



December 12, 1986

Mr. Harvey G. Hubbs
Secretary
State of Missouri
Public Service Commission
Post Office Box 360
Jefferson City, MO 65102

Re: Case No. AO-87-48
In the matter of the investigation
of the revenue effects upon
Missouri utilities of the Tax Reform
Act of 1986

FILED
DEC 15 1986
PUBLIC SERVICE COMMISSION

Dear Mr. Hubbs:

In response to the Commission's order dated November 3, The Kansas Power and Light Company (KPL) submits the following comments and attached schedules, in triplicate, on the revenue effects of the Tax Reform Act of 1986 (Act).

Our comments and schedules are, of course, based on our current understanding of the tax changes and information currently available. There will be, undoubtedly, further clarifications and interpretations of the tax changes which may affect our analysis.

Tax Reform Act of 1986 - Overview

On October 22, 1986, the Tax Reform Act of 1986 (Act), P.L. No. 99-514 (H.R. 3838) became law. The Act represents the most comprehensive and extensive overhaul of the tax laws since the enactment of the Internal Revenue Code of 1954 (1954 Code). In fact, the scope and magnitude of the Act is so great that Congress thought it appropriate to redesignate the 1954 Code as the Internal Revenue Code of 1986.

The objectives of the Act were twofold; first, to reduce both individual and corporate income tax rates and second, to shift approximately \$120 billion of the country's tax burden from

Harvey G. Hubbs
December 12, 1986
Page Two

individuals to corporations. The Act achieved these results by eliminating or curtailing substantial deductions and credits as well as by imposing a new corporate alternative minimum tax.

Public utilities, like other industries, were not unscathed. The Act makes significant changes in the Federal taxation of public utilities. These include a reduction in the corporate income tax rate from 46 percent to 34 percent; repeal of the investment tax credits and the reserve method for bad debts; reduced deductions for accelerated depreciation, vacation pay accruals, and business entertainment and meal expenses; required capitalization of construction related interest and overheads; new taxation of earned but unbilled revenues and contributions by customers for construction; stricter depreciation and investment tax credit normalization requirements; and the imposition of a new corporate alternative minimum tax. The Act also contains a number of other changes which will affect public utilities to a lesser degree. These changes are generally effective in 1987, however, in many cases there are transition rules which provide temporary relief.

For public utilities, these tax changes are significant and will impact operations, accounting and ratemaking. However, the extent of the impact will vary among utility services and among individual companies because of factors such as the availability of unused net operating losses and investment tax credits, construction expenditure requirements, current financial condition and regulatory treatment.

Tax Reform Act of 1986 - Effects on KPL

The attached schedules quantify the estimated revenue requirement impact of the tax changes on our 1985 Missouri jurisdictional gas operations. The schedules show our revenue requirement calculation and each of the various components of the revenue requirement (year-end rate base, rate of return, income statement and current, deferred and total income tax expense).

Based on our calculations, the net result of the tax changes is a reduction in income tax expense and revenue requirements. This reduction results principally from the decrease in the corporate tax rate from the current 46 percent to 40 percent in 1987 and then 34 percent in 1988. The reduction is offset somewhat by the repeal of the current tax deductions for capitalized construction interest and overheads. The reduction in tax rates will result in a lower current and deferred income tax expense in cost of service which causes an immediate reduction in our revenue requirement. On the other hand, our revenue requirement will increase as a result of the new required capitalization rules for

Harvey G. Hubbs
December 12, 1986
Page Three

construction interest and overheads. This is because this Commission currently requires flow-through accounting for these tax deductions. Under the Commission's flow-through accounting, the benefit of these current tax deductions has been passed on to our customers immediately as a reduction in current income tax expense. This benefit will no longer be available under the new rules.

In the past, tax deductions for accelerated depreciation have been normalized in setting rates charged our customers as required by the income tax laws. As a result, we have provided deferred income taxes for our accelerated depreciation deductions. We realize that the tax rate reduction effectively forgives a substantial portion of these deferred income taxes and creates an excess deferred tax reserve. Under the new tax law, the excess deferrals related to accelerated depreciation must be flowed back in rates using the "average-rate assumption method." Under this method, as the accelerated depreciation deductions begin to reverse, the deferred taxes are amortized over the remaining life of the property by using the historical, weighted tax rate used to generate the deferrals. We have not, however, recognized this new requirement since the amount of the excess deferred income tax to be flowed back is insignificant. As a result, our deferred income tax expense in cost of service has been provided at the tax rates in effect in 1986, 1987 and 1988.

The Act also makes numerous other changes in the tax treatment for certain items which either do not have or have potential but immaterial ratemaking implications. These include cutbacks in deductions for accelerated depreciation, vacation pay accruals and business entertainment and meal expenses; the accelerated taxation of unbilled revenues and contribution in aid of construction; and the imposition of a new alternative minimum tax. In general, these tax changes create additional tax timing differences which, under normalization accounting procedures, will not affect the calculation of total income tax expense in cost of service. Under normalization accounting, deferred income taxes will be provided to offset the additional current income tax expense resulting from the changes in the tax laws.

Although the Act reduces income tax expense and revenue requirements, the Act significantly and adversely impacts our cash flow. The adverse cash flow impact stems primarily from the repeal of the investment tax credit and the lower deferred income tax expense resulting from the tax rate reduction. This loss of cash flow is of great concern for the future. We anticipate this cash flow loss will increase our external financing needs and lower our interest coverage ratio. This will eventually put


Harvey G. Hubbs
December 12, 1986
Page Four

upward pressure on rates and possibly necessitate a rate increase.

In sum, the Act has made sweeping changes in the Federal taxation of public utilities. However, we believe that the impact of the changes varies among utility services and among individual companies. We recommend therefore, that the Commission assess the effects of the Act on a case by case basis.

Should you have any questions or need additional information, please let us know. We will be available to discuss this matter with you at your convenience.

Sincerely,


Steven L. Kitchen
Vice President, Finance

rp

Enclosure

cc: Doug Brooks
Office of the Public Council

THE KANSAS POWER AND LIGHT COMPANY

Schedule 1

MISSOURI GAS OPERATIONS

Revenue Requirement

<u>Description</u>	Year Ended December 31, 1985 Based on Tax Laws in Effect		
	<u>1985</u>	<u>1987</u>	<u>1988</u>
Total rate base	\$124,521,060	\$124,521,060	\$124,521,060
Rate of return	10.818%	10.818%	10.818%
Total operating income requirement	13,471,028	13,471,028	13,471,028
Total operating income available	13,471,028	13,798,947	14,471,712
Excess operating income available over requirement		(327,919)	(1,000,684)
Revenue factor (1 - tax rate)		58.1634%	63.7844%
Gross revenue requirement decrease - cumulative		(563,789)	(1,568,854)
Gross revenue requirement decrease - annual		(563,789)	(1,005,065)

THE KANSAS POWER AND LIGHT COMPANY

Schedule 2

MISSOURI GAS OPERATIONS

Rate Base

<u>Description</u>	<u>Year Ended December 31, 1985</u>
Gas plant in service	\$220,803,105
Less: accumulated provision for depreciation	77,724,935
Net gas plant in service	143,078,170
Add: Cash working capital	(932,765)
Materials and supplies	1,557,623
Prepayments	456,432
Less: Customer advances	4,346,348
Customer deposits	3,113,243
Deferred income taxes	12,178,809
Total rate base	\$124,521,060

THE KANSAS POWER AND LIGHT COMPANY

Schedule 3

MISSOURI GAS OPERATIONS

Income Statement

<u>Description</u>	<u>Year Ended December 31, 1985</u>
Operating revenue - Gas	\$359,539,134
- Other	1,383,683
Total operating revenue	360,922,817
Operating expenses:	
Purchased gas	265,957,646
Distribution	15,272,080
Customer accounts	11,471,817
Customer service & information	1,029,610
Sales	56,388
Administrative & general	15,708,296
Operation & maintenance expense	309,495,837
Depreciation and amortization	6,451,213
Taxes other than income	26,450,610
Income taxes-current	2,650,494
Deferred income taxes	1,148,041
Investment tax credit-net	1,255,594
Total operating expenses	347,451,789
Operating income	\$13,471,028

THE KANSAS POWER AND LIGHT COMPANY

Schedule 4

MISSOURI GAS OPERATIONS

Rate of Return

<u>Description</u>	<u>Total Company</u>	<u>Percent of Total Capital</u>	<u>Cost of Related Cost</u>	<u>Weighted Cost of Capital</u>
Long term debt	\$496,290,000	43.76922%	9.91%	4.338%
Preferred & Preference stock	101,591,150	8.95961%	7.61%	0.682%
Common equity	535,997,899	47.27117%	12.27%	5.798%
Rate of return				10.818%

THE KANSAS POWER AND LIGHT COMPANY

Schedule 5

MISSOURI GAS OPERATIONS

Provision for Current Income Taxes

Description	Year Ended December 31, 1985 Based on Tax Laws in Effect		
	1985	1987	1988
Net income before taxes	\$18,525,157	\$18,525,157	\$18,525,157
Additions (deductions)			
Interest charges	(5,112,507)	(5,112,507)	(5,112,507)
Interest capitalized	(6,700)	0	0
Pension & benefits capitalized	(397,439)	0	0
Payroll taxes capitalized	(305,566)	0	0
Ad Valorem taxes capitalized	(25,200)	0	0
Book depreciation to expense	6,409,504	6,409,504	6,409,504
Book depreciation to clearing	659,442	659,442	659,442
Accelerated tax depreciation	(10,387,527)	(10,387,527)	(10,387,527)
Removal costs	(371,304)	(371,304)	(371,304)
ESOP dividends	(171,221)	(171,221)	(171,221)
Net taxable income	8,816,639	9,551,544	9,551,544
Provision for Federal income taxes			
Net taxable income	8,816,639	9,551,544	9,551,544
Less:			
Missouri income tax	243,656	292,373	320,645
Federal taxable income	8,572,983	9,259,171	9,230,899
Federal income tax	3,943,572	3,703,668	3,138,506
Less:			
ITC available	1,536,734	0	0
Rate for deferred ITC	85.00%	75.00%	75.00%
Investment tax credit used	1,536,734	0	0
Provision for Federal income taxes	2,406,838	3,703,668	3,138,506
Provision for Missouri income taxes			
Net taxable income	8,816,639	9,551,544	9,551,544
Less:			
Federal income tax	3,943,572	3,703,668	3,138,506
Missouri taxable income	4,873,067	5,847,876	6,413,038
Provision for Missouri income taxes	243,656	292,373	320,645
Summary of provision for income tax - current			
Federal income tax	2,406,838	3,703,668	3,138,506
Missouri income tax	243,656	292,373	320,645
Provision for income taxes - current	\$2,650,494	\$3,996,041	\$3,459,151

THE KANSAS POWER AND LIGHT COMPANY

Schedule 6

MISSOURI GAS OPERATIONS

Provision for Deferred Income Taxes
and Investment Tax Credits

<u>Description</u>	Year Ended December 31, 1985 Based on Tax Laws in Effect		
	<u>1985</u>	<u>1987</u>	<u>1988</u>
Provision for deferred income taxes			
Liberalized depreciation			
Accelerated tax depreciation	\$10,387,527		
Tax straight line depreciation	<u>7,970,243</u>		
Excess tax over			
tax straight line depreciation	\$ 2,417,284	\$1,148,031	\$1,011,309
			\$875,434
Provision for deferred investment tax credit			
Investment tax credit deferred	1,536,734	0	0
Amortization of investment tax credit	(281,140)	(281,140)	(281,140)
Provision for deferred investment tax credit	1,255,594	(281,140)	(281,140)

THE KANSAS POWER AND LIGHT COMPANY

Schedule 7

MISSOURI GAS OPERATIONS

Provision for Total Income Taxes

<u>Description</u>	Year Ended December 31, 1985 Based on Tax Laws in Effect		
	<u>1985</u>	<u>1987</u>	<u>1988</u>
Net income before taxes	\$18,525,157	\$18,525,157	\$18,525,157
Additions (deductions)			
Interest charges	(5,112,507)	(5,112,507)	(5,112,507)
Interest capitalized	(6,700)	0	0
Pension & benefits capitalized	(397,439)	0	0
Payroll taxes capitalized	(305,566)	0	0
Ad Valorem taxes capitalized	(25,200)	0	0
Book depreciation to expense	6,409,504	6,409,504	6,409,504
Book depreciation to clearing	659,442	659,442	659,442
Tax straight line depreciation	(7,970,243)	(7,970,243)	(7,970,243)
Removal costs	(371,304)	(371,304)	(371,304)
ESOP dividends	(171,221)	(171,221)	(171,221)
Income on which tax should be provided	11,233,923	11,968,828	11,968,828
Composite income tax rate	47.4924%	41.8366%	36.2156%
Income taxes	5,335,260	5,007,351	4,334,583
Amortization of investment credit	(281,140)	(281,140)	(281,140)
Total income taxes	\$5,054,120	\$4,726,211	\$4,053,443

The Kansas Power & Light Company
 Docket No. AD-87-98
 Provision for Current Income Taxes
 As Adjusted for Tax Reform Changes

	Per Book	Non Utility Operations	Eliminations	Missouri Gas Department	Construction Overheads	Investment Tax Credit	Tax Reform 1986	Tax Reform 1987	Tax Reform 1988
Net income before taxes	18,525,157	0	0	18,525,157	0	0	18,525,157	18,525,157	18,525,157
Additions (deductions)									
Interest charges	(5,112,507)	0	0	(5,112,507)	0	0	(5,112,507)	(5,112,507)	(5,112,507)
Interest capitalized	(6,700)	0	0	(6,700)	6,700	0	0	0	0
Pension & benefits capitalized	(397,439)	0	0	(397,439)	397,439	0	0	0	0
Payroll taxes capitalized	(305,566)	0	0	(305,566)	305,566	0	0	0	0
Ad Valorem taxes capitalized	(25,200)	0	0	(25,200)	25,200	0	0	0	0
Book depreciation to expense	6,409,504	0	0	6,409,504	0	0	6,409,504	6,409,504	6,409,504
Book depreciation to clearing	659,442	0	0	659,442	0	0	659,442	659,442	659,442
Accelerated tax depreciation	(10,387,527)	0	0	(10,387,527)	0	0	(10,387,527)	(10,387,527)	(10,387,527)
Removal costs	(371,304)	0	0	(371,304)	0	0	(371,304)	(371,304)	(371,304)
Purchased gas costs	(11,071,932)	0	11,071,932	0	0	0	0	0	0
Bad debts	81,912	0	(81,912)	0	0	0	0	0	0
Amortization of A & C	15,697	0	(15,697)	0	0	0	0	0	0
Injuries & Damages	(177,055)	0	177,055	0	0	0	0	0	0
Accrued revenues - prior years	4,153,558	0	(4,153,558)	0	0	0	0	0	0
Level payment plan	115,593	0	(115,593)	0	0	0	0	0	0
ESOP dividends	(171,221)	0	0	(171,221)	0	0	(171,221)	(171,221)	(171,221)
Non utility income	248,080	(248,080)	0	0	0	0	0	0	0
	(16,342,665)	(248,080)	6,882,227	(9,708,518)	734,905	0	(8,973,613)	(8,973,613)	(8,973,613)
Net taxable income	2,182,492	(248,080)	6,882,227	8,816,639	734,905	0	9,551,544	9,551,544	9,551,544
Provision for current income taxes									
Provision for Federal income taxes									
Net taxable income	2,182,492	(248,080)	6,882,227	8,816,639	734,905	0	9,551,544	9,551,544	9,551,544
Less:									
Missouri income tax	60,315	(6,856)	190,197	243,656	20,310	0	263,966	292,373	320,645
Federal taxable income	2,122,177	(241,224)	6,692,030	8,572,983	714,595	0	9,287,578	9,259,171	9,230,899
Federal income tax	976,201	(110,963)	3,078,334	3,943,572	328,714	0	4,272,286	3,703,668	3,138,506
Less:									
ITC available	1,536,734	0	0	1,536,734	0	(1,536,734)	0	0	0
Rate for deferred ITC	85.00%	85.00%	85.00%	85.00%	85.00%	0	85.00%	75.00%	75.00%
Investment tax credit used	1,536,734	0	0	1,536,734	0	(1,536,734)	0	0	0
Provision for Federal income taxes	(560,533)	(110,963)	3,078,334	2,406,838	328,714	1,536,734	4,272,286	3,703,668	3,138,506
Provision for Missouri income taxes									
Net taxable income	2,182,492	(248,080)	6,882,227	8,816,639	734,905	0	9,551,544	9,551,544	9,551,544
Less:									
Federal income tax	976,201	(110,963)	3,078,334	3,943,572	328,714	0	4,272,286	3,703,668	3,138,506
Missouri taxable income	1,206,291	(137,117)	3,803,893	4,873,067	406,191	0	5,279,258	5,847,876	6,413,038
Provision for Missouri income taxes	60,315	(6,856)	190,197	243,656	20,310	0	263,966	292,373	320,645
Summary of provision for income tax - current									
Federal income tax	(560,533)	(110,963)	3,078,334	2,406,838	328,714	1,536,734	4,272,286	3,703,668	3,138,506
Missouri income tax	60,315	(6,856)	190,197	243,656	20,310	0	263,966	292,373	320,645
Provision for income taxes - current	(500,218)	(117,819)	3,268,531	2,650,494	349,024	1,536,734	4,536,252	3,996,041	3,459,151

The Kansas Power & Light Company
Docket No. A0-87-48
Provision for Deferred Income Taxes
As Adjusted for Tax Reform Changes

	Per Book	Non Utility Operations	Eliminations	Missouri Gas Department	Construction Overheads	Investment Tax Credit	Tax Reform 1986	Tax Reform 1987	Tax Reform 1988
Provision for deferred income taxes									
Liberalized depreciation	1,148,031	0	0	1,148,031	0	0	1,148,026	1,011,309	875,434
Purchased gas costs	5,258,348	0	(5,258,348)	0	0	0	0	0	0
Accrued revenue - prior years	(1,972,633)	0	1,972,633	0	0	0	0	0	0
Level payment plan	(54,898)	0	54,898	0	0	0	0	0	0
Provision for deferred income taxes	4,378,848	0	(3,230,817)	1,148,031	0	0	1,148,026	1,011,309	875,434
Provision for deferred investment tax credit									
Investment credit deferred	1,536,734	0	0	1,536,734	0	(1,536,734)	0	0	0
Amortization of investment credit	(281,140)	0	0	(281,140)	0	0	(281,140)	(281,140)	(281,140)
Provision for deferred I T C	1,255,594	0	0	1,255,594	0	(1,536,734)	(281,140)	(281,140)	(281,140)
Total income taxes	5,134,224	(117,819)	37,714	5,054,119	349,024	0	5,403,138	4,726,210	4,053,445

The Kansas Power & Light Company
Docket No. A0-87-48
Provision for Total Income Taxes
As Adjusted for Tax Reform Changes

Provision for total taxes									
Net income before taxes	18,525,157	0	0	18,525,157	0	0	18,525,157	18,525,157	18,525,157
Additions (deductions)									
Interest charges	(5,112,507)	0	0	(5,112,507)	0	0	(5,112,507)	(5,112,507)	(5,112,507)
Interest capitalized	(6,700)	0	0	(6,700)	6,700	0	0	0	0
Pension & benefits capitalized	(397,439)	0	0	(397,439)	397,439	0	0	0	0
Payroll taxes capitalized	(305,566)	0	0	(305,566)	305,566	0	0	0	0
Ad Valorem taxes capitalized	(25,200)	0	0	(25,200)	25,200	0	0	0	0
Book depreciation to expense	6,409,504	0	0	6,409,504	0	0	6,409,504	6,409,504	6,409,504
Book depreciation to clearing	659,442	0	0	659,442	0	0	659,442	659,442	659,442
Tax straight line depreciation	(7,970,243)	0	0	(7,970,243)	0	0	(7,970,243)	(7,970,243)	(7,970,243)
Removal costs	(371,304)	0	0	(371,304)	0	0	(371,304)	(371,304)	(371,304)
Purchased gas costs	0	0	0	0	0	0	0	0	0
Bad debts	81,912	0	(81,912)	0	0	0	0	0	0
Amortization of A & G	15,697	0	(15,697)	0	0	0	0	0	0
Injuries & damages	(177,055)	0	177,055	0	0	0	0	0	0
Accrued revenue - prior years	0	0	0	0	0	0	0	0	0
Level payment plan	0	0	0	0	0	0	0	0	0
ESOP dividends	(171,221)	0	0	(171,221)	0	0	(171,221)	(171,221)	(171,221)
Non utility income	248,080	(248,080)	0	0	0	0	0	0	0
Total	(7,122,600)	(248,080)	79,446	(7,291,234)	734,905	0	(6,556,329)	(6,556,329)	(6,556,329)
Income on which tax should be provided	11,402,557	(248,080)	79,446	11,233,923	734,905	0	11,968,828	11,968,828	11,968,828
Composite income tax rate	47.4924%		47.4924%	47.4924%	47.4924%	47.4924%	47.4924%	41.8366%	36.2156%
Income taxes	5,415,348	(117,819)	37,731	5,335,260	349,024	0	5,684,284	5,007,351	4,334,583
Amortization of investment credit	(281,140)	0	0	(281,140)	0	0	(281,140)	(281,140)	(281,140)
Total income taxes	5,134,208	(117,819)	37,731	5,054,120	349,024	0	5,403,144	4,726,211	4,053,443
Check difference	16	0	(17)	(1)	0	0	(6)	(1)	2

The Kansas Power & Light Company
Docket No. AD-87-48
Analysis of Excess Deferred Income Tax
Reserves for Accelerated Depreciation

Vintage	Total				
	Tax Depreciation	Tax Straight Line Depreciation	Depreciation Difference	Deferred Tax at 40%	Deferred Tax at 34%
1969	2,287,698	2,356,184	(68,486)	(28,632)	(24,803)
1970	151,089	200,345	(49,256)	(20,691)	(17,910)
	2,438,787	2,556,729	(117,942)	(49,323)	(42,713)
1971	230,833	205,524	25,309	10,588	9,166
1972	185,265	178,144	7,121	2,979	2,579
1973	244,990	214,178	30,812	12,891	11,159
1974	324,292	267,925	56,367	23,582	20,413
1975	336,235	276,692	65,543	27,420	23,737
1976	351,409	280,829	70,580	29,528	25,561
1977	358,598	288,879	69,719	29,169	25,249
1978	380,888	284,383	96,505	40,375	34,950
1979	521,282	356,116	165,166	69,100	59,815
1980	521,640	428,378	93,262	39,017	33,775
	3,455,432	2,775,048	680,384	284,649	246,404
1981	581,071	330,199	250,872	104,956	90,855
1982	826,800	713,042	113,758	47,592	41,198
1983	853,432	477,592	375,840	157,239	136,113
1984	1,291,743	671,008	620,735	255,511	221,182
1985	950,262	446,625	503,637	210,705	182,395
	4,493,308	2,638,466	1,854,842	776,003	671,743
Total	10,387,527	7,970,243	2,417,284	1,011,309	875,436