FLORIDA PUBLIC SERVICE COMMISSION

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M E M O R A N D U M

AUGUST 29, 1991

TO : DIRECTOR, DIVISION OF RECORDS AND REPORTING

FROM : DIVISION OF WATER AND SEWER (MCCASKILL)
DIVISION OF LEGAL SERVICES (FRAZIER)
DIVISION OF AUDIT & FINANCIAL ANALYSIS (HICKS, SALAK)

RE : UTILITY: PALM COAST UTILITY CORPORATION
DOCKET NO.: 900876-WS
COUNTY: FLAGLER
CASE: PETITION FOR CONTINUATION OF GROSS-UP OF CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION (CIAC)

AGENDA : SEPTEMBER 10, 1991 - PROPOSED AGENCY ACTION - PARTIES MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

DOCUMENT NUMBER-DATE
08694 AUG 29 1991
FPSC-RECORDS/REPORTING

CASE BACKGROUND

By Order No. 16971, issued December 18, 1986, the Commission granted approval for water and wastewater utilities to amend their service availability policies to meet the tax impact on contributions-in-aid-of-construction (CIAC) resulting from the amendment of Section 118(b) of the Internal Revenue Code. Order No. 23541, issued October 1, 1990, ordered utilities currently grossing-up CIAC to file a petition for continued authority to gross-up and also ordered that no utility may gross-up CIAC without first obtaining the approval of this Commission. Orders No. 16971 and 23541 also prescribed the accounting and regulatory treatments for the gross-up and required refunds of certain gross-up amounts collected. On October 29, 1990, pursuant to Florida Administrative Code Rule 25-22.036 and Commission Order No. 23541, Palm Coast Utility Corporation filed its petition for continuation of CIAC tax gross-up. Upon review of the information filed, it was determined that additional clarifying or explanatory information was needed and the utility was so notified on March 6, 1991. The utility filed the additional information on May 3, 1991.

Palm Coast is a wholly owned subsidiary of ITT Corporation. The company is a Class A water and wastewater utility and provides water and wastewater services to Palm Coast, Florida, a community being developed by its affiliate, ITT-Community Development Corporation. Based on the 1990 Annual Report on file with the Commission, the utility served approximately 11,259 water and 7,529 wastewater customers at the end of December 31, 1990. Gross operating revenues were reported as $4,523,942 for the water system and $2,004,804 for the wastewater system. Net operating income was reported as $716,982 and $144,177 for water and wastewater, respectively. The utility's reported achieved rate of return is 2.99% and .67%

DISCUSSION OF ISSUES

ISSUE 1: Should Palm Coast be allowed to continue to gross-up CIAC utilizing the net present value (NPV) gross-up method?

RECOMMENDATION: Yes, the Commission should allow the utility to continue to gross-up CIAC using the net present value (NPV) gross-up method. The collections of the CIAC gross-up should be made in accordance with the provisions of Orders No. 16971 and 23541. The tariffs should be approved as filed and become effective at the expiration of the protest period, if no timely protests are received. (MCCASKILL, HICKS, SALAK)

STAFF ANALYSIS: Order No. 23541 required that all utilities, that wished to collect the gross-up, file a petition for approval of the gross-up with this Commission. The order stated that each utility must demonstrate that a tax liability exists and that sources of funds are not available at a reasonable cost. Utilities were required to file the following information to demonstrate the need to gross-up: Demonstration of Actual Tax Liability, Cash Flow Statement (except for Class C Utilities), Statement of Interest Coverage, Statement of Alternative Financing, Justification for Gross-up, Gross-up Method Selected and Proposed Tariffs. On October 30, 1990, Palm Coast filed information which it believed demonstrated its need to continue the net present value (NPV) gross-up as previously approved in Docket No. 860184-PU, Order No. 17598, issued May 26, 1987. We have completed our review of the information filed, and our findings are as discussed below:

DEMONSTRATION OF ACTUAL TAX LIABILITY: Our review of the financial statements filed by the utility indicates that Palm Coast will incur an actual above-the-line tax liability as a result of its collection of CIAC. The utility prepared schedules projecting operating results through 1995, using actual 1990 data as the base year. These schedules were projected assuming Palm Coast uses the NPV gross-up method to fund CIAC taxes and assuming that Palm Coast uses no gross-up. Both assumptions reflect an overall tax liability for Palm Coast in each of the years 1991 through 1995. Palm Coast, therefore, is projected to satisfy the Order's minimum requirement that utilities grossing up CIAC acutally have an above-the-line tax liability.

CASH FLOW STATEMENT: Projected cash flow statements were presented with and without NPV gross-up for the years 1991 through 1995. The purpose of the cash flow statement is to demonstrate whether liquid funds are available to pay taxes on CIAC. Under both methods, the utility projects a deficit in its net cash flow for 1991, 1994 and 1995; therefore, it appears that funds will not be available to pay CIAC taxes in those years. In 1992 and 1993 the utility reflects positive net cash flows; however, the tax liability associated with the CIAC exceeds the net cash flows available. Under the NPV gross-up method the utility's cash position is strengthened due to the collection of the taxes on the CIAC from the contributor; however, it does not appear that the utility will be able to fully fund the taxes on CIAC in any of the projected years under either method.

STATEMENT OF INTEREST COVERAGE: The times interest earned (TIE) ratio indicates the number of times a utility is able to cover its interest. This ratio demonstrates the company's ability to service its debt. It is also an indicator of the relative protection of the bondholders, and the utility's ability to go into the financial market to borrow money or issue stock at a reasonable rate. Order No. 23541 established a TIE ratio of 2x as a benchmark.

Based on the projected data submitted for the utility, in 1991 the TIE ratio using the NPV gross-up method is 2.01. Under the no gross-up method, the TIE ratio is 1.93 which is slightly below the threshold of 2.00 established in Order No. 23541. Under the no gross-up method, the TIE ratio remains slightly below 2.00 until 1994 when it rises to 2.45 and 2.28 in 1995. This increase appears to be due to increased income as a result of the forecasted rate increase in late 1993. Under the NPV gross-up method the TIE ratio in 1992 is 1.35; however, in 1993 the TIE increases to 2.26 and in 1994 and 1995 the TIE is 3.15 and 3.01. respectively. If allowed to gross-up CIAC, the required debt financing is reduced and the associated interest expense is reduced, resulting in an improvement in the TIE ratio. As a result of this reduction in required debt financing, the utility's TIE ratio is stronger under the NPV gross-up method than under the no gross-up projections. Therefore, it appears that the utility's ability to service its debt is better under the NPV gross-up method.

STATEMENT OF ALTERNATIVE FINANCING: The utility states that financing to pay the CIAC-related taxes have not been obtained and that the overall financial health of the utility 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. The utility stated that the majority of its CIAC is received from individuals, not developers; therefore, developer financing is not considered to be a viable borrowing source for funds to pay CIAC taxes. In addition, the utility stated that the record-keeping requirements related to numerous homeowner loans are generally onerous and not cost effective.

The utility has maintained total debt facilities of $12 million. However, this amount has been maintained in anticipation of financing the utility's high level of capital additions. In 1991, capital additions were projected at $12.7 million resulting in additional borrowings of $7.5 million. The utility indicated that the capital additions included construction of the first two-million-gallon-per-day (MGD) phase of a water treatment facility and appurtenances totalling approximately $7 million. In 1994 and 1995 large amounts of capital additions are projected as a result of the construction of a 1 MGD wastewater treatment facility, including effluent disposal. The $12 million debt facility consists of an $11 million line of credit with Manufacturers Hanover Trust Company (MHTCO) which converts to a three year loan effective December 31, 1992. The final maturity date of the loan is December 31, 1995. At the election of the company, the outstanding principal amount of the loan bears interest at either (1) the commercial lending rate of MHTCO or (2) the London Interbank Offered Rate of plus 1/2% per annum. A commitment fee of .35% per annum is charged on the unused portion of the commitment. The utility's 1990 Annual Report indicates that outstanding borrowings under this agreement were $4.5 million at December 31, 1990. The utility also has a $1 million line of credit with Barnett Bank of Volusia County which it renewed through May 31, 1990 at an interest rate equal to the bank's prime rate. The unused portion of this line of credit is subject to a commitment fee of 1/2% per annum. The utility's 1990 Annual Report reflected no borrowings outstanding under this agreement at December 31, 1990. If the utility is not allowed to gross-up, it is projected that Palm Coast's available debt facility would be exceeded in 1995 by over $4 million due entirely to the requirement to finance taxes on CIAC.

Based on the foregoing, it appears that although the utility may have an alternate source of funds to finance CIAC taxes, available funds for planned capital additions would be reduced if the utility funded the taxes. In addition, by 1995, borrowings to finance CIAC taxes and capital additions would exceed the utility's available debt facility by approximately $2.2 million if the utility grossed-up CIAC and by approximately $4.2 million if the utility did not gross-up CIAC. Further, the effect of the increased borrowings seems to be a reduction in the utility's TIE ratio. It is projected that over the next five years, customer revenue requirements would be 3.4% higher per equivalent residential connection (ERC) in 1995 if the utility were not allowed to continue the NPV gross-up. Therefore, it appears that the utility should be allowed to continue the NPV gross-up.

JUSTIFICATION FOR THE GROSS-UP: Palm Coast believes that a gross-up of CIAC is required based upon its projected limited cash flows, high capital expenditures, and unsatisfactory interest coverage ratio if the gross-up is not continued. Further, the utility states that it has demonstrated that an actual above-the-line tax liability is projected to exist in each of the years 1991 through 1995 without the gross-up. Staff concurs with the utility that on a projected basis an actual above-the-line tax liability exists for the years 1991 through 1995. Further, the projected financial statements indicate that funds are not sufficient to totally finance CIAC taxes and that the utility's TIE ratio is below the threshold established in Order No. 23541. Also, although the utility has a $12 million line of credit, if the utility financed the CIAC taxes, funds to finance planned capital additions would be reduced and debt borrowings would be increased by approximately 32% as a result of financing the CIAC taxes. Therefore, it appears that the utility's continued use of the NPV gross-up method is justified.

GROSS-UP METHOD SELECTED: Palm Coast has requested continued authority to gross-up CIAC for income taxes using the net present value (NPV) method. Palm Coast states that its believes that the NPV gross-up method is preferable for Palm Coast over the full gross-up method as the NPV method more appropriately balances the interests of all parties, particularly the contributor. In particular, the utility states that under the NPV method only the carrying costs associated with the taxes on CIAC are collected from the contributor. Thus, the NPV gross-up method is revenue neutral, and it has no revenue requirement impact on existing customers. The utility stated that it also believes that the NPV gross-up method most fairly assigns the costs and benefits associated with taxes on CIAC.

Order No. 17598, issued May 26, 1987, approved Palm Coast's request to modify the gross-up formula to recognize the present value of the tax effect of depreciation to be taken in the future. The order stated that the effect is to reduce the amount of taxes that must be collected up front, which benefits the developers and future customers. Therefore, Palm Coast's request to modify the gross-up formula was approved.

PROPOSED TARIFFS: In accordance with Order No. 23541, the utility has submitted proposed tariffs for the NPV gross-up method as requested in its filing. Staff recommends that the tariffs be approved as filed and become effective upon the expiration of the protest period.

OTHER CONSIDERATIONS: Our review of the information submitted by the utility indicates that the utility will incur an actual above-the-line tax liability as a result of collecting CIAC. It appears that while the utility will have some funds available in 1992 and 1993 to finance taxes on CIAC, it does not appear that the funds available will be sufficient to fully fund the tax liability related with the collection of CIAC. It appears that funds are not available to finance CIAC taxes in 1991, 1994 and 1995. The utility has a $12 million line of credit available for borrowing; however, this line of credit was intended fo finance the utility's large capital additons. It appears that if the utility was required to finance the taxes on CIAC, additional borrowings to finance the capital additions and CIAC taxes would exceed the utility's available debt facility of $12 million. If the utility is not allowed to gross-up, it appears that over the projected period, the utility will require increased borrowing as well as incur a higher interest expense. As a result of the increased borrowings and interest expense, the TIE ratio in 1991 is slightly below the 2.00 standard established in Order No. 23541, Docket No. 860184-PU, and it remains below the standard until 1994 when it increases slightly above the standard. Thus, if not allowed to gross-up, the utility may experience some difficulty in servicing its debt.

Based on its 1990 Annual Report filing, the utility's achieved rate of return is 2.99% and .67% for the water and wastewater systems, respectively. Neither return is compensatory in view of the 9.21% return allowed in Docket No. 890277-WS, Order No. 22843, issued April 23, 1990. When these factors are considered, Staff does not believe it is in the interest of either the utility or the ratepayers to increase a net operating income (NOI) deficiency even though the effect of not grossing-up would be immaterial.

In consideration of the above, we recommend that Palm Coast be allowed to continue the gross-up of CIAC utilizing the NPV gross-up method. Further, Orders No. 16971 and 23541 prescribe the accounting and regulatory treatments and record keeping for the gross-up, and require refunds of certain gross-up amounts collected. Staff recommends that the CIAC collections be made in accordance with those Orders and that all matters discussed in the body of those Orders be expressly incorporated herein by reference.

ISSUE 2: Should the docket be closed?

RECOMMENDATION: Yes, if no protests are received, the docket should be closed upon expiration of the protest period. (MCCASKILL)

STAFF ANALYSIS: Upon the expiration of the protest period, if no protests have been received, the docket should be closed.