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April 8, 2011

Commissioner Catherine Sandoval  
Commissioner Mark Ferron  
California Public Utilities Commission  
505 Van Ness Avenue  
San Francisco, CA 94102

Re: Draft Resolution L-411

Dear Commissioners Sandoval and Ferron:

I am writing on behalf of San Diego Gas & Electric Company (“SDG&E”) and Southern California Gas Company (“SoCalGas”) (jointly, Sempra Energy Utilities or “SEU”) in response to the All-Party meeting on Draft Resolution L-411 (“Draft Resolution”) held on March 30, 2011. This letter also addresses the alternative approach to the advice letter process described in the April 5, 2010 letter from The Utility Reform Network (“TURN”).

At the All-Party meeting you requested that SEU identify the cash impact of bonus depreciation in 2011. Attached to this letter is the requested analysis. In summary, the estimated effect for the entire year of 2011, expressed on a revenue requirements basis is \$1 million for SDG&E and \$2 million for SoCalGas.<sup>1</sup> As noted at the All-Party meeting, due to the expedited nature of this request and the limited time to review the recently-issued Treasury Department and Internal Revenue Service (“IRS”) guidance regarding the election of bonus depreciation,<sup>2</sup> the information provided is a preliminary estimate subject to change after further analysis. You also offered SEU the opportunity to provide additional comments on the Draft Resolution. SEU appreciates this opportunity and hopes that these additional comments will help the Commission understand the complexity of the issues surrounding bonus depreciation and why SEU feels the Draft Resolution should not be adopted.

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<sup>1</sup> If authorized, it is SEU’s understanding the contemplated memorandum accounts would reflect a portion of the amounts, according to the time remaining in 2011 following approval of the Draft Resolution by the Commission.

<sup>2</sup> IRS Rev. Proc. 2011-26, dated March 29, 2011.

As expressed at the meeting and previously in written comments, SEU believes the memorandum accounts proposed in the Draft Resolution are not necessary for utilities with a pending 2012 General Rate Case (“GRC”) proceeding. This is due to the fact that SEU’s January 1, 2012 rate base forecast for the GRC will be lower than otherwise forecasted due to the projected net accrued deferred tax liability resulting from the bonus depreciation deducted for income tax purposes with ratepayers realizing 100% of the forecasted benefits due to the election of bonus depreciation as a rate base offset upon implementation of the 2012 GRC decision. If the Commission does not withdraw or reject the Draft Resolution, it should be modified to exempt parties with Test Year 2012 GRCs as a matter of both fairness and implementation feasibility.

By electing bonus depreciation for federal income tax filing purposes an economic benefit is realized as a result of a reduction in near-term cash taxes. However, as stated at the All-Party meeting, and reiterated here, this economic benefit is a timing difference, not a reduction to tax expense – it is a reduction of cash tax payments in the years in which bonus depreciation is elected which will be offset by an increase in cash tax payments in subsequent years as a result of increased taxable income due to lower depreciation expense for tax purposes. The economic benefit is derived from the availability of additional cash during the time period of the deferred payment. It is, in essence, an interest-free loan from the Federal Government. However, receiving the benefit is wholly dependent on the ability to take advantage of the timing difference. SEU does expect to be able to reduce its estimated tax payments in 2011 as a result of these Acts, but, as reflected in the analysis accompanying this letter, these benefits will be realized ratably during 2011. Further, any benefits that do materialize from the election of bonus depreciation may be offset by higher tax obligations resulting from enactment of the legislation, such as loss of the tax deduction for domestic manufacturing activities under Internal Revenue Code Section 199.

Since the Small Business Jobs Act of 2010 (“Small Business Act”) was enacted prior to SEU’s submittal of the 2012 GRC applications, the impact of the Small Business Act is already reflected in its 2012 GRCs. However, since the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“Tax Relief Act”) was enacted after SEU’s submittal of the 2012 GRC applications, the impact of the Tax Relief Act was not reflected in the applications. SEU has previously advised the Commission (reiterated at the All-Party meeting) of its intent to amend its showing and to also include the effect of the Tax Relief Act in its 2012 GRCs. As a result, all of the expected net accrued benefits resulting from the deferral of cash tax payments from 2011 associated with both the Small Business Act and the Tax Relief Act, and the vast majority of the expected cash tax benefits realized as a result of the deferral of cash tax payments for 2010 will be reflected in the deferred tax liability as of December 31, 2011 - resulting in a lower rate base than would have otherwise been forecasted. Therefore, by virtue of the GRC process, 100% of the forecasted accrued benefits of both pieces of legislation will flow to SEU ratepayers as an offset to rate base effective January 1, 2012, or upon approval by the CPUC of SEU’s 2012 GRCs. Yet despite this, the Draft Resolution would contravene long-standing Commission precedent for the treatment of bonus depreciation and would create serious implementation issues.

Bonus depreciation has been enacted a number of times in prior years to stimulate the economy and there is no precedent from those earlier occasions supporting what is proposed in Draft Resolution L-411. Further, in Decision 84-05-036 (“OII 24”), the Commission “declined...to require utilities to submit adjustments reflecting reductions in taxes” for tax law changes, and instead established a standard of “changes that appear to be permanent and substantial” to overcome that hurdle. As supported by the schedule attached, SEU estimates the tax laws enacted in 2010 to have a small revenue requirement impact and are clearly not permanent. The change in taxes is temporal, in that it does not alter the tax expense itself,<sup>3</sup> but simply defers the timing of the payment to a later date.<sup>4</sup> The Draft Resolution thus clearly fails both tests established by the Commission since 1984. In the absence of showing the tax changes are permanent and substantial, the logic for abandoning standards that emerged from a general investigation into Commission practices is left wanting.

In addition to the issues discussed above, the Draft Resolution lacks clarity in how to quantify the benefits realized as a result of bonus depreciation and for incremental costs associated with the tax law changes which creates serious implementation issues. The Draft Resolution would have SEU compare the net benefits realized due to the tax law changes with any incremental capital investments made as a result of the benefits realized. This creates serious issues in the determination of what the authorized levels of capital investments are in post-test years. SEU’s 2008 GRC decision approved settlements that do not contain specific authorized capital investment levels for 2009-2011 to complete such a computation. Once such investment levels were authorized for 2008, post-test year increases are in the form of fixed total revenue requirement increases in each of 2009, 2010 and 2011. In the absence of authorized capital investment levels for the post-test years, it is not clear how the memorandum account will properly measure the incremental benefits and costs from the tax laws. In order to comply with memorandum account requirements of the Draft Resolution, SEU will need to devise a “proxy method” to record incremental costs and benefits. SEU believes that having to resort to proxy methods is an inferior alternative to existing ratemaking mechanisms which address the unique circumstances of each utility in their respective GRCs.

Lastly, SEU provides comments regarding the alternative approach to the advice letter process suggested by TURN. In its letter, TURN discusses the concern expressed by the utilities regarding the ability to determine capital investment levels incremental to GRC authorized levels, and recommends a “proxy method” with reference to Southern California Edison’s Reliability Investment Incentive Mechanism. SEU strongly disagrees that any memorandum account is necessary for utilities with a 2012 GRC, however in the event a memorandum account is ordered, SEU intends to propose its own proxy method and continues to urge the Commission to not prejudge the details that will need to be addressed during the review process.

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<sup>3</sup> Except the potential loss of tax deductions, such as the Section 199 deduction, that would *increase* income taxes for SDG&E.

<sup>4</sup> In addition, the ability to elect bonus depreciation under the Tax Relief Act, generally, will expire on December 31, 2012.

In summary, SEU first recommends the Commission withdraw or reject the Draft Resolution, as the current draft of the resolution has been shown to be seriously flawed. In the alternative, SEU asks that any utility with a Test Year 2012 GRC be exempted from the Draft Resolution, because the impact is not permanent or substantial in 2011, and ratepayers will receive 100% of the forecasted accrued benefit beginning January 1, 2012.

Sincerely,



Robert Schlax  
Vice President, Controller & Chief Financial Officer  
Sempra Energy Utilities

Attachment

cc: Commission President Michael Peevey  
Commissioner Mike Florio  
Commissioner Timothy Alan Simon  
Joel Perlstein, Esq., Legal Division  
Paul Clanon, Executive Director  
Karen Clopton, Chief ALJ  
Marzia Zafar, Executive Division  
Frank R. Lindh, General Counsel  
Rami Kahlon, Director, Division of Water and Audits  
Phil Weismehl, Interim Chief-of-Staff for Cmmr. Sandoval  
Service List for Draft Resolution L-411

**Preliminary - Subject to Change**

San Diego Gas & Electric and Southern California Gas Company  
 Estimated Revenue Requirement Impact of Bonus Depreciation in 2011  
 (\$ in Millions, Rounded)

Line	SCG	SDG&E
1 Weighted Average Deferred Tax Impact - (higher credit)/lower credit	\$ (14)	\$ (19)
2		
3 Conversion from Rate Base Component to Revenue Requirement		
4 Combined Return and Income Tax Gross up	12.28%	12.20%
5 Revenue Requirement Increase/(Decrease)	\$ (2)	\$ (2)
6		
7 Offsets:		
8 SDG&E - Loss of IRC Section 199 Deduction, Rev Req Impact	N/A	1
9		
10 Estimated Revenue Requirement Impact	\$ (2)	\$ (1)

**Preliminary - Subject to Change**

**San Diego Gas and Electric Company**

**Net Cash Tax Deferral and Weighted Average Deferred Tax Impact - \$000  
Estimated Revenue Requirement Impact of Bonus Depreciation in 2011**

Line			Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total 2011
1	Forecasted Costs Eligible for 50% Bonus Depreciation		50,078	50,078	83,744	14,120	
2	50% Bonus Depreciation on Above Costs		25,039	25,039	41,872	7,060	
3	Add: Regular Federal Tax Depreciation on Above Costs		(2,003)	(2,003)	(3,350)	(565)	
4	Difference Due to 50% Bonus Depreciation	A	23,036	23,036	38,522	6,495	
5							
6	Forecasted Costs Eligible for 100% Bonus Depreciation		97,906	97,906	103,910	85,522	
7	100% Bonus Depreciation on Above Costs		97,906	97,906	103,910	85,522	
8	Add: Regular Federal Tax Depreciation on Above Costs		(3,916)	(3,916)	(4,156)	(3,421)	
9	Difference Due to 100% Bonus Depreciation	B	93,990	93,990	99,754	82,101	
10							
11	Total Difference Due to Additional Bonus Depreciation	A+B=C	117,026	117,026	138,276	88,596	460,923
12	Federal Tax Rate	D	35%	35%	35%	35%	35%
13	Incremental Deferred Tax Liability	CxD=E	40,959	40,959	48,397	31,009	161,323
14	Add: Deferred Tax Asset Created by Net Operating Loss	F	(19,377)	(19,377)	(19,377)	(19,377)	(77,509)
15	Net Cash Tax Deferral (See Note 1)	E+F=G	21,582	21,582	29,019	11,631	83,814
16							
17							
18							
19							
		A	B	C = B/366	D = A x C	E	
		Monthly	Days	Days	Monthly Wtd	Prorated	
	Weighted Average Calculation (See Note 2)	Deferral	Remaining	Remaining %	Avg	Deferral	
20							
21							
22	Jan	6,984	335	0.9153	6393	6,393	
23	Feb	6,984	304	0.8306	5801	12,194	
24	Mar	6,984	276	0.7541	5267	17,461	
25	Apr	6,984	245	0.6694	4675	22,137	
26	May	6,984	215	0.5874	4103	26,240	
27	Jun	6,984	184	0.5027	3511	29,751	
28	Jul	6,984	154	0.4208	2939	32,690	
29	Aug	6,984	123	0.3361	2347	35,037	
30	Sep	6,984	92	0.2514	1756	36,793	
31	Oct	6,984	62	0.1694	1183	37,976	
32	Nov	6,984	31	0.0847	592	38,567	
33	Dec	6,984	1	0.0027	19	38,586	
34		<u>83,814</u>					
35	Prorated Additions					38,586	
36	Beginning of Year Balance					-	
37	Prorated End of Year Balance					38,586	
38	Weighted Average Deferred Tax					19,293	

Note 1

Bonus depreciation in 2011 includes both 50% and 100% eligible property (if construction began on self-constructed property before 9/9/2010), only 50% bonus depreciation is allowed. Regular federal tax depreciation provides approximately 4% composite depreciation on 2011 capital additions. The cash tax benefit of bonus depreciation in 2011 is measured by the difference between bonus depreciation and regular federal tax depreciation that would have been claimed had bonus depreciation not been enacted for 2011. Due to 50% and 100% bonus depreciation in 2011, SDG&E will be in a net operating loss (NOL). The NOL will not provide an economic benefit until the IRS processes a refund against prior or future years' tax liabilities. This will occur in late 2012 after the 2011 tax return is filed and amended returns for other years can be processed by the IRS. As a result, the deferred tax asset created by the NOL will partially offset the deferred tax liability created by additional bonus depreciation.

Note 2

IRS Regulation 1.167(l)-1(h)(6)(ii) requires the proration methodology used above when rates are set on a projected future period.

**Preliminary, Subject to Change**

**Southern California Gas Company  
Net Cash Tax Deferral and Weighted Average Deferred Tax Impact - \$000  
Estimated Revenue Requirement Impact of Bonus Depreciation in 2011**

Line			Qtr 1	Qtr 2	Qtr 3	Qtr 4	Total 2011
1	Forecasted Costs Eligible for 50% Bonus Depreciation		35,859	35,859	18,133	22,880	
2	50% Bonus Depreciation on Above Costs		17,930	17,930	9,066	11,440	
3	Add: Regular Federal Tax Depreciation on Above Costs		(1,434)	(1,434)	(725)	(915)	
4	Difference Due to 50% Bonus Depreciation	A	16,495	16,495	8,341	10,525	
5							
6	Forecasted Costs Eligible for 100% Bonus Depreciation		75,058	75,058	109,429	74,762	
7	100% Bonus Depreciation on Above Costs		75,058	75,058	109,429	74,762	
8	Add: Regular Federal Tax Depreciation on Above Costs		(3,002)	(3,002)	(4,377)	(2,990)	
9	Difference Due to 100% Bonus Depreciation	B	72,056	72,056	105,052	71,772	
10							
11	Total Difference Due to Additional Bonus Depreciation	A+B=C	88,551	88,551	113,393	82,297	372,792
12	Federal Tax Rate	D	35%	35%	35%	35%	35%
13	Incremental Deferred Tax Liability	CxD=E	30,993	30,993	39,688	28,804	130,477
14	Add: Deferred Tax Asset Created by Net Operating Loss	F	(17,096)	(17,096)	(17,096)	(17,096)	(68,384)
15	Net Cash Tax Deferral (See Note 1)	E+F=G	13,897	13,897	22,591	11,708	62,093
16							
17							
18							
19							
		A	B	C = B/366	D = A x C	E	
		Monthly	Days	Days	Monthly Wtd	Prorated	
		Deferral	Remaining	Remaining %	Avg	Deferral	
20	Weighted Average Calculation (See Note 2)						
21							
22	Jan	5,174	335	0.9153	4736	4,736	
23	Feb	5,174	304	0.8306	4298	9,034	
24	Mar	5,174	276	0.7541	3902	12,936	
25	Apr	5,174	245	0.6694	3464	16,400	
26	May	5,174	215	0.5874	3040	19,439	
27	Jun	5,174	184	0.5027	2601	22,041	
28	Jul	5,174	154	0.4208	2177	24,218	
29	Aug	5,174	123	0.3361	1739	25,957	
30	Sep	5,174	92	0.2514	1301	27,258	
31	Oct	5,174	62	0.1694	877	28,134	
32	Nov	5,174	31	0.0847	438	28,572	
33	Dec	5,174	1	0.0027	14	28,586	
34		<u>62,093</u>					
35	Prorated Additions					28,586	
36	Beginning of Year Balance					-	
37	Prorated End of Year Balance					28,586	
38	Weighted Average Deferred Tax					14,293	

Note 1

Bonus depreciation in 2011 includes both 50% and 100% eligible property (if construction began on self-constructed property before 9/9/2010), only 50% bonus depreciation is allowed. Regular federal tax depreciation provides approximately 4% composite depreciation on 2011 capital additions. The cash tax benefit of bonus depreciation in 2011 is measured by the difference between bonus depreciation and regular federal tax depreciation that would have been claimed had bonus depreciation not been enacted for 2011. Due to 50% and 100% bonus depreciation in 2011, SoCalGas will be in a net operating loss (NOL). The NOL will not provide an economic benefit until the IRS processes a refund against prior or future years' tax liabilities. This will occur in late 2012 after the 2011 tax return is filed and amended returns for other years can be processed by the IRS. As a result, the deferred tax asset created by the NOL will partially offset the deferred tax liability created by additional bonus depreciation.

Note 2

IRS Regulation 1.167(l)-1(h)(6)(ii) requires the proration methodology used above when rates are set on a projected future period.