

Exhibit No.: Gmo-18
Issue: Taxes
Witness: Melissa K. Hardesty
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Sponsoring Party: KCP&L Greater Missouri Operations Company
Case No.: ER-2010-0356
Date Testimony Prepared: December 15, 2010

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2010-0356

REBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

ON BEHALF OF

KCP&L GREATER MISSOURI OPERATIONS COMPANY

**Kansas City, Missouri
December 2010**

KCP&L Exhibit No. GMD18
Date 2/14/11 Reporter LMB
File No. ER-2010-0356

REBUTTAL TESTIMONY

OF

MELISSA K. HARDESTY

Case No. ER-2010-0356

1 **Q: Please state your name and business address.**

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

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

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

7 **Q: What are your responsibilities?**

8 A: My responsibilities include management of KCP&L's taxes, including income, property,
9 sales and use, and transactional taxes.

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

11 A: I graduated from the University of Kansas in 1996 with a Bachelor of Science in
12 Accounting. I am a Certified Public Accountant with a permit to practice in the State of
13 Kansas. After completion of my degree, I worked at the public accounting firm Marks,
14 Stallings & Campbell, P.A. as a staff accountant from 1996 to 1999. In 1999, I went to
15 work for Sprint Corporation as a Tax Specialist in the company's federal income tax
16 department. I held various positions from 1999 to 2006. When I left Sprint to join
17 KCP&L in December 2006, I was Manager of Income Taxes for Sprint's Wireless
18 Division. I joined KCP&L in December of 2006 as Director of Taxes and was

1 subsequently promoted to my current position of Senior Director of Taxes for KCP&L in
2 May of 2009.

3 **Q: Have you previously testified in a proceeding at the Missouri Public Service**
4 **Commission (“MPSC” or the “Commission”) or before any other utility regulatory**
5 **agency?**

6 A: Yes. I provided testimony in Case Nos. ER-2007-0291, ER-2009-0089 and ER-2009-
7 0090 for KCP&L and KCP&L Greater Missouri Operations Company.

8 **Q: What is the purpose of your testimony?**

9 A: The purpose of my testimony is to rebut testimony provided by Staff’s Expert Witnesses,
10 Karen Lyons concerning property taxes, Paul Harrison concerning, Kansas City Earnings
11 Tax, Advanced Coal Credits and Other ITC Excess, Deferred Income Taxes, and Charles
12 Hyneman concerning accumulated deferred income taxes related to the Crossroads
13 Energy Center.

14 **Property Taxes**

15 **Q: Please address your concerns regarding Ms. Lyons’ property tax testimony.**

16 A: Ms. Lyons direct testimony indicates that the case will be tried up to utilize actual 2010
17 property tax cost billed as of December 31, 2010 since that is the known and measurable
18 costs. However, Ms. Lyons does not address whether this includes the property taxes
19 capitalized during the construction of Iatan Unit 2. The method used by Staff is an
20 annualized level of 2010 property taxes. In her testimony, Ms. Lyons state that the
21 annualized 2010 property tax expenses was calculated by multiplying January 1, 2010
22 plant-in-service balance by the ratio of January 1, 2009 plant-in-service balance to the
23 taxes paid in 2009.

1 Q: Are you in agreement with the method Ms. Lyons used to calculate annualized 2010
2 property tax expense?

3 A: No. I do not agree with the calculations prepared by Ms. Lyons. Ms. Lyons stated in her
4 testimony that the 2009 property taxes paid should be divided by the January 1, 2009
5 plant-in-service balances to determine the ratio to be applied to the January 2010 plant-
6 in-service balance to calculate the 2010 property tax expense. The formula used on Ms.
7 Lyons' supporting schedule for property taxes used information from schedule CS-126
8 that was updated on June, 30, 2010. On this schedule, the total 2009 property tax
9 expenses for MPS was \$10,981,169 and for L&P the total property tax expense was
10 \$3,360,364. I believe that actual 2009 property taxes from MPSC-20101012, DR #131.1
11 should have been used. On this schedule, the total O&M property tax expense for MPS is
12 \$11,283,646 and for L&P the property tax expense is \$3,485,420. I believe this is a
13 computational error on Ms. Lyons' part. Staff's calculations also appear to exclude unit
14 train property taxes and property taxes on vehicles.

15 The calculation of the ratio to be applied to the plant-in-service balance should
16 have been as follows:

17 ***MPS***

18	2009 Missouri Property Taxes	\$ 9,871,741
19	Add: 2009 Unit Trains Property Tax	\$ 33,860
20	Add: 2009 Kansas Electric Property	<u>\$ 1,378,045</u>
21	Total Adjusted Property taxes	\$11,283,646
22	1/1/2009 Plant-in-Service	\$1,452,858,965

23 $11,283,646/1,452,858,965 = .7767\%$

1 In her written testimony Ms Lyons indicates the Staff then used the percentage
 2 calculated above to annualize the 2010 property taxes by multiplying this percentage by
 3 the plant-in-service as of January 1, 2010. The Company believes that the September 30,
 4 2010 plant-in-service balance should be used to compute the annualized property tax
 5 expense. By using the January 1, 2010 plant-in-service balance, the Staff is excluding an
 6 estimate of property taxes for Iatan 2 that will be paid in 2010 and expensed after Iatan 2
 7 is placed-in-service.

8 If the correct percentage of property taxes paid over the plant-in-service balance
 9 for January 1, 2009 is applied to the September 30, 2010 plant-in-service balance, the
 10 annualized 2010 property taxes would be calculated as follows:

11	Plant in Service September 30, 2010	\$2,373,226,688
12	2009 Property Tax divided by 1/1/09 Plant-in-Service	<u>.7767%</u>
13	Annualized 2010 Property taxes	18,432,851
14	Add: Allocation of ECORP property taxes	295,765
15	Add: South Harper Pilot	241,832
16	Add: Crossroads Pilot	<u>258,000</u>
17	Annualized 2010 Total Property Taxes and Pilot	<u>\$ 19,228,448</u>

18 The computations for L&P using the same method described above are as follows:

19 ***L&P***

20	2009 Missouri Property Taxes	\$ 3,452,095
21	Add: 2009 Unit Trains Property Tax	<u>\$ 5,391</u>
22	Total Adjusted Property Taxes	\$ 3,457,486
23	1/1/2009 Plant-in-Service	\$405,914,437

1		3,457,486/405,914,437 = .8517%
2	Plant in Service September 30, 2010	\$ 553,776,877
3	2009 Property Tax divided by 1/1/09 Plant-in-Service	<u>.8517%</u>
4	Annualized L&P 2010 Property Taxes	4,716,517
5	Add: Allocated ECORP property taxes	<u>83,420</u>
6	Annualized Total 2010 Property Taxes	<u>\$ 4,799,937</u>

7 The annualized property taxes are total company before Missouri Jurisdictional
8 allocation.

9 **Q: Has the Company discussed with Staff which method should be used for the final**
10 **true-up of property taxes in this Case?**

11 A: Subsequent to the filing of the direct testimony in this case, Staff has indicated that it
12 intends to calculate property taxes by applying a ratio, determined by dividing the 2010
13 property tax expense by the January 1, 2010 plant-in-service balance, to the January, 1,
14 2011 plant-in-service balance. The company would be in agreement with this approach.

15 **Q: If instead, both parties utilize 2010 actual property taxes cost incurred, will there**
16 **then be any property tax expense difference between the parties at true-up?**

17 A: There is likely to be one difference. Ms. Lyons did not include in her testimony any
18 reference about the inclusion of 2010 property taxes actually incurred and billed in 2010
19 related to the Iatan Unit 2 construction work in progress. These property taxes were
20 capitalized to Iatan construction work orders during 2010.

21 **Q: Since the capitalized 2010 Iatan generation facility property tax cost was not a 2010**
22 **O&M expense why should this cost be included in property tax expense in this rate**
23 **proceeding?**

1 A: Beginning with the in-service date of Iatan Unit 2 in September 2010, the associated
2 property taxes previously capitalized will be or has been classified as O&M property tax
3 expense. These property taxes are a known and measurable expense that will occur after
4 the assets related to Iatan Unit 2 are placed-in-service. It is reasonable to expect that the
5 O&M property tax impact for these units will be significantly greater than the capitalized
6 property tax during 2009 at issue in this case. This is true because the capitalized
7 property taxes for 2009 were based on January 1, 2009 CWIP balances for Iatan Unit 2.
8 The property taxes associated with the final costs will be much higher because the final
9 costs for the assets placed-in-service during 2010 is higher. The total plant in-service
10 cost for MPS increased from \$1,534,683,198 on January 1, 2010 to \$2,373,226,688 on
11 September 30, 2010, and the total plant in service cost for L&P increased from
12 \$415,824,209 on January 1, 2010 to \$553,776,877 on September 20, 2010. It is for this
13 reason that the Company considers the inclusion of the 2010 Iatan Unit 2 previously
14 capitalized property taxes as a component of property tax expense in this case to be
15 appropriate.

16 **Q: Does including the 2009 Iatan Unit 2 property tax cost result in a “double recovery”**
17 **by “earning a return of and on” the same item?**

18 A: No. It is correct that taxes capitalized prior to the assets being placed in service will be
19 included in the rate base for which GMO will earn a return on in this rate case. This is
20 always the case for capitalized property taxes. However, it is also correct that GMO will
21 incur property taxes as O&M expenses after the assets are placed in service. This annual
22 cost should not be treated differently than any other cost of operating the plant once the
23 assets are placed-in-service.

1 Kansas City Earnings Tax

2 **Q: What concerns do you have concerning Mr. Harrison's testimony on Kansas City**
3 **earnings tax?**

4 A: Mr. Harrison believes that it appropriate to reallocate a portion of Kansas City earnings
5 tax paid and reported by KCP&L to be included as expense in GMO's cost of service
6 schedules.

7 **Q: Do you agree with Mr. Harrison that some of the earnings tax paid by KCP&L be**
8 **reallocated to GMO customers?**

9 A: No. We do not agree with Mr. Harrison's adjustment. However, we agree with Mr.
10 Harrison that some of the work spent by KCP&L employees in Kansas City, Missouri
11 locations do go to support GMO customers. Similarly, work performed at locations by
12 KCP&L employees outside of Kansas City, Missouri also supports GMO's Kansas City,
13 Missouri customers. Because GMO files its own Kansas City earning tax return, it
14 makes more sense to adjust GMO's payroll factor on its Kansas City earnings tax return
15 than to allocate a portion of KCP&L tax to GMO. If we used GMO's gross receipts
16 factor as an estimate of the payroll cost factor used to support GMO's Kansas City,
17 Missouri customers, the revised total allocation factor would be 8.0823% versus the
18 7.1157% used on GMO's Kansas City earnings tax return for 2009. When taken into
19 account with the 1% tax rate imposed by Kansas City, Missouri, the overall adjustment to
20 Kansas City Missouri earnings tax for GMO's ratepayers would be less than .1% of what
21 was originally reported. This would result in an immaterial adjustment to the Kansas
22 City earnings tax included in general taxes for GMO's cost of service schedule.

1 Therefore, the Company believes that the amount of Kansas City earnings tax included
2 on its cost of service schedules is reasonable and proper.

3 **Advanced Coal Credits and Other ITC**

4 **Q: Please describe the advanced coal credits issue.**

5 A: Mr. Harrison has asserted that \$26.5 million of advanced coal credit allocated to KCP&L
6 should be reallocated to GMO (MPS and L&P) to reduce cost of service for GMO
7 ratepayers in this case.

8 **Q: Do you agree with Mr. Harrison's adjustment to the tax credits?**

9 A: No. I do not.

10 **Q: Briefly describe what the advanced coal credit is?**

11 A: An advanced coal credit is an investment tax credit (ITC) allocated to qualifying
12 advanced coal projects by the Internal Revenue Service. KCP&L was initially allocated
13 \$125 million of advanced coal ITC for its qualified investment in Iatan Unit 2 in 2008.
14 The amount of the advanced coal ITC was later reduced to \$107.3 million when
15 arbitration proceedings, with certain joint owners, other than GMO, were finalized in
16 September 2010.

17 **Q: Why has Mr. Harrison proposed an adjustment to reallocate \$25.6 million of coal
18 credits from KCP&L to GMO?**

19 A: The Empire District Electric Company, Kansas Electric Power Cooperative, and Missouri
20 Joint Municipal Utility Commission, certain joint owners of Iatan Unit 2, filed a notice to
21 arbitrate in 2009, asserting that they were entitled to receive proportionate shares (or the
22 monetary equivalent) of the \$125 million of advanced coal ITC allocated to KCP&L.
23 KCP&L was not successful in arbitration and \$17.7 million of advanced coal ITC was

1 allocated to The Empire District Electric Company. Mr. Harrison believes that since
2 GMO owns 18% of Iatan Unit 2, it should also be allocated its proportionate share of the
3 advanced coal ITC.

4 **Q: Why does the Company believe that GMO should not be allocated any of the credit?**

5 A: The Company believes that it would be a violation of the Internal Revenue Service
6 normalization rules under Internal Revenue Code Section 46(f) to allocate advanced coal
7 ITC directly or indirectly and an entity that did not claim the credit on its tax return.

8 **Q: What is a normalization violation and why does the Company believe that an
9 allocation of advanced coal credits to GMO would be considered a violation?**

10 A: The advanced coal ITC at issue is really a credit defined under Internal Revenue Code
11 Section 48A, Qualifying Advanced Coal Project Investment Tax Credits (ITC). These
12 ITC credits are subject to the normalization rules set forth in IRC Section 46(f). IRC
13 Section 46(f)(2)(A) states that if the taxpayer's cost of service for ratemaking purposes or
14 its regulated books of account is reduced by more than a ratable portion of the credit, then
15 no credit is allowed. This is considered a normalization violation. Since GMO has not
16 been awarded any Section 48A credits, (or been reallocated credits by the IRS in the
17 arbitration proceedings), it is not allowed to include any Section 48A credit to reduce
18 income tax expense for ratemaking purposes.

19 In addition, Regulation 1.46-6(b)(4) also states that the indirect reductions to cost
20 of service of a taxpayer are also considered a violation. This includes any ratemaking
21 decision intended to achieve an effect similar to a direct reduction to cost of service.
22 Several private letter rulings have interpreted the restrictions against indirect reductions
23 of cost of service related to ITC and have held that various ratemaking proposals would

1 violate the normalization requirements. Most recently, PLR 200945006 addressed the
2 sale of regulated gas distribution assets from one utility to another. At issue was whether
3 the accumulated deferred ITC of the selling utility could be transferred to the buying
4 utility to ultimately be used to reduce the rates of the buying utility. The IRS National
5 Office held that the selling utility would violate the requirements of the investment tax
6 credit normalization rules set forth in former section 46(f), if it directly or indirectly
7 passes the accumulated deferred ITC balance to another taxpayer who did not claim such
8 ITC tax benefits. Therefore any direct or indirect allocation of credits to GMO from
9 KCP&L would also be normalization violation under IRS regulations.

10 **Q: What is the penalty for a normalization violation?**

11 A: Per the Tax Reform Act of 1986 Section 211(b), the penalty for a violation of the ITC
12 normalization requirements is the recapture/repayment to the IRS the greater of ITC
13 claimed in all open tax years as of the date of the violation or the amount of ITC tax
14 credit remaining on the taxpayers' books of account. This would include all advanced
15 coal credit ITC used to offset the Company's tax liability for open periods and all
16 accumulated deferred ITC remaining on GMO for any other previous qualifying
17 investment tax credit properties. Therefore, if GMO received allocated benefits of
18 advanced coal ITC credits in violation of the normalization rules, GMO would have to
19 repay the IRS for all outstanding ITC remaining on its books for previous investment tax
20 credit properties. It would not have to repay any advanced coal ITC since it never
21 claimed any of these credits on a tax return.

22 **Q: What is the amount of ITC that would have to be repaid to the IRS by GMO for a**
23 **normalization violation?**

1 A: The penalty for a normalization violation would be the remaining ITC on GMO books for
2 other previous ITC projects. At September 30, 2010, the amount of ITC on the books is
3 \$3,963,573 for MPS and \$287,722 for L&P.

4 **Q: Can the Company get guidance from the IRS regarding a potential normalization**
5 **violation?**

6 A: Yes. The Company may request a ruling from the IRS as to whether or not the
7 reallocation of the credits to GMO is, in fact, a normalization violation. The Company
8 feels strongly that any allocation of the advanced coal credits to GMO would be a
9 normalization violation. However, if the Commission believes that it is appropriate to
10 allocate credits to GMO, we request the opportunity to first request a ruling from the IRS
11 before any decision is made final and the harm that may be incurred to the Company and
12 the ratepayers cannot be reversed.

13 **Q: Are there any other issues related to the advanced coal credits or other ITC in this**
14 **case?**

15 A: Yes. The amortization of the ITC cannot be more than a ratable portion of the credit over
16 the life used for book purposes to depreciation the assets associated with the ITC. If the
17 depreciable book life is changed for assets that generated ITC in prior years, then the
18 amount of other ITC included in the case must also be recomputed.

19 **Q: What happens if the life used for amortization of ITC does not agree with the**
20 **amortization period used for the depreciable book life that generated the ITC?**

21 A: If the life used for the amortization of ITC does not agree with the depreciable book life
22 for the assets they relate to, then a normalization violation has occurred and the penalty is

1 the same as the penalty for allocating a portion of the advanced coal credit ITC to GMO
2 mentioned previously.

3 **Q: Please summarize your position on the issues associated with the advanced coal ITC**
4 **credit?**

5 A: The Company believes that it cannot allocate advanced coal ITC to GMO or have a
6 different amortization period for ITC from the book depreciable life without incurring
7 significant penalties by the IRS and harming the Company and the ratepayers. Therefore,
8 the Company is requesting that no advanced coal ITC be allocated to GMO and that the
9 amortization period for the ITC agree with the depreciable book life ultimately
10 determined in this case. If in the event the Commission believes that it may be
11 appropriate to allocate advanced coal ITC to GMO, the Company is also requesting that it
12 be allowed to request a private letter ruling from the IRS stating that the allocation is not
13 a normalization violation before an order is made final on this issue.

14 **Excess Deferred Income Taxes**

15 **Q: What concerns do you have with excess deferred income taxes adjustment proposed**
16 **by Mr. Harrison?**

17 A: Mr. Harrison includes an adjustment to flow back excess deferred taxes over the
18 approximate depreciable book life of the property for which the deferred taxes are
19 associated. Mr. Harrison's adjustment does not appear to be adjusted for the change in
20 depreciable book lives requested by the Staff in this case.

21 **Q: Why does the excess deferred income taxes need to be adjusted?**

22 A: The IRS requires that the excess deferred taxes be flowed back the ratepayers not more
23 rapidly than by a proportionate amount of deferred taxes when the timing differences

1 related the same property reverses for the same period. Since book depreciation is
2 needed to determine how much of the timing differences reverse in a period, a change to
3 the book depreciation rates will impact the amount of excess deferred taxes that should be
4 flowed back to ratepayers.

5 **Q: What is the penalty by the IRS if more excess deferred taxes are flowed back to**
6 **ratepayers than should be in setting rates?**

7 A: This is also considered a normalization violation by the IRS and the penalty for a
8 violation of this nature is a loss of the use of accelerated depreciation when computing
9 the Company's federal tax liability. This penalty would create significant harm the
10 ratepayers. The deferred taxes created by accelerated depreciation are a significant
11 reduction to rate base. Without accelerated depreciation, GMO would pay income taxes
12 much sooner and it would need a higher revenue requirement cover those tax payments.

13 **Crossroad Accumulated Deferred Income Taxes**

14 **Q: Please address concerns with Mr. Hyneman's testimony related to accumulated**
15 **deferred income taxes associated with Crossroads.**

16 A: Mr. Hyneman states that GMO is refusing to include the accumulated deferred taxes
17 associated with Crossroads since the plant has been operating in the accumulated deferred
18 taxes included in rate base associated with the plant. I would like to clarify that GMO is
19 only proposing that the deferred taxes recorded while the plant was owned by the non-
20 regulated subsidiary should be excluded from the amount transferred to GMO's regulated
21 operations. All deferred taxes recorded subsequent to the transfer to GMO's regulated
22 operations have been included.

1 **Q: Please explain why the accumulated deferred taxes recorded while Crossroads was**
2 **owned by the non-regulated subsidiary should not be transferred to the regulated**
3 **operations.**

4 **A: As per Staff witness Paul R. Harrison's testimony on page 187 of the Staff Report:**

5 MPS's and L&P's deferred income tax reserve represents, in effect, a
6 prepayment of income taxes by MPS's customers. As an example,
7 because MPS and L&P are allowed to deduct depreciation expense on an
8 accelerated basis for income tax purposes, depreciation expense used for
9 income taxes is significantly higher than depreciation expense used for
10 financial reporting (book purposes) and for ratemaking purposes...The net
11 credit balance in the deferred tax reserve represents a source of cost-free
12 funds to MPS and L&P. Therefore, MPS's and L&P's rate base is
13 reduced by the deferred tax reserve balance to avoid having customers pay
14 a return on funds that are provided cost-free to the Company.

15 The deferred taxes related to the Crossroads units prior to the transfer to GMO-MPS were
16 never a prepayment of income taxes by GMO-MPS's customers or any other customer in
17 a regulated environment. Therefore, the Company does not believe that it is appropriate
18 to reduce its rate base for these deferred taxes.

19 **Q: Are deferred taxes generally transferred on the sale of an asset?**

20 **A: If an asset that has been included in a regulated environment since it was constructed or**
21 **purchased, the deferred taxes associated with that asset are generally required to be**
22 **included as a reduction to rate base for the purchasing Company. This procedure ensures**
23 **that customers who provided "cost-free" funds do not have to pay a return on those funds**
24 **when they are transferred to a different but also regulated entity. In this case, the**
25 **Crossroads units' accelerated tax benefits were never a source of "cost-free" funds for**
26 **GMO-MPS or any other regulated entity. Therefore, it is not appropriate to reduce the**
27 **rate base of Crossroads by the amount of deferred taxes generated while it was owned by**
28 **the non-regulated subsidiary.**

1 Q: Does that conclude your testimony?

2 A: Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Application of KCP&L Greater)
Missouri Operations Company to Modify Its) Docket No. ER-2010-0356
Electric Tariffs to Effectuate a Rate Increase)

AFFIDAVIT OF MELISSA K. HARDESTY


STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

Melissa K. Hardesty, being first duly sworn on her 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, Tax.

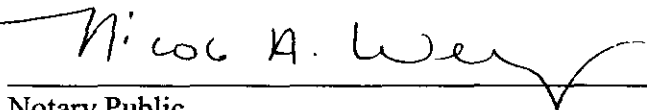
2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of KCP&L Greater Missouri Operations Company consisting of fifteen (15) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

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 14 day of December, 2010.



Notary Public

My commission expires: Feb. 4, 2011

