

**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

DIRECT TESTIMONY OF

PHILIP M. BURRIGHT

**ON BEHALF OF
KANSAS CITY POWER & LIGHT COMPANY**

**IN THE MATTER OF THE APPLICATION OF
KANSAS CITY POWER & LIGHT COMPANY
TO MODIFY ITS TARIFFS TO BEGIN THE
IMPLEMENTATION OF ITS REGULATORY PLAN**

DOCKET NO. 06-KCPE-____ - ____

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

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

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

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

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

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

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

2 A: I graduated from Wichita State University in 1984 with a Bachelor of Business

3 Administration in Accounting. I received my Master of Business Administration

4 degree from Rockhurst University in 2004. I am a Certified Public Accountant. I was

5 first employed at KCPL in 2000 as Manager, Taxes and became Director, Taxes in

6 2002. From 1998 to 2000, I was a Senior Tax Manager with Sprint and was Director

7 of Taxes for Harris Chemical Company from 1992-1998. I am a member of the

8 American Institute of Certified Public Accountants, Tax Executive Institute, and the

9 Edison Electric Institute Taxation Committee.

10 **Q: Have you previously testified in a proceeding at the State Corporation**

11 **Commission for the State of Kansas (“KCC”) or before any other utility**

12 **regulatory agency?**

13 A: No, I have not.

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

15 A: The purpose of my testimony is to address (i) the income tax component of KCPL’s

16 cost of service; (ii) the accumulated deferred income tax rate base adjustments; (iii)

17 the deferred tax treatment relating to the sale of SO₂ emission allowances; (iv) the

18 production tax credit for wind generation; and (v) the property tax adjustment.

19 **Q: Are you sponsoring adjustments related to current and deferred income tax**

20 **expense and deferred income tax reserves?**

21 A: Yes. I am sponsoring several adjustments shown on the Summary of Adjustments

22 attached as schedule DAF-2 to the direct testimony of KCPL witness Don A. Frerking.

1 Additionally, I am sponsoring the following adjustments to Deferred Income Tax
2 Reserves shown on the Summary of Adjustments:

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

6 Adj-57 - Adjust Deferred Income Tax Reserves for the incremental impact of
7 adjustments to Deferred Gain on Sale of Emissions Allowances under the 2006
8 Emission Allowance Management Policy attached as Appendix C-1 to the
9 Stipulation that was approved by the Commission in Docket No. 04-KCPE-
10 1025-GIE (“Emission Policy”).

11 **I. Income Tax Component in Cost of Service**

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

15 **A:** The income tax component includes current income taxes, deferred income taxes and
16 the amortization of investment tax credits. Current income taxes represent the income
17 taxes currently payable to the federal and state governments. Deferred taxes are taxes
18 that are reported currently on KCPL’s books but are payable to the federal and state
19 governments at some future date. Deferred taxes are established for timing differences
20 between when an item of income or expense is recorded for book purposes and when
21 that same item is reported on KCPL’s tax returns. The amortization of investment tax
22 credits represents the amount of tax credits flowing through to customers over the
23 remaining lives of the related property. Schedule 7 follows these basic concepts but

1 calculates both the currently payable and deferred income tax components of tax
2 expense using a simplified method that results in a shift of income tax expense from
3 the deferred income tax classification to the current income tax classification.

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

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

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

- 1 A: The following are the primary adjustments to derive net taxable income for
2 ratemaking:
- 3 ○ Depreciation expense, as calculated on Schedule 5 of KCPL's revenue
4 requirement model, has been excluded from the deductions listed on Schedule
5 7.
 - 6 ○ As previously discussed, tax straight-line depreciation is subtracted to derive
7 taxable income. Tax straight-line depreciation is computed by applying
8 existing jurisdictional book straight-line depreciation rates to each vintage
9 year's depreciable tax basis. No deferred taxes are provided for tax straight-
10 line depreciation as the depreciation is flowed through ratably over the book
11 life. Tax straight-line depreciation decreases taxable income, although it
12 generally results in a higher taxable income than would have resulted if
13 accelerated tax depreciation had been used. In addition, under this simplified
14 approach, neither the reduction of currently payable income tax expense nor
15 the offsetting provision for deferred income tax expense on originating basis
16 differences is recognized. (See discussion on deferred income tax expense
17 below.)
 - 18 ○ Nuclear fuel book amortization is excluded from the deductions listed on
19 Schedule 7 and is replaced with nuclear fuel tax amortization using the
20 appropriate modified accelerated cost recovery or units of production
21 depreciation convention.
 - 22 ○ The Manufacturer's Deduction amount is deducted from net income in
23 deriving taxable income. This special deduction is allowable under the

1 American Jobs Creation Act and is effective for years beginning after 2004.

2 The deduction is based upon taxable income derived from the production of

3 electricity. For 2006, the deduction is 3% of electricity production taxable

4 income. The percentage increases to 9% by 2010. The amount of the

5 deduction is based upon budgeted 2006 production net income before taxes.

6 The amount of the manufacturer's deduction is intended to be what will be

7 deducted on KCPL's actual federal return. The deduction has not been

8 adjusted to conform to Kansas jurisdictional taxable income as shown on

9 Schedule 7. This deduction is not an expense for book purposes, so no

10 deferred taxes are created. It results in a lower taxable income with ultimately

11 a lower current tax provision for cost of service.

- 12 ○ Meals and Entertainment expenses are added back in deriving net taxable
- 13 income, since a portion of certain meals and entertainment expenses are not tax
- 14 deductible. This adjustment will increase taxable income and ultimately
- 15 increase the current tax provision.

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

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

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

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

1 A: Once the deductions and adjustments have been applied to net income to derive
2 taxable income for ratemaking, the taxable income amount is multiplied by the overall
3 tax rate of 39.78% to derive the current tax provision.

4 **Q: How is the 39.78% income tax rate determined for calculating the current tax**
5 **provision for cost of service?**

6 A: The current provision calculation utilizes a 35% federal tax rate and a 7.35% Kansas
7 state rate resulting in an overall tax rate of 39.78%. The overall tax rate reflects the
8 federal benefit relating to deductible Kansas state income tax.

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

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

1 being amortized into the cost of service over the remaining book lives of the assets
2 that generated the timing differences.

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

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

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

10 A: In accordance with the Order Approving Stipulation and Agreement that was issued
11 on May 24, 2002 by the Commission in Docket No. 02-KCPE-840-RTS, the
12 Commission agreed to extend the lifespan of the Wolf Creek plant from 40 years to 60
13 years beginning January 1, 2003. As a result, the remaining unamortized amount of
14 Wolf Creek’s ITC is being amortized over the longer life. The lengthening of the
15 book life from 40 to 60 years decreases the annual ITC amortization specific to Wolf
16 Creek. The non-Wolf Creek ITC continues to be amortized ratably over the remaining
17 book lives of the underlying assets. Another reason that the ITC is separated between
18 Wolf Creek and non-Wolf Creek is to allow for a specific allocation factor for each
19 ITC component in deriving Missouri jurisdictional income tax cost of service.

20 **II. Accumulated Deferred Income Tax Rate Base Adjustments**

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

22 A: Deferred income taxes represent the tax on timing differences for deductions and
23 income reported on KCPL’s tax return compared to what has been reported for book

1 purposes. An expense deducted for tax purposes that exceeds what has been deducted
2 for book purposes creates a deferred tax liability. A deferred tax liability is also
3 recorded when income is recorded for book purposes sooner than when the income is
4 reported for tax purposes.

5 **Q: What is an example of a “book” versus “tax” expense timing difference that**
6 **creates a deferred income tax liability?**

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

14 **Q: What is an example of a “book” versus “tax” income timing difference that**
15 **creates a deferred income tax liability?**

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

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

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

6 **Q: Please explain other types of deferred income taxes.**

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

11 **Q: What is an example of a “book” versus “tax” expense timing difference that
12 creates a deferred income tax asset?**

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

18 **Q: What is an example of a “book” versus “tax” income timing difference that
19 creates a deferred income tax asset?**

20 A: The most significant income item that creates a deferred tax asset specific to KCPL is
21 the sale of SO₂ emission allowances. For tax purposes, any gains on the sales of
22 emission allowances are taxable when the allowances are sold. However, in
23 accordance with the Emission Policy, does not record the income associated with the

1 sale in its current period income, but defers gains in a regulated liability account. This
2 timing difference of when income is recognized for tax and when it will be recognized
3 for book creates a deferred tax asset, as future tax liabilities will be lower for tax
4 purposes compared to book purposes when the deferred gains are amortized to book
5 income in accordance with future regulatory orders. I will be discussing in more detail
6 the tax treatment of the sale of SO₂ emission allowances later in my testimony.

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

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

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

15 A: Schedule 8 of KCPL's revenue requirement model, which is attached to the testimony
16 of KCPL witness Don A. Frerking as Schedule DAF-1 ("Schedule 8"), itemizes the
17 deferred income tax reserves and adjustments and *pro forma* deferred income tax
18 reserve adjustments related to items included in KCPL's rate base. Schedule 8 reflects
19 the deferred tax liabilities relating to depreciation and other expenses deducted for the
20 tax return in excess of book deductions resulting in a rate base decrease. Schedule 8
21 also reflects deferred tax assets that serve to increase rate base. Adjustments to the
22 deferred income tax reserves shown on Schedule 8 include the changes in deferred
23 income tax reserves related to the addition of net plant and changes to certain deferred

1 regulatory assets during the 2006 period ending September 2006. The deferred tax
2 asset relating to the sale of emission allowances is a significant adjustment to rate base
3 and warrants additional explanation.

4 **III. Deferred Tax Treatment Relating to the Sale of SO₂ Emission Allowances**

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

6 A: In accordance with the Emission Policy, KCPL is authorized to sell specified emission
7 allowances. KCPL is planning to sell approximately ** [REDACTED] ** of SO₂
8 emission allowances by ** [REDACTED] **. These allowances have a \$0 cost
9 basis. The Emission Policy requires KCPL to record the gains on these emission
10 allowance sales as a regulatory liability and not record the sales transactions as
11 income. The regulatory treatment provides that the allowances belong to the
12 ratepayers and that the ratepayers are allowing KCPL to use these proceeds to fund its
13 cash requirements. This ratepayer loan is considered a source of funding and as a
14 result, the regulatory liability is a reduction to rate base. The deferred gain on the sale
15 of emissions allowances will be returned to ratepayers through amortization in
16 accordance with future regulatory orders. This regulatory treatment differs from the
17 tax treatment.

18 **Q: Please explain KCPL's tax treatment of the sale of SO₂ emission allowances.**

19 A: For tax purposes, the sales of emission allowances are taxable income in the period
20 during which they are sold. KCPL has a zero (\$0) tax basis in the allowances as they
21 were allotted from the Environmental Protection Agency at no cost. As a result, the
22 entire estimated ** [REDACTED] ** would be reported as a taxable gain on KCPL's
23 2005 and 2006 income tax returns. Current taxes will be provided at the 39.78%

1 Kansas jurisdictional rate or ** [REDACTED] **. The ** [REDACTED] ** will not be
2 reflected on Schedule 7 as a current income tax component of cost of service as it will
3 be recorded as a deferred tax asset on Schedule 8.

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

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

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

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

15 **Q: Why wasn't KCPL able to treat the sale of allowances as like-kind exchanges and**
16 **defer the tax on the sale of the emission allowances as contemplated in the**
17 **Emission Policy?**

18 A: KCPL investigated this treatment and concluded that the sales transactions would not
19 qualify as a like-kind exchange ("LKE"). Internal Revenue Code ("IRC") Section
20 1031 and the regulation thereunder explicitly disallow the exchanging of intangible
21 assets (*e.g.*, emission allowances) for tangible assets (*e.g.*, pollution control). This
22 narrow definition precludes the deferral of tax under the LKE rules.

1 **Q: Will KCPL pursue a ruling on this issue from the IRS?**

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

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

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

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

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

1 **IV. Production Tax Credit for Wind Generation**

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

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

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

16 A: We believe this is prudent as the \$19 per megawatt hour is known and measurable.

17 **V. Property Tax Adjustment**

18 **Q: Please explain the property tax adjustments.**

19 A: Adjustment 33b, as set forth in the Summary of Adjustments, which is attached to the
20 testimony of KCPL witness Don A. Frerking as Schedule DAF-2, annualizes the real
21 estate and personal property taxes and payments-in-lieu-of-taxes ("PILOTs") for *pro*
22 *forma* end-of-period plant in service. The amount of the adjustment relating to real

1 estate and personal property taxes is \$4,843,767 (before jurisdictional allocations) and
2 the portion relating to the PILOT is \$300,000, for a total adjustment of \$5,143,767.

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

5 A: The test year real estate and personal property tax amount reflects taxes based on
6 assessments on plant in service as of December 31, 2004. The annualized adjustment
7 is calculated using (a) estimated 2006 assessed values based on plant in service as of
8 December 31, 2005, (b) anticipated 2006 tax levies based on historical trends, and (c)
9 January 1- September 30, 2006 estimated plant additions (excluding the new wind
10 generating facility). This portion of the annualized adjustment is \$3,393,955. The
11 2006 tax levy effect is \$682,100. The January 1- September 30, 2006 estimated plant
12 additions resulted in an additional \$767,712 adjustment. This adjustment was
13 determined by developing a ratio of the latest known amount of property taxes to
14 plant-in-service as of December 31, 2005. This ratio was then applied to 2006 plant
15 additions as of September 30, 2006, excluding any plant additions for the new wind
16 generating facility.

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

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

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

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

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

6 A. The PILOT agreement anticipates annual payments of \$300,000 to taxing subdivisions
7 commencing in 2007 based on the wind generating property to be placed in service
8 during 2006.

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

10 A: Yes, it does.

