Decision _____

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Castlerock Estates, Inc. and Bruce B. Breiholz, Complainants, vs. Toro Water Service, Inc., California Utilities Services, Inc., Robert T. Adcock, Defendants.	Case 92-04-034 (Filed April 28, 1992)

Last, Harrelson & Faoro by William C. Last, Jr., Attorney at Law, for Castlerock Estates, Inc. and Bruce B. Breiholz, complainants.
McDermott, Will & Emery by Marc P. Fairman, Attorney at Law, for Toro Water Service, Inc., California Utilities Services, Inc., and Robert T. Adcock, defendants.

OPINION DISMISSING COMPLAINT

1. Summary

The Commission dismisses this complaint seeking both reformation of the main extension contracts between Castlerock Estates, Inc. (Castlerock) and California Utilities Services, Inc. (Cal Utilities) and Toro Water Service, Inc.

(Toro) and a refund of the federal tax "gross-up" portions of contributions in aid of construction (CIAC) made by Castlerock to Cal Utilities and Toro. The complaint for reformation was untimely filed. The CIAC was properly calculated and collected in accordance with prior decisions of the Commission.

2. Statement of Facts

2.1 Defendants

By Decision (D.) 72192 issued on March 21, 1967, Toro received authorization to construct and operate a public utility water system in the Corral de Tierra Oaks subdivision in the area south of State Highway 68, between Salinas and Monterey, in Monterey County. Subsequently, the Toro service area was expanded and included the adjacent Markham Ranch property to the east of Corral de Tierra Road.

By D.87-05-033 issued on May 18, 1987, Cal Utilities received authorization to acquire from Salinas Utility Service a public utility sewer system serving an area along State Highway 68, between Salinas and Monterey, known as the Toro area. The service area acquisition included certain areas east of Corral de Tierra Road.

Robert T. Adcock was president of both Toro and Cal Utilities at all times relevant to this proceeding.

2.2. Complainants

In 1979, Castlerock was organized to develop a subdivision of approximately 140 homes on a portion of the Markham Ranch. The subdivision, sited between Markham Lane and Corral de Tierra Creek, was styled "Phase 1 of the Palma Grove."

Bruce B. Breiholz, at the initial Castlerock Board of Directors' meeting October 12, 1979, had purchased 128 shares of Castlerock stock and had been

elected corporate secretary. From 1986 to 1990, Breiholz was Castlerock's president. In a 1990 restructuring of Castlerock, Salvatore T. Palma became Castlerock president, and Breiholz transferred his Castlerock stock to Palma. In partial consideration for this transfer, a 50% interest in 12 acres of the Castlerock property was transferred to Monterey Palisades, Ltd., an entity of which Breiholz was a general partner.

2.3. Genesis of the Complaint

Prior to October 1986, in general, when a developer applied to a public utility for a service extension to provide water or sewer service to a new area, the developer paid the utility contributions in the form of money or property, which were termed CIAC. These contributions were exempt from federal income tax and consequently had no effect on either the utility's ratemaking or its federal income tax.

In October 1986, Congress passed Public Law 99-514, the Tax Reform Act of 1986. This Act changed matters by requiring utilities to include CIAC in income for federal taxation purposes. As a result, unless the CIAC was "grossed-up" to account for the taxable effect of the contribution on the utility, the CIAC would not be adequate to compensate the utility for its construction costs, thereby requiring the utility, and ultimately its ratepayers, to absorb the shortfall.

Subsequently, the Commission instituted Investigation (I.) 86-11-019 to determine "methods to be used to establish the proper levels of expense for ratemaking purposes for public utilities and other regulated entities due to changes resulting from the Act." The investigation resulted in D.87-09-026, Re Tax Reform Act of 1986 (1987) 25 CPUC 2d 299, which allowed utilities to gross-up the amount of a developer's CIAC. The gross-up would make the total amount of the developer's contribution income neutral, thus mitigating the

ratemaking effect of including the CIAC in the utility's taxable income. We considered five possible methods that had been proposed during the investigation. We concluded that two of the proposals were appropriate responses to the problem posed by the federal tax law change.[1] We adopted Method 5 for most utilities, but allowed small water companies (such as Cal Utilities and Toro) and small telephone companies to use Method 2.[2] Both methods further our goal of ensuring that the collections from the developer are revenue neutral to the utilities. This objective is reflected in D.87-09-026, Conclusion of Law 12, which provides:

> If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor.

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[1] In D.87-09-026, we numbered the five proposals and referred to them by their numerical designations. The parties used those designations in this proceeding, and for convenience we will continue to use them in this decision.

[2] Method 2 provides for complete gross-up by the contributor at the utility's incremental federal tax rate. That is, the contributor pays to the utility the amount of the contribution, as well as an amount equal to the utility's total federal tax liability on the contribution and the gross-up amount.

Method 5 likewise requires the contributor to gross-up the contribution, but requires payment only of the net present value of the tax amount at the time of the contribution. We adopted uniform state-wide discount rates and pre-tax rates of return to make implementation of Method 5 consistent and easy to administer.

In 1988, the year at issue here, Cal Utilities selected Method 2; Toro selected Method 5.

Following a protracted permitting process, the Castlerock subdivision was approved. On February 23, 1988, Toro and Cal Utilities signed water and sewer main extension construction contracts respectively with Castlerock. Adcock signed for Toro and Cal Utilities, and Breiholz signed for Castlerock. Form E of the Toro and Cal Utilities tariffs' contracts were used. Each contract was for a non-refundable contribution of the facilities to be installed. Attached to each contract was a copy of each utility's respective Tariff Rule 15 on file with the Commission.

2.4 Issues

The captioned complaint was filed on behalf of Castlerock and Breiholz, with Breiholz signing the complaint and providing verification, ostensibly as the president of the corporation. The complaint raised two issues:

First, complainants asserted that when the contracts were made in 1988, they were informed that only "non-refundable" contracts were available. The complainants later learned this not to be true. Accordingly, their complaint seeks to have both contracts reformed to make them "refundable."

Second, complainants asserted that in 1988 they had been informed that the gross-up had to be paid whether or not the utility actually paid any tax. When in 1989 they obtained the Annual Reports of Toro and Cal Utilities, they discovered that each showed a taxable loss. Complainants relied upon the first two sentences of Conclusion of Law 12 to claim that neither utility was in a "taxable position" in 1988, and that consequently both owed Castlerock refunds of the tax gross-ups.

3. Chronology of Proceedings

Because this proceeding extended over several years, it is useful to summarize the various stages. At a hearing on February 18, 1993, preliminary

legal issues were addressed. At a prehearing conference (PHC) on June 1, 1994, the assigned administrative law judge (ALJ) ruled on discovery requests and the parties decided to seek clarification of D.87-09-026. An additional PHC was held on July 19, 1994.

In a Joint Petition dated October 4, 1994, Toro and Cal Utilities joined Castlerock in requesting that I.86-11-019 be reopened for the purpose of modifying D.87-09-026 to clarify Conclusion of Law 12 in regard to circumstances under which utilities might become obligated to refund tax gross-ups on CIAC. Accordingly, the Commission reopened I.86-11-019. This proceeding was in abeyance while the Commission reviewed D.87-09-026.

The Commission issued D.96-10-037 (68 CPUC 2d 469), clarifying D.87-09-026, on October 9, 1996. (This clarification is critical to this case and is discussed at length in Section 4.2, below.) This proceeding resumed with a PHC on July 30, 1997, where evidentiary submissions were discussed. Evidentiary hearings were held on October 21, 1997 and March 3, 1998. Closing briefs were submitted by all parties on June 19, 1998.

4. Discussion

4.1. Preliminary Matters

There are three preliminary matters related to the Commission's jurisdiction and the parties' capacity: the timeliness of the complaint, the interests of Breiholz and Adcock in this proceeding, and the verification of the complaint. We affirm the ALJ's rulings on these matters as set forth below.

As to the timeliness of the requests for reformation of the contracts, the ALJ ruled at the February 18, 1993 hearing that the request to reform the 1988 contracts to be "refundable" in character was filed beyond the three-year statute of limitations of Pub. Util. Code § 736, since the contracts were executed and

carried out in 1988, but the request for reformation was not filed until April 1992.[3] As to the requests for CIAC refunds, the ALJ ruled that the complaint was timely. The three-year statute of limitations on the refund claim could not begin to run before complainants had an opportunity to inspect the 1988 Annual Reports of Toro and Cal Utilities. These reports were not filed with the Commission until May 9, 1989 (although due March 31, 1989). The complaint was therefore timely filed on April 28, 1992.

Defendants moved to dismiss the complaint on the basis that Breiholz, at the time he signed the Castlerock complaint both as an individual and for Castlerock, and verified the complaint on April 25, 1992 as "PRES," lacked both personal interest and capacity to verify. In reply, Castlerock submitted a declaration by its president (Palma) purporting to show that the Castlerock Board had authorized Breiholz to act for it as "President pro tem." On May 2, 1994, after receipt of extensive briefing, the ALJ ruled that the evidence clearly showed that Breiholz had no interest either in Castlerock or in the water and sewer contracts, and lacked any standing as a possible complainant. Accordingly Breiholz was dismissed as an individual complainant. Breiholz's role as the verifier of the complaint was a closer question under the evidence presented. Inasmuch as dismissal would merely have delayed the issue, since Castlerock's present principals would immediately refile, the ALJ denied the motion to dismiss the complaint for lack of appropriate verification.

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[3] On March 22, 1993, Castlerock moved for Commission review of the ALJ's Ruling dismissing the request for reformation of the 1988 contracts. On April 2, 1993, the ALJ denied the motion, noting that Commission Rules of Practice and Procedure provide that almost no appeals from ALJ Rulings will be considered by the Commission outside its final consideration of the merits of the case. *See* Rule 65.

Adcock, as an individual, was named a defendant in the Complaint. The Commission, pursuant to Pub. Util. Code § 1702, has jurisdiction over public utilities, not individuals, in a complaint proceeding. Although Adcock was not appropriately named as a defendant, and the complaint should be dismissed as to him, the two utilities were properly named in this proceeding.

4.2 Castlerock's Refund Claim

Castlerock asserted two bases for its claim for a refund of part of the CIAC gross-up: that the actual federal income taxes paid by the utilities must be the basis for calculating the gross-up; and that, regardless of the actual taxes paid, the gross-up amount was wrongly calculated.

This refund dispute is governed by Commission decisions in response to the Federal Tax Reform Act of 1986, which for the first time included CIAC payments in the federally taxable income of water and sewer utilities.[4] In D.87-09-026, the Commission identified methods for utilities to use to ensure that the new tax consequences of CIAC would neither burden ratepayers nor result in windfalls for developers. During the course of this proceeding, the parties sought clarification of ambiguities in D.87-09-026 that had become evident as it was sought to be applied in this case. We responded by issuing D.96-10-037, which clarified the Commission's requirements related to tax gross-ups. Among other things, we clarified that Conclusion of Law 12, and thus the refund question, was limited to utilities choosing Method 2. This clarification effectively eliminated Toro as a defendant, since Toro utilized Method 5. (See Toro Tariff

[4] Section 1613 of the Small Business Jobs Protection Act of 1996 exempts from federal taxation CIAC received by all water and sewer utilities after June 12, 1996. This case will therefore not be repeated.

Sheet No. 163-W, effective January 1, 1988.) Accordingly, this proceeding thereafter was limited to Castlerock's complaint against Cal Utilities.

Castlerock's initial argument focused on the need to determine the actual tax paid by the utility in order to figure the correct gross-up amount. Although this was arguably a possible reading of D.87-09-026, we considered and rejected that reading in D.96-10-037. We emphasized that the actual incremental tax rate, not the tax paid, is the basis for calculating the gross-up. In so doing, we identified a number of tax-reducing elements of federal taxation that we would *not* apply in the gross-up calculation.[5]

Conclusion of Law 12, as modified in D.96-10-037, states:

> For utilities which elect Method 2, if the utility collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collected should be refunded to the contributor.

This clarification had the incidental effect of eliminating the need to determine whether the utilities' federal tax returns were discoverable. The parties expended much effort on this issue. The clarification provided by D.96-10-037, however, rendered the entire question of the content of Cal Utilities' tax returns irrelevant. In D.96-10-037, the focus is on the appropriate incremental tax rate—about which there is no disagreement in this proceeding.

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[5] These elements included tax loss carry forward, loss carry backs, fuel credits, accelerated depreciation, and investment tax credit. The decision denominated these last four considerations "tax credits." 68 CPUC 2d at 474 and n.2.

Under the methodology established to make the CIAC from a developer revenue neutral to a utility, the information needed to identify the proper incremental tax rate for the developer contribution is contained in the utility's Annual Report.[6] In this case, there was no dispute that 34% was the appropriate incremental tax rate. Nothing else was needed to determine whether Castlerock was entitled to a refund, except consideration of whether the Commission's decisions had been properly applied and the calculations properly performed.

Castlerock's remaining argument addressed the propriety of the calculation of the gross-up paid to Cal Utilities. Castlerock's principal complaint was that it should have been liable for a gross-up consisting of only 34% (the incremental tax rate) of the basic CIAC amount ($354,790), or $120,629, rather than the gross-up of $182,717 collected by Cal Utilities.[7] This idea about how to apply the incremental rate was, however, rejected by the Commission in D.87-09-026. Rather than a simple percentage of the CIAC, the gross-up under Method 2 was defined to include "tax-on-tax."[8] In that decision, we pointed out that "[i]n 1988, at the 34% federal tax rate, under Method 2 an advance or

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[6] Cal Utilities' 1988 Annual Report was admitted as Exh. 7. Cal Utilities also submitted an explanation of its revenues and operating expenses based on figures in its annual report. This explanation was admitted as Exh. 4. Although somewhat difficult to follow because of the accounting requirement that developer contributions be credited directly to a CIAC account balance sheet amount, with an offsetting charge to Water Plant in Service, this explanation adequately demonstrated the basis for the incremental tax rate used in the CIAC gross-up calculations.

[7] Castlerock's calculations were set out in Exh. 5 at the hearing.

[8] "Method 2 provides for complete gross-up by the contributor at the utility's incremental federal tax rate. The ratepayer pays nothing. The contributor. . . pays a tax-on-tax. . ." 25 CPUC 2d at 326.

contribution of $1,000 would require an additional $515 to cover the federal tax." 25 CPUC 2d at 303. That is exactly the situation here, where Cal Utilities applied the 51.5% addition to the $354,790 amount of the contribution, yielding the correct total for the gross-up of $182,717.

Castlerock half-heartedly advanced the alternative claim that a refund of $21,062 of the gross-up was due. This claim was based on a methodology that Castlerock conceded was not based on application of the incremental tax rate to the CIAC. It is therefore not a viable alternative ground for any refund.

5. Assignment of Proceeding

Henry Duque is the Assigned Commissioner and ALJ Simon is the assigned ALJ in this proceeding.

6. Comments on Proposed Decision

The proposed decision in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Commission's Rules of Practice and Procedure. No comments were received.

Findings of Fact

1. The Federal Tax Reform Act of 1986 required, for the first time, that utilities include in their federal taxable income CIAC that they collect from developers.

2. The inclusion of CIAC in a utility's taxable income increases its income taxes and reduces after tax funds available to the utility and its ratepayers.

3. D.87-09-026 was intended to set forth procedures which, when applied, would cause the consequences of including CIAC in taxable income to be revenue neutral.

4. Conclusion of Law 12 in D.87-09-026 incorporated a methodology for the "gross-up" of CIAC that was intended to make CIAC revenue neutral to the recipient utility.

5. On February 23, 1988, Castlerock signed non-refundable Main Extension Contracts with Toro and Cal Utilities that required Castlerock to pay contributions in the amount of $354,790 for the Cal Utilities extension, and $153,736 for the Toro extension. These contracts contained notices that any disputes could be referred to the Commission.

6. In addition to the CIAC, Castlerock paid Cal Utilities $182,717 as the "gross-up" Cal Utilities stated was necessary to render the CIAC revenue neutral.

7. Adcock, an individual, is not a "public utility" for purposes of the complaint procedure set out in Pub. Util. Code § 1702 *et seq.*

8. At the time of the filing of the complaint, Breiholz had no interest in Castlerock or in either of the Main Extension Contracts.

9. Pub. Util. Code § 736 provides a three-year statute of limitations for claims brought before the Commission.

10. Castlerock's claims for reformation were filed more than three years after the contracts were signed with Toro and Cal Utilities.

11. Castlerock's gross-up refund claim against Cal Utilities accrued on May 9, 1989, when the 1988 Cal Utilities Annual Report was filed with the Commission, less than three years before the refund claim was filed on April 28, 1992.

12. At the request of the parties to this proceeding, the Commission reviewed D.87-09-026 and issued D.96-10-037 clarifying its prior decision.

13. Cal Utilities utilized Method 2 described in D.87-09-026 to collect its gross-up on the Castlerock CIAC.

14. Toro employed Method 5 described in D.87-09-026 to collect its gross-up on the Castlerock CIAC.

15. Pursuant to D.96-10-037, utilities using Method 5 are not subject to any claims for refund of CIAC gross-up amounts; consequently, Toro is not subject to Castlerock's claim for a refund of CIAC gross-up payments.

16. Cal Utilities calculated the gross-up it collected from Castlerock in 1988 by applying the applicable marginal tax rate to the sum created by adding Castlerock's CIAC and gross-up contribution total of $537,507 to taxable income loss of $31,254.

17. The methodology Cal Utilities used to compute the payments collected from Castlerock conformed to the approved methodology in D.87-09-026, as modified by D.96-10-037.

18. The information necessary to calculate Castlerock's contribution was all obtained from Cal Utilities' Annual Report.

19. As the methodology prescribed by D.96-10-037 does not depend on the actual taxes paid by a utility or on information from its income tax returns, the income tax returns are not relevant to any issue in this case.

20. Cal Utilities does not owe any refund to Castlerock for the gross-up payments made by Castlerock on account of the 1988 CIAC contracts.

Conclusions of Law

1. Castlerock's request to reform the two contracts to be "refundable" should be denied because it was made after the expiration of the applicable limitations period.

2. Castlerock's claim for a refund of its CIAC gross-up was made within the applicable limitations period.

3. Breiholz should not be allowed as a complainant, because at the time of filing the complaint he had no legal interest in Castlerock or either of the contracts at issue.

4. Adcock should be dismissed as a defendant, since he is an individual and not a public utility.

5. Toro should be dismissed as a defendant, since D.96-10-037, which clarified D.87-09-026, specifically limited refund provisions to those utilities that elected Method 2; Toro elected and applied Method 5.

6. The complaint for a refund by Cal Utilities should be dismissed effective immediately because Cal Utilities properly applied the method prescribed by D.87-09-026 as modified by D.96-10-037 and properly computed the amount due.

O R D E R

IT IS ORDERED that:

1. Case 92-04-034 is dismissed as to all defendants.
2. Case 92-04-034 is closed.

This order is effective today.

Dated _____, at San Francisco, California.