O/a 11-7-84

IN THE SUPREME COURT OF FLORIDA

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CITIZENS OF THE STATE OF FLORIDA,

Petitioner,

v.

PUBLIC SERVICE COMMISSION, et. al.,

Respondents.

Case No. 64,680

APPEAL FROM THE DISTRICT
COURT OF APPEAL, FIRST DISTRICT,
STATE OF FLORIDA

PETITIONER'S BRIEF ON THE MERITS

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STATEMENT OF THE CASE AND OF THE FACTS

Jacksonville Utilities Corporation and Southern Utilities Company, two water and sewer utilities, petitioned the Public Service Commission for rate relief on April 5, 1979. [R.1, 65]. Since both utilities provide service in Duval County and both are subsidiaries of General Waterworks Corporation, these cases were consolidated for resolution. Public Counsel, on behalf of the Citizens of the State of Florida (the Citizens), intervened to represent the utilities' customers on May 21, 1979. [R. 140, 141].

Hearings were held before a hearing examiner on December 3-6, 1979, in Jacksonville, Florida. The facts relevant to the controversy before this Court are simple and uncontroverted. The utilities requested a rate base for their water and sewer operations that included a deduction for contributions-in-aid-of-construction (CIAC) net of accumulated depreciation on CIAC. In other words, the Commission's past practice of deducting total CIAC and then adding back accumulated depreciation on CIAC was combined into one, mathematically equivalent, step. The Public Counsel opposed this treatment in his proposed findings of fact and conclusions of law to the hearing examiner [R. 548] and in his exceptions to the examiner's recommended order. [R. 688]. The Commission rejected those arguments in its final order, Order No. 9533, issued September 12, 1980, relying upon its earlier decision in Order No. 9443, dated July 9, 1980. Order No. 9533, page 11. [R. 831]. Reconsideration of Order No. 9533 was taken on grounds irrelevant to this appeal. [R. 883]. Order No. 10007, issued May 12, 1981 [R. 945], resolved the petition for reconsideration. Notice of appeal to the First District Court of Appeal was filed by Public Counsel on June 11,

1981. The Citizens appealed the Commission's add-back of accumulated depreciation on CIAC property.

On January 14, 1983, the District Court affirmed that portion of Order No. 9533 which had been appealed by the Public Counsel. On January 31, 1983, the Public Counsel moved for clarfication and rehearing, informing the court, inter alia, that it had not understood what was in controversy and had therefore dealt with an irrevelant issue, or more accurately, a non-issue. On November 23, 1983, the court denied the Public Counsel's motion without further comment.

The Citizens filed a Notice to Invoke Discretionary Jurisdiction on December 27, 1983, and filed Appellants' Brief on Jurisdiction on January 6, 1984. This Court accepted jurisdiction through its Order issued June 15, 1984.

ARGUMENT

THE COMMISSION'S "ADD-BACK" OF THE ACCUMULATED DEPRECIATION ON CIAC IS DIRECTLY CONTRARY TO THE TREATMENT REQUIRED BY THIS COURT IN HOLIDAY LAKE AND IS THEREFORE NOT CONSISTENT WITH THE ESSENTIAL REQUIREMENTS OF LAW. THE LOWER COURT ERRED IN UPHOLDING THE COMMISSION'S UNLAWFUL DECISION.

The issue that the Citizens present to this Court is whether either tribunal below has followed the legal principles required by Citizens of the State of Florida v. Hawkins (Holiday Lake), 364 So.2d 723 (Fla. 1978). Neither tribunal has. Before a meaningful discussion of this controversy can take place, however, certain regulatory tenets must be thoroughly understood. Just as this Court made liberal use of hypotheticals to facilitate its explanation of difficult concepts in Holiday Lake, so also the Citizens believe it will be helpful to employ numerous hypotheticals to establish the foundation necessary to discuss the issues involved in this appeal. The Citizens therefore will first present a general discussion of the regulatory concepts involved and follow with the application of those concepts to the specific circumstances of the instant case. The result will be a demonstration of the Commission's failure to follow the mandate this Court articulated through Holiday Lake.

In establishing rates, regulatory bodies must proceed in a reverse direction from competitive enterprises. A competitive company simply prices its product to obtain maximum revenues. From those revenues the company must pay its expenses, and the remaining funds constitute the profit. The regulatory agency, on the other hand, begins by determining the profit appropriate for the company to make and then adds the expenses to arrive at the rates. To determine the appropriate profit, the regulatory body

multiplies an acceptable rate of return times the amount which is invested by the utility at that time.

In this respect, the regulatory body acts no differently than a bank, which, to determine the dollars of interest, must multiply the interest rate times the amount in a savings account. The bank therefore must keep scrupulously accurate records of the amount in the savings account. The balance in the account must be properly altered with each deposit and withdrawal. If a withdrawal goes unrecorded, the bank will pay more than the proper amount of interest.

Just as the bank must keep an accurate account of the amount upon which a saver is entitled to earn the interest rate, it is extremely important that a regulatory body have a mechanism to keep an accurate account of the amount which is invested by the utility. Any "withdrawals" by the utility which go unrecorded will result in the customers paying more than a fair level of rates.

In a regulatory context, depreciation expense functions the same as withdrawals from a savings account. Suppose one began a savings account of $1,000 at 12% interest and determined to remove the interest earned plus $100 of the principal each year. After the first year he would withdraw $220 -- the $120 interest earned plus 1/10 of his initial investment. For the second year, he would have, of course, only $900 of investment on which to earn, having removed $100 of his initial investment. The second year's withdrawal would then be $208--$108 interest and $100 principal. At the end of ten years the saver will have withdrawn the full amount of his initial investment. For any given year the bank would determine the amount of interest by multiplying the 12% rate times the investment during that year.

The investment would be determined by subtracting the accumulated total of the $100 principal withdrawals from the initial $1,000 deposit. While admittedly simplistic, the above example illustrates two concepts: the return on investment and the return of investment. Each withdrawal of interest is the return earned on the investment. Each withdrawal of principal is a period-by-period return of the original investment back to the saver.

The function of depreciation in a regulatory context is as simple as withdrawals from a savings account. Consider the following hypothetical utility company:

Hypothetical I:

(1) the company requires a $1000 initial investment for the plant.

(2) the plant will have a useful life of 10 years.

(3) the business costs $80 per year to run.

(4) the business is entitled to 12% return on its investment.

Because the useful life of the plant is 10 years, the depreciation rate will be 10% or $100 per year. For the first year, the regulatory body would properly compute the revenues as follows:

(1)	investment		$1,000
(2)	allowed return	x	12%
(3)	amount which the investor is entitled to clear	=	$ 120
(4)	expenses which were paid to run the business	+	$ 80
(5)	depreciation expense (which were not paid to anyone)	+	$ 100
(6)	revenues to be collected from the customers		$ 300

While the company collects $300 from its customers, it only pays $80 in expenses (the $100 depreciation expense is not paid to anyone - the company receives $180 for total expenses, but must pay only $80 in expenses). The company will then have $220 cash at the end of the year. Assuming there is no re-investment (and no taxes), the company will distribute the entire $220 to the shareholders, even though they are only entitled to $120 return on their investment. The other $100 is considered a return of their investment, and reduces the amount on which they are entitled to earn in the subsequent period. The following year they will be entitled to earn 12% on only $900 because $100 of their initial $1000 investment has already been returned to them (in the form of depreciation expense). Each year the shareholders would receive 12% times their remaining investment plus the $100 allowed in depreciation expense (that is, $100 above the $80 allowed each year for expenses actually paid). At the end of the 10-year life of the plant, the company will have no more investment to earn on, having had their full $1000 investment returned in ten $100 installments. This is the same as the savings account with the allowed return corresponding to the interest earned, and the principal withdrawals corresponding to the depreciation expense.

The accounting mechanism to recognize this return of the original investment is the accumulated depreciation account.. In a double entry

accounting system, for each debit there must be an equal credit. For the Hypothetical I, the following journal entries would be made each year:

	Debit	Credit
Depreciation expense	$ 100	
Accumulated depreciation		$ 100

But while the balance in the "depreciation expense" account is removed each year (closed out to the income statement), the balance in the "accumulated depreciation" account remains in that account and accumulates more each year until the asset is fully depreciated. So, for example, in year three the same entry will be made:

Year 3

	Debit	Credit
Depreciation expense	$ 100	
Accumulated depreciation		$ 100

The significant difference is the balance in each account. The balance in the depreciation expense account will only be $100, the entry that was made for year three only. The balance in the accumulated depreciation account, however, will be $300, representing the total of the $100 entries for each of the years 1, 2 and 3. The balance in the accumulated depreciation account keeps track of the full amount of the initial investment which has been returned to the investors, that is, the total of the installments which were returned via the annual depreciation expense. The accumulated depreciation account is netted against the initial investment to determine how much of the initial investment remains invested in the company. On the balance sheet, after year three, one would find:

Assets

Gross plant (this is the initial investment)		$1000
less:		
Accumulated depreciation	(300)	
Net Plant		$ 700

The Commission would thereby know that the Rate Base is $700 on which the company is entitled to earn 12%. This computation is made throughout the ten-year life of the plant. Each year, the investors would be "withdrawing" $100 of their initial $1000 investment, and each year would earn 12% on the balance which remained "un-withdrawn."

Because each year a portion of the initial investment is returned via depreciation expense, it is extremely important that the investment (which is the equivalent of rate base) be reduced by the amount of depreciation expense taken by a company.

Hypothetical II:

The situation involved in the issue at bar includes the added factor of contributed property. The construction of water and sewer systems is often funded by a combination of cash put up by an investor and cash collected from the customers (contributions-in-aid-of-construction, or CIAC). Hypothesize a water system (plant and distribution pipes) costing $1000 to build, with an expected useful life of ten years. Further suppose that in order to build the system, the investor puts up $400 for the plant and collects from the customers the remaining $600 necessary to purchase and install the pipes. The Commission policy has always been that a utility may earn only upon the money which is actually supplied by the investor. At an

authorized return of 12%, this hypothetical company would clear a profit of 12% times $400 or $48. Prior to 1979, the Commission allowed the utilities to charge depreciation expense on the amount supplied by the customers as well as the amount supplied by the investor (in 1979 this practice was recognized as improper by the Commission). So, prior to 1979, the Commission have would set the revenues for Hypothetical II as such:

(1)	investment		$ 400
(2)	authorized return	x	12%
(3)	profit allowed	=	$ 48
(4)	expenses paid to run the business	+	80
(5)	depreciation expense	+	100
(6)	Total revenues		$ 228

Of the $228, the company would pay bills of $80, leaving $148 to be distributed to the investor. Because the investor is entitled to only $48 profit on his investment, the other $100 distributed to the investor, as in Hypothetical I, must be considered as a return of his original investment. For the second year, therefore, the amount of investment remaining (on which the investor is entitled to earn the 12%) is $300, calculated by subtracting the $100 "principal withdrawal" from the $400 original investment.

Incredibly, however, the Commission's policy did not reduce the investment by the full amount of the depreciation expense taken. For the second year's operations, the Commission would have calculated the remaining investment of the Hypothetical II utility to be $360. The Commission would have reduced the investment by only $40 (the application of the 10% depreciation rate to the $400 supplied by the investor), even though the customers had paid $100 in depreciation expense. The $60 depreciation associated with the amount supplied by the customers would be "added back" to the rate base.

The Commission's policy was grievously unfair. It was akin to partners X and Y pooling their money in a savings account to get a higher interest rate, X putting in $400 and Y $600, with the agreement that X is to earn interest only on the amount he has in the account. X then withdraws his interest plus $100 of principal, but asserts that he has $360 remaining in the account.

It is precisely that unfair treatment by the Commission that this Court rejected in Citizens of the State of Florida v. Hawkins (Holiday Lake), 364 So.2d 723 (Fla. 1978). The Public Counsel, as appellant, did not challenge the amount of depreciation expense taken in any given year. Rather, the Public Counsel challenged only the rate base, specifically asserting that because the utility had collected depreciation expense on CIAC, that amount of depreciation had to be removed from the utility's investment. This Court agreed with the Public Counsel, stating that the total authorized depreciation expense, as reflected in the accumulated depreciation account, must be removed from the utility's rate base. Id., at 725.

The controversy presented to this Court in Holiday Lake can be readily analogized to the framework of Hypothetical II. Had the utility in Hypothetical II completed three years of operation, the Commission would compute the rate base as follows:

Gross Plant		$1000
less: total amount of CIAC	($600)	
less: total accumulated depreciation	($300)	
		$ 100
ADD BACK: Accumulated depreciation on CIAC		180
Rate Base for year 4		$ 280

Although somewhat convoluted, the Commission's method with the "add back" is nothing more than beginning with the investor's initial investment

and reducing it by only the accumulated depreciation on the amount put up by the investor:

Initial investment		$ 400
less: accumulated depreciation on amount put up by investors. $40/year for 3 years	($120)	
Remaining investment after 3 years		$ 280

This Court, however, ruled that to the extent that depreciation expense was authorized, it must be removed from rate base. The Court's determination of the rate base after three years of operation by the utility in Hypothetical II would be:

Gross Plant (initial cost)		$1000
less: total CIAC		
less: total accumulated	($600)	
depreciation	($300)	
		$ 100

Notice that the Court explicitly removed the "add back". The operation performed by the Court is nothing more than removing the full amount of depreciation from the amount initially supplied by the investors:

Initial investment		$ 400
less: total depreciation expense taken - the full amount of the accumulated depreciation account	($300)	
Remaining investment (Rate base)		$ 100

The result is precisely as fairness dictates because the accumulated depreciation account is the total of the depreciation expense authorized to be taken by the investor. Every dollar of depreciation expense taken is a dollar which (1) is <u>not</u> spent on expenses to run the operation, (2) is <u>not</u> authorized return (profit) and (3) must therefore be a return <u>of</u> the initial

investment. It should be fully removed from the initial investment to accurately reflect the remaining investment.

The former Commission policy had the astounding result of requiring the customers to pay twice for the same property. Consider that in Hypothetical II, the investor purchased the plant for $400 and the customers purchased the piping system for $600. By paying depreciation expense of $60 per year on the property which was purchased with their own money initially, the customers would pay a second $600 over the ten-year useful life of the pipes. The utility would be extracting the full price of the pipes from the customers a second time. This practice is akin to paying cash for an automobile and then being required to make payments on that very car until it is paid for a second time. Requiring customers to pay twice for the same property clearly was not good public policy, and in Holiday Lake the Supreme Court attempted to remedy the situation.

This Court, however, has not been successful in remedying the problem because other than for Holiday Lake itself, the Commission has never applied this Court's formula for computing rate base. In order to understand how the Commission has been ignoring this Court's mandate, it us useful to again consider Hypothetical II, with the assumption that the utility had operated for three years before the Holiday Lake decision. At that point the Public Counsel would have asserted that the rate base was $100 (the initial $400 investment minus the three years of depreciation collected at $100 per year). The Commission's policy, with its "add-back" of $180, would have set the rate base at $280.

Now if the Holiday Lake decision is superimposed on the situation, the Commission's add-back policy would have been overruled and the utility's

rate base would be properly set at $100. At this point there simply can be no argument. This Court explicitly rejected the Commission's add-back policy, and held that the original investment must be reduced by the full amount of the depreciation taken. So, if after three years' operations the Holiday Lake holding is applied, the rate base would be $100.

If the Commission were to then set the proper rates for the fourth year's operations, it would begin by determining the dollars of profit to which the investor is entitled. The profit, of course, is simply the product of the authorized rate or return times the rate base ($100 x 12% = $12). To set the final rates the Commission then merely adds (1) the profit, plus (2) the expenses to run the business, plus (3) the depreciation expense to be allowed for year 4. Since the profit must be $12 and the expenses to run the business are $80, the only remaining piece of the ratesetting formula to be filled in is the depreciation expense which the Commission deems appropriate for year 4. The proper rates for year 4 will be $92 ($12 + $80) plus the year 4 depreciation. Once the Commission determines the proper year 4 depreciation expense, that expense completes the formula and can simply be added to the $92 to arrive at the rates for year 4. Assuming the Commission were to continue to allow the same $100 of annual depreciation expense, the rates for year 4 would be set at $192.

The Commission, however, did not continue to allow the same amount as the annual depreciation expense, and the proper treatment of the Commission's shift in policy is the center of the instant controversy.

As a result of the Holiday Lake decision, the Commission perceived that it should have been allowing depreciation expense only on that amount supplied by the investor. The Commission came to believe that it should not

have been allowing the utilities to charge depreciation expense on the amount supplied by the customers. The Commission therefore changed its policy for future application and from that point forward began to allow depreciation expense only on the amount supplied by the investor.

Within the hypothetical, then, the final piece of the formula for year 4 rates would be $40 (the 10% depreciation rate times the $400 initial investment) instead of $100. So year 4 rates would be $92 + $40 = $132, displayed as follows:

<u>Rates for Year 4</u>

(1)	Rate base at the end of year 3 (as required by the Supreme Court and dictated by logic) =	100
(2)	Allowed return	x 12%
(3)	Profit	$ 12
(4)	Expenses to run the business	+ 80
(5)	Depreciation expense (now being allowed by the Commission only on that amount provided by the investors)	+ 40
(6)	Total revenues to be provided by the rates in year 4	$ 132

At this point there should have been no controversy as to the proper rate base for setting rates for year 4. This Court had settled the rate base argument through its holding in <u>Holiday Lake</u> and the Commission itself had established the new annual depreciation to allow on a prospective basis.

Astoundingly, however, the Commission totally ignored this Court's formula for establishing rate base. The Commission went right back to its pre-<u>Holiday Lake</u> policy of setting rate base. In Hypothetical II, the

Commission would set rates for year 4 by first establishing rate base as such:

Gross Plant		$1000
less: total amount of CIAC	($600)	
less: total accumulated depreciation	($300)	
		$ 100
ADD BACK: Accumulated depreciation on CIAC		180
Rate Base for year 4		$ 280

The Commission then continued the calculation of total rates as such:

(1) Rate Base	280
(2) Rate of Return	X 12%
(3) Profit	$33.6
(4) plus expenses to run the business	80
(5) plus authorized depreciation expense	40
(6) Total revenues to be collected	$153.6

The Commission somehow reasons that because it had altered the future depreciation rate, it could ignore this Court's method of computing the remaining investment, which was based solely on the amount of previous depreciation that the utility had already collected from its customers.

Contrary to the Commission's practice, of course, the new policy has absolutely no logical connection to the amount of investment remaining at the time that the new depreciation rate is prospectively applied. One need only consider the Holiday Lake holding to see the fundamental flaw in the

Commission's practice. The add-back was disallowed because those funds had already been withdrawn by the investor. The funds had already been extracted from the customers by the investor, so those funds must be removed in determining the remaining investment (rate base). A change in the rate at which the further extractions will be made cannot possibly affect the amount of funds which have already been extracted. The Commission simply has no justification for asserting that a change in the future depreciation expense can affect the amount of depreciation expense previously charged to the customers.

As illustrations, consider the following two short hypotheticals (a) and (b):

> (a) Two partners X and Y pool their money in a savings account, with X depositing $400 and Y $600. Assume the partners agree that X will withdraw his deposit in ten equal annual withdrawals. Through inadvertence, X makes his first three annual withdrawals at $100 per year (plus the interest earned). X and Y discover the mistake and correct X's annual withdrawals to the proper $40 per year for the fourth year. How much does X now have in the savings account after the three years? The Commission's logic would dictate that even though he began with $400 and withdrew $300, his remaining amount is $280. The Commission would ignore reality and treat the three withdrawals as though they had been made at $40 per year. The only fair solution, of course, would be to remove the first three withdrawals at $100 each, the amount at which they were actually taken. This is precisely the formula

the Public Counsel recommends be used in determining a utility's rate base.

(b) If Debtor is to pay Creditor $1,000 in ten equal annual installments, and Creditor mistakenly sets the payments at $200 annually, what happens after five years of payments? When the mistake is discovered, should Creditor claim that even though the loan has been repaid in full, Debtor still owes the remaining five annual payments at $100 each? Do you "add back" to the debt the accumulated amount of the over-payments?

The point of the two hypotheticals is to illustrate that changing the amount of depreciation expense allowed affects the treatment of the accumulated depreciation prospectively only. The CIAC accumulated depreciation which accumulated while CIAC depreciation expense was charged in the rates has already been extracted from the ratepayers and returned to the investors. That return of investment has already occurred and simply cannot be affected by future treatment of CIAC depreciation expense. From the time that the Commission began disallowing depreciation expense, the accumulated depreciation should be added back; for the time during which the utilities were entitled to collect CIAC depreciation expense, the accumulated depreciation should not be added back.The Commission is laboring under the mistaken belief that their prospective treatment of CIAC depreciation expense can somehow alter the nature of the CIAC accumulated depreciation from previous periods. It simply cannot.

An illustration of the application of Holiday Lake to the following specific situation further demonstrates the impossibility of the new

depreciation rates to affect the treatment of accumulated depreciation in previous periods. Suppose Hypothetical II is altered slightly such that instead of three years, the utility had operated for four years before the Holiday Lake decision became effective. Application of Holiday Lake would result in a rate base computed as follows:

Gross Plant	$1,000
Less: total accumulated depreciation (4 years times $100/year)	(400)
Less: total "contributed" property (CIAC)	(600)
Total rate base to begin operations for year 5.	-0-

The rate base would be zero. This is, of course, the logical result of beginning with the $400 initial investment provided by the investor and subtracting the total amount of investment that has been returned through the $100 depreciation expense in the rates during each of the four years. The rate base is zero; the investor has received back all of the money he initially invested; the investor has no more money invested, upon which he would be entitled to earn a return; through their rates for the first four years, the ratepayers have paid back every dollar of the initial investment to the investor.

It is axiomatic that the only way for an investor to increase his rate base is to invest additional dollars into the operations (or leave profits in the operations which is the identical proposition). The only justification for awarding a percentage return to an investor is if he has something invested. If an investment has been reduced to zero by the investor removing his total investment over a period of years, the only way

to arrive at a positive investment is by putting in additional dollars of investment.

Consider the hypothetical after four years' operations. The Supreme Court has just stated that the rate base for the hypothetical utility is zero. The only way for the rate base to become positive for setting rates in the fifth year would be if the investor put in additional funds for investment. Yet the Commission's method turns a zero rate base (where the investor has already received back the full amount of his investment) into a positive rate base (requiring the customers to pay a return on an investment which is truly non-existent) without requiring the investor to re-invest another dollar. The Commission does this through the retroactive application of the "add-back":

Gross Plant in Service	$1,000
Less: total accumulated depreciation	(400)
Less: total (CIAC)	(600)
	-0-
ADD BACK: accumulated depreciation on CIAC ($60/year for 4 years)	$ 240
	$ 240

In other words, the Commission would require the customers to pay as though the investor had $240 at stake in the hypothetical utility, when the investor would not have a single dollar invested in that utility.

The Commission's misguided approach has two unconscionable results. First, the customers will pay twice for the same property. When the rate base is fully depreciated to zero, and the customers must "repay" the $240 a second time, they are paying twice for whatever property was purchased with

the $240. Secondly, the customers not only must pay for that property, they must in the meantime pay the utility a return on the property which they have fully purchased. It can be again analogized to the Debtor who borrowed $1,000 to be paid back in ten equal annual payments with 12% interest on the outstanding balance, and who inadvertently makes the first five repayments at $200 per year (along with the interest). Upon realizing the mistake that Debtor has already paid back the $1,000 with the full amount of interest, the Creditor asserts that the Debtor not only owes five more $100 installments, but also must pay the 12% interest on the $500 which has already been paid back. As illogical as this sounds, it is precisely the effect of "adding back" accumulated depreciation which has already been recovered by utilities.

The Commission's justification for its practice is that in the future, the customers will not be overcharged for depreciation expense. It should be perfectly clear that the prospective application of the correct depreciation rate has absolutely nothing to do with the amount the investor has already removed from his initial investment.

One further nuance must be examined to illustrate a particular area in which a controversy does not exist, but which might create some confusion if not explored. The area upon which no disagreement exists is the accumulated depreciation that has accumulated since the inception of the Commission's new policy. It must be understood that a utility <u>books</u> both depreciation expense and accumulated depreciation on CIAC, regardless of what the Commission allows for rates. Even after the Commission stopped allowing the utilities to <u>charge</u> depreciation expense on CIAC, the accumulated depreciation account balance continues to grow at the same rate as previously.

Therefore, many utilities have a CIAC accumulated depreciation balance, some of which accumulated during the period when depreciation expense was collected on the CIAC property, and some of which has accumulated during the subsequent period when CIAC depreciation expense was not allowed in the rates.

The only disagreement in the issue at bar is the proper treatment of the accumulated depreciation balance which accumulated during the period in which the Commission allowed utilities to charge CIAC depreciation expense in their rates. It cannot be overemphasized that the Public Counsel totally agrees that the portion of the accumulated depreciation balance which has accumulated after the Commission began disallowing CIAC depreciation expense should not be removed from the original investment (in other words, it should be added back). It is the portion of the accumulated depreciation account which accumulated when depreciation expense on CIAC was charged to ratepayers that should be removed from the original investment to properly determine rate base. The distinction lies in whether the rates for a given year included a charge for depreciation expense on CIAC: for those years in which CIAC depreciation expense was charged, the corresponding CIAC accumulated depreciation must be removed from the original investment; for the years in which CIAC depreciation expense was not allowed in rates, the corresponding CIAC accumulated depreciation should not be removed from the original investment.

Returning to Hypothetical II, assume the utility operated for three years pre-Holiday Lake, charging $100 annual depreciation expense. The rate base at that point, as directed by this Court, would be $100. Then suppose the Commission allowed only $40 depreciation expense for year 4. The Public Counsel is suggesting that to set rates for year 5, the rate base would be

computed by deducting the depreciation expense charged in year 4 from the rate base at the beginning of year 4, or:

Rate base at beginning of year 4	$ 100
Minus the amount of investment "withdrawn" in year 4 through depreciation expense,	- 40
Equals the remaining rate base for the beginning of year 5.	$ 60

Notice that from the original initial investment of $400, the Public Counsel would remove $100 per year for the first three years when depreciation expense on CIAC was charged in the rates, but would remove only $40 for the year in which CIAC depreciation expense was not allowed in the rates. It is on this point that the Public Counsel and the PSC disagree. The Commission would ignore reality and treat the investment as though only $40 of depreciation had been taken in each of the four years. The hypothetical helps define the specific area of controversy. For year 4, (and all subsequent years) the Public Counsel and the Commission agree that the investment should be reduced by only $40. The controversy is limited only to the depreciation taken in years 1-3. Whereas the Commission believes it shoud "pretend" depreciation of only $40 was taken in years 1-3, the Public Counsel believes that Holiday Lake requires that the Commission deduct the amount of depreciation actually collected in those years.

With the foregoing explanation as backgound, the Citizens now to attempt to demonstrate how the Commission and the Court below erred, by failing to apply the legal requirements of Holiday Lake. The first step in the demonstration is an examination of the specific language employed by this Court in Holiday Lake. The opinion is attached to this brief as Appendix 1, pages A-1 to A-6.

This Court first sketched the facts and described the controversy:

> In the instant case, approximately half of Holiday's capital is attributable to assets purchased with invested or borrowed capital and the other half to contributions in aid of construction. CIAC funds are collected from customers or developers to defray the expense of extending service to such new customers. Thus they represent capital outside of the utility's debt and equtiy capital structure. In calculating respondent's rate of return, the Commission determined the original cost of the utility's plant and subtracted the amount representing CIAC funds. The Commission also allowed respondent to claim as an operating expense depreciation upon facilities purchased from investment capital and CIAC funds. Neither of these practices is at issue in this case. What is contested by petitioners is the Commission's further practice of allowing the utility to add back into the computation of rate base a figure which represents that portion of previously deducted depreciation attributable to CIAC property.
>
> Id., at 724.

This Court then presented the position taken by the Public Counsel:

> Petitioners assert that the Public Service Commission's accounting practice in determining rate base is inequitable, in that it returns a portion of contributions in aid of construction into the rate base, resulting in a windfall to the utility and unjust rates to its customers. By allowing a return on property outside of the utility's capital investment structure the Commission exceeds its jurisdiction under Section 367.081(2), Florida Statutes (1975).
>
> Id. at 725.

The Court reached its conclusion:

> For the following reasons, we accept petitioner's contentions.
>
> Id.,

and supplied the reasons underlying that conclusion:

> We believe the Commission exceeds its authority under Section 367.081(2) and contravenes its own policy by adding back the accumulated depreciation of CIAC into the rate base calculation. 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 ratepayers, who must pay higher rates in spite of their contributed capital.
>
> Id.

The opinion continues with a number of hypothetical examples, discussing several of the points that the Citizens have attempted to explain through the hypotheticals presented earlier in this brief. It could hardly be more clear that this Court rejected the Commission's add-back of CIAC accumulated depreciation which accumulated during a period that the utilities were charging their customers for depreciation expense on CIAC.

The Court's clear mandate notwithstanding, the Commission has explicitly added back the prohibited CIAC accumulated depreciation in the instant case.

In allowing CIAC accumulated depreciation to be added back, the Commission did not explain its position in Order No. 9533 (relevant portions of which are attached as Appendix 2, pages A-7 and A-8), rendered in the instant case. Rather the Commission adopted the reasoning it had offered in a previous decision.

> Public Counsel takes exceptions insisting that the reserve for depreciation on CIAC should be used to reduce rate base to be consistent with the decision of the Florida Supreme Court in the case of Citizens of the State of Florida v. Hawkins, 364 So.2d (1978).
>
> Our views on these issues are fully set forth in Commission Order 9443, dated July 9, 1980, in

> Docket No. 780222-WS, pages five through nine. We adopt the same as if fully set forth in this order.
>
> In re: Application of Jacksonville Suburban Utilities, 80 FPSCR 9:98,107 (PSC Sept. 12, 1980)
>
> [A-7]

In Order No. 9443 (relevant portions of which are attached as Appendix 3, pages A-9 to A-15), the Commission presented its argument in support of the add-back, explaining that the issue would be addressed within the context of two distinct circumstances.

> B) The treatment of CIAC in rate base.
>
> This issue must be addressed in two parts. One is treatment where depreciation on CIAC has been authorized in the past, and the other is where no depreciation on CIAC is allowed as an operating expense.
>
> In re: Petition of General Waterworks Corporation, 80 FPSCR 7:12,16 (PSC July 9, 1980)
>
> [A-9]

The Commission then begins with the second part first and devotes the next two pages addressing the proper treatment of rate base when no depreciation on CIAC has been allowed in the rates. This section of Order No. 9443 can be ignored because it is not being challenged by the Citizens. The Citizens are in complete agreement that to the extent that depreciation on CIAC has not been allowed in rates, it should not be used to reduce the investment base.

The area in which the Citizens do challenge Order No. 9443 begins with 80 FPSCR 7: at 19 [A-11], where the Commission addresses its second scenario:

> 2) Rate base treatment where depreciation on CIAC has been authorized as an operating expense in the past.

Id.

In addressing this treatment the Commission first quotes the language that this Court used in Holiday Lake prohibiting the add back. Id. [A-12]. The Commission then states that it will no longer allow depreciation expense to be charged on CIAC property, characterizing it as "fictional" and a "mistake of the past." Id. [A-12].

At this point, it must be emphatically pointed out that while the Commission may wish its previous mistake were fictional, the CIAC depreciation expense was very much a reality to those customers who have paid it. The suggestion that there is anything fictional about this depreciation expense would certainly come as a shock to the customers who paid real dollars to the utility to cover that specific expense.

In the final paragraph of 80 FPSCR 7: at 19 [A-12], the Commission explains how it can view the previous CIAC depreciation expense as fictional. That explanation is nothing short of the most contrived, twisted logic imaginable:

> The facts in this case demonstrate that allowing depreciation on CIAC as an operating expense in the past was not to recover capital invested by the company, because in fact CIAC was charged to the customer. Since no capital was invested by the Company in these facilities, in essence, the dollars collected from the customers in the past labled as "depreciation on CIAC" represented an attrition allowance.
>
> Id.

Amazingly, the Commission is actually saying that all of the money that it has authorized utilities to collect over the past years, money that the Commission itself had specifically defined as depreciation expense, was not for depreciation expense at all. The Commission is saying that by a

figurative wave of its wand, it is changing all of its previous orders which allowed depreciation expense on CIAC, to instead disallow CIAC depreciation expense, but allow an attrition award for exactly the same amount.

It is painfully obvious that the Commission is aware of this Court's mandate that a utility's investment must be reduced by the full amount of CIAC depreciation expense authorized in past periods. Rather than follow the law, established by this Court, however, the Commission has chosen this very peculiar response. The Commission is informing this Court that the amount which the Court thought was depreciation expense (because, of course, the Commission itself had explicitly called it depreciation expense), was not depreciation expense at all. Because the Commission has now chosen not to call those funds "depreciation expense", it reasons that it need not follow the treatment that this Court required be applied to depreciation expense.

The Commission's "now you see it, now you don't" explanation is the only reason given to support its policy. The Commission is apparently not at all concerned with retroactive rate setting of the most flagrant nature. Neither is the Commission concerned that before an attrition allowance could have been granted in any previous case, the utility would have been required to provide proof that it was suffering from that specific amount of attrition. In each of those cases, had the utility asserted that the depreciation expense was actually to cover attrition, adversarial parties (and the Commission staff) would have had the opportunity and the right to cross-examine or provide contrary testimony. Since all of the cases are long-since over, those rights can never be exercised. Yet the Commission shows no compunction about making an absolute mockery of the most fundamental rights available to parties in an adversarial system.

The Citizens can only observe that Chairman Mann employed restraint in his dissent on this issue when he stated:

> The Supreme Court has directly and clearly ruled upon this issue....This Commission is bound by that decision. How my colleagues can choose to ignore it, and the irrefutable logic which supports it, is incomprehensible.
>
> 80 FPSCR 7: at 30
>
> [A-13, 14]

One more point within Order No. 9443 must be addressed to avoid potential confusion. After the Commission performs its regulatory alchemy, transforming depreciation into attrition, it states:

> However, even though the Commission allowed depreciation on CIAC as an operating expense in the past, when you change that policy, it does not reduce the investment in assets which were invested.
>
> 80 FPSCR 7: at 20
>
> [A-12]

Here the Commission seems to be equating the effect of the previous depreciation policy with that of the future depreciation policy. This concept is explored earlier in this brief through the use of hypotheticals. The conclusion there, as here, is that once the Commission changed the policy, the Citizens agree that from that point forward, the investment should not be reduced by depreciation on CIAC. That prospective change in policy, however, has absolutely no affect on the amount of depreciation expense that the utility has already collected from its customers.

When this case was appealed to the First District Court of Appeal, that Court upheld the Commission (the opinion of which is attached as

Appendix 4, pages A-16 to A-18), relying on the reasoning of an earlier case decided in the First District.

> On appeal, Citizens contend that PSC erred in permitting Utilities to include in their rate base an "add-back" of accumulated depreciation on contributions-in-aid-of-construction (CIAC), citing Citizens of the State of Florida v. Hawkins (Holiday Lakes) [sic], 364 So. 2d 723 (Fla 1978) This contention has no merit. A similar argument was rejected in Citizens of the State of Florida v. Florida Public Service Commission, 399 So. 2d 9, 11 (Fla. 1st DCA 1981) (General Waterworks), wherein this court distinguished the Holiday Lakes [sic] case....
>
> Citizens of the State of Florida v. Florida Public Service Commission (Jacksonville Suburban), 440 So. 2d, 371, 372 (Fla. 1st DCA 1983).

This Court must therefore examine the lower Court's opinion in the General Waterworks case to determine the reasoning employed by the lower Court in the instant case. That opinion has been attached to this brief as Appendix 5, pages A-19 to A-21.

Early in that opinion the lower Court attempts to demonstrate how General Waterworks was factually distinguishable for Holiday Lake. In its attempt, however, the Court commits a fundamental error which leads to its confusion throughout the remainder of the opinion. The Court states:

> First, and most importantly, Holiday Lakes [sic] is factually distinguishable because there the PSC, in addition to allowing the add-back into the rate base, also allowed the utility to treat that depreciation on CIAC as an operating expense. In this case, however, the PSC did not allow depreciation on CIAC as an operating expense. This difference in treatment is important.
>
> 399 So. 2d at 10

The Court below simply overlooked the most important point of all, namely, that this Court's rejection of the add-back was premised on the

depreciation expense that had already been taken. In Holiday Lake, this Court had said:

> What is contested by petitioners is the Commission's further practice of allowing the utility to add back into the computation of rate base a figure which represents that portion of previously deducted depreciation attributable to CIAC property.
>
> [Emphasis supplied]
>
> 364 So. 2d at 724

In other words, this Court's decision had absolutely nothing to do with the depreciation expense which would be allowed for the future. It hinged entirely on what depreciation had already been collected from the customers. By failing to understand the true nature of this Court's holding in Holiday Lake, the Court below has misapprehended the actual controversy brought before it.

The true controversy is how the investment base should be affected by the CIAC depreciation expense which had already been collected from the customers. Prior to this present case, Jacksonville Suburban, the instant respondent, had collected depreciation expense on CIAC property, just as the respondent before this Court in Holiday Lake had collected an identical expense. It is therefore inescapable that the relevant facts in the instant case are absolutely undistinguishable from those involved in the Holiday Lake decision.

The remainder of the lower Court's opinion is premised upon its initial misapprehension of the question actually brought before it. The Court's error therefore proceeds to compound itself and results in pronouncements which diametrically oppose this Court's holding in Holiday Lake.

While the lower court exclaims:

> PSC's allowance of the add-back does not reintroduce CIAC into the rate base. Rather, it completely eliminates its influence!
>
> 399 So. 2d at 11,

This Court states:

> This procedure reintroduces CIAC property into the rate base structure.
>
> 364 So.2d at 725.

Where the lower Court states:

> The formula allows the utility to receive a fair return on its investment....
>
> 399 So.2d at 11,

This Court states:

> This procedure results in a windfall to the utility....
>
> 364 So.2d at 725.

Where the lower Court states:

> The formula ... in no way penalizes the rate payers....
>
> 399 So.2d at 11,

This Court states:

> This procedure... results in... unfairness to the ratepayers....
>
> 364 So.2d at 725.

And where the lower Court states:

> [T]he rate payers.... are paying for the cost of using up the equipment which provides them service.

399 So.2d at 11,

this Court states:

> [T]he ratepayers... must pay higher rates in spite of their contributed capital.
>
> 364 So.2d at 725.

The conflict hardly could be more striking. By failing to perceive that the treatment of the rate base depends on whether depreciation has been allowed in past periods, the lower Court failed to apply the law appropriate to the controversy in the instant case.

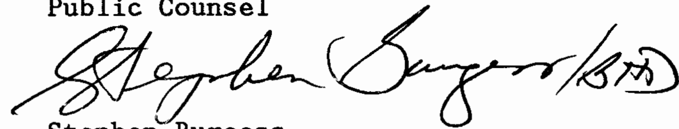
The lower court has thereby allowed the Commission to engage in a procedure which was explicitly ruled unlawful by this Court. In Holiday Lake that procedure was found to be a departure "from the essential requirements of law." 364 So.2d at 728. This Court should likewise reject that same procedure in the instant case and reverse the decision of the lower court.

CONCLUSION

In light of the foregoing, the Citizens of Florida seek this Court to reverse the decision of the lower Court and remand the case to the Public Service Commission with instructions to remove from the Respondent's rate base the add-back of the CIAC accumulated depreciation which accumulated during the period that CIAC depreciation expense was authorized for inclusion in the rates. The Citizens further seek the Court to require a refund with interest all rates collected pursuant to PSC Order No. 9533 which exceed the rates that would have been set had Holiday Lake been properly applied. Finally, the Citizens seek this Court to order the Commission to refrain from awarding the Respondent any costs resulting from this action.

Respectfully submitted,

Jack Shreve
Public Counsel



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by U.S. Mail or by hand-delivery to the following parties of record this 5th day of July, 1984.

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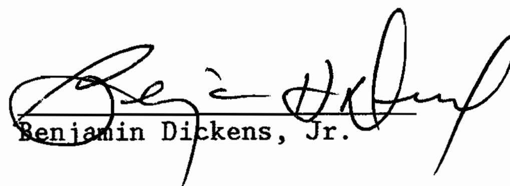

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