

Application: 17-11-XXX
Exhibit No.: SDGE-X
Witness: Ragan G. Reeves

Application of San Diego Gas & Electric
Company (U 902 E) for Approval Pursuant to
Public Utilities Code Section 851 to Lease
Transfer Capability Rights to Citizens
Sycamore-Penasquitos Transmission LLC

DIRECT TESTIMONY OF
RAGAN G. REEVES
SAN DIEGO GAS & ELECTRIC COMPANY

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

November 13, 2017



1 **I. SUMMARY AND PURPOSE OF TESTIMONY**

2 The purpose of my testimony is to explain how the Transfer Capability Lease, between
3 San Diego Gas & Electric Company (“SDG&E”) and Citizens Sycamore-Penasquitos
4 Transmission LLC (a form of which is attached as Exhibit A to the Development, Coordination,
5 and Option Agreement, dated November 9, 2017, between SDG&E and Citizens Energy
6 Corporation (Citizens Energy Corporation and Citizens Sycamore-Penasquitos Transmission
7 LLC are collectively and individually referred to herein as “Citizens”), has special tax
8 implications due to the fact that the agreement has been characterized as a lease agreement. My
9 testimony also discusses the impact of deferred taxes and bonus depreciation and explains how
10 SDG&E ratepayers are economically neutral in this transaction for tax purposes.

11 **II. LEASE AGREEMENT**

12 Under general tax principles, an amount received by a taxpayer as gross income must be
13 taken into account in the year payment is received. However, when a lease agreement calls for
14 prepaid rent, Internal Revenue Code (“IRC”) Section (“§”) 467 requires the lessor and lessee to
15 report the rents for tax purposes as they accrue and to take into account time value of money
16 principles. Under a formula specified in IRC §467 and the related regulations, rental revenues
17 and expenses are accounted for tax purposes on an accrual basis and the taxable income and
18 expenses are treated in a reciprocal manner by the parties. SDG&E and Citizens agreed to
19 structure the transaction as an IRC §467 lease in order to obtain more certainty about the tax
20 treatment that both parties desired and to spread the income and expense items for tax purposes
21 over the life of the agreement.

1 **III. PRE-PAID RENT**

2 Citizens will pay SDG&E an amount equal to all of the acquisition costs for the property
3 subject to its leasehold interest up front as “prepaid rent.” SDG&E will amortize the prepaid rent
4 into taxable income ratably over the 30-year lease term based on a rent schedule calculated under
5 IRC §467 rules. Another requirement of IRC §467 is to treat the prepaid rent as a loan from the
6 lessee to the lessor. Accordingly, to the extent the unamortized prepaid rent exceeds the
7 cumulative rental payments due at the end of each rental accrual period, the excess is deemed to
8 be the outstanding loan balance. IRC §467 requires SDG&E and Citizens to establish a schedule
9 showing the taxable interest income to be recognized by Citizens and the deductible interest
10 expense to be recognized by SDG&E for each period. The loan bears interest at 110% of the
11 “applicable federal rate,” as defined in IRC §467. The applicable rate is the long-term interest
12 rate published by the U.S. Treasury Department.

13 The IRC §467 treatment does not change the total taxable income or expense to be
14 recognized by SDG&E or Citizens compared to recognizing the prepaid rent as taxable upon
15 receipt by SDG&E and deductible upon payment by Citizens, but it does change how the items
16 of income and expense are labeled for tax purposes and the timing of their recognition. Each
17 year, SDG&E’s net taxable income will be equal to the sum of its rental income and interest
18 expense, while Citizens will recognize the reciprocal rental expense and interest income on its
19 tax return. As a result, the net rental income less interest expense recognized by SDG&E over
20 the 30-year life of the agreement will exactly equal Citizens’ prepaid rent. Accordingly, over the
21 30-year life of the lease, SDG&E and Citizens will have complementary tax treatment.

22 The following example illustrates this complementary tax treatment: assume Citizens
23 makes an up-front payment to SDG&E equal to all the construction costs of the segment of the

1 Sycamore-Penasquitos Transmission Line (“Sycamore”) it will lease from SDG&E. SDG&E
2 and Citizens would calculate the accrued rental income to be recognized each period using
3 present value principles outlined in the regulations under IRC §467. Interest on the outstanding
4 balance of the “IRC §467 loan” would also be calculated for each period. Over the life of the
5 agreement, the net difference between the rental income less interest expense recognized for tax
6 purposes by SDG&E would equal the prepaid rent. Similarly, the net difference between the
7 interest income less rent expense attributed to Citizens would also be equal to the prepaid rent.
8 A calculation of the IRC §467 rents and interest based on the \$27 million of projected
9 construction costs for the portion of Sycamore leased to Citizens is shown in Appendix A to this
10 testimony.¹

11 **IV. DEFERRED TAXES**

12 The accumulated deferred federal and state income taxes (“ADIT”) resulting from the
13 difference between federal tax depreciation computed using the Modified Accelerated Cost
14 Recovery System (“MACRS”) specified in IRC §168 and state tax depreciation computed using
15 the Asset Depreciation Range (“ADR”) system used by California versus normalized tax
16 depreciation computed using the same life, method, and salvage assumption used to compute
17 book depreciation will be included as an adjustment to rate base by SDG&E for purposes of
18 establishing a baseline revenue requirement. Under IRS rules,² the adjustment to rate base will
19 be offset by the amount of SDG&E’s net operating loss (“NOL”) carryforward, if any, allocated
20 to the portion of Sycamore leased to Citizens, so that the ADIT impact on rate base is net of the
21 applicable NOL carryforward (“net ADIT”).³ Citizens also will adjust rate base for ADIT based

¹ IRC §467 Rent Schedule, Appendix A.

² See Treas. Reg. § 1.167(l)-1(h)(1)(iii).

³ The NOL carryforward creates a deferred tax asset because it represents a future cash tax benefit that the taxpayer has not yet received.

1 on the timing difference between the book and tax recognition of the lease amortization
2 expense.⁴

3 **V. BONUS DEPRECIATION**

4 The bonus depreciation rules of IRC §168(k) also impact ADIT. Bonus depreciation is a
5 special provision that allows taxpayers to immediately expense a specified percentage of
6 qualifying property placed into service in a particular year, rather than requiring the taxpayer to
7 depreciate the full amount of the property over multiple years.

8 The Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”)⁵ extended the
9 bonus depreciation rules, which had expired on December 31, 2014. Unlike previous extensions
10 that generally extended bonus depreciation for only one year, the PATH Act extended bonus
11 depreciation to eligible property placed into service between January 1, 2015 and December 31,
12 2019,⁶ and for costs incurred before January 1, 2020 attributable to eligible long production
13 period property (“LPPP”)⁷ that is placed into service before January 1, 2021.⁸

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

18 The bonus depreciation percentage for eligible property placed in service in 2015-2017 is
19 50%.⁹ The percentage decreases to 40% for 2018 and decreases further to 30% for 2019.¹⁰

⁴ For a more detailed discussion of rate base, see the direct testimony of SDG&E witness Amanda White.

⁵ Pub. L. No. 114-113, H.R. 2029.

⁶ IRC §168(k).

⁷ LPPP is defined as property with a MACRS tax depreciation life of at least 10 years, a cost of more than \$1 million, and a construction period of one year or more. IRC §168(k)(2)(B)(i).

⁸ IRC §168(k)(2)(B).

⁹ IRC §168(k)(1)(A).

¹⁰ IRC §168(k)(6).

1 Special rules allow qualifying LPPP to receive a one-year extension on the bonus depreciation
2 phase-out rates. Therefore, for qualifying LPPP, the 50% bonus depreciation rate applies to
3 property placed in service in 2018, the 40% rate applies to property placed in service in 2019,
4 and the 30% rate applies to property placed in service in 2020.¹¹ SDG&E expects Sycamore to
5 qualify as LPPP, and thus to qualify for 50% bonus depreciation assuming the project is placed in
6 service in 2018.

7 The effect of the bonus depreciation provisions is to increase the income tax deduction for
8 depreciation, thereby reducing current income taxes expensed and paid with an equal and
9 offsetting increase to deferred tax expense and ADIT, the latter representing income tax liabilities
10 that will be paid in the future. SDG&E has computed its federal tax depreciation on forecasted
11 capital additions otherwise eligible for MACRS depreciation using the bonus tax depreciation
12 provisions contained in the PATH Act, as applicable. The incremental ADIT generated is equal
13 to the additional first year bonus depreciation in excess of the ratemaking allowance for
14 depreciation multiplied by the 35% federal income tax rate.¹² Assuming Sycamore is placed in
15 service in 2018, SDG&E will reflect 50% bonus depreciation on Sycamore in its calculation of
16 federal tax depreciation for 2018.

17 The net ADIT resulting from the difference between ratemaking depreciation computed
18 using a book life and method and the comparable tax depreciation computed using MACRS plus
19 bonus depreciation or the state ADR will be included as a reduction to rate base. As ADIT
20 reduces rate base, failure to account for the impact of bonus depreciation in computing net ADIT
21 would inflate rate base and result in higher rates paid by customers. Pursuant to tax law, SDG&E
22 remains the tax owner of the portion of Sycamore leased to Citizens under the Transfer Capacity

¹¹ *Id.*

¹² California has not adopted the bonus depreciation rules; accordingly, only the federal tax rate is used to compute the incremental ADIT.

1 Lease between the parties. As a result, SDG&E will be entitled to claim bonus depreciation on all
2 of the eligible costs attributable to Sycamore, and conversely, Citizens has no ADIT attributable to
3 bonus depreciation related to Sycamore. Under Section 8.3 of the Transfer Capacity Lease
4 between SDG&E and Citizens, SDG&E is obligated to transfer to Citizens an amount equal to the
5 revenue requirement benefit of the net ADIT offset to rate base resulting from bonus depreciation
6 achieved by SDG&E for the portion of Sycamore leased to Citizens. Citizens will then pass this
7 benefit along to its ratepayers.

8 Accordingly, SDG&E proposes computing the revenue requirement attributable to the net
9 deferred tax benefit attributable to bonus depreciation claimed by SDG&E on the portion of
10 Sycamore leased to Citizens and transferring this amount to Citizens. The net deferred taxes that
11 reduce rate base measure the actual cash tax benefit received by SDG&E at the measurement
12 date. The amount transferred to Citizens by SDG&E is incremental to the deferred taxes Citizens
13 has already reflected in its filing for accelerated cost recovery for tax over the book recognition of
14 expense.

15 From a tax perspective, SDG&E's ratepayers are economically neutral in this transaction
16 between SDG&E and Citizens. Since SDG&E's ratepayers are not funding capital costs or
17 paying a return on capital costs attributable to the portion of Sycamore leased to Citizens,
18 SDG&E customers do not have a claim on the tax benefits associated with bonus depreciation on
19 that portion of Sycamore. By transferring this tax benefit to Citizen's customers, who do bear the
20 cost, SDG&E's customers are not harmed and Citizens' customers receive the benefits associated
21 with costs funded by them.

1 **VI. PROPERTY TAX TREATMENT**

2 The California State Board of Equalization (“SBE”) values utility property on a unitary
3 basis as an entire operating system rather than valuing each individual component individually.
4 It then allocates the system value among the affected counties according to a formula required by
5 statute. However, beginning in 2007, property tax revenues generated by construction of new
6 electric transmission property with a nameplate value of 200,000 volts or greater is allocated
7 entirely to the county in which the newly constructed property is located.¹³ Accordingly, since
8 the property subject to the agreement between SDG&E and Citizens is located wholly within San
9 Diego County, that county will receive the entire share of new property tax revenue created by
10 the assessment of Citizens’ transmission capacity leasehold interest. The county
11 auditor/controller then allocates property tax revenue among all the tax jurisdictions within the
12 county based on a formula established after Proposition 13. The agreement between SDG&E
13 and Citizens will have no impact on the allocation of property tax revenues to San Diego County
14 or to the various tax jurisdictions within the county.

15 This concludes my direct testimony.

¹³ California Revenue and Taxation Code §100.95.

1 **VII. QUALIFICATIONS**

2 My name is Ragan G. Reeves. I am employed by Sempra Energy, SDG&E's parent
3 company, as a Principal Tax Counsel. My business address is 488 8th Avenue, HQ08N1, San
4 Diego, California 92101-7123. I advise SDG&E and Sempra's other business units on the
5 implications of federal and state tax law, including tax compliance issues, tax audit issues and
6 strategies, and proposed acquisitions and restructurings.

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

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

14 I have previously testified before the Commission.