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Proceeding: 2016 General Rate Case
Application: A.14-11-004
Exhibit: SCG-228

SOCALGAS

REBUTTAL TESTIMONY OF RAGAN G. REEVES

(TAXES)

June 2015

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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SOCALGAS REBUTTAL TESTIMONY OF RAGAN G. REEVES
(TAXES)

I. SUMMARY

A. OFFICE OF RATEPAYER ADVOCATES ("ORA")

ORA issued its report on Taxes on April 24, 2015.[1] The following is a summary of ORA's positions:

- ORA accepts SoCalGas' methodology for forecasting ad valorem taxes (i.e., property taxes).
- ORA accepts SoCalGas' methodology for forecasting deferred income taxes.
- ORA accepts SoCalGas' methodology for forecasting franchise fees.
- ORA accepts the tax rates and tax adjustments that SoCalGas uses in its calculation of income tax expense; however, ORA proposes that adjustments to tax expense be updated if any tax-related bills are enacted before a final decision in this GRC.
- ORA proposes two changes to the calculation of SoCalGas' composite payroll tax rate:
  - ORA proposes that SoCalGas use the actual 2015 Old-Age, Survivors, and Disability Insurance ("OASDI") wage base limitation of $118,500 for calculating the 2015 and forecasted 2016 composite payroll tax rates instead of the OASDI wage base limitations for 2015 and 2016 as forecasted by the Social Security Administration in its 2014 Annual Report ("2014 Annual Report").
  - ORA proposes that SoCalGas use a California Unemployment Insurance ("UI") rate of 3.4% for calculating the 2015 and forecasted 2016 payroll tax rates instead of the 3.6% UI rate forecasted by SoCalGas for 2015 and 2016.

B. THE UTILITY REFORM NETWORK ("TURN")

TURN submitted testimony on May 15, 2015.[2] The following is a summary of TURN's position on Income Taxes:

- TURN is proposing to take the incremental increase in the repairs deduction resulting from the change in accounting method for SoCalGas from its 2012-2014 tax years, which

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[1] Exhibit ORA-21 (M. Campbell), Report on Taxes (full title truncated) ("ORA-21").
[2] Prepared Testimony of William B. Marcus on Behalf of TURN (full title truncated) ("TURN/Marcus").

SoCalGas had treated as flow-through items in those years, and normalize that total amount beginning in the 2016 Test Year.

- TURN is proposing to flow through to ratepayers the end-of-2015 amount of money reflected in the memorandum account established for SoCalGas' 2015 repairs deduction. Alternatively, TURN proposes to normalize the 2015 repairs deduction for SoCalGas beginning in the 2016 Test Year.
- TURN also proposes that any future voluntary "tax changes" made by SoCalGas should not take effect until a GRC test year "unless provisions are made to make ratepayers whole."

II. REBUTTAL TO PARTIES' PROPOSALS

A. ORA

1. Issues Not in Dispute

ORA accepts SoCalGas' methodology for forecasting ad valorem taxes,[3] franchise fees,[4] and deferred income taxes.[5] ORA also accepts the tax rates and tax adjustments that SoCalGas uses in its calculation of income tax expense.[6] Accordingly, any differences between SoCalGas' and ORA's estimates of ad valorem taxes, franchise fees, income tax expense, and deferred taxes are attributable to differences in forecasted capital additions, rate base, and other non-tax-related adjustments resulting from ORA's proposed changes to the SoCalGas GRC application.

2. ORA's Proposed Timing for Updating the Tax Calculations to Reflect Potential Future Changes in Tax Law Go Beyond the Procedures Set Forth in the Rate Case Plan and Scoping Memorandum for this GRC

While ORA accepts SoCalGas' income tax rates and income tax adjustments, ORA proposes that adjustments to tax expense be updated if any tax-related legislative bills are enacted before a final decision in this GRC.[7] In response to ORA's proposal, SoCalGas notes that the Rate Case Plan already includes a mechanism for SoCalGas to update its testimony to reflect changes in the relevant tax laws. Under the Rate Case Plan, "[k]nown changes due to governmental action such as changes in tax rates . . ." are to be reflected during the Update phase

[3] ORA-21, page 8, lines 6-7.
[4] *Id.* at page 11, lines 6-7.
[5] *Id.* at page 10, lines 17-18.
[6] *Id.* at page 8, line 18; page 9, lines 3-4 and 9-10.
[7] *Id.* at page 10, lines 7-11.

of the GRC.[8] Under the Assigned Commissioner's Scoping Memo and Ruling for this GRC dated February 15, 2015 ("Scoping Memo"), the due date for Update Testimony is August 24, 2015.[9]

SoCalGas will follow the procedures and deadlines set forth in the Rate Case Plan and Scoping Memo for updating its forecasts to reflect tax law changes, including tax-extender legislation, extension of bonus depreciation, or other tax-related law changes that occur prior to the closing of the record in this GRC. ORA's proposal would go beyond the procedures set forth in the Rate Case Plan and Scoping Memo and would require SoCalGas to update its forecasts after the record in this GRC has closed. Accordingly, ORA's proposal should not be adopted.

3. <u>SoCalGas' Methodology for Computing its Composite Payroll Tax Rate is Reasonable, and ORA's Proposed Changes to that Methodology Should Not Be Adopted</u>

ORA recommends a composite payroll tax rate of 7.58% for Test Year 2016 as compared to SoCalGas' proposed rate of 7.63%.[10] The difference in the proposed tax rates reflects two proposed changes to the composite payroll tax rate computation by ORA: (1) ORA proposes that SoCalGas use the actual 2015 OASDI wage base limitation of $118,500 for calculating the 2015 and forecasted 2016 composite payroll tax rates instead of the OASDI wage base limitations for 2015 and 2016 as forecasted by the Social Security Administration in the 2014 Annual Report; and (2) ORA proposes that SoCalGas use a UI rate of 3.4% for calculating the 2015 and forecasted 2016 payroll tax rates instead of the 3.6% UI rate forecasted by SoCalGas for 2015 and 2016. Each of ORA's proposals will be discussed in turn.

a. <u>SoCalGas' OASDI Wage Base Limitation Methodology is the Same Methodology that the Commission Adopted in SoCalGas' 2012 GRC</u>

ORA recommends that SoCalGas use the 2015 actual OASDI wage base of $118,500 as the wage base for Test Year 2016 "because it is the most accurate and currently available information to estimate TY 2016."[11] SoCalGas uses the projected OASDI wage base for 2016 from the 2014 Annual Report from the Social Security Administration, which was $123,600.

[8] Decision ("D") 07-07-004, Appendix A, page A-36.
[9] Scoping Memo, page 10.
[10] ORA-21, page 7, Table 21-5.
[11] *Id.* at page 5, lines 11-12.

The methodology that SoCalGas uses to forecast the OASDI wage base for 2016 – i.e., to use the wage base amount projected for the Test Year from the most recently published Social Security Administration Annual Report available at the time the application was filed, is the same methodology that SoCalGas used in its prior 2012 GRC forecast, which was adopted by the Commission. In the final decision for SoCalGas' 2012 GRC, the Commission held that SoCalGas' "forecasts of the payroll taxes are reasonable and should be used instead of adopting the adjustments that DRA, TURN and UCAN have proposed."[12]

Similar to its approach in the 2012 GRC, ORA is proposing to make isolated adjustments to 2016 test year amounts using 2015 information. The Commission agreed with SoCalGas' position in the 2012 GRC that such selective updating is inappropriate because it "ignores the fact that while certain costs may be lower than expected, other costs are higher than expected and there is no provision to reflect those instances."[13]

b. ORA's Proposed OASDI Wage Base Methodology Does Not Provide a More Reasonable Forecast than SoCalGas' Methodology

ORA has not demonstrated in its testimony that its proposed approach to forecasting the OASDI wage base for 2016 is a more accurate or reliable indicator of the wage base than SoCalGas' approach. To the contrary, as shown in ORA's testimony, the actual OASDI wage base has increased each year for four consecutive years by an average of $2,875 over the prior year.[14] Accordingly, ORA's recommendation to use the current year OASDI wage base to estimate the wage base for the following year would yield inherently and historically inaccurate results.

c. ORA's Challenge to SoCalGas' OASDI Wage Base Methodology is Inconsistent with ORA's Position on the Same Issue in Southern California Edison's 2015 GRC

As discussed above, SoCalGas' methodology for forecasting the OASDI wage base limitation in this GRC is the same methodology that was adopted by the Commission in its prior 2012 GRC. Specifically, SoCalGas' methodology is to use the wage base limitation projected for the Test Year from the most recently published Social Security Administration Annual Report at the time the GRC application was filed (which for this GRC is the 2014 Annual

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[12] D.13-05-010 at 939.
[13] *Id.*
[14] ORA-21, page 4, Table 21-3.

Report). In its 2015 GRC application, Southern California Edison ("Edison") used the <u>same methodology</u> as SoCalGas in forecasting its OASDI wage base limitation for Edison's 2015 Test Year.[15] ORA in Edison's GRC <u>did not challenge any aspect</u> of Edison's composite payroll tax rate computation, including the OASDI wage base methodology shared by Edison and SoCalGas. Specifically, ORA in its direct testimony in Edison's 2015 GRC stated: "ORA agrees with [Edison's] payroll tax rates and wage bases."[16] It is not appropriate or reasonable for ORA to accept another utility's methodology in full while challenging <u>the exact same methodology</u> in SoCalGas' GRC.

d. <u>SoCalGas' Methodology for Forecasting the UI rate is the Same Methodology that the Commission Adopted in SoCalGas' 2012 GRC</u>

For the UI portion of the composite payroll tax rate calculation, ORA also recommends that SoCalGas use the "current 2015 3.4% UI tax rate until the new UI tax rate is approved for 2016"[17] instead of the 3.6% UI rate forecasted by SoCalGas. SoCalGas' methodology for forecasting its UI rate for the Test Year is the same methodology SoCalGas employed in its 2012 GRC, which was adopted by the Commission. In the final decision for SoCalGas' 2012 GRC, the Commission held that SoCalGas' "forecasts of the payroll taxes are reasonable and should be used instead of adopting the adjustments that DRA, TURN and UCAN have proposed."[18]

Similar to its approach in the 2012 GRC, ORA is proposing to make isolated adjustments to 2016 test year amounts using 2015 information. The Commission agreed with SoCalGas' position in the 2012 GRC that such selective updating is inappropriate because it "ignores the fact that while certain costs may be lower than expected, other costs are higher than expected and there is no provision to reflect those instances."[19]

e. <u>ORA's Proposed Forecasting Methodology for the UI Rate Does Not Provide a More Reasonable Forecast than SoCalGas' Methodology</u>

As with its OASDI wage base proposal, ORA is proposing selective updating and has not demonstrated that its proposed approach is a more accurate or reliable indicator of the forecasted UI rate than SoCalGas' approach. Moreover, ORA provides no support for its proposed 3.4% UI

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[15] *See* A.13-11-003 ("Edison 2015 GRC"), Ex. SCE-10, Vol.2, Chapter IV, page 287, Table B-2, line 1.
[16] Edison 2015 GRC, Exhibit ORA-22 (M. Campbell), Report on Taxes (full title truncated), August 4, 2014, page 5, lines 17-18.
[17] ORA-21, page 6, lines 8-9.
[18] D.13-05-010 at 939.
[19] *Id.*

rate, and the "current 2015 3.4% UI tax rate" proposed by ORA is not, in fact, SoCalGas' current 2015 UI tax rate. ORA instead cites a link to the federal Social Security Administration website to support the California UI rate.[20] The federal authority cited by ORA is irrelevant for state payroll tax purposes and includes no discussion of California UI rates and no reference to any 3.4% rate.

According to the State of California's Employment Development Department ("EDD") website, the 3.4% UI rate for 2015 proposed by ORA applies only to new employers.[21] For all other employers (including SoCalGas), the UI rate varies by employer and is computed based on a formula that uses historical unemployment benefit payout experience specific to that employer.[22] The EDD computes the UI rate annually for each employer and notifies the employer in late December of its UI rate for the following year.

SoCalGas' actual UI rate for 2015 as established by the EDD is 3.6%,[23] which is the same UI rate that SoCalGas forecasts for 2016 in its GRC application. Therefore, even if ORA's proposed methodology of using the actual UI rate for 2015 as the Test Year 2016 projected rate were adopted, there would be no change to SoCalGas' composite payroll rate computation if the 2015 actual 3.6% UI rate applicable to SoCalGas were utilized as the forecasted UI rate for Test Year 2016.

B. TURN

TURN proposes to retroactively recapture the flow-through impact of repair deductions for 2012-2015 that SoCalGas received by electing to change its method of accounting for the repairs deduction under the guidelines of Internal Revenue Service ("IRS") Revenue Procedure ("Rev. Proc.") 2012-19.[24] TURN's proposals and SoCalGas' response to those proposals differ somewhat for the 2015 year versus the 2012-2014 years. The reason is that on January 15, 2015, the Commission granted TURN's motion to establish memorandum accounts to track the revenue requirement impact of San Diego Gas & Electric Company's ("SDG&E's") and SoCalGas' increased repairs deductions for the 2015 year. As instructed by the Commission,

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[20] ORA-21, page 6, footnote 10.
[21] http://edd.ca.gov/Payroll_Taxes/Rates_and_Withholding.htm
[22] *Id.*
[23] The EDD's 2015 Contribution Statement applicable to all Sempra Energy companies shows the actual UI rate of 3.6%. *See* Appendix A.
[24] 2012-14 I.R.B. 689, issued on March 7, 2012.

SoCalGas filed a Tier 3 Advice Letter to establish a Repairs Deduction Memorandum Account for the 2015 year on March 2, 2015.

TURN proposes to take the incremental increase in the repairs deduction resulting from SoCalGas' change in accounting method for its 2012-2014 tax years, which SoCalGas had treated as a flow-through tax adjustment in those years, and normalize that total amount beginning in the 2016 Test Year. Normally, a flow-through tax adjustment impacts the cost of service, but TURN's proposal would instead reverse the flow-through treatment and instead calculate the incremental Accumulated Deferred Income Tax ("ADIT") increase resulting from the accounting method change and reduce ratebase with those deferred taxes for the next 25-30 years. Then, in 2016, TURN would have the Commission reverse course once again and begin flowing the tax adjustment through as a revenue requirement reduction in the cost of service. According to TURN's testimony, this proposal, if adopted, would increase ADIT by $92.3 million,[25] which in turn reduces rate base and the revenue requirement over the next 25-30 years. For the 2015 year, TURN proposes to flow through to ratepayers the end-of-2015 amount of the revenue requirement reduction reflected in the memorandum account established for SoCalGas' 2015 repairs deduction. TURN estimates that approximately $20 million would be flowed through to ratepayers for 2015 if its proposal is adopted. Alternatively, TURN proposes to normalize the 2015 repairs deduction for SoCalGas beginning in the 2016 Test Year (i.e., the same approach TURN proposes for the 2012-2014 years).

Consistent with the Commission's longstanding precedent and policy[26], SoCalGas flowed through the repairs deductions for its 2012-2015 tax years. TURN acknowledges in its testimony that "[t]he repairs deduction is a flow-through deduction"[27] and that SoCalGas changed its method of accounting for the repairs deduction "between rate cases."[28] TURN cites <u>no precedent or authority</u> to support an argument that SoCalGas' treatment of the repairs deduction in between rate cases was improper. Rather, TURN objects to the <u>outcome</u> of SoCalGas' treatment, and

[25] As of the date this testimony was written, SoCalGas was unable to confirm the accuracy of TURN's tax computations based on the workpapers TURN provided.
[26] The Commission's longstanding preference for flowthrough treatment of repairs deductions was reaffirmed in two comprehensive decisions dealing with the proper ratemaking treatment of income taxes. *See* D.93848, 7 CPUC 2d 332 (1981); D.84-05-036, OII 24, 15 CPUC 2d 42 (1984).
[27] TURN/Marcus at 15.
[28] *Id.*

attempts to create the perception that any tax-related benefits that are not immediately flowed through to ratepayers serve to enrich shareholders to the detriment of ratepayers.

TURN's "zero-sum game" portrayal is flawed, and its proposed remedy for the 2012-2014 years would be impermissible retroactive ratemaking. SoCalGas' tax elections, and the timing of those elections, were appropriate, fully supported by tax law and regulatory precedent, and do in fact provide ratepayers with a substantial benefit. A taxpayer is prudent to minimize its tax liability as permissible by law. For a regulated utility, resulting tax benefits can be flowed to ratepayers, shareholders, or both, depending on timing of events, the existence of sharing mechanisms, and compliance with longstanding ratemaking principles. The changes in tax guidance described further below drove SoCalGas' deduction elections and the Commission's flow-through policy dictated the result. Moreover, as shown in its data request responses to TURN, both the ratepayers and the shareholders received more tax benefits from the cumulative effect of the accounting method change for the 2012-2015 period than if SoCalGas had not made the accounting method change for repairs. In addition, SoCalGas forecasts that the enhanced repairs deductions being flowed through to the ratepayers beginning in 2016 will increase tax deductions by more than $273 million for the 2016-2018 years,[29] which results in a corresponding reduction to the revenue requirement of over $155 million more for those years than if SoCalGas had not changed its method of accounting for repairs.[30] Thus, SoCalGas' change of accounting method for repairs provides significant additional tax benefits to ratepayers now and into the future, but those benefits must be reflected within the regulatory framework and timing approved by the IRS and Commission.

1. TURN's Proposal Contravenes Years of Established Commission Ratemaking Precedent and Policy

TURN's proposal to reach back into prior years and re-characterize flow-through repairs deductions for those years as normalized deductions beginning in 2016 ignores long-established Commission precedent. Specifically, because TURN does not agree with the particular outcome regarding the enhanced repairs deduction, TURN sets forth a proposal that contravenes (1) the Commission's long-stated precedent and policy to treat expenses as flow-through items

[29] The forecasted repairs deduction for 2016-2018 reflects the post-test-year Operations and Maintenance ("O&M") escalation rate for SoCalGas of 2.52% and 2.42% for 2017 and 2018, respectively. *See* Ex. SCG-35-R-WP, Table 2.

[30] SoCalGas' calculation of the revenue requirement impact for 2016-2018 is shown in Appendix B.

whenever possible under the federal tax law; and (2) the Commission's long-standing precedent and policy prohibiting true-ups of forecasted tax expenses adopted in a prior GRC to actual expenses for years in between rate cases. TURN's testimony does not include <u>any authority</u> that would support TURN's proposed deviation from long-standing Commission precedent and policy.

a. <u>The Commission's Longstanding Ratemaking Policy Has Been To Flow Through All Income Tax Deductions Except Where Otherwise Required By Law</u>

As TURN acknowledges in its testimony, the Commission's longstanding policy has been to flow-through all deductions except when specifically required by law (or authorized in a proceeding) to be normalized.[31] In Pacific Bell Telephone Company Interim Opinion, the Commission described the difference between flow-through and normalized ratemaking for income taxes as follows:

> There are two methods to account for income tax expense for regulatory purposes. Under the flow-through method, the income tax expense recognized for regulatory purposes during a given period is equal to the taxes that are assessed and paid during the period. Under the normalization method, the income tax expense for a given period is based on the net income recognized for regulatory accounting purposes during the period, regardless of when the taxes associated with the accounting income are actually paid. The flow-through method can be viewed as cash-basis accounting, while the normalization method reflects accrual accounting.[32]

In that same decision, the Commission reiterated that its longstanding policy has been to flow through income tax deductions for ratemaking purposes except when otherwise required by law:

> In 1981, newly enacted federal tax laws effectively mandated the use of normalized tax accounting for accelerated depreciation and ITC [Investment Tax Credit]. The effect of the new laws was that the Commission could no longer require utilities to flow-through to ratepayers the substantial tax benefits associated with accelerated depreciation and ITC. As a result, ratepayers had to pay substantially more money in rates for income taxes than were actually paid by the utilities.

[31] TURN's testimony states that the Commission "has for the last 50 years" preferred, when possible, to flow through deductions as they occur. TURN/Marcus at 15.
[32] *Re Pacific Bell*, D.04-02-063, pp. 96-97, 2004 Cal. PUC LEXIS 55 (2004), at *163.

> Although federal law had preempted the Commission's flow-through policy with respect to accelerated depreciation and ITC, in D.84-05-036, the Commission held that its flow-through policy should remain in effect to the extent allowed by law.[33]

Following that policy, SoCalGas treated repair deductions on a flow-through basis.

b. <u>Adjustments Can Cut Both Ways and The Commission Has Previously Held That Absent A Memorandum Account, There Should Be No "True Up" to a Prior Year's Ratemaking to Match a Subsequent Adjustment</u>

Forecast test year ratemaking carries with it the inherent risk that actual income tax amounts will differ from forecast. Among the many situations when this can occur include:

- a difference between the amount and/or type of actual expenditures incurred and the amount and/or type of expenditures that had been forecasted;
- a change in tax authority impacting a forecasted year where this change was not known at the time the forecast was established;
- a challenge to a tax position by the IRS (or a state taxing authority) employing an argument that had not yet been developed by the IRS and/or not known by the taxpayer at the time the forecast was established.

The ratemaking impact of differences between forecast and actual will vary based on whether the tax item to which the difference relates is normalized or flowed through.[34] In either case, the rate impact will be prospective, but a difference in a normalized tax item can be remediated by the resetting of rates to reflect the actual result in the next rate case; a difference in a flow-through tax item cannot be reset.

In this regard, the Commission has previously held in OII 24 that the impact of tax adjustments in periods in between rate cases in excess of or below what was forecasted in the prior GRC should not be trued up.[35] In that same decision, the Commission agreed with the view expressed by both Commission staff and Industry representatives that seeking a change from this general ratemaking policy for a particular, isolated tax item (which TURN is proposing to do in

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[33] *Id.* at *190.

[34] Normalization amortizes the difference between book accounting ("GAAP") and income tax accounting over a period of years. Flow-through matches deductions used to compute cost-of-service income tax expense to those used on the tax return.

[35] *See* D.84-05-036, OII 24, 1984 Cal. PUC LEXIS 1325, at *33-34, 15 CPUC 2d 42 (1984) ("such differences are inherent in the use of future test periods for ratemaking . . . Since income taxes are derived residually, we agree that individual factors should not be isolated for purposes of comparing estimated and recorded results.").

this case regarding the repairs deduction) would not be appropriate:

> Staff and Industry agree . . . that differences in income taxes between estimated and actual cannot be isolated from other factors in determining whether an adjustment should be made to the test-year estimate. Any review of differences would have to include the effects of differences of all estimates for revenues, operating expenses, income taxes and return on investment. Any prospective adjustment based on past over or underestimates would have to take into consideration the overall effect of the differences for all components of the test year. Under these circumstances parties recommend no change in the present ratemaking procedure.[36]

The Commission's policy on tax adjustments between rate cases set forth in OII 24 is consistent with the Commission's general policy toward the treatment of differences between forecasted and actual results between rate cases. The Commission has previously explained its reasons for adopting this general policy:

> In the short term, between general rate proceedings, the shareholders benefit when the company's management can 'do it for less', and correspondingly, ratepayers ultimately benefit because the productivity improvement will be reflected periodically when there is a comprehensive review of the utility's revenue requirement. Keeping this incentive for utility management is a cornerstone of ratemaking . . .[37]

Similarly, the Commission has previously recognized that "[u]nder traditional rate of return regulation, utilities are given an incentive to reduce expenditures through increased productivity, with the understanding that these savings accrue to shareholders between rate cases and are passed on to ratepayers in the next GRC."[38]

2. <u>TURN's Proposed Adjustments for 2012-2014 are Impermissible Retroactive Ratemaking</u>

    a. <u>The Commission Has Previously Rejected an After The-Fact Attempt to Match Ratemaking Taxes With Paid Taxes</u>

TURN is proposing to reach back into prior rate case periods (i.e., 2012-2014) and use

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[36] *Id.* at *33.
[37] *Re General Telephone of California*, D.85-03-042, 17 CPUC 2d 246, 254 (1985).
[38] *Re Application of Pacific Gas & Electric Company*, D.00-02-046, 2000 Cal. PUC LEXIS 239 (Cal. PUC 2000), at *201. *See also re Application of Pacific Gas & Electric Company*, D.96-12-066, 1996 Cal. PUC LEXIS 1111 (Cal PUC 1996), at *9 ("Any savings the utility can generate between general rate cases belong to the shareholders. In exchange for this opportunity, the shareholders take on the burden of added expenses it may incur during a rate case cycle").

tax deductions from those prior years to compute prospective ratemaking adjustments. A deviation of paid taxes from forecast is not and has never been a basis for the Commission to reach back to prior year taxes and change the ratemaking methodology to "true up" the difference. Retroactive ratemaking is prohibited by California Public Utilities Code Section 728. TURN's proposed adjustments are inconsistent with that law and Commission policies.

Although TURN describes its normalization proposal as not violating the rule against retroactive ratemaking,[39] it would in fact do so. This proposal is no different in principle than an issue the Commission addressed in SoCalGas' 1990 GRC. At issue in that case was the tax treatment of certain employee benefit costs. In a prior GRC, SoCalGas had treated these costs as currently deductible and flowed through the tax benefit in its cost-of service calculations. The IRS later determined that these amounts should be capitalized. In its 1990 GRC, SoCalGas sought to recover the difference. DRA and TURN objected to SoCalGas' request, arguing that it amounted to retroactive ratemaking. Agreeing with those parties, the Commission observed that, unless a memorandum account had been established in advance, there can be no after-the-fact true-up to match ratemaking taxes with paid taxes:

> First, as pointed out by DRA, it is fundamental that there can be no after-the-fact "true up" to match ratemaking taxes with as-paid taxes, unless the Commission specifically made provision for such an adjustment prior to the rates in question becoming effective.
>
> Second, a tax return is filed with the IRS after the tax year in which the return relates is over and tax positions may not have been developed at the time of a general rate case. Because of the rule against retroactive ratemaking, we cannot make a tax memorandum account available to address a tax year that has passed even if such IRS action was not anticipated in the general rate case for that year.[40]

SoCalGas' position in that rate case is the counterpart of TURN's position in this case, which the Commission anticipated in that earlier decision: "The same rule applies whether the amount at issue is an overcollection, resulting in a windfall to the utility, or an undercollection, as is alleged in the instant case.[41]

[39] TURN/Marcus at 27.

[40] *Re Southern California Gas Co.*, D.92-08-007, 1992 Cal. PUC LEXIS 532, at *5-6, 45 CPUC2d 256 (1992).

[41] *Id.* at *4.

b. The Commission Similarly Restricts a Utility from Recovering Tax Obligations Paid in Prior Years

A year later the Commission addressed an application from Southern California Water Company "to establish a memorandum account in which it could book as much as $4 million in payments to the IRS for contested back taxes."[42] The Division of Ratepayer Advocates ("DRA") protested the application, claiming that granting it would amount to retroactive ratemaking. As the Commission described DRA's position:

> Tax deductions and credits have long since been estimated in SCWC's general rate cases covering the years 1983 through 1988. Those estimates were calculated in the rates that SCWC was authorized to collect in those years. The utility did not seek to keep any tax estimates open for reconsideration by the Commission at a later date. To revisit those estimates now and, ultimately, to collect from ratepayers the actual tax assessment that IRS says should have been paid at that time is, in DRA's view, a classic example of revising rates retroactively. The Division states:
>
> The Commission would no more guarantee the utility be made whole for taxes than for any other estimated expense…. Tax deductions and credits are estimates based on the best information available at the time of the estimate. This Commission has never made prospective adjustments to ratemaking tax deductions and credits based on tax refunds received or additional taxes owed based on real world audits by the IRS except for specific unique items held open by Commission decision.[43]

The Commission held in the Southern California Water Company decision that the SoCalGas decision discussed above was "dispositive:"

> The SoCalGas decisions are dispositive of the issues in this application. The facts in SoCalGas were virtually identical to those here. A claim was made that the IRS deficiency claim could not have been foreseen. The disputed tax matter had been part of a rate case. SoCalGas argued that it could not pursue aggressive tax strategies if it was compelled to bear all of the risk of claimed deficiencies. Our conclusion was that none of these factors overcomes our mandate to set rate increases and rate reductions on a prospective basis only, except under certain prescribed conditions. We noted that a utility could always seek and would be likely to obtain memorandum account treatment to deal with significant tax uncertainties, provided it sought such relief prospectively.
>
> SCWC argues that the claimed deficiency in its case constitutes a prospective cost, rather than an adjustment of a past cost, because the amount has not yet been

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[42] *Re Southern California Water Co.*, D.93-04-046, 1993 Cal. PUC LEXIS 223, at *1, 49 CPUC2d 60 (1993).
[43] *Id.* at *7-8.

> paid and is not absolutely due until after the IRS appeal process. That argument approaches sophistry. Clearly, the alleged deficiency relates to tax obligations that are alleged to have been due for each of the tax years 1983 through 1988, and that is what the utility would seek to recover through rates.[44]

If Southern California Water Company's argument "approaches sophistry," then the Commission has to conclude that the TURN's proposed adjustment does so as well. TURN wants to reach back to prior ratemaking years and use "real world" tax calculations from those years to compute a prospective adjustment. If for no other reason, the TURN proposal should be rejected for the same reason the Commission rejected the prior proposals of SoCalGas and Southern California Water Company accepting such proposals would be retroactive ratemaking.

c. <u>Rates May Only Be Set Prospectively</u>

The prohibition against retroactive ratemaking reflected in the SoCalGas and Southern California Water Company decisions is more than a matter of Commission ratemaking policy. Public Utilities Code §728 specifically prohibits retroactive ratemaking. Interpreting that statute in *Pacific Telephone and Telegraph Company v. Public Utilities Commission*,[45] the California Supreme Court held that the Commission was empowered in general rate case proceedings to set rates *prospectively* only, and that the Commission had overstepped its statutory power by ordering a refund of previously approved rates after a Commission investigation had determined that these previously approved rates were too high:

> *Section 728 of the Public Utilities Code* provides so far as here material that "Whenever the commission, *after* a hearing, finds that the rates . . . demanded, observed, charged, or collected by any public utility for or in connection with any service . . . are . . . unreasonable, . . . the commission shall determine and fix, by order, the just, reasonable, or sufficient rates . . . *to be thereafter* observed and *in force*." (Italics added.)
>
> As Pacific states, this language is plain and unambiguous. The Legislature has instructed the commission that after a hearing it is to make its order fixing rates to be in force *thereafter*.[46]

TURN's retroactive ratemaking proposal in this GRC would also violate Section 728. TURN's attempt to distinguish its proposal from retroactive ratemaking is premised on its use of

[44] *Id.* at *11-12.
[45] *Pacific Telephone and Telegraph Company v. Public Utilities Commission*, 62 Cal.2d 634; 1965 Cal. LEXIS 286.
[46] *Id.* at 650.

the word "prospectively" in its testimony.[47] But merely labeling its proposal as "prospective" does not save it from being retroactive ratemaking. It does not matter that the impact of TURN's retroactive ratemaking proposal will apply to future 2016 rates. All retroactive proposals propose future ratemaking impact. What all retroactive ratemaking proposals also have in common is that they modify what was reflected in prior settled rates by adjusting future rates.

TURN states that "[t]his rate case is the first time [the Commission] will get a chance to address how to treat these funds for ratemaking purposes, starting from first principles, without any prior testimony or half-measures."[48] This statement does not support TURN's argument because *any* attempt to adjust previously approved rates is prohibited retroactive ratemaking.[49] TURN's proposal to reach back into the 2012-2014 prior rate case periods and use actual taxes from those prior rate case proceeding years to compute prospective adjustments would be retroactive ratemaking, prohibited by Public Utilities Code Section 728.

TURN asks to have it both ways at the same time accept current deductions under the Commission's flow-through policy, and change historical deductions using a "normalization" methodology. These inconsistent and unsupported requests should be rejected.

3. <u>SoCalGas' Tax Filing Actions and Regulatory Treatment were Proper and Appropriate</u>

TURN acknowledges that SoCalGas' change in accounting method for its repairs deduction was made between rate cases.[50] Nonetheless, TURN questions the timing of the election and criticizes SoCalGas for not taking certain steps following (or in some cases even before) SoCalGas made its decision to change its method of accounting for repairs. The facts and timeline of events does not support TURN's criticisms, as discussed below.

a. <u>SoCalGas has the Responsibility to Comply with Changing Tax Authority to Legally Minimize its Tax Burden</u>

SoCalGas' 2012 accounting method change for computing repair deductions was prudent and made to minimize its income tax liability. Income tax authority is constantly changing. Each year Congress passes new legislation amending the Internal Revenue Code. In addition, the IRS frequently issues new guidance in various forms (e.g., regulations, rulings, notices and

[47] TURN/Marcus at 27.
[48] *Id.* at 25.
[49] Exceptions apply if a memorandum account has been established in advance.
[50] TURN/Marcus at 15.

procedures) that constitute either a change in the application of current law or an interpretation of existing law. The accounting method change made by SoCalGas was just such a change; it was a change in the application of current law by the IRS to reduce the number of disputes between the IRS and taxpayers. In addition, federal court decisions serve to create new or modified income tax authority.

SoCalGas, like any other taxpayer (whether rate-regulated or not), strives to legally comply with the income tax rules and to pay the tax it owes, but no more than the law requires.[51] SoCalGas appropriately monitors tax law changes and IRS administrative guidance to identify opportunities to minimize its liability. The Commission develops the rules that determine how income taxes are to be addressed in ratemaking. The impact to customers of SoCalGas' efforts to minimize its tax liabilities ultimately results from applying the Commission's ratemaking policies.

b. SoCalGas' Repair Deductions Were Prudent and Appropriate

TURN claims SoCalGas' management "pursued a tax strategy that enriches shareholders at the expense of ratepayers."[52] This claim is not supported by the facts. As explained below, it was the technical requirements of the tax law and prudent income tax administration that determined how and when SoCalGas acted to change its accounting method for repairs. The regulatory outcome to which TURN objects was just that, an outcome. The regulatory outcome was not why SoCalGas made the voluntary accounting method change, nor did it impact the timing of when such changes were made. Almost all utilities in the United States have made changes in their repair deductions over the past several years as a result of changes in guidance contained in Revenue Procedure notices issued by the IRS to address the longstanding disputes between the IRS and taxpayers over the proper expensing or capitalization of expenditures to repair, replace, or relocate portions of their network assets.

There are two key aspects relating to the tax deductions a utility is entitled to claim on account of its incidental repair expenditures: (1) which expenditures qualify as incidental

[51] In a seminal court decision regarding the obligation to pay taxes, Judge Learned Hand of the U.S. Second Circuit Court of Appeals said: "Anyone [sic] may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Circ. 1934), aff'd, 293 U.S. 465, 55 S. Ct. 266, 79 L.Ed. 596 (1935).
[52] TURN/Marcus at 14.

repairs under the applicable tax rules; and (2) when a taxpayer can change its method of accounting for any material item, such as treating an expenditure as a repair versus a capital improvement. The distinction between whether or not these expenditures are deductible as paid or capitalized and depreciated for income tax purposes has long been a complex and disputed issue between taxpayers and the IRS. The Internal Revenue Code provides that expenditures that: (1) do not substantially prolong the life of an asset; (2) materially increase its value; or (3) adapt it for a substantially different use may be deducted as an expense. Even if a utility were to know which of its expenditures qualified as deductible repairs, if it has not historically deducted them, it cannot start to deduct them unless and until the IRS grants it permission to change its accounting method.

Beginning in 2011, the IRS issued a series of guidance in this area to help clarify the distinction between capital expenditures versus expenditures that qualify for immediate deduction and also to provide taxpayers with additional options for making an accounting method change from one acceptable method to another acceptable method for the repairs deduction. TURN mischaracterizes the guidance and method change options as "administrative largesse from a very generous IRS at the expense of all US taxpayers."[53] In reality, the IRS's primary reason for its guidance and the additional options for making accounting method changes was to make IRS audits of taxpayers' repairs deductions less contentious, controversial, and time consuming.[54] Moreover, as discussed in more detail below, these new procedures required significant analysis before a taxpayer could determine whether the new options for making an accounting method change would be beneficial.

c. <u>SoCalGas' Analysis of the Impact of Electing the Accounting Method Change for Repairs</u>

On March 7, 2012, the IRS issued Rev. Proc. 2012-19, which superseded Rev. Proc. 2011-14 and updated the procedures for requesting automatic consent to make accounting method changes from the IRS. Upon the issuance of Rev. Proc. 2012-19, SoCalGas immediately began analyzing the potential impact on its repairs deduction. It soon became clear that the complexity of this analysis would require substantial resources and time.

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[53] *Id.* at 19.
[54] *See* Rev. Proc. 2011-43, 2011-37 IRB 326 (August 19, 2011), Section 2.02.

Rev. Proc. 2012-19 provided general procedures for requesting automatic consent from the IRS to make a change of accounting method. Unlike Rev. Proc. 2011-43, which was industry specific to electric distribution and transmission property, Rev. Proc. 2012-19 was generic in its application to all industries and to a host of possible accounting method changes. Rev. Proc. 2012-19 provided no safe harbors[55] for repairs to gas transmission and distribution systems.

The IRS issued temporary tangible property regulations on December 23, 2011 providing further guidance and clarity on capitalization and expensing of expenditures to acquire, repair, and dispose of tangible property. Based on a preliminary analysis of Rev. Proc. 2012-19 in March 2012 in combination with the temporary tangible property regulations issued in December 2011, SoCalGas determined that there existed a possibility of an increased repair deduction over the amount that could be claimed under its existing percentage repair allowance methodology.[56] SoCalGas engaged the accounting firm of Pricewaterhouse Coopers ("PwC") to scope the potential benefit of adopting a "facts and circumstances" method of accounting in place of its existing percentage repair allowance method.[57] PwC began its work on March 26, 2012.[58] PwC worked with Sempra staff to test a statistical sample of capital expenditures between 2009 and 2011 to determine which expenditures could be deducted currently and which had to be capitalized based on the tests in case law and the proposed tangible property regulations. PwC's scoping study determined that a larger repairs deduction could be obtained using a "facts and circumstances" approach compared to a percentage repair allowance approach, so on July 18, 2012, SoCalGas engaged PwC to do a full workup.[59]

This very time-intensive effort to evaluate the impact of a potential accounting method change for repairs did not culminate until more than a year later. Ultimately, the method change for repairs authorized by Rev. Proc. 2012-19 was deemed favorable and resulted in a larger repairs deduction compared to percentage repairs allowance method that SoCalGas had used prior to its 2012 repairs method change.[60] SoCalGas formally adopted the new accounting method for repairs under Rev. Proc. 2012-19 by its filing of IRS Form 3115 with the Ogden

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[55] "Safe Harbor" is a term used to describe an accounting method prescribed by the IRS, that when followed by the taxpayer, will result in audit protection upon later examination by the IRS.
[56] *See* SoCalGas' response to TURN Data Request-02, Question 23 (Appendix C)
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*

office of the IRS on August 20, 2013.[61]

As a result of these efforts, SoCalGas forecasts annual repair deductions in excess of $88 million each year for both the 2016 test year and the post-test-year period, which is significantly larger than what the repairs deduction would have been had SoCalGas not changed its method of accounting from the percentage repair allowance method. Those deductions are being flowed-through to SoCalGas ratepayers beginning in the 2016 test year, which is the first GRC test year in which SoCalGas has had the opportunity to flow through the benefits of the higher repairs deduction to ratepayers.

d. <u>SoCalGas Adopted the Method Change as Soon as it Determined the Tax Benefits of Doing So</u>

There were at least two reasons for SoCalGas to adopt the accounting method change for repairs at the earliest possible time. The most obvious reason was that the sooner it was adopted, the sooner SoCalGas' tax liabilities would be reduced. In addition, under the terms of Rev. Proc. 2012-19, taxpayers adopting the method change in 2012 or 2013 were relieved of restrictions on the timing of their change in accounting method to which taxpayers are normally subject (*e.g.*, taxpayers may not make an accounting method change when under audit, where the accounting method for the same item has been changed in the past five years, etc.).[62] The practical impact of these limitations is that SoCalGas could not make the automatic accounting method change while under audit by the IRS. Since Sempra Energy and its affiliates, including SoCalGas, are under virtually continuous IRS audit, the opportunity to file an automatic request for an accounting method change within the window provided was a critical factor in the timing of the accounting method change.

In conclusion, SoCalGas proceeded in a rational manner. We quantified the impact of implementing Rev. Proc. 2012-19 as quickly as practicable. We reduced our tax liability at the earliest possible time. We took steps to reduce the time, expense, and risk of potentially contentious IRS audits for prior year tax returns subject to audit. SoCalGas could not have incorporated the incremental repair deductions into its 2012 GRC or, as alternatively proposed by TURN, waited until the next rate case (i.e., the 2016 GRC) to adopt the change in method for repairs. Contrary to TURN's assertion, SoCalGas was not motivated by the desire to "transfer"

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[61] *Id.*

[62] Rev. Proc. 2012-19, Section 4.10(2).

tax benefits to shareholders. SoCalGas handled its corporate tax affairs prudently.

4. <u>SoCalGas' Accounting Method Change Benefitted Ratepayers</u>

TURN's provides several tables attempting to demonstrate what SoCalGas could have done differently in regard to its treatment of the repairs deduction between rate cases. Yet none of these tables reflects that SoCalGas, at its first opportunity to do so in a GRC, is flowing through to ratepayers a forecasted repairs deduction of more than $273 million for the 2016-2018 years (with similar benefits expected for future years).

Moreover, TURN downplays the critical fact that even when isolating just the 2012-2015 years, both shareholders **<u>and ratepayers</u>** were better off as a result of SoCalGas' decision to change its method of accounting in 2012 than they would have been if SoCalGas had not made the method change. TURN was made aware of this fact through SoCalGas' response to TURN Data Request-02, Question 20. The table provided in that response (reproduced below) shows that, as of the end of 2015, the cumulative balance of ADIT <u>was $60.5 million higher</u> that it would have been if SoCalGas had made no method change. The increased ADIT balance reduces ratebase and revenue requirement, thereby benefiting ratepayers.

SoCalGas					
Calculation of (Additional)/Foregone ADIT Due to Change in Method for Repairs					
(amounts in thousands)					
Gas Transmission and Distribution		**2012**	**2013**	**2014**	**2015**
		Actual	**Actual**	**Forecasted**	**Forecasted**
Actual and Forecasted Repairs Deduction	a	(126,443)	(114,561)	(107,823)	(93,192)
Foregone Percentage Repair Allowance Deduction	b	15,054	15,054	15,054	15,054
Incremental Repairs Deduction	a-b = c	(111,389)	(99,507)	(92,769)	(78,138)
Incremental Foregone Deferred Tax Calculation:					
Bonus Depreciation	c x rate = d	(55,695)	(49,754)	(46,385)	(39,069)
1st Yr MACRS Depreciation	c - d x rate = e	(2,785)	(2,488)	(2,319)	(1,953)
2nd Yr MACRS Depreciation	c - d x rate = f		(5,291)	(4,727)	(4,407)
3rd Yr Macrs Depreciation	c - d x rate = g			(4,762)	(4,254)
4th Yr MACRS Depreciation	c - d x rate = h				(4,288)
Annual Foregone Tax Depreciation on Incremental Repairs	sum of (d:h)= i	(58,479)	(57,532)	(58,192)	(53,971)
1st Yr Book Depreciation	i x rate = j	3,793	3,437	3,235	2,796
2nd Year Book Depreciation	i x rate = k		3,793	3,437	3,235
3rd Yr Book Depreciation	I x rate = l			3,793	3,437
4th Yr Book Depreciaiton	i x rate = m				3,793
Total Annual Book Deprecaiation	sum of (l:m) = n	3,793	7,230	10,465	13,261
Difference Between Tax and Book Depreciation	i - j = o	(54,686)	(50,302)	(47,727)	(40,711)
Tax Rate	p	35%	35%	35%	35%
Incremental Foregone Deferred Taxes	o x p = q	(19,140)	(17,606)	(16,705)	(14,249)
Offset for Incremental ADIT due to Section 481(a) Adjustment	$366.3M x 35% = r	128,205			
Incremental (Foregone)/Additional Accumulated DIT	q + r	109,065	91,459	74,755	60,506
Conclusion: ADIT at the beginning of 2016 would have been $60.5 million lower if SoCal Gas had not changed its method of accounting for repairs.					

TURN claims in its testimony that "[i]f shareholders are going to win, as the Sempra Utilities propose, then of necessity, ratepayers must lose."[63] Yet, as shown by the table above, SoCalGas' change in accounting method benefits both shareholders and ratepayers. Moreover, the table does not reflect the significant repairs deductions that will be flowed through to the ratepayers beginning with the 2016 test year. Specifically, SoCalGas' change in accounting method for repairs will result in a reduction to the revenue requirement of over $155 million for the 2016-2018 years. SoCalGas fully acknowledges that shareholders benefited from the accounting method change for the 2012-2015 years. In contrast, TURN describes the fact that the change in accounting method for repairs also benefited ratepayers for the 2012-2015 period as "no big deal,"[64] focusing instead on the shareholder benefits during this period. SoCalGas believes that the more appropriate focus should be on whether the change in accounting method

[63] TURN/Marcus at 14.
[64] *Id.* at 22.

benefitted ratepayers (which it did for 2012-2015 and will even more so beginning in 2016) and whether SoCalGas' treatment of the repairs deduction was consistent with Commission precedent and policy (which it was as discussed earlier in this testimony), and not on "who wins more" for years preceding the test year. The fact is that both ratepayers and shareholders clearly benefitted from SoCalGas' accounting method change, and ratepayers will continue to benefit in the future.

5. TURN's Criticisms of SoCalGas' Approach to the Method Change for Repairs are Factually Incorrect and/or are Based on Incorrect Assumptions

In discussing the higher repairs deduction for 2012-2015, TURN states in its testimony that SoCalGas "took absolutely no steps to pass any of this money through to ratepayers, even though they had several options to do so."[65] As discussed below, TURN's statement is incorrect. Moreover, all of the "options" suggested by TURN were either precluded by the facts, unrealistic, or inconsistent with the precedent and policy established by the Commission.

a. SoCalGas Proposed an Earnings Sharing Mechanism in the 2012 GRC Which Would Have Shared the Benefits of the Increased Repairs Deduction Between Ratepayers and Shareholders

SoCalGas proposed an earnings sharing mechanism in the 2012 GRC, which would have shared the earnings above or below the authorized rate of return with ratepayers and shareholders during the post-test-year period.[66] The proposed earnings sharing mechanism would have covered items such as the increased repairs deduction. Under the proposed mechanism, 65% of the first band of earnings (i.e., 51 to 100 basis points above the authorized rate of return) would have gone to ratepayers.[67] The Commission ultimately decided to adopt an alternative, more conventional post-test-year mechanism that did not include the earnings sharing mechanism proposed by SoCalGas.[68] Nonetheless, the fact that SoCalGas proposed an earnings sharing mechanism that would have provided significant benefits from the increased repairs deduction to ratepayers during the 2013-2015 period further demonstrates that TURN's statement that SoCalGas "took absolutely no steps to pass any of this money through to ratepayers" is incorrect.

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[65] *Id.* at 17.
[66] D.13-05-010 (May 14, 2013), at 1002.
[67] *Id.* at 1004.
[68] *Id.* at 1010.

b. TURN's Suggestion that SoCalGas Should Have Included the Increased Repair Deduction in 2012 GRC Update Testimony Is Contrary to the Facts

TURN suggests that SoCalGas should have reflected the increased repairs deduction in its 2012 GRC Update testimony. As SoCalGas explained in its response to TURN Data Request-02, Question 24:

> The initial scoping work regarding the potential impact of a change in accounting method for repairs had not been completed for SDG&E and had not yet begun for SoCalGas at the time the 2012 update testimony was served. Therefore, neither SDG&E nor SoCalGas knew at the time whether a method change would be made, or what the potential amount of the repairs deduction could be under the alternative method of accounting. Additionally, the 2012 update testimony was limited in scope and included only enacted tax law changes and changes to published tax rates.

Accordingly, at that point in time, SoCalGas could not include the repairs impact in its update testimony, even if the scope of the update phase of the proceeding had allowed it.

c. There Was No Precedent At the Time to Suggest that a Memorandum Account was Appropriate for IRS Accounting Method Changes

As discussed earlier in this testimony, at the direction of the Commission, SoCalGas filed Advice Letter 4771 on filed March 2, 2015 to track its repairs tax deductions for 2015. Prior to the Commission's order to establish this memorandum account on January 15, 2015, SoCalGas was unaware of any Commission precedent that would have suggested that a memorandum account was appropriate for tracking the impact of IRS administrative guidance which allowed taxpayers to change from one acceptable method of accounting to another acceptable method of accounting.[69] Unlike the adoption of a new tax law, such administrative guidance from the IRS is very common and is not at all an unusual event in the tax world. To the contrary, there were 64 Revenue Procedures issued by the IRS during 2014 alone, and Revenue Procedures are just one of many forms of administrative guidance that the IRS issues each year. Thus, for TURN to

[69] In Resolution No. L-411-A (issued June 23, 2011), the Commission established a memorandum account to track the impact of new legislation that, for the first time, authorized utilities to claim a 100% bonus depreciation deduction on qualified assets. The Commission specifically limited the scope of this memorandum account to encompass only the impact of this new tax legislation and denied TURN's request to expand the scope of the Resolution beyond the new legislation. SoCalGas was exempt from the memorandum account established in the Resolution because of the timing of SoCalGas' upcoming 2012 GRC.

suggest in 2015 that SoCalGas should have anticipated the need for a memorandum account to track the repairs deduction back in 2012 or 2013 is unrealistic and does not accurately reflect the Commission precedent available at the time.

d. The Increased Repairs Deduction Does Not Qualify for Z-Factor Treatment

TURN also lists Z-Factor treatment as an "option" for SoCalGas regarding the increased repairs deductions.[70] However, as TURN explains in its own testimony, Z Factors are "exogenous events" which are "largely uncontrollable by management" and include costs "which are not a normal part of doing business."[71] Repairs clearly are a normal part of the utilities business, and repair deductions in some form have been claimed by utilities for decades. In addition, the change in method was elective and not something "uncontrollable by management." As discussed in more detail below, these facts alone preclude Z-Factor treatment for the increased repairs deduction.

Nonetheless, TURN ignores these requirements and states that "[p]otential Z Factors shall include, **but are not limited to** . . . Tax law changes by the federal government, the State Franchise Tax Board, Board of Equalization, or any local jurisdiction having taxing authority" (emphasis in original).[72] Since the change in accounting method for repairs is clearly not a federal, state, or local tax law change of any kind, TURN is trying to shoehorn the "but are not limited to" language to encompass this kind of administrative change. TURN, however, cites nothing to support such a stretch in interpreting the requirements of the Z Factor.

The Z Factor tariff includes eight specific requirements, all of which must be met for the Z Factor to apply. These eight requirements are that the event must be:

1. Caused by an event exogenous to the utility;
2. Caused by an event that occurred after the implementation of rates;
3. Costs that the utility cannot control;
4. Costs that are not a normal cost of doing business;
5. Caused by an event that affects the utility disproportionately;
6. Costs that have a major impact on the utility;
7. Costs that have a measureable impact on the utility; and

[70] TURN/Marcus at 18-19.
[71] *Id.* at 19.
[72] *Id.*

8. Costs that the utility has reasonably incurred.[73]

In regards to the accounting method change for the repairs deduction, SoCalGas clearly does not meet Z Factor requirements 1, 3, 4, and 5, above. And since all eight requirements must be met for the Z Factor to apply, Z Factor treatment is inappropriate in this case.

e. <u>TURN's Suggestion that SoCalGas Could Have Waited until 2016 to Make its Repairs Method Change is Factually Inaccurate</u>

As an additional "option," TURN speculates that "[i]f Sempra had/could have waited until 2016 to begin taking this [higher repairs] deduction, when it could have been flowed through to ratepayers, the operation of Section 481(a) through 2015 would have given the ratepayers at least the same amount if not a slightly larger normalized amount relative to 2011 (for SDG&E) or 2012 (for SoCal)."[74] This statement neglects the procedural details of the IRS Revenue Procedure allowing an accounting method change. As discussed earlier in this testimony, SoCalGas faced time sensitivities for making the method change. Under the terms of Rev. Proc. 2012-19, taxpayers needed to make the method change in 2012 or 2013 in order to be relieved of restrictions on the timing of their change in accounting method to which taxpayers are normally subject (*e.g.*, taxpayers may not make an accounting method change when under audit, where the accounting method for the same item has been changed in the past five years, etc.).[75] As discussed earlier in this testimony, the practical impact of these limitations is that SoCalGas could not make the automatic accounting method change while under audit by the IRS. Since Sempra Energy and its affiliates, including SoCalGas, are under virtually continuous IRS audit, the opportunity to file an automatic request for an accounting method change within the window provided was a critical factor in the timing of the accounting method change. Moreover, it would not be a prudent business practice for SoCalGas to forego until a later year a material tax deduction for which it has determined it is qualified to claim in the current year. Thus, TURN's suggestion that SoCalGas should have or even could have waited until 2016 to make its accounting method change for repairs is unrealistic and is not supported by the facts.[76]

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[73] SoCalGas Preliminary Statement part XI.E.1.
[74] TURN/Marcus at 23.
[75] Rev. Proc. 2012-19, Section 4.10(2).
[76] The calculations shown in Table 9 of TURN's testimony are premised upon this unrealistic assumption that SoCalGas could have waited until 2016 to make the repairs method change; therefore, the Table is not instructive or relevant to the underlying repairs deduction issue.

6. TURN's Comparison to PG&E's Approach to Repairs Is Incomplete

TURN notes that Pacific Gas & Electric Company ("PG&E") has taken a different approach to its repairs deduction from SoCalGas and "effectively recommends the PG&E method be adopted."[77] In order to make a meaningful comparison between SoCalGas' approach and PG&E's approach, we would need to know the details of PG&E's repair methodology for example, how much of its repairs deduction was federal versus California, the timing of its repairs analysis, the impact of the Section 481(a) adjustments, etc. We would also need to understand how PG&E's overall ratemaking policy regarding taxes compares to that of SoCalGas. To illustrate this point, TURN quotes the following PG&E testimony from PG&E's 2014 GRC: "It is PG&E's policy to reflect changes in accounting method in the first rate filings after it has received full approval from the IRS, California Franchise Tax Board and if applicable, the congressional Joint Committee on Taxation."[78] SoCalGas has a different policy in this regard. Specifically, SoCalGas' policy is that it does not wait for full approval from the IRS, California Franchise Tax Board, or the Joint Committee on Taxation before reflecting the tax impact of changes in accounting methods in rates. SoCalGas' policy is more ratepayer-favorable, because SoCalGas bears the full risk of IRS or Franchise Tax Board audit adjustments that reduce the amount of the deduction for SoCalGas (while ratepayers would have already received the benefit of the pre-audit forecasted amount of the deduction). Without understanding the full picture of the two utilities' repairs deductions and overall ratemaking policy regarding taxes, a comparison between the two utilities on the treatment of repairs would not be complete or meaningful.

7. The Commission Has The Discretion To Change Its Policies But Should Only Do So Prospectively And Consistently

TURN also recommends that the Commission "order that any future voluntary tax changes made by SDG&E and SoCal should only take effect in GRC test years unless provisions are made to make ratepayers whole."[79] It is often not possible and/or not prudent to wait until a GRC test year before making an accounting method change. As explained earlier in this testimony, that was the case with SoCalGas' accounting method change for repairs. Thus, TURN's proposal to force utilities to wait until a GRC test year before implementing an

[77] TURN/Marcus at 26.
[78] *Id.* (emphasis added).
[79] *Id.* at 13.

accounting method change is not practical.

Presumably, TURN's request for provisions "to make ratepayers whole" is akin TURN's proposal in this GRC, in which TURN proposes that the repair deduction be treated on a flow-through basis prospectively (i.e., starting in 2016) but also that a special rate base adjustment be applied to the repairs deductions for the 2012-2014 years. This rate base adjustment applies a normalization-like offset to repair deductions that were subject to flow-through treatment based on longstanding Commission policy. If the Commission seeks to consider such a major change to its long-standing flow-through policy, this GRC is not the proper forum, given the many ramifications yet to be raised and discussed, and all the stakeholders potentially impacted. However, the Commission has shown consistency through the years in upholding its longstanding tax ratemaking precedent, even amidst aggressive challenges that have come in many forms and argued from many different angles. This is not a zero-sum game, as TURN suggests. TURN's proposal does not comport to the Commission's enduring tax policies and precedent and should therefore be rejected.

III. CONCLUSION

To summarize, SoCalGas uses the same methodology for forecasting payroll taxes in this GRC that it used in its 2012 GRC. That methodology was found to be reasonable by the Commission and was adopted in the 2012 GRC final decision. ORA has not demonstrated in its testimony that its proposed approach to forecasting payroll taxes is more accurate or reliable than SoCalGas' approach. To the contrary, ORA's proposed methodology is either historically less accurate than SoCalGas' methodology or is unsupported by any authority. In addition, SoCalGas' OASDI wage base methodology that ORA is challenging is the same methodology that Southern California Edison used in its 2015 GRC to forecast the OASDI wage base limitation, yet ORA accepted Southern California Edison's methodology without challenge. For these reasons, ORA's proposals regarding SoCalGas' payroll taxes should be rejected, and SoCalGas' forecasts should be adopted in full.

TURN's proposals regarding SoCalGas' income tax repairs deduction should also be rejected. SoCalGas followed long-established Commission precedent and policy in its treatment of the accounting method change for repairs that occurred between rate cases. As a result of its accounting method change, ratepayers benefitted for the 2012-2015 years through the increased ADIT balance, which reduces ratebase and the revenue requirement. Ratepayers will benefit even more significantly in 2016 and subsequent years, when the benefit of the larger repairs deduction is flowed through to ratepayers, consistent with Commission precedent and policy. Thus, SoCalGas' treatment of the repairs deductions for 2016 and prior years is reasonable and should be adopted. Moreover, TURN's proposal to reach back into the 2012-2014 years and re-characterize the flow-through repairs deductions for these years as normalized deductions constitutes impermissible retroactive ratemaking.

This concludes my prepared rebuttal testimony.

APPENDIX A

2015 California Unemployment Insurance Rate

EDD DE 2088
PO BOX 826880 MIC 4
SACRAMENTO, CA 94280-0001

Employment Development Department
State of California

Letter ID	L0238891840
Issued Date	December 31, 2014
Account ID	001-5390-8
	981925888_P9913_E3305

SEMPRA GLOBAL SERVICES, INC
101 ASH ST # HQ01C
SAN DIEGO CA 92101-3017

NOTICE OF CONTRIBUTION RATES AND STATEMENT OF UI RESERVE ACCOUNT FOR THE PERIOD OF JANUARY 1, 2015, TO DECEMBER 31, 2015

IMPORTANT NOTICE
This is not a bill, do not pay this amount This is to inform you of your **UI**, **ETT**, and **SDI** contribution rates for the year shown above The following is a breakdown of your UI reserve account balance and the factors used to calculate your UI contribution rate **YOUR UI RESERVE BALANCE IS NON-REFUNDABLE**

Your Unemployment Insurance (UI) Contribution Rate is	**3.60%**
UI Rate Schedule is	**F+**
Your Employment Training Tax (ETT) rate is	**0.10%**
Your SDI Rate is	**0.90%**
The Annual Taxable Wage Limit Per Employee for UI and ETT is	**$7,000.00**
SDI is	**$104,378.00**

1 Previous reserve balance as of **7/31/13**			**$10,239,405.19**
2 UI Contributions paid from **8/1/13** to **7/31/14**	**$3,666,767.25**		
3 Interest earned by the UI Fund (*for positive reserve account employers only*)	**$0.00**		
4 Negative balance reduction (*for negative reserve account employers only*)	**$0.00**		
5 Benefit overpayments collected	**$92,317.79**		
6 Positive reserve balances cancelled	**$66,508.21**		
7 Other income to the UI Fund	**$10,683.26**		
8 TOTAL CREDITS		+	**$3,836,276.51**
9 UI benefits charged to your reserve account from **7/1/13** to **6/30/14**	**$1,439,557.00**		
10 Increase in the total of all negative reserve account balances	**$1,240,264.31**		
11 Benefit overpayments established	**$144,971.64**		
12 UI benefits not charged to reserve accounts	**$251,006.25**		
13 Other expenses of UI Fund	**$17,990.23**		
14 TOTAL CHARGES		-	**$3,093,789.43**
15 New reserve account balance as of **7/31/14**			**$10,981,892.27**
16 UI taxable payroll for calendar years **2011-2012-2013**	**$304,207,429.32**		
17 Ratio (Line 15 divided by the average of Line 16)	**0.1083**		

COMPUTATION OF SHARED CREDITS AND CHARGES Lines 5, 6, 7, 10, 11, 12 and 13 are credits and charges shared by all California employers. The shared amounts are computed using fiscal year UI taxable wages.

Your UI taxable wages from **7/1/13** through **6/30/14** were	**$101,746,120.28**

APPENDIX B

Ratepayer Benefit from Change in Accounting Method for Repairs

APPENDIX B

SoCalGas
Ratepayer Benefit from Change in Accounting Method for Repairs
2016 - 2018

($ in thousands)	**2016** Forecasted	**2017** Forecasted	**2018** Forecasted	**TOTAL**
Actual and Forecasted Repairs Deduction [1]	(88,812)	(91,050)	(93,253)	
Total Annual Ratemaking Depreciation Offset to Repairs Deduction [2]	18,622	21,818	25,091	
Net Repairs Tax Deduction	(70,190)	(69,232)	(68,162)	
Forecasted Repairs Deduction Under PRA Method [1]	(15,054)	(15,433)	(15,807)	
Total Annual Ratemaking Depreciation Addback on PRA [2]	2,811	3,352	3,907	
Net PRA Tax Deduction	(12,243)	(12,081)	(11,900)	
Difference in Net Tax Deduction Between Repairs and PRA Method	(57,946)	(57,151)	(56,262)	
Combined Federal & State Tax Rate (net of federal impact of state taxes)	40.746%	40.746%	40.746%	
Incremental Tax Benefit	(23,611)	(23,287)	(22,925)	
Gross up Factor	1.68746	1.68746	1.68746	
Incremental Revenue Requirement Repairs Method vs. PRA	(39,842)	(39,295)	(38,684)	
IRC Section 481(a) Catch-up Adjustment [2]	(314,760)	(303,712)	(293,052)	
Federal Tax Rate [3]	35%	35%	35%	
ADIT Liability	(110,166)	(106,299)	(102,568)	
Pre-Tax ROR	11.72%	11.72%	11.72%	
Revenue Requirement Impact	(12,911)	(12,458)	(12,021)	
Annual Revenue Requirement Benefit for Ratepayers in 2016-2018	(52,754)	(51,754)	(50,705)	**(155,213)**

Notes:

[1] 2017 and 2018 amounts reflect the post-test-year O&M escalation rates of 2.52% and 2.42%, respectively. *See* Ex. SCG-35-R-WP, Table 2.

[2] Calculations reflect a book depreciation rate of 3.79% for 2012-2015 and 3.51% for 2016-2018. *See* Ex. SCG-28-WP-R, page 28.

[3] California does not allow a Sec. 481(a) adjustment for repairs because all vintages of assets are eligible for PRA in California.

APPENDIX C

Response to TURN Data Request-02, Question 23(a-d)

TURN DATA REQUEST-02
SDG&E-SOCALGAS 2016 GRC – A.14-11-003-004
SDG&E_SOCALGAS FINAL RESPONSE
DATE RECEIVED: DECEMBER 22, 2014
DATE RESPONDED: JANUARY 16, 2015

23. Please answer the following questions for each of the Sempra Utilities. If the answer to any question is different as it relates to SDG&E and SoCal Gas, answer separately for each utility and explain why there is a difference between the two Sempra utilities.

    a. When did the Sempra utilities first become aware that an increased repair deduction could potentially be available?
    b. When did the Sempra utilities determine that they were going to implement the changes to the repair deduction as a result of the IRS revenue procedures?
    c. Please explain and describe the process involved in determining whether the Sempra utilities would take the larger deductions, including but not limited to identification of the persons who provided material input, the persons who ultimately made the decision, and the dates of each step of the consideration. Please also provide all internal memoranda or other documents addressing the question of whether a memorandum account should be established to track increased repair deductions.
    d. Please identify each corporate officer who reviewed or ultimately approved any decision to implement the changes to the repair deduction, and the approximate date of that review or approval.
    e. Please provide all internal memoranda or other documents given or made available to the corporate officer(s) on the topic of the repair deduction and any minutes or other documentation of meetings that addressed this topic.
    f. Please provide all internal memoranda or other documents addressing the question of the timing of the increased repair deductions, including but not limited to the impact of taking the increased repair deductions immediately versus waiting until the Test Year of the next general rate case.
    g. Please provide all internal memoranda or other documents regarding the change to the repair deduction once the Sempra utilities had decided to make the change, including but not limited to material given to staff on how to implement the change in the Sempra Energy Utilities' accounting system and material given to internal and external auditors supporting the change.

Utility Response:

Each Sempra utility relied on IRS guidance applicable to that utility, therefore, a separate response will be provided for each utility:

SoCal Gas:

a. When did the Sempra utilities first become aware that an increased repair deduction could potentially be available?

Response: SoCalGas made its accounting method change for repairs pursuant to Revenue Procedure 2012-19, which superseded Revenue Procedure 2011-14. Revenue Procedure 2012-19 provided general procedures for requesting automatic consent to make a change of accounting method.

Unlike Revenue Procedure 2011-43, which was industry specific to electric distribution and transmission property, Revenue Procedure 2011-14 (issued 1/10/2011) was generic in its application to all industries and to a host of possible accounting method changes. Revenue Procedure 2011-14 provided no safe harbors for repairs to gas transmission and distribution systems.

On March 7, 2012, the IRS issued Revenue Procedure 2012-19, which superseded Revenue Procedure 2011-14 and updated the procedures for requesting automatic consent to make accounting method changes from the IRS. Again, similar to its predecessor 2011-14, there was no safe harbor guidance specific to gas transmission and distribution expenditures in 2012-19; however, the IRS issued temporary tangible property regulations on December 23, 2011 providing further guidance and clarity on capitalization and expensing of expenditures to acquire, repair, and dispose of tangible property. Based on a reading of Revenue Procedure 2012-19 in March 2012 in combination with the temporary tangible property regulations issued in December 2011, SCG determined that there existed a possibility of an increased repair deduction over the amount that could be claimed under the percentage repair allowance methodology. SoCalGas engaged the accounting firm of PwC to scope the potential benefit of adopting a "facts and circumstances" method of accounting in place of the percentage repair allowance method. PwC began its work on March 26, 2012. PwC worked with Sempra staff to test a statistical sample of capital expenditures between 2009 and 2011 to determine which expenditures could be deducted currently and which had to be capitalized based on the tests in case law and the proposed tangible property regulations. PwC's scoping study determined that a larger repairs deduction could be obtained using a "facts and circumstances" approach compared to a percentage repair allowance approach, so on July 18, 2012, SoCalGas engaged PwC to do a full workup.

b. When did the Sempra utilities determine that they were going to implement the changes to the repair deduction as a result of the IRS revenue procedures?

   Response: SoCalGas did not determine it was going to formally implement the changes to the repairs deduction in until August 2013, as indicated by its filing of IRS Form 3115 with the Ogden office of the IRS on August 20, 2013.

c. Please explain and describe the process involved in determining whether the Sempra utilities would take the larger deductions, including but not limited to identification of the persons who provided material input, the persons who ultimately made the decision, and the dates of each step of the consideration. Please also provide all internal memoranda or other documents addressing the question of whether a memorandum account should be established to track increased repair deductions.

Response: To the best of our knowledge, documentation of exact dates of each step in SCG's consideration to change from a percentage repair allowance methodology to the facts and circumstances methodology does not exist; however, the decision-making would have coincided with the dates described in the responses to a and b above.

The individuals involved in generating and reviewing the data and making the decision to adopt the safe harbor methodology were Steve Olivier, Tax Manager, Randall Rose, Tax Director, Paul Yong, Vice President of Tax, Robert Schlax, CFO and Controller of the Sempra Utilities, and Joseph Householder, Controller for Sempra Energy. These individuals would have been responsible for briefing any senior officers on the change in accounting method.

d. Please identify each corporate officer who reviewed or ultimately approved any decision to implement the changes to the repair deduction, and the approximate date of that review or approval.

Response: Paul Yong, Vice President of Tax for Sempra Energy, Joseph Householder, Controller for Sempra Energy, and Robert Schlax, CFO and Controller for the Sempra Utilities would have had the ultimate decision to implement the changes to the repair deduction. Their decision to implement the changes to the repair deduction would have coincided with the preparation and review of the 2012 income tax return, which occurred between March and September 2013.

The Form 3115 (Application for Change in Accounting Method) that was filed with the IRS on August 20, 2013 was previously provided on January 9, 2015 in our response to question 27.