FLORIDA PUBLIC SERVICE COMMISSION
Fletcher Building, 101 East Gaines Street
Tallahassee, Florida 32399-0850

MEMORANDUM

May 18, 1995

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

FROM: DIVISION OF WATER & WASTEWATER (IWENJIORA)
DIVISION OF LEGAL SERVICES (NASH)
DIVISION OF AUDITING & FINANCIAL ANALYSIS (HICKS)

RE: DOCKET NO. 931141-WS - PARKLAND UTILITIES, INC. - PETITION TO GROSS-UP CONTRIBUTIONS IN AID OF CONSTRUCTION (CIAC) FOR RELATED TAX IMPACT
COUNTY: BROWARD

AGENDA: MAY 30, 1995 - REGULAR AGENDA - TARIFF FILING - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: I:\PSC\WAW\WP\931141.RCM

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 November 24, 1993, pursuant to Order No. 23541, Parkland Utilities, Inc. (Parkland or Utility) filed its petition for authority to gross-up CIAC. The information as filed met the filing requirements of Order No. 23541; however, numerous questions resulted from review of the filing. In an effort to complete our review and analysis, staff requested additional information and clarification. As a result of staff's request, the utility submitted several revisions to its initial application.

By Order No. PSC-94-0653-FOF-WS, issued May 31, 1994, the Commission allowed the full gross-up tariffs to become effective on an interim basis, subject to refund with interest, by not acting to suspend the rates.

Parkland Utilities, Inc. is a Class C water and wastewater utility providing service to the public in Broward County. A review of the utility's 1993 annual report reflected 470 water and 469 wastewater customers as of December 31, 1993. Gross annual operating revenues were $156,986 and $299,230 for the water and wastewater systems, respectively. The utility reported a net operating loss of $30,690 for water and a net operating profit of $11,414 for the wastewater system. The utility was granted a 1993 price index rate increase of 3.25% for the water system and 1.51% for the wastewater system effective February 28, 1994, pursuant to Section 367.081, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should Parkland Utilities, Inc.'s tariff authority to gross-up Contributions in Aid of Construction (CIAC) using the full gross-up method be approved?

RECOMMENDATION: No, the Commission should deny the utility's tariff authority to gross-up CIAC using the full gross-up method. The interim gross-up tariff should be cancelled and all gross-up monies collected during the interim period should be refunded to the contributors of those monies with interest. The refund should be completed within 90 days of the effective date of this Order. The utility should submit copies of canceled checks, credits applied to monthly bills or other evidence which verifies that the refund has been made, within 90 days from the date of refund. (IWENJIORA, HICKS)

STAFF ANALYSIS: Order No. 23541 required all utilities that wished to collect the gross-up to file a petition for approval of the gross-up with the Commission. The Order stated that each utility demonstrate that an above-the-line tax liability exists and that alternate 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 Statements (except for Class C Utilities), Statement of Interest Coverage, Statement of Alternate Financing, Justification for Gross-up, Gross-up Method Selected and Proposed Tariffs.

On November 24, 1993, Parkland Utilities, Inc. filed the information which it believed demonstrated its need to gross-up CIAC using the full gross-up method. Although the information filed appeared to indicate that the utility would have an above-the-line tax liability, staff needed additional information to determine whether an above-the-line tax liability would be created by the collection of CIAC and that other sources of funds would not be available at a reasonable cost, as required by Order No. 23541. The utility submitted several revisions to its initial application in order to answer and clarify our questions.

In its petition, the utility asserts that gross-up authority is necessary because it anticipates that a substantial portion of CIAC received in the future will be taxed at federal statutory rates. Parkland agreed to provide service to 341 equivalent residential connections (ERCs) to be developed by Transeastern Properties of Florida, Inc. over the next two to three years. Such service will result in a receipt of approximately

$750,000 in CIAC. Parkland states that unless gross-up authority is effective throughout this period, it will incur a substantial tax liability with no apparent source for the funding of such liability.

<u>DEMONSTRATION OF ACTUAL TAX LIABILITY:</u> The utility submitted a pro forma schedule which calculated an above-the-line income of $112,500 before the inclusion of taxable CIAC in income for the fiscal year ended February 28, 1994. Additionally, the utility reported $744,450 CIAC and gross-up collections in the fiscal year ended February 28, 1994. Therefore, as a result of the above-the-line taxable income, CIAC and gross-up collection, the utility projected a $856,950 tax liability for the projected fiscal year ended February 28, 1994.

Staff believes the utility's above-the-line income calculation is inaccurate based on the information on file at the Commission. Staff's position is that in determining the utility's taxable above-the-line income, the utility did not appropriately reflect its operating expense. Most of the operating expense that was allocated below-the-line should have been classified above-the-line. The utility reported projected operating revenue of $410,855 and projected operating expense of $298,355 for the fiscal tax year ended February 28, 1993. The amount of the utility's projected operating expense is not consistent with the operating expense as reported in its 1993 tax return, nor are they comparable with the expense reported in the utility's 1992 and 1993 annual report. According to the utility's 1992 annual report, operating income was $395,119 and operating expense was $449,461. Although the projected fiscal year end is two months different from the annual report's year end, the utility's pro forma expense should be similar or comparable to that reflected in the annual report.

In calculating the above-the-line taxable income , the utility reduced all operating expense as reported on the tax return to reflect the amount allowed in the last rate case. Staff admits that it does consider the expense recognized in the last rate case to determine reasonableness and in removing any disallowed expense: However, reducing the operating expense to the level reflected in the last rate case does not allow for the normal increase in expenses due to inflation and customer growth. Thus the utility has not shown the actual expense incurred and reported on the tax return. Having allocated operating expense consistent with the amount reported in the tax return, staff has increased operating expense above-the-line and thus reduced above-the-line operating income prior to the inclusion of taxable CIAC. Based on these adjustments, Parkland will not incur an actual above-the-line tax liability as a result of its collection of CIAC.

Secondly, the utility has predominately operated at a loss over the past five years. According to the utility's tax return, the utility has at its disposal cumulative net operating loss (NOLs) carryforwards of $1,091,336. In order to determine how much of the NOLs should be allocated above the line, the utility provided a schedule of the tax years ended 1990 through 1994. The utility indicated that the cumulative operating loss associated with above-the-line operations was $37,083. However, in allocating the above-the-line NOLs, the utility used the same method of reducing the operating expense to the level reflected in the last rate case; thereby allocating more NOLs below-the-line than is appropriate. Therefore, as discussed above, operating expense was adjusted to reflect the level consistent with operations reported in the tax return; this resulted in more than $500,000 in NOLs being available for above-the-line allocation.

By letter dated April 3, 1995, the utility notified staff that during the fiscal year ended February 28, 1994, the utility spun off from the consolidated group and now files a stand alone return. In addition, the utility submitted a revised net operating loss carryforward (NOLs) amount of $971,948. This amount only reflected the NOLs that related to fiscal years 1991 through 1993. Staff requested information from the utility that would explain why the fiscal years 1989 and 1990 NOLs were not carried over or made available. The utility responded by submitting a workpaper that did not adequately resolve staff's concern. However, staff believes that even with the revised NOLs' amount the utility would not have an above-the-line tax liability that would require gross-up authority.

Finally, it should be noted that collection of the $744,450 CIAC and gross-up reported on the pro forma schedule would not occur in one year. Based on information contained in the utility's developer agreement and additional information requested from the utility, the CIAC collections would be spread over four years as follows: $131,950 in 1994, $467,500 in 1995, $145,000 in 1996, and $125,000 in 1997. The tax liability associated with these collections would be: $49,653 in 1994, $175,920 in 1995, $54,564 in 1996, and $47,038 in 1997. The cumulative tax effect for 1994 through 1997 would be $327,175. However, if the gross-up amount is included in the taxable income the utility would be required to pay an additional tax to cover the gross-up amount; thereby increasing the utility's tax liability. Staff has determined that the utility has accumulated more than $500,000 in NOLs that could be used to offset any tax liability associated with the collection of CIAC. Since Parkland has been operating at a loss for the past five years, staff does not foresee any dramatic change in this trend. Therefore, staff firmly believes that this request should be denied and the interim gross-up tariff should be cancelled and all gross-up monies collected during the interim period should be refunded to the contributors of those monies with interest. The refund should be completed within 90 days of the effective date of this Order.

Staff reviewed the Cash Flow Statements, Statement of Interest Coverage, Statement of Alternate Financing, and Statement of Justification for Gross-up. However, staff's review of these statements did not outweigh the fact that the utility would not have a tax liability. In addition, the collection of CIAC would not create an above-the-line tax liability which would require consideration of an alternate source of funds to pay a tax liability.

CASH FLOW STATEMENT: A cash flow statement shows whether liquid funds are available to pay taxes on CIAC. Our review of the cash flow statement filed by the utility indicates that, if the collection of CIAC would create a tax liability, funds would not be available to pay the taxes associated with CIAC. For the fiscal year ended February 28, 1993, the company had negative cash flow of $2,310. Although net cash increased by $56,689, this increase was a result of additional borrowing and cash capital contributions from the parent company to finance capital expenditures for plant and fund operating activities. The utility states that no net cash is available from operations to fund the tax related to CIAC expected to be received over the coming years. Based on the foregoing, staff does not believe funds would be available for payment of taxes , if the CIAC created a tax liability.

STATEMENT OF INTEREST COVERAGE: The times interest earned (TIE) ratio indicates the number of times a utility is able to cover its interest. The ratio is an indicator of the relative protection for the bondholders. It is also indicative of 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.

Parkland receives financing through non-interest bearing advances from its parent, NARCO Realty, Inc. As of February 28, 1993, such advances totaled $2,383,238. Additionally, the parent invested $293,620 as paid in capital in fiscal year 1993 to pay for additional Broward County wastewater capacity charges and advanced $10,679 to fund operations.

The TIE ratio was calculated to be a negative 113.45 times, which is less than the benchmark established by Order No.

23541. This TIE ratio indicates that the utility does not have adequate interest coverage. It should be noted that the utility has a large deficit in retained earnings. This factor coupled with the utility's low TIE ratio may be indicative of the utility's inability to go into the financial market to borrow money. Additionally, the 1992 Annual Report indicates the utility is earning a negative 1.93% rate of return for water and a negative 6.89% for wastewater. These rates are not compensatory in view of the 9.21% overall rate of return authorized in the utility's last rate case in Docket No. 900598-WS, Order No. 24417, issued April 23, 1991. When these factors are considered, staff does not believe that it is in the interest of either the utility or the ratepayer to increase a NOI deficiency.

__STATEMENT OF ALTERNATIVE FINANCING:__ The utility stated that no alternative for gross-up exists at a reasonable rate. The company receives financing through non-interest bearing advances from its parent, NARCO Realty, Inc. Through February 28, 1993, such advances totaled $2,383,238. Additionally, the parent invested $293,620 as paid in capital in fiscal year 1993 to pay for additional Broward County wastewater capacity charges and advanced $10,679 to fund operations.

For the fiscal year ended February 28, 1993, the company had negative cash flow of $2,310 from operations, with the parent making up the shortfall with additional investment mentioned above. At the same time, the company lost ($54,821) in calendar year 1992 and had an accumulated deficit of ($1,422,868). Therefore, the company does not believe that financing for any reason is available, much less to pay for income taxes on CIAC. The utility believes that if financing could be obtained, the interest rate would in all likelihood be unreasonable. Staff believes that because the utility has inadequate interest coverage, negative retained earnings, and receives financing through non-interest bearing advances from its parent, that the utility's ability to go into the financial market to borrow money may be impaired and the utility may not be able to obtain alternative financing at a reasonable rat

__JUSTIFICATION FOR THE GROSS-UP:__ The utility indicated that it is in need of the gross-up authority because cash flow is not available, and the company has survived only by support from its parent. The company continues to accumulate losses, even though no interest is charged on borrowing from its parent. Additionally, the company states that borrowing, if available at all, could not be obtained at a reasonable rate. Therefore, based on the data filed , staff believes that if the utility had a tax liability associated with the collection of CIAC, there would be justification for this utility to gross-up CIAC.

<u>GROSS-UP METHOD SELECTED:</u> The utility has elected to use the full gross-up method. This method was selected due to its cost effectiveness and relative simplicity as opposed to the present value method. The utility stated its opinion that full gross-up is the least costly alternative.

<u>PROPOSED TARIFFS:</u> In accordance with Order No. 23541, the utility has submitted proposed tariffs for the full gross-up method as requested in its filing. These tariffs are consistent with the revised formula in Order No. PSC-94-1265-FOF-WS, issued October 12, 1994. However, as previously stated staff calculates that the utility will not incur a tax liability with the collection of CIAC. Therefore, the utility should be denied gross-up authority and the interim gross-up tariff should be cancelled and all gross-up monies collected during the interim period should be refunded to the contributors of those monies with interest. The refund should be completed within 90 days of the effective date of this Order. The utility should submit copies of canceled checks, credits applied to monthly bills or other evidence which verifies that the refund has been made, within 90 days from the date of refund.

ISSUE 2: Should the docket be closed?

RECOMMENDATION: No, the docket should remain open pending verification of the refund. Staff should be granted administrative authority to close the docket upon verification that the refunds have been made. (IWENJIORA, NASH)

STAFF ANALYSIS: The docket should remain open pending verification of the refund. Staff should be granted administrative authority to close the docket upon verification that the refunds have been made.