single out either CIAC or the

income, some level of review is necessary. I further believe that a uniform system of accounting is necessary to protect the interests of all ratepayers and of the utilities. For example, an accounting system that at the very least adheres to the expectations of the Internal Revenue Service (IRS) protects various tax benefits of the utilities. If it also helps support the contention that CIAC is not income and so should not be taxed, it may ultimately provide an immeasurable benefit. I also realize that it may not appear cost beneficial for utilities with small customer bases or very small utilities--not affiliated with larger, more sophisticated parents--to maintain records that would normally be kept by other utilities. That, however, is a decision that should be made after informed consideration.

Q. Do you have formulae for the calculation of the tax effect of CIAC?

A. Yes, Exhibits A, B and C provide formulae for the gross-up of CIAC.

Q. What is the formula on Exhibit A?

A. The formula shown on Exhibit A grosses-up net contributed depreciable plant or plant acquired with the contributed cash to a pre-tax level that will result in the collection of the entire amount of related taxes.

Q. Please explain the formula?

A. The formula for contributed plant multiplies net contributed

plant by the result of dividing one divided by the remainder when the combined federal and state tax rate is subtracted from one. Plant is net of tax depreciation--either accelerated or straight-line. The formula also makes use of the half-year convention. That is, one half of the first year's depreciation is considered. The formula is (CP-(CP*(1/TL)*AR*.5))*(1/(1-CTR)). CP is contributed plant. TL is the tax life to be used for the contributed asset. AR is the rate at which the tax depreciation is accelerated. CTR is the combined federal and state corporate income tax rate applicable to the utility. The .5 takes into consideration half of the first year's tax depreciation.

Q. What is the formula shown on Exhibit B?

A. It calculates the amount of gross-up if the present value of the future depreciation to be taken on the tax return is considered.

Q. Please explain that formula.

A. This formula deals with depreciable contributed property, contributed cash and contributed land. The formula is (CTR/(1-CTR))*((C+CP+CL)-((((C+CP)/TL)*(1-(1+ROR)-tl))/ROR)*(CTRi/CTR)). The additions are ROR which is the utility's last allowed rate of return, C which is contributed cash, CTRi which is the tax rate expected to be in effect when the depreciation is taken on the tax return--absent a known change CTRi would equal CTR, and CL which is contributed land. The lower case -tl

is an exponent and indicates that the information should be raised to the negative power represented by the tax life of the related depreciable asset. The effect of the addition of the ROR is to use the utility's rate of return as the factor for the determination of the present value of the future depreciation deductions to taxable income. The gross-up is thus reduced.

Q. What is the formula on Exhibit C?

A. That formula would be used when the contributed property was land.

Q. Please explain the formula.

A. The formula is (CL*(1/(1-CTR))). The effect of this formula is to gross-up the entire contribution. There will be no future depreciation on the land. However, any subsequent gain on the sale of the land will be reduced by the amount of the contribution. Thus, the proceeds from the sale will not be taxed as would have been the case prior to the amendment of section 118 of the Internal Revenue Code.

Q. How could a utility prove it should be allowed to gross-up?

A. A utility could demonstrate that the gross-up is necessary to preserve the utility's financial integrity.

Q. Please explain.

A. Financial integrity can be described as the ability of a utility to meet obligations to existing investors. That is, the utility must be able to pay the interest on its indebtedness and dividends on its stock. At the same time, the utility must

retain the ability to borrow additional capital and issue more stock when needed at a reasonable cost. In order to test this ability of a regulated utility, several ratios are often used. Some are: interest coverage, AFUDC as a percentage of net income, internally generated funds as a percentage of construction expenditures, long term debt as a percent of total capital, short term debt as a percent of total capital, and earned return on equity.

Q. Are any of these ratios used in the water and sewer industry?

A. Yes, for the water and sewer industry, staff currently uses a financial integrity test based on a utility's interest coverage ratio to determine the amount of CWIP that should be allowed in rate base.

Q. How could a financial integrity test based on an interest coverage ratio be used to determine whether a utility should be allowed to gross-up?

A. The interest coverage ratio shows the number of times that interest charges are earned or covered. The ratio's purpose is to indicate the relative protection of bondholders and to estimate the probability that a company will be forced into bankruptcy by a failure to meet required interest payments. The interest coverage ratio is somewhat indicative of a utility's ability to go into the financial market and borrow money or issue stock at a reasonable cost.

A minimum interest coverage level can be established so

that a utility whose interest coverage ratio is above the minimum would not be allowed to gross-up and a utility whose interest coverage ratio is below the minimum would be allowed to gross-up. Essentially, the premise would be that the utility above the minimum would be able to maintain its financial integrity. That is, the utility would still be able to borrow at a reasonable cost.

Q. What minimum would you suggest?

A. It is my understanding that staff uses a minimum interest coverage ratio without AFUDC of 2.0x in determining the amount of construction work in progress to allow in the rate base of a water or wastewater utility. This appears to be a conservative ratio that maintains a utility's financial integrity without unduly burdening the ratepayers.

Q. Should the utility's interest coverage ratio be used in isolation to decide whether to allow the gross-up?

A. No, a cash flow analysis or budget could also be used.

Q. Why do you suggest that?

A. Interest coverage can sometimes be a poor indicator of the cash actually available to meet interest expense. It is possible for a utility to show earnings adequate to cover 2.0x interest expense while not having the cash on hand to meet the interest payments.

Further, it is difficult to develop one method of dealing with all water and sewer utilities. An interest coverage ratio

might not be appropriate in the case of a utility that was experiencing either no income from operations or net operating losses.

Q. Please explain.

A. Simply put, there is no net operating income for use in the calculation. A schedule that showed the utility's anticipated sources and uses of cash for the next year would tend to confirm that a balance sheet showing a low cash balance and few if any temporary cash investments was not a temporary phenomena.

Q. Do you have alternatives to present for the accounting treatment of the tax effect of CIAC?

A. Yes, the Commission can follow:

1. flow-through accounting or
2. normalization accounting.

If the Commission follows normalization accounting it may use one of several methods:

1. the method recommended by staff on April 20, 1989,
2. some other method such as another also considered by staff, or,
3. the method anticipated by the Internal Revenue Service (IRS).

The third method is essentially the method that should have been used for connection fees and any other item that created a debit deferred tax balance. However, connection fees have been given various treatments. They have been flowed

through much like the equity portion of AFUDC.

Q. How would flow-through accounting work?

A. The tax effect of CIAC would be recognized in the year the CIAC are received and in subsequent years as the contributed property is depreciated for tax purposes.

Q. How would normalization accounting work?

A. The tax effect of the CIAC would be recognized over the life of the asset acquired by contribution or the expenditure of contributed monies. There could also be a partial recognition currently with a partial recognition over the life of the related asset if a partial gross-up was used.

Q. What is the effect on cost of service and rate base of flow-through?

A. Cost of service will increase in the year that the CIAC is received and will decrease in the years the property is depreciated on the tax return.

Q. Is this appropriate?

A. I do not believe that it is. I believe that all ratepayers benefiting from the asset through the receipt of service should pay the associated costs. One of those costs is the tax effect of the CIAC.

If the increase in taxable income, or decrease in tax loss, is recognized in the year of receipt, ratepayers in that year will pay the cost and ratepayers in later years will receive the benefit of the deprecation taken on the tax return.

When there is a real increase in tax expense because of the receipt of the asset, the ratepayers benefiting from the asset should share in the increase. There may be a real increase in the level of the utility's tax expense because of the interrelationship of the state and federal tax laws, the age of the utility, the level of the CIAC of the utility and the tax and book lives of the asset.

Similarly, when there is a reduction in the tax expense due to depreciation of the asset, the ratepayers paying the costs associated with receiving service from the asset should receive a portion of that benefit.

Q. How can this be accomplished?

A. This can be accomplished through normalization accounting.

Q. Isn't normalization used only when there is no gross-up?

A. Normalization is required by the IRS only when there is no gross-up. That requirement appears to be based on the presumption that, because of gross-up there will be no effect on cost of service. However, that is not necessarily true. In subsequent years there is still the effect of the depreciation to be considered. Without normalization, there would be an effect on cost of service. Further, treatment of that benefit determines who receives the benefit: the utility and its stockholders, the ratepayers, or the contributor.

Q. How should the normalization be accomplished?

A. It is in this area where several alternatives have been

considered at times by staff. One alternative would be to follow the method proposed in the recommendation of April 20, 1989.

Q. What are the advantages to that method?

A. It is fairly straight forward. The utilities should not have too much difficulty following it. Indeed, it reaches the same result reached by several methods that staff has considered or that various utilities have presented for the Commission's consideration.

Q. Does this method have any disadvantages?

A. The allocation of the benefit of the depreciation to the utility and its stockholders could be seen as a disadvantage.

Q. How else could normalization be accomplished?

A. Another alternative that has been considered would be to flow back equal increments of the tax effect each year of the related asset's life.

Q. What are the advantages to this method?

A. It's relatively simple. The period of time over which the utility and it stockholders will receive the benefit of the depreciation is prolonged. In this sense, it provides for a sharing of the benefit of the contributed taxes between the utility, its stockholders and the ratepayers.

Q. Does it have any disadvantages?

A. It sounds simple but is complex. It does not follow the normalization method anticipated by the IRS. It would create

confusion on the part of utilities, consultants, analysts, auditors, and the IRS if there were at least two methods of normalization in place.

Q. Why is this?

A. Realistically, nothing is ever "all" or "none". Thus, if the Commission decided that there would be a gross-up, the time would inevitably come when equity required that, in a specific case, there would be no gross-up. This could happen to a specific charge by a utility or to all charges by a specific utility. When that time came, normalization would be required and would be required in the manner prescribed by the IRS. At that point in time, two methods of normalization would be in place. Further, if this Commission determined that the decision to allow a gross-up would continue to be on a case-by-case basis, two methods of normalization would be in place.

Q. What is the IRS required method of normalization?

A. If the IRS examined the deferred tax balances to judge their adequacy, the IRS would expect to find a debit balance of deferred taxes in the amount of the tax effect of the undepreciated balance of the related contributed plant. Further, because this Commission treats credit balance deferred taxes as zero cost capital in the capital structure, the IRS would expect to find the debit balance deferred taxes used to offset the credit balance or zero cost deferred taxes in the capital structure. The effect would be to increase the rate of

return of the utility. However, that increase would not equal the return that would have been earned on the entire property if it was not contributed. Further, it would probably not equal the cost of the contributed taxes when they were included in the amount the home buyer had to finance especially if they caused the interest to be paid by the home buyer to increase.

Q. Do you have schedules that illustrate the different accounting treatments?

A. Yes, Exhibit D illustrates flow-through accounting. Exhibit E illustrates staff's recommendation of April 20, 1989. Exhibit F illustrates the other method that staff considered. Exhibit G illustrates the IRS method of normalization.

Q. Please explain Exhibit D.

A. Exhibit D illustrates the effect of the Tax Reform Act of 1986 (TRA '86) on CIAC and thus rate base, net operating income and capital. It presents the problems that must be solved. The only journal entries shown are those related to CIAC that change or are added as result of TRA '86.

The assumptions underlying Exhibit D are:

1. The cash is not spent currently to either construct or acquire plant or land. This might not be the case.

2. CIAC related to land and cash is not amortized. This may or may not reflect actual practice in some cases.

3. CIAC amortization and book depreciation use the half year convention in the year of receipt. Again, actual practice

may vary.

Rate base is not reduced by CIAC related to cash contributions. This might vary. If it does, amortization might begin before depreciation in some cases.

5. The state tax rate is 5.50%.

6. The federal tax rate is 34.00%. This might vary.

7. Tax depreciation is 150% of the straight-line depreciation and reverts to straight-line. This might also vary.

8. The tax life of the asset is 24 years. This might vary.

9. The book life of the asset is 40 years. This might vary.

In year 1, NOI is reduced as are retained earnings. If a balance sheet approach to working capital is used, rate base is reduced. If a formula working capital approach is taken, the effect is present but hidden.

In the second year the NOI deficiency reverses and becomes an excess however small. The effect of the reduction in tax taxable income could be used:

1. to offset other current taxable income thereby reducing a potential cash out flow,

2. as a carryback to offset income taxed in a prior year thereby creating a refund and increasing cash flow,

3. to offset taxable income used in estimating current year tax payments thereby creating increasing cash flow or

reducing potential cash out flow,

4. to offset future estimated taxable income thereby reducing potential cash out flow,

5. as a carry forward to offset taxable income in future periods thereby reducing potential cash out flow. The net effect would be to enhance the cash working capital position of the utility as well as the retained earnings of the stockholders.

Q. Please explain Exhibit E.

A. Exhibit E illustrates the effect of a full gross-up. Page 1 shows the effect of the additional cash. Because the additional cash is also taxable, the tax liabilities increase and the tax expenses also increase. This serves to compound the rate base NOI and equity problems. If the tax effect were allowed to flow-through, it would have essentially the same effect as a revenue increase and would begin to reverse in the next year.

Q. Please explain Exhibit F.

A. Exhibit F illustrates the effect of combining a full gross-up with the normalization method proposed at the April 20, 1989, Agenda. The gross-up amount is treated as contributed taxes since they were paid for by the ratepayer. However, a portion of the contributed taxes is written-off in the first year to offset the permanent increase in taxes that will never reverse on either the books or the tax return. The increase is an expense of the period due solely to the contribution of the

taxes and portion which is used currently to meet that expense.

In the second year, the deferred taxes begin to reverse as the effect of tax depreciation is seen.

Q. Please explain Exhibit G.

A. Exhibit G illustrates the effect when the utility pays the taxes and uses the IRS method for normalization.

Q. What do you recommend in regard to the amount of taxes that should be collected because of the receipt of CIAC?

A. I do not believe that there should be a gross-up unless the utility is unable to pay its taxes by some other method.

Q. How would a utility show that it is not able to pay its taxes without a gross-up?

A. A utility could use a source and use of cash schedule and a financial integrity test such as times interest earned. These would use information that should be readily available to the utility and they are not complex.

Q. What formula should be used if a utility must collect taxes in order to pay its taxes?

A. Formula (CP-(CP*(1/TL)*AR*.5))*(1/(1-CTR)) calculates the full gross-up. It is the formula found on Exhibit A.

Q. How should the tax effect of CIAC be accounted for?

A. In all cases, the tax effect of CIAC should be normalized by the IRS method.

Q. Does that conclude your testimony?

A. Yes, it does.

FORMULA TO GROSS-UP NET CONTRIBUTED DEPRECIABLE PLANT

$$(CP-(CP*(1/TL)*AR*.5))*(1/(1-CTR))$$

where:

CP	= Contributed Plant
TL	= Tax Life to be used for the contributed asset
AR	= Rate at which the tax depreciation is accelerated
CTR	= Combined federal and state corporate income tax rate
.5	= To reflect the half-year convention for depreciation

EXHIBIT B
Page 1 of 1

**FORMULA TO GROSS-UP - PRESENT VALUE METHOD
FOR CONTRIBUTED
DEPRECIABLE PROPERTY, CASH, LAND**

$$(CTR/(1-CTR))*((C+CP+CL)-((((C+CP)/TL)*(1-(1+ROR)^{-tl}))/ROR)*(CTRi/CTR))$$

where:

CP	= Contributed Plant
TL	= Tax Life to be used for the contributed asset
CTR	= Combined federal and state corporate income tax rate
ROR	= Utility's last allowed Rate of Return
C	= Contributed Cash
CTRi	= Tax Rate expected to be in effect when depreciation is taken on tax return
CL	= Contributed Land
-tl	= Negative exponent represented by the tax life of the depreciable asset

EXHIBIT C
Page 1 of 1

FORMULA TO GROSS-UP CONTRIBUTED LAND

$$(CL*(1/(1-CTR)))$$

where:
CL = Contributed Land
CTR = Combined federal and state corporate income tax rate

YEAR 1

FLOW THROUGH ACCOUNTING

Exhibit D
Page 1 of 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000		100000			0
Accounts rec.			0			0
Prepaid taxes			0			0
Accum amort. CIAC	1250		1250	1250		1250
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-1250		-1250	-1250		-1250
Accrued taxes		-111716	-111716			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	0	-111716	-111716	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current		111716	111716		111716	111716
Income taxes - deferred			0			0
Amort. cont. taxes			0			0
NOI	0	-111716	-111716	0	-111716	-111716
Dept			0			0
Equity		-111716	-111716		-111716	-111716
TOTAL CAPITAL	0	-111716	-111716	0	-111716	-111716

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

YEAR 2

FLOW THROUGH ACCOUNTING

Exhibit D
Page 2 of 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000		100000			0
Accounts rec.			0			0
Prepaid taxes			0			0
Accum amort. CIAC	3750		3750	3750		3750
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-3750		-3750	-3750		-3750
Accrued taxes		1411	1411			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	0	1411	1411	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current		-1411	-1411		-1411	-1411
Income taxes - deferred			0			0
Amort. cont. taxes			0			0
NOI	0	1411	1411	0	1411	1411
Dept			0			0
Equity		1411	1411		1411	1411
TOTAL CAPITAL	0	1411	1411	0	1411	1411

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

YEAR 1

OTHER ALTERNATIVE

Exhibit E
Page 1 of 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000	179118	279118			0
Accounts rec.			0			0
Prepaid taxes		111716	111716			0
Accum amort. CIAC	1250		1250	1250		1250
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-1250		-1250	-1250		-1250
Accrued taxes	-111716		-111716			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes		-66559	-66559			0
RATE BASE	-111716	224275	112559	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	111716		111716		111716	111716
Income taxes - deferred		-111716	-111716			0
Amort. cont. taxes		-843	-843			0
NOI	-111716	112559	843	0	-111716	-111716
Dept			0			0
Equity	-111716	112559	843		-111716	-111716
TOTAL CAPITAL	-111716	112559	843	0	-111716	-111716

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

YEAR 2

OTHER ALTERNATIVE

Exhibit E
Page 2 of 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	279118		279118			0
Accounts rec.			0			0
Prepaid taxes	111716		111716			0
Accum amort. CIAC	3750		3750	3750		3750
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-3750		-3750	-3750		-3750
Accrued taxes	1411		1411			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes	-66559		-66559			0
RATE BASE	225686	0	225686	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	-1411		-1411	1411		1411
Income taxes - deferred		1411	1411		1411	1411
Amort. cont. taxes		-1684	-1684		-1684	-1684
NOI	1411	273	1684	-1411	273	-1138
Dept			0			0
Equity	-110305	273	-110032	-110305	273	-110032
TOTAL CAPITAL	-110305	273	-110032	-110305	273	-110032

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

YEAR 1

UTILITY PAYS
PER APRIL 20, 1989

Exhibit F
Page 1 of 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000	111716	211716			0
Accounts rec.			0			0
Prepaid taxes		111716	111716			0
Accum amort. CIAC	1250		1250	1250		1250
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-1250		-1250	-1250		-1250
Accrued taxes	-111716		-111716			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	-111716	223432	111716	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	111716		111716	111716		111716
Income taxes - deferred		-111716	-111716		-111716	-111716
Amort. cont. taxes			0			0
NOI	-111716	111716	0	-111716	111716	0
Dept			0			0
Equity	-111716	223432	111716	-111716	223432	111716
TOTAL CAPITAL	-111716	223432	111716	-111716	223432	111716

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

YEAR 2	UTILITY PAYS PER APRIL 20, 1989				Exhibit F Page 2 of 2	
	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000		100000			0
Accounts rec.			0			0
Prepaid taxes	111716	-1411	110305			0
Accum amort. CIAC	3750		3750	3750		3750
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-3750		-3750	-3750		-3750
Accrued taxes	1411		1411			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	113127	-1411	111716	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	1411		1411	-2278		-2278
Income taxes - deferred		1411	1411		2278	2278
Amort. cont. taxes			0			0
NOI	-1411	-1411	-2822	2278	-2278	0
Dept			0			0
Equity	111716	-1411	110305	111716	-2278	109438
TOTAL CAPITAL	111716	-1411	110305	111716	-2278	109438

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

IRS METHOD

Exhibit G
Page 1 of 2

YEAR 1

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000	111716	211716			0
Accounts rec.			0			0
Prepaid taxes		111716	111716			0
Accum amort. CIAC	1250		1250	1250		1250
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-1250		-1250	-1250		-1250
Accrued taxes	-111716		-111716			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	-111716	223432	111716	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	-111716		-111716	-111716		-111716
Income taxes - deferred		111716	111716		111716	111716
Amort. cont. taxes			0			0
NOI	111716	-111716	0	111716	-111716	0
Dept			0			0
Equity	0	0	0	0	0	0
TOTAL CAPITAL	0	0	0	0	0	0

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

IRS METHOD

Exhibit G
Page 2 of 2

YEAR 2

	A	B	C	D	E	F
	BALANCE SHEET			FORMULA		
	POST TRA '86	Solution	Adjusted	POST TRA '86	Solution	Adjusted
Plant	100000		100000	100000		100000
Land	100000		100000	100000		100000
Cash	100000		100000			0
Accounts rec.			0			0
Prepaid taxes	111716	1411	113127			0
Accum amort. CIAC	3750		3750	3750		3750
Accum. Amort. Cont. taxes			0			0
Accum. deprec.	-3750		-3750	-3750		-3750
Accrued taxes	1411		1411			0
CIAC	-300000		-300000	-200000		-200000
Cont. taxes			0			0
RATE BASE	113127	1411	114538	0	0	0
Revenue			0			0
Deprec. expense			0			0
Income taxes - current	-1411		-1411	-1411		-1411
Income taxes - deferred		1411	1411		1411	1411
Amort. cont. taxes			0			0
NOI	1411	-1411	0	1411	-1411	0
Dept			0			0
Equity	1411	-1411	0	1411	-1411	0
TOTAL CAPITAL	1411	-1411	0	1411	-1411	0

	Debit	Credit
Income taxes utility operations	111716	
Accrued taxes		111716

To record income tax liability

The NOI would close to retained earnings.

future depreciation for separate treatment. It treats the tax effect of CIAC like any other expense of operations just as it indeed is.

Q. Does the third alternative have any disadvantages?

A. It does not provide any relief for utilities who are in a poor cash position, especially those who receive primarily property contributions. If one subscribes to the theory that all CIAC are growth related, it requires that the new ratepayers be subsidized by the old.

Q. Does the fourth alternative have any benefits?

A. Yes, it possesses the benefits of the other three alternatives as well as their disadvantages. Essentially, alternative four is a case-by-case approach. It is, in essence, the policy that is in existence at present and it is the policy that I believe is most reasonable.

Q. Why do you believe that the fourth alternative is most reasonable?

A. I believe that it allows the Commission to adopt a policy that is flexible. By that I mean, the Commission can review the facts and circumstances surrounding each individual case and determine whether a gross-up is needed and if so, how much of a gross-up is required. I also believe that a case-by-case examination protects the interests of the ratepayers without adversely affecting those of the utilities. I believe that, because of the potential to convert the cost free cash into net