Exhibit No.:
Issue: Accumulated Deferred Income Taxes
Property Taxes, Franchise Taxes, and
Income Tax Expense
Witness: Melissa K. Hardesty
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Kansas City Power & Light Company
Case No.: ER-2014-0370
Date Testimony Prepared: May 7, 2015

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2014-0370

REBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
May 2015

" ** " Designates "Highly Confidential" Information Has Been Removed.**

REBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

Case No. ER-2014-0370

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: By whom and in what capacity are you employed?**

5 A: I am employed by Kansas City Power & Light Company ("KCP&L" or the "Company")
6 as Senior Director of Taxes.

7 **Q: What are your responsibilities?**

8 A: My responsibilities include management of KCP&L's taxes, including income, property,
9 sales and use, and transactional taxes.

10 **Q: Please describe your education, experience, and employment history.**

11 A: I graduated from the University of Kansas in 1996 with a Bachelor of Science in
12 Accounting. I am a Certified Public Accountant with a permit to practice in the State of
13 Kansas. After completion of my degree, I worked at the public accounting firm Marks,
14 Stallings & Campbell, P.A. as a staff accountant from 1996 to 1999. In 1999, I went to
15 work for Sprint Corporation as a Tax Specialist in the company's federal income tax
16 department. I held various positions at Sprint from 1999 to 2006. When I left Sprint to
17 join KCP&L in December 2006, I was Manager of Income Taxes for Sprint's Wireless
18 Division. I joined KCP&L as the Director of Taxes and was subsequently promoted to
19 my current position of Senior Director of Taxes for KCP&L in May of 2009.

1 **Q: Have you previously testified in a proceeding at the Missouri Public Service**
2 **Commission ("MPSC" or the "Commission") or before any other utility regulatory**
3 **agency?**

4 A: Yes. I have testified before the MPSC.

5 **Q: What is the purpose of your testimony?**

6 A: The purpose of my testimony is to respond to the proposed tax related adjustments
7 included in the Direct Testimony of Michael L. Brosch filed on behalf of Missouri
8 Energy Consumers Group ("MECG"), William Addo on behalf of the Office of Public
9 Counsel ("OPC"), and Matthew Young and Keith Majors on behalf of the Missouri
10 Public Service Commission ("MPSC" or the "Commission") Staff.

11 **Q: What are the tax related adjustments proposed by Mr. Brosch?**

12 A: Mr. Brosch has proposed four adjustments to the amount of accumulated deferred income
13 taxes ("ADIT") in rate base and several adjustments to how the income tax expense is
14 computed in cost of service.

15 **Q: What are adjustments that impact the amount of ADIT included in rate base?**

16 A: Mr. Brosch has proposed four adjustments that impact the amount of ADIT that is
17 included in rate base. The first adjustment is to include the construction work-in-progress
18 ("CWIP") related ADIT liability balance in rate base. The second adjustment is to
19 exclude the ADIT asset balance related to the lease on the KCP&L downtown office
20 building ("1KC Lease") from rate base. The third adjustment is to exclude the ADIT
21 asset balance related to deferred employee compensation and bonus pay from rate base.
22 And the fourth adjustment is to compute the amount of net operating loss ("NOL")
23 carryforward ADIT asset in rate base on a KCP&L standalone basis instead of using the

1 amount computed under the Company's tax allocation agreement ("TAA") with Great
2 Plains Energy, Inc. ("GPE") and its other subsidiaries.

3 **Q: Do you agree with the proposed adjustments to ADIT made by Mr. Brosch?**

4 A: No. I do not. I will discuss each proposed adjustment below.

5 **INCLUSION OF ADIT LIABILITY RELATED TO CWIP IN RATE BASE**

6 **Q: Please describe this proposed adjustment?**

7 A: The first proposed adjustment is related to the inclusion of the ADIT liability related to
8 CWIP that has not previously and will not be placed in service in this case. The
9 Company has excluded the ADIT liability since the capital expenditures have not been
10 included in rate base. In this case, Mr. Brosch has argued that since ratepayers are paying
11 a return on the CWIP investment, in the form of allowance for funds used during
12 construction ("AFUDC"), that it should be allowed to include the ADIT liability in rate
13 base before the asset is placed in service.

14 **Q: Do you agree that CWIP capital expenditures earn a return in the form of AFUDC?**

15 A: Yes. CWIP capital expenditures do earn a return in the form of AFUDC. And, as Mr.
16 Brosch states the amount of AFUDC earned is based on the gross investment (without
17 any reduction for ADIT). However, I do not agree that in KCP&L's case that the
18 AFUDC earned on a gross investment will over-compensate for the Company's actual
19 investment in newly constructed assets.

20 **Q: Why do you disagree with Mr. Brosch's assertion that the ratepayers will over-**
21 **compensate the ratepayers since the AFUDC is based on the gross investment?**

22 A: Mr. Brosch appears to argue that the Company will get an out of pocket cash tax benefit
23 for tax basis differences related to CWIP. Mr. Brosch argues that this out of pocket cash

1 tax benefit is not included in the AFUDC computation and therefore rate base should be
2 reduced for this ADIT related to the CWIP tax basis differences before the assets are
3 placed in service to compensate ratepayers for this free loan. However, KCP&L
4 generated an NOL during the period that the assets were in CWIP and it has not and will
5 not receive a cash tax benefit related to the tax basis differences related to CWIP in this
6 case. Therefore, I believe the ratepayers have not been denied any tax cash benefit in the
7 computation of AFUDC and the ADIT liability should not be included in rate base prior
8 to being placed in service.

9 **Q: Do you have any other concerns with including ADIT related to CWIP in rate base?**

10 A: Yes. Even if we did get a tax cash benefit related to CWIP, AFUDC is only an
11 accounting entry that increases non-cash income during the construction period of an
12 asset. This entry has no effect on revenue requirement during the construction period and
13 does not result in a cash return on or the return of the CWIP investment during
14 construction. Only once the asset is placed in service (and if allowed by the Commission
15 in the Company's next rate case), then and only then will rates reflect the plant that is
16 placed in service. If the ADIT associated with CWIP is included in rate base before the
17 assets that it is associated with, then customer rates today would be reduced on account of
18 expenditures for which ratepayers have not yet funded and which they do not yet support.
19 This rate reduction would reduce the Company's cash flow at time when the funds are
20 needed most to invest in the assets under construction. The timing of inclusion in rate
21 base for the ADIT generated on CWIP should be at the same time that the assets it is
22 related to are included in rate base.

1 **Q: How are the facts for KCP&L different from the decision on CWIP related ADIT**
2 **addressed by the MPSC in Union Electric Company (d/b/a Ameren Missouri)**
3 **("Ameren") Case No. ER-2012-0166?**
4 A: Mr. Brosch states that the relevant facts are the same for KCP&L as in the 2012 Ameren
5 case. However, the 2012 Ameren rate case order was silent regarding whether a NOL
6 was generated for Ameren and Mr. Brosch did not address whether an NOL was
7 generated by Ameren and whether or not this fact would have changed the outcome on
8 this issue in that case. KCP&L did have an NOL for 2014 that precluded it from
9 receiving the tax cash benefit identified by Mr. Brosch for tax basis differences related to
10 CWIP in his testimony. Because of the NOL, KCP&L's credit ADIT balance was not a
11 free loan to the Company from ratepayers and there is no justification for including
12 CWIP-related ADIT balances as an offset to KCP&L's rate base.
13 **Q: Has anyone else proposed an adjustment similar to this one in the case?**
14 A: Yes. Mr. Majors has also proposed that ADIT related to CWIP be included in this case.
15 **Q: Does Mr. Majors have the same reasons as Mr. Brosch for including ADIT related**
16 **to CWIP?**
17 A: Yes. Mr. Majors also cites the decision on CWIP related ADIT in the Ameren Case No.
18 ER-2012-0166. As mentioned above, this case does not provide support for including
19 ADIT related to CWIP as an offset to rate base because Ameren did not address whether
20 or not an NOL precluded it from receiving a tax cash benefit.

1 **Q: Do you have any additional comments regarding Mr. Majors' testimony on this**
2 **issue?**
3 A: No. The explanations given in response to Mr. Brosch's testimony cover all the issues
4 raised.

5 **<u>EXCLUSION OF ADIT ASSET RELATED TO THE 1KC LEASE FROM RATE BASE</u>**

6 **Q: Please describe this proposed adjustment?**
7 A: The second proposed adjustment is related to the exclusion of the ADIT asset related to
8 the 1KC Lease. In this proposal, Mr. Brosch argues that the accrued liability for the
9 deferred rent payments on the 1KC Lease on KCP&L's books was not included in rate
10 base, therefore the ADIT on this tax timing difference should also be excluded from rate
11 base.
12 **Q: Do you agree that the accrued liability for the deferred rent payments on the 1KC**
13 **Lease has been excluded from rate base?**
14 A: Yes. The accrued liability for the deferred rent payments on the 1KC Lease has not been
15 included in rate base.
16 **Q: Then why do you believe that the ADIT asset related to the 1KC Lease should be**
17 **included in rate base?**
18 A: This accrued liability is being amortized monthly as a reduction to rent expense. This
19 reduced rent expense is included in the cash voucher line within the expense lead day
20 calculations of KCP&L's lead lag study. Although there has not been a separate lead lag
21 computation on the 1KC Lease directly, the reduction in rent expense is included in the
22 overall cash working capital computations and in the rent expense included in cost of

1 service. Therefore, the impact of this liability has been included in this case and the
2 ADIT asset related to this liability should also be included in rate base.

3 **EXCLUSION OF ADIT ASSET RELATED TO EMPLOYEE COMPENSATION AND**
4 **BONUS PAY FROM RATE BASE**

5 **Q: Please describe this proposed adjustment?**

6 A: The third proposed adjustment is related to the exclusion of the ADIT asset related to
7 accrued employee compensation and bonus pay from rate base. This proposal is similar
8 to the proposal for the 1KC Lease, whereby the liability for the accrued employee
9 compensation and bonus pay is not in rate base so the ADIT asset related to this tax
10 timing difference should also be excluded.

11 **Q: Do you agree that the accrued liability for the employee compensation and bonus**
12 **pay have been excluded rate base?**

13 A: Yes. The accrued liability for the employee compensation and bonus pay has not been
14 included in rate base.

15 **Q: Then why do you believe that the ADIT asset related to the employee compensation**
16 **and bonus pay should be included in rate base?**

17 A: This accrued liability is for two different items. One item is the ADIT asset for the
18 deferred compensation, where certain executives have elected to defer the payout of a
19 portion of their salary and incentive compensation to a future period. The second item is
20 the ADIT asset for the incentive compensation (bonus pay) that is accrued during the
21 year, but is not paid out in cash until March 15 of the following year. For both of these
22 items, the salary and incentive compensation is included in cost of service expense and in
23 the total payroll or cash voucher line on the lead day calculations of KCP&L's lead lag
24 study. Although there has not been a separate lead lag computation on these liabilities

1 directly, the salary and incentive compensation is included in the overall cash working
2 capital computations and in the payroll expense included in cost of service. Therefore,
3 the impact of this liability has been included in this case and the ADIT asset related to
4 this liability should also be included in rate base.

5 **COMPUTATION OF ADIT ASSETS RELATED TO NOLS**
6 **ON A KCP&L STAND-ALONE BASIS**

7 **Q: Please describe this proposed adjustment?**

8 A: In the Company's filing, it reflected the impact of its NOL carryforward for tax purposes
9 as an ADIT asset (a deferred tax asset) of approximately $37.8 million. This had the
10 effect of increasing rate base by that amount (by decreasing the overall ADIT balance
11 which reduces rate base). Mr. Brosch proposes to reduce the NOL carryforward ADIT
12 asset by computing the NOL amounts on a KCP&L "stand-alone" basis instead of using
13 the amounts computed under the GPE and subsidiaries tax allocation agreement. This
14 adjustment would have reduced the Company's direct filing rate base amount by
15 $11,323,199. See Brosch Direct, Schedule MLB-4.

16 **Q: Will you summarize the issue in dispute with respect to this proposed adjustment?**

17 A. Yes, I will. KCP&L reduces its rate base by its net ADIT liability balance (sum of
18 deferred tax assets and deferred tax liabilities) as a result of timing differences between
19 deductions for tax purposes and financial statement purposes. The net deferred tax
20 liability is used to reduce rate base because it represents a source of cost-free capital (a
21 reduction in the amount of cash paid for tax purposes) the Company has received as a
22 consequence of claiming certain tax deductions. In a year that the Company generates a
23 net operating loss for tax purposes that is carried forward, the NOL carryforward reduces
24 the amount of cost-free capital it received. Therefore, the Company has reflected in its

1 rate base computation the actual impact its NOL has had on the amount of cost-free
2 capital it received using the method prescribed under the Internal Revenue Service
3 regulations to allocate losses to companies within a consolidated group. Mr. Brosch
4 proposes an alternative to reflecting the actual quantity of cost-free capital received. He
5 proposes that this Commission impute for this purpose the hypothetical quantity of cost-
6 free capital that the Company would have received if it had always filed a separate
7 federal income tax return ("stand-alone") instead of filing as a member of the GPE
8 consolidated tax group.

9 **Q: Please summarize why you disagree with Mr. Brosch's proposal.**

10 A: Mr. Brosch proposes to impute cost-free capital that the Company did not receive.
11 KCP&L files as part of a consolidated group. Overall, filing consolidated benefits the
12 entire group. However, it is the nature of a consolidated filing that any given member
13 may be better off in some years as a result of consolidated filing and worse off in other
14 years. Mr. Brosch has identified and selected a single point in time when KCP&L may
15 be worse off as a result of consolidated filing to perform his hypothetical assessment of
16 available cost-free capital. This hypothetical computation is just that, "hypothetical," and
17 does not represent the actual economics for the Company.

18 **Q: What produces deferred taxes?**

19 A: Deferred taxes are created when an item of income or expense is recognized for financial
20 reporting purposes in a period that is different from the period in which it is recognized
21 for tax purposes.

22 **Q: What is the source of most of KCP&L's deferred taxes?**

23 A: Accelerated depreciation for tax purposes (including bonus deprecation).

1 **Q: Would you provide an example of how deferred taxes work?**

2 A: Yes. We can look at what happens when a specific asset is placed in service. Assume a
3 $1 million communication asset is placed in service in 2011 and is assigned a 10-year life
4 for regulatory purposes. Its book (or regulated) depreciation rate would, therefore, be
5 10% and rates would be set to allow the company the opportunity to collect $100,000 ($1
6 million multiplied by 10%) in depreciation from its customers each year for 10 years.
7 For tax purposes, however, assume the asset is eligible for 100% "bonus" depreciation
8 and its cost is fully deductible in 2011. Thus, looking at only depreciation for this asset,
9 in 2011 the company would collect $100,000 of taxable revenue and claim a tax
10 deduction of $1 million. Thus, it would produce a net tax deduction of $900,000 ($1
11 million minus $100,000) which, if offset by the company's other taxable income (and
12 assuming a 35% tax rate), would produce incremental cash (*i.e.*, a reduction in the
13 amount of tax otherwise payable) of $315,000 ($900,000 multiplied by 35%).

14 **Q: What is the nature of this cash?**

15 A: This cash represents funds not paid to the government and presently available to the
16 company. However, these funds will have to be paid back to the government over time
17 (similar to a loan). In fact, in the example above, the funds will be paid back over the
18 next nine years. The company will collect $100,000 from its customers to fund the
19 depreciation on the line over the next nine years. However, because the company
20 claimed 100% depreciation on the asset in the first year, it will be entitled to no further
21 depreciation tax deductions. Thus, in each of the nine years, the company will include on
22 its tax return $100,000 of taxable income upon which it will pay $35,000 ($100,000

1 multiplied by 35%) of tax. Over the nine years, it will pay a total of $315,000 ($35,000
2 multiplied by 9) – an amount precisely equal to the cash benefit it enjoyed in 2011.

3 **Q: So the repayment of the government "loan" is made by filing future tax returns?**

4 A: Yes.

5 **Q: What are the consequences of the "loan" being repaid in this way?**

6 A: Because the loan is repaid by the filing of future tax returns, there is no interest
7 associated with it. That is why it represents cost-free capital.

8 **Q: How does this relate to deferred taxes?**

9 A: The outstanding loan balance is reflected as a deferred tax liability in rate base.

10 **Q: Why is this deferred tax liability treated as a reduction in rate base?**

11 A: Because the company had incremental capital in the amount of its deferred tax liability
12 for which it did not incur a carrying cost, it is properly reflected as a reduction to rate
13 base. Thus, the ratepayers receive the entire benefit of the interest-free feature of the
14 loan.

15 **Q: What is a NOL?**

16 A: An NOL is created when, in any year, a taxpayer reports more deductions than it has
17 taxable income. Under the generally applicable tax rules, an NOL can be carried back
18 two years or forward 20 years. In the year in which it is carried to, an NOL is treated like
19 an additional deduction, reducing the taxable income otherwise produced in that year.
20 The general rule is that an NOL must be carried back to the earliest possible year and
21 then, to the extent not absorbed, applied to subsequent years in chronological order.

1 **Q: What is the impact of carrying an NOL forward on the cost-free capital?**

2 A: When an NOL must be carried forward, a portion of the deductions claimed by the
3 taxpayer in the year that the NOL is created will not offset taxable income and not reduce
4 the taxpayer's tax liability – thus, no cost-free capital was received for the amount of
5 NOL that did not reduce the tax liability.

6 **Q: Please provide a simple example of how this works.**

7 A: Assume a 35% tax rate in all years. In each of three years, the company produces taxable
8 income before accelerated depreciation of $100. In both Year 1 and Year 2, the company
9 claims $100 of accelerated depreciation and in Year 3 it claims $300. Thus, while in
10 Years 1 and 2, the company produces $0 taxable income, in Year 3 the company
11 produces an NOL of $200 ($100 minus $300), all of which it must carry forward. In each
12 year, $100 of accelerated depreciation is used to offset the company's $100 taxable
13 income before accelerated depreciation. As a result, in each year the accelerated
14 depreciation it claimed reduces the company's tax due by $35 ($100 multiplied by 35%).
15 However, with respect to the remaining $200 of Year 3 accelerated depreciation, the
16 company receives no incremental cash.

17 **Q: What if company's Year 3 accelerated depreciation deduction was $500 or $1,000**
18 **instead of only $300?**

19 A: It wouldn't matter. If, in Year 3, the company were to claim $500 or $1,000 or even $1
20 million of accelerated tax depreciation, no deduction in excess of $100 would produce
21 any additional cash – at least, not in Year 3. Additional cash would only be produced in a
22 future year when the NOL carryforward is used to reduce a tax liability that would
23 otherwise be due in that year.

1 **Q: What, then, is the significance of an NOL carryforward?**

2 A: In terms of the "loan" analogy I used previously, the government does not extend a loan
3 until the accelerated tax depreciation deduction is ***both*** claimed on a tax return ***and*** is
4 used to reduce a tax liability. In terms of the example, as of the end of Year 3, the
5 governmental loan extended with respect to that year's accelerated depreciation
6 deduction is $35 ($100 multiplied by 35%), not $105 ($300 multiplied by 35%).

7 **Q: How is this situation represented in the company's records?**

8 A: The company reflects as a deferred tax liability in rate base the tax benefit of its favorable
9 tax deductions regardless of whether or not they actually produce cash (in the example,
10 35% X $300 or $105). However, it also includes the amount of the loan that has not yet
11 been made but that will be made in the future (35% X $200 or $70) as a deferred tax
12 asset. You can look at the deferred tax asset as a future cash flow – like a receivable or
13 any other asset. Until the NOL carryforward is used to offset a future year's taxable
14 income, the tax deductions that created the NOL carryforward do not produce any cost-
15 free capital.

16 **Q: How is the NOL carryforward represented for ratemaking purposes?**

17 A: Where there is an NOL carryforward, the true level of cost-free capital received by the
18 company is the net of its deferred tax liability balance and its deferred tax asset balance –
19 in the example, the $105 deferred tax liability balance less the $70 deferred tax asset
20 balance. The net, $35, represents the tax avoided in Year 3 by claiming accelerated
21 depreciation and, consequently, the actual economics of the company's access to cost-
22 free capital. This is how the deferred tax liabilities and assets are reflected on the
23 company schedules for ADIT.

1 **Q: Does Mr. Brosch dispute any of the economics or ratemaking implications you have**
2 **described above in his testimony?**
3 A: No. Mr. Brosch appears to focus on how the deferred tax asset for the NOL carryforward
4 is computed.
5 **Q: How has the Company computed the deferred tax asset for NOL carryforwards?**
6 A: In its calculations, the Company has used the actual amount of cost-free capital it actually
7 received. That is, it has used the amounts reflected on its financial records. These
8 amounts reflect the actual cash that the Company has received in connection with the
9 claiming of its tax deductions.
10 **Q: What does Mr. Brosch propose?**
11 A: Mr. Brosch proposes to compute this amount as if the Company filed and continues to
12 file its tax returns on a "stand alone" basis. He proposes that the amount be computed as
13 if the Company didn't file as a member of the consolidated tax return group. He
14 proposes that this Commission impute an additional amount of cost-free capital equal to
15 the additional amount that would have had been received as of the end of the true up
16 period had KCP&L filed on this "stand alone" basis. He estimates that, on a hypothetical
17 "stand alone" basis KCP&L would have been able to use more of its own NOL
18 carryforwards and should reduce its NOL carryforward deferred tax assets in its rate base
19 calculation.
20 **Q: Why does he propose this?**
21 A: Mr. Brosch proposes his "stand alone" view because it produces more cost-free capital
22 than the Company actually received. Thus, reducing the amount of deferred tax asset
23 included in rate base.

1 **Q: Please explain how using a "stand alone" analysis can produce a result that is**
2 **different from what actually occurs.**
3 A: As I previously indicated, when a company produces an NOL, it can be carried back two
4 years and forward 20 years. The same rules apply to a consolidated group. When a
5 consolidated group produces a consolidated NOL, it can be carried back against the
6 group's consolidated taxable income for the prior two years and forward to the
7 subsequent 20 years. On a consolidated income tax return, the net taxable income or loss
8 of each of the members of the group are added together to derive a consolidated taxable
9 income or loss amount. Thus, NOLs produced by one member can offset taxable income
10 produced by another member. This is generally a favorable process since it has the
11 capacity to accelerate the use of a loss member's tax deductions. However, the amount
12 of NOL carried forward or carried back will be different than the amount carried forward
13 or carried back on a "stand-alone" return because the overall taxable income or loss for
14 the consolidated return or on a "stand-alone" return is different.
15 **Q: Please provide an example.**
16 A: Assume a consolidated group consists of Company A and KCP&L. Further assume that
17 Company A and KCP&L produce the following taxable income or loss for a two year
18 period: Company A has $100 taxable income both years. KCP&L has a taxable loss of
19 $100 for Year 1, a taxable loss of $200 for Year 2. In both years, the consolidated and
20 KCP&L stand-alone tax liability would be $0 since KCP&L's losses reduced Company
21 A's taxable income to $0 on a consolidated basis. However, the NOL carryforward for
22 the consolidated group would be $100 and for KCP&L "stand-alone" it would be $300.

1 The deferred tax asset allocated to KCPL using consolidated amounts would be $35 (100 x 35%) or $105 (300 x 35%) using "stand-alone" amounts.

3 **Q: In this example, KCP&L benefitted by using *not* using the hypothetical "stand alone" basis?**

5 A: Yes. However, the "stand-alone" amounts could be lower than the deferred tax asset allocated to KCP&L using consolidated amounts. It all depends on the taxable income or loss generated by the other subsidiaries. This taxable income or loss varies greatly depending on the current tax laws as passed by Congress.

9 **Q: How does this relate to how the Company computed the deferred tax asset under the Company's tax allocation agreement?**

11 A: The Company computes the amount of NOLs allocated to each subsidiary based on when and how the NOLs are used by the consolidated group in accordance with the Tax Allocation Agreement Among Great Plains Energy Incorporated and Affiliates ("Tax Allocation Agreement"). The Tax Allocation Agreement was put in place to ensure that each subsidiary received benefit for all tax attributes when used by the consolidated group. At the time the agreement was prepared, in 2008, the company had no reason to believe this agreement would produce unfair results to any subsidiary. In fact, it was put in place to ensure that all subsidiaries paid any tax liabilities it incurred or got benefit for any tax credits or NOLs it generated, but only when incurred or used by the consolidated group. This method most accurately represents the economics and the cash flow that actually occurs when a consolidated return is filed.

1 **Q: Does Mr. Brosch agree with this method?**

2 A: No. Mr. Brosch has indicated that he believes that the Tax Allocation Agreement
3 produces adverse consequences for KCP&L ratepayers and that the "stand-alone" method
4 would produce better results.

5 **Q: Do you agree with Mr. Brosch?**

6 A: No. Even though the rate base deferred tax asset would be lower using Mr. Brosch's
7 method, it does not represent the true economics of tax deductions and cash received for
8 KCP&L NOLs.

9 **Q: Does Mr. Brosch cite any way for the Commission to address this issue?**

10 A: Yes. Mr. Brosch cites the Commission rule governing affiliate transactions under 4 CSR
11 240-20.015 Affiliate Transactions. In Mr. Brosch's words on page 60, lines 14-16 of his
12 Direct Testimony filed April 2, 2015, the Commission may "employ affiliate transactions
13 policies and safeguards that protect against unreasonable utility transactions with
14 affiliated companies." He proposes that the Commission use the affiliate transaction
15 rules to change the way the NOLs deferred tax assets are computed for KCP&L. As
16 discussed later in my testimony, the Commission has rejected the use of the affiliate
17 transaction rule in a similar case involving Ameren.

18 **Q: Do you believe that the method the Company uses for computing the deferred tax**
19 **assets for NOLs is unreasonable?**

20 A: No, I do not. The method used by the Company is the method that ensures that all
21 subsidiaries are treated fairly and consistently. Mr. Brosch is requesting the Commission
22 disregard what is fair and equitable to all subsidiaries, including KCP&L, to compute the
23 deferred tax assets for NOLs on some "hypothetical" basis. The NOL allocation method

1 used by the Company and the Tax Allocation Agreement is the same method proscribed
2 by the Internal Revenue Service regulations for consolidated returns and represents the
3 true economics of filing a consolidated return.

4 **Q: Can KCP&L file a separate or "stand-alone" return if it chooses?**

5 A: No. Once KCP&L elected to be treated as a member of a consolidated return (decades
6 ago), it cannot then file as a separate return without the consent of the Internal Revenue
7 Service. And, the Internal Revenue Service has indicated that it will only provide
8 consent if a transaction occurs or a new law passes that creates significant harm to the
9 company requesting to leave the consolidated group if it remained as a member of the
10 consolidated group.

11 **Q: Has the issue regarding the computation of NOLs ADIT assets in rate base been**
12 **addressed by the Commission?**

13 A: The Commission ruled on this issue in Ameren Case No. ER-2014-0258. In the Report
14 and Order in this case the Commission rendered a decision that stated:

15 Ameren Missouri proposes to use a NOLC[arryforward] it has actually
16 accumulated rather than a hypothetical NOLC[arryforward] proposed by
17 MIEC and supported by Staff, MIEC advocates a policy that arrangements
18 between affiliates should always be interpreted in a manner that benefits
19 ratepayers, even if that results in a detriment to the utility. There is no
20 basis in law or fact for such a policy. The Commission must balance the
21 interest of ratepayers and shareholders to set just and reasonable rates.
22 Ameren Missouri's position is fair and will be adopted.[1]

23 **Q: Are the relevant facts similar for KCP&L to the Ameren facts?**

24 A: Yes. I believe so. Both utilities used the consolidated NOL, as allocated to the utility,
25 under the applicable tax allocation agreement in place between all subsidiaries of each
26 consolidated group to compute the NOL ADIT asset included in rate base.

[1] ER-2014-0258, Report and Order, p. 22.

1 **Q: What did the Commission say about the use of the affiliate transaction rule in the**
2 **Ameren case?**
3 A: On p. 21 of the Report and Order, the Commission found that the rule does not apply
4 because there is no transaction involved.
5 **Q: Are there any other ADIT adjustments proposed by Mr. Brosch?**
6 A: No.
7 **Q: What are adjustments that Mr. Brosch proposed that impact the amount of income**
8 **tax expense in this case?**
9 A: Mr. Brosch proposes several adjustments that impact the amount of income tax expense
10 included in cost of service. The first adjustment is to adjust the amount of tax-straight
11 line depreciation, nuclear amortization, and other tax amortization used in computing
12 income tax expense. The second adjustment is to simplify the computation of income tax
13 expense by ignoring the current and deferred income tax expense computation.

14 **<u>TAX DEPRECIATION AND TAX AMORTIZATION USED</u>**
15 **<u>TO COMPUTE INCOME TAX EXPENSE</u>**

16 **Q: Do you agree with Mr. Brosch's assertion that tax straight-line depreciation, tax**
17 **straight-line amortization and nuclear fuel amortization used to compute income tax**
18 **expense is understated in the direct filing?**
19 A: Yes. Several errors were made in the original computation of these items in the direct
20 filing by the Company. We have attempted to correct all of the issues and will adjust the
21 true up amounts in this case to reflect the corrected amounts.
22 **Q: Is Mr. Brosch correct that "inconsistencies" in the numbers for the tax straight-line**
23 **depreciation, tax straight-line amortization and nuclear fuel used in the data**

1 **requests still includes $1.1 million of unreconciled differences even after the errors**
2 **were corrected?**
3 A: Yes. Due to a number of estimates and assumptions used to compute these amounts for
4 the rate case, we were not able to reconcile the amounts fully.
5 **Q: Does Mr. Brosch's method of computing these amounts on Schedule MLB-1 reflect**
6 **the correct amount of tax straight-line depreciation, tax straight-line amortization,**
7 **and nuclear fuel amortization in computing "taxable income"?**
8 A: No. Mr. Brosch believes that it is not important to distinguish between current and
9 deferred tax expense computation. Therefore, he only adjusts the book depreciation and
10 amortization amounts in computing taxable income except for flow-through tax items
11 (such as AFUDC Equity, ITC Coal Basis Adjustments, and other Miscellaneous flow-
12 through items). This does not result in the correct taxable income, current income tax
13 expense, or cash working capital needed for income taxes.
14 **Q: If you use Mr. Brosch's method to compute tax straight-line depreciation, tax**
15 **straight-line amortization, and nuclear fuel do you get the correct "overall income**
16 **tax expense"?**
17 A: Yes. Book depreciation, plus book amortization, plus book nuclear fuel, plus the tax flow
18 through items will result in the correct overall depreciation and amortization deductions
19 needed to compute overall income tax expense (current income tax expense plus deferred
20 tax expense). However, it is still necessary to compute the current and deferred
21 components of income tax expense to get the correct amount of current income tax
22 expense necessary for cash working capital purposes.

1 **IT IS UNREASONABLE TO DISREGARD THE CURRENT AND**
2 **DEFERRED INCOME TAX EXPENSE COMPUTATIONS**

3 **Q: Do you agree with Mr. Brosch that the computation of income tax expense should**
4 **ignore the current and deferred income tax expense components?**

5 A: No. I do not.

6 **Q: Please explain why?**

7 A: The current income tax component of the income tax expense computation replicates the
8 amount of tax that would be needed on tax return using the rate case amount of revenue
9 and expenses. This current amount of income tax has an impact on the amount of cash
10 KCP&L needs to pay its tax liabilities for the current period. If we did not compute this
11 amount, the amount of cash taxes included in the working capital computations would not
12 be representative of the amount of cash taxes needed to pay for KCP&L's tax liabilities.
13 The deferred income tax component of this computation is then added in order to
14 normalize the amount of overall tax expense needed in this case under rate making
15 principles.

16 **Q: Why does Mr. Brosch believe that a current income tax expense calculation is not**
17 **needed?**

18 A: Mr. Brosch states that KCP&L is in a net operating loss position therefore it does not
19 need to include any cash taxes in cash working capital or cash flows.

20 **Q: Do you agree with Mr. Brosch?**

21 A: No. KCP&L was in a net operating loss position in 2014. However, in 2015 and as
22 computed in this case, KCP&L will pay cash for its tax liabilities. The NOL
23 carryforwards generated by the consolidated group are used on the consolidated return in
24 chronological order. The consolidated group has a large amount of NOLs acquired with

1 the Aquila, Inc. acquisition that were generated in years prior to when KCP&L generated
2 NOLs. These NOLs will be used before the NOLs allocated to KCP&L and will be used
3 in accordance with Internal Revenue Service regulations. Therefore, KCP&L will have
4 tax liabilities that it will need cash for until its allocated NOLs are used to offset its tax
5 liabilities.

6 **Q: Do you expect any of KCP&Ls NOLs to be used in 2015?**

7 A: No.

8 **FRANCHISE TAXES**

9 **Q: What is the tax related adjustment proposed by Mr. Addo?**

10 A: Mr. Addo has proposed to reduce franchise taxes included in the case to an average of the
11 estimated 2015 and 2016 franchise tax amounts.

12 **Q: Why has Mr. Addo proposed to use 2015 and 2016 to estimate franchise taxes?**

13 A: Mr. Addo has indicated that the Missouri franchise tax amounts will be phased out
14 completely by 2016 and believes there is "no reason" for ratepayers to pay for expenses
15 that will be gone in 2016. Therefore, he suggests using an estimate of the 2015 franchise
16 taxes, plus $0 for 2016 and dividing by 2 in order to "normalize" the franchise tax
17 expense in this case.

18 **Q: Do you agree with Mr. Addo?**

19 A: I do agree that Missouri franchise taxes will be completely phased out in 2016. However,
20 I do not believe it is appropriate to look at future costs to determine the franchise tax
21 expense in this case.

1 **Q: What amount does the Company expect to include for franchise tax expense in the**
2 **case?**
3 A: The Company included the actual amount of franchise expense accrued during the test
4 period in the case in the direct filing. The Company will include the amount of franchise
5 tax accrued for the true-up period when it is filed. This amount will be based on a
6 portion of the actual 2014 franchise tax expense and 2015 franchise tax expense recorded
7 for the 12 months ending May 31, 2015.
8 **Q: Does the Commission look at future cost in computing expenses in cost of service?**
9 A: No. The Commission looks a historical costs to determine the appropriate amount of
10 costs to include in cost of service. It is inappropriate to single out one expense item and
11 adjust it to a future cost amount.
12 **PROPERTY TAXES**
13 **Q: What is the tax related adjustments proposed by Mr. Young?**
14 A: Mr. Young proposed to adjust the property tax expense in this case to an amount
15 computed by determining a ratio of property tax payments for 2014 divided by taxable
16 property owned by KCP&L at January 1, 2014 and then multiplying it times the taxable
17 property at January 1, 2015 to compute the estimated property taxes for 2015. Then it
18 added the contractual payments in lieu of taxes (PILOT) applicable to non-taxable
19 property to compute total property tax expense in this case.
20 **Q: Is this method consistent with how property taxes were computed in prior KCP&L**
21 **rate cases?**
22 A: Yes. As noted by Mr. Young, this is a method used in prior rate cases.

1 **Q: Do you agree with this adjustment to property tax expense?**

2 A: Yes, I do, for purposes of establishing a baseline of property taxes such that differences
3 in future years from this baseline amount can be deferred under the tracker mechanism
4 proposed by KCP&L for property taxes and addressed for rate treatment in a subsequent
5 rate case.

6 **Q: What property tax levels do you expect KCP&L to incur in future years?**

7 A: We expect property taxes expensed to increase to ** ** million in 2016 and
8 ** ** million in 2017.

9 **Q: Why are property tax levels increasing in 2016 and 2017?**

10 A: For utilities like KCP&L, property taxes are generally determined by Missouri and
11 Kansas based on the fair value of the company (except for real estate and vehicles)
12 instead of on the value of the property owned by the Company. Both states rely heavily
13 on an appraisal method that uses a historical net operating income and cost of capital of
14 the business to determine the fair value of the Company. Due to the rate cases and other
15 economic factors, the Company expects our net operating income to increase and the cost
16 of capital to remain low. This will cause the fair value of the Company to increase and
17 for property taxes to increase as well in 2016 and 2017.

18 **PRODUCTION TAX CREDITS**

19 **Q: Are there any other tax related adjustments made by Staff that you would like to**
20 **address?**

21 A: Yes. It appears that the Staff has adjusted the wind production tax credits used in
22 computing income tax expense.

1 **Q: What are wind production tax credits?**

2 A: Wind production tax credits are income tax credits allowed by Internal Revenue Code
3 Section 45, Credit for Electricity produced from certain renewable resources. The credit
4 is allowed at a rate of 2.3 cents per kilowatt produced by the renewable generating
5 facility. KCP&L has two wind farms, Spearville 1 and Spearville 2 that produce wind
6 production tax credits.

7 **Q: How has the Staff adjusted these wind production tax credits in this case?**

8 A: It appears that the Staff has computed the wind production tax credits by using the Staff's
9 fuel model to estimate the amount of kilowatts generated by Spearville 1 and Spearville 2
10 and then multiplied the amount by 2.3 cents.

11 **Q: Do you agree with this adjustment?**

12 A: This appears to be a reasonable method that may be used to estimate the production tax
13 credits in this case. However, it will be necessary to ensure in the true up of the
14 Company's case, that the final estimated output of Spearville 1 and Spearville 2 that is
15 used in the rate case for the wind farms is also used to estimate the wind production tax
16 credits.

17 **<u>TRUE UP PERIOD UPDATES</u>**

18 **Q: Are the amounts included in ADIT, income tax expense, and franchise tax expense**
19 **subject to change based on the true up phase in this proceeding.**

20 A: Yes. All amounts used to compute ADIT, income taxes, and franchise taxes will be
21 updated in the true up phase in this proceeding. However, the methods used to compute
22 those amounts will be consistent with direct filing (except for the correction of errors)

1 unless the parties agree to a different method or if the Commission rules that a different

2 method should be applied.

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

4 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 A General Rate Increase for Electric Service	)))	Case No. ER-2014-0370

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 Rebuttal Testimony on behalf of Kansas City Power & Light Company consisting of twenty-six (26) 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 7th day of May, 2015.

Notary Public

My commission expires: Feb. 4 2019

NICOLE A. WEHRY
Notary Public - Notary Seal
State of Missouri
Commissioned for Jackson County
My Commission Expires: February 04, 2019
Commission Number: 14391200