Exhibit No.:
Issue: NOLs in Rate Base
Witness: Melissa K. Hardesty
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company
Case Nos.: ER-2018-0145 and ER-2018-0146
Date Testimony Prepared: September 4, 2018

MISSOURI PUBLIC SERVICE COMMISSION

CASE NOS.: ER-2018-0145 and ER-2018-0146

SURREBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY and KCP&L GREATER MISSOURI OPERATIONS COMPANY

Kansas City, Missouri
September 2018

SURREBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

Case Nos. ER-2018-0145 and ER-2018-0146

Q: Please state your name and business address.

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

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

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

Q: On whose behalf are you testifying?

A: I am testifying on behalf of KCP&L and KCP&L Greater Missouri Operations Company ("GMO") (collectively, the "Company").

Q: Are you the same Melissa K. Hardesty who filed Direct Testimony in both ER-2018-0145 and ER-2018-0146?

A: Yes, I am.

Q: What is the purpose of your testimony?

A: The purpose of my testimony is to respond to the proposed tax related adjustments included in the rebuttal testimony John S. Riley on behalf of the Office of Public Counsel ("OPC").

Q: What are the tax related adjustments proposed by Mr. Riley?

A: Mr. Riley has proposed to exclude the amount of accumulated deferred income taxes ("ADIT") in rate base for net operating losses ("NOLs") and to amortize any excess deferred income taxes related to NOLs using the average rate assumption method ("ARAM").

Q: Please describe the proposed adjustment to exclude the ADIT for NOLs from rate base?

A: In the Company's filing, it reflected the impact of its NOL carryforward for tax purposes as an ADIT asset (a deferred tax asset). This has the effect of increasing rate base (by decreasing the overall ADIT balance which reduces rate base). Mr. Riley proposes to exclude the NOL carryforward ADIT asset. Mr. Riley describes these assets as a "fictitious asset" which does not exist in the regulatory environment.

Q: Do you agree with Mr. Riley's adjustment?

A. No. KCP&L reduces its rate base by its net ADIT liability balance (sum of deferred tax assets and deferred tax liabilities) as a result of timing differences between deductions for tax purposes and financial statement purposes. The net deferred tax liability is used to reduce rate base because it represents a source of cost-free capital (a reduction in the amount of cash paid for tax purposes) the Company has received as a consequence of claiming certain tax deductions. In a year that the Company generates a net operating loss for tax purposes that is carried forward, the NOL carryforward reduces the amount of cost-free capital it received. Therefore, the Company has reflected in its rate base computation the actual impact its NOL has had on the amount of cost-free capital it received using the method prescribed under the Internal Revenue Service regulations to allocate losses to companies within a consolidated group. Mr. Riley seems to ignore the fact that the company did not receive the benefit of cost-free capital created by the deferred tax liabilities due to the NOL carryforward. He proposes that this Commission impute for this purpose the hypothetical quantity of cost-free capital that the Company would have received if it did not have a NOL.

Q: Please summarize why you disagree with Mr. Riley's proposal.

A: Mr. Riley proposes to impute cost-free capital that the Company did not receive.

Q: What produces deferred taxes?

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

Q: What is the source of most deferred taxes?

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

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

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

Q: What is the nature of this cash?

A: This cash represents funds not paid to the government and presently available to the company. However, these funds will have to be paid back to the government over time (similar to a loan). In fact, in the example above, the funds will be paid back over the next nine years. The company will collect $100,000 from its customers to fund the depreciation on the line over the next nine years. However, because the company claimed 100% depreciation on the asset in the first year, it will be entitled to no further depreciation tax deductions. Thus, in each of the nine years, the company will include on its tax return $100,000 of taxable income upon which it will pay $35,000 ($100,000 multiplied by 35%) of tax. Over the nine years, it will pay a total of $315,000 ($35,000 multiplied by 9) – an amount precisely equal to the cash benefit it enjoyed in 2011.

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

A: Yes.

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

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

Q: How does this relate to deferred taxes?

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

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

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

Q: What is a NOL?

A: An NOL is created when, in any year, a taxpayer reports more deductions than it has taxable income. Under the generally applicable tax rules before 2018, an NOL can be carried back two years or forward 20 years. In the year in which it is carried to, an NOL is treated like an additional deduction, reducing the taxable income otherwise produced in that year. The general rule is that an NOL must be carried back to the earliest possible year and then, to the extent not absorbed, applied to subsequent years in chronological order.

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

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

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

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

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

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

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

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

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

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

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

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

Q: Does Mr. Riley dispute any of the economics or ratemaking implications you have described above in his testimony?

A: Yes. Mr. Riley appears to imply that the deferred tax asset for NOLs is a "fictitious" asset. He would have the Commission believe that all of the deferred tax liabilities created by accelerated depreciation and other tax deductions in rate base should not be reduced by the deferred tax assets for NOLs even if the Company never received the cost-free capital.

Q: How has the Company computed the deferred tax asset for NOL carryforwards?

A: In its calculations, the Company has used the actual amount of cost-free capital it actually received. These amounts reflect the actual cash that the Company has received in connection with the claiming of its tax deductions.

Q: Do you agree with Mr. Riley that the Company is receiving a "double recovery" of income tax expense if it includes the ADIT for NOLs in rate base?

A: No. Under Mr. Riley's theory, deferred tax liabilities (not just deferred tax assets) should also be excluded from rate base, since these deductions are also not included for computing income tax expense in cost of service. This notion does not make sense. The deferred taxes in rate base represent the cost-free capital received by the Company. If it never received the cost-free capital due to NOLs, then the deferred taxes should be reduced by the amount it never received.

Q: Do you agree with the IRS Private Letter ruling that Mr. Riley quotes in his testimony?

A: Yes. However, this does not change the fact that the company did not receive the cost-free capital due to the NOLs. It only means that there may not be a normalization violation if the deferred tax assets related to NOLs are not included as an offset to the deferred tax liabilities included in rate base.

Q: Are there any private letter rulings that indicate that the deferred tax assets for NOLs should be included in rate base or risk an IRS normalization violation?

A: Yes. In the Deloitte analysis attached to Mr. Riley's testimony, two other IRS private letter rulings from 2014 are listed (PLR 201436037 and PLR 201436038) whereby it would have been a normalization violation not to include the deferred tax assets for NOLs in rate base. In each case, the facts and circumstances must be looked at to ensure that a normalization violation has not been triggered.

Q: Would a normalization violation occur if the deferred tax assets for NOLs were excluded from rate base?

A: At this time, it is unclear whether or not a normalization violation would occur if the ADIT for NOLs was excluded from rate base in this case. If the Commission determined that it should exclude ADIT for NOLs from rate base, the Company would need to request a private letter ruling from the IRS to determine if a violation has occurred. If the IRS determined that there was a violation, then the Company would lose the ability to use accelerated depreciation for tax return purposes for all future periods. This would be detrimental to customers and the Company.

Q: Has the Commission reviewed how the Company computed ADIT for NOLs in the past?

A: Yes. The Commission ruled in KCP&L's Case No. ER-2014-0370 Report and Order that the method used by the Company to compute ADIT for NOLs in rate base is appropriate.

Q: Is there any ADIT related to NOLs of unregulated subsidiaries included in rate base?

A: No. The ADIT assets for NOLs for KCP&L and the regulated division of GMO are computed separately and there are no NOLs for our unregulated operations included in rate base.

Q: Do you agree with the adjustment Mr. Riley proposes to the amortization of excess deferred income taxes related to NOLs (if ADIT assets for NOLs are included in rate base)?

A: No. The Company believes that any amortization of excess deferred income taxes related to NOLs should match how the deferred taxes would have reversed if they were in rate base. ADIT assets for NOLs reverse when the NOLs are used to reduce future tax liabilities. Since KCP&L and GMO will no longer be able to claim bonus depreciation under the new tax laws, the Company should be able to use all of its NOLs in the next five years. This is why the Company has proposed a five-year amortization of excess deferred income taxes related to NOLs. Mr. Riley proposes using the IRS's ARAM method for giving back NOLs over the remaining book life of fixed assets. Using the ARAM method would keep the excess deferred income taxes for NOLs in rate base for 30 or more years. Long after the ADIT for NOLs will be in rate base.

Q: Does the Company's proposal to amortize the NOL excess deferred income taxes violate the IRS normalization rules?

A: No. The IRS normalization rules state that the protected excess deferred income taxes cannot be given back more quickly than using the IRS's ARAM method. Since the amortization of excess deferred income taxes for NOLs reduces the total amount of protected excess deferred income taxes given back to customers, the Company can amortize them more quickly without causing a normalization violation.

Q: Does that conclude your testimony?

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-2018-0145
In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement A General Rate Increase for Electric Service	))))	Case No. ER-2018-0146

AFFIDAVIT OF MELISSA K. HARDESTY

STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

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

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

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company consisting of ten (10) 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 4th day of September 2018.

Notary Public

My commission expires: 4/26/2021

ANTHONY R WESTENKIRCHNER
Notary Public, Notary Seal
State of Missouri
Platte County
Commission # 17279952
My Commission Expires April 26, 2021