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Witness: Salvatore P. Montalbano
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2012-0174

REBUTTAL TESTIMONY

OF

SALVATORE P. MONTALBANO

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

**Kansas City, Missouri
September 2012**

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SALVATORE P. MONTALBANO

Case No. ER-2012-0174

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

2 A: My name is Salvatore P. Montalbano. My business address is 1100 Walnut Street, Suite
3 1300, Kansas City, Missouri, 64106.

4 **Q: Are you the same Salvatore P. Montalbano who pre-filed Direct Testimony in this**
5 **matter?**

6 A: Yes, I am.

7 *Purpose and Summary of Testimony*

8 **Q: What is the purpose of your Rebuttal Testimony?**

9 A: My rebuttal testimony addresses Section XIII of the Missouri Public Service Commission
10 ("MPSC" or "Commission") Staff ("Staff") Revenue Requirement Cost of Service Report
11 on the Qualifying Advanced Coal Project Credit for Iatan 2 Facility ("New ITCs").

12 **Q: More specifically, what subject matter does your testimony address?**

13 A: My Rebuttal Testimony addresses the federal income tax risks associated with the Staff's
14 recommendation that the Commission order the reallocation (or monetary equivalent of
15 the reallocation) of the New ITCs between Kansas City Power & Light Company
16 ("KCP&L" or the "Company") and KCP&L Greater Missouri Operations Company
17 ("GMO"). My testimony also addresses Staff's alternative recommendations that the
18 Commission disallow a portion of KCP&L and GMO officers' salaries and benefits

1 allocated to GMO or consider KCP&L as imprudent in failing to allocate the new ITCs to
2 GMO when determining the return on equity allowed to KCP&L and GMO.

3 ***Background Facts on New ITCs and Relationship to Direct Testimony***

4 **Q: Have the background facts surrounding the New ITCs changed from your Direct**
5 **Testimony?**

6 A: No. Both KCP&L and GMO have received previous investment tax credits ("ITCs")
7 under the former Internal Revenue Code of 1986, as amended ("IRC") Section 46. As of
8 December 31, 2011, GMO has \$3.4 million of unamortized ITCs, and KCP&L has
9 \$127.9 million of unamortized ITCs, including the New ITCs. KCP&L, GMO, The
10 Empire District Electric Company ("Empire"), Missouri Joint Municipal Electric Utility
11 Commission ("MJMEUC") and the Kansas Electric Power Cooperative, Inc. ("KEPCo")
12 all agreed to construct and own the Iatan 2 plant. KCP&L owns 54.71%. GMO owns
13 18%. Empire owns 12%. MJMEUC owns 11.76%. KEPCo owns 3.53%.

14 In 2007, KCP&L applied to the Department of Energy for advanced coal credits under
15 IRC Section 48A. In April 2008, the Department of Energy and IRS accepted the
16 application and allocated \$125 million in IRC Section 48A credits for Iatan 2 to KCP&L
17 only. In 2009, Empire and the other co-owners non-affiliated with KCP&L or GMO
18 initiated arbitration proceedings against KCP&L claiming entitlement to a portion of the
19 credits.

20 In December 2009, the arbitrator found in favor of Empire (and ruled against the
21 municipals and cooperative because they are tax exempt entities and would not benefit
22 from the underlying credits) and directed KCP&L and Empire to apply for a revised
23 Memorandum of Understanding ("MOU") from the IRS to allow Empire to share in IRC

1 Section 48A credits equal to \$17,712,500, representing its proportionate share of the
2 ownership of Iatan 2.

3 In September 2010, the revised MOUs were issued to Empire and KCP&L by the IRS.
4 The Commission issued a report and order on March 16, 2011, that, among other
5 findings, ordered KCP&L and GMO to apply for a revised MOU with the IRS that would
6 allow GMO to have its proportionate share of the IRC Section 48A credits, much like
7 Empire. This would have resulted in GMO being allocated \$26,562,500 in credits. The
8 IRS sent KCP&L and GMO a letter on August 24, 2011 which denied their request for a
9 second revised MOU.

10 **Q: Are the facts laid out above in dispute?**

11 A: They do not appear to be. These same facts are essentially laid out in the Staff report.

12 **Q: From these facts, what did your Direct Testimony conclude?**

13 A: An imputation of new ITCs from KCP&L to GMO could constitute a normalization
14 violation under IRC Section 50(d)(2) and former IRC Section 46(f)(2). Also, that a
15 merger of KCP&L and GMO would not remedy any potential normalization violation.

16 **Q: Can you elaborate as to what the ITC normalization rules are?**

17 A: As discussed in my direct testimony, Congress mandated a sharing of tax benefits
18 between ratepayers and utilities from a regulatory perspective in the Revenue Act of 1971
19 by adding former IRC Section 46(f)(1) and (f)(2). Regulated utilities were bound to
20 choose one of two options for recording ITCs in their regulated books. These options
21 have collectively been referred to as the federal normalization rules. The elections are
22 irrevocable and cannot be changed. Both GMO and KCP&L chose option 2 under IRC
23 Section 46(f)(2) in the 1970's.

1 Under option 2 of IRC Section 46(f)(2), utilities would have no rate base adjustment for
2 ITCs, but would amortize ITCs in cost of service no more rapidly than ratably over the
3 regulatory (book) life of the underlying property. Section 46(f) was removed from the
4 IRC by the Revenue Reconciliation Act of 1990, but is still operative with respect to
5 normalization of investment tax credits. Moreover, IRC Section 50(d)(2) provides that
6 rules similar to former IRC Section 46(f) rules apply with respect to investment credits in
7 this particular part of the IRC. IRC Section 48A credits are investment credits in this
8 particular part of the IRC.

9 **Q: What did your direct testimony conclude regarding a reallocation of credits between**
10 **KCPL and GMO?**

11 A: My direct testimony concluded that the imputation of credits and assumed amortization in
12 GMO's rates could constitute an indirect violation of the normalization rules. There could
13 be a normalization issue with ITC benefit flowing through to the ratepayers of GMO even
14 though, if the MOU is not modified, GMO would not be entitled to any ITC under IRC
15 Section 48A.

16 **Q: What support did you cite to for the proposition of an indirect violation?**

17 A: Treasury regulations under former IRC Section 46 prevent state commissions from doing
18 indirectly what they cannot do directly without violating the normalization rules. Treas.
19 Reg. Section 1.46-6(b)(4) indicates that cost of service or rate base is considered to have
20 been reduced by reason of all or a portion of a credit if such reduction is done in an
21 indirect manner. Treas. Reg. Section 1.46-6(b)(4)(iii) provides that a type of indirect
22 reduction is any ratemaking decision intended to achieve an effect similar to a direct
23 reduction to cost of service or rate base. In determining whether a ratemaking decision is

1 intended to achieve this effect, consideration is given to all the relevant facts and
2 circumstances, including the record of the proceeding, the regulatory body's orders, and
3 the anticipated effect of the ratemaking decision on the company's revenues in
4 comparison to a direct reduction to cost of service or rate base.

5 **Q: Is there further support for this position?**

6 A: Yes. The reallocation of credits is analogous to the facts in Private Letter Ruling ("PLR")
7 200945006¹. PLR 200945006 involved the sale of natural gas assets of a public utility to
8 another unrelated public utility. The regulatory commission in question sought to require
9 the seller to transfer to the buyer the balance of its then-existing accumulated deferred
10 ITC as part of the transaction, or, in the alternative, that seller transfer amounts to buyer
11 in lieu of the annual ITC amortization for purposes of flowing through those amounts to
12 the ratepayers of the buyer. The IRS ruled that such a transfer of the unamortized ITC
13 balance (or an amount in lieu of the actual ITC) and continued amortization by the buyer
14 would violate the normalization rules.

15 The IRS objected to the fact that the buyer would be flowing through to its ratepayers
16 ITC that was not available to, and was not claimed by, the buyer. Consequently, the
17 buyer would have received no tax benefits of the investment credit but it would be forced
18 to give a nonexistent benefit to its ratepayers. Like the buyer in PLR 200945006, GMO
19 would receive no actual ITC but its ratepayers would be receiving the benefit of the ITC.
20 The strong analogy to the facts in the PLR is extremely troublesome from a normalization
21 viewpoint.

¹ Although a PLR is technically only authority to the taxpayer to whom it is issued, the IRS follows a consistent policy in issuing PLRs on similar issues to other taxpayers.

1 **Q: What was your conclusion in your direct testimony should a normalization violation**
2 **be found to exist here?**

3 A: My direct testimony indicated that if a normalization violation were deemed to exist, any
4 imputed credits could be lost. As indicated, Congress mandated certain penalties in
5 Section 211(b) of the Tax Reform Act of 1986. The penalty is the recapture and payment
6 to the IRS of the greater of ITCs claimed in any open tax years or any unamortized ITC
7 (for option 2 companies), or ITCs not restored to rate base (for option 1 companies),
8 remaining on its regulated books.

9 Under the penalty provisions, the \$3.2 million in deferred ITC on GMO's books that has
10 not been amortized would almost certainly be required to be paid back to the IRS. In
11 addition, any amounts imputed could also be in jeopardy of being returned to the IRS.

12 In addition, I concluded that under Treas. Reg. Section 1.46-6(f)(4), once a violation
13 occurs, it would continue until a final rate order is put into effect curing the violation.

14 Thus, if a violation occurs at GMO for the imputation of credits, GMO would lose the
15 opportunity to pursue additional ITCs until the MPSC cured the violation through a
16 subsequent conforming final rate order.

17 *Effect of Staff's Specific Recommendations*

18 **Q: What is Staff specifically proposing with respect to the New ITCs**

19 A: Staff recommends the Commission order Great Plains Energy, KCP&L and GMO to
20 request a reallocation between KCP&L and GMO of the New ITCs. If the IRS does not
21 reallocate the New ITCs, Staff suggests KCP&L should pay the monetary equivalent to
22 GMO of its proposed respective share of New ITCs. Alternatively, Staff recommends
23 that the Commission could disallow the allocation of Great Plains Energy, KCP&L and

1 GMO officers' salaries and benefits to GMO. The recommended disallowed officers'
2 salaries and benefits are \$617,857 for GMO-MPS and \$269,445 for GMO-L&P.²
3 Alternatively, if the Commission does not agree with either allocating credits or a
4 monetary equivalent of the credits to GMO or removing officers salaries and benefits
5 from GMO's cost of service, Staff recommends the Commission adjust the return on
6 equity for KCP&L and GMO.

7 **Q: Would the Staff proposals create a normalization violation?**

8 A: Yes. All of the Staff proposals could constitute a normalization violation.

9 **Q: Why would the Staff proposal to reallocate the New ITCs constitute a normalization**
10 **violation?**

11 A: This is exactly the scenario contemplated by my direct testimony. For all the reasons
12 mentioned in my direct testimony and outlined above, the IRS may likely contend this is
13 an indirect violation of the normalization rules. Treas. Reg. Section 1.46-6(b)(4)
14 indicates that cost of service or rate base is considered to have been reduced by reason of
15 all or a portion of a credit if such reduction is done in an indirect manner. Treas. Reg.
16 Section 1.46-6(b)(4)(iii) provides that a type of indirect reduction is any ratemaking
17 decision intended to achieve an effect similar to a direct reduction to cost of service or
18 rate base. Like the buyer in PLR 200945006, GMO would receive no actual ITC but its
19 ratepayers would be receiving the benefit of the ITC.

20 **Q: Why would Staff's other proposals constitute a normalization violation?**

21 A: As indicated above, Treas. Reg. Section 1.46-6(b)(4) prohibits any reduction in cost of
22 service or rate base if it cannot be done directly. Therefore no matter how Staff tries to

² GMO contains the activities of two operating divisions, Missouri Public Service ("GMO-MPS") and St. Joseph Light & Power ("GMO-L&P").

1 craft it: as a direct re-allocation, as a monetary equivalent, as an equivalent reduction in
2 officers' salaries and benefits in cost of service or as a reduction in the rate of return, it is
3 clear that Staff is suggesting that GMO receive indirectly the benefits of the New ITCs
4 that it has never received from the IRS. Any of these attempts could be deemed a
5 normalization violation. I would not advise my utility clients to make the imputations
6 requested by Staff due to the fact that in my opinion they would constitute normalization
7 violations.

8 **Q: Staff has made a number of equitable and prudence arguments for the reallocation**
9 **of the credits. Will the IRS consider these arguments in determining whether a**
10 **normalization violation exists?**

11 A: No. The IRS limits its analysis to the application of the technical normalization rules and
12 does not address regulatory questions concerning just and equitable rates. For example,
13 in PLR 9312007, the IRS was asked to rule on an ITC normalization issue. Before ruling
14 on the issue, the IRS stated the following:

15 The Service does not determine such purely regulatory questions as
16 whether the proposals of a public utility commission will produce just and
17 equitable rates. Consequently, the Service in Taxpayer's first ruling
18 request will determine only whether the normalization provisions of
19 section 46(f)(2) of the Code are violated when the investment credit
20 generated by the disallowed portion of the Plant is transferred to a
21 nonoperating income account.

22 This is a straightforward indication that the IRS concerns itself only with the
23 technicalities of normalization rules and not with any particular ratemaking prudence
24 when determining if the normalization rules have been violated.

1 **Q: Has the analysis you have based your Direct Testimony on changed between the**
2 **submission of your Direct Testimony and now?**

3 A: No. There has been no evolution in the tax law with respect to this particular issue that
4 would change my analysis and conclusions.

5 **Q: What about with respect to the implications of a normalization violation? Have**
6 **your conclusions changed from your Direct Testimony?**

7 A: No. I still believe that under the penalty provisions, the \$3.2 million in deferred ITC on
8 GMO's books that has not been amortized would almost certainly be required to be paid
9 back to the IRS. In addition, any New ITCs or amounts equivalent to New ITCs imputed
10 by the Commission could also be in jeopardy of being returned to the IRS.

11 Moreover, I also continue to believe that under Treas. Reg. Section 1.46-6(f)(4), if a
12 violation occurs at GMO for the imputation of credits, GMO would lose the opportunity
13 to pursue additional ITCs until the MPSC cured the violation through a subsequent
14 conforming final rate order.

15 **Q: Given the potential for normalization violation here and the potential uncertainty**
16 **around the implications of one, would Great Plains Energy, KCP&L and GMO be**
17 **agreeable to requesting a PLR from the IRS on the federal tax implications of what**
18 **the Staff has proposed?**

19 A: Yes. In fact, the Company has drafted a PLR on this issue and is waiting for
20 acknowledgement from the Staff of the MPSC to send to the IRS. Please see the rebuttal
21 testimony of Company witness Melissa K. Hardesty for more information.

1 *Conclusion*

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

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

