Application of San Diego Gas & Electric Company (U902M) for Authority, Among Other Things, to Increase Rates and Charges for Electric and Gas Service Effective on January 1, 2012.	A.10-12-005 (Filed December 15, 2010)
Application of Southern California Gas Company (U904G) for authority to update its gas revenue requirement and base rates effective on January 1, 2012.	A.10-12-006 (Filed December 15, 2010)

Application 10-12-006
Exhibit No.: (SCG-28-R)

REVISED

PREPARED DIRECT TESTIMONY OF

RANDALL G. ROSE

ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

JULY 2011

SCG Doc#256950

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REVISED PREPARED DIRECT TESTIMONY
OF RANDALL G. ROSE
ON BEHALF OF SOUTHERN CALIFORNIA GAS COMPANY
(TAXES)

I. PURPOSE

This testimony presents Southern California Gas Company's ("SCG's") estimated tax expense for Test Year ("TY") 2012, and explains how those estimates were derived. SCG incurs three categories of taxes: (1) payroll taxes, (2) ad valorem (i.e., property) taxes, and (3) income taxes. In addition, SCG incurs franchise fees, which it includes in its tax expense estimates. A summary table for each category of tax expense is presented at the end of each section.

To the extent that the California Public Utilities Commission ("Commission") adopts levels of operations and maintenance ("O&M") expense or capital that are different from what has been proposed by SCG, taxes would be re-calculated to reflect the impact of the changes.

II. PAYROLL TAXES

A. Introduction

The purpose of this section is to provide an estimate of SCG's 2012 payroll tax expenses, and to describe the methodology used to develop SCG's estimate.

B. Discussion

Payroll taxes were estimated by applying a tax rate on TY 2012 O&M and capital labor covered under this filing up to a maximum wage base. Payroll taxes are paid by both the employee and the employer. The following discussion relates to the employer's payroll tax liability.

1. Federal Insurance Contributions Act ("FICA")

FICA taxes, also referred to as social security taxes, are composed of two pieces: (1) the Old-Age, Survivors, and Disability Insurance ("OASDI") and (2) the Hospital Insurance (Medicare). For 2009, the OASDI tax rate was 6.2% of wages up to a maximum wage base of $106,800. The Medicare tax rate was 1.45% of wages with no maximum wage base. Based on rate schedules contained in the 2009 Annual Report published by the Social Security Administration (2009 Annual Report), the OASDI and Medicare tax rates have been at current levels since 1990 and are not expected to change through 2012 based on currently enacted law.[1] The OASDI wage base will remain at $106,800 in 2010 and 2011, but is expected to increase to $114,900 in 2012 based on data reported in the 2009 Annual Report.[2]

2. Federal Unemployment Tax Act ("FUTA")

The 2009 FUTA tax rate was 0.8% on wages up to $7,000. Based on currently enacted law, the FUTA tax rate and wage base are not expected to change through 2012.

3. California State Unemployment Insurance ("SUI")

The SUI is composed of two pieces: (1) the Unemployment Insurance ("UI") and (2) the California Employment Training Tax ("CET"). The 2009 UI tax rate was 2.4% on wages up to $7,000. The CET tax rate was an additional 0.1% on wages up to $7,000. Based on currently enacted law, the UI and CET tax rates and wage bases are not expected to change through 2012.

4. Methodology Used to Estimate Tax Expense

Payroll taxes are a function of taxable wages and applicable tax rates. The computation of the estimated payroll taxes begins with the 2009 taxable wages stratified into salary increments. The annual wage base in effect for the year for each type of payroll tax was applied to total wages to ensure that wages up to, but not exceeding, the wage base cap were subject to the tax. Thus, wages up to the salary increment where the annual wage is closest to the wage base cap are subject to the tax. Wages above the wage base cap for any particular type of payroll tax were derived from multiplying the number of employees in each strata above the cap by the wage base cap. The resulting taxable wages for each tax type were totaled and the applicable statutory tax rate was then applied to the total taxable wages. The Medicare portion of the FICA tax is computed without respect to a wage base since all wages are subject to that tax. A companywide composite tax rate was computed based on total forecasted payroll taxes using the above methodology divided by total forecasted wages. The composite payroll tax rate for each year was applied to labor dollars applicable to this filing to determine the employer's payroll tax

[1] See Table VI.F1, Contribution Rates for the OASDI and HI Programs, 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.
[2] See Table V.C1, 2009 Annual Report.

expense. This methodology is a departure from the methodology employed by SCG to estimate payroll tax expense in prior rate cases and is intended to provide a more granular analysis and a more accurate forecast.

C. Summary of Estimated Payroll Taxes

The summary reflects the amount of payroll taxes on all non-capitalized wages applicable to this filing.

Table SCG-RGR-1

Summary of Estimated Payroll Taxes

(Thousands of nominal $)

Line No.	***Acct. No.***	***2009 Recorded***	***2010 Forecast***	***2011 Forecast***	***2012 Test Year***
1	408	31,778	33,381	34,963	36,688

D. Results

The increase in payroll taxes from 2009 to 2012 reflects the impacts of staffing level changes presented by other witnesses in their direct testimony, the impact of labor cost escalation on those changes, and the increase in the composite payroll tax rate resulting from the OASDI wage base increase as discussed above.

III. AD VALOREM TAXES

A. Introduction

The purpose of this section is to provide an estimate of SCG's ad valorem taxes that will be incurred during TY 2012, and to describe the methodology used to develop the estimate.

B. Discussion

Ad valorem taxes are a function of the assessed value of property and a tax rate applied to that value. Property owned and used by public utilities as of January 1 (the lien date) each year is re-assessed to its full market value by the California State Board of Equalization ("SBE"). By definition, ad valorem taxes are based on the value of the property being taxed. Appraisers have developed various generally accepted indicators of value that are correlated to yield an estimation of the market value of the property being assessed. The primary indicator of value for regulated public utility property is the Historical Cost Less Depreciation ("HCLD") indicator, and a secondary indicator is the Capitalized Earnings Ability ("CEA").

HCLD is the primary indicator of value for closely rate-regulated property because it approximates rate base. HCLD is equal to the estimated cost of property which is subject to assessment by the SBE less the accumulated depreciation taken on the property. Historical cost consists of the original cost of plant balances on the January 1 lien date, plus construction work-in-progress, materials and supplies on hand to operate the plant, and non-current (cushion) gas stored underground. Adjustments are made to add the value of possessory interests held by the utility on government-owned property and to deduct non-taxable licensed motor vehicles, leasehold improvements, business inventories, and other property not subject to ad valorem taxes. Finally, the HCLD indicator is adjusted by deducting the accumulated deferred federal income taxes on taxable property.

The CEA, or the income approach to value, is designed to recognize the concept that the value of business property is closely related to its ability to generate income. The CEA indicator is used when the property being appraised is purchased in anticipation of receiving income (i.e., rental property), and the actual future income stream can be reliably forecast, or a hypothetical income stream can be estimated by comparison to other similar properties. CEA is the preferred approach for the appraisal of properties when reliable sales data are not available or the cost approach does not yield reliable results. CEA is a secondary indicator of value for public utility property because the income of public utility property is limited by regulation, and comparison to the income stream from similar properties is limited.

SCG has filed its property statement with the SBE for the 2010 lien date. The property statement forms the basis of the appraisal to set the value of SCG's property for the 2010-2011 fiscal years. The SBE reports the value of property subject to ad valorem tax annually on the "Notice of Unitary Appraised Value," which SCG has received for the 2010-2011 lien date. In correlating the value indicators calculated by the SBE from information contained in the property statement, the SBE applied a weighting of 75% to the HCLD indicator and 25% to the CEA indicator to derive the total appraised valuation of SCG's unitary property.[3] Added to the unitary

[3] Unitary property is property owned or used by a utility that the SBE has determined is used in SCG's operating business. The weight given to the CEA and HCLD indicators by the SBE can be derived mathematically by correlating the value indicators to the final value.

value of SCG's property is the value of SCG's non-unitary property.[4] In estimating taxes for ratemaking purposes, adjustments were made to exclude taxes resulting from (a) the assessment of non-utility property since it is not included as an operating expense and (b) Construction Work in Process ("CWIP") that gets capitalized rather than directly charged to ad valorem tax expense. In the event the Commission does not approve the request to modify the ratemaking treatment of ad valorem taxes associated with capital construction projects as proposed in the testimony of witness Garry G. Yee (see Exhibit SCG-26), when determining the final revenue requirement for SCG, taxes must be recalculated accordingly.

The SBE has followed the same assessment methodology for several years; consequently, SCG followed this methodology to estimate the assessed value for unitary property and the resulting ad valorem tax expense estimate for TY 2012.

The tax rate used to estimate ad valorem taxes is the basic statewide tax rate of 1% established under Proposition 13 plus an additional rate component of 0.243%, which is a composite rate derived from dividing taxes paid to local jurisdictions by the total assessed value of property in all voter approved local assessment districts (as allowed under Proposition 13). The escalation in rates from 2009 to 2012 represents the average historical rate of increase in local tax rates over the most recent five year period. Tax expense for TY 2012 is comprised of the second installment payment from fiscal year 2011 plus the first installment payment for fiscal year 2012.

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4 Non-unitary property is property owned or used by the utility that the SBE has determined is not used in SCG's operating business.

C. Summary of Estimated Ad Valorem Tax Expenses

TABLE SCG-RGR-2

Southern California Gas Company

Summary of Estimated Ad Valorem Tax Expenses

(Thousands in nominal $)

Line No.	*Description*	*2009 Recorded*	*2010 Estimated*	*2011 Estimated*	*2012 Test Year*
1	Plant in Service	8,398,831	8,684,222	9,174,085	9,749,686
2	Reserve for Depreciation	(4,758,331)	(4,952,263)	(5,142,744)	(5,344,076)
3	Net Plant	3,640,500	3,731,959	4,031,341	4,405,610
4	Reserve for Deferred Income Taxes	(389,916)	(438,674)	(521,573)	(601,054)
5	Adjustment for Income Approach	(55,987)	44,977	47,933	51,960
6	Assessed Value - Non-Unitary	49,875	52,118	55,544	60,209
7	Assessable Value before adjustment	3,244,472	3,390,380	3,613,245	3,916,725
8	Adjustment due to tax appeal				
9	Net Assessable Value	3,244,472	3,390,380	3,612,245	3,916,725
10	Ad Valorem Tax Rate	x 1.224%	x 1.230%	x 1.236%	x 1.243%
11	Ad Valorem Tax - Fiscal Year	39,697	41,698	44,669	48,670
12	Other Adjustments	(613)	(613)	(613)	(2,516)
	Ad Valorem Tax - Fiscal Yr-Operating	39,084	41,085	44,056	46,154
13	Ad Valorem Tax - Calendar Year*	38,862	40,084	42,570	44,382

*1/2 of the current fiscal year ad valorem tax plus 1/2 of the prior fiscal year ad valorem tax.

D. Results

The changes from 2009 to 2012 are the result of changes in plant and depreciation balances presented by other witnesses in their direct testimony and the expected escalation in the tax rate for local assessments as discussed above.

IV. INCOME TAXES

A. Introduction

The purpose of this section is to provide an estimate of SCG's income tax expense for TY 2012, and to describe the assumptions and methodology used to calculate income tax expense.

B. Discussion of Income Tax Expense

1. Methodology

SCG operating income is subject to federal income tax and the California Corporation Franchise Tax ("CCFT"). The calculation of ratemaking income taxes is dependent upon federal and state tax laws, prior Commission decisions with general applicability to all utilities, and decisions with specific reference to SCG.

Consistent with Order Instituting Investigation ("OII") 24, Decision ("D.") 84-05-036, the income tax estimates contained in this section are based on SCG's stand-alone taxes, not on an allocation of tax expense from Sempra Energy, the parent company of SCG.[5]

The estimates contained in this section were calculated using current federal and state tax laws enacted through December 31, 2010. SCG has not attempted to forecast future changes in tax law in the income tax calculations. SCG has utilized current federal and state statutory tax rates of 35% and 8.84%, respectively, in developing its estimate of federal and state income tax expense.

State income tax expense has been computed by reducing operating income by operating expenses, including property taxes and payroll taxes, and making certain permanent and flow through tax adjustments for differences in the book and state tax treatment of items of income and expense (Schedule M adjustments) as explained in more detail later in this section. Consistent with Commission policy, a flow through accounting methodology has been utilized in estimating state tax expense.[6]

Federal income tax expense has been computed by reducing operating income by operating expenses, including property taxes, payroll taxes, and prior year state taxes, and making tax adjustments for differences in the book and federal tax treatment of certain items of income and expense (Schedule M adjustments), also explained in more detail later in this section.

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[5] 1984 Cal. PUC LEXIS 1325, p. 57-58 (Finding of Fact #12); 15 CPUC 2d 42.

[6] Flow-through accounting treats temporary differences between recognition of expenses for book purposes and their tax return treatment as current adjustments to the revenue requirement.

Where required, SCG has followed the normalization rules contained in Internal Revenue Code Section ("IRC §") 168 and Treasury Regulations Section ("Reg. §") 1.167(l)-1 in computing federal income tax expense.[7] Accordingly, federal tax depreciation on post-1980 vintage assets has been "normalized" by using a book life and method to calculate tax depreciation. Consistent with Commission policy, where normalization is not required by the IRC, SCG has flowed through tax deductions. For example, tax depreciation on pre-1981 vintage assets has been flowed through as an adjustment to federal tax expense as required by D.93848.[8]

Tax expense based on income has been reduced by the amortization of Investment Tax Credits ("ITC") generated in prior years that were deferred in accordance with SCG's election under applicable tax law[9] to ratably flow through the ITC benefit as a reduction to ratemaking tax expense at a rate not to exceed the book life of the property that generated the ITC. This application conforms to the treatment of deferred ITC amortization mandated by D.88-01-061[10] and is the same treatment employed by SCG in prior rate cases. A small portion of deferred ITC reduced rate base, pursuant to an election made under applicable law[11] by a predecessor company, Pacific Lighting Gas Supply Company ("Pacific Lighting"), which merged with SCG in November 1985. As a successor in interest, SCG continues to amortize deferred ITC generated by Pacific Lighting as a ratable restoration to rate base.

SCG's federal income tax expense has been reduced by the amortization of remaining excess deferred taxes utilizing the Average Rate Assumption Method ("ARAM") as required by Internal Revenue Service ("IRS") normalization rules and mandated by D.88-01-061.[12]

The Tax Reform Act of 1986 ("TRA 86") adopted rules regarding capitalization of construction period interest for long-lived assets that have an extended construction period. These rules were codified in IRC §263A. For book and ratemaking purposes, construction period interest is capitalized through an allowance for funds used during construction ("AFUDC"). While similar in concept, there are specific differences between the book and tax

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[7] Normalized tax accounting follows the book treatment for items of income and expense in the revenue requirement calculation.
[8] 1981 Cal. PUC LEXIS 1240; 7 CPUC 2d 332.
[9] SCG's election under former IRC §46(f)(2).
[10] 1988 Cal. PUC LEXIS 102; 27 CPUC 2d 310.
[11] Pacific Gas Lighting's election under former IRC §46(f)(1).
[12] *Id.* at 95-96.

treatment of construction period interest. As in prior rate cases, for tax purposes, SCG follows the rules in IRC §263A in this filing with respect to the capitalization of construction period interest.

As prescribed by the Commission, SCG used the statutory federal tax rate of 35% and the statutory state tax rate of 8.84% in development of the net-to-gross multiplier used to gross-up tax expense to a revenue requirement.[13]

2. Schedule M Items and Other Specific Tax Deductions

SCG made several adjustments to book income in the form of Schedule M adjustments to arrive at taxable income. In addition, there are other types of deductions permitted under the IRC that have been incorporated into the computation of SCG's tax expense, as discussed below.

<u>Synchronized Interest Adjustment.</u> This adjustment represents the interest expense on debt used to finance rate base. The deduction is computed using rate base and the authorized weighted-average cost of long-term debt. The CCFT synchronized interest deduction is based on rate base net of deferred ITC (as ITC is not available for CCFT purposes).

<u>Preferred Dividend Deduction</u>. IRC §247 allows a deduction for dividends paid on preferred stock issued prior to October 1, 1942. A deduction is also allowed for dividends on preferred stock issued after October 1, 1942 if the preferred stock replaced other preferred stock or bonds issued before October 1, 1942. A portion of SCG's preferred stock dividends qualify for deduction, which is a permanent difference between the book and tax treatment. SCG has flowed through this deduction.

<u>Fiscal Year/Calendar Year Property Tax Adjustment</u>. An adjustment is made to add back calendar-year property tax expense per books and deduct fiscal-year property tax expense as allowed by federal and state tax law. SCG has flowed through the fiscal year tax expense as a deduction in calculating tax expense.

<u>Prior Year CCFT</u>. Federal law allows a deduction for state income taxes paid. In California, this is the CCFT deduction. However, for ratemaking purposes, D.89-11-058[14] specifies that the allowable deduction is the prior years' Commission-adopted CCFT, not the current year CCFT. Since there is, as yet, no Commission-adopted CCFT, SCG has used the prior year's CCFT estimate in calculating federal tax expense for TY 2012.

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[13] *Supra* at 62-63 (Conclusion of Law #9).
[14] 1989 Cal. PUC LEXIS 815, p. 34 (Conclusion of Law #1); 33 CPUC 2d 495.

Internally-Developed Software. For financial accounting purposes, software expenses are capitalized and amortized over various lives. For tax purposes, a current year deduction is allowed under IRC §174 for internally-developed software costs.[15] SCG has flowed through the deduction for internally-developed software expenditures. Un-modified, or "canned," software must be capitalized and amortized under IRC §167(f).[16] SCG has normalized the deduction for capitalized software pursuant to D.84-05-036.[17]

Non-Deductible Meals. Federal and state tax laws limit the deduction for meals and entertainment to 50% of the actual costs incurred. Consequently, SCG must add to taxable income 50% of meals and entertainment expense deducted for financial reporting purposes. SCG's 2012 Schedule M tax adjustment is based on a trend of actual tax return experience in prior years.

Federal Tax Depreciation. Federal tax depreciation on post-1980 vintage property is governed by the normalization rules described earlier. Differences between book and tax depreciation resulting from the different methods and lives used to compute book and tax depreciation are normalized. Federal tax depreciation on pre-1981 vintage property is flowed through as a deduction in the computation of federal taxable income as are differences in book and tax depreciation related to the basis of depreciable property.

State Tax Depreciation. California did not adopt the federal accelerated depreciation ACRS and MACRS methods and lives or the normalization requirements enacted by the Economic Recovery Tax Act of 1981 ("ERTA") and the TRA 86. Accordingly, there is no requirement to normalize state tax depreciation; therefore, SCG flows through the state tax depreciation in excess of the book amount. SCG's state tax depreciation is calculated using the Asset Depreciation Range Method ("ADR") prescribed by the IRS prior to 1981, which utilizes double declining balance depreciation switching to a straight-line method when book depreciation exceeds the double declining balance method.

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[15] The 2012 tax deduction for internally-developed software is a function of the forecasted spend on internally-developed software in TY 2012. Spend data is forecasted by capital witnesses in the rate base module and the tax module pulls in the forecasted spend data from the rate base module. A formula error was discovered in the Results of Operations model that caused the TY 2012 forecast of internally-developed software to be understated. SCG has corrected the error, and the corrected tax deduction for internally-developed software is reflected in Table SCG-RGR-3-2 and my revised testimony.

[16] IRC §167(f) required capitalization of un-modified software purchased after August 10, 1993.

[17] *Supra*.

Federal Cost of Removal. SCG follows the guidance in IRS Revenue Ruling 2000-7, which provides a current deduction for actual costs to remove assets retired from service. However, under the normalization rules, costs to remove assets that have been depreciated using either Accelerated Cost Recovery System ("ACRS") or Modified Accelerated Cost Recovery System ("MACRS") cannot be flowed through. Accordingly, federal removal costs are deducted only on pre-1981 vintage assets retired from service. This decision is consistent with D.93848.

State Cost of Removal. California did not adopt the federal ACRS or MACRS depreciation systems, choosing instead to remain on the ADR system. Accordingly, SCG flows through removal costs without regard to the vintage of the underlying assets per D.84-05-036.[18]

Federal Percentage Repair Allowance. As noted above, SCG depreciates its pre-1981 vintage assets under the ADR system of depreciation. Under this election, SCG is entitled to take a current deduction for a specified percentage of capitalized book repairs related to ADR property. SCG has flowed through this deduction in accordance with D.93848.

State Percentage Repair Allowance. California did not adopt the federal ACRS or MACRS tax depreciation systems, therefore, the ADR tax depreciation system continues in use for all vintages of property for California depreciation purposes. Accordingly, SCG is entitled to take a current deduction for a specified percentage of capitalized book repairs without limitation based on the vintage of property. Consistent with D.93848, SCG has flowed through this deduction.

Tax Credits. SCG has reflected an offset to tax expense for allowable federal and state tax credits it claims on its tax return, including the Child Care Credit, Empowerment Zone Credit, R&D Credit, Alternative Motor Vehicle Credit, and Enterprise Zone Credits. Under current law, the federal fuel tax credit contained in IRC §6426(d)(5) that SCG has claimed in the past is not available for any period after December 31, 2011. Accordingly, SCG has not reflected an offset for the fuel tax credit in its test year 2012 income tax expense. SCG has also reflected a "credit addback" where required in computing taxable income. As a general rule, a taxpayer cannot claim both a deduction and a credit for the same item of expense. Therefore, SCG added the amount of credits claimed back to taxable income to reverse the corresponding tax deductions.

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[18] *Supra* at 59 (Finding of Fact #23).

C. Discussion of Deferred Taxes

The accumulated deferred federal income tax ("ADFIT") resulting from the difference between normalized tax depreciation computed using a book life and book method and the comparable tax depreciation computed using ACRS or MACRS has been included as an adjustment to rate base in this General Rate Case ("GRC") (see the testimony of Garry G. Yee, Exhibit SCG-26, for a discussion of rate base). SCG's treatment of deferred taxes is in accordance with IRC §168(i) (9), Reg. §1.167(l)-1, and related IRS rulings.[19]

All current law has been followed in the development of deferred federal income taxes. Recent significant changes in law affecting deferred taxes include the expiration on January 1, 2005 of the 30% and 50% bonus depreciation provisions enacted by the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Act of 2003, respectively. Accordingly, except in the case of certain qualified self-constructed assets placed in service in 2005, bonus depreciation has not been calculated on property placed in service between January 1, 2005 and December 31, 2007 when bonus depreciation was not allowed. The residual impact of bonus depreciation taken on qualified property placed in service in prior periods is reflected in the accumulated deferred income tax balances for 2009-2012.

Since the effective date of SCG's 2008 GRC decision, Congress has passed four major pieces of legislation with deferred tax implications for SCG's 2012 TY estimates.

- The Economic Stimulus Act of 2008 included a provision that allowed additional 50% bonus depreciation on the acquition cost of qualified property, with a recovery period of 20 years or less that got placed in service in 2008.
- The American Recovery and Reinvestment Act of 2009 included a one year extension of 50% bonus depreciation for qualified property placed into service before 1/1/2010.
- The Small Business Jobs Act of 2010 included another one-year extension of 50% bonus depreciation for qualified property placed in service before January 1, 2011.
- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("Tax Relief Act"), which the President signed on December 17, 2010, as described below.

[19] IRC §168, Reg. §1.167(l)-1, and numerous IRS rulings make up the "tax normalization" requirements.

Section 401 of the Tax Relief Act, includes an extension and enhancement of bonus tax depreciation provisions that were in effect for 2010 pursuant to the Small Business Jobs Act and made them applicable to tax years 2010 (but only for qualified property acquired after September 8, 2010), 2011, and 2012. Section 401 amends IRC§168(k) to extend the period in which taxpayers may elect to claim bonus tax depreciation on qualified capital additions for income tax reporting purposes. Qualified property acquired and placed in service after September 8, 2010 and before January 1, 2012 is eligible for 100% bonus depreciation. Property acquired and placed in service after December 31, 2011 and before January 31, 2013 is eligible for 50% bonus depreciation. Property that was acquired under a binding written contract in effect prior to January 1, 2008 is not eligible for bonus depreciation and there are other special eligibility rules that apply to self-constructed property with a long-construction period and a cost exceeding $1 million. The effect of these bonus depreciation provisions is to reduce current income taxes paid and to increase deferred income tax liabilities that will be paid in the future.

The bonus depreciation provisions contained in the Tax Relief Act apply to the same types of property eligible for bonus depreciation under prior law. Property eligible for bonus depreciation is generally limited to business property with a tax recovery period of 20 years or less and only if the original use of the property commences with the taxpayer.

For ratemaking purposes, bonus depreciation allowed by the Tax Relief Act is subject to the tax normalization rules contained in IRC §168 and Treasury Regulations under former IRC §167. The tax normalization rules effectively bar the utility from passing the current income tax savings resulting from bonus depreciation to ratepayers by lowering the revenue requirement for income tax expense in the cost of service. However, the resulting deferred taxes generated by bonus depreciation represent a reduction to rate base, which is reduced accordingly. The incremental addition to the deferred tax reserve created by this legislation is equal to the bonus depreciation multiplied by the federal tax rate of 35%.

On March 29, 2011, the IRS issued Revenue Procedure 2011-26 (“Rev Proc 2011-26”), to interpret and make specific the rules pertaining to 50% and 100% bonus depreciation allowances in IRC §168(k) as amended by the Tax Relief Act. Under Rev Proc 2011-26, qualified property is eligible for 100% first year bonus depreciation if the property meets all of the following requirements:

1) The taxpayer acquires the qualified property after September 8, 2010 and before January 1, 2012, (or before January 1, 2013 in the case of self-constructed property with a production period exceeding one year and a cost in excess of $1,000,000).
2) The taxpayer places the qualified property in service after September 8, 2010 and before January 1, 2012 (or before January 1, 2013 in the case of self-constructed property with a production period exceeding one year and a cost in excess of $1,000,000).
3) The original use of the property commences with the taxpayer.

The IRS guidance in Rev Proc 2011-26 further defines when property is "acquired" for purposes of determining whether the property is eligible for 50% or 100% bonus depreciation. Qualified property is "acquired" when the taxpayer pays or incurs the cost of the property. In the case of qualified property that a taxpayer manufacturers, self-constructs, or produces for use in its trade or business, the property is "acquired" by the taxpayer when manufacturing, construction, or production of the property begins. As a result, self-constructed property with a production period exceeding one year is considered to be acquired by the taxpayer when construction commences and is considered to be placed-in-service when the property begins operating.

To minimize disputes regarding whether a taxpayer acquired or placed in service particular property before or after September 8, 2010, the IRS guidance allows taxpayers to make an election to forego the 100% additional first year depreciation for all qualified property that is in the same eligible class of property and claim only 50% bonus depreciation instead. This election is available for eligible property acquired and placed in service in 2010. SCG has not made this election, and has claimed 100% bonus depreciation on qualified eligible property in 2010. There are other safe-harbors and elections available. For example, taxpayers may opt out of bonus depreciation altogether in 2010, 2011, or 2012 for particular classes of eligible property while claiming bonus depreciation on other eligible classes. It may be beneficial for a taxpayer to forgo claiming bonus depreciation on one or more classes of eligible property in a particular year if the taxpayer would otherwise lose the benefit of tax credits or expiring net operating losses ("NOLs") carried over from prior years.

SCG has recomputed its federal tax depreciation on forecasted capital additions otherwise eligible for MACRS depreciation in 2010, 2011, and 2012 to reflect the impact of the 50% and 100% bonus deprecation provisions contained in the Tax Relief Act, as applicable. The incremental deferred tax liability generated each year is equal to the additional first year bonus deprecation multiplied by the 35% federal income tax rate. 100% depreciation has been claimed on qualified self-constructed property with a construction period exceeding one year and a cost in excess of $1,000,000 in 2012 when 50% bonus depreciation would otherwise be in effect.

As a result of bonus depreciation, current taxes have decreased and deferred federal income tax liabilities have increased compared to the Application filing. The net cumulative effect of additional deferred taxes created in 2010 and 2011 are reflected in the beginning accumulated deferred tax balance at January 1, 2012. Deferred taxes created by additional first year bonus deprecation in 2012 have been layered on and are reflected in the ending deferred tax balance at December 31, 2012. The increase in the accumulated deferred tax reserve results in a reduction to rate base and the revenue requirement as discussed by other witnesses.

The additional first-year bonus depreciation reflected in 2010, 2011, and 2012 under the Tax Relief Act has other indirect implications on the revenue requirement. First, additional first-year bonus depreciation may result in tax deductions that exceed taxable income in some years, producing a NOL. In such cases, IRS rules require the incremental deferred tax liability associated with bonus depreciation to be calculated net of the deferred tax asset resulting from the NOL.[20] The deferred tax asset will not be utilized until the company monetizes the extra bonus depreciation benefit by obtaining a refund of prior years' taxes or offsetting future years' taxes. (A taxpayer is allowed to carry back NOLs against taxable income in the prior two years or forward to offset taxable income for the next twenty years). Second, the ITCC collected from customers on taxable CIAC is an offset to rate base. Bonus depreciation reduces the ITCC rate, and therefore the offset to rate base associated with the ITCC (see the discussion of CIAC and ITCC below). Third, as discussed more fully in the section on Ad Valorem taxes above, utility property tax assessments are largely a function of net plant less 100% of the deferred tax reserve. SCG has reflected the reduction in forecasted property taxes resulting from the impact of bonus depreciation on the deferred tax reserve.

Contributions-in-aid-of-construction ("CIAC") became taxable under the TRA 86. Pursuant to D.87-09-026, SCG elected Method 5 to account for the tax impacts of CIAC, and the related income tax component of the contribution ("ITCC") as required by the TRA 86. In

[20] Treas. Reg. Section 1.167(l)-1(h)(1)(iii).

accordance with the decision, SCG has increased rate base for the tax paid on CIAC and its related ITCC received subsequent to February 10, 1987, the date that CIAC became taxable under the TRA 86. The increase to rate base related to CIAC tax impacts is reversed through tax depreciation over the tax life of the constructed property. The increase to rate base related to ITCC tax impacts is reversed through the amortization of ITCC to miscellaneous revenue over the tax life of the constructed property.

ITCC represents the tax gross-up for CIAC. It also became taxable under TRA 86. These tax gross-up amounts reflect the present value of tax paid upon receipt of CIAC, less the future tax benefits to be received through tax depreciation over the tax life of the constructed property. ITCC is included as a reduction to rate base and is amortized to miscellaneous revenue over the tax life of the constructed property as instructed by D.87-09-026.[21]

Accumulated deferred taxes for TY 2012 were developed on a monthly basis and prorated in accordance with the normalization requirements of Reg. §1.167(l)-1(h)(6)(ii).[22]

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[21] 1987 Cal. PUC LEXIS 195; 25 CPUC 2d 299.

[22] The method prescribed by Reg. §1.167(l)-1(h)(6)(ii) is to be used when rates are set on a projected future period. Tax expense must be computed using a rate and method consistent with the rate and method used for book depreciation. The deferred tax reserve that reduces rate base must be computed using the average of the beginning-of-year balance plus a prorated end-of-year balance. The prorated end-of-year balance was computed assuming that additions to the deferred tax balances are credited ratably at the end of each month throughout the year.

D. Summary Tables

TABLE SCG-RGR-3-1

Southern California Gas Company

Calculation of Federal & State Income Taxes

($ in Thousands)

Line No.	*Description*	*2009 Recorded*	*2010 Estimated*	*2011 Estimated*	*2012 Test Year*
1	Total Operating Revenue (Table 24, Line 1)	1,654,468	1,782,585	1,928,690	2,107,463
2	O&M Expenses (Table 24, Line 2)	(977,434)	(1,056,565)	(1,139,068)	(1,212,503)
3	Taxes Other than Income Taxes (Table 24, Line 3)	(70,640)	(73,465)	(77,534)	(81,070)
4	Book Income Before Depr. & Income Taxes	606,394	652,555	712,088	813,890
5	State Tax Adjustments (Table 24, Line 5)	(486,035)	(525,651)	(561,460)	(572,786)
6	Taxable Income	120,359	126,904	150,628	241,104
7	CCFT Rate	x 8.84%	x 8.84%	x 8.84%	x 8.84%
8	**California Corporate Franchise Tax**	10,640	11,218	13,316	21,314
9	Book Income Before Depr. & Income Taxes (Line 4, above)	606,394	652,555	712,088	813,890
10	Federal Tax Adjustments (Table 24, Line 10)	(427,848)	(431,140)	(462,431)	(484,309)
11	Taxable Income	178,546	221,415	249,657	329,581
12	Federal Income Tax Rate	x 35%	x 35%	x 35%	x 35%
13	Federal Income Tax Before Credits	62,491	77,495	87,380	115,353
14	Investment Tax Credit Amortization	(2,617)	(2,559)	(2,508)	(2,426)
15	Average Rate Assumption Method (ARAM)	(195)	(195)	(195)	(195)
16	Other	(797)	(797)	(797)	(470)
17	**Total Federal Income Tax**	58,882	73,944	83,880	112,262

TABLE SCG-RGR-3-2

Southern California Gas Company

Summary of Income Tax Adjustments

($ in Thousands)

Line No.	***Description***	***2009 Recorded***	***2010 Estimated***	***2011 Estimated***	***2012 Test Year***
	Federal Tax Adjustments:				
1	Tax Depreciation	(224,206)	(239,672)	(271,587)	(310,416)
2	Fixed Charges – Operating	(89,863)	(93,947)	(100,529)	(113,453)
3	Cost of Removal	(3,917)	(5,386)	(5,386)	(5,386)
4	Percentage Repair Allowance	(16,340)	(15,293)	(15,293)	(15,293)
5	Prior Year Calif. Corp. Franchise	(23,249)	(10,640)	(11,218)	(13,316)
6	Software Dev	(70,745)	(65,998)	(57,729)	(25,145)
7	50% of Meals & Entertainment	414	517	517	517
8	Ad Valorem Tax - Fiscal/Calendar	(222)	(1,001)	(1,486)	(1,770)
9	Preferred Dividend & Credit Addback	280	280	280	(47)
10	Total Federal Tax Adj. (Deduction)	(427,848)	(431,140)	(462,431)	(484,309)
	State Tax Adjustments				
11	Tax Depreciation	(270,337)	(308,359)	(345,291)	(375,914)
12	Fixed Charges – Operating	(88,988)	(93,154)	(99,815)	(112,816)
13	Cost of Removal	(11,423)	(12,792)	(12,792)	(12,792)
14	Percentage Repair Allowance	(44,217)	(44,347)	(44,347)	(44,347)
15	Software Dev	(70,745)	(65,998)	(57,729)	(25,145)
16	50% of Meals & Entertainment	414	517	517	517
17	Ad Valorem Tax - Fiscal/Calendar	(222)	(1,001)	(1,486)	(1,772)
18	Preferred Dividend	(517)	(517)	(517)	(517)
19	Total State Tax Adj. (Deduction)	(486,035)	(525,651	(561,460)	(572,786)

E. Results

The increase in federal and state tax expense from 2009 to TY 2012 is primarily a function of increasing book income before taxes resulting from the return on a growing rate base. Federal and state tax adjustments are also growing annually, partially offsetting the growth in book income before taxes from 2009 to TY 2012.

V. FRANCHISE FEES – ACCOUNT 927

A. Introduction

The purpose of this section is to provide background and analysis for SCG's franchise fees as estimated for TY 2012.

B. Discussion

Franchise fees are payments made to counties and incorporated cities pursuant to local ordinances granting a franchise to the company to place utility property in the public rights of way. These facilities include pipes and appurtenances for transmitting and distributing gas. As of January 1, 2009, SCG had franchise fee agreements with 242 taxing jurisdictions.

The franchise fee requirements are based upon gross receipts representing the recovery of base margin. The franchise factor upon which the estimated 2010-2012 franchise fees were determined is based on a summary of 2009 gas sales, transportation revenues, rate refunds, state fees, uncollectibles, and miscellaneous service receipts. The factor was adjusted to 2012 using historic trends in franchise payment data and by factoring in expectations of future franchise fee rates.

Franchise fees are calculated using two formulas: (1) the "Broughton Act" formula, and (2) the "Percent of Gross Receipts" formula. The Broughton Act formula, as prescribed by Commission guidelines, is calculated based upon the summarized receipts within each city as allocated by gas pipeline mileage in their public rights-of-way, and the applicable franchise fee rate pursuant to the franchise fee ordinance. The Percent of Gross Receipts formula is calculated based upon the summarized receipts within each city or county and the applicable franchise fee rate pursuant to the franchise fee ordinance.

The franchise agreement with each taxing authority specifies which of the above methods SCG will use to determine its franchise fee liability. The majority of agreements require that the franchise fee be calculated under both methods with SCG paying the higher of the two calculated fees. The remaining agreements specify that only the Broughton Act or Percent of Gross Receipts method be used.

The total payments to all taxing authorities were summed and divided by total receipts to arrive at a systemwide franchise fee factor. The systemwide franchise fee factors for the most recent five years were then averaged to yield a forecasted average franchise fee factor for TY 2012. The average franchise fee factor was adjusted to incorporate a forecasted increase in the Los Angeles County franchise fee that expires in 2011 and will be renewed for 2012 and beyond. We have not included any potential granting fees in the projected 2012 franchise fee factor that could be imposed on SCG during upcoming negotiations with Los Angeles County. In the event that the negotiations result in the imposition of a granting fee after the GRC application is filed, but before the update filing, the granting fee will be capitalized and SCG will propose an amortization of the granting fee to be included in the franchise fee factor in the update filing. In addition, the City of Huntington Beach implemented a franchise fee surcharge on customers located in the City beginning in 2010 that resulted in a decrease to the systemwide franchise fee factor. The average franchise fee factor for 2012 is projected to be 1.4593%.

Table SCG-RGR-4-1 below provides the detail for Account 927, Franchise Fees as estimated for the 2012 TY.

C. Summary of Estimated Franchise Fees

Table SCG-RGR-4-1

($ in thousands)

Line No.	*Acct. No.*	*Title*	*2009 Recorded*	*2010 Forecast*	*2011 Forecast*	*2012 Test Year*
1	927	Franchise Fees	23,101	24,627	26,547	29,651

D. Results

The change in franchise fee expense from 2009 to 2012 results from changes in base margin as presented by other witnesses in their direct testimony, the increase to the franchise fee factor due to the renewal of the Los Angeles County franchise, partially offset by the impact of the surcharge adopted by the City of Huntington Beach.

This concludes my prepared direct testimony.

VI. WITNESS QUALIFICATIONS

My name is Randall G. Rose. I am employed by Sempra Energy as a Tax Director responsible for tax operations on behalf of San Diego Gas & Electric Company ("SDG&E") and Southern California Gas Company ("SCG"). My business address is 101 Ash Street, HQ-07, San Diego, California 92101. I direct the preparation of SCG's federal and state income tax returns and the tax adjustments reflected in the accounting for income taxes. I am also responsible for the development and analysis of payroll tax estimates, income tax estimates, ad valorem tax estimates, and franchise fee estimates for use in SCG's ratemaking proceedings.

I received a Bachelor of Science Degree Business Administration with an emphasis in Accounting from San Diego State University. I am a Certified Public Accountant licensed by the State of California.

Prior to being employed by Sempra Energy, I was employed by SDG&E as the Property Tax Administrator. Before joining SDG&E, I was a senior tax advisor to the elected member of the California State Board of Equalization from the 3rd Equalization District. In that function, I advised the Board Member on tax appeals cases and utility ad valorem assessments that came before the Board for a decision.

I have previously testified before this Commission.

CHANGE LOG

Errata Only

Page	Line	Errata Item
RGR-3	7-10	Table SCG-RGR-1 changed and replaced to show corrected amounts.
RGR-5	13	Replaced “0.2263%” with “0.243%.”
RGR-5	16-17	Deleted text: “The increase in the rates from 2009 to 2012 represents the historical increase in local tax rates.” Replaced with: “The escalation in the rates from 2009 to 2012 represents the average historical rate of increase in local tax rates over the most recent five year period.”
RGR-6	7	Replaced “increase” with “escalation.”
RGR-7	16	Added text after word “law”: “in the income tax calculations.”
RGR-9	8	Replaced “Schedule Ms” with “Schedule M adjustments.”
RGR-10	Fn.15	Deleted text: “Because this error was discovered after the model’s output was finalized, SCG will seek to correct this error in a subsequent submittal (e.g., errata).” Replaced with: “SCG has corrected the error, and the corrected tax deduction for internally-developed software is reflected in Table SCG-RGR-3-2 and my revised testimony.”
RGR-11	20-29	Added an omitted section discussing Tax Credits.
RGR-12	3	Added “book” before “method.”
RGR-12	4	Deleted “depreciation methods” after “MACRS.”
RGR-12	9	Deleted text: “The most significant recent change in law affecting deferred taxes is…” Replaced with: “Recent significant changes in tax law affecting deferred taxes include…”
RGR-12	19	Deleted “(2008 Act)” after “Economic Stimulus Act of 2008.”
RGR-12	19	Changed “enhanced” to “additional.”
RGR-12	22	Deleted “(2009 Act)” after “American Recovery and Reinvestment Act of 2009.”
RGR-12	25	Deleted “(2010 Act)” after “Small Business Jobs Act of 2010.”
RGR-12	25-26	Added “50%” before “bonus” and deleted “tax” before “depreciation.”
RGR-14		Fixed pagination error from page RGR-14 on.

Tax Relief Act Updates
(combined with Errata Items where applicable)

Page	Line	Errata Item (Interim Step)	Tax Relief Act Item (Final)
RGR-6	2-3	Tables SCG-RGR-2 was changed to reflect corrected data.	Table SCG-RGR-2 was changed and replaced to incorporate impacts from Tax Relief Act.
RGR-7	15	Changed July 30 to September 30.	Changed September 30 to December 31.
RGR-12	17	N/A	Changed "three" to "four."
RGR-12	18	N/A	Added "deferred" before "tax implications."
RGR-12 thru RGR-15	27 thru 26	N/A	Added new bullet point on the Tax Relief Act. Added new discussion on the Tax Relief Act.
RGR-15	28	N/A	Deleted text immediately preceding paragraph on CIAC: "The ratemaking effect of these three Acts was to increase federal tax return depreciation in 2008, 2009, and 2010 above the regular tax depreciation provided by the federal MACRS depreciation system. The extra bonus tax depreciation allowed by the Acts created additional deferred taxes equal to the extra bonus depreciation multiplied by the 35% federal income tax rate. The additional deferred taxes created by bonus depreciation in 2008, 2009, and 2010 are reflected in the accumulated deferred tax balances for purposes of calculating rate base for TY 2012."
RGR-15	Fn.20	N/A	Added new footnote 20, resulting in re-numbering of subsequent footnotes.
RGR-17 thru RGR-18		Tables SCG-RGR-3-1 and SCG-RGR-3-2 were changed to reflect corrected data.	Tables SCG-RGR-3-1 and SCG-RGR-3-2 were changed and replaced to incorporate impacts from Tax Relief Act.
RGR-20	18-19	Table SCG-RGR-4-1 was changed to reflect corrected data.	Table SCG-RGR-4-1 was changed and replaced to incorporate impacts from Tax Relief Act.