IN THE SUPREME COURT OF FLORIDA

TAMARON HOMEOWNERS ASSOCIATION, INC.,

Petitioner,

v.

TAMARON UTILITIES, INC.,

Respondent.

CASE NO. 63,626

2nd DCA Case Nos. 82-1594 and 82-1744

PETITIONER'S REPLY BRIEF

DANIEL JOY
2055 Wood Street, Suite 200
Sarasota, Florida 33577
(813) 365-7240
Attorney for Petitioner

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REPLY TO TAMARON'S STATEMENT OF THE FACTS AND CASE

TAMARON takes this Court far beyond the record to delve into the subjective intent of the Sarasota County Commission as it relates to the reasons why the Commission prohibited a utility in Ordinance 80-62 from including in the rate award a depreciation expense attributable to CIAC assets. TAMARON would have this Court conclude that the only reason was the Circuit Court's ruling in the case of Southeastern Development & Utilities Company, Inc. v. Board of County Commissioners, 398 So.2d 882 (Fla. 2nd DCA 1980).

Prior to the Circuit Court ruling in the case aforementioned, Ordinance 72-64 was silent on the issue of whether contributed assets should be treated, for depreciation purposes, differently than assets the origin of which is traceable to the utility owners' investment. The Circuit Court ordered the BOARD to remove the amount from the rate awarded. The Second District Court of Appeal in the Southeastern case, supra, quashed the decision of the Circuit Court for one reason only: that to permit a depreciation expense attributable to contributed assets did not depart from the essential requirements of law. The Second District did not suggest that the inclusion of some factor attributable to contributed assets was mandatory until the Tamaron case sub judice.

Following the decision of the Second District in the first Southeastern case, the County Commission did not automatically, or even quickly, reinstate its prior practice of including

depreciation of contributed assets in a utility's rate award. It was not until after the Second District sub judice determined that a utility has a constitutional right to have a contributed asset factor included in the rate that the County abandoned its policy of prohibiting an expense attributable to the depreciation of CIAC. The impression sought to be conveyed by TAMARON that the Commission's policy towards including or excluding a depreciation expense attributable to CIAC had been determined by the Courts is conjecture on the part of TAMARON, and unreasonable. This Ordinance speaks for itself.

TAMARON's attorney quotes his partner, Mr. Meshad, as advising the BOARD that TAMARON was not explicitly seeking a depreciation expense for contributed assets, but sought only an amount, categorized as a utility expense, and called a "reserve contingency account." What TAMARON failed to point out is that the financial effect of the so-called reserve contingency account was to create for the utility an increased cash flow in the amount of $23,500 per year, without any corresponding obligation regarding the use of that money. Nothing in TAMARON's Petition to the BOARD suggests that TAMARON intended to keep the money booked as a reserve contingency account on hand for future use. Nothing contained in the Ordinance would have so required. What is as a practical matter crucial to the consideration of the issues presented in this case is to separate the useful arguments from financial reality. TAMARON argues that it needs to collect money now as a means to ensuring that money will be on hand at such time as the contributed assets need replacement. The reality is that TAMARON would not be obligated to retain the funds collected

for that purpose. It would be free to utilize the amount on hand as it sees fit, including increasing dividend distributions. Should at the time in the future CIAC assets need replacement, there was not and is not any guarantee that the funds would then be available to finance the expenditures. Because a bookkeeping account shows a credit does not ipso facto mean that the cash has been retained internally for the use for which TAMARON argues is its purpose.

ARGUMENT

TAMARON IS NOT DEPRIVED OF ITS PROPERTY WITHOUT DUE PROCESS OF LAW WHEN IT IS AT ONCE PRECLUDED BY LAW FROM COLLECTING A DEPRECIATION EXPENSE ATTRIBUTABLE TO THE AMORTIZATION OF CONTRIBUTED ASSETS WHEREIN IT [THE UTILITY] DOES NOT HAVE ACQUISITION COSTS AND SIMULTANEOUSLY IS PRECLUDED FROM INCLUDING ANY PORTION OF THE VALUE OF THOSE ASSETS IN THE RATE BASE ON WHICH IT IS ENTITLED TO EARN A REASONABLE RATE OF RETURN.

TAMARON has quite apparently missed completely what is at issue before this Court. The Second District Court of Appeal did not conclude that it was preferable public policy for a regulatory body to make use of CIAC depreciation in the ratemaking process. It concluded that the Constitutions of the United States and the State of Florida require that a regulatory body include either a CIAC depreciation expense, or allow "add-back," or incorporate some contributed asset factor into the rate award.

The HOMEOWNERS did not attempt to argue ratemaking policy, which is the basis of TAMARON's Answer Brief. The HOMEOWNERS argued that to the extent the Supreme Court of the United States

has dealt with the issue of the deprivation of the UTILITY's property, it has determined that a utility is not deprived of its property without due process of law when the utility is prohibited from valuing assets other than at its actual cost. TAMARON acknowledges that the Supreme Court held, in Federal Power Commission v. Hope Natural Gas, 320 U.S. 591, 88 L.Ed.333, 64 S.Ct. 281 (1944), a utility would not be deprived of property without due process of law when it is prohibited from including in its rate base assets at values greater than its [the utility's] actual legitimate acquisition costs.

In attempting to distinguish the Hope Natural Gas case from the matter sub judice, TAMARON argues that the rule enunciated is irrelevant because the Supreme Court did not deal with or even mention contributed property. This ignores that the category of assets with which the Supreme Court dealt would include contributed property. The BOARD, by Ordinance, prohibited a utility from including within its rate depreciation expenses on assets other than those for which the utility had actual, legitimate acquisition costs. The United States Supreme Court held that a utility's constitutionally protected property interest is limited to actual legitimate acquisition costs. TAMARON did not have any acquisition costs associated with its ownership of contributed assets. Therefore, on the authority of the rule in the Hope Natural Gas case, TAMARON does not have a constitutionally protected property interest in the contributed assets.

The Second District in holding that the utility does have a

constitutionally protected property interest, failed to specify what is the nature of that property interest, or specify how that property interest is being deprived. The Supreme Court in Hope Natural Gas reasoned that a utility does not have a constitutionally protected property interest beyond acquisition costs because those assets are mandated by law to be used by the utility for public service until those assets are completely exhausted. The utility is not free to remove those assets from public service. Perhaps inadvertently, TAMARON admits this point when it states at page 20 of its Answer Brief

> At the risk of being redundant, the allowance of depreciation on contributed property is not for the purpose of giving the utility a return on property in which it has no investment. It is for the purpose of providing a fund to replace the property as the consumer consumes it. The customer is ultimately going to bear the cost of replacing the property when it fails, regardless of how the property was initially acquired by the utility.

Accepting that conclusion as the basis of TAMARON's position, the utility appears to be arguing that the Constitution of the United States operates to require the utility to be permitted to accumulate a "fund" to replace the contributed property as the consumer consumes it. What TAMARON has failed to grasp is that it has identified a policy dispute, not a constitutional issue. TAMARON acknowledges, as do the HOMEOWNERS, that some utility customer is at some time going to bear the cost of replacement of CIAC assets, if and/or when they fail. But the issue before this Court is the one presented to it by the Second District, which is whether the BOARD is constitutionally obligated to permit the

utility to collect a fund for replacement now when that replacement is off to somewhere in the unspecified future.

There are at least three reasons why the Court should not recognize this as a constitutional right of the utility. First, the matter is one of policy. An important policy issue exists over who should finance the funding of the replacement of contributed assets. Authorities universally agree the first purchaser of a lot, where the developer has installed the utility system and then donated it to an operating utility company, pays for the cost of the utility in the cost of the lot. Princess Anne Utilities Corporation v. Commonwealth of Virginia, ex rel. State Corporation Commission, 179 SE2d 714 (Va. 1971).

In other words, the initial lot purchaser has paid for the contributed assets. The legislative authority regulating a utility could very reasonably conclude that replacement funding should come from future users, not current users. The uncertainty as to when, or even if, contributed assets will require replacement suggests that policymakers could reasonably defer making decisions until there are fewer uncertainties. To require depreciation for the purposes of collecting a replacement fund is to determine that those who have contributed once should be required to pay for those assets again in the form of building up a replacement fund, even assuming that the utility's access to the funds was restricted to that purpose. Certainly the Constitution of the United States does not require that the replacement costs must be borne by those using the assets who have already paid once.

Second, some of the assets included within the CIAC category

will never run out. In-ground concrete pipelines could very reasonably have a use life far beyond any amortization schedule. They may figuratively never need replacement. Also, cash in the form of connection charges is included in contributed assets. Inflation to the contrary notwithstanding, contributed assets in the nature of cash will never require replacement.

The third argument relies less on a micro-economic cost allocation analysis than it does on the practicalities of the matter. TAMARON would have this Court believe that it has pursued this matter in order to secure a right to collect a CIAC replacement fund. The facts of the matter are, if the Second District's ruling is left standing, the utility is free to utilize the money collected as it wishes. The so-called reserve fund is a fund in name only. While Sarasota's new ordinance places restrictions on the utility's access to and use of the amounts collected by the utility which are attributable to CIAC depreciation, there is nothing which restricts TAMARON's access to or use over the fund to which it claims a constitutional entitlement. This fund will appear on the books of the utility as an accruing liability. Whether it is funded is an entirely different question.

Moreover, the Second District's ruling raises a difficult issue for those regulators who wish to permit the utility to collect such an expense, but would restrict the utility's access to the funded reserve and control the expenditures from it. If there is a constitutional right for the utility to have included in its rate some contributed asset factor, on what basis could a

regulatory body seek to control how that money is going to be used? If to deny the utility the right to include a CIAC factor in the ratemaking process is to deny the utility of its property without due process of law, then on what basis can the legislative body restrict the utility's access to the funds collected? That also would seemingly deny the utility of the same property right the Second District found to have been denied TAMARON.

These points emphasize the policy-oriented nature of the regulatory issue, out of which the Second District Court determined a constitutional right. This is emphasized by a close reading of the utility's Brief. The utility concentrates on whether this Court previously rejected the recovery of investment theory and/or adopted the replacement theory. By so arguing, the utility virtually admits that the issue is not one of constitutional law. The HOMEOWNERS would argue that neither theory would violate the essential requirements of law, which means that the legislative body could <u>adopt either</u> theory. The BOARD adopted the replacement theory. But what the Second District has done is to determine that the recovery of investment theory violates the operative requirements of the due process clause of the Constitutions of the United States and the State of Florida.

There is not, however, any authority for such a proposition. To the contrary, the HOMEOWNERS cited four cases, from four sister jurisdictions, (Virginia, Missouri, North Carolina and Maryland) which have considered the issue of whether a prohibition similar to the one contained in Sarasota's Ordinance 80-62 operates to confiscate the property of the utility. Each of those courts

concluded that the prohibition does not operate to confiscate the utility's property.

This Court has long recognized that when an administrative agency is acting within the scope of its authority as defined by law, the Courts will not substitute their judgment for that of the regulating agency. Troup v. Bird, 53 So.2d 717 (Fla. 1951) This is a cardinal principle governing the judicial review of administrative action. Wilson v. Pest Control Commission, 199 So.2d 777 (Fla. 4th DCA 1967) The obvious policy-oriented nature of the contributed assets issue and the choices implicit in the program for replacement operates to reserve to the legislative body the manner and means by which the policy issue will be resolved. State ex. rel Railroad Commissioners v. Louisville & Nashville R. Co., (1911) 62 Fla. 315, 57 So.175; Richards v. Baldwin (1936) 124 Fla. 233, 168 So.255. TAMARON responded to the cases from the sister jurisdictions by referring this Court to DuPage Utility Company v. Illinois Commerce Commission, 267 NE2d 662 (Ill. 1971). The Illinois Court did not hold that an allowance for depreciation attributable to CIAC is mandated by the Constitution, but only that such was not improper. In other words, it did not violate the essential requirements of law. There, the intervenors were attacking and asking the Supreme Court of Illinois to declare that the allowance of CIAC depreciation violated fundamental law. The Court declined to do so. The DuPage Utility case is analogous to the Opinion of the Second District Court in Southeastern Development & Utilities Company v. Board of County Commissioners, supra, which concluded

that given an appropriate reserve account, the BOARD could authorize the collection of a CIAC depreciation expense.

In reply to one argument put forward by the HOMEOWNERS, TAMARON argues that the Second District's reference to the Internal Revenue Code was in passing only, and was not fundamental to the decision. The Court's own language suggests otherwise.

> It seems reasonable to us [2nd DCA] that if contributed property can be depreciated annually for federal income tax purposes, this depreciation ought also to be considered at some point in the ratemaking process. [See Homeowners' Appendix No. 6, Main Brief, pp. 8-9.]

The Court asserted as its hypothesis that if the Internal Revenue Code recognizes depreciation on CIAC, then ratemaking in Florida ought to also. The hypothesis, however, was incorrect. Interestingly, the utility chose not to argue that point. It chose, however, to answer the HOMEOWNERS by stating that the Internal Revenue regulation to which the HOMEOWNERS referred this Court is a proposed regulation, and had never been adopted. This line of argument strongly suggests that TAMARON does not fully appreciate the role of IRS regulations, including proposed regulations. A regulation to be effective need not be finally adopted by the Internal Revenue Service to be IRS policy. A proposed regulation is as much a policy determination of the Internal Revenue Service as is an adopted regulation. In either instance, the regulation is intended as a construction of the Internal Revenue Code section on which it is based. In this instance, it is Section 118(b)(4) IRC. The Internal Revenue Service in construing Section 118(b)(4) determined that a deduction for depreciation of

contributed assets will not be allowed for a water or sewer disposal facility where the regulated public utility perceives the property as a result of a non-taxable contribution in aid of construction. This proposed regulation has, for purposes of administering the Internal Revenue Code, at least as much authoritativeness as a Revenue ruling, and can be considered the Internal Revenue Service's construction of the Internal Revenue Code section on which it is based.

The only distinction between an adopted regulation and a proposed regulation is the standard by which the judiciary will review the regulation. Where the regulation has been adopted pursuant to the requirements of the Administrative Procedure Act, the Courts recognize the adopted regulation as presumptively correct. In any case, the adopted rule, the proposed rule, and revenue ruling, are all intended and serve the purpose of construing that section of the Internal Revenue Code under consideration. See Saltzman, IRS Practice & Procedure, New York: Warren, Gorham & Lamonte, 1981.

REPLY TO FLORIDA CITIES WATER COMPANY

The ruling which FCWC defends in its Amicus Curiae Brief is not the ruling handed down by the Second District. This is amply demonstrated by FCWC's concluding sentence in the argument portion of its Brief wherein Attorney Gatlin writes

> Contrary to the County's assertion at page 10 of its Brief, the Florida statute is, in fact, "persuasive argument" for the Second District Court's holding that an add-back to

> rate base of accumulated depreciation on CIAC is constitutionally required where CIAC depreciation is disallowed as an operating expense.

The Second District did not so hold, and a reading of its opinion amply demonstrates that point. One, however, should assume that FCWC's advocate appreciates the distinction, but wishes this Court to affirm the Second District, thereby protecting the "add-back" it receives. Therefore, insofar as it relates to FCWC's position, the issue is not the Second District's issue, but whether the Constitution of the United States requires the legislative body to include accumulated CIAC depreciation as an add-back to the rate base.

All three Sarasota County Ordinances [72-64, 80-62, and 83-48] prohibit or have prohibited contributed assets from being included in the rate base. So does state statute. The HOMEOWNERS previously argued that "add-back" violates that prohibition. FCWC claims that the HOMEOWNERS' reliance on State v. Hawkins, 364 So.2d 723 (Fla. 1978) for that proposition is misplaced. FCWC contends that this Court in that case held only that an add-back of CIAC depreciation to rate base is inappropriate in cases where a utility is allowed to recover CIAC depreciation as an operating expense. This is manifestly untrue. First, this Court in that case stated the issue under review:

> The issue presented is whether the Commission departed from the essential requirements of law in utilizing an accounting method to determine rate base which adds back the accumulated depreciation attributable to the contributions in aid of construction (CIAC). (p. 724)

Not only did this Court not qualify its treatment of the issue with the dependent clause, "Where a utility is allowed to recover CIAC depreciation as an operating expense," but it specifically noted that the issue of an operating expense depreciation upon facilities acquired as contributed assets was not at issue. The Court did not deal with it in any way. What was at issue is whether the Public Service Commission departed from the essential requirement of the Statute which prohibited the inclusion in the rate base of contributed assets when it utilized an accounting procedure which employed "add-back." The Court said,

> This procedure reintroduces CIAC property into the rate base structure and results in a windfall to the utility, which earns a return on property other than its own, and unfairness to the rate-payers, who must pay higher rates in spite of their contributed capital. (p. 725) [emphasis added]

What this Court concluded was that to permit the "add-back" accounting procedure was to include contributed assets in the rate base, thereby departing from the essential requirement of State law. It struck down the practice. The Court did not qualify or condition its finding to those utilities where CIAC depreciation expense is allowed. Counsel for FCWC has provided that aspect.

FCWC's thesis is that add-back is necessary to ensure that CIAC has no effect on the rate base. (Amicus Curiae Brief, p. 4) To prove its point, it utilizes an accounting illustration which is misleading as well as unnecessary. A utility is entitled to

earn a reasonable return on its rate base, which is properly defined as capital investment of and by the utility, minus accumulated depreciation. The accounting illustration utilized by FCWC does not meet this definition, as it included contributed assets in the investment figure. The illustration begins with a one million dollar figure, representing gross utility plant from all sources (investment capital and contributed assets). The process continues by deleting the $500,000 of contributed assets. At the point of commencement, the rate base is $500,000. No one would argue with this point, at the point of commencement.

What is in error is the procedure by which FCWC assumes that the accounting calculation for determination of the rate base should include contributed assets in the first place. Florida Statutes and all the pertinent Sarasota ordinances specifically exclude contributed assets from the rate base. Therefore, the formula by which the rate base is determined should not have contributed assets included in the first place. Utilizing the FCWC accounting procedure, this is the picture after twenty years:

Gross Utility Plant	$1,000,000
Less Accumulated Depreciation	(500,000)
Net Utility Plant	500,000
Less CIAC	(500,000)
Add Accumulated Depreciation of CIAC	250,000
Rate Base	$ 250,000

The same result would be obtained by excluding contributed assets from the onset. The illustration is as follows:

Invested capital utility plant	$500,000
Less accumulated depreciation (of those assets)	(250,000)
Rate Base	$250,000

The accounting procedure which FCWC utilized is neither mandated by law nor sacrosanct. If a utility ratemaking board, statute or ordinance operates to deprive a utility of rate base to which it is entitled, that utility can seek and obtain judicial redress at that time. There is not before this Court any claim that TAMARON, or even FCWC for that matter, has been deprived of rate base to which it is entitled. What FCWC argues is that given a certain accounting procedure, it could be deprived of rate base if "add-back" is not permitted. The problem is that the accounting procedure includes contributed assets in the rate base. Change the arithmetic and FCWC would not have even a theoretical complaint. Exclude contributed assets from the rate base calculation formula, then one does not need add-back as an adjusting factor to neutralize that which should not have been in the rate base in the first place.

CONCLUSION

Fair results, equitable treatment, sound ratemaking, and the requirements of constitutional law, mandate that the Lower Court's opinion be vacated. The issue is, after all, whether a regulatory body <u>may</u> adopt rules, regulations and rates which as a matter of policy exclude a depreciation allowance for contributed assets,

while also precluding the inclusion of some CIAC factor in the rate base. Sarasota County adopted this position in Ordinance 80-62.

The HOMEOWNERS respectfully suggest that the Constitutions of the United States and the State of Florida do not require that depreciation of contributed assets be included in some way in the operating rate granted a regulated utility. The HOMEOWNERS would request that this Court reject the rule of constitutional law adopted by the Lower Court, and at the same time, reaffirm its commitment to both the constitutional requirements articulated in the Hope Natural Gas Company case, supra., and to the end results doctrine which limits judicial review of any given rate to whether the utility is compensated for its expenses and allowed to earn a reasonable return on its investment. All other issues and questions are appropriately reserved as policy issues.

Respectfully submitted,

DANIEL JOY
2055 Wood Street, Suite 200
Sarasota, Florida 33577
(813) 365-7240

Attorney for Petitioner

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that true and correct copies of the foregoing have been furnished, by mail, to RICHARD E. NELSON, ESQUIRE, Nelson, Hesse, Cyril, Smith, Widman & Herb, 2070 Ringling Boulevard, Sarasota, Florida 33577, Attorney for Sarasota County; to M. JOSEPH LIEB, ESQUIRE, Syprett, Meshad, Resnick & Lieb, 1900 Ringling Boulevard, Sarasota, Florida 33577, Attorney for Tamaron Utilities; and to B. KENNETH GATLIN, ESQUIRE, Madigan, Parker, Gatlin, Swedmark & Skelding, P. O. Box 669, Tallahassee, Florida 32302, Attorney for Florida Cities Water Company, this 23rd day of December, 1983.

DANIEL JOY
2055 Wood Street, Suite 200
Sarasota, Florida 33577
(813) 365-7240

Attorney for Petitioner