

Exhibit No.:  
Issue: Taxes  
Witness: Melissa K. Hardesty  
Type of Exhibit: Surrebuttal Testimony  
Sponsoring Party: Kansas City Power & Light Company  
Case No.: ER-2012-0174  
Date Testimony Prepared: October 8, 2012

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO.: ER-2012-0174**

**SURREBUTTAL TESTIMONY**

**OF**

**MELISSA K. HARDESTY**

**ON BEHALF OF**

**KANSAS CITY POWER & LIGHT COMPANY**

**Kansas City, Missouri  
October 2012**

**\*\*\* [REDACTED] \*\*\* Designates "Highly Confidential" Information  
Has Been Removed.  
Certain Schedules Attached To This Testimony Designated "Highly Confidential"  
Have Been Removed  
Pursuant To 4 CSR 240-2.135.**

**SURREBUTTAL TESTIMONY**

**OF**

**MELISSA K. HARDESTY**

**Case No. ER-2012-0174**

1 **Q: Please state your name and business address.**

2 A: My name is Melissa K. Hardesty. My business address is 1200 Main Street, Kansas City,  
3 Missouri, 64105.

4 **Q: Are you the same Melissa K. Hardesty who pre-filed Direct and Rebuttal Testimony**  
5 **in this matter?**

6 A: Yes, I am.

7 **Q: What is the purpose of your Surrebuttal Testimony?**

8 A: The purpose of my testimony is to correct my Rebuttal Testimony and to provide  
9 additional information related to Kansas City Earnings Tax, and to address the Rebuttal  
10 Testimony of Missouri Public Service Commission Staff (“Staff”) witness Cary G.  
11 Featherstone related to Iatan 2 Advanced Coal Tax Credits.

12 **KANSAS CITY EARNINGS TAX**

13 **Q: Are you aware of any errors that were included in your rebuttal testimony for**  
14 **Kansas City Earnings Tax?**

15 A: Yes. On pages 9 and 10 of my Rebuttal Testimony, I understated the value of the Kansas  
16 City, Missouri Earnings Tax issue as \$721,000 based on Kansas City Power & Light  
17 Company’s (“KCP&L or “Company”) projected case as of August 31, 2012. It should  
18 have been reflected as \$931,000.

1 **Q: Have different methods been used for computing Kansas City Earnings Tax by**  
2 **KCP&L and the Staff in prior rate cases?**

3 A: Yes. In Case No. ER-2007-0291 KCP&L included the Kansas City Earnings Tax as a  
4 general tax, consistent with its presentation in Case No. ER-2006-0314, instead of as a  
5 component of income taxes in KCP&L's revenue requirement model and Staff  
6 inadvertently included it as both a general tax and as a component of income taxes. The  
7 Company prepared a memo in December 2007 that documented the differences in the  
8 methods used by KCP&L and the Staff and proposed some recommendations for  
9 changing the calculations in the future. A copy of this memo is provided as Schedule  
10 MKH-7.

11 **Q: Was the Company and Staff able to come to a resolution on the method that should**  
12 **be used to compute the Kansas City Earnings Tax?**

13 Yes. After several discussions with Staff during 2008, the Company and Staff agreed  
14 that it was appropriate for the Kansas City Earnings Tax to be removed from general  
15 taxes and that it should be included as a component of income taxes. Attached, as  
16 Schedule MKH-8, is a copy of a string of emails in 2008 that documents the Staff's  
17 agreement with the proposed changes.

18 **Q: Have there been any changes in law since 2008 that would change the method for**  
19 **computing Kansas City Earnings Tax?**

20 A: There have not been any changes to the statutes related to Kansas City Earnings Tax  
21 since 2008 that would change how it should be computed.

1 **Q: What method has the Company used for computing Kansas City Earnings Tax in**  
2 **this case?**

3 A: The Company has followed the agreement it made with the Staff in 2008. Therefore, the  
4 Kansas City Earnings Tax has been removed from general taxes and has been included as  
5 a component of income tax expense in our revenue requirement model.

6 **Q: Does the Company believe that it is appropriate to continue to include Kansas City**  
7 **Earnings Tax as a component of income tax expense?**

8 A: Yes. Please refer to pages 1 through 11 of my Rebuttal Testimony for a detailed  
9 explanation of why it is appropriate to include Kansas City Earnings Tax as a component  
10 of income tax expense.

11 **IATAN 2 ADVANCED COAL TAX CREDITS**

12 **Q: What is Staff's position regarding the reallocation of Iatan 2 Advanced Coal Tax**  
13 **Credits to KCP&L Greater Missouri Operations Company ("GMO") from**  
14 **KCP&L?**

15 A: Mr. Featherstone states on page17 of his Rebuttal Testimony that Staff continues to  
16 support its recommendations related to the Iatan 2 Advanced Coal Credits as presented in  
17 its Cost of Service Report on page 195.

18 **Q: What were the Staff's recommendations?**

19 A: Staff recommended the following actions:

20 1. That the Commission order Great Plains Energy Incorporated ("GPE"), KCP&L and  
21 GMO to request a reallocation [for a second time] between KCP&L and GMO of the  
22 Iatan 2 Qualifying Advanced Coal Tax Credits from the Internal Revenue Service  
23 ("IRS").

1 2. If the IRS does not reallocate these credits to the IRS, then the Staff recommended  
2 that KC&L should be ordered to pay GMO the monetary equivalent to GMO of the value  
3 of the coal credits that should be allocated to GMO.

4 **Q: Does the Company agree with these recommendations?**

5 A: No. We do not. Adopting Staff's recommendations without first obtaining a ruling from  
6 the IRS could have a severe negative financial impact on both KCP&L and GMO.

7 **Q: Why does the Company disagree with the recommendation to request for a second  
8 time a reallocation of credits from KCP&L to GMO from the IRS?**

9 A: The Commission has already ordered the Company to request a reallocation of credits  
10 from KCP&L and GMO in the last case. The Company complied with this order and the  
11 IRS denied our request. We do not believe that the IRS would be willing to reallocate the  
12 credits, even if it was requested again.

13 **Q: Did you retain counsel to provide you with advice on whether to request for a  
14 second time a reallocation of credits from KCP&L to GMO?**

15 A: Yes. The Company requested that Gary Wilcox, an attorney with Morgan, Lewis &  
16 Bockius LLP, provide us with an analysis of the risks associated with another request and  
17 chances of whether or not he believed we would be successful.

18 **Q: What was Mr. Wilcox's advice?**

19 A: Mr. Wilcox stated in his analysis that he believes \*\* [REDACTED]  
20 [REDACTED]  
21 [REDACTED]  
22 [REDACTED]

23 [REDACTED] \*\* A copy of Mr. Wilcox's full analysis is attached as Schedule MKH-9.

1 **Q: Why does the Company disagree with the recommendation for KCP&L to pay the**  
2 **monetary equivalent of the value of the coal credits to GMO?**

3 A: The Company believes that paying the monetary equivalent of the value of the coal  
4 credits to GMO would be a normalization violation and may subject both KCP&L and  
5 GMO to severe penalties under the normalization rules. The normalization rules and the  
6 penalties imposed by the IRS for violating them are discussed in Direct, Rebuttal and  
7 Surrebuttal Testimony of Company witness, Salvatore Montalbano.

8 **Q: Mr. Featherstone states on page 11 of his Rebuttal Testimony that there is**  
9 **uncertainty surrounding whether or not a reallocation of credits to GMO without a**  
10 **reallocation from the IRS, or alternative remedies, would be a normalization**  
11 **violation. Do you agree with Mr. Featherstone?**

12 A: Yes. The Company has always stated that there is not specific guidance related to the  
13 normalization rules based on our facts in this case. However, we have consulted with  
14 two consulting firms who have national experts on the normalization rules. The first firm  
15 is PricewaterhouseCoopers LLP (“PricewaterhouseCoopers”). PricewaterhouseCooper’s  
16 representative, Salvatore Montalbano is an expert witness in this case and he has stated in  
17 his Direct, Rebuttal and Surrebuttal Testimony that the actions recommended by Staff  
18 whereby credits are reallocated to GMO directly or indirectly from KCP&L would likely  
19 be a normalization violation. The second firm, Deloitte LLP (“Deloitte”), has prepared a  
20 private letter ruling for us that we are waiting to send to the IRS to get a definitive ruling  
21 on this issue. As part of this process, KCP&L has also sought guidance from Deloitte  
22 and relied on their guidance for the KCP&L’s position as well as the way the private  
23 letter ruling has been prepared. KCP&L has found no one – including Mr. Featherstone -

1 - who is willing to opine that a reallocation of credits would *not* be a normalization  
2 violation. KCP&L simply does not believe taking the risk would be prudent.

3 **Q: Mr. Featherstone also states in his Rebuttal Testimony on page 17 that “what Mr.**  
4 **Montalbano’s testimony is really attempting to do is scare the Commission about**  
5 **these alleged tax consequences of imputing coal credits to GMO.” Do you agree**  
6 **with this statement?**

7 A: No. The testimony provided by Mr. Montalbano indicates that there is a very real  
8 possibility that a normalization violation would occur if coal credits were reallocated to  
9 GMO without a reallocation by the IRS. The Company takes this risk very seriously and  
10 believes it would not be prudent to agree to a reallocation of credits without guidance  
11 from the IRS that specifically states that it would not be a normalization violation in this  
12 case.

13 **Q: Is the Company willing to request guidance from the IRS on whether a reallocation**  
14 **would be a violation?**

15 A: Yes. As stated in my Rebuttal Testimony on pages 28 and 29, the Company has prepared  
16 a private letter ruling request to get guidance from the IRS and is waiting for information  
17 from the Missouri Staff to send to the IRS. More detail is provided in my Rebuttal  
18 Testimony on the private letter ruling requirements and the information we are waiting on  
19 to send the request.

1 **Q: If the IRS states in a private letter ruling that any of the proposed actions in the**  
2 **private letter ruling request related the Advanced Coal Tax Credits would NOT be**  
3 **a normalization violation, would the Company take such action?**

4 A: Yes. As stated and outlined in more detail on page 29 in my Rebuttal Testimony, the  
5 Company would agree to provide GMO ratepayers with the equivalent amount of tax  
6 benefits they would have gotten if the IRS had agreed to reallocated the Advanced Coal  
7 Tax Credits to GMO. Any action should only impact the revenue requirement of  
8 KCP&L and GMO by the approximate amount of tax benefits that GMO ratepayers  
9 would have received if the IRS had agreed to reallocate the Advanced Coal Tax Credits.

10 **Q: Why has KCP&L not yet sent the request for private letter ruling?**

11 A: As discussed in prior testimony, the IRS requires the Commission to provide certain  
12 information for the PLR. Although the Kansas Corporations Commission has already  
13 signed the needed documentation, KCP&L has not yet received final documentation from  
14 the Staff of this Commission.

15 **Q: Mr. Featherstone also states on page 16 of his Rebuttal Testimony that the Staff**  
16 **believes that “the actions of KCPL constitute affiliate abuse toward GMO.” Do you**  
17 **agree?**

18 A: No. Every action taken by GPE and KCP&L has been to maximize the amount of  
19 Advanced Coal Tax Credits for all of the affected ratepayers. KCP&L was the only joint  
20 owner of the plant who pursued the Advanced Coal Tax Credits with the IRS and the  
21 Department of Energy before the acquisition of GMO. And all actions KCP&L has taken  
22 since it received an allocation of the credits have been taken to avoid any potential



1 normalization violations. It is absurd to state that KCP&L actions taken to prevent a  
2 normalization violation should be considered affiliate abuse toward GMO.

3 **Q: On Page 16 of Mr. Featherstone’s Rebuttal Testimony, he has provided a list of six**  
4 **key facts [imprudent actions] that were not addressed in KCP&L’s Direct**  
5 **Testimony related to the coal credits. Have these actions been addressed in**  
6 **subsequent testimony?**

7 A: Yes. I have specifically addressed each allegation outlined by Mr. Featherstone in my  
8 Rebuttal Testimony starting on page 19. The Company strongly disagrees with each  
9 assertion and has provided a detailed explanation in my Rebuttal Testimony.

10 **Q: Has the Company addressed these actions in any other manner in this case?**

11 A: Yes. KCP&L has had multiple conversations with the Staff, provided explanations in  
12 multiple data requests and provide technical analysis at every possible point in this case.  
13 I have attached data request number 0289 as Schedule MKH-10 as one example where  
14 the Company has tried to address the concerns of the Staff around these actions. In  
15 addition to data request number 0289, the Company has received approximately one  
16 hundred data requests related to this issue in this case or in prior cases. It is very  
17 frustrating and disturbing to me that the Staff continues to assert that we have not  
18 provided information to explain or address our actions as it relates to the Advanced Coal  
19 Tax Credits.

20 **Q: On page 17 of his testimony, Mr. Featherstone refers to KCP&L’s decision-making**  
21 **in this case as “self serving.” Please address this comment.**

22 A: KCP&L's position is that the company will reallocate credits to GMO should the IRS  
23 approve of such treatment. Because KCP&L and GMO share a common parent, there is

1 really no issue of which company will be better served. KCP&L's sole motivation is to  
2 avoid adverse tax treatment and avoid the significant risk of financial harm. Mr.  
3 Featherstone's testimony identifies no other motive for KCP&L's position in this case  
4 and does not explain what is meant by his comment that KCP&L's decision is "self  
5 serving." KCP&L appears to have an honest disagreement with Staff about how the IRS  
6 will treat an attempt to reallocate tax credits. KCP&L's position is based on the opinions  
7 of highly qualified outside professionals, while Mr. Featherstone's opinion appears to be  
8 based on his understanding of the "spirit of the normalization rules." *See* Featherstone  
9 Rebuttal at page 10. The prudent way to resolve this disagreement is by all parties  
10 coming together and seeking a PLR from the IRS, a ruling by which KCP&L will gladly  
11 abide.

12 **Q: Does that conclude your testimony?**

13 **A:** Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the Matter of Kansas City Power & Light                    )  
Company's Request for Authority to Implement            )        Case No. ER-2012-0174  
A General Rate Increase for Electric Service            )

**AFFIDAVIT OF MELISSA K. HARDESTY**

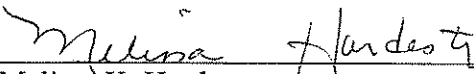
**STATE OF MISSOURI     )**  
  **) ss**  
**COUNTY OF JACKSON    )**

Melissa K. Hardesty, being first duly sworn on her oath, states:

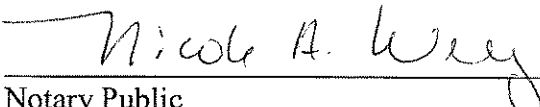
1. My name is Melissa K. Hardesty. I work in Kansas City, Missouri, and I am employed by Kansas City Power & Light Company as Senior Director of Taxes.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of Kansas City Power & Light Company consisting of nine (9) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

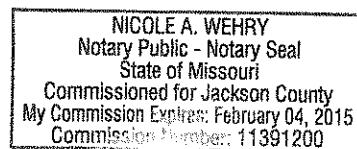
3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

  
\_\_\_\_\_  
Melissa K. Hardesty

Subscribed and sworn before me this 8<sup>th</sup> day of October, 2012.

  
\_\_\_\_\_  
Notary Public

My commission expires: Feb. 4 2015



**Chris Davidson**  
**12-26-07**

## **Analysis of Model Treatment for KCMO Earnings taxes – EMS and KCPL Revenue Requirements Model**

### **Overview**

KCMO Earnings Tax (Earnings Tax) impacts the traditional revenue requirement. It also impacts the calculation of additional amortization to meet credit ratios through the application of an effective income tax rate that includes Federal, State and Earnings Taxes. It appears that neither the KCPL Revenue Requirement Model nor the MPSC Staff EMS Model is handling the Earnings Tax entirely correctly. The Reconciliation is also not prepared consistently between Staff and KCPL.

The EMS appears to be including the Earnings Tax both through inclusion of “per books” general taxes recorded in KCPL account A/C 708 (FERC 408), as well as in A/C 709 (FERC 409) through calculation of income tax expense for Federal, State and City components based on adjusted Missouri jurisdictional taxable income. The amount reflected for book income tax expense in A/C 709 is adjusted to this target amount. Note that the Earnings Tax included in A/C 708 is multiplied by an allocation factor, without recognition that KCMO Earnings Tax is 100% Missouri jurisdictional. Consequently, Earnings Tax is reflected in the EMS at about 150% of the appropriate amount. The calculation methodology for Missouri jurisdictional annualized earnings tax calculated in A/C 709 is also flawed, although the errors are substantially offsetting.

Until the September 2007 True Up, the KCPL model improperly assumed that only 50% of the Earnings Tax was deductible when calculating State income taxes. Additionally, the Earnings Taxes is reflected in A/C 708 as a general tax and not in A/C 709 as an income tax. Consequently, the effective income tax rate used on the MPSC Staff reconciliation for “income tax expense” excludes the Earnings Tax component. This causes two issues: 1) Staff income tax expense includes Earnings Tax while KCPL income tax amounts do not, and 2) adjustments and settlements reflected on the Reconciliation (and not in the KCPL Model) only receive the offsetting impact of Federal and State income taxes and not Earnings Tax. The effective Earnings Tax rate used to determine the Earnings Tax impact of adjustments is calculated on a Total Company basis and understates the pro-forma impact of Earnings Tax on the Missouri jurisdictional revenue requirement by about 45%.

### **MPSC Staff EMS (dated 12-6-2007)**

The Staff EMS run appears to include Earnings Tax in more than one line item.

1. Schedule 9 - Income Statement, line 108 - 708.000 Taxes Other Than Income –
  - a. The Total Company “per books” amount of \$68,646,335 includes \$544,334 from the December 2006 KCPL Trial Balance A/C 708110,

Earning Tax Electric. There are no adjustments to this line item for Earnings Tax.

- b. The entire total company adjusted line item amount, which totaled \$72,400,589 after adjustments, was allocated 54.4380% to Missouri (for \$39,413,433), despite the fact that 100% of the Earnings Tax should have been attributed to Missouri jurisdictional. Resulting Missouri jurisdictional Earnings Tax in A/C 708 was \$296,325. Note that Missouri gross receipts taxes, which are allocated 100% to Missouri, are reflected on Schedule 9, line 109.
2. Schedule 11 – Income Tax –
- a. The calculation of income taxes begins with the Missouri jurisdictional, Net Income Tax Before Taxes (line 1) carried forward from Schedule 9, line 11, column F. For the 2007 rate case, the final EMS reported this test year amount as \$128,608,985. Note that this amount includes a deduction of \$296,325 ( $\$544,334 \times 54.4380\%$ ) for Earnings Tax expense.
  - b. Numerous additions and subtractions are made to arrive at Missouri jurisdictional Net Taxable Income on line 16. None of these additions or subtractions relate to Earnings Tax.
  - c. Federal State and City income taxes were calculated and reflected on lines 32 through 34, in the amounts of \$27,654,499, \$4,345,707 and \$518,771, respectively. For the 2007 rate case, the final EMS showed adjusted test year income taxes of \$32,518,977, including the Earnings Tax of \$518,771.
  - d. Note that the calculated Federal and State income tax expense was understated because the amount subject to tax included deductions for the \$296,325 allocated amount in A/C 708 and the actual calculation of federal and state taxes included an additional \$518,771 amount calculated on Schedule 11.
  - e. Note that the calculated Federal and State income tax expense was misstated because it was calculated on Schedule 11, line 31, as 1% of the Missouri jurisdictional City Taxable Income as shown on line 30. This is erroneous because the 1% rate does not apply to all of the Missouri jurisdictional taxable income but only to that portion attributable to Kansas City, Missouri. However, this error is offset because the amount calculated by the EMS as the City Taxable Income is misstated. The EMS begins with the amount of Federal Taxable Income (line 27) and deducts 100% of the Missouri jurisdictional Federal and State income taxes (lines 28 and 29). Per Melissa Hardesty, when calculating the amount subject to KCMO Earnings Tax, there are no deductions for Federal or State income taxes. Consequently, the EMS calculates Earnings Tax as 1% of \$51,877,126 (Schedule 11, line 30) rather than at 1% of some reduced KCMO only portion of \$83,877,332 (Schedule 11, line 16.)
  - f. Regardless of Notes (d) and (e) the income tax expense as currently calculated by the EMS, including Earnings Tax, was carried forward to Schedule 9 - Income Statement, line 113 – 709.000 current Income Taxes.

3. Consequently, the final EMS included Earnings Tax of \$296,325 as a general tax expense and \$518,771 as an income tax expense, for a total of \$815,096.
4. Total current income tax expense of \$32,518,977 (Schedule 11, line 35) results in a combined effective income tax rate of 38.77%, including Earnings Tax, when compared with Taxable Income of \$83,877,332 (Schedule 11, line 16.) This translates to an income tax gross up factor of 1.633178 ( $1 / (1 - 38.77\%)$ ). These factors are reflected in the final EMS and associated revenue requirement calculation.
5. The effective income tax rate excluding Earnings Tax was 38.15% ( $(\$27,654,499 \text{ federal} + \$4,345,707 \text{ state}) / 83,877,332 \text{ taxable income}$ ), reduced from the otherwise expected effective tax rate of 38.39% due to the EMS treatment of the wind and R&D tax credits. Because EMS is not able to deal with tax credits, \$4,784,523 of adjusted Missouri jurisdictional tax credits (KCPL Schedule 7, line 7-064) was treated in EMS as \$12,462,941 of deductions (Schedule 11, lines 13 and 14). Comparison of the embedded tax rate of 38.77% with the 38.15% indicated that the effective tax rate for Missouri jurisdictional earnings tax included in income tax expense was .62%. (Note that the Staff method assumes that the wind/R&D pseudo-deduction is the same for federal and state income taxes. However, only 50% of the federal tax credits should be considered for the state income tax calculation.)

#### **Staff Calculation of Additional Amortization To Meet Credit Ratios**

The effective income tax rate used by Staff on line 69 of the calculation is consistent with the effective income tax rate embedded in its EMS run.

#### **KCPL Revenue Requirement Model**

KCPL's Revenue Requirement Model appears to be handling Earnings Tax substantially correctly subsequent to the modification made for the September 2007 True Up in which the amount of earnings tax deduction for state income tax calculation was increased to 100%. There is an error in the calculation of Earnings Tax on the pro-forma revenue requirement "Ask" that will be discussed below. There is also an inconsistency between the "income tax" expense classification used by Staff and the "general tax" expense classification used by KCPL.

The overall mechanics for Earnings Tax calculation in the KCPL Revenue Requirement Model are as follows:

1. The KCPL Model reflects both the "per books" unadjusted test year amount, test year adjustments and proforma adjustments on its Schedule 6, Taxes Other Than Income Taxes, line 6-040, KCMO Earnings Tax.
2. Earnings Tax adjustments required due to revenue and cost of service adjustments in the Model are calculated in the Adjustment Model on Schedule 7, Income Taxes, but not included in the final income tax expense amount reflected on Schedule 7. While they are calculated on Schedule 7, they are reflected and included in the totals on Schedule 6.

3. Line 7-053, Income Subject to Taxation, shown on Schedule 7, does not reflect any deduction for Earnings Tax. The amount of general taxes included as a deduction on line 7-019, Other Taxes W/O Earnings & Environmental Tax, reflects the subtotal from Schedule 6, line 6-036, which excludes Earnings Tax.
4. Earnings Tax for the adjusted Missouri jurisdictional Income Subject to Taxation is calculated in three pieces: “per book” amount from the KCPL Trial Balance for the 12- month test year, Earnings Tax impact of each adjustment reflected in the Adjustment Model, and calculation of the Earnings Tax impact of the pro-forma net income resulting from the requested revenue requirement. All amounts are allocated 100% to Missouri jurisdictional. The second and third amounts are determined by applying the earnings tax rate from the MISC % schedule, line %-014, times the total for each adjustment, including the pro-forma “Ask.”

The application of the book Earnings Tax rate (book Earnings Tax / book Taxable Income) to subsequent adjustment amounts is imperfect. The value on Schedule MISC %, line %-014, Calculated KCMO Earnings Tax, is derived from “per book” amounts shown on Schedule 7. “Per book” KCMO Earnings Tax on line 7-055 is divided by the “per book” Income Subject to Taxation on line 53. The value shown on the September 2007 True Up was .33065% (\$544,334 / \$164,625,804.) For comparison purposes, the value on the September 2006 True Up based on per book values was .20179%. This looks peculiar when compared with the Column 606 (Proforma Missouri Jurisdiction) result after test year and proforma adjustments, the calculated values of which results in a combined Earnings Tax rate of .55425% (\$704,173 / \$126,987,040.) This variance is not meaningful and is caused primarily because the “per book” rate divides Earnings Tax (100% Missouri jurisdictional) by Total Company Taxable Income (Missouri jurisdictional + Kansas jurisdictional) while the Column 606 amount divides the adjusted Earnings Tax (100% Missouri jurisdictional) by the Missouri jurisdictional Income subject to Taxes. Consequently, it could be expected to be slightly less than double the book rate.

The adjusted Missouri jurisdictional taxable income is 59.6% of the Adjusted Total Company Taxable Income (\$93,761,433 / \$157,244,995.) The high jurisdictional percentage was due to the various differences in tax deductions between Missouri and Kansas.

#### **KCPL Calculation of Additional Amortization to Meet Credit Ratios**

For the September True Up, KCPL used Staff’s 38.77% effective tax rate on its Additional Amortization calculation to gross up the additional FFO required to cover Federal, State and Earnings Tax. Because this calculation is based on Missouri jurisdictional amounts, it would be improper to use the effective income tax rate of 38.39% + .33% (above) and would have been more consistent with the KCPL Model to have used 38.39% + .55% (above) or 38.94%. The Staff effective income tax rate is slightly understated because of the treatment of wind and R&D income tax credits. See discussion above.

#### **KCPL Input into MPSC Staff Reconciliation**

The KCPL income tax input on the Income Stmt Schedule of the Reconciliation has been inconsistent with the input from the MPSC Staff. KCPL has tied reconciliation amounts to its Model in which income tax expense excludes Earnings Tax. Consequently, the KCPL effective tax rate for currently payable income taxes equals the 38.39% effective tax rate shown on the KCPL Model MISC % schedule, line 17. Staff, however, ties reconciliation amounts to its EMS income tax expense that includes Earnings Tax. That is why the Staff's effective tax rate is 38.77%. The 38% increase over the KCPL rate is due to an increase to include Earnings Tax, partially offset by a decrease to reflect wind and R&D tax credits as deductions rather than credits. Adjustments made by KCPL on the reconciliation only and outside of the Model are therefore tax-effected by an improper rate, excluding Earnings Tax impact. Note that Staff's effective income tax rate excluding Earnings tax in the final Order is 38.15% ( $(\$27,654,499 + \$4,345,707) / \$83,877,332$ ). It appears low, when compared to KCPL's 38.39% because the Staff turns the wind production and R&D tax credits into deductions, lowering taxable income. KCPL applies the 38.39% to a higher taxable income and then applies the tax credits. The amount of tax credits has no direct relationship with taxable income. Based on the Staff's 38.15% effective tax rate for federal and state income taxes, its incremental Earnings tax rate is .62% (38.77% - 38.15%).

### **Recommendations**

This entire issue requires more analysis. However, I have several preliminary recommendations for rate case purposes:

1. Both Staff and KCPL should include an adjustment to remove book Earnings Tax from A/C 408, Taxes Other than Income, and calculate Earnings Taxes as part of the income tax calculation on adjusted Missouri jurisdictional taxable income. Such taxes should be reflected as a component of income tax expense. The effective income tax rate reflected by KCPL on the Reconciliation would then include Earnings Tax, consistent with the Staff.
2. Staff must modify its calculation of Earnings Tax on EMS Schedule 11 to eliminate inappropriate deductions for federal and state income taxes. It must also take into consideration that not all of the Missouri Taxable Income is subject to a KCMO 1% Earnings Tax.
3. KCPL must add a new MISC % that indicates the effective tax rate for Earnings Tax if applied to the Missouri jurisdictional "Ask" rather than a Total Company amount. It is probably too difficult to vary the %, Total Company vs 100% MO, for individual adjustments. However, if the MO only deferrals and amortizations continue to grow relative to the KS only amounts, this may need to be considered.
4. Melissa Hardesty is considering what would be the most efficient method to calculate Earnings Tax for ratemaking, either a) derive City Taxable Income as a proportion of Missouri jurisdictional taxable income and apply the 1% rate to the result or b) develop an increment to the Missouri jurisdictional effective income tax rate that is less than 1%, taking into consideration that not all Missouri jurisdictional taxable income is subject to the KCMO Earnings Tax. Preliminarily, it seems most efficient to calculate an incremental Missouri jurisdictional effective income tax rate for Earnings Tax such as KCPL's .55%, above, or Staff's .62%, above.





**Davidson Christine**

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**From:** Davidson Christine  
**Sent:** Monday, November 03, 2008 4:28 PM  
**To:** Featherstone, Cary  
**Cc:** 'Traxler, Steve'; Weisensee John  
**Subject:** FW: Agreements on KC Earnings Tax/ tax credit treatment  
**Attachments:** KCMO Earnings taxes.doc; KCMO Earnings Tax.xls

Here is the e-mail that I forwarded to Steve last week about the changes we agreed to make to the KCPL and Staff models regarding tax credits and KCMO City Earnings taxes. Also attached are two files. The Word file was my December analysis of what was happening in each model. The Excel file is a whole series of computations that I made to arrive at the .65 % effective tax rate to add to the MO jurisdictional tax rate. It is based upon the fact that about 65% of the MO jurisdictional taxable income should be subject to the KCMO 1% earnings tax rate. As you can see from the rate computation, the rate varies depending on how you calculate it but .65% seems to be in the middle of the range.

Chris Davidson  
Regulatory Affairs  
816-654-1666

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**From:** Davidson Christine  
**Sent:** Friday, October 31, 2008 11:27 AM  
**To:** steve.traxler@psc.mo.gov  
**Cc:** Weisensee John  
**Subject:** FW: Agreements on KC Earnings Tax/ tax credit treatment

John asked me to forward another copy of this to you.

Chris Davidson  
Regulatory Affairs  
816-654-1666

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**From:** Traxler, Steve [mailto:steve.traxler@psc.mo.gov]  
**Sent:** Tuesday, May 27, 2008 9:19 AM  
**To:** Davidson Christine  
**Subject:** RE: Agreements on KC Earnings Tax/ tax credit treatment

Yes. .65 appears to be correct at this time. I plan to use .65 X Taxable Income and then back into a rate to be applied to Taxable Income less Federal & State income tax because , as you point out, the EMS run cannot be changed to eliminate the reduction for Federal & State income tax when calculating City income tax.

Steve Traxler  
Missouri Public Service Commission  
Regulatory Auditor V  
816-889-3943

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**From:** Davidson Christine [mailto:Christine.Davidson@kcpl.com]  
**Sent:** Wednesday, May 21, 2008 11:09 AM  
**To:** Traxler, Steve  
**Cc:** Branson Aron; Weisensee John  
**Subject:** FW: Agreements on KC Earnings Tax/ tax credit treatment

Steve - Have you had an opportunity to look at this? We need to begin our Revenue Requirement Model changes.

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**From:** Davidson Christine  
**Sent:** Wednesday, May 14, 2008 2:37 PM  
**To:** steve.traxler@psc.mo.gov  
**Cc:** Branson Aron; Weisensee John  
**Subject:** Agreements on KC Earnings Tax/ tax credit treatment

Steve - I thought it would be a good idea to document our agreements this morning on the future treatment of KCMO Earnings Tax and the wind/R&D tax credits in both Staff's EMS and KCPL's Revenue Requirement Models. Our determinations were based on the information I presented this morning, including my analysis of the earnings tax issue dated 12-26-2007. Please confirm that what I present below is also your understanding of how we agreed to proceed.

#### Kansas City Earnings Tax

- Both Staff and KCPL will include a new adjustment to reduce the "per books" KCMO Earnings tax, recorded in A/C 408 - General Taxes, to \$0. Earnings tax will be included as a component of currently payable income taxes.
- Based on the 2006 KCMO Earnings Tax Return, the portion of Missouri Jurisdictional taxable income subject to the KCMO Earnings Tax is established as 65%. This ratio reflects the KCMO taxable income as compared to Missouri jurisdictional taxable income. Given a KCMO tax rate of 1%, the ratio translates to a tax rate of .65% for application to Missouri jurisdictional taxable income. This increment will be added to the composite federal and state rate for purposes of calculating the income tax "gross up" factor used in the reconciliation. This tax rate may move slightly higher or lower from year to year, but the changes will be immaterial unless the proportion of KCMO taxable income to Missouri jurisdictional taxable income changes significantly. Consequently, the rate will not be adjusted each period but can be reevaluated periodically as appropriate.
- Taxable income subject to the KCMO Earnings Tax is equal to the Taxable income computed on

EMS Schedule 11, line 16, and KCPL Schedule 7, line 7-053. Based on the KCMO Earnings Tax regulations, the federal taxable amount is not reduced for either federal or state income taxes.

- It is not possible to modify the current EMS model Schedule 11 to eliminate the federal and state tax deductions currently shown on lines 28 and 29 as part of the calculation of city earnings taxes. Consequently, Staff will first calculate an earnings tax amount equal to line 27 x .65%. Next, Staff will back into an EMS earnings tax rate that will equal the earnings tax amount calculated in step 1 when the modified rate is applied to line 30. This will cause an artificially higher tax rate to be applied to a reduced city taxable income, but result in the correct earnings tax amount.
- KCPL will modify its Schedule 7 income tax calculation to include a new section to calculate the KCMO Earnings tax as line 7-053 x KCMO tax rate. The earnings tax will be reflected in the currently payable income tax subtotals. The earnings tax rate will be input on Schedule MISC%, line %-014. The rate for application to Missouri jurisdictional taxable income will be .65%. It will be .36% for application to total company amounts. The lower "total company" rate reflects that none of the KS jurisdictional portion of total company taxable income is subject to KCMO earnings tax.

#### Wind Production / R&D Income Tax Credits

- Tax credits will be applied after the application of the federal and state statutory tax rates to the taxable income shown on EMS Schedule 11, line 16, and KCPL Schedule 7, line 7-053, (after reducing as appropriate for federal, state and earnings taxes.) Because tax credits do not vary based on the level of taxable income, they do not effect the composite effective income tax rate used to calculate the income tax gross up to the incremental revenue requirement. Further, the tax credits are federal and impact the level of state income tax expense only to the extent that 1/2 of federal income taxes are deductible when computing state income taxes.
- KCPL will continue to reflect tax credits on its Schedule 7 (Income Tax), line 7-064, as a reduction taken after the statutory federal tax rate is applied to the appropriate taxable income.
- Staff will eliminate the imputed deductions currently shown on its Schedule 11, lines 13 and 14, and which currently reduce both federal and state taxable income by the entire amount. Instead, the tax credits will be reflected as an input on Schedule 11 in the same section with other manual adjustments such as that shown on line 40 for amortization of cost of removal from Case No. ER-2007-0291. Transfer of the tax credits from the currently payable calculation to this section will result in a composite tax rate closer to the KCPL composite tax rate of 38.39% (before inclusion of earnings taxes) rather than the 38.15% used in Case No. ER-2007-0291. (Steve - you will need to somehow consider that 1/2 of the federal tax credits will reduce the federal tax deduction taken for the state income tax calculation or state income taxes will be understated.)

I believe that these modifications by both Staff and KCPL will result in a more appropriate, consistent treatment of these items and eliminate many of the reconciliation difficulties that we have experienced in the past. Please verify that this is also your understanding of how we will treat these items in the future. I can be reached at 654-1661 if you would like to discuss further.

**Computation of Kansas City Missouri Earnings Tax factors**

Year	Per Books KCMO Earnings Tax	Source	MO Juris Taxable Income	Source	Factor
2007	Per Books	462,816 A/C 408110			
	Add back adj-06 overpayment	95,975			
	Trsf from GPES	32,955 A/C 923100			
		<u>591,746</u>	<u>108,600,957</u>	Sch 7, Col 604, line 7-053	0.5449%
2006	Per Books	544,334 A/C 408110			
	Trsf from GPES	94,282 A/C 923100			
		<u>638,616</u>	<u>77,864,476</u>	Sch 7, Col 604, line 7-053	0.8202%
		(95,975)		KCPL rate case for adjs	0.3306% Error
		<u>542,641</u>			Tot Company incl KS
<b>Surveillance Report</b>		<b>2,006</b>	<b>2,007</b>		
	MO Taxable Income	77,864,476 c	108,600,957		
	Total Adj Company Taxable Inc	155,147,152 d	190,930,529		
	Earn Tx factor on Tot Company	36.15% b	36.15%		
	MO Juris as % of Total Co	50.19% c/d = a	56.88%		
	MO Taxable subject to 1% City	72.02% b/a	63.55%		
	City Earnings at 1%	1.00%	1.00%		
	Effective City Tx Rate on MO Juris	<u>0.72%</u>	<u>0.64%</u>		
<b>Sept 07 True Up</b>					
	Missouri Taxable Income		87,253,598 e		83,677,331 = Order
	Total Adjusted Company Taxable Income		145,693,794 f		
	Earning Tax factor - KCMO as % of Total Company		36.15% b		
	Missouri Jurisdictional Taxable Income as % of Total Company		59.89% e/f = g		
	Missouri Taxable Income subject to 1% City Earnings Tax		60.35% b/g		
	City Earnings at 1%		1.00%		
	Effective City Tx Rate on MO Juris		<u>0.60%</u>		
<b>Earnings Tax Return-2006</b>					
	Total Co Tax Inc - Fed as Adj		160,193,194		
	Earn Tx factor on Tot Company		36.15%		
	KCMO taxable income		<u>57,902,471</u> h		
	KCMO/MO taxable income-2006		74.36% h/c		
	City Earnings at 1%		1.00%		
	Effective City Tx Rate on MO Juris		<u>0.74%</u>		
<b>Staff EMS-Sept 07 True Up</b>					
	Effective Tax Rate Incl City Earn		38.77% i		
	Effective Tax Rate Excl City Earn		38.15% j		
	Eff Tax Rate-City Earnings		<u>0.62%</u> = i-j		

**SCHEDULE MKH-9  
THIS DOCUMENT CONTAINS  
HIGHLY CONFIDENTIAL  
INFORMATION NOT AVAILABLE  
TO THE PUBLIC**

*Verification of Response*

**Kansas City Power & Light Company  
AND  
KCP&L Greater Missouri Operations**

**Docket No. ER-2012-0174**

The response to Data Request # 0289 is true and accurate to the best of my knowledge and belief.

Signed: 

Date: July 2, 2012

Company Name: KCPL  
Case Description: 2012 KCP&L Rate Case  
Case: ER-2012-0174

Response to Featherstone Cary Interrogatories – Set MPSC\_20120524  
Date of Response:

Question No. :0289

Identify any and rationale and provide documentation, including but not limited to any and all written communication including all correspondence, e-mails, studies, reports, detailed analyses, etc to support why Great Plains Energy Incorporated, Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company believes GMO is not entitled to and included as part of the allocation the Iatan 2 Advance Coal Tax Credits based on its ownership share of Iatan 2 in (a). late 2006 when KCPL requested the Advance Coal Tax Credits from the Internal Revenue Service (b). April 28, 2008 notice of acceptance by the IRS (c) August 2008 at the time of KCPL's memorandum of understanding with the IRS (d) at any time during the period of July 14, 2008 to present.

**RESPONSE:** (do not edit or delete this line or anything above this)

Before the acquisition of GMO by GPE, GMO did not apply for Section 48A Qualifying Advanced Coal Project Investment Tax Credits in the allocation round for 2006 or 2007. At this time, KCPL believed that income tax items, including tax credits, were the responsibility of each owner in accordance with the operating agreement and did not notify or file on behalf of the other joint owners for tax credits. In addition, KCPL believed that a taxpayer had to have 400 Megawatts or more of nameplate capacity of a qualifying facility to qualify per IRC Section 48A. GMO and the other owners did not meet this requirement. In addition, GMO would likely not have been able to utilize the credits since it was not paying income taxes due to significant net operating losses.

In October 2008, subsequent to the acquisition by GPE, GMO became aware that there was an additional \$250 million of credits available to be awarded and did file an application for the advanced coal investment tax credits in 2008. The IRS denied GMO's application and indicated that the full \$125 million of credits available for the Iatan 2 plant project had already been awarded to KCP&L in the 2007 allocation round. This was the first indication by the IRS that a definition of a project was not limited to the amount owned by a taxpayer, but included an entire project even if it was owned by multiple parties.

Shortly after the Company received the denial letter from the IRS for GMO's application, Empire began the arbitration proceedings to have credits reallocated to them by the panel. The Company did not include GMO in the arbitration proceedings since it felt strongly



that income taxes were the responsibility of each owner per the operating agreement and because GMO's application had just been denied. In December of 2009, the arbitration panel issued its order to allocate credits to Empire (via an amended Memorandum of Understanding by the IRS). The order does not require any credits to be reallocated or the monetary equivalent of its proportionate share of the credits to be paid to GMO.

Since the IRS denied GMO's application for credits and because GMO was not included in the arbitration order, the Company determined, in consultation with outside counsel, that it was likely that the IRS would not reallocate credits to GMO. In fact, the IRS requested document demonstrating that GMO would not request a reallocation.

Pursuant to the MPSC Order dated March 16, 2011, GPE, KCPL and GMO did request the IRS to reallocate credits to GMO during 2011. The IRS denied this request on September 8, 2011. The Company determined, again in consultation with outside counsel, that requesting a reconsideration of the IRS decision regarding GMO could jeopardize our previous agreement with the IRS regarding the Empire allocation. If this agreement was changed, then it is possible that a normalization violation could occur. A normalization violation would not be in the best interest of GPE, KCPL or GMO.

Since the IRS denied the request and no allocation has been made by the IRS, GPE, KCPL and GMO have not included any credits for GMO in the rate case proceedings due to the normalization rules outlined below.

Section 48A Qualifying Advanced Coal Project Investment Tax Credits (ITC) are subject to the normalization rules set forth in IRC Section 46(f). IRC Section 46(f)(2)(A) states that if the taxpayer's cost of service for ratemaking purposes or its regulated books of account is reduced by more than a ratable portion of the credit, then no credit is allowed. Since GMO has not been awarded any Section 48A credits, it is not allowed to include any Section 48A credit to reduce income tax expense for ratemaking purposes.

Regulation 1.46-6(b)(4) also states that the indirect reductions to cost of service of a taxpayer are also considered a violation. This includes any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service. Several private letter rulings have interpreted the restrictions against indirect reductions of cost of service related to ITC and have held that various ratemaking proposals would violate the normalization requirements. Most recently, PLR 200945006 addressed the sale of regulated gas distribution assets from one utility to another. At issue was whether the accumulated deferred ITC of the selling utility could be transferred to the buying utility to ultimately be used to reduce the rates of the buying utility. The IRS National Office held that the selling utility would violate the requirements of the investment tax credit normalization rules set forth in former section 46(f), if it directly or indirectly passes the accumulated deferred ITC balance to another taxpayer who did not claim such ITC tax benefits. Therefore any indirect allocation of credits to GMO would also be normalization violation under IRS regulations.

Per the Tax Reform Act of 1986 Section 211(b), the penalty for a violation of the ITC normalization requirements is the recaptured/repayment to the IRS the greater of ITC claimed in all open tax years as of the date of the violation or the amount of ITC tax credit remaining on the taxpayers' books of account. This would include all accumulated deferred ITC remaining on GMO for any other previous qualifying investment tax credit properties. Therefore, if GMO included benefits of Section 48A credits in violation of the normalization rules, GMO would be not only be including benefits of Section 48A credits that it never received on any tax return, it would have to pay the IRS for all outstanding ITC remaining on its books for previous investment tax credit properties.

KCP&L objects to the extent this request seeks attorney-client privileged information, attorney work product information, and/or accountant-client privileged information. A privilege log will be produced in a supplemental response.

A disc containing non-privileged materials responsive to data requests 0285, 0286, 0287, 0288, and 0289 will be provided to Staff. The materials are deemed **HIGHLY CONFIDENTIAL** pursuant to 4 CSR 240-2.135.

Additional documentation has also been provided as a response to Data Requests: 0289, 0294, 0295, 0307, 0309, 0310, 0313, 0314, 0315, 0317, 0321, 0322, 0324, 0330, 0331, and 0334.

Attachment:  
Q0289 MO Verification.pdf