Exhibit No.:	
Issue:	Income Tax Expense Accumulated Deferred Income Tax SO_2 Deferred Tax Asset Wind Energy Credit Property Taxes
Witness:	Philip M. Burright
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Kansas City Power & Light Company
Case No.:	ER-2006-____
Date Testimony Prepared:	January 27, 2006

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2006-____

FILED[3]
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Missouri Public Service Commission

DIRECT TESTIMONY

OF

PHILIP M. BURRIGHT

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
January 2006

"[redacted]**" Designates that "Highly Confidential" Information has been Removed Pursuant to the Standard Protective Order.**

KCPL Exhibit No. 43
Case No(s). ER-2006-0314
Date 10-16-06 Rptr KF

DIRECT TESTIMONY

OF

PHILIP M. BURRIGHT

Case No. ER-2006-____

Q: Please state your name and business address.

A: My name is Philip M. Burright. My business address is 1201 Walnut, Kansas City, Missouri, 64106-2124.

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

A: I am employed by Great Plains Energy Services as Director, Taxes. Great Plains Energy Services is the service company for Kansas City Power & Light Company ("KCPL").

Q: What are your responsibilities?

A: As Director, Taxes, I have the primary responsibility for management of KCPL's taxes, including income, property, sales and use, and transactional taxes.

Q: Please describe your education, experience and employment history.

A: I graduated from Wichita State University in 1984 with a Bachelor of Business Administration in Accounting. I received my Master of Business Administration degree from Rockhurst University in 2004. I am a Certified Public Accountant. I was first employed at KCPL in 2000 as Manager, Taxes and became Director, Taxes in 2002. From 1998 to 2000, I was a Senior Tax Manager with Sprint and was Director of Taxes for Harris Chemical Company from 1992-1998. I am a member of the American Institute of Certified Public Accountants, Tax Executive Institute, and the Edison Electric Institute Taxation Committee.

Q: Have you previously testified in a proceeding at the Missouri Public Service Commission ("MPSC") or before any other utility regulatory agency?

A: No, I have not.

Q: What is the purpose of your testimony?

A: The purpose of my testimony is to address (i) the income tax component of KCPL's cost of service; (ii) the accumulated deferred income tax rate base adjustments; (iii) the deferred tax treatment relating to the sale of SO_2 emission allowances; (iv) the production tax credit for wind generation; and (v) the property tax adjustment.

Q: **Are you sponsoring adjustments related to current and deferred income tax expense and deferred income tax reserves?**

A: Yes. I am sponsoring several adjustments shown on the Summary of Adjustments attached as schedule DAF-2 to the direct testimony of KCPL witness Don A. Frerking. Additionally, I am sponsoring the following adjustments to Deferred Income Tax Reserves shown on the Summary of Adjustments:

Adj-33a – Adjust Deferred Income Tax Reserves for the proforma impact of straight-line depreciation on 2006 plant additions and adjustments to deferred regulatory assets and liabilities; and

Adj-57 - Adjust Deferred Income Tax Reserves for the incremental impact of adjustments to Deferred Gain on Sale of Emissions Allowances under the 2006 Emission Allowance Management Policy.

I. <u>Income Tax Component in Cost of Service</u>

Q: Please explain the income tax component of KCPL's cost of service as calculated in Schedule 7 of KCPL's revenue requirement model, which is attached to the testimony of KCPL witness Don A. Frerking as Schedule DAF-1 ("Schedule 7").

A: The income tax component includes current income taxes, deferred income taxes and the amortization of investment tax credits. Current income taxes represent the income taxes currently payable to the federal and state governments. Deferred taxes are taxes that are reported currently on KCPL's books but are payable to the federal and state governments at some future date. Deferred taxes are established for timing differences between when an item of income or expense is recorded for book purposes and when that same item is reported on KCPL's tax returns. The amortization of investment tax credits represents the amount of tax credits flowing through to customers over the remaining lives of the related property. Schedule 7 follows these basic concepts but calculates both the currently payable and deferred income tax components of tax expense using a simplified method that results in a shift of income tax expense from the deferred income tax classification to the current income tax classification.

Q: Please explain the current income tax component in cost of service as calculated in Schedule 7.

A: Jurisdictional operations and maintenance deductions and other adjustments are applied against jurisdictional revenues to derive net taxable income, which is then used to compute the current tax expense component (current provision) for cost of service. For book purposes, these adjustments are the result of book versus tax differences and their implementation under normalization or flow-through tax methods. Each adjustment is either added to or subtracted from net income to derive net taxable income for ratemaking. For Schedule 7, however, a simplified methodology is used which eliminates the need to specifically identify all book and tax differences. Most significantly, all basis differences between the book basis and tax basis of assets are ignored in the current tax provision. The tax effect on basis differences is considered in the deferred tax section of Schedule 7. Additionally, accelerated tax depreciation is not used. Instead, a deduction for tax depreciation on tax basis assets, calculated on a straight-line basis, is used. This modified approach normalizes depreciation relating to the method differences (*e.g.*, accelerated versus straight-line) and life differences. This is referred to as tax straight-line depreciation. The MPSC Staff has previously agreed to this modified approach and it is used routinely in the KCPL Surveillance Report submitted annually to the MPSC Staff.

Q: **Please describe the adjustments to derive net taxable income for ratemaking.**

A: The following are the primary adjustments to derive net taxable income for ratemaking:

- Depreciation expense, as calculated on Schedule 5 of KCPL's revenue requirement model, has been excluded from the deductions listed on Schedule 7.
- As previously discussed, tax straight-line depreciation is subtracted to derive taxable income. Tax straight-line depreciation is computed by applying existing jurisdictional book straight-line depreciation rates to each vintage year's depreciable tax basis. No deferred taxes are provided for tax straight-line depreciation as the depreciation is flowed through ratably over the book life. Tax straight-line depreciation decreases taxable income, although it generally results in a higher taxable income than would have resulted if accelerated tax

depreciation had been used. In addition, under this simplified approach, neither the reduction of currently payable income tax expense nor the offsetting provision for deferred income tax expense on originating basis differences is recognized. (See discussion on deferred income tax expense below.)

- Nuclear fuel book amortization is excluded from the deductions listed on Schedule 7 and is replaced with nuclear fuel tax amortization using the appropriate modified accelerated cost recovery or units of production depreciation convention.
- The Manufacturer's Deduction amount is deducted from net income in deriving taxable income. This special deduction is allowable under the American Jobs Creation Act and is effective for years beginning after 2004. The deduction is based upon taxable income derived from the production of electricity. For 2006, the deduction is 3% of electricity production taxable income. The percentage increases to 9% by 2010. The amount of the deduction is based upon budgeted 2006 production net income before taxes. The amount of the manufacturer's deduction is intended to be what will be deducted on KCPL's actual federal return. The deduction has not been adjusted to conform to Missouri jurisdictional taxable income as shown on Schedule 7. This deduction is not an expense for book purposes, so no deferred taxes are created. It results in a lower taxable income with ultimately a lower current tax provision for cost of service.
- Meals and Entertainment expenses are added back in deriving net taxable income, since a portion of certain meals and entertainment expenses are not tax deductible.

This adjustment will increase taxable income and ultimately increase the current tax provision.

- Interest expense is subtracted to derive net taxable income. It is calculated by multiplying net rate base by the weighted average cost of debt as proposed in this proceeding. This is referred to as interest synchronization because this calculation ensures that the interest expense deducted for deriving current taxable income equals the interest expense provided for in rates.

Q: Are there other adjustments for deriving net taxable income for ratemaking?

A: Yes. However, they are not material for purposes of this testimony.

Q: Please continue with the current tax provision calculation discussion.

A: Once the deductions and adjustments have been applied to net income to derive taxable income for ratemaking, the taxable income amount is multiplied by the overall tax rate of 38.39% to derive the current tax provision.

Q: How is the 38.39% income tax rate determined for calculating the current tax provision for cost of service?

A: The current provision calculation utilizes a 35% federal tax rate and a 6.25% Missouri state rate resulting in an overall tax rate of 38.39%. The overall tax rate reflects the federal benefit relating to deductible Missouri state income tax and Missouri allowing 50% of federal taxes to be deducted when computing the current Missouri tax provision.

Q: Please explain the deferred income tax component in cost of service as calculated in Schedule 7.

A: The deferred income tax component in cost of service is primarily made up of the reversal of deferred income taxes on basis timing differences over the related assets' jurisdictional book lives. These basis difference adjustments serve to normalize the tax effect of items deducted for tax purposes and capitalized for book purposes. The other main deferred tax component is the average rate assumption method of deferred tax amortization. This adjustment represents the amortization of excess deferred income taxes over the remaining book lives. It reduces the income tax component of cost of service. During the 1980's, the federal tax rate was higher than today's 35% rate. Since deferred taxes were provided at the rate in effect when the originating timing differences were generated, the deferred income taxes were provided at a rate higher than the tax rate that is expected to be in existence when the timing differences reverse and the taxes are due to the federal government. This difference in rates is being amortized into the cost of service over the remaining book lives of the assets that generated the timing differences.

Q: **Please explain the Investment Tax Credit ("ITC") amortization component in cost of service as calculated in Schedule 7.**

A: ITC amortization reduces the income tax component of cost of service. The investment tax credit amortization is separated into two parts – Wolf Creek and non-Wolf Creek.

Q: **Why is the ITC amortization separated between Wolf Creek and non-Wolf Creek?**

A: In accordance with the Stipulation and Agreement concerning KCPL's Regulatory Plan, which the MPSC approved in Case No. EO-2005-0329 ("Regulatory Plan Stipulation and Agreement"), KCPL and the MPSC Staff agreed to extend the lifespan of the Wolf Creek plant from 40 years to 60 years effective August 7, 2005. As a result, the remaining unamortized amount of Wolf Creek's ITC is being amortized over the longer life. The lengthening of the book life from 40 to 60 years decreases the annual ITC amortization specific to Wolf Creek. The non-Wolf Creek ITC continues to be amortized ratably over the remaining book lives of the underlying assets. Another reason that the ITC is separated between Wolf Creek and non-Wolf Creek is to allow for a specific allocation factor for each ITC component in deriving Missouri jurisdictional income tax cost of service.

II. Accumulated Deferred Income Tax Rate Base Adjustments

Q: Please explain deferred income taxes and why they are a component of rate base.

A: Deferred income taxes represent the tax on timing differences for deductions and income reported on KCPL's tax return compared to what has been reported for book purposes. An expense deducted for tax purposes that exceeds what has been deducted for book purposes creates a deferred tax liability. A deferred tax liability is also recorded when income is recorded for book purposes sooner than when the income is reported for tax purposes.

Q: What is an example of a "book" versus "tax" expense timing difference that creates a deferred income tax liability?

A: The most significant timing difference is depreciation expense. Tax laws provide for a much quicker method of tax depreciation compared to book depreciation. This accelerated depreciation reduces KCPL's current income tax liability compared to the tax liability computed based upon book depreciation. As a result, KCPL has deferred its tax liability until a future point in time when tax depreciation is less than book depreciation. At that time, the deferred tax liability will no longer be deferred but be paid as part of the tax return.

Q: What is an example of a "book" versus "tax" income timing difference that creates a deferred income tax liability?

A: An example of a timing difference relating to an income item is unrealized gains associated with investments. The gain is recognized for book purposes but is deferred for tax purposes until the investment is sold and the gain is actually recognized. Unrealized gains result in a lower amount of income reported on KCPL's tax return compared to the amount of income reported on KCPL's books. This timing difference results in a deferred tax liability. Later when the investment is sold, the gain will be included in KCPL's tax return, and the associated tax will be paid to the government. At that time, the deferred tax liability will be reduced to $0.

Q: How do deferred income tax liabilities affect rate base?

A: Deferred tax liabilities related to items in the rate base are considered a cost-free source of financing for ratemaking purposes. Ratepayers should not be required to provide for a return on the portion of rate base that has been funded by the government in the form of reduced (albeit temporarily) taxes.

Q: Please explain other types of deferred income taxes.

A: Deferred taxes can also be a result of timing differences whereby book expenses exceed tax expenses, creating a deferred income tax receivable (asset). Income reported for tax purposes before being recorded for book purposes also results in a deferred tax asset.

Q: What is an example of a "book" versus "tax" expense timing difference that creates a deferred income tax asset?

A: A common expense that is deducted for book purposes before being deducted for tax purposes is the reserve for injuries & damages. KCPL deducts additions to the reserve for book purposes. However, a deduction is only allowed for tax purposes when settlements are paid in cash. This timing difference creates a deferred income tax asset.

Q: What is an example of a "book" versus "tax" income timing difference that creates a deferred income tax asset?

A: The most significant income item that creates a deferred tax asset specific to KCPL is the sale of SO_2 emission allowances. For tax purposes, any gains on the sales of emission allowances are taxable when the allowances are sold. However, as agreed in previous rate orders, KCPL does not record the income associated with the sale in its current period income, but defers gains in a regulated liability account. This timing difference of when income is recognized for tax and when it will be recognized for book creates a deferred tax asset, as future tax liabilities will be lower for tax purposes compared to book purposes when the deferred gains are amortized to book income in accordance with future regulatory orders. I will be discussing in more detail the tax treatment of the sale of SO_2 emission allowances later in my testimony.

Q: How do deferred income tax assets affect rate base?

A: Converse to deferred tax liabilities, deferred tax assets increase rate base. KCPL has paid taxes to the government in advance of the time when such taxes are included in cost of service and are collected from ratepayers. To the extent of taxes paid, KCPL must borrow money and/or use shareholder funds. The increase to rate base for deferred income tax assets allows shareholders to earn a return on shareholder provided funds until recovered from ratepayers through ratemaking.

Q: What are the deferred income tax reserve adjustments for KCPL's rate base?

A: Schedule 8 of KCPL's revenue requirement model, which is attached to the testimony of KCPL witness Don A. Frerking as Schedule DAF-1 ("Schedule 8"), itemizes the deferred income tax reserves and adjustments and *pro forma* deferred income tax reserve adjustments related to items included in KCPL's rate base. Schedule 8 reflects the deferred tax liabilities relating to depreciation and other expenses deducted for the tax return in excess of book deductions resulting in a rate base decrease. Schedule 8 also reflects deferred tax assets that serve to increase rate base. Adjustments to the deferred income tax reserves shown on Schedule 8 include the changes in deferred income tax reserves related to the addition of net plant and changes to certain deferred regulatory assets during the 2006 period ending September 2006. The deferred tax asset relating to the sale of emission allowances is a significant adjustment to rate base and warrants additional explanation.

III. <u>Deferred Tax Treatment Relating to the Sale of SO_2 Emission Allowances</u>

Q: Please explain KCPL's book treatment of the sale of emission allowances.

A: In accordance with the Regulatory Plan Stipulation and Agreement, and the amended SO_2 Emissions Allowance Management Policy and related SO_2 Plan dated December 29, 2005, KCPL is authorized to sell specified emission allowances. KCPL is planning to sell approximately **[redacted]** of SO_2 emission allowances by **[redacted]**. These allowances have a $0 cost basis. The Regulatory Plan Stipulation and Agreement requires KCPL to record the gains on these emission allowance sales as a regulatory liability and not record the sales transactions as income. The regulatory treatment provides that the allowances belong to the ratepayers and that the ratepayers are allowing KCPL to use these proceeds to fund its cash requirements. This ratepayer loan is considered a source of funding and as a result, the regulatory liability is a reduction to rate base. The deferred gain on the sale of emissions allowances will be returned to ratepayers through amortization in accordance with future regulatory orders. This regulatory treatment differs from the tax treatment.

Q: Please explain KCPL's tax treatment of the sale of SO_2 emission allowances.

A: For tax purposes, the sales of emission allowances are taxable income in the period during which they are sold. KCPL has a zero ($0) tax basis in the allowances as they were allotted from the Environmental Protection Agency at no cost. As a result, the entire estimated **[redacted]** would be reported as a taxable gain on KCPL's 2005 and 2006 income tax returns. Current taxes will be provided at the 38.39% Missouri jurisdictional rate or **[redacted]**. The **[redacted]** will not be reflected on Schedule 7 as a current income tax component of cost of service as it will be recorded as a deferred tax asset on Schedule 8.

Q: When will the taxes paid become a component of tax expense for cost of service?

A: At the point in time when the regulatory liability is amortized into book income, the corresponding amount of tax will be included in the current tax expense calculated on Schedule 7.

Q: How is the **[redacted] deferred tax asset treated for rate base?**

A: The **[redacted]** deferred tax asset will increase rate base. This is an appropriate ratemaking treatment as it is an offset to the emission allowance regulatory liability treated for regulatory purposes as a reduction to rate base. The net after-tax proceeds of **[redacted]** is the proper net rate base offset because KCPL will have **[redacted]** of funds provided by the emission allowance sales.

Q: Why wasn't KCPL able to treat the sale of allowances as like-kind exchanges and defer the tax on the sale of the emission allowances as contemplated in the Regulatory Plan Stipulation and Agreement?

A: KCPL investigated this treatment and concluded that the sales transactions would not qualify as a like-kind exchange ("LKE"). Internal Revenue Code ("IRC") Section 1031 and the regulation thereunder explicitly disallow the exchanging of intangible assets (*e.g.*, emission allowances) for tangible assets (*e.g.*, pollution control). This narrow definition precludes the deferral of tax under the LKE rules.

Q: Will KCPL pursue a ruling on this issue from the IRS as contemplated by the Regulatory Plan Stipulation and Agreement?

A: No. KCPL does not believe it to be a prudent use of funds to pursue a letter ruling.

Q: Please explain your rationale for not pursuing a letter ruling.

A: KCPL's outside legal counsel contacted an IRS representative on a no-name basis to discuss the tax treatment of the transaction. The representative indicated that favorable tax treatment would be "very, very remote" and that it would signify a "substantial change in corporate tax policy." Also, the IRS would not view the language in the Regulatory Plan Stipulation and Agreement as a determination of tax treatment.

Q: Why is it so unlikely that the IRS would permit KCPL to treat the transaction as a LKE?

A: Allowances are considered "intangible" assets whereas environmental assets are "tangible" assets. Exchanging intangible assets for tangible assets does not fall under the tax deferral provisions of Section 1031. Even if both assets involved in the exchange are tangible or intangible does not insure that the transaction will be tax-free. For tangible assets to be exchanged tax-free, the assets must be of the same class. For example, real estate exchanged for real estate is like-kind, but real estate exchanged for a computer is not. For exchanges of intangible assets, the IRS looks to the underlying nature or character of the rights involved, *e.g.*, a patent or a copyright, to determine whether the intangibles are like-kind. An exchange of a copyright on a song for a copyright on a novel, for example, is not like-kind. This narrow definition of like-kind effectively prohibits the transaction from qualifying as a LKE.

IV. Production Tax Credit for Wind Generation

Q: Please explain the production tax credit for wind generation adjustment on Schedule 7?

A: IRC Section 45 allows for a federal tax credit based upon the amount of electricity produced by a qualifying wind generating facility. The credit is allowed for 10 years after the facility is placed in service. The adjustment shown on Schedule 7 as a direct reduction of federal currently payable income tax expense reflects the *pro forma* production tax credits for KPCL's wind generation facility anticipated to be used and useful in September 2006. This adjustment uses the presently allowable $19 per megawatt hour of generation multiplied by the annualized amount of megawatt hours of wind generation to determine the amount of credit. The actual dollar credit per megawatt hour of generation is statutorily defined and is adjusted each year for inflation. We have not adjusted this credit per megawatt hour of generation amount for the *pro forma*.

Q: Why didn't KCPL adjust the credit per megawatt amount?

A: The $19 per megawatt hour is known and measurable, and therefore prudent.

V. Property Tax Adjustment

Q: Please explain the property tax adjustments.

A: Adjustment 33b, as set forth in the Summary of Adjustments, which is attached to the testimony of KCPL witness Don A. Frerking as Schedule DAF-2, annualizes the real estate and personal property taxes and payments-in-lieu-of-taxes ("PILOTs") for *pro forma* end-of-period plant in service. The amount of the adjustment relating to real estate and personal property taxes is $4,843,767 (before jurisdictional allocations) and the portion relating to the PILOT is $300,000, for a total adjustment of $5,143,767.

Q: Please describe how the adjustment relating to the real estate and personal property taxes was calculated.

A: The test year real estate and personal property tax amount reflects taxes based on assessments on plant in service as of December 31, 2004. The annualized adjustment is calculated using (a) estimated 2006 assessed values based on plant in service as of December 31, 2005, (b) anticipated 2006 tax levies based on historical trends, and (c) January 1- September 30, 2006 estimated plant additions (excluding the new wind generating facility). The actual 2006 assessed valuation should be finalized before the end of the true up period and will thus be known and measurable. This portion of the annualized adjustment is $3,393,955. The 2006 tax levy effect is $682,100. The January 1- September 30, 2006 estimated plant additions resulted in an additional $767,712 adjustment. This adjustment was determined by developing a ratio of the latest known amount of property taxes to plant-in-service as of December 31, 2005. This ratio was then applied to 2006 plant additions as of September 30, 2006, excluding any plant additions for the new wind generating facility.

Q. Why was there not an annualized tax adjustment applied to the additions to plant in service for the new wind generating facility?

A. The plant in service additions for the new wind generating facility will be located in Ford County, Kansas. Pursuant to K.S.A. 79-201 *Eleventh,* such property is exempt from real and personal property taxes.

Q. Does Kansas law provide for PILOTs on property that is exempt from property taxes?

A. Yes, pursuant to K.S.A. 12-147, taxing subdivisions of the state of Kansas are authorized and empowered to enter into contracts for PILOTs with the owners of property that is exempt from *ad valorem* taxes.

Q. Please explain the PILOT agreement relating to the new wind generating facility located in Ford County, Kansas.

A. The PILOT agreement anticipates annual payments of $300,000 to taxing subdivisions commencing in 2007 based on the wind generating property to be placed in service during 2006. This agreement is expected to be completed before the end of the true-up period.

Q: Does that conclude your testimony?

A: Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power & Light Company to Modify Its Tariffs to Begin the Implementation of Its Regulatory Plan	)))	Case No. ER-2006-____

AFFIDAVIT OF PHILIP M. BURRIGHT

STATE OF MISSOURI)
) **ss**
COUNTY OF JACKSON)

Philip M. Burright, being first duly sworn on his oath, states:

1. My name is Philip M. Burright. I work in Kansas City, Missouri, and I am employed by Great Plains Energy Services as Director of Taxes. Great Plains Energy Services is the services company for Kansas City Power & Light Company.

2. Attached hereto and made a part hereof for all purposes is my Direct Testimony on behalf of Kansas City Power & Light Company consisting of sixteen (16) pages all of which 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.

Philip M. Burright

Subscribed and sworn before me this 27th day of January 2006.

Nicole A. Wehry
Notary Public

My commission expires: Feb 4, 2007

NICOLE A. WEHRY
Notary Public - Notary Seal
STATE OF MISSOURI
Jackson County
My Commission Expires: Feb. 4, 2007