

State of Florida



Public Service Commission

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RECORDS AND REPORTING

DATE: NOVEMBER 4, 1999

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

FROM: DIVISION OF LEGAL SERVICES (JAEGER) *RS*
 DIVISION OF AUDITING AND FINANCIAL ANALYSIS (CASSEAU) *Casseau*
 DIVISION OF WATER AND WASTEWATER (MCCASKILL) *Mccaskill*

RE: DOCKET NO. 971179-SU - DISPOSITION OF CIAC GROSS-UP FUNDS COLLECTED BY NORTH FORT MYERS UTILITY, INC. IN LEE COUNTY. *at*

AGENDA: NOVEMBER 16, 1999 - REGULAR AGENDA - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\LEG\WP\971179S3.RCM

CASE BACKGROUND

North Fort Myers Utility, Inc. (NFMU or utility) is a Class A wastewater utility providing service to approximately 5,360 customers in Lee County. According to its 1997 annual report, the utility reported gross operating revenues of \$1,958,553 and net operating income of \$446,362.

This docket was opened to determine whether North Ft. Myers Utility, Inc., should be required to refund excess gross-up collections for fiscal year 1994 (ended May 31, 1995), fiscal year 1995 (ended May 31, 1996), and fiscal year 1996 (ended May 31, 1997). 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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FPSC-RECORDS/REPORTING

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

However, the Small Business Job Protection Act of 1996 (the Act) provided for the non-taxability of CIAC collected by water and wastewater utilities effective for amounts received after June 12, 1996. Based on this change in the law, by Order No. PSC-96-1180-FOF-WS issued September 20, 1996, in Docket No. 960965-WS, the Commission revoked the authority of utilities to collect gross-up of CIAC and canceled the respective tariffs unless, within 30 days of the issuance of the order, affected utilities requested a variance. Although NFMU did not request a variance, it explained in a letter dated January 10, 1997, that it did not believe that the continued collection of the installment payments constituted a variance, but merely a payment of a debt over a period of time. To the extent a variance was required, the utility requested a variance. Pursuant to Order No. PSC-96-0686-FOF-WS, all pending CIAC gross-up refund cases continue to be processed in accordance with Orders Nos. 16971 and 23541.

NFMU provides wastewater service to several subdivisions (Forest Park, Lake Arrowhead, Carriage Village, Tamiami Village, and Lazy Days) formerly receiving service through package plants. In each case, under the authority granted in its tariff, NFMU allowed each customer to either pay in full the plant capacity charge and applicable gross-up at the time of connection onto the utility's central wastewater system or pay by installment payments over a seven-year period for the total amount owed. This installment arrangement was undertaken and authorized for the convenience of the customers who could not or chose not to pay their plant capacity fees and gross-up at the time of connection.

Although the Act provided for the non-taxability of CIAC collected by water and wastewater utilities for amounts received after June 12, 1996, several of the contractual agreements between the customers and the utility continue to be outstanding and require payments after June 12, 1996. As a result, on November 18, 1996, staff received a call from the Office of Public Counsel (OPC), advising staff that several customers had contacted OPC regarding the status of the customer's obligation to continue paying the gross-up amount of the installment payment to NFMU. On November 12, 1997, OPC filed its Notice of Intervention and by Order No. PSC-97-1474-PCO-SU, the Commission acknowledged OPC's intervention.

Because the utility had entered into these "installment contract" agreements prior to June 12, 1996, in its recommendation dated October 23, 1997, staff initially treated the installment contracts as "income" in the year the contracts were entered into. However, subsequent to filing its recommendation, staff realized

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

that the utility had not reported the amounts due as income and that the utility was not treating the installment payments received after June 12, 1996 as taxable income on its tax return. Therefore, the utility was not paying tax on this CIAC and it would have given the utility a windfall to allow gross-up on CIAC which was not being reported as taxable income. Therefore, the gross-up refund calculations appearing in staff's recommendation of October 23, 1997, were revised to remove the installment contracts as being taxable income and the utility was advised accordingly. As a result, staff's recommendation of October 23, 1997, was deferred from the November 4, 1997, Agenda Conference.

By letter dated November 14, 1997, staff submitted its revised refund calculations to the utility. In response to staff's letter, the utility advised staff that it would be filing amended tax returns to reflect as taxable income, the CIAC and gross-up due from customers paying by installment. On December 12, 1997, the utility filed a certified copy of the amended tax returns with this Commission along with a copy of the return receipt from the Internal Revenue Service.

Based on these revised tax returns, staff filed a recommendation on December 3, 1998, to address the utility's request for a variance from Order No. PSC-96-1180-FOF-WS, to address the disposition of gross-up funds collected by the utility in 1994, 1995, and 1996, including the concerns of Mr. Pete Longjohn, President of Tamiami Village Homeowners Association, and the concerns expressed in the letters and telephone calls received from customers of NFMU, to address the utility's request that 50% of its legal and accounting costs be offset against the refund amounts, and to address the utility's informal Settlement Offer filed October 2, 1998, and OPC's response to the utility's offer. Staff's recommendation of December 3, 1998, was deferred from the December 16, 1998, Agenda Conference.

Finally, at the May 4, 1999 Agenda Conference, the Commission considered staff's recommendation on all the above-noted concerns. In addition to those concerns, staff added the following issue:

Should the Commission order North Fort Myers Utility, Inc., to show cause, in writing within twenty-one days, why it should not be fined an amount up to \$5,000 for each offense for: 1) its apparent failure to timely request a variance for the continued collection of CIAC gross-up as required by Order No. PSC-96-1180-FOF-WS; 2) its apparent failure to file accurate annual reports for the years 1994, 1995, 1996, and 1997, in compliance with

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

Rule 25-30.110(9), Florida Administrative Code; and 3) its apparent implementation of price-index rate increases based on inaccurate operating costs in violation of Section 367.081(4)(c), Florida Statutes?

In voting on this issue, the Commission decided that the utility should not be made to show cause why it should not be fined for its apparent failure to timely request a variance and its apparent failure to file accurate annual reports. However, the Commission did vote to require the utility to show cause, in writing, within 21 days why a fine in the total amount of \$15,000 should not be imposed for the utility having improperly implemented three price indexes in apparent violation of Section 367.081(4), Florida Statutes. This vote was memorialized by Order No. PSC-99-1068-PAA-SU, issued May 25, 1999. That Order further required any utility response to contain specific allegations of fact and law, and that if the response raised material questions of fact and requested a hearing pursuant to Section 120.57, Florida Statutes, further proceedings would be scheduled before final determination was made. The portion of the Order addressing the show cause proceedings was issued as final agency action.

In that same Order, the Commission, by proposed agency action: (1) approved the utility's request for a variance from Order No. PSC-96-1180-FOF-WS (Order revoking authority to continue CIAC gross-up); (2) required the utility to refund a portion of CIAC gross-up for fiscal years 1994, 1995, and 1996; and (3) required the utility to refund portions of the price indexes for the years 1995, 1996, and 1997. However, by Petition on Proposed Agency Action filed June 15, 1999, OPC protested the proposed agency action portion of the Order and requested a formal hearing. As a result of this protest, a formal hearing is now scheduled for April 13-14, 2000.

On June 15, 1999, the utility filed its Response to Show Cause. In that response, the utility "contends that it is not in violation of any provision of Commission Rule, Statute or Order and to the extent the Commission determines that such violation exists, requests a hearing pursuant to the provisions of Chapter 120.57(1), Florida Administrative Code." Also, in its response, the utility alleges that there are at least nine separate issues of material fact and at least two issues of law.

The staff originally filed its recommendation on the utility's response to the show cause for the October 5, 1999 Agenda Conference. In that recommendation, staff recommended that the show cause issue merely be included in the hearing currently

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

scheduled on the protest of Proposed Agency Action Order No. PSC-99-1068-PAA-SU. However, at the agenda conference, staff indicated that perhaps a show cause proceeding should not proceed at all. Therefore, the Commission voted to defer the item and have staff file another recommendation on the appropriate action for the Commission to take in this show cause proceeding.

The purpose of this recommendation is to address the response of the utility to the order to show cause and what action the Commission should take in regard to this response.

DISCUSSION OF ISSUES

ISSUE 1: What action should the Commission take in regards to the utility's Response to Show Cause as to why it should not be fined \$15,000 for having improperly implemented three price indexes in apparent violation of Section 367.081(4)(c), Florida Statutes?

RECOMMENDATION: The utility should not be fined for its apparent violation of Section 367.081(4)(c), Florida Statutes, and the show cause proceeding should be terminated. However, the Commission should strongly admonish the utility to provide the most accurate information possible in future annual reports and price-index rate increase applications. (JAEGER)

STAFF ANALYSIS: As stated in the Case Background, by Order No. PSC-99-1068-PAA-SU, issued May 25, 1999, the Commission ordered NFMU to show cause, in writing, within 21 days why a fine in the total amount of \$15,000 should not be imposed for the utility having improperly implemented three price indexes in apparent violation of Section 367.081(4), Florida Statutes. Pursuant to that Order, the utility timely filed its response on June 15, 1999.

In that response, the utility argues that its original annual reports were correct and that the price indexes were "correct, and not 'improperly implemented,' or 'based on inaccurate operating costs.'" It further argues "that there is a distinction between what should be considered above and below-the-line for gross-up, versus rate setting, and regulatory reporting purposes."

The utility maintains that the staff (and Commission) has had a dramatic shift in policy in that the staff has previously recognized that the costs classified as below-the-line for gross-up purposes might be different and were not tied to the annual report. Specifically, the utility states that the costs may be "below-the-line for gross-up purposes either because they have never been recognized by the . . . Commission in rate setting, and are therefore funded by the shareholders of the Utility rather than the ratepayers, or because they relate to 'non-used and useful' plant and facilities which the shareholders of the Utility are therefore funding by definition." The utility concludes that to separate the above and below-the-line operating expenses for annual reporting purposes would require "each Utility to do a detailed rate analysis at substantial cost with the filing of each annual report," and that such analysis "would be very speculative and unprecedented."

In its response, the utility claims that Order No. PSC-99-1068-PAA-SU raises issues of material fact such as:

- (A) Whether the Utility improperly implemented three price indexes for the years 1995, 1996 and 1997.
- (B) Whether the indexes filed by the Utility for the years 1995, 1996 and 1997 were based on inaccurate operating costs.
- (C) Whether the requirements of Order No. 23541 specifically recognized a distinction between a Utility's operating costs for gross-up purposes and for all rate setting purposes, including indexing.
- (D) Whether the operating costs of the Utility as originally reported in its annual report constitute the actual Utility's operating costs as required to be reported under Commission Rule 25-30.110(9), Florida Administrative Code.
- (E) Whether any Utility has ever been required to meet the requirements of separately analyzing all operation and maintenance expenses, revenues, and rate base components in applying for an index rate increase as proposed in the show cause provisions of Order No. PSC-99-1068-PAA-SU.
- (F) Whether the Commission's proposed treatment of gross-up in this proceeding represents a change in policy.
- (G) Whether the Commission's proposed treatment of gross-up in this proceeding, and specifically, in Order No. PSC-99-1068-PAA-SU constitutes a change in policy which varies from that previously utilized in approving gross-up distribution proposed by NFMU in its 8 years of previous gross-up filings approved by the Commission.
- (H) Whether the Commission's proposal for the calculations required within the annual reports of NFMU as outlined in Order No. PSC-99-1068-PAA-SU, constitutes a substantial change in policy from those inherent in previous annual report, index and gross-up filings submitted by NFMU between 1987 and 1995.

- (I) Whether the Commission's proposed treatment of indexes and findings related to the appropriateness of the indexes filed by NFMU represents a change in policy from the treatment previously afforded to this and other Utilities for index filings prior to 1997.

Based on all the above, the utility concludes that:

[t]he Utility should not be fined for the alleged violations of Section 367.081(4), Florida Statutes, since the Utility is not in violation of those provisions of the Florida Statutes. The alleged violation is the result of a change in Commission policy in reviewing gross-up, annual report and index filings and contrary to 8 years of findings by this Commission on previous filings by this Utility. To the extent that the Commission ultimately finds that a violation did occur, the fact that no Utility has ever been required to perform the type of analysis that is proposed for this Utility in complying with that statutory provision, a fine of any amount, much less \$5,000 per incident is clearly excessive and must be reduced. North Fort Myers Utility, Inc. contends that it is not in violation of any provision of Commission Rule, Statute or Order and to the extent the Commission determines that such violation exists, requests a hearing pursuant to the provisions of Chapter 120.57(1), Florida Administrative Code.

Staff believes that the utility filed for and implemented Price Index rate increases for the years 1995, 1996 and 1997 based on incorrect annual reports filed for those years. Staff believes that the utility included operation and maintenance (O&M) expenses above-the-line in its calculation of utility operating income, that should have been included below-the-line. The utility, however, contends that its original annual reports were correct and that the price indexes were "correct, and not 'improperly implemented,' or 'based on inaccurate operating costs.'" Yet, by letter dated June 11, 1998, the utility contended that \$437,968 and \$374,019 of O&M expenses in its 1994 and 1995 annual reports should be reclassified below-the-line for gross-up purposes. In addition, on February 15, 1999, the utility filed revised sheets for its annual reports for 1994-1997, accordingly. The annual report pages indicated that an additional \$296,941 of expenses were reclassified below-the-line for 1996 and \$297,092 was reclassified below-the-line for 1997.

The utility argues "that there is a distinction between what should be considered above and below-the-line for gross-up, versus rate setting, and regulatory reporting purposes." Staff disagrees. Staff believes that the expenses should be given consistent treatment for all regulatory purposes. Otherwise, as in this case, different treatment of the same expenses could lead to inconsistent results or an unfair benefit to the utility. For instance, in this case, by including the expenses above-the-line for annual reporting purposes, the utility was able to realize the benefit of increased revenues through price indexing. Then, by including these same expenses below-the-line for gross-up purposes, the utility was able to reduce the refund to the contributors, thus, again resulting in a benefit for the utility.

Staff acknowledges that many O&M expenses are included in the annual report which are later disallowed in a rate case. Staff further acknowledges that through application of price index increases, rates may be increased for expenses which may not in a subsequent rate case be classified as legitimate utility expenses for which the customers should be made to pay. However, staff is seriously troubled by what appears in this case to be a manipulation by the utility of the CIAC gross-up disposition procedures in an attempt to maximize the amount of CIAC gross-up collections retained. The manipulation has occurred through revisions to its annual reports in this case. Staff is further troubled by the inference made at a past agenda conference that the effort necessary to prepare the most accurate annual report was not initially made.

In consideration of the above, staff believes that the Commission has two options on the continued processing of this show cause proceeding. First, the Commission could determine that the actions of the utility do not rise to the level of requiring a fine and close the show cause proceeding. Second, because there appear to be issues of material fact (utility alleges nine separate issues of material fact) and the utility has requested a formal hearing if any fine is contemplated, the Commission could include the show cause issue in the issues to be considered at the formal hearing scheduled for April 13-14, 2000 (hearing scheduled for protest of PAA portion of Order No. PSC-99-1068-PAA-SU).

Based on the following, staff believes that the Commission should adopt the first option. First, staff notes that the expenses in question were utility related expenses. Thus, staff believes that the expenses were appropriately included in the operating costs of the utility, and the utility was in compliance with the NARUC Uniform System of Accounts when it included the

expenses in the various O&M subaccounts. Second, because the Commission wished to promote the filing of accurate annual reports, it did not initiate a show cause proceeding for the utility's apparent failure to file an accurate annual report. However, the implementation of the apparently improper price indexes is based directly on the annual reports that were filed.

Finally, though staff believes that the utility should have allocated the expenses between above and below-the-line operations in its annual report, there is no rule or other written instructions requiring the utility to allocate utility related expenses between above and below-the-line operations when filing its annual report. However, since the Commission uses the annual report to monitor the level of earnings of the utility, the issue arises whether the expense, though utility related, should be allocated to above or below-the-line operations in the utility's annual report.

Staff believes that any expense, though utility related, that would not generally be allowed in the recovery of rates, should be included below-the-line for annual report purposes. For example in this case, the utility included legal fees above-the-line in its annual report that related primarily to litigation over an agreement with a consulting firm for assistance in refinancing the company's Industrial Development Revenue Bonds. Although the legal fees are utility company expenses, since they were not incurred in the provision of service, and there is no definable benefit to the ratepayers, the legal fees would not be classified as legitimate utility expenses for which the customers should be made to pay. Therefore, they should be classified below-the-line. The utility concludes that to separate the above and below-the-line operating expenses for annual reporting purposes would require "each utility to do a detailed rate analysis at substantial cost with the filing of each annual report," and that such analysis "would be very speculative and unprecedented." While it is not the intention of staff to burden the utility with additional work or cost, staff notes that as stated in Order No. PSC-99-1068-PAA-SU, in this case "An error of \$437,978, \$374,019, \$296,841 and \$279,072 of O&M expenses shown in the utility's 1994, 1995, 1996 and 1997 annual reports, respectively, is not insignificant." Plus, if the utility did not make the allocations, the annual report would not yield meaningful results as it relates to calculating the earned rate of return of the utility. In addition, the utility would receive revenues to which it was not entitled if the erroneously classified expenses were indexed.

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

However, because there is no rule or other written directive requiring the utility to allocate utility related expenses between above and below-the-line operations in its annual report, staff recommends that the utility not be fined for its apparent violation of Section 367.081(4), Florida Statutes. Additionally, staff notes that it was recommended that the index rate increases for the affected years be recalculated based on the revised annual reports and that refunds be made with interest for the amounts overcollected. Plus, it was also recommended that the utility reduce its rates accordingly. Both these recommendations were approved by the Commission at the May 4, 1999 Agenda Conference and incorporated in the PAA portion of Order No. PSC-99-1068-PAA-SU (which order has been protested). If the refunds and reduction in rates are ultimately upheld, there will be some administrative burden for the utility. Staff believes that the administrative burden should serve as a sufficient punitive measure and that no fine is necessary.

Therefore, upon further analysis as set forth above, staff recommends that the utility should not be fined for its apparent violation of Section 367.081(4)(c), Florida Statutes, and the show cause proceeding should be terminated. However, staff recommends that the Commission strongly admonish the utility to provide the most accurate information possible in future annual reports and price index rate increase applications.

DOCKET NO. 971179-SU
DATE: NOVEMBER 4, 1999

ISSUE 2: Should the docket be closed?

RECOMMENDATION: No. This docket should remain open to conduct the formal hearing on the protested proposed agency action portion of Order No. PSC-99-1068-PAA-SU. (JAEGER)

STAFF ANALYSIS: This docket should remain open to conduct the formal hearing on the protested proposed agency action portion of Order No. PSC-99-1068-PAA-SU.