Exhibit No.: _______________
Issue(s): NOL Exclusion From Cost of Service and Rate Base/ STUB Period Calculations/ Bad Debt Expense in the Cost of Service/ Missouri Tax Reform
Witness/Type of Exhibit: Riley/Surrebuttal True Up Direct
Sponsoring Party: Public Counsel
Case No.: ER-2018-0145 and ER-2018-0146

SURREBUTTAL TESTIMONY
TRUE UP DIRECT TESTIMONY

OF

JOHN S. RILEY

Submitted on Behalf of
the Office of the Public Counsel

KANSAS CITY POWER & LIGHT COMPANY
Case No. ER-2018-0145

KCP&L GREATER MISSOURI OPERATIONS COMPANY
Case No. ER-2018-0146

** **

Denotes Confidential Information that has been redacted

September 4, 2018

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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	))))	File 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	))))	File No. ER-2018-0146

AFFIDAVIT OF JOHN S. RILEY

STATE OF MISSOURI)
) **ss**
COUNTY OF COLE)

John S. Riley, of lawful age and being first duly sworn, deposes and states:

1. My name is John S. Riley. I am a Public Utility Accountant III for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal and true up direct testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

John S. Riley
John S. Riley, C.P.A.
Public Utility Accountant III

Subscribed and sworn to me this 4th day of September 2018.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI
JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037

Jerene A. Buckman
Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.

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OF

JOHN S. RILEY

KANSAS CITY POWER & LIGHT COMPANY
CASE NO. ER-2018-0145

KCP&L GREATER MISSOURI OPERATIONS COMPANY
CASE NO. ER-2018-0146

Q. What is your name and what is your business address?

A. John S. Riley, PO Box 2230, Jefferson City, Missouri 65102.

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

A. I am employed by the Missouri Office of the Public Counsel ("OPC") as a Public Utility Accountant III.

Q. Are you the same John S. Riley that filed direct and rebuttal testimony in this case?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my testimony is to address Company witness Ms. Melissa Hardesty contention that Net Operating Losses ("NOL") should be amortized in the cost of service and its inclusion in rate base. I will explain how these calculations are already included in the cost of service. I will also argue that Ms. Hardesty incorrectly asserts that NOLs for KCPL were predominantly generated through tax benefiting bonus and accelerated depreciation. A review of eight years of Great Plains Energy consolidated tax returns indicates that KCPL has considerably more tax deductions than just accelerated depreciation generating its NOLs. I will also be responding to Mr. Ronald Klote's methodology concerning the amount and refunding of the stub period tax windfall. Finally, I will address Ms. Linda Nunn's argument to adjust the level of bad debt to be included in the cost of service. As a result of rebutting company witnesses, OPC will be sponsoring two cost of service adjustments. One is to adjust the stub period amount of income tax savings due to the change in tax rates and two is opposition to KCPL and GMO's adjustments to transfer to the utilities' cost of service bad debt expense recorded on the books of their non-regulated receivable subsidiaries.

NOL EXCLUSION FROM COST OF SERVICE AND RATE BASE

Q. Ms. Hardesty proposes to amortize the Companies' NOL, in the cost of service and rate base, over a five year period because she expects the Companies to be able to exhaust the amount within a five year period. How does OPC respond to her assertion?

A. First of all, as OPC argued in rebuttal testimony, the Companies NOL should not be factored into this rate case. It has no business in any calculation of cost of service (COS) or rate base rate of return. Rate Base reflects costs that the utility has invested in the provision of safe and adequate service. The Return on Rate Base represents the return on the investment the utility has made into its provision of utility service. Depreciation and amortizations reflect the return of the investment the utility has committed to its business. This NOL asset had no cost or expenditure. KCPL and GMO had no outlay of funds specifically to create a NOL asset. Money that was spent or received is already recorded in accounts used to prepare the tax return. Money spent to prepare the tax return does not change depending on whether the utility has taxable income versus taxable loss. Thus there is no millions of dollars spent by KCPL and GMO invested in a NOL to justify earning a return on let alone receiving a return of over any amortization period. The NOL is be adjusted in the future if and when it is used but the original cost of this asset is zero.

The utilities are afforded the appropriate amount of income tax expense, within the COS, for the net income allowed by the Commission when setting the rate of return, yet KCPL and GMO do not pay these taxes to the federal government. So the utilities and Staff account for the deferred tax due to accelerated tax depreciation but they fail to recognize the subsidization of the operating loss taken on the company tax return by way of excess tax expense included in rates. So income tax expense is not adjusted down to reflect a NOL which is why excluding the NOL from rate base still meets the IRS normalization rules. If one wants to reconcile the amount of income taxes paid to the rate base offset, then one compares the rate base offset to the amount of income taxes collected and record the difference as a regulatory asset or liability depending on the result.

Secondly, the IRS has stated that the NOL to be addressed in the ADIT balance must be attributable to the tax advantaged accelerated depreciation. Examination of the consolidated tax returns including KCPL and GMO show that their tax losses attributed to these utilities is caused by the fact that their deductions contain quite a bit more than accelerated depreciation.

Q. You state that there is more to the Company's tax advantages than just the difference between book depreciation and accelerated tax depreciation. How do costs for income tax purposes differ from the COS calculations for ratemaking?

A. Keep in mind that the simple definition of an NOL is when <u>expenses exceed revenues for tax purposes</u>. We know this rarely has happened in the regulated utility arena but is quite common on the income tax return. OPC determined that KCPL is the primary service organization for GPE and does not assign much labor or interest expenses deductions beyond its two utility subsidiaries' taxable income determinations Schedule JSR-S-1 is a CONFIDENTIAL SCHEDULE of the pages of the GPE showing the deviation of taxable income or loss for KCPL and its affiliates for the years 2009 thru 2016. The 2017 return has been requested and will be provided next month when it is filed with the IRS[1]. I did not recognize an allocation factor when assigning costs to KCPL and GMO for tax purposes. KCPL, in particular, bears the brunt of the consolidated company's expenses as shown in this exhibit. KCPL is the primary subsidiary for the company wide costs when calculating taxable income. Some of these costs are subjected to assignment and charges to KCPL affiliates as they constitute the

[1] OPC data request 1323

costs to operate KCPL's affiliates. However, for tax purposes they are a direct deduction to KCPL's NOL when one occurs.

Q. How do these costs contribute to the NOL and the carryforward?

A. Accelerated depreciation is a major expense when considering taxable income; however, the expenses listed on Schedule JSR-S-02 may overshadow the emphasis on the accelerated depreciation deduction. When reviewing the Company's tax returns, this short list of expenses has a tremendous effect on the taxable income of the utilities. So if the KCPL claims that it currently has a NOLC of $192 million on its general ledger and GMO has $128,258,446, OPC found that its tax losses only exists because of the huge amount of non-tax accelerated depreciation expenses directed to the utility tax calculations, and these expenses continue to extend the life and balance of the NOLC asset at issue here. The loss could very well not exist without the massive amount of nontax accelerated depreciation costs reflected on the KCPL and GMO tax returns.

Q. What are some of the major expenses that KCPL and GMO list on its income tax return that the other subsidiaries do not list?

A. I have developed a spreadsheet (Schedule JSR-S-2) that lists the major expenses that KCPL and GMO absorbs for income tax purposes.

The first column, Compensation of Officers is not allocated to GPE, GMO or any KCPL affiliate and is the sole deduction against KCPL's taxable income. The second column is the sale of utility assets. KCPL takes a tax loss every year for the sale of utility assets. Over the years, this has been a substantial amount. Since 2009, KCPL has lost $141 million in the sale of plant assets which ratepayers have paid a return <u>of</u> and <u>on</u> in rate base. Columns three and four are tax expenses that can be found in "other deductions". Both KCPL and GMO have taken deductions for retiring plant, which is plant retired without a sale and for Section 174 deductions, which is research and development expenditures. But the largest adjustment to taxable income on this spreadsheet is the combination of the loss on the sale of KCPL and GMO accounts receivable to their respective subsidiary receivable companies combined with exclusion of the taxable income created in these receivable companies by KCPL's machinations.

I have complied a short list of non-tax depreciation expenses that when reflected in the utilities' taxable income determination are major contributors to the NOL that utility and Staff witnesses have included in the cost of service and rate base of the utilities cost of service in these cases. These are tax maneuvers that concentrate other affiliate expenses against the utilities' taxable income as well artificially divert income to KCPL and GMO's two major subsidiaries so that a larger NOL can be attributed to the Missouri utilities. The ratepayer does not benefit from these tax advantages in determining the income taxes that they must pay and should not be expected to subsidize them by increasing the rate base recovered in rates to reflect the fictitious NOL asset.

Q. Since 2009, what is the amount of taxable income reductions attributable to this concentration of expenses and revenues?

A. The compensation of officers, loss on sales, loss on A/R and the income made by the receivable companies amounts contributed ** ** for KCPL and ** ** for GMO to reduce their taxable income and create their taxable losses. It is apparent how the respective utilities have supplemented its tax advantage accelerated depreciation with other expenses that either the ratepayer has funded through the cost of service or is denied a benefit due to tax return shuffling of deductions.

Q. Ms. Hardesty has testified that she believes that the NOL carryover will offset tax liabilities for about 5 more years. Will these tax deductions continue past the five year offset?

A. Yes, GPE will continue to reduce taxable income with transactions that are not reflected in the cost of service, and may actually generate more taxable NOLs for the utility subsidiaries by way of juggling and concentrating expenses in these subsidiaries. These expenses increase the balance of the NOL and may very well extend the life of the NOL well past the five years that is predicted by Company witnesses. The important fact to note here is that the asset will dissolve independent of inclusion of its amortization in Missouri retail rates. Missouri ratepayers have already paid income taxes the utility does not pay. It is patently unfair to make Missouri ratepayers pay the utility for the income taxes again through the Company's and Staff's proposal that KCPL and GMO's new customers rates reflect a return on and of the excessive amount of utility tax deductions the utility could not use during period customers already paid these income taxes to the company.

<u>STUB PERIOD CALCULATIONS</u>

Q. How does Mr. Klote propose to calculate and return the excess income tax that has been collected in rates since January 1 of this year?

A. Mr. Klote has explained that there are essentially three steps to return the excess tax accumulated during the stub period. For step 1, he has explained the mechanics of using the rates set in the last general rate case (ER-2016-0285) and recalculated the taxes using the 21% tax rate. He points out that these are the calculations applied in Staff data request 304. Company has also calculated the excess deferred tax expense for the same period and has also included that amount in the rate reduction. The reduction is approximately ** ** for KCPL and ** ** million for GMO. In his second step, Mr. Klote proposes to examine the earnings of the Companies during 2018, which would be the same timeframe as the stub period, and adjust the tax reduction amount that was calculated in step 1 by the Company's under earnings for 2018. The third step is to conduct a one-time bill credit to the ratepayers for the combined over earnings of the stub period.

Q. How does OPC view this proposal?

A. OPC takes no issue with the mechanics of reducing taxes from 34% to 21%. As for step two, OPC is firmly against any estimation or consideration of a new revenue requirement and applying that calculation as an offset to the simple change in tax rates that was calculated against the current rates of the Company.

Q. Why is OPC opposed to any adjustments other than amount associated with the change in tax rates?

A. The Stub Period is a timeframe that should take into consideration only the change in tax rates from 34% to 21% and apply that to the current rates. No consideration should be given to refunding the calculated excess deferred tax for that period or a reassessment of the revenue requirement. The stub period is only a recalculation of a tax rate change against the Company's established rates. It is a substantial change that neither the Company nor the Commission had any control over and therefore needed to be addressed. It is just a simple math calculation. The Companies would wish to change the rules and amounts so they are *guaranteed* its rate of return by way of true-up and an uncontested adjustments. In the Commission's Accounting Authority Orders (AAOs) there is no adjustment of this nature. In fact, the Company has indicated that the adjustment can only reduce the Stub Period amount, any excess determination cannot increase Stub Period amount. Nothing else has been identified as extraordinary so the usual rules must be applied. The tax rate change should be the only consideration in the Stub period.

Q. In direct testimony, you stated that the excess earnings should be offset against regulatory assets. The Company proposes to refund the amount as soon as possible. Is OPC opposed to the refund?

A. OPC is not necessarily opposed to a one-time refund; however, OPC does not want either utility to weaken its cash flow position to provide a refund. If providing a refund causes the company to seek additional financing to cover the cash flow shortfall then the customer ends up paying for additional carrying costs to service the shortfall, whereas, a reduction to rate base lowers revenue requirement by direct reduction of a regulatory asset with the highest amortization is acceptable and has less of an immediate impact to the Company's financing.

Q. What amount does OPC propose as the stub period adjustment for each Company?

A. For KCPL, the change in tax rates from 34% to 21% created a tax amount change of $15,704,432 with a gross up factor of 1.34135 makes the total adjustment of $21,065,140. For GMO, the change in rates created a difference of $15,003,593 with a gross up of the taxes, the total stub period tax change would be $20,125,069[2]. These amounts are based on a period beginning January 1, 2018 and ending in late December.

<u>BAD DEBT EXPENSE IN THE COST OF SERVICE</u>

Q. What has Company witness Ms. Linda Nunn presented in her rebuttal testimony to change the level of bad debt expense that is included in the cost of service?

A. Ms. Nunn points out that Staff did not apply the proper revenues to the bad debt factor to include what she believes to be the proper amount of bad debt in the revenue requirement. In short, Ms. Nunn points out that Staff did not calculate bad debt in this case based on a rate increase.

Q. Does OPC take issue with how KCPL and GMO regulated bad debt is handled between subsidiaries?

A. Yes, both KCPL and GMO sell their receivables to its receivable subsidiaries[3] at a tremendous discount on cost and then apply this loss to reduce their taxable income. The total loss to KCPL on the receivable sales since 2009 was also approximately ** ** and GMO is ** **. However, the receivable companies resell these customer accounts to a

[2] These adjustments were calculated from answers to Staff data requests 304. A change in OPC office software prevented access to Staff's final run from the ER-2016-0285 case to verify the new tax amounts. These amounts may be adjusted when verified through the 2016 EMS run.
[3] Kansas City Power & Light Receivables Co and KCP&L Greater Missouri Operations

non-affiliate for amounts greater than the receivables subsidiaries paid to KCPL and GMO. The loss KCPL and GMO incur from selling their customer account receivables below costs to their subsidiaries is great enough to cover the receivable subsidiaries bad debt expense associated with the purchased receivables and make a profit, which is separate from KCPL and GMO. Since 2009, KCPL and GMO receivable companies have made approximately ** ** and ** ** million respectively on this business arrangement. This confidential schedule shows that KCPL and GMO have no bad debts and are recovered by their receivable subsidiaries through the profit created by KCPL and GMO selling their customer account receivable to their receivable subsidiaries at below cost and fair market value while KCPL still collects and processes these receivables at a fee that guarantees their subsidiaries will generate a profit for ultimately KCPL's sole owner.

This arrangement is very much like robbing Peter to pay Paul because the utilities take the loss for tax purposes and the receivable company records a profit, however, the ratepayer still is asked to supplement the utility by having bad debt expense included in the cost of service and recovered by Missouri ratepayers even though the consolidated company shows a profit on the arrangement. It should be noted that KCPL and GMO also want their customers to pay the bank finance charges of their non-regulated receivables subsidiaries as well as the receivables subsidiaries bad debt expense which result in double recovery for bad debt and bank fee expenses.

Q. How does Staff calculate bad debt amounts to include in its cost of service?

A. As Staff explains in it Cost of Service report:

> Staff's recommended treatment of bad debt expense is to calculate the ratio of KCPL's and GMO's net write-offs to annualized retail revenue to determine an appropriate level of bad debt expense. Bad debt expense is the portion of retail revenues KCPL and GMO are unable to collect from retail customers by reason of bill non-payment. After a certain amount of time has passed, delinquent customer accounts are written off and turned over to a third party

> collection agency for recovery. **If the collection agency is subsequently able to successfully collect some portion of previously written off delinquent amounts owed, then those collected amounts reduce current write-offs. Offsetting successful collection agency recoveries against total write-offs creates the "net write-off" amount used to determine the annualized level of bad debt expense.**
>
> Staff calculated the annualized bad debt expense by examining the ratio between billed revenues, net of gross receipt taxes, for the twelve month period ended December 31, 2017, and the actual 12-month history of billed revenues that were never collected (net write-offs) for the twelve months ended June 30, 2017. From this information a bad debt ratio was derived, which was then applied to Staff's adjusted weather normalized level of retail revenues to obtain the annualized level of bad debt expense.[4] (Emphasis added)

Q. What is the current level of bad debt in Staff's cost of service?

A. Accounting Schedule 09 indicates that Staff has included $5,453,715 for bad debt expense for KCPL and $2,523,153 for GMO[5].

Q. Why has OPC determined that bad debt expense should be adjusted?

A. Both KCPL and GMO use "receivable companies"[6] to hypothetically administer its delinquent accounts receivables ("A/R"). Actually KCPL administer the customer accounts for a fee. The utilities sell the A/R at below cost or a steep discount[7], claiming a loss on the consolidated federal tax return and wiping the receivables off its books. Please review the column on CONFIDENTIAL Schedule JSR-S-02, page 1, Titled "Loss on Sale of A/R" for the years 2009-2016. The receivable company then turns around and sells the delinquent accounts to a third party for fair market value considering the fact that the bad debts, collection costs, financing fees and other costs will be charged to the receivable subsidiary. The

[4] Staff Cost of Service Report pages 107 and 108
[5] Schedule 09, Account 904, Column M-MO adj. Jurisdictional
[6] KCPL uses Kansas City Power & Light Receivables Co and GMO uses GMO Receivables Company
[7] Schedule JSR-S-1, page 6 line titled "DISCOUNT EXPENSE ON SOLD A/R"

receivable company ultimately makes a profit on the heavily discounted below cost customer accounts receivables purchased from KCPL and GMO. The heavily discounted (loss) lowers KCPL and GMO taxable net income and while increases the NOL carryforward asset and amortization at dispute in this case.

Q. What is the tax effect of the sales of the discounted accounts receivables?

A. For 2016, KCPL reduced its potential taxes by ** ** and GMO reduced its potential taxes by ** ** inversely, KCPL Receivables reported income of ** ** and GMO Receivables reported ** ** which will not be taxable due to the extensive consolidated NOL. So the question should be asked. Why should bad debt expense of $5,453,715 and $2,523,153 be built into the revenue requirement when the Companies enjoy a tax and income windfall from its affiliated transactions?

Q. What level of bad debt does OPC believe should be included in the revenue requirement?

A. Confidential Schedules JSR-S- 1 and 2, were created by OPC. OPC has reviewed several years of consolidated income tax returns of GPE and in conjunction with our review of the NOL issue in this case and information compiled in these schedules, OPC has determined that neither KCPL nor GMO should have any amount of bad debt built into its cost of service as the amount is recovered by the profit on their subsidiaries financial results targeted to enhance GPE's overall finances. It would be inappropriate to make KCPL and GMO Missouri customers to pay again for bad debt expenses already recovered by the operation of their receivable affiliates.

MISSOURI TAX REFORM

Q. Are there any other income tax true-up issues that need to be addressed?

A. OPC has been informed that the KCPL and GMO true-up cases will support greater rate increases than the amount filed. KCPL was unable to identify the items causing the greater rate increase position. OPC discovered the following item in Evergy's 2nd Quarter 2018 10 Q filing with the Security and Exchange Commission:

> On June 1, 2018, the Missouri governor signed Senate Bill (S.B.) 884 into law. Most notably, S.B. 884 reduces the corporate income tax rate from 6.25% to 4.0% beginning in 2020, provides for the mandatory use of the single sales factor formula and eliminates intercompany transactions between corporations that file a consolidated Missouri income tax return. As a result of the change in the Missouri corporate income tax rate, KCP&L revalued and restated its deferred income tax assets and liabilities as of June 1, 2018. KCP&L decreased its net deferred income tax liabilities by $46.6 million, primarily consisting of a $28.8 million adjustment for the revaluation and restatement of deferred income tax assets and liabilities included in Missouri jurisdictional rate base and a $9.9 million tax gross-up adjustment for ratemaking purposes. The decrease to KCP&L's net deferred income tax liabilities included in Missouri jurisdictional rate base were offset by a corresponding increase in regulatory liabilities. The net regulatory liabilities will be amortized to customers over a period to be determined in a future rate case. KCP&L recognized $15.5 million of income tax benefit primarily related to the difference between KCP&L's revaluation of its deferred income tax assets and liabilities for financial reporting purposes and the amount of the revaluation pertaining to KCP&L's Missouri jurisdictional rate base.[8]

The above information raises the possible issue that KCPL on its and GMO's behalf has recorded adjustments to reduce their deferred income tax reserves used as an offset to rate

[8] Page 60 Evergy 10Q 2nd Qtr 2018

base. Such adjustments would increase their rate base with KCPL and GMO expending no monies to justify the increase in investment to serve Missouri. OPC has issued a Data Request seeking information regarding the details of this matter. Without further information, OPC is opposed to these adjustments as they do not reflect the current impact on unpaid income taxes collected from Missouri ratepayers in determining the cost to provide them service.

Q. Does this conclude your surrebuttal testimony?

A. Yes.

ER-2018-0145
and
ER-2018-0146

KANSAS CITY POWER & LIGHT COMPANY
and
KANSAS CITY POWER LIGHT
GREATER OPERATIONSCOMPANY

SCHEDULE
JSR-S-01

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KANSAS CITY POWER & LIGHT COMPANY
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