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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2012-0175

DIRECT TESTIMONY

OF

SALVATORE P. MONTALBANO

ON BEHALF OF

KCP&L GREATER MISSOURI OPERATIONS COMPANY

**Kansas City, Missouri
February 2012**

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Date 10-29-12 Reporter KF
File No. ER-2012-0175

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OF
SALVATORE P. MONTALBANO
Case No. ER-2012-0175

1 *Personal Qualifications*

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

3 A: My name is Salvatore P. Montalbano. My business address is 1100 Walnut Street, Suite
4 1300, Kansas City, Missouri, 64106.

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

6 A: I am a tax partner with PricewaterhouseCoopers, LLP ("PwC").

7 **Q: On whose behalf are you testifying?**

8 A: I am testifying on behalf of KCP&L Greater Missouri Operations Company ("GMO" or
9 the "Company").

10 **Q: Would you please describe the firm of PwC?**

11 A: PwC is a firm of independent public accountants with offices/affiliates throughout the
12 United States and in many countries. We have as clients a large number of both publicly
13 and privately owned companies. The firm performs audits of financial statements,
14 prepares and reviews income tax returns for all types of businesses, and consults with
15 businesses regarding financial, accounting and tax matters. PwC audits a significant
16 number of the electric, gas and telecommunications companies in the United States.

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

18 A: My responsibilities include the general practice of corporate income taxation. I
19 specialize in the taxation of, and the tax issues related to, regulated public utilities. I am

1 responsible for reviewing and signing off on a number of income tax provision
2 calculations for financial reporting purposes for a number of different U.S. Securities
3 Exchange Commission ("SEC") and non-SEC registrants. I am a member of PwC's
4 utilities and power generation practice.

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

6 A: I received a Bachelor of Science degree in Accounting from Truman State University and
7 a law degree (J.D.) from Washington University in St. Louis.

8 I joined Coopers & Lybrand LLP (a predecessor firm to PwC) in August 1995. Starting
9 in 1998, I became a full time member of the utilities and power generation practice. I
10 became a partner at PwC in 2009.

11 Among various duties, my practice has included preparing and signing corporate income
12 tax returns, reviewing and signing off on income tax provisions for financial reporting
13 purposes, and advising companies on the regulatory impact of tax positions taken. I have
14 represented various utilities before the Internal Revenue Service ("IRS") regarding
15 certain tax positions at issue with the IRS. In addition, I have been involved in procuring
16 private letter rulings from the IRS National Office.

17 I am a frequent presenter at various utility tax conferences on tax related accounting and
18 regulatory matters sponsored by Edison Electric Institute, National Association of
19 Regulated Utility Commissioners and American Gas Association. I have instructed or
20 co-instructed PwC's annual Utility Accounting for Income Taxes training for the last
21 eight years.

1 I am a member of the Missouri Bar and also am licensed as a Certified Public Accountant
2 in Missouri. Additionally, I am a member of both the American Bar Association Section
3 of Taxation and the American Institute of Certified Public Accountants.

4 ***Purpose and Summary of Testimony***

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

8 A: No. I have not testified before the MPSC or any other utility commission.

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

10 A: The purpose of my testimony is to support GMO’s tax calculations in its rate filings as it
11 relates to the potential imputation of advanced coal investment tax credits (“ITCs”) under
12 Section 48A of the Internal Revenue Code of 1986, as amended (“IRC”) for the Iatan 2
13 plant.

14 **Q: What, specifically, does your testimony address?**

15 A: My testimony addresses two potential issues. The first is the propriety under the federal
16 tax normalization rules of including an adjustment for imputed ITCs in GMO’s rate
17 proceeding. The second addresses whether merging GMO with Kansas City Power &
18 Light Company (“KCP&L”) will satisfy the federal tax normalization rules.

19 ***Background Surrounding ITCs***

20 **Q: Please explain the relationship between GMO and KCP&L.**

21 A: Great Plains Energy Incorporated (“GPE”) is a parent corporation that owns all the stock
22 of two regulated subsidiaries, KCP&L and GMO. KCP&L serves primarily the Kansas
23 City area and has regulated operations in Missouri and Kansas. GMO contains the

1 activities of two regulated divisions, both operating exclusively in Missouri, Missouri
2 Public Service ("MPS") and St. Joseph Light & Power ("L&P"). KCP&L, between
3 Missouri and Kansas, and GMO, between MPS and L&P operate under four separate rate
4 tariffs.

5 **Q: Have KCP&L and GMO received ITCs in the past?**

6 A: Yes. Both KCP&L and GMO have received ITCs under the former IRC Section 46.

7 **Q: Are there special tax accounting rules related to ITCs?**

8 A: Yes. ITCs are designed to incent investment in qualifying tangible property. However,
9 regulated utilities would lose that incentive if they immediately flowed through (or
10 flowed through too rapidly) the benefit of the ITCs to their ratepayers. Congress
11 mandated a sharing of tax benefits between ratepayers and utilities from a regulatory
12 perspective in the Revenue Act of 1971 by adding former IRC Section 46(f)(1) and (f)(2).

13 **Q: How does this "sharing" work?**

14 A: Regulated utilities were required to choose one of two options for recording ITCs in their
15 regulated books. These options have collectively been referred to as the federal
16 normalization rules. Under option 1 of Section 46(f)(1), utilities would have no cost of
17 service adjustment for ITCs, but would reduce rate base immediately by the amount of
18 any ITCs and would restore the credits to rate base no less rapidly than ratably over the
19 regulatory (book) life of the underlying property. Under option 2 of Section 46(f)(2),
20 utilities would have no rate base adjustment for ITCs, but would amortize ITCs in cost of
21 service no more rapidly than ratably over the regulatory (book) life of the underlying
22 property.

1 **Q: Did KCP&L and GMO make an election?**

2 A: Yes, both GMO and KCP&L chose option 2 under IRC Section 46(f)(2). The elections
3 are irrevocable and cannot be changed.

4 **Q: Are the ITC elections still operative under current tax law?**

5 A: Yes. Section 46(f) was removed from the IRC by the Revenue Reconciliation Act of
6 1990, but is still operative with respect to normalization of investment tax credits.

7 **Q: What would happen if a regulatory commission forced a utility to treat ITCs in
8 rates in a manner inconsistent with their chosen option?**

9 A: Congress mandated certain penalties in Section 211(b) of the Tax Reform Act of 1986.
10 The penalty is the recapture and payment to the IRS of the greater of ITCs claimed in any
11 open tax years or any unamortized ITC (for option 2 companies), or ITCs not restored to
12 rate base (for option 1 companies), remaining on its regulated books.

13 **Q: Independent of the ITCs on Iatan 2, do KCP&L and GMO have unamortized ITCs?**

14 A: Yes. As of December 31, 2011, GMO has \$3.4 million of unamortized ITCs, and
15 KCP&L has \$127.9 million of unamortized ITCs.

16 *Facts with Regard to Iatan 2 Plant and Advanced Coal Credits*

17 **Q: Who are the owners of the Iatan 2 plant?**

18 A: KCP&L, GMO, The Empire District Electric Company ("Empire"), Missouri Joint
19 Municipal Electric Utility Commission ("MJMEUC") and the Kansas Electric Power
20 Cooperative, Inc. ("KEPCo") all agreed to construct and own the Iatan 2 plant.

21 **Q: What percentages do the respective owners hold in Iatan 2?**

22 A: KCP&L owns 54.71%. GMO owns 18%. Empire owns 12%. MJMEUC owns 11.76%.
23 KEPCo owns 3.53%.

1 **Q: What is the tax structure of the ownership in Iatan 2?**

2 A: For tax purposes, the joint owners elected not to be treated as a partnership and have joint
3 ownership of Iatan 2 as tenants in common. Thus, each owner is taxed on its
4 proportionate share of taxable earnings from Iatan 2.

5 **Q: When did Iatan 2 go into service?**

6 A: Iatan 2 went into service in August of 2010.

7 **Q: Did any of the joint owners apply for credits on Iatan 2?**

8 A: Yes. In 2007, KCP&L applied to the Department of Energy for advanced coal credits
9 under IRC Section 48A. In April 2008, the Department of Energy and IRS accepted the
10 application and allocated \$125 million in IRC Section 48A credits for Iatan 2 to KCP&L
11 only.

12 **Q: Are the advanced coal credits considered ITCs?**

13 A: Yes. The IRC Section 48A credits are investment credits under IRC Section 46.

14 **Q: Are they subject to the previously discussed normalization rules with respect to
15 ITCs?**

16 A: Yes. IRC Section 50(d)(2) provides that rules similar to former IRC Section 46(f) rules
17 apply with respect to investment credits under the current IRC Section 46.

18 **Q: Did any of the other joint owners, besides KCP&L, attempt to apply for the IRC
19 Section 48A credits?**

20 A: Yes. In 2008, GMO and Empire applied for IRC Section 48A credits but were denied.

21 **Q: Why were they denied?**

22 A: The IRS had indicated that the \$125 million allocated to KCP&L represented the full
23 amount of IRC Section 48A credits available for Iatan 2.

1 **Q: Did the joint owners of Iatan 2 seek recompense from KCP&L?**

2 A: Yes. In 2009, Empire and the other co-owners non-affiliated with KCP&L or GMO
3 initiated arbitration proceedings against KCP&L claiming entitlement to a portion of the
4 credits.

5 **Q: How did the arbitrator rule?**

6 A: In December 2009, the arbitrator found in favor of Empire (and ruled against the
7 municipals and cooperative because they are tax exempt entities and would not benefit
8 from the underlying credits) and directed KCP&L and Empire to apply for a revised
9 Memorandum of Understanding ("MOU") from the IRS to allow Empire to share in IRC
10 Section 48A credits equal to \$17,712,500, representing its proportionate share of the
11 ownership of Iatan 2.

12 **Q: Was the MOU revised?**

13 A: Yes. In September 2010, the revised MOUs were issued to Empire and KCP&L by the
14 IRS.

15 **Q: Did the revised MOUs allocate any of the credits to GMO?**

16 A: No.

17 **Q: Did GMO seek to get a revised MOU?**

18 A: Yes. The Commission issued a report and order on March 16, 2011, that, among other
19 findings, ordered KCP&L and GMO to apply for a revised MOU with the IRS that would
20 allow GMO to have its proportionate share of the IRC Section 48A credits, much like
21 Empire. This would have resulted in GMO being allocated \$26,562,500 in credits.

1 **Q: Did the IRS issue the revised MOU to GMO?**

2 A: No. The IRS sent KCP&L and GMO a letter on August 24, 2011 which denied their
3 request for a second revised MOU.

4 ***Imputation of ITCs to GMO***

5 **Q: Would it be proper for the MPSC to impute credits to GMO as if the revised MOU**
6 **was issued?**

7 A: No.

8 **Q: Why not?**

9 A: The imputation of credits and assumed amortization in GMO's rates could constitute a
10 normalization violation and trigger the penalties enumerated above as described in
11 Section 211(b) of the Tax Reform Act of 1986. Such amortization would constitute an
12 indirect violation of the normalization rules.

13 **Q: What is an "indirect violation" of the normalization rules?**

14 A: Treasury regulations under former IRC Section 46 prevent state commissions from doing
15 indirectly what they cannot do directly without violating the normalization rules. Treas.
16 Reg. Section 1.46-6(b)(4) indicates that cost of service or rate base is considered to have
17 been reduced by reason of all or a portion of a credit if such reduction is done in an
18 indirect manner. Treas. Reg. Section 1.46-6(b)(4)(iii) provides that a type of indirect
19 reduction is any ratemaking decision intended to achieve an effect similar to a direct
20 reduction to cost of service or rate base. In determining whether a ratemaking decision is
21 intended to achieve this effect, consideration is given to all the relevant facts and
22 circumstances, including the record of the proceeding, the regulatory body's orders, and

1 the anticipated effect of the ratemaking decision on the company's revenues in
2 comparison to a direct reduction to cost of service or rate base.

3 **Q: Can you provide an example of an indirect violation?**

4 A: Private Letter Ruling ("PLR") 200945006¹ involved the sale of natural gas assets of a
5 public utility to another unrelated public utility. The regulatory commission in question
6 sought to require the seller to transfer to the buyer the balance of its then-existing
7 accumulated deferred ITC as part of the transaction, or, in the alternative, that seller
8 transfer amounts to buyer in lieu of the annual ITC amortization for purposes of flowing
9 through those amounts to the ratepayers of the buyer. The IRS ruled that such a transfer
10 of the unamortized ITC balance (or an amount in lieu of the actual ITC) and continued
11 amortization by the buyer would violate the normalization rules.

12 The IRS objected to the fact that the buyer would be flowing through to its ratepayers
13 ITC that was not available to, and was not claimed by, the buyer. Consequently, the
14 buyer would have received no tax benefits of the investment credit but it would be forced
15 to give a nonexistent benefit to its ratepayers.

16 **Q: How is the imputation of credits to GMO like the above PLR?**

17 A: Although the present situation does not involve a sale of regulated utility assets, it
18 appears that the potential imputation of credits is similar to the commission's proposal in
19 PLR 200945006 in that an ITC benefit would be flowing through to the ratepayers of
20 GMO even though, if the MOU is not modified, GMO would not be entitled to any ITC
21 under IRC Section 48A. Thus, like the buyer in PLR 200945006, GMO would receive no
22 actual ITC but its ratepayers would be receiving the benefit of the ITC.

¹ Although a PLR is technically only authority to the taxpayer to whom it is issued, the IRS follows a consistent policy in issuing PLRs on similar issues to other taxpayers.

1 **Q: What would be the impact of an indirect normalization violation?**

2 A: Given that a normalization violation could arise from the imputation of credits from
3 KCP&L to GMO, there is a serious concern that any imputed credits could be lost if a
4 normalization violation is determined. Under the penalty provisions, the \$3.4 million in
5 deferred ITC on GMO's books that has not been amortized would almost certainly be
6 required to be paid back to the IRS. In addition, depending on the interaction of any
7 further potential Commission action involving KCP&L's Missouri operations and GMO
8 with respect to these credits, any amounts imputed could also be in jeopardy of being
9 returned to the IRS.

10 **Q: How long would the normalization violation last?**

11 A: Under Treas. Reg. Section 1.46-6(f)(4), once a violation occurs, it would continue until a
12 final rate order is put into effect curing the violation. Thus, if a violation occurs at GMO
13 for the imputation of credits, GMO would lose the opportunity to pursue additional ITCs
14 until the MPSC cured the violation through a subsequent conforming final rate order.

15 **Q: What opportunities for additional ITCs would exist for GMO?**

16 A: In addition to the advanced coal project ITCs in IRC Section 48A that were claimed for
17 Iatan II, the energy credit provisions of IRC Section 48 provide a number of different
18 opportunities for ITCs for various alternative energy investments through various dates
19 into the future. For instance, ITCs may be claimed on 30% of the eligible cost basis in
20 large wind investment projects placed in service before January 1, 2013. Also, ITCs may
21 be claimed on 30% of the eligible cost basis on equipment which uses solar energy to
22 generate electricity for equipment placed in service before January 1, 2017.

1 In addition, Congress may add to the types of property in the future which qualify for
2 ITCs, and/or extend the placed in service dates for various alternative energy property
3 that currently qualify for ITCs.

4 ***Merger of KCP&L and GMO***

5 **Q: Given that KCP&L does rightfully have ITCs under the MOU, could GMO avoid**
6 **violating the normalization rules by merging with KCP&L into one legal entity?**

7 A: No.

8 **Q: Why not?**

9 A: The treasury regulations interpreting former IRC Section 46 indicate that the
10 normalization rules should be applied on a jurisdictional basis and not an entity wide
11 basis. Treas. Reg. Section 1.46-6(j)(1) states that if a taxpayer is required by a regulatory
12 body having jurisdiction over less than all its property to account for the credit under a
13 determination inconsistent with former IRC Section 46(f)(2), such credit shall be
14 disallowed only with respect to property subject to the jurisdiction of the regulatory body.

15 **Q: How does this apply to a merger of KCP&L and GMO?**

16 A: Even though KCP&L and GMO would form one legal entity, there would still be three
17 separate regulatory divisions operating under three separate tariffs in Missouri: KCP&L,
18 MPS and L&P.

19 **Q: Does Treas. Reg. Section 1.46-6(j)(1) apply across jurisdictions in multiple states or**
20 **would it equally apply to separate regulatory divisions within the same state?**

21 A: The regulation describes a situation where multiple jurisdictions regulate property
22 generating the ITC, so that a violation in one jurisdiction would not necessarily cause a
23 violation in another. But, the application of the regulation would also apply to different

1 rate regulated entities within the same jurisdiction if their rates are set under separate
2 tariffs.

3 **Q: Would a normalization violation at GMO be isolated to GMO's regulatory accounts**
4 **even if GMO was merged with KCP&L?**

5 A: Yes, so long as KCP&L and GMO continued with separate tariffs in Missouri. A
6 violation at KCP&L would not necessarily taint the ITC of GMO and vice versa.

7 *Conclusion*

8 **Q: Does that conclude your testimony?**

9 A: Yes, it does.

