

Exhibit No.:
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Witness: Salvatore P. Montalbano
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: KCP&L Greater Missouri Operations Company
Case No.: ER-2012-0175
Date Testimony Prepared: October 10, 2012

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2012-0175

SURREBUTTAL TESTIMONY

OF

SALVATORE P. MONTALBANO

ON BEHALF OF

KCP&L GREATER MISSOURI OPERATIONS COMPANY

**Kansas City, Missouri
October 2012**

SURREBUTTAL TESTIMONY

OF

SALVATORE P. MONTALBANO

Case No. ER-2012-0175

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 and Rebuttal**
5 **Testimony in this matter?**

6 A: Yes, I am.

7 **Q: On whose behalf are you testifying?**

8 A: I am testifying on behalf of KCP&L Greater Missouri Operations Company ("GMO" or
9 the "Company") for St. Joseph Light & Power ("L&P") and Missouri Public Service
10 ("MPS") territories.

11 *Purpose and Summary of Testimony*

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

13 A: My Surrebuttal Testimony addresses the portion of the Rebuttal Testimony of Mr. Cary
14 G. Featherstone of the Missouri Public Service Commission ("MPSC" or the
15 "Commission") Staff ("Staff") addressing Iatan 2 Advanced Coal Credits ("New ITCs").

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

17 A: My Surrebuttal Testimony discusses the federal income tax risks associated with Mr.
18 Featherstone's contention that the Commission adopt the MPSC Staff's recommendations
19 found at pages 201-202 of Staff's Revenue Requirement/Cost of Service Report for the

1 GMO rate case. My Surrebuttal Testimony further expounds upon the findings made in
2 my Rebuttal Testimony and explains why Mr. Featherstone's recommendations may
3 create a potential loss of credits for Kansas City Power & Light Company ("KCP&L")
4 and GMO.

5 ***Background Facts on New ITCs***

6 **Q: Have the background facts surrounding the New ITCs changed from your Direct or**
7 **Rebuttal Testimonies?**

8 A: No. Please see my Direct Testimony and/or Rebuttal Testimony surrounding the facts
9 explaining how KCP&L was allocated New ITCs but GMO has not actually been
10 allocated any of the New ITCs.

11 **Q: What is Staff recommending on pages 201-202 of its Cost of Service Report for the**
12 **GMO rate case (Case No. ER-2012-0175)?**

13 A: Staff recommends the Commission order the reallocation of New ITCs between KCP&L
14 and GMO, or at least order Great Plains Energy Incorporated ("GPE") to request a
15 reallocation from the Internal Revenue Service ("IRS") of New ITCs between KCP&L
16 and GMO. If the IRS does not reallocate the New ITCs, Staff suggests KCP&L should
17 pay the monetary equivalent to GMO of its proposed respective share of New ITCs.
18 Alternatively, Staff recommends that the Commission could disallow the allocation of
19 GPE, KCP&L and GMO officers' salaries and benefits to GMO. The recommended
20 disallowed officers' salaries and benefits are \$617,857 for GMO-MPS and \$269,445 for
21 GMO-L&P.¹ Alternatively, if the Commission does not agree with either allocating
22 credits or a monetary equivalent of the credits to GMO or removing officers' salaries and

¹ GMO contains the activities of two operating divisions, Missouri Public Service ("GMO-MPS") and St. Joseph Light & Power ("GMO-L&P").

1 benefits from GMO's cost of service, Staff recommends the Commission adjust the return
2 on equity for KCP&L and GMO.

3 **Q: From these facts, what did your Rebuttal Testimony conclude?**

4 A: A reallocation of new ITCs from KCP&L to GMO could constitute a normalization
5 violation under Internal Revenue Code ("IRC") Section 50(d)(2) and former IRC Section
6 46(f)(2). Moreover, all the other proposals recommended by Staff could constitute
7 normalization violations.

8 **Q: Why did your Rebuttal Testimony indicate that all of Staff's proposals constitute**
9 **normalization violations?**

10 A: Treas. Reg. Section 1.46-6(b)(4) prohibits any reduction in cost of service or rate base if
11 it cannot be done directly. Therefore, no matter how Staff tries to craft it: as a direct re-
12 allocation, as a monetary equivalent, as an equivalent reduction in officers' salaries and
13 benefits in cost of service or as a reduction in the rate of return, it is clear that Staff is
14 suggesting that GMO receive indirectly the benefits of the New ITCs that it has never
15 received from the IRS. Any of these attempts could be deemed a normalization violation.
16 I referred to Private Letter Ruling ("PLR") 200945006.² PLR 200945006 involved the
17 sale of natural gas assets of a public utility to another unrelated public utility. The
18 regulatory commission in question sought to require the seller to transfer to the buyer the
19 balance of its then-existing accumulated deferred investment tax credit ("ITC") as part of
20 the transaction, or, in the alternative, that seller transfer amounts to buyer in lieu of the
21 annual ITC amortization for purposes of flowing through those amounts to the ratepayers
22 of the buyer. The IRS ruled that such a transfer of the unamortized ITC balance (or an

² 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 amount in lieu of the actual ITC) and continued amortization by the buyer would violate
2 the normalization rules.

3 The IRS objected to the fact that the buyer would be flowing through to its ratepayers
4 ITC that was not available to, and was not claimed by, the buyer. Consequently, the
5 buyer would have received no tax benefits of the investment credit but it would be forced
6 to give a nonexistent benefit to its ratepayers. Like the buyer in PLR 200945006, under
7 Staff's proposal, GMO would receive no actual ITC but its ratepayers would be receiving
8 the benefit of the ITC.

9 **Q: What was your conclusion in your Direct and Rebuttal Testimonies should a**
10 **normalization violation be found to exist here?**

11 A: My testimonies indicated that if a normalization violation were deemed to exist, any
12 reallocated credits could be lost. Congress mandated certain penalties in Section 211(b)
13 of the Tax Reform Act of 1986. The penalty is the recapture and payment to the IRS of
14 the greater of ITCs claimed in any open tax years or any unamortized ITC (for option 2
15 companies), or ITCs not restored to rate base (for option 1 companies), remaining on its
16 regulated books.

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

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

22 Thus, if a violation occurs at GMO for the imputation of credits, GMO would lose the

1 opportunity to pursue additional ITCs until the MPSC cured the violation through a
2 subsequent conforming final rate order.

3 *Arguments Made in Mr. Featherstone's Rebuttal*

4 **Q: What arguments does Mr. Featherstone make to support Staff's recommendations?**

5 A: First, Mr. Featherstone indicates that Staff is not imputing tax credits from KCP&L to
6 GMO. Staff is not proposing to reduce GMO's tax expense in GMO's rate case filing
7 (Case No. ER-2012-0175). Second, Mr. Featherstone indicates that the "spirit of the
8 normalization rules" is not violated by the allocation of a portion of the New ITCs from
9 KCP&L to GMO. Third, Mr. Featherstone indicates that the ITC normalization rules do
10 not provide for any "sharing" of benefits between utilities and their customers. Lastly,
11 Mr. Featherstone contends the reallocation is a prudency issue at heart and not really a
12 tax issue, and that it would be unfair to not allocate credits between KCP&L and GMO or
13 develop some other equitable remedy to compensate GMO for not receiving the New
14 ITCs. He concludes that my Direct Testimony is attempting to "scare" the Commission
15 in order to let KCP&L "off the hook."

16 *Response to Mr. Featherstone's Rebuttal*

17 **Q: Is it true that the Staff is not imputing tax credits between KCP&L and GMO?**

18 A: At the time my Direct Testimony was prepared, Staff's recommendation was not
19 available. As discussed above, the import of my Direct Testimony (and Rebuttal
20 Testimony for that matter) is that any attempt to make GMO economically whole for the
21 New ITCs that have not been assigned to them by the IRS could be a normalization
22 violation. The mechanism chosen initially by the Staff to do so is a "reallocation" as
23 opposed to an "imputation." The difference is mere semantics here and does not change

1 the fact that the Staff recommendation jeopardizes the creation of a normalization
2 violation.

3 **Q: Does Mr. Featherstone make a secondary argument around the imputation of**
4 **credits?**

5 A: Yes, he indicates that Staff "has not included these coal credits as a reduction to GMO's
6 tax expense in GMO's rate case filing."

7 **Q: Does this cure the normalization concerns?**

8 A: Not really. Presumably, it is Staff's intent to get the New ITCs over to GMO and start
9 amortizing them consistently with GMO's election under former IRC Section 46(f)(2).
10 Technically, there is no amortization in cost of service for GMO in this rate case, but
11 assuming Staff's recommendation were to be carried out, any amortization in future rate
12 periods would raise normalization concerns consistent with my Direct and Rebuttal
13 Testimonies. In addition, the other alternative Staff recommendations not directly
14 involving the reallocation of the credits could also still be considered an indirect
15 violation.

16 **Q: Does Mr. Featherstone conclude that a normalization violation does not exist here?**

17 A: No. He indicates that the "spirit of the normalization rules" would not be violated
18 because GMO would be getting its share of the credits commensurate with its respective
19 plant ownership. That is as close as he comes to actually indicating that there are no
20 normalization issues here. His analysis ignores the IRS and Department of Treasury
21 guidance I have provided, and recapped above, that supports that the IRS may indeed find
22 that a normalization violation exists here.

1 **Q: What about Mr. Featherstone's contention that the ITC normalization rules do not**
2 **provide for a sharing of tax benefits among utility companies and its customers?**

3 A: This appears to be a difference of opinion between Mr. Featherstone and me. Based on
4 his Rebuttal Testimony, Mr. Featherstone appears to favor the equity of the depreciation
5 normalization rules, which allow for cost free use of capital by the utility with a rate base
6 offset for the deferred taxes created through depreciation. He mentions the ITC
7 normalization rules as providing a strict choice between giving the ITC benefit over time
8 through cost of service or allowing the ITC to be a rate base offset but not both.

9 I view the ITC normalization rules as an evolution from pure flow through ratemaking.
10 As I mention in my Direct Testimony, the ITC normalization rules were enacted to allow
11 utilities to retain some benefit from ITCs as opposed to flowing the ITCs through
12 immediately as a reduction to cost of service. The "sharing" aspect to me is that the rules
13 do not condone the utility amortizing ITC below the line, and they do not allow for
14 immediate flow through of the benefit to customers. Hence, both the rate base restoration
15 method of former IRC Section 46(f)(1) and the ratable flow through method of former
16 IRC Section 46(f)(2) provide different ways for utilities and customers to share the
17 benefit of the ITCs.

18 **Q: Given that Mr. Featherstone addresses "the spirit" of the normalization rules and**
19 **provides his opinion as to the ratemaking propriety of the normalization rules, does**
20 **he provide any other arguments in support of the Staff recommendations?**

21 A: Yes. He concludes his testimony by indicating that the Staff recommendations are more
22 of a prudence issue as opposed to a tax issue. He runs through a litany of perceived

1 KCP&L abuses, and accuses the Company of hiring me to "scare the Commission" and
2 "hide behind the IRS on this issue."

3 **Q: Will the IRS consider the "spirit of the normalization rules" and prudence in**
4 **determining if the Staff's recommendations violate the normalization rules?**

5 A: No. As I indicated in my Rebuttal Testimony, the IRS limits its analysis to the
6 application of the technical normalization rules and does not address regulatory questions
7 concerning just and equitable rates. For example, in PLR 9312007, the IRS was asked to
8 rule on an ITC normalization issue. Before ruling on the issue, the IRS stated the
9 following:

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

17 Note that there is similar language in PLRs 9214033, 9045014 and 9547008. The IRS
18 has made it clear in multiple instances that it will look to whether the letter of the law has
19 been violated, and not consider Mr. Featherstone's arguments around prudence and the
20 spirit of the rules in making its normalization determination.

21 **Q: Are there any arguments outside the IRC and federal regulations interpreting the**
22 **code that the IRS does consider?**

23 A. Yes. The IRS has indicated in a number of PLRs that it will consider whether the state
24 commission intends to put the utility into a normalization violation when ruling as to
25 whether a violation exists. For example, in KCP&L's normalization ruling referenced in
26 the Rebuttal Testimony of Melissa K. Hardesty, PLR 201230021, the IRS conditions its
27 ruling that no violation exists if the Commission allows the Company to take corrective

1 action to remediate the violation. A number of other PLRs, including 200933023,
2 200811004 and 200802025 rule that the main reason a normalization violation was not
3 found in those cases was because the state commission did not force the utility into the
4 ratemaking treatment that violated the normalization rules.

5 **Q: So, the IRS will ignore Mr. Featherstone's prudence arguments but would not**
6 **ignore the Staff's recommendations if they were to force a reallocation or other**
7 **equitable remedy?**

8 A: Based on the IRS' ruling history, yes. The IRS has repeatedly indicated that it will ignore
9 equitable ratemaking in determining if a normalization violation exists, but will only find
10 a violation where a state commission insists on the particular ratemaking treatment that
11 violates the rules.

12 **Q: Given that Mr. Featherstone does not refute the potential for a normalization**
13 **violation here and the potential uncertainty around the implications of one, would**
14 **GPE, KCP&L and GMO be agreeable to requesting a PLR from the IRS on the**
15 **federal tax implications of what the Staff has proposed?**

16 A: Yes. As indicated in my Rebuttal Testimony and the Rebuttal Testimony of Melissa K.
17 Hardesty, the Company has drafted a PLR on this issue and is waiting for
18 acknowledgement from the Staff of the MPSC to send to the IRS.

19 *Conclusion*

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

21 A: Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of KCP&L Greater Missouri)
Operations Company's Request for Authority to) Case No. ER-2012-0175
Implement General Rate Increase for Electric Service)

AFFIDAVIT OF SALVATORE P. MONTALBANO

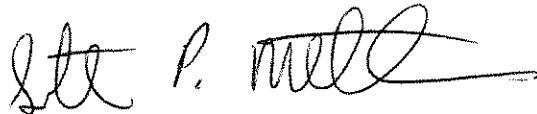
STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

Salvatore P. Montalbano, being first duly sworn on his oath, states:

1. My name is Salvatore P. Montalbano. I am partner with the accounting firm PricewaterhouseCoopers, LLP in Kansas City, Missouri. I have been retained by Great Plains Energy Services, Incorporated, an affiliate of KC&PL Greater Missouri Operations Company, to serve as an expert witness to provide tax testimony on behalf of KC&PL Greater Missouri Operations Company.

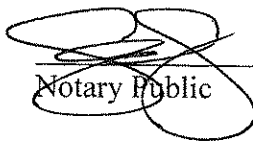
2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of KC&PL Greater Missouri Operations Company consisting of nine (9) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

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.



Salvatore P. Montalbano

Subscribed and sworn before me this 8th day of October, 2012.


Notary Public

SARAH E. LONG

My commission expires: 2-21-2014