Company: Southern California Gas Company (U904G)
Proceeding: 2016 General Rate Case
Application: A.14-11-___
Exhibit: SCG-28

SOCALGAS

DIRECT TESTIMONY OF RAGAN G. REEVES

(TAXES)

November 2014

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

TABLE OF CONTENTS

LIST OF APPENDICIES

SUMMARY

- My testimony presents SoCalGas' estimated tax expense for TY 2016, and explains how those estimates were derived. The tax expenses discussed in my testimony include income taxes, payroll taxes, ad valorem taxes, and franchise fees.
- My testimony estimates a Test Year 2016 income tax expense of $113.0 million, payroll tax expense of $48.3 million, ad valorem tax expense of $ 52.2 million, and franchise fees of $32.2 million.
- The Internal Revenue Service's and California Franchise Tax Board's approval of SoCalGas' change in accounting method regarding its repairs deduction for federal and California income tax purposes, respectively, results in a repairs deduction for Test Year 2016 that is substantially larger than the percentage repair allowance ("PRA") deduction from prior GRCs. This change lowers the revenue requirement significantly for Test Year 2016 relative to the PRA deduction in prior GRCs.

SOCALGAS DIRECT TESTIMONY OF RAGAN G. REEVES
(TAXES)

I. INTRODUCTION

A. Summary of Proposals

I sponsor the Test Year ("TY") 2016. My testimony presents Southern California Gas Company's ("SoCalGas'") estimated tax expense for TY 2016, and explains how those estimates were derived.

B. Organization of Testimony

SoCalGas incurs three categories of taxes: (1) payroll taxes, (2) ad valorem (i.e., property) taxes, and (3) income taxes. In addition, SoCalGas incurs franchise fees, which it includes in its tax expense estimates. I will discuss each of these tax expense categories in turn. 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 ("CPUC") adopts levels of operations and maintenance ("O&M") expense or capital that are different from what has been proposed by SoCalGas, 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 SoCalGas' 2016 payroll tax expenses, and to describe the methodology used to develop SoCalGas' estimate.

B. Discussion

Payroll taxes were estimated by applying a tax rate on TY 2016 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 2013, the OASDI tax rate was 6.2% of wages up to a maximum wage base of $113,700. The Medicare tax rate was 1.45% of wages with no maximum wage base. Based on rate schedules contained in the 2014 Annual Report published by the Social Security Administration ("2014 Annual Report"), the employer's portion of the OASDI and Medicare tax rates have been at current levels since 1990 and are not expected to change through 2016 based on currently enacted law.[1] The OASDI wage base will increase to $117,000 in 2014, $119,100 in 2015, and is expected to increase to $123,600 in 2016 based on data reported in the 2014 Annual Report.[2]

2. Federal Unemployment Tax Act ("FUTA")

The 2013 FUTA tax rate was 0.6% on wages up to $7,000. Based on currently enacted law, the FUTA tax rate and wage base are not expected to change through 2016.

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 2013 UI tax rate was 3.8% 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 tax rate for SoCalGas is expected to decrease to 3.6% from 2014 through 2016, but wage bases are not expected to change through 2016.

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 2013 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 stratum 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 expense.

[1] See Table VI.G1, Contribution Rates for the OASDI and HI Programs, 2014 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, 2014 Annual Report.

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
($ in Thousands)

Line No.	*Acct. No.*	*2013 Recorded*	*2014 Forecast*	*2015 Forecast*	*2016 Test Year*
1	408	38,366	40,691	43,746	48,280

D. Results

The increase in payroll taxes from 2013 to 2016 reflects the impacts of staffing level changes presented by other witnesses in their direct testimonies, 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 SoCalGas' ad valorem taxes that will be incurred during TY 2016, 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, software, 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.

SoCalGas has filed its property statements with the SBE for the 2013 and 2014 lien dates. The property statements form the basis of the appraisals to set the value of SoCalGas' property for the 2013-2014 and 2014-2015 fiscal years. The SBE reports the value of property subject to ad valorem tax annually on the "Notice of Unitary Appraised Value," which SoCalGas has received for the 2013 and 2014 lien dates. 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 SoCalGas' unitary property.[3] Added to the unitary value of SoCalGas' property is the value of SoCalGas' 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

[3] Unitary property is property owned or used by a utility that the SBE has determined is used in SoCalGas' 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.
[4] Non-unitary property is property owned or used by the utility that the SBE has determined is not used in SoCalGas' operating business.

included as an operating expense and (b) Construction Work in Process ("CWIP") that gets capitalized rather than directly charged to ad valorem tax expense.

The SBE has followed the same assessment methodology for several years; consequently, SoCalGas followed this methodology to estimate the assessed value for unitary property and the resulting ad valorem tax expense estimate for TY 2016.

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 0.2645%, 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 2013 to 2016 represents the average historical rate of increase in local tax rates over the most recent five-year period. Tax expense for TY 2016 is comprised of the second installment payment from fiscal year 2015-2016 plus the first installment payment for fiscal year 2016-2017.

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C. Summary of Estimated Ad Valorem Tax Expenses

TABLE SCG-RGR-2

Southern California Gas Company

Summary of Estimated Ad Valorem Tax Expenses

($ in Thousands)

Line No.	*Description*	*2013 Recorded*	*2014 Estimated*	*2015 Estimated*	*2016 Test Year*
1	Taxable Plant in Service	9,871,266	10,483,301	11,047,229	11,693,555
2	Taxable Reserve for Depreciation	(5,519,654)	(5,740,638)	(6,005,046)	(6,288,476)
3	Taxable Net Plant	4,351,612	4,742,663	5,042,183	5,405,079
4	Taxable Reserve for Def. Inc. Tax	(804,795)	(863,577)	(871,973)	(884,796)
5	Adjustment for Income Approach	(83,617)	77,814	83,654	90,676
6	Assessed Value - Non-Unitary	48,645	55,580	59,751	64,767
7	Net Assessable Value	3,511,845	4,012,480	4,313,615	4,675,726
8	Ad Valorem Tax Rate	1.244080%	1.250873%	1.257666%	1.264459%
9	Ad Valorem Tax - Fiscal Year	43,690	50,191	54,251	59,123
10	Other Adjustments	(725)	(725)	(725)	(725)
	<u>Fiscal Year</u>				
11	Total Operating Ad Valorem Tax	42,965	49,466	53,526	58,398
12	Capitalized Ad Valorem Tax	(2,031)	(2,591)	(3,300)	(3,757)
13	Net Operating Ad Valorem Tax	40,934	46,875	50,226	54,641
	<u>Calendar Year</u> (Note 1)				
14	Total Operating Ad Valorem Tax	43,056	46,216	51,496	55,962
15	Capitalized Ad Valorem Tax	(1,019)	(2,333)	(2,849)	(3,752)
16	Net Operating Ad Valorem Tax	42,037	43,882	48,647	52,210

(Note 1) - Calendar year total operating ad valorem tax = ½ of the current fiscal year total ad valorem tax plus ½ of the prior fiscal year total ad valorem tax.

D. Results

The changes from 2013 to 2016 are the result of changes in plant and depreciation balances presented by other witnesses in their direct testimonies 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 SoCalGas' income tax expense for TY 2016, and to describe the assumptions and methodology used to calculate income tax expense.

B. Discussion of Income Tax Expense

1. Methodology

SoCalGas 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 CPUC decisions with general applicability to all utilities, and decisions with specific reference to SoCalGas.

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

The estimates contained in this section were calculated using current federal and state tax laws enacted through the filing date of this testimony. SoCalGas has not attempted to forecast future changes in tax law in the income tax calculations. SoCalGas 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 CPUC 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

[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.

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.

Where required, SoCalGas 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 CPUC policy, where normalization is not required by the IRC, SoCalGas 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 SoCalGas' 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 SoCalGas in prior rate cases. A small portion of deferred ITC reduced ratebase, pursuant to an election made under applicable law[11] by a predecessor company, Pacific Lighting Gas Supply Company ("Pacific Lighting"), which merged with SoCalGas in November 1985. As a successor in interest, SoCalGas continues to amortize deferred ITC generated by Pacific Lighting as a ratable restoration to rate base.

SoCalGas' federal income tax expense has been reduced by the amortization of remaining excess deferred taxes resulting from a reduction in the federal income tax rate from a high of 41% to the current 35% rate beginning in 1993, utilizing the Average Rate Assumption Method ("ARAM") as required by Internal Revenue Service ("IRS") normalization rules and mandated by D.88-01-061.[12]

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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] SoCalGas' 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] *Supra* at 95-96.

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

As prescribed by the CPUC in D.84-05-036, SoCalGas 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

SoCalGas 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 SoCalGas' tax expense, as discussed below.

Fixed Charges – Operating. 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 interest deduction is based on ratebase net of deferred ITC (as ITC is not available for CCFT purposes).

Preferred Dividend Deduction. 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 SoCalGas' preferred stock dividends qualify for deduction, which is a permanent difference between the book and tax treatment. SoCalGas has flowed through this deduction.

Fiscal Year/Calendar Year Property Tax Adjustment. 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. SoCalGas has flowed through the fiscal year tax expense as a deduction in calculating tax expense.

[13] *Supra* at 62-63 (Conclusion of Law #9).

Prior Year CCFT. 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' CPUC-adopted CCFT, not the current year CCFT. Since there is, as yet, no CPUC-adopted CCFT, SoCalGas has used the prior year's CCFT estimate in calculating federal tax expense for TY 2016.

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] SoCalGas 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] SoCalGas has normalized the deduction for capitalized software pursuant to D.84-05-036.[17]

Meals and Entertainment. Consistent with the final decision in its 2012 General Rate Case ("GRC"), the tax adjustment limiting the deduction for meals and entertainment costs to 50% is a function of administrative and general ("A&G") costs.[18] The company has not specified an amount for recovery of meals and entertainment in the A&G revenue requirement request; accordingly, there is no tax adjustment for meals and entertainment expenses for TY 2016.

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

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[14] 1989 Cal. PUC LEXIS 815, p. 34 (Conclusion of Law #1); 33 CPUC 2d 495.
[15] The 2016 tax deduction for internally-developed software is a function of the forecasted spend on internally-developed software in TY 2016. 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. .
[16] IRC Section 167(f) required capitalization of un-modified software purchased after August 10, 1993.
[17] *Supra*.
[18] D.13-05-010 at 942.

requirement to normalize state tax depreciation; therefore, SoCalGas flows through the state tax depreciation in excess of the book amount. SoCalGas' 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.

Federal Cost of Removal. SoCalGas 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 approach 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, SoCalGas flows through removal costs without regard to the vintage of the underlying assets per D.84-05-036.[19]

Repairs Deduction/Percentage Repair Allowance. The Schedule M adjustment for the repairs deduction represents the difference between expenditures that are permitted to be deducted as repairs for tax purposes and those same expenditures that are required to be capitalized for financial reporting purposes. During 2013, pursuant to Revenue Procedure 2011-14[20] and the adoption of final tangible property regulations[21] by the IRS interpreting IRC Sections 162 and 263(a), SoCalGas obtained automatic consents from the IRS and the FTB to change its method of accounting to begin deducting certain repairs that are capitalized for book purposes.[22]

Prior to the change in accounting method, SoCalGas followed its book capitalization policy for tax purposes. Accordingly, if the books treated an expenditure as a repair expense,

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

[20] 2011-4 I.R.B. 330, issued on January 10, 2011.

[21] The IRS issued final tangible property regulations on September 13, 2013 to define expense recognition and capitalization policies related to the acquisition, production, repair, and improvement of tangible property.

[22] The procedures for changing the method of accounting for repair and maintenance costs are covered in the Appendix to Revenue Procedure 2011-14 at Section 3.06.

then tax followed book to deduct the expense. Similarly, if books treated an expenditure as capital, then tax followed book to capitalize the expense.

The change in method of accounting was for SoCalGas to begin deducting repairs as they are defined in IRC §162 and IRC §263(a) and the Treasury Regulations thereunder, rather than following the book capitalization policy. This change in method of accounting is applicable to all assets eligible for the repairs deduction, including pre-1981 property that would otherwise qualify for the percentage repair allowance ("PRA") deduction permitted under Treasury Regulations Section 1.167(a)-11(d)(2). Accordingly, PRA has now been superseded by the repairs deduction going forward.

Consistent with the treatment of its PRA deduction in prior years, SoCalGas has flowed through the tax benefits associated with its projected repairs deduction to ratepayers for TY 2016 for both federal and California purposes in accordance with D.93848. The repairs deduction that is flowed through for TY 2016 is substantially larger than the PRA deduction from prior GRCs. The corresponding decrease to income tax expense and to the revenue requirement resulting from the repairs deduction is significantly larger than if SoCalGas had continued to deduct repairs under the PRA method.

<u>Tax Credits.</u> SoCalGas has reflected an offset to tax expense for allowable federal and state tax credits allowed under current law. SoCalGas 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, SoCalGas has added the amount of credits claimed back to taxable income to reverse the corresponding tax deductions.

Under current law as of the filing date of this testimony, all of credits that SoCalGas historically has claimed on its tax returns either have expired or will expire for TY 2016, except for the Child Care Credit.[23]

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[23] Section 45F of the IRC specifies the rules for claiming the Child Care Credit. Employers are allowed a credit equal to the sum of 25% of the qualified child care expenditures and 10% of the qualified child care resource and referral expenditures that employers incur for the benefit of their employees, subject to a limit of $150,000 of total credit per year. SoCalGas provides backup dependent care for its employees, provided by a third party, at various locations in proximity to its offices. It is provided for a limited number of days per year, and employees are responsible for a co-payment portion. The net costs incurred by SoCalGas for these child-care activities qualify for the credit.

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 GRC (see the testimony of Garry G. Yee, Exhibit SCG-26, for a discussion of rate base). SoCalGas' treatment of deferred taxes is in accordance with IRC §168(i)(9), Reg. §1.167(l)-1, and related IRS rulings.[24]

All current law has been followed in the development of deferred federal income taxes. Accumulated deferred taxes for TY 2016 were developed on a monthly basis and prorated in accordance with the normalization requirements in Reg. §1.167(l)-1(h)(6)(ii).[25]

1. Bonus Depreciation

Since the effective date of SoCalGas' 2012 GRC decision, Congress passed the American Taxpayer Relief Act of 2012 ("ATRA"), which has deferred tax implications related to bonus depreciation for SoCalGas' 2016 TY estimates.

The ATRA was enacted into law on January 2, 2013. The ATRA included a one-year extension of the 50 percent bonus tax depreciation for eligible property placed into service before January 1, 2014, and for costs incurred before January 1, 2014 attributable to eligible long production period property placed into service before January 1, 2015.[26]

The 50 percent bonus depreciation provisions contained in the ATRA 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 ATRA is subject to the tax normalization rules contained in IRC §168 and Treasury Regulations under former IRC §167. The ratemaking effect of the ATRA is to increase federal tax return depreciation in 2013 (and in 2014 for qualified long production period property) above the regular tax depreciation provided

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

[25] 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.

[26] *See* Pub. L. No. 112-240, Section 331, H.R. 8-23.

by the federal MACRS depreciation system. The extra bonus tax depreciation allowed by the ATRA creates 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 2013 (and in 2014 for qualified long period production property) are reflected in the accumulated deferred tax balances for purposes of calculating rate base for TY 2016.

Except in the case of certain qualified self-constructed assets placed in service in 2005 and certain qualified long period production property placed in service in 2014, bonus depreciation has not been calculated on property placed in service between January 1, 2005 and December 31, 2007, and after December 31, 2013, 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 2013-2016.

2. Contributions-in-Aid-of-Construction

Contributions-in-aid-of-construction ("CIAC") became taxable under the TRA 86. Pursuant to D.87-09-026, SoCalGas 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 accordance with the decision, SoCalGas 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.[27]

[27] 1987 Cal. PUC LEXIS 195; 25 CPUC 2d 299.

D. Summary Tables

TABLE SCG-RGR-3-1

Southern California Gas Company

Calculation of Federal & State Income Taxes

($ in Thousands)

Line No	*Description*	*2013 Recorded*	*2014 Estimated*	*2015 Estimated*	*2016 Test Year*
1	Total Operating Revenue	1,826,694	1,971,355	2,092,452	2,352,421
2	O&M Expenses	(1,079,404)	(1,127,023)	(1,176,624)	(1,381,099)
3	Taxes Other than Income Taxes	(80,403)	(84,573)	(92,393)	(100,490)
4	Book Income Before Depr. & Income Taxes	666,887	759,760	823,435	870,833
5	State Tax Adjustments	(618,171)	(674,390)	(706,235)	(708,731)
6	Taxable Income	48,716	85,369	117,200	162,101
7	CCFT Rate	8.84%	8.84%	8.84%	8.84%
8	**California Corporate Franchise Tax**	4,306	7,547	10,360	14,330
9	Book Income Before Depr. & Income Taxes (Line 4, above)	666,887	759,760	823,435	870,833
10	Federal Tax Adjustments	(572,631)	(554,771)	(592,194)	(581,458)
11	Taxable Income	94,256	204,989	231,241	289,375
12	Federal Income Tax Rate	35%	35%	35%	35%
13	Federal Income Tax Before Credits	32,990	71,746	80,934	101,281
14	Investment Tax Credit Amortization	(2,316)	(2,199)	(2,133)	(1,945)
15	Average Rate Assumption Method (ARAM)	(626)	(622)	(675)	(654)
16	Other	(1,883)	(15)	(15)	(15)
17	**Total Federal Income Tax**	28,164	68,910	78,111	98,667

TABLE SCG-RGR-3-2

Southern California Gas Company

Summary of Income Tax Adjustments

($ in Thousands)

Line No.	*Description*	*2013 Recorded*	*2014 Estimated*	*2015 Estimated*	*2016 Test Year*
	Federal Tax Adjustments:				
1	Tax Depreciation	(279,441)	(302,079)	(320,912)	(307,373)
2	Fixed Charges – Operating	(87,972)	(93,508)	(101,520)	(114,043)
3	Cost of Removal	(5,604)	(6,423)	(6,423)	(6,423)
4	Repairs	(107,822)	(87,362)	(87,476)	(88,813)
5	Prior Year Calif. Corp. Franchise	(24,316)	(4,306)	(7,547)	(10,360)
6	Software Dev	(68,600)	(57,598)	(66,236)	(51,513)
7	50% of Meals & Entertainment	0	0	0	0
8	Ad Valorem Tax - Fiscal/Calendar	1,102	(2,993)	(1,578)	(2,431)
9	Preferred Dividend & Other	23	(502)	(502)	(502)
10	Total Federal Tax Adj. (Deduction)	(572,631)	(554,771)	(592,194)	(581,458)
	State Tax Adjustments:				
11	Tax Depreciation	(341,205)	(415,678)	(432,118)	(434,574)
12	Fixed Charges – Operating	(87,505)	(93,099)	(101,166)	(113,741)
13	Cost of Removal	(14,968)	(17,144)	(17,144)	(17,144)
14	Repairs	(107,822)	(87,362)	(87,476)	(88,813)
15	Software Dev	(68,600)	(57,598)	(66,236)	(51,513)
16	50% of Meals & Entertainment	0	0	0	0
17	Ad Valorem Tax - Fiscal/Calendar	1,102	(2,993)	(1,578)	(2,431)
18	Preferred Dividend & Other	826	(517)	(517)	(517)
19	Total State Tax Adj. (Deduction)	(618,171)	(674,390)	(706,235)	(708,731)

E. Results

The increase in federal and state tax expense from 2013 to TY 2016 is primarily a function of increasing book income before taxes resulting from the return on a growing rate base (see the testimony of Garry G. Yee, Exhibit SCG-26, for a discussion of rate base). Federal and state tax adjustments are also growing annually, partially offsetting the growth in book income before taxes from 2013 to TY 2016.

V. FRANCHISE FEES – ACCOUNT 927

A. Introduction

The purpose of this section is to provide background and analysis for SoCalGas' franchise fees as estimated for TY 2016.

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, 2013, SoCalGas had franchise fee agreements with 245 taxing jurisdictions.

The franchise fee requirements are based upon gross receipts representing the recovery of base margin. The franchise factor upon which the estimated 2014-2016 franchise fees were determined is based on a summary of 2013 gas sales, transportation revenues, rate refunds, state fees, uncollectibles, and miscellaneous service receipts. The factor was adjusted to 2016 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 CPUC 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 SoCalGas will use to determine its franchise fee liability. The majority of agreements require that the franchise fee be calculated under both methods with SoCalGas 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 system-wide franchise fee factor. The system-wide franchise fee factors for the most recent five years were then averaged to yield a forecasted average franchise fee factor for TY 2016. The average franchise fee factor for 2016 is projected to be 1.4136% based on the trend from actual 2009-2013 franchise fees.

Table SCG-RGR-4-1 below provides the detail for Account 927, Franchise Fees as estimated for the 2016 TY.

C. Summary of Estimated Franchise Fees

Table SCG-RGR-4-1

($ in Thousands)

Line No.	*Acct. No.*	*Title*	*2013 Recorded*	*2014 Forecast*	*2015 Forecast*	*2016 Test Year*
1	927	Franchise Fees	24,556	26,704	28,460	32,197

D. Results

The change in franchise fee expense from 2013 to 2016 results from changes in base margin as presented by other witnesses in their direct testimonies.

VI. CONCLUSION

This concludes my prepared direct testimony.

VII. WITNESS QUALIFICATIONS

My name is Ragan G. Reeves. I am employed by Sempra Energy, SoCalGas' parent company, as a Principal Tax Counsel. My business address is 101 Ash Street, HQ06-TX, San Diego, California 92101. I advise SoCalGas and Sempra Energy's other business units on the implications of federal and state tax law, including tax compliance issues, tax audit issues and strategies, and proposed acquisitions and restructurings.

Prior to joining Sempra Energy in 2005, I worked as a tax attorney for eight years at Miller & Chevalier, Chartered, in Washington, D.C., where my practice focused on tax credits, tax litigation, and tax controversy matters.

I received a Bachelor's of Business Administration in Accounting, a Masters in Professional Accounting, and a Juris Doctorate from the University of Texas at Austin. I am licensed to practice law in the District of Columbia and Texas, and I am a registered in-house counsel in California. I am also a licensed Certified Public Accountant in Texas.

I have previously testified before the CPUC.

APPENDIX A – GLOSSARY OF TERMS

ACRS: Accelerated Cost Recovery System
ADFIT: accumulated deferred federal income tax
ADR: Asset Depreciation Range
AFUDC: allowance for funds used during construction
A&G: administrative and general
ARAM: Average Rate Assumption Method
ATRA: American Taxpayer Relief Act of 2012
CEA: capitalized earnings ability
CCFT: California Corporation Franchise Tax
CET: California Employment Training
CIAC: contribution in aid of construction
CWIP: Construction Work in Progress
ERTA: Economic Recovery Tax Act of 1981
FICA: Federal Insurance Contributions Act
FTB: Franchise Tax Board
FUTA: Federal Unemployment Tax Act
HCLD: historical cost less depreciation
HI: Hospital Insurance (i.e., Medicare)
IRC: Internal Revenue Code
IRS: Internal Revenue Service
ITC: Investment Tax Credit
ITCC: Income Tax Component of CIAC
MACRS: Modified Accelerated Cost Recovery System
OASDI: Old Age, Survivors, and Disability Insurance
PRA: Percentage Repair Allowance
Regs: Treasury Regulations
SBE: California State Board of Equalization
SONGS: San Onofre Nuclear Generating Station
SUI: State Unemployment Insurance
TRA 86: Tax Reform Act of 1986
UI: Unemployment Insurance