Application No: A.10-07-XXX
Exhibit No.: ________________
Witness: Ragan G. Reeves

Application of San Diego Gas & Electric Company (U 902 E) to Amend Renewable Energy Power Purchase Agreement with NaturEner Rim Rock Wind Energy, LLC and for Authority to Make a Tax Equity Investment in the Project.

Application 10-07-___
(Filed July 15, 2010)

CHAPTER 4

PREPARED DIRECT TESTIMONY OF

RAGAN G. REEVES

ON BEHALF OF

SAN DIEGO GAS & ELECTRIC COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

July 15, 2010

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I. INTRODUCTION – GENERAL TAX MATTERS

Federal tax law provides alternative incentives for wind energy projects. For qualified projects, taxpayers may claim production tax credits, investment tax credits, or a federal cash grant in lieu of credits. This chapter of testimony will discuss each of these alternatives, both in terms of the requirements under the tax law generally, and also how those requirements relate to the Rim Rock tax equity investment. The details of the Rim Rock tax equity investment are discussed further in the testimonies of Mr. McClenahan and Mr. Moftakhar.

II. PRODUCTION TAX CREDITS

Internal Revenue Code ("IRC") § 45 allows taxpayers to claim production tax credits ("PTCs") for electricity produced in the United States from certain renewable resources. Qualified facilities, including wind-powered generation facilities, are eligible for PTCs over a 10-year period from the placed-in-service date. The American Recovery and Reinvestment Act ("ARRA") of 2009, also referred to as "the Stimulus Bill," extended the availability of PTCs to wind projects placed in service through December 31, 2012. The PTC rate for 2010 is $22 per megawatt hour of electricity produced[1/]. The rate is set according to a formula contained in IRC § 45 and is adjusted annually for inflation.

[1/] IRS Notice 2010-37, 2010-18 IRB 654.

Unlike the investment tax credit ("ITC"), which is claimed in its entirety on the tax return for the year the qualified property is placed in service, PTCs are earned annually based on the output of the qualified facility over the first 10 years of the facility's production life. Also unlike ITCs, there is no tax normalization requirement associated with PTCs. PTCs obtained by a regulated public utility may be passed through to ratepayers each year as they are earned.

As discussed in the testimony of Mr. Niggli, it is widely acknowledged that most independent power producers currently do not have sufficient taxable income to utilize tax credits and favorable tax depreciation deductions provided by federal law. As a result, independent power producers may enter into partnerships with taxpaying entities as a means of raising development capital. Where the facility is owned by a partnership, the partnership agreement will determine the allocation of PTCs among the partners.[2/] IRS guidance to partnerships engaged in generating electricity from wind requires that the partnership allocations have "economic effect,"[3/] such that the partners have a "reasonable anticipation" of deriving an investment return from a combination of cash flows and PTCs[4/] generated by the wind project.

A common method of generating investment capital for wind projects is a so-called "partnership flip" structure. In this type of transaction, a wind project developer enters into a partnership with a tax equity investor to own a project with the developer. The tax equity partner may be allocated as much as 99% of the PTCs and income and expense items of the partnership during the 10-year period that the project is eligible for PTCs. Generally, the investor and the developer agree on a target return to the investor. Once the investor's target return is achieved, the partnership interests "flip," so that the investor's allocation of partnership income, expense, and remaining PTCs (if any) drops to as low as 4.95%, while the developer's allocation of these

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[2/] IRC §704(a).
[3/] Treasury Regulation §1.704-1.
[4/] Revenue Procedure 2007-65, section 4, paragraph .01.

1 items increases to as much as 95.05%. The developer may have an option to buy out the
2 investor's interest at fair market value after the flip. SDG&E and the developer (NaturEner)
3 have chosen the PTC "partnership flip" structure for the Rim Rock tax equity investment.[5/]
4 In order to answer questions posed by investors and developers and to provide some
5 certainty around each stakeholder's ability to claim PTCs, the IRS issued Revenue Procedure
6 2007-65 to provide a set of "safe harbors" that partnerships may rely upon to structure their
7 "partnership flip" agreements in such a way that the PTCs are not at risk, and so that the
8 allocations of the PTCs as specified in the partnership agreement are respected by the IRS.
9 SDG&E and NaturEner have structured their partnership agreement to satisfy each of the
10 safe harbors specified in Revenue Procedure 2007-65, so as to ensure that the anticipated PTCs
11 will materialize if the project operates as expected. Each of the safe harbors is quoted below,[6/]
12 followed by a brief discussion of how the Rim Rock tax equity investment satisfies that safe
13 harbor's requirements:

14 .01. Investors Defined. Investors are partners in the Project Company whose
15 investment return is reasonably anticipated to be derived from both § 45 credits
16 and participation in operating cash flow.

17 As discussed in the testimony of Mr. Moftakhar, the Rim Rock tax equity investment will
18 provide a return to its partners both from the PTCs and from project operations. Therefore, this
19 requirement is satisfied.

20 .02. Partners' Minimum Partnership Interest. The Developer must have a
21 minimum one percent interest in each material item of partnership income, gain,
22 loss, deduction and credit at all times during the existence of the Project
23 Company. Each Investor must have, at all times during the period it owns a
24 partnership interest in the Project Company, a minimum interest in each material
25 item of partnership income and gain equal to 5 percent of the Investor's
26 percentage interest in partnership income and gain for the taxable year for which

[5/] SDG&E would be required to seek the Commission's approval before NaturEner could exercise its post-flip purchase option.

[6/] Revenue Procedure 2007-65, section 4, as revised by IRS Announcement 2009-69.

> the Investor's percentage share of income and gain will be the largest, as adjusted for sales, redemptions or dilution of its interest.

NaturEner will have at least a 1% interest in each material item of partnership income, gain, loss, deduction and credit at all times during the partnership's existence. SDG&E's minimum interest in each material item of partnership income, gain, loss, deduction, and credit is at least 5% of SDG&E's highest percentage interest of such items at all times during the partnership's existence. Accordingly, this safe harbor is satisfied.

> .03. Investor's Minimum Unconditional Investment. On or before the later of the date the Wind Farm is placed in service or the date the Investor acquires its interest in the Project Company, the Investor must make a minimum unconditional investment in the Project Company (the "Investor Minimum Investment"). The Investor must maintain the Investor Minimum Investment throughout the duration of its ownership of its partnership interest in the Project Company, except that the Investor Minimum Investment can be reduced as a result of distributions of cash flow from the Project Company's operation of the Wind Farm or in connection with section 4.05. Contributions required to be made in the future will not be included in the Investor Minimum Investment until the contributions are actually made to the partnership. The Investor Minimum Investment must be equal to at least 20 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions required to be made by the Investor under the partnership agreement. The Investor must not be protected against loss of any portion of the Investor Minimum Investment through any arrangement, directly or indirectly, with the Developer, any other Investor, the turbine supplier or the power purchaser or any party related to the Developer, other Investors, turbine supplier or the power purchaser.

SDG&E's initial, unconditional investment in the project company will not be reduced, other than as a consequence of distributions of cash flow from the project company's operations or as contemplated by section 4.05 of the Revenue Procedure, as discussed below. Accordingly, this requirement is satisfied.

> .04. Contingent Consideration. At least 75 percent of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by an Investor with respect to an interest in the Project Company must be fixed and determinable obligations that are not contingent in amount or certainty of payment.

The full amount of SDG&E's initial capital contribution to the partnership is fixed and determinable. The partnership agreement does not call for any additional fixed capital contributions or any reasonably anticipated contingent capital contributions by SDG&E. Therefore, this requirement is satisfied.

> .05. Purchase Rights. The Developer, the Investor, or any related party may only have a contractual right to purchase the Wind Farm, any property included in the Wind Farm, or an interest in the Project Company (the Property) that satisfies the requirements of this section 4.05. The contractual right must be negotiated for valid non-tax business reasons at arm's length by parties with material adverse interests. The purchase price for the Property must either be a price that is not less than the fair market value of the Property determined at the time of exercise or, if the purchase price is determined prior to exercise, a price that the parties reasonably believe, based on all facts and circumstances at the time the price is determined, will not be less than the fair market value of the Property at the time the right may be exercised. Finally, the Developer (or any party related to the Developer) may not have a contractual right to purchase the Property earlier than 5 years after the qualified facility is first placed in service.
>
> Any determination of the fair market value of the Wind Farm or an interest in the Project Company may take into account: (i) contracts or other arrangements creating rights or obligations (excluding power purchase agreements) only if such contracts or other arrangements creating rights or obligations are entered into in the ordinary course of the Wind Farm's business and are negotiated at arm's length with parties not related to the Project Company or Investors; and (ii) any power purchase contract only if such contract is entered into with parties not related (within the meaning of § 45(e)(4)) to the Project Company.

NaturEner's contractual purchase rights in the project property were negotiated at arm-length between SDG&E and NaturEner, two unrelated parties. As discussed in the testimony of Mr. McClenahan, the purchase price will be calculated at a fair market value price at the time the purchase option is exercised, and the purchase option may not be exercised earlier than 5 years after the facility is placed in service. Accordingly, this requirement is satisfied.

> .06. Sale Rights. The Project Company may not have a contractual right to cause any party to purchase the Wind Farm or any property included in the Wind Farm, excluding electricity, from the Project Company. An Investor may not have a contractual right to cause any party to purchase its partnership interest in the Project Company.

Excluding electricity, there are no contractual sale rights as described in Section 4.06 of the Revenue Procedure. Therefore, this requirement is satisfied.

> .07. Guarantees and Loans. No person may guarantee or otherwise insure the Investor the right to any allocation of the credit under § 45.
> The Project Company must bear the risk that the available wind resource is not as great as anticipated or projected. The Developer, the turbine supplier, or any power purchaser may not provide a guarantee that the wind resource will be available at a certain level. A guarantee regarding wind resource availability may be provided by a third party not related to the Developer, the turbine supplier, any power purchaser, or any other project participant if the Project Company or an Investor directly pays the cost of or premium for such guarantee. For example, a weather derivative contract between the Project Company and an unrelated third party (such as an insurance company) is an acceptable guarantee.
> A long-term power purchase agreement entered into between the Project Company and a party not related to the Project Company under § 45(e)(4) does not constitute a guarantee. However, a Take or Pay contract between related parties would constitute a guarantee and is not permissible. Any sale of electricity between related persons as defined in § 45(e)(4) will not qualify for the credit under § 45.
>
> The Developer (or a party related to the Developer) may not lend any Investor the funds to acquire any part of the Investor's interest in the Project Company or guarantee any indebtedness incurred or created in connection with the acquisition of such Investor's interest in the Project Company.

There are no guarantees as part of the Rim Rock tax equity investment that would violate Section 4.07 of the Revenue Procedure. As discussed in more detail below, the IRS has clarified in published guidance that the sale of electricity under a power purchase agreement will not be considered a related-party transaction as long as the electricity is ultimately resold to a person that is not related to the producer of the electricity. As discussed in more detail below, such is the case here; therefore, this requirement is satisfied.

> .08. Allocation of § 45 Production Tax Credits. The § 45 credit must be allocated in accordance with § 1.704-1(b)(4)(ii).

The Treasury Regulation referenced in this safe harbor requires the allocation of tax credits among the partners to be in the same proportion as the allocation of loss or deduction related to the credit property. Under the terms of the partnership agreement, the allocations of

PTCs to SDG&E and NaturEner follow the same percentage as the allocations of net income/loss to the partners. Therefore, this requirement is satisfied.

> .09. Separate Activity for Purposes of § 469. For purposes of the passive activity loss rules, under § 1.469-4(d)(4) each qualified facility will be treated as a separate activity for purposes of § 469 and that activity may not be grouped with any other activity, except other qualified wind facilities. Generally, a taxpayer subject to § 469 may utilize passive activity credits from qualified wind facilities only to the extent of their tax liability allocable to passive activities, whether from qualified wind facilities or other sources.

The passive activity loss and credit rules under IRC § 469 only apply to individuals, estates, trusts, and to limited groups of small corporations that fit within the statutory definitions of "closely held C corporations" or "personal service corporations" under the IRC. SDG&E, NaturEner, and the partnership do not fall into any of these categories. Accordingly, this provision is not relevant to the Rim Rock tax equity investment.

> .10. Definition of Related Party. Except as otherwise provided, for purposes of this revenue procedure parties are related if they bear a relationship to each other that is specified in § 267(b) or 707(b)(1).

Under the related party rules of IRC §§ 267(b) and 707(b)(1), SDG&E and NaturEner are unrelated parties.

III. ARMS-LENGTH GREEN ATTRIBUTES PRICE

In addition to meeting the safe harbors to ensure that the PTCs are not at risk, SDG&E and NaturEner must consider that the IRS will generally scrutinize partnership agreements where the partnership has negotiated a separate agreement for the offtake with one if its partners. SDG&E has negotiated a power purchase agreement ("PPA") for the renewable energy credits ("Green Attributes") generated by the project. SDG&E and NaturEner are unrelated parties. However, once SDG&E becomes an investor in the partnership, SDG&E and the partnership will be considered related parties for purposes of federal tax law.

In transactions involving related parties, the IRS recognizes that there is an opportunity for manipulation in pricing. If the IRS were to determine that the Green Attributes were not priced at market, it may impute a market price and attribute any additional income to the partnership. The additional imputed taxable income would flow to the partners according to the terms of the partnership agreement and in proportion to each partner's interest in the partnership. SDG&E and NaturEner are cognizant of these IRS concerns; accordingly, as discussed in the testimony of Mr. McClenehan, the PPA between SDG&E and NaturEner was negotiated on terms that reflect an arms-length transaction. Specifically, the Green Attributes price is based on the cost structure of the partnership and is based on the same terms as if SDG&E will not have an ownership interest in the partnership. In fact, SDG&E is requesting that the Commission approve the PPA with NaturEner even if it denies the tax equity investment.

IV. SALES OF ELECTRICITY TO UNRELATED PARTIES

IRC § 45 holds that the PTCs are not available where the offtake is sold to a related person[7/]. In Notice 2008-60, the IRS refined its historic narrow view of the IRC § 45(e)(4) unrelated party sale rule. Notice 2008-60 states that "[t]he guidance for sales to unrelated persons applies with respect to electricity produced from any qualified energy resource," which includes wind energy. The Notice provides that "[e]lectricity . . . will be treated as sold to an unrelated person . . . if the ultimate purchaser of the electricity . . . is not related to the person that produces the electricity . . . The requirement of a sale to an unrelated person will be satisfied in these circumstances if the producer sells the electricity . . . to a related person for resale by the related person to a person that is not related to the producer of the electricity." This was an important clarification by the IRS which opened the door to utility investments in wind energy projects as tax equity partners.

[7/] IRC § 45(e)(4).

In the Rim Rock tax equity investment, SDG&E will resell the conventional power produced by the project back to the partnership, which will in turn sell the conventional power to the Alberta Electric System Operator ("AESO"). The AESO is unrelated to SDG&E, and therefore the ultimate sale of the conventional power is to an unrelated person, in compliance with IRS rules for obtaining the PTCs. Furthermore, the unrelated person rule in IRC § 45 applies solely to the electricity produced by the project, and does not include the Green Attributes. Green Attributes are severable from the electricity produced and may be bought and sold separately from the electricity. As such, they are not subject the unrelated person rule contained in IRC § 45.

V. INVESTMENT TAX CREDIT AND CASH GRANT OPTIONS

ARRA provided flexibility in the types of incentives available to developers and investors in renewable energy projects. Congress recognized that based on the individual circumstances of stakeholders and the wind capacity factor of the project, ITCs or even direct cash grants might be more attractive alternatives than PTCs in helping to spur investment in renewable energy projects. As a result, ARRA provides an option to select a 30% ITC, or a cash grant equivalent to a 30% ITC, in lieu of PTCs.

The ITC or the cash grant may be claimed on qualified equipment that is used to generate electricity from renewable resources, but may not be claimed on property that is used to transmit electricity or on buildings. As discussed in the testimony of Mr. Moftakhar, financial modeling indicates that the benchmark over which PTCs would be more attractive for the Rim Rock project than the ITC or the cash grant is a wind capacity factor of 36%. As further discussed in Mr. Moftakhar's testimony, the Rim Rock project is expected to exceed this wind capacity factor benchmark, so the selection of PTCs is the most economic option for the Rim Rock project.

1 If ITC or the cash grant is claimed in lieu of PTCs, the basis of the qualified property for
2 tax depreciation purposes must be reduced by 50% of the ITC claimed or the cash grant received.
3 For example, in the case of a $1,000,000 investment in qualified renewable energy property, a
4 $300,000 ITC is allowable (30% of $1,000,000). When computing tax depreciation, the
5 depreciable basis must be reduced by 50% of $300,000, or $150,000. As a result, the taxpayer
6 may depreciate only $850,000 of the asset's cost, and not the full $1,000,000. This is a
7 permanent loss of depreciable basis. In contrast, no reduction in depreciable basis is required if a
8 taxpayer elects to claim PTCs. Accordingly, as a consequence of electing to claim PTCs for the
9 Rim Rock project, the depreciation deductions allocated to SDG&E will be higher than under
10 either the ITC or cash grant.
11 Moreover, SDG&E made an irrevocable election several years ago under former IRC §
12 46(f)(2) to flow ITCs to ratepayers as a ratable reduction to tax expense in the revenue
13 requirement for cost of service, at a rate not to exceed the book life of the property that generated
14 the ITCs. Such treatment of ITCs conforms to the treatment mandated by D.88-01-061.[8/]
15 Accordingly, ITCs must not be flowed to ratepayers more rapidly than ratably over the useful life
16 used to depreciate the qualified property for ratemaking purposes, which is usually a 20-25 year
17 useful life. Pursuant to the tax normalization rules, ITCs claimed by a regulated public utility
18 adopting the IRC § 46(f)(2) option may not reduce ratebase by any part of the ITCs claimed.[9/] In
19 contrast, PTCs are not subject to the normalization rules; therefore, PTCs are flowed to
20 ratepayers as they are earned over the 10-year credit period.
21 In summary, for the Rim Rock tax equity investment, PTCs provide three tax advantages
22 for SDG&E and its ratepayers over the ITC or the cash grant: (1) as discussed in the testimony of

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8/ CPUC D.88-01-061, 27 CPUC 2d 310 at page 3.
9/ The normalization rules also apply to cash grants.

Mr. Moftakhar, the projected wind capacity for the project exceeds the threshold over which PTCs produce better economic results than either the ITC or cash grant; (2) PTCs do not result in a reduction in the depreciable basis of qualified renewable energy property; and (3) because PTCs are not subject to the normalization rules, PTCs are flowed to the ratepayers as they are earned over the 10-year credit period, as opposed to the 20-25 year period required for ITC or the cash grant under the normalization rules.

VI. MONETIZATION OF TAX BENEFITS

Consistent with Order Instituting Investigation ("OII") 24 (Decision No. ("D.") 84-05-036), SDG&E computes ratemaking income taxes on a stand-alone basis, not an allocation of consolidated tax expense from Sempra Energy, the parent company of SDG&E. Accordingly, normalized tax depreciation and PTCs that inure to the benefit SDG&E's ratepayers from the project are not dependent upon Sempra Energy's consolidated tax position in order for SDG&E to monetize the benefit on behalf of ratepayers. Sempra Energy is obligated under its tax sharing agreement with SDG&E to monetize tax burdens and benefits SDG&E would otherwise realize on its own stand-alone tax return if it were not a member of Sempra Energy's consolidated group of companies. As a result, tax benefits flowing from the project to SDG&E will be monetized by Sempra, and SDG&E will pass these benefits to ratepayers through the ratemaking process as directed by the Commission.

VII. DISCUSSION OF DEFERRED FEDERAL INCOME TAXES

Property that uses wind to generate electricity is also eligible for favorable tax depreciation treatment. Such property is depreciated using a five year life and 200% declining balance method specified under the Modified Accelerated Cost Recovery System ("MACRS") established by the 1986 Tax Reform Act. SDG&E will be allocated nearly all of the MACRS tax depreciation up to the flip date according to the terms of the partnership agreement.

1 Under IRS regulations, the cash tax benefit from federal tax depreciation in excess of
2 book depreciation must be normalized.[10] SDG&E has reduced rate base by the weighted
3 average accumulated deferred federal income taxes generated by the difference between
4 MACRS tax depreciation and normalized federal tax depreciation, in accordance with
5 longstanding CPUC policy.
6 This concludes my direct testimony.

[10] Treasury Regulation § 1.167(l)-1.

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VIII. STATEMENT OF QUALIFICATIONS

My name is Ragan G. Reeves. I am employed by Sempra Energy, SDG&E's parent company, as a Senior Tax Counsel. My business address is 101 Ash Street, HQ-02, San Diego, California 92101. One of my primary responsibilities is to advise Sempra's business units on the tax implications of proposed acquisitions and restructurings, including the tax implications of renewable energy projects.

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 Bachelors 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.