Applications	:	A.06-12-009 / 010
Exhibit Number	:	DRA-37-R
Commissioner	:	Bohn
ALJ	:	Long
Witness	:	Loy

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Report on the Results of Operations for San Diego Gas & Electric Company Southern California Gas Company General Rate Case

Test Year 2008

SoCalGas Taxes

San Francisco, California
August 10, 2007

NOTE:

Corrections / revisions to this exhibit are due to the consideration of information contained in rebuttal Exhibit SCG-245.

SOUTHERN CALIFORNIA GAS COMPANY
TAXES

I. INTRODUCTION

This exhibit presents DRA's analysis and recommendations on the estimated tax expenses of Southern California Gas Company (SCG) for Test Year (TY) 2008 in response to SCG's request for revenue requirements to recover tax expenses in Exhibit No. SCG-17, "Prepared Direct Testimony of Randall G. Rose on Behalf of Southern California Gas Company." SCG is seeking rate recovery in TY2008 of (1) state and federal income taxes, (2) property (i.e., ad valorem) taxes, (3) payroll taxes, and (4) local franchise fees.

Taxes for regulatory ratemaking are a function of "real world" tax law (e.g., the Internal Revenue Code or "IRC") filtered through the complicated lens of regulatory statutes, and policies and practices adopted by the Commission. Revenue requirements for taxes are essentially the "real world" rates applied to projected revenues, net taxable income, employee payroll, or property value adjusted for ratemaking purposes. Furthermore, to the extent that the Commission adopts levels of operations and maintenance expense, payroll, and/or capital expenditures that are different than DRA's recommendations, taxes would be re-calculated to reflect the impact of these changes.

II. SUMMARY OF RECOMMENDATIONS

The following summarizes DRA's recommendations:

- DRA recommends that all entertainment-related activities be eliminated from revenue requirements and be rejected for ratemaking purposes.
- ~~DRA's forecast of $56.5 million for Contributions-In-Aid-of-Construction should be adopted.~~

Table 37-1 compares DRA's recommendation with SCG's proposed estimates for TY 2008:

Table 37-1
Federal and State Income Taxes
(In Thousands of 2008 Dollars)

Description (a)	DRA Recommended (b)	SCG Proposed[1] (c)	Amount SCG>DRA (d=c-b)	Percentage SCG>DRA (e=d/b)
Adj. for 50% Deduction for Entertainment	$291.7	$562	$270.3	92.67%
~~Contributions-In-Aid-Of-Construction~~[2]	~~$56,563~~	~~$70,634~~	~~$13,801~~	~~24.40%~~

III. DISCUSSION

The following subsection provides some brief background on regulated tax expense and a discussion of key concepts for certain tax deductions, credits, and other tax policy issues used in determining taxable income for ratemaking purposes and other issues affecting revenue requirements for taxes other than income. Unless stated otherwise, all discussions apply equally to state and federal income taxes.

A. Key Concepts for Income Tax Expense

SCG's operating income is subject to federal income tax (FIT) and the California Corporate Franchise Tax (CCFT). The calculation of ratemaking income taxes is based on federal and state tax laws, Commission decisions, and established Commission policy and practice specific to SCG's operations.

SCG's ratemaking income taxes in this section are projected on a stand-alone, non-consolidated–basis. However, SCG's actual tax payments are shared with the holding company and affiliates.[3]

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[1] Exhibit SCG-17, p. RGR-13, Table SCG-RGR-3-2.

[2] ~~This value represents the weighted-average, calendar-year balance for "Accumulated Deferred Taxes - CIAC." It is a component of rate base.~~

[3] D.84-05-036, 15 CPUC 2d at 49-51.

DRA's estimates were calculated using current federal and state tax laws enacted through June 30, 2006. Neither DRA nor SCG has attempted to forecast future changes in tax law or in generic ratemaking policies (e.g., flow-through and normalization).

In estimating taxes (e.g., property and state and federal income taxes) for ratemaking purposes, the tax obligations incurred by non-utility property is excluded because, by definition, it is not a cost of service.[4]

State income tax expense was computed in DRA's Results of Operations Model by reducing DRA's estimate of operating income by property taxes, payroll taxes, and making certain adjustments to "flow-through" (1) timing differences between regulatory books and state tax filings and (2) deductions not already reflected in the Results of Operations Model (e.g., interest expense on rate base, internally developed software, investment tax credits, and preferred stock dividends).

Federal income tax expense was computed in DRA's Results of Operations Model by reducing DRA's estimate of operating income by property taxes, payroll taxes, and state income taxes, and making certain adjustments to "flow-through" (1) timing differences between regulatory books and federal tax filings[5] and (2) deductions not already reflected in the Results of Operations Model (e.g., interest expense on rate base, internally developed software, investment tax credits, and preferred stock dividends).

Where required, normalization rules are applied to adjust a utility's deductions for ratemaking income taxes. By tax law,[6] "normalized" tax treatment follows the regulatory accounting and results in deferred taxes. For example, federal tax depreciation on post-1980 vintage assets has been "normalized" by using a regulatory book life and method to calculate depreciation rather than the accelerated

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[4] D.06-12-029, Appendix A, Section VII.

[5] For example, tax depreciation on pre-1981 vintage assets was flowed-through as an adjustment to federal taxes as ordered in D.93848.

[6] IRC Section 168 and Treasury Regulation Section 1.167(l)-1.

method used in federal tax returns. Conceptually, this results in a regulatory tax expense that is temporarily higher than what is actually paid in federal tax filings. This quantitative differential is then booked to a deferred tax reserve to reflect the fact that this ratepayer overpayment is, in fact, a regulatory deferral or postponement of the real tax obligation. The underlying justification for establishing this ratemaking treatment is that the balance in the deferred tax reserve is used to reduce rate base, thereby compensating ratepayers for the use of their over-payment. In addition, SCG's federal income tax has been reduced by the amortization of excess deferred taxes as required under the IRC normalization statutes[7] and by D.88-01-061.

B. Federal and State Income Taxes

For FIT and CCFT, DRA and SCG respectively use the corporate tax rate of 35% and 8.84%. The next subsections discuss the adjustments to FIT and CCFT for ratemaking purposes.

1. Interest Expense Deduction

SCG used rate base, net of Investment Tax Credit, and the authorized weighted-average cost of long-term debt. DRA used its estimates in the same formula. Any differences are attributable to DRA's estimates of rate base and long-term debt rather than tax issues.

2. Preferred Dividend Deduction

DRA and SCG used the actual dividends as filed in SCG's tax returns.

3. Fiscal Year/Calendar Year Property Tax Adjustment

SCG flowed through the fiscal year tax expense as a line item deduction. DRA obtained and analyzed SCG's workpapers and other data and proposes no adjustments at this time.

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[7] IRC Section 168 and Treasury Regulation Section 1.167(l)-1.

4. State Income Tax

To calculate the FIT deduction for ratemaking purposes, D.89-11-058[8] ruled that the prior year's CCFT is to be used as a proxy for the current year CCFT deduction. Both SCG and DRA used the prior year CCFT.

5. Internally-developed Software

For tax purposes, a deduction is allowed for internally-developed software under IRC Section 174. Both DRA and SCG flowed through the deduction for internally developed software generated by the Results of Operations Model. Thus any differences are attributable to the respective witnesses on computer software expenditures.

6. Adjustment for the Fifty Percent Deduction for Meals and Entertainment

Tax laws place a limit of 50% on the deduction for meals and entertainment expenditures. To reconcile this limit for regulatory taxes, SCG includes a negative deduction equal to 50% of its estimates of the amount of meals and entertainment that are embedded in its capital, operations and maintenance, and administrative and general expenses.[9] SCG's estimate is ~~based on a computerized~~~~[10]~~ ~~expenditure extraction from its shareholders' general ledger accounts for 2005~~ a three-year moving average.

DRA's estimate is based on a computerized[11] expenditure extraction from its shareholders' general ledger accounts for 2005. DRA eliminated the deduction and associated revenue requirements for entertainment-related travel, meals, and tickets. This was done by eliminating the negative deduction adjustment using the

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[8] 33 CPUC 2d at 495.

[9] SCG Exhibit No. 17, page RGR-9.

~~[10] SAP: *Systeme, Anwendungen und Produkte in der Datenverarbeitung* ("Systems, Applications and Products in Data Processing")~~

[11] SAP: *Systeme, Anwendungen und Produkte in der Datenverarbeitung* ("Systems, Applications and Products in Data Processing")

entertainment-related expenditure data from the SAP extraction.[12] The same entertainment-related expenditures were removed from the appropriate FERC accounts.[13] DRA's estimate of these entertainment-related expenses for TY 2008 is $291,700 (nominal dollars).

DRA's justification for removing entertainment-related expenses from all revenue requirements is that these social and cultural activities are of a dubious benefit to ratepayers and SCG has not produced any testimony asserting any ratepayer benefit. DRA's adjustment is supported by prior Commission decisions, which have twice rejected entertainment-related expenses (e.g., Disneyland tickets, luncheons, retiree dinners) from ratesetting because they are an unfair economic burden[14] and ratepayers should not be required to pay for them.[15] Furthermore, the Commission has rejected entertainment expenditures because they give the appearance of a "free lunch" at ratepayers' expense.[16] SCG's entertainment expenses clearly fall under the same category of expenses that the Commission has rejected in the past, and therefore DRA rightfully removes them.

7. Depreciation

The federal and state tax deductions for depreciation are generated by the Results of Operations Model and reflect the respective witnesses' estimates for capital additions. SCG and DRA have no differences with regard to the method of calculating the tax deductions.

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[12] Response to Data Request DRA-SCG-131, Item 2.A.1.

[13] Response to Data Request DRA-SCG-131, Item 2.A.1. DRA estimates this amount to be $216,900 (nominal dollars).

[14] D.82-12-054; 10 CPUC 2d at 140-141.

[15] D.93-12-043; 52 CPUC 2d at 513-514.

[16] D.90-01-016; 35 CPUC 2d 80 at 135-136.

8. Percentage Repair Allowances

Consistent with D.93848, both SCG and DRA "flowed through" these state and federal deductions. DRA obtained SCG's workpapers and analyzed them using the most recent recorded data. DRA proposes no adjustments.

C. Payroll Taxes

SCG's payroll tax expenses are for the employer's tax obligation and are comprised of Federal Insurance Contribution Act, Federal Unemployment Insurance, and State Unemployment Insurance. DRA calculated SCG's obligations by applying statutory rates to the appropriate taxable wages. DRA analyzed SCG's workpapers using the most recent recorded data and proposes no adjustments at this time. Any difference between DRA and SCG are the result of other witnesses' testimony that impact payroll (a.k.a., labor dollars), such as workforce levels and labor inflation.

D. Property Taxes

SCG's method for calculating property or ad valorem taxes is based upon the most recent State Board of Equalization assessment methodology. DRA analyzed SCG workpapers using the most recent recorded data and proposes no adjustments at this time. Any difference between DRA and SCG is the result of other witnesses' testimony that impact plant estimates, such as capital additions and nonlabor inflation.

E. FERC Account 927 – Franchise Fees

Franchise fees are payments made to counties and incorporated cities pursuant to local ordinances granting a franchise to the utility to place utility facilities in public rights of way. SCG has franchise agreements with 241 taxing jurisdictions. DRA analyzed SCG's workpapers and confirmed that the cities of Whittier and Ventura are expected to increase their franchise fee rate. DRA proposes no adjustments. Any differences between DRA and SCG are the result of respective differences in forecasts of utility gross receipts (i.e., base margin).

~~F. Contributions-In-Aid-Of-Construction (CIAC)~~

~~Contributions-in-aid-of-construction and the related income tax gross-up on the contribution (ITCC) became taxable under the Tax Reform Act of 1986, as directed in Decision 87-09-026. SCG used estimates as its 2005 "actual"[17] for beginning of year and end of year balances for CIAC. SCG estimates resulted in a weighted average for the 2005 CIAC that was 122% of the actual weighted-average for 2005. DRA replaced SCG's 2005 "actual" with the values reported in the 2005 Federal Energy Regulatory Commission Form No. 2, page 269. The result was reductions in the 2005 and TY 2008 weighted average balance for CIAC accumulated deferred taxes of $6.3 million and $13.8 million, respectively. DRA's relatively larger reduction for the Test Year is directly attributable to using the correct $37.6 billion balance instead of SCG's estimate of $50.3 million for 2005 end of year and 2006 beginning of year. For the beginning of year 2006, DRA's correction shifts the weighted average down in 2006 by $14.6 million. This level is then carried-over to the later years. For TY 2008, DRA recommends $56.6 million and SCG is proposing $70.4 million for a difference of $13.8 million or 24.4 percent. This balance is titled, "Accumulated Deferred Taxes-CIAC," and is a component of rate base.~~

~~The following table compares SCG's 2005 estimate with the amounts SCG reported in its FERC Form No. 2:~~

~~[17] See SCG response to DRA Data Request DRA-SCG-103 for SCG's explanation of its characterization of its estimates for 2005 as "actual."~~

~~Table 37-2~~
~~Accumulated Deferred Federal Income Taxes~~
~~For 2005 CIAC~~
~~SCG Estimated Versus Recorded~~
~~(Thousands of Nominal Dollars)~~

~~2005 CIAC~~	~~SCG Estimate (a)~~	~~SCG FERC Recorded (b)~~	~~Difference Dollars (c=a-b)~~	~~Percentage Difference (d=a/b)~~
~~Beginning of Year~~	~~$27,428~~	~~$23,934~~	~~$3,494~~	~~115%~~
~~End of Year~~	~~50,275~~	~~37,647~~	~~12,628~~	~~133%~~
~~Weighted Average~~	~~34,329~~	~~28,076~~	~~6,253~~	~~122%~~

~~Table 37-3~~
~~Accumulated Deferred Federal Income Taxes~~
~~For 2006 CIAC~~
~~Effect of 2005 Recorded Data~~
~~(Thousands of Nominal Dollars)~~

~~2006 CIAC Forecast~~	~~SCG Estimate (a)~~	~~DRA Forecast using FERC Recorded (b)~~	~~Difference Dollars (c=a-b)~~	~~Percentage Difference (d=a/b)~~
~~Beginning of Year~~	~~$50,275~~	~~$37,647~~	~~$12,628~~	~~134%~~
~~End of Year~~	~~60,157~~	~~47,529~~	~~12,628~~	~~127%~~
~~Weighted Average~~	~~55,216~~	~~40,632~~	~~14,584~~	~~136%~~