Exhibit No.:	
Issues:	*Income Tax – Cost of Removal*
	Incentive Compensation
	R&D Tax Credits
Witness:	*Steve M. Traxler*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
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Date Testimony Prepared:	*September 20, 2007*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

STEVE M. TRAXLER

KANSAS CITY POWER & LIGHT COMPANY

CASE NO. ER-2007-0291

Jefferson City, Missouri
September 2007

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STEVE M. TRAXLER

KANSAS CITY POWER & LIGHT COMPANY

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Q. Please state your name and business address.

A. Steve M. Traxler, Fletcher Daniels State Office Building, Room G 8, 615 East 13th Street, Kansas City, Missouri 64106.

Q. Have you prefiled direct testimony in this proceeding?

A. Yes, I have.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony will address the surrebuttal testimony of Kansas City Power & Light Company (KCPL) witnesses Melissa K. Hardesty, Michael Halloran and Chris B. Giles on the issues of Income Tax – Cost of Removal, Executive Short Term Incentive Compensation and Income Tax – Research & Development Tax Credits respectively.

<u>EXECUTIVE SUMMARY</u>

Q. In summary, what does your testimony cover?

A. In the rebuttal testimony of KCPL witness, Melissa K. Hardesty, KCPL has raised an income tax issue which was not addressed by any KCPL witness in the direct testimony filed by KCPL in this case. Ms. Hardesty is recommending that the tax timing difference for Cost of Removal, related to pre-1981 vintage property, be given flow-through treatment as opposed to a continuation of normalization treatment consistent with Case No.

ER-2006-0314 as recommended by the Staff. My surrebuttal testimony will explain in detail the difference between flow-through treatment and normalization treatment for the tax timing difference for Cost of Removal. I will also address the validity of Ms. Hardesty's reliance on a purported "agreement" between the Staff and KCPL that goes back to 1978, which she refers to in her rebuttal testimony.

KCPL has taken a position on Executive Short Term Incentive Compensation which was rejected by the Commission in its Report And Order in Case No. ER-2006-0314. In Case ER-2006-0314, the Staff recommended a disallowance for Short Term Incentive Compensation payments related at an Earnings Per Share (EPS) goal and Discretionary payments which are unsupported by achievement of defined goals considered beneficial to providing service to ratepayers. The Commission's Report And Order adopted the Staff's position. I referenced the specific language form the Commission's Report And Order in Case No. ER-2006-0314 on page 30 of my direct testimony in this current case, Case No. ER-2007-0291. The Staff's recommended disallowance of Executive Short Term Incentive Compensation tied to an EPS goal and undefined Discretionary goals is consistent with the Staff's position in KCPL's last rate case, ER-2006-0314 and the Commission's decision on this issue in Case No. ER-2006-0314.

In the Staff's Cost of Service Report filed with the Staff's direct testimony in this case, Case No. ER-2007-0291, pages 51 and 52, the Staff recommended deferred accounting treatment and amortization for Research & Development (R&D) Tax Credits anticipated to be received by KCPL as a result of filing amended tax returns for the years 2001-2005. In his rebuttal testimony, KCPL witness, Chris B. Giles has opposed any current or future cost of service recognition for R&D Tax Credits received related to years prior to 2006 on the grounds that cost of service recognition would represent retroactive ratemaking and violation of the matching principle. This position is completely contradictory to KCPL's requested and approved deferred accounting treatment for the abnormal maintenance costs related to an ice storm in 2002. KCPL has no problem deferring an abnormal cost from a prior period for future rate recovery, however, an abnormal revenue received by KCPL, related to prior periods, should in KCPL's view, be ignored and allowed to accrue to the benefit of KCPL's shareholders. KCPL's position is both unfair and inconsistent from a ratemaking perspective. The Staff and Department of Energy (DOE) witness James R. Dittmer are recommending that any R&D Tax Credits received by KCPL for years prior to 2006, be deferred and amortized to cost of service over 5 years starting in this case, if the amounts are known by the September 30, 2007 true-up ordered for this case, or alternatively, amortized over 5 years in KCPL's next rate case.

INCOME TAX – COST OF REMOVAL

Q. Provide a brief description of the issue between the Staff and KCPL related to the tax timing difference for Cost of Removal.

A. The Staff is recommending a continuation of *normalization* treatment for the tax timing difference for Cost of Removal consistent with the treatment recommended by the Staff in KCPL's last case, Case No. ER-2006-0314, and reflected in the Scenario supporting the Commission's Report And Order in Case No. ER-2006-0314. KCPL is recommending *flow-through* treatment for the tax timing difference for Cost of Removal related to pre-1981 vintage property and *normalization* treatment for the tax timing difference for Cost of Removal related to post-1980 vintage property. There is no valid reason in Staff's view for a position proposed by KCPL based upon *flow-through* treatment for pre-1981 assets and *normalization* treatment for post-1980 assets. Under *normalization* treatment for the tax timing difference the ratepayer receives recognition of the tax deduction for cost of removal consistent with timing for expense recognition for Cost of Removal in the book depreciation rate. For example a coal unit with a 30-year life will have a Cost of Removal component in its book depreciation rate which will result in recovery of the estimated Cost of Removal over the 30-year expected life of the plant. Under *normalization* accounting the tax deduction for Cost of Removal will also be recognized over the 30-year expected life used to develop the book depreciation rate. Recovery of the cost and recognition of the corresponding tax deduction is *matched* under normalization treatment for the tax timing difference. Under *flow-through* treatment proposed by KCPL for pre-1981 vintage property, the ratepayer pays for Cost of Removal through depreciation expense over the 30-year life of asset but does not receive the tax deduction for Cost of Removal until the end of the 30-year life of the asset when the cost to remove the asset from service is actually incurred. Thus under KCPL's proposed *flow-through* treatment, there is a 30-year disconnect between the timing of when the ratepayer pays for Cost of Removal in rates and when he receives the benefit of the related *tax deduction*. This significant mismatch between cost recovery in rates and income tax recognition is eliminated under *normalization* treatment recommended by the Staff.

Q. Please provide an explanation for a tax timing difference.

A. There are "timing differences" between when specific costs are reflected in determining pretax operating income, for both financial reporting and ratemaking purposes, and when they are reflected in determining current year taxable income under Internal Revenue Service (IRS) rules. In calculating income tax for ratemaking purposes, timing differences can be reflected consistent with when they are reflected under IRS rules (*flow-through treatment*) or they can be reflected consistent with when they are reflected in determining pretax operating income for financial reporting and ratemaking purposes (*normalization treatment*). When timing differences are normalized for ratemaking purposes, a deferred tax adjustment is used for the purpose of *not* reflecting the timing of cost recognition under IRS rules. Deferred taxes are reversed in subsequent years consistent with the timing for recognizing the related costs for financial reporting purposes in determining pretax operating income. The deferral of a tax timing difference (normalization treatment) can result in either a Deferred Tax Liability or a Deferred Tax Asset.

Q. Please define the difference between a Deferred Tax Liability and a Deferred Tax Asset under *normalization* treatment for a regulated utility.

A. When the current year deduction for a specific cost, allowed for determining taxable income to the IRS, *exceeds* the cost used for determining pre-tax operating income for ratemaking purposes, a Deferred Tax Liability is recognized under normalization treatment to recognize that the utility's *actual* income tax expense will be higher in the future than the income tax expense recovered in rates.

When the current year deduction for a specific cost allowed for determining taxable income to the IRS is *less than* the cost used in determining pre-tax operating income for ratemaking purposes, a Deferred Tax Asset is recognized under *normalization* treatment to recognize that the utility's *actual* income tax expense will be less in the future than the amount recovered in rates.

Q. Can you provide an example for a Deferred Tax Liability under *normalization* treatment for a tax timing difference?

A. Yes. The most common tax timing difference which results in a Deferred Tax Liability is the tax timing difference related to depreciation expense. The tax timing difference resulting from accelerated depreciation methods allowed by the IRS must be normalized under IRS rules for a regulated utility. The *tax deduction* for depreciation expense cannot be reflected for ratemaking purposes any sooner than the timing for recognizing book depreciation in determining pre-tax operating income for ratemaking purposes. The IRS allows a regulated utility, like all corporations, to use an accelerated depreciation method in calculating its current income tax liability. However, with regard to a regulated utility, Congress intended for the additional cash flow (lower current income tax), resulting from an accelerated depreciation method, to be retained by the utility. As a result, under IRS rules for a regulated utility, the additional deduction resulting from the use of an accelerated depreciation method cannot be reflected in rates. Ratepayers receive the tax deduction for depreciation expense over the same period used for recovery of book depreciation expense in rates – the expected life of the asset. Over the life of the asset, the *tax deduction* for depreciation expense is the same for ratemaking purposes and calculating taxable income to the IRS. The only difference is that *tax deduction* is reflected sooner under IRS rules than it is for cost of service recognition for ratemaking purposes. Attached as Schedule SMT-1 is an example of the Deferred Tax Liability which results from *normalization* treatment for the tax timing difference related to depreciation expense.

Q. Please explain Schedule SMT-1.

A. Schedule SMT-1 attached to this surrebuttal testimony provides an example of the Deferred Tax Liability which results from *normalizing* the tax timing difference related to depreciation expense. Lines 1, 2 and 3 provide the assumptions for the example:

$1,000,000 asset with a 10 year expected life resulting in a 10% book depreciation rate and IRS accelerated depreciation method with a 20% depreciation rate. Column A reflects the tax deduction for depreciation allowed for ratemaking purposes and financial reporting - $100,000 per year for 10 years. The utility's actual tax deduction for calculating current income tax to the IRS is reflected at $200,000 per year for 5 years in Column B. Column C reflects the difference between the IRS tax depreciation deduction (Column B) and the Book Depreciation amount in Column A. This difference represents the tax timing difference which must be *normalized* under IRS rules. Column D reflects an assumed effective tax rate of 40%. Column E reflects deferred income tax expense by year. Note that the positive deferred income tax expense for years 1-5 represents recognition of the a Deferred Tax Liability. The Accumulated Deferred Tax Liability is reflected in Column F.

Q. Please explain the significance of the Deferred Tax Liability in Column F.

A. As previously stated a Deferred Tax Liability results when the current year tax deduction allowed by the IRS ($200,000 in Column B) exceeds the tax deduction allowed for ratemaking purposes ($100,000 in Column A). The Accumulated Deferred Tax Liability in Column F at the end of year 5, $200,000, recognizes that the utility has collected $200,000 more in rates than its actual IRS tax liability for years 1-5. However, for years 6-10, the reverse is true. In years 6 -10, ratepayers continue to receive a $100,000 per year tax deduction for depreciation expense as reflected in Column A. The utility's tax return however will reflect a $0 tax deduction in years 6-10 (Column B) because the asset is fully depreciated at the end of year 5 life allowed for IRS purposes using the accelerated depreciation method with a 20% rate. The utility will pay $40,000 more in income tax to the IRS in years 6-10 than it collects in rates from ratepayers. The $200,000 Deferred Tax Liability at the end of year 5 in Column F will be reduced by $40,000 / year in year 6-10 until is reduced to $0 at the end of year 10.

Q. What is the relevance of understanding a Deferred Tax Liability as it relates to the issue between the Staff and KCPL related to the timing difference for Cost of Removal?

A. In her surrebuttal testimony on page 3, lines 15-20 Ms. Hardesty makes the following statement in her explanation of *normalization* treatment for tax timing differences:

> " *Any* differences between the tax calculated per the books and the tax payment due based upon the filed income tax return for the same period are provided for by recording a deferred tax *liability*. *All* timing differences between book income or deductions and tax income or deductions must have a deferred tax *liability* recognized that will be available in the future to satisfy the tax liability when the tax payment becomes due." (emphasis added)

This statement is not correct when discussing the tax timing difference for Cost of Removal. When the tax timing difference for Cost of Removal is *normalized* for income tax expense recognition, a Deferred Tax *Asset* results instead of a Deferred Tax Liability. In order to understand this complicated issue it is important to understand the difference between a Deferred Tax Liability and a Deferred Tax Asset and more importantly to understand that *normalizing* the timing difference for Cost of Removal results in a Deferred Tax Asset when the book depreciation rate includes a component for Cost of Removal which is the case for KCPL as well as other Missouri utilities.

Q. Please explain the tax timing difference related to Cost of Removal.

A. The book depreciation rates approved for KCPL include a component for Cost of Removal. Expense recognition of Cost of Removal for rate recovery occurs over the life assumption used is determining the book depreciation rate. However, the tax deduction for Cost of Removal is not allowed by the IRS until it is actually incurred when the asset is retired from service at the end of its service life. The timing difference for Cost of Removal is just the opposite of the timing difference previously discussed for Depreciation expense. Recognition of tax deduction for depreciation expense under IRS rules occurs in *advance* of the recognition of the tax deduction for ratemaking purposes. *Normalizing* the timing difference for depreciation expense results in a Deferred Tax Liability. A Deferred Tax Liability reflects recovery of income tax expense in rates which exceeds the actual income tax paid to the IRS in the early years of the asset under an accelerated method allowed by the IRS. This Deferred Tax Liability reverses (turns around) in the later years of the asset when income tax collected in rates is less than the actual IRS tax liability.

However, normalizing the timing difference for Cost of Removal results in a Deferred Tax Asset because the recognition of the *tax deduction* for of Cost of Removal for ratemaking purposes occurs sooner than recognition of the tax deduction under IRS rules. As previously discussed, under *normalization* treatment for Cost of Removal the ratepayer receives the benefit of the tax deduction for Cost of Removal consistent with expense recognition included in book depreciation expense. Cost recognition and tax recognition for Cost of Removal are recognized at the same time. However, recognition of the tax deduction by the IRS does not occur until retirement of the asset at the end of the life of the asset. The Deferred Tax Asset recognized from normalizing the tax timing difference for Cost of Removal recognizes that the utility will collect a higher amount of income tax in the future in rates than the utility's actual income tax to the IRS when the actual Cost of Removal is incurred and taken as a deduction in determining the IRS tax liability.

Q. Have you prepared an example to demonstrate the Deferred Tax Asset which results from *normalizing* the timing difference from Cost of Removal?

A. Yes. Attached as Schedule SMT-2 is an example of normalizing the tax timing difference for Cost of Removal. The assumptions for the example are reflected on lines 1-7. The asset cost $1,000,000 and has an expected life of 10 years. The estimated cost to remove the asset from service (Cost of Removal) at the end of its useful life is $150,000. The total annual depreciation rate required to recover the cost of the asset and the cost to remove it from service is 11.5% - 10% for 10 years to recover the cost of the asset and 1.5% for 10 years to recover the Cost of Removal.

Normalizing a tax timing difference for any expense results in recognition of the *tax deduction* for ratemaking purposes consistent with when the expense is recovered in rates. Cost of Removal is recovered in rates in depreciation expense over the 10 year life assumption. Cost of Removal recovered in book depreciation is reflected in Column A at $15,000 per year for 10 years. Under normalization treatment, rates would reflect a corresponding $15,000 tax deduction for Cost of Removal. Under the Staff's recommendation to normalize the tax timing difference for Cost of Removal, ratepayers receive a *tax deduction* for Cost of Removal equal to the amount they are paying in rates and at the same time they are paying for Cost of Removal which is annually for 10 years in the example. Column B reflects the timing for recognizing the *tax deduction* for Cost of Removal by the IRS which is in year 11, the year the asset is retired from service. Column B reflects KCPL's recommended flow-through treatment for Cost of Removal which requires recognition of the entire $150,000 *tax deduction* in year 11 when the asset is retired from service. Flow-through treatment for a tax timing difference results in reflecting a tax deduction consistent with the timing used in determining taxable income to the IRS.

Column C reflects the annual tax timing difference. Column E reflects the annual amount of Deferred Income Tax Expense recognized based upon the assumed 40% effective tax rate in Column D. The $6,000 negative result in Column E represents an annual Deferred Tax Asset which accumulates in Column F to the balance of $60,000 in year 10. This $60,000 Deferred Tax Asset represents that the utility's actual tax liability to the IRS in year 11 will be $60,000 less than the amount collected from ratepayers in year 11. Recognition of the actual $150,000 tax deduction for Cost of Removal in year 11 eliminates (reverses) the Deferred Tax Asset recognized in years 1-10 in the example.

Q. Please summarize your testimony at this point regarding the difference between the Staff and KCPL as to the treatment to be used for recognizing the tax timing difference for Cost of Removal.

A. The Staff is recommending *normalization* treatment for the tax timing difference for *all* of KCPL's Cost of Removal. Under *normalization* treatment the ratepayer receives the *tax deduction* for the Cost of Removal at the same time he is paying for the cost included in book depreciation expense. Referring to the example in schedule SMT-2, ratepayers are providing $15,000 annually for Cost of Removal included in the 11.5% book depreciation rate. Ratepayers are also receiving a corresponding $15,000 *tax deduction* over the same 10 year time period under *normalization* treatment. Thus expense recognition for Cost of Removal and the corresponding tax deduction are matched under *normalization* treatment recommended by the Staff. Referring again to Schedule SMT-2, *flow-through* treatment proposed by KCPL for pre-1981 vintage property results in recovery of $15,000 per year for Cost of Removal from ratepayers without reflecting the benefit of the tax deduction until year 11 in Column B when the actual cost to remove the asset from service is incurred and taken as a tax deduction under IRS rules.

The use of *flow-through* treatment for the tax timing difference related to Cost of Removal results in a significant mismatch between the recovery of Cost of Removal from ratepayers and recognition in rates of the *benefit* of the corresponding *tax deduction.*

In addition, KCPL's position on this issue is inconsistent. KCPL is recommending *normalization* treatment for Cost of Removal related to post-1980 vintage property and *flow-through* treatment for pre-1981 vintage property.

Q. Is Staff's position to use normalization treatment for the tax timing difference related to Cost of Removal consistent with the treatment used in KCPL's last rate case, Case No. ER 2006-0314?

A. Yes. The Staff normalized the timing difference for Cost of Removal in Case No. ER 2006-0314. KCPL did not oppose normalization treatment for Cost of Removal in Case No. ER 2006-0314. I was personally responsible for preparing the Scenario selected by the Commission for determining KCPL's revenue requirement in Case No. ER 2006-0314. The Scenario supporting the Commission's Report and Order in Case No. ER 2006-0314 reflected the Staff's proposed normalization treatment for the tax timing difference related to Cost of Removal.

Q. On page 4 of her Rebuttal testimony in the question and answer on lines 9-11, Ms. Hardesty states that KCPL has consistently applied flowed-through for Pre-81 Cost of Removal for regulatory purposes since 1978. Is this an accurate statement as it relates to KCPL's current rates established in Case No. ER-2006-0314?

A. No. As previously stated, KCPL's existing rates resulting from the Commission's Report And Order in Case No. ER 2006-0314 were not based upon flow-through treatment for pre-1981 Cost of Removal. Staff's recommended normalization treatment for the tax timing difference for all of KCPL's Cost of Removal was not opposed by KCPL in Case No. ER-2006-0314.

Q. What justification has been provided by Ms. Hardesty for recommending *flow-through* treatment for Cost of Removal related to pre-1981 vintage property and *normalization* treatment for post-1980 property?

A. On page 4, lines 3-8 of her Rebuttal testimony, Ms. Hardesty references an agreement between the Staff and KCPL in Case No. ER-78-252 as "authorization" to flow through the tax benefits related to pre-1981 Cost of Removal?

Q. Did you issue a Data Request to KCPL in an attempt to identify the purported "agreement" between Staff and KCPL in Case No. ER-78-252?

A. Yes. I issued Staff Data Request No. 273 for the purpose of identifying the agreement in Case No. ER-78-252 on which Ms. Hardesty asserts that KCPL is relying upon as authorization for flow-through treatment related to pre-1981 Cost of Removal. In response to Staff Data Request No. 273, KCPL provided the direct testimony and accounting schedules filed in Case No. ER-78-252.

Q. Did the Staff's direct testimony provide a detailed explanation regarding an agreement reached between the Staff and KCPL on the issue of Cost of Removal?

A. No. There were two questions and answers related to the Staff's treatment for Cost of Removal in the direct testimony of Staff witness James R. Dittmer in Case No. ER-78-252:

> "Q. Mr. Dittmer, the Staff has taken a new position on the normalization of deferred taxes associated with cost of removal. At the same time, the Staff is recommending a different amortization period for the flowback of deferred taxes associated with repair allowance. Could you please explain briefly the rationale for these new tax treatments?
>
> A. The Staff's feels that it has determined a new method of accounting which more accurately reflects the actual timing difference for book and tax purposes for these two items.
>
> Q. Are the two items separate issues?
>
> A. No, the Staff's recommendation for the flowback treatment of repair allowance is contingent upon the Commission's acceptance of the Staff's interpretation of the proper treatment of ***deferring taxes*** associated with the tax timing difference associated with cost of removal." (emphasis added)

This brief explanation addresses only the Staff's position on the tax timing difference and does not mention any "agreement" reached between Staff and KCPL. Additionally, the explanation is insufficient to determine what the Staff's position actually was.

Q. Referring to the quote in your last answer from Mr. Dittmer's direct testimony in Case No. ER-78-252, is the reference to the term "*deferring taxes*" consistent with an assertion by Ms. Hardesty that an agreement was reached between KCPL and Staff which authorized *flow-through* treatment for the timing difference related to pre-1981 Cost of Removal?

A. No. Deferred income taxes do not result from flow-through treatment for any tax timing difference including the tax timing difference related to Cost of Removal. The recognition of deferred income taxes for ratemaking purposes occurs only when *normalization* treatment is used for a tax timing difference. Referring again to my schedules SMT-1 and SMT-2, the deferred income tax expense recognized in Columns E and F on both schedules result only under a *normalization* assumption in both examples related to the tax timing difference for Depreciation Expense and Cost of Removal.

Q. Isn't Mr. Dittmer a witness in this current proceeding, Case No. ER 2007-0291?

A. Yes. However, Mr. Dittmer is out of the country at this time and is not expected to return until after the filing of surrebuttal testimony in this case. Staff will have the opportunity to explore Mr. Dittmer's memory on the Staff's position on this issue in Case No. ER-78-252.

Q. Did you also review the Commission's Report And Order in Case No. ER-78-252 in an attempt to find support for Ms. Hardesty's assertion that this case provides prior Commission precedent for KCPL on the issue of flow-through treatment for the tax timing difference related to Cost of Removal?

A. Yes I did. The Commission's Report and Order makes no mention of Cost of Removal issue or any agreement between the Staff and KCPL regarding the issue of Cost of Removal.

Q. Even if an agreement were reached between the Staff and KCPL regarding the treatment of the tax timing difference for Cost of Removal in Case No. ER-78-252, would such an agreement have any bearing on any future case after Case No. ER-78-252?

A. Certainly not. In order for any such agreement to apply to a future rate proceeding it would have had to been addressed in the Commission's Report And Order or in a Stipulation and Agreement approved by the Commission in Case No. ER-78-252.

Q. Would the prior use of flow-through treatment for the timing difference for pre-1981 Cost of Removal in a prior KCPL rate case, limit the Staff's ability to recommend normalization treatment for the timing difference related to both pre-1981 and post-1980 Cost of Removal in KCPL's last case, ER 2006-0314 or in this current case, ER-2007-0291?

A. No. It is rare that a Commission Report And Order addresses ratemaking treatment to be used in future rate proceedings. There is certainly no such Report and Order and/or approved Stipulation And Agreement related to the ratemaking treatment to be used for the tax timing difference for Cost of Removal in KCPL's prior case, ER-2006-0314 or current case, Case No. ER-2007-0291.

Q. On page 5, lines 15-17 of her rebuttal testimony, Ms. Hardesty asserts that "KCPL has realized income tax deductions of $45,421,611 Pre-1981 COR (total Company) in excess of the expense that was accrued for book/regulatory purposes through the depreciation provision as of June 30, 2007." Has any other regulated utility in Missouri asserted that its actual Cost of Removal expenditures exceed the accrued cost for Cost of Removal recovered in rates through the recovery of book depreciation expense?

A. No. In fact the depreciation studies conducted by the Staff of the Commission's depreciation department generally reflect the exact opposite result. The accrued recovery of Cost of Removal using a book depreciation rate which includes a Cost of Removal component is generally significantly higher than the utility's actual incurred cost for removing retired assets from service.

Q. Why is it unlikely that a Missouri utility would fail to recover sufficient Cost of Removal over the life of the asset through book depreciation expense to cover its actual cost of removing the retired asset from service?

A. The book depreciation rates approved for KCPL and other Missouri utilities include a component for the recovery of Cost of Removal over the expected life used in setting the book depreciation rate. Referring back to Schedule SMT-2, the $1,000,000 asset had an expected life of 10 years with an expected cost to remove the asset from service of $150,000. The book depreciation rate was set at 11.5 % to recover the cost of the asset and the cost to remove it from service over the 10 year "expected life" of the asset. The key word here is "expected life" of the asset. Many of an electric utility's major assets are in service well beyond the "expected life" used in setting the book depreciation rate. For example, Aquila's Sibley coal generating units were originally expected to have service lives of approximately 30 years. The book depreciation rate was therefore intended to recover both the cost of the plant and the estimated cost of removal at the end of 30 years. However, it was more economic to overhaul the Sibley units and extend their useful lives rather than remove the units from service and build new units. Aquila's life extension project for the Sibley units extended the expected lives of the units by approximately 20 years. The result was that Aquila will collect the estimated Cost of Removal for an additional 20 years even though 100% of the cost to retire the Sibley plant was assumed in the book depreciation rate to be collected by the end of year 30 – the original life assumption. Extending the accrual of Cost of Removal through the book depreciation rate for an additional 20 years will result in an approximate additional collection of Cost of Removal of 65%.

KCPL's assertion that it has experienced a $45.4 million deficiency in the recovery of Cost of Removal related to pre-1981 assets is contrary to the experience of other Missouri utilities.

Q. If in fact KCPL was aware of a $45.4 million deficiency in the recovery of its actual Cost of Removal, what action should KCPL have initiated before now?

A. A $45.4 deficiency in the recovery of its actual Cost of Removal should have been addressed with a requested change in the approved book depreciation rates. No such request has been made by KCPL. The Regulatory Plan Stipulation and Agreement approved in Case No. ER-2005-0329 did not preclude the parties from recommending changes to KCPL's existing book depreciation rates.

Q. Does KCPL's failure to request a change in its book depreciation rates to address a $45.4 million deficiency in the recovery of its actual Cost of Removal related to pre-1981 vintage property raise questions regarding the validity of such a deficiency claim in Ms. Hardesty's rebuttal testimony?

A. Yes it does. It is unlikely in Staff's view that KCPL would not have addressed a deficiency of this magnitude with a requested change in its book depreciation rates. The Staff has requested detailed support for this alleged deficiency which is not due to be provided until after the September 20th filing date for this Surrebuttal testimony.

Q. Does KCPL's current calculation of the annual timing difference for Cost of Removal related to pre-1981 vintage property support Ms. Hardesty's assertion that KCPL has a $45.4 million deficiency in recovery of its actual cost of removal related to pre-1981 vintage property?

A. Certainly not. In fact KCPL's calculation of the timing difference for Cost of Removal related to pre-1981 vintage property reflects the *opposite* result. KCPL's March updated cost of service in this case, ER-2007-0291, reflects that the Cost of Removal being collected in book depreciation expense is higher than KCPL's actual Cost of Removal by approximately $1.8 million annually on a Missouri jurisdictional basis. This equates to an excess of rate recovery over actual cost of approximately $3.4 million annually on a total company basis.

Q. On page 5 of her Rebuttal testimony, Ms. Hardesty suggests that KCPL will experience a $17 million income tax expense write-off if it is not allowed to flow through the tax timing difference for Cost of Removal related to pre-1981 vintage property without any amortization of the regulatory asset. What is the Staff's response to this statement?

A. The Staff has never seen such a claim from any other Missouri utility in similar circumstances as KCPL. The tax timing difference for Cost of Removal is being normalized for Union Electric Company d/b/a AmerenUE, Aquila, Inc. and The Empire District Electric Company to name a few. I am personally aware that flow-through treatment for Cost of Removal was used in prior cases when the Staff's position was to flow-through all tax timing differences allowed by IRS rules. None of these utilities has raised an issue regarding a significant charge against earnings as a result of a change from flow-through treatment to normalization treatment for the tax timing difference related to Cost of Removal. This alleged charge against earnings is premised upon acceptance of KCPL's assertion that it has a $45.4 million deficiency in the recovery Cost of Removal related to pre-1981 vintage property. The $17 million income tax impact was calculated by KCPL by applying a 37.6% tax rate to the $45.4 million deficiency. KCPL has not provided any evidence that a $45.4 million deficiency exists. To the contrary, KCPL's current calculation of the timing difference related to Cost of Removal for pre-1981 vintage property reflects the opposite result. KCPL is collecting an *excess* of approximately $3.4 million annually over its actual Cost of Removal related to pre-1981 vintage property. This result is consistent with historical results for other Missouri utilities.

Q. Please summarize your testimony on this issue.

A. Staff is recommending *normalization* treatment for the tax timing difference for Cost of Removal. This recommendation is consistent with Staff's recommendation in Case No. ER 2006-0314 and the Scenario supporting the Commission's Report And Order in Case No. ER-2006-0314. Normalization treatment matches the *tax deduction* for Cost of Removal with expense recovery of Cost of Removal from ratepayers.

KCPL's position on this issue is not consistent for pre-1981 property and post-1980 property. KCPL is recommending *flow-through* treatment for the tax timing difference related to pre-1981 property and *normalization* treatment for post-1980 property. Ms. Hardesty attempts to support this inconsistent approach with a reference to an "agreement" between Staff and KCPL in Case No. ER-78-252 which Ms. Hardesty asserts "required" KCPL to flow through the tax timing difference for pre-1981 vintage property. KCPL has not provided sufficient support for its claim that an "agreement" was made with the Staff. In addition, my review of KCPL's Annual Report to the Federal Energy Regulatory Commission (FERC) for 2006 does identify flow-through treatment for Cost of Removal related to pre-1981 vintage property. Even if an "agreement" had been made in 1978 in Case No. ER 78-252, KCPL does not claim that the purported "agreement" was with the Commission, and Staff counsel advises me that the 1978 Commission could not necessarily bind subsequent Commissions.

KCPL and the Staff concur that normalization treatment should be used for the tax timing difference related to post-1981 property. KCPL has not provided an appropriate explanation or rationale why normalization treatment should not be used for the entire tax timing difference related to Cost of Removal consistent with how this issue is being treated by other major utilities regulated by this Commission.

Ms. Hardesty asserts that KCPL will have to recognize a $17 million income tax expense/write-off if it is not allowed to continue flow-through treatment for the tax timing difference related to pre-1981 Cost of Removal. This assertion is premised on a claim that KCPL has experienced a $45.4 million deficiency in the recovery of its actual Cost of Removal related to pre-1981 vintage property. No support has been provided by KCPL to demonstrate this deficiency. In fact KCPL's current calculation of the tax timing difference related to pre-1981 Cost of Removal suggests the opposite result. KCPL is currently recovering approximately $3.4 million more annually in rates for Cost of Removal than its actual cost incurred for removing pre-1981 assets from service.

EXECUTIVE INCENTIVE COMPENSATION

Q. What is the purpose of this section of your surrebuttal testimony?

A. This section of my surrebuttal testimony will address the rebuttal testimony of KCPL witness, Michael Halloran on the issue of Executive Short Term and Long Term Incentive Compensation.

Q. Provide a brief explanation of the issue between the Staff and KCPL on executive incentive compensation.

A. As addressed in pages 29-32 of my direct testimony, KCPL's Executive Short Term and Long Term Incentive Compensation plans include goals based on earnings per share (EPS) and return on total capital both of which goals benefit shareholders. The cost for achieving such goals is therefore properly assignable to shareholders. The Staff has eliminated the portion of short term executive incentive compensation tied to EPS and the 20% portion which is a discretionary payment and is unsupported by achievement of defined goals which could be considered beneficial to ratepayer interests. Staff is recommending a 100% disallowance of long term executive compensation because it is tied almost entirely to goals beneficial to shareholders and does not represent a cash outlay by KCPL now or in the future. Long term executive incentive compensation is paid by KCPL by the issuance of stock and/or stock options. Requiring ratepayers to provide cash through rates for an expense which requires *no* cash outlay by the utility is inappropriate for ratemaking purposes. The Staff's position on executive short term and long term incentive compensation in this case, ER 2007-0291, is consistent with both, the Staff's position on this issue in KCPL's recent prior case, ER-2006-0314, and the Commission's decision on this issue in that case. KCPL has chosen to relitigate the same issues on incentive compensation which were decided by the Commission nine months ago in Case No. ER-2006-0314.

Q. Does the issue between the Staff and KCPL on executive compensation relate to whether EPS should be a goal in the GPE and KCPL Executive Incentive Compensation Plans?

A. Certainly not. The Staff is not recommending that GPE and KCPL restructure their incentive compensation plans to eliminate goals related to EPS. Rather, the issue between KCPL and the Staff on executive incentive compensation relates to the proper *assignment* of the cost to those who *benefit* from achievement of the goals of the plan. The beneficiaries of a goal tied to EPS are the shareholders of GPE. GPE's shareholders should therefore be assigned the cost of executive incentive compensation tied to EPS performance.

Q. On page 3 of his rebuttal testimony, Mr. Halloran states:

> "In addition, stronger financial performance through EPS provides additional cash, allowing the utility to invest in ongoing maintenance and upgrading of facilities, which ensures a steady, reliable, low cost supply of electricity to the customer."

Is a regulated utility dependent upon EPS for the cash required to maintain and upgrade its facilities?

A. No. The funds required for a regulated utility to maintain its facilities are provided by including a normal level of maintenance expense in the cost of service calculation used to determine the utility's overall revenue requirement. The question as to whether executive incentive compensation, tied to EPS, should be recovered in rates is unrelated to the cash required to maintain the assets used in providing electric service.

Q. On page 4 of his rebuttal testimony, Mr. Halloran states that "FFO is important because it is a key component to the two credit metrics used to evaluate utilities. Credit rating agencies use FFO divided by debt, and FFO divided by interest as two primary credit metrics." Does the Staff agree that adequate FFO (Funds From Operations) is required by KCPL for meeting the credit metrics used by rating agencies to determine a credit rating?

A. Yes. However, the Staff does not agree with Mr. Halloran's attempt to justify rate recovery for incentive compensation tied to EPS on the basis that increasing EPS improves FFO. There is no disagreement that increasing return on equity (ROE) and resulting EPS will increase the cash flow (FFO) available to meet the credit metrics used by rating agencies in determining the credit rating for a utility. However, increasing ROE and resulting EPS is not the most cost effective mechanism for ratepayers for ensuring that KCPL has sufficient FFO for maintaining its credit rating.

Q. Why is increasing ROE and resulting EPS not the most cost effective mechanism for providing the FFO required for maintaining KCPL's credit rating?

A. The return allowed in rates for equity investors is not tax deductible. Any cost which is not tax deductible requires a $1.62 cash outlay by ratepayers for every $1.00 allowed for ROE based upon an assumed effective tax rate of 38%. The most cost effective method for providing the FFO required for KCPL in maintaining its credit rating is the Regulatory Plan Additional Amortization provided for in the Stipulation and Agreement in KCPL's regulatory plan docket, ER 2005-0329.

Q. Why is the Regulatory Plan Additional Amortization a more cost effective mechanism for providing an adequate level of FFO than EPS as suggested by Mr. Halloran?

A. The Regulatory Plan Additional Amortization is in effect an accelerated recovery of depreciation expense. Because depreciation expense is tax deductible a $1.00 increase in depreciation expense requires a $1.00 cash outlay from ratepayers as opposed to the $1.62 cash outlay required from a $1.00 increase in ROE and resulting EPS. The Regulatory Plan Additional Amortization addresses both credit metrics mentioned on page 4, lines 3 and 4 of Mr. Halloran's rebuttal testimony – FFO divided by debt and FFO divided by interest.

In summary, Mr. Halloran's attempt to support rate recovery for incentive compensation tied to EPS on the grounds that increased EPS provides additional FFO used in maintaining KCPL's credit rating should be rejected because it is not the most cost effective mechanism for providing the cash flow (FFO) necessary for maintaining KCPL's credit rating. The beneficiaries of incentive compensation tied to EPS are the shareholders of GPE. They should therefore bear the cost of incentive compensation tied to EPS.

Q. On page 4 of Mr. Halloran's rebuttal testimony he sates:

> "Yes, increasing EPS is the result of increased FFO and operating income. These results serve to minimize the Company's borrowing costs via interest on long term debt."

Does the Staff agree with this statement?

A. No. Again, Mr. Halloran fails to consider the difference in the tax consequences for increasing ROE (and EPS) where no tax deduction is available as opposed to financing with additional long term debt where tax deduction is available for interest. As stated previously, because ROE is not tax deductible, ratepayers must pay $1.62 in rates for every $1.00 allowed for an equity return. The interest cost on long term debt requires a cash outlay from ratepayer of $1.00 for every $1.00 of interest cost included in rates because interest expense is tax deductible.

Mr. Halloran's attempt to justify rate recovery for incentive compensation tied to EPS on the grounds that increasing EPS results in lower borrowing costs fails to consider the tax consequences of a higher ROE and resulting EPS and should be rejected.

Q. On page 5, lines 11-14 of his rebuttal testimony regarding the Discretionary payments to executives under the GPE and KCPL short term incentive compensation plan, Mr. Halloran makes the following statement:

> "The discretionary component of KCPL's incentive program ensures that the management team understands that strong performance for the *customer unrelated to financial results* will be recognized and rewarded." (Emphasis added)

What is Staff's response to this statement?

A. Mr. Halloran's statement regarding the Discretionary component of the executive short term incentive plan includes two implications. He implies that he has knowledge that

1) the goals supporting the Discretionary payments are related to customer benefits and

2) the goals supporting the Discretionary payments are unrelated to the achievement of any financial goals

The Staff has not been provided any evidence which would support either conclusion implied in Mr. Halloran's statement. The achievement of defined goals which support the Discretionary payments to GPE and KCPL executives under the plan have not been identified by KCPL and provided to the Staff. Any incentive compensation payment to executive management which cannot be tied to achievement of goals beneficial to customer interests should be excluded from recovery in rates.

RESEARCH & DEVELOPMENT TAX CREDITS

Q. What is the purpose of this section of your surrebuttal testimony?

A. This section of my surrebuttal testimony will address the rebuttal testimony of KCPL witness Chris B. Giles on the issue Research & Development (R&D) Tax Credits related to years prior to 2006.

Q. Please define the issue between Staff and KCPL related to R&D Tax Credits.

A. In response to Department of Energy Data Request No. 55, KCPL indicated that it had filed amended tax returns for the years 2000 – 2004 for the purpose of reflecting allowable tax credits and current year tax deductions for research and experimental expenditures under Internal Revenue Code (IRC) Sections 41 and 174. It is the Staff's position that the additional cash flow from a tax refund from an amended tax return should be deferred and amortized for ratemaking purposes. This increase in cash flow to KCPL should be used to mitigate the Regulatory Plan Additional Amortization that KCPL's ratepayers are paying in current rates and will continue to pay until rates become effective in 2010 to recognize the in service date for KCPL's new coal burning generating facility, Iatan 2. KCPL has taken the position that cost of service recognition for tax refunds related to years prior to 2006 represents retroactive ratemaking and a violation of the matching principle. If KCPL's position on this issue is adopted by the Commission, then 100% of the benefit from any tax refund received by KCPL for the years 2000 - 2004 will accrue to shareholders. KCPL's position on this issue is completely contradictory to its historical position regarding the deferral and rate recovery of *extraordinary costs* which occurred in a prior period.

Q. On page 8 of his rebuttal testimony Mr. Giles makes the following statement:

> "It is not appropriate to reach back to events that occurred in prior years outside the test period to set rates for future periods."

Is this position consistent with KCPL's deferral and rate recovery of extraordinary maintenance costs resulting from an ice storm which occurred in 2002?

A. Certainly not. KCPL requested and was granted an Accounting Authority Order (AAO) to defer extraordinary maintenance costs related to an ice storm which occurred in 2002. The rates established in Case No. ER-2006-0314 included a full year of those *extraordinary costs* based upon a 5 year amortization. Clearly it was "appropriate" in KCPL's view to "reach back" to ice storm costs which occurred 3 years prior to the 2005 test year used in Case No. ER 2006-0314 for purposes of rate recovery of the extraordinary ice storm costs. It is the position of the Staff and Department of Energy (DOE) that the *extraordinary revenue* anticipated in 2008, resulting from tax refunds for prior years, should be given treatment consistent with the Commission's treatment of KCPL's 2002 extraordinary ice storm costs.

Q. Since the tax refunds related to R&D Tax Credits are not anticipated to be received by KCPL until 2008, is Mr. Giles characterization of "reaching back to events that occurred in prior years" accurate for this issue?

A. No it is not. The actual receipt of the R&D Tax Credit refund is not expected until 2008 according to page 8, lines 13 - 14 of Mr. Giles' rebuttal testimony. Therefore, this issue is not related to monies "received" by KCPL in "prior years". According to Mr. Giles' direct testimony, KCPL anticipates filing another rate case by April, 2008. The test year and/or known and measurable period for that rate case will therefore include the period when KCPL actually receives the tax refund from the IRS. The recommended deferral and amortization of the R&D Tax Credit refund in KCPL's next rate case is consistent with Mr. Giles' following statement on page 9, lines 1-3 of his rebuttal testimony:

> "Extraordinary cost events are amortized when they occur in a test year or when the Commission has approved an accounting authority order to defer and amortize for recovery purposes an unusual but prudently incurred expense over time."

The Staff and DOE are simply asking the Commission to authorize deferred accounting treatment and amortization in KCPL's next rate case consistent with the treatment recognized by Mr. Giles in his rebuttal testimony quoted above.

Q. Is Mr. Giles' allegation of "retroactive ratemaking" a valid basis for rejecting the Staff's and DOE's recommendation to defer the income statement recognition of a R&D Tax Credit refund anticipated to be received in 2008?

A. No. The Staff finds this criticism to be inappropriately applied to this issue. Deferred accounting treatment and cost of service recognition for a "future event" cannot be fairly characterized as retroactive ratemaking.

Q. Why is it appropriate to request a Commission decision on this issue in this case?

A. At the time the Staff filed its direct testimony in this case it was Staff's understanding that the receipt of the R&D Tax Credit refund could occur by the September 30, 2007 true-up end date approved for this case. Mr. Giles' indication that the receipt of the R&D Tax Credit refund is now expected to occur in 2008 does not change the facts on this issue. The Staff, DOE and KCPL have filed direct, rebuttal and surrebuttal testimony on this issue. The question as to whether deferred accounting treatment and cost of service recognition is appropriate for the R&D Tax Credit refund is not dependent upon knowing the actual amount of the refund received. A Commission decision on this issue in this case, ER-2007-0291, might avoid having to address this issue again in KCPL's next rate case.

Q. Does this conclude your surrebuttal 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 and Light Company for Approval to Make Certain Changes in its Charges for Electric Service To Implement Its Regulatory Plan.	)))))	Case No. ER-2007-0291

AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Steve M. Traxler, being of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 29 pages to be presented in the above case; that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler

Subscribed and sworn to before me this 20th day of September, 2007.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

Notary Public

Deferred Tax Laibility - Normalizing the Timing Difference for Depreciation Expense

LineNo.		
1	Asset Cost	$ 1,000,000
2	Accelerated Tax Depreciation Rate - 5 years = 20%	
3	Book Depreciation Rate - 10 years = 10%	

		Book Depreciation (A)	Accelerated Tax Depreciation (B)	Tax Deprec. to be Deferred (C) (B) - (A)	Effective Tax Rate (D)	Deferred Tax Expense (E) (C) X (D)	Accumulated Deferred Income Tax ***Liability*** (F)
4	Year 1	$100,000	$200,000	$100,000	40%	$40,000	$40,000
5	Year 2	$100,000	$200,000	$100,000	40%	$40,000	$80,000
6	Year 3	$100,000	$200,000	$100,000	40%	$40,000	$120,000
7	Year 4	$100,000	$200,000	$100,000	40%	$40,000	$160,000
8	Year 5	$100,000	$200,000	$100,000	40%	$40,000	$200,000
9	Year 6	$100,000	$0	($100,000)	40%	($40,000)	$160,000
10	Year 7	$100,000	$0	($100,000)	40%	($40,000)	$120,000
11	Year 8	$100,000	$0	($100,000)	40%	($40,000)	$80,000
12	Year 9	$100,000	$0	($100,000)	40%	($40,000)	$40,000
13	Year 10	$100,000	$0	($100,000)	40%	($40,000)	$0
14	Total	$1,000,000	$1,000,000	$0		$0	$0

Schedule SMT 1

Deferred Tax Asset - Normalizing the Timing Difference for Cost of Removal

LineNo.		
1	Asset Cost	$ 1,000,000
2	Estimated Cost of Removal	$ 150,000
3	Total Cost to Recovered in Book Depreciation Expense	$ 1,150,000
4	Expected Life of the Asset	10 years
5	Book Depreciation Rate - Life Assumption	10.00%
6	Book Depreciation Rate - Cost of Removal Assumption	1.50%
7	Total Book Depreciation Rate	11.50%

		Cost of Removal Recovered in Book Depreciation	Cost of Removal Tax Deduction IRS	Tax Deprec. to be Deferred	Effective Tax Rate	Deferred Tax Expense	Accumulated Deferred Income Tax ***Asset***
		(A)	(B)	(C) (B) - (A)	(D)	(E) (C) X (D)	(F)
8	Year 1	$15,000	$0	($15,000)	40%	($6,000)	($6,000)
9	Year 2	$15,000	$0	($15,000)	40%	($6,000)	($12,000)
10	Year 3	$15,000	$0	($15,000)	40%	($6,000)	($18,000)
11	Year 4	$15,000	$0	($15,000)	40%	($6,000)	($24,000)
12	Year 5	$15,000	$0	($15,000)	40%	($6,000)	($30,000)
13	Year 6	$15,000	$0	($15,000)	40%	($6,000)	($36,000)
14	Year 7	$15,000	$0	($15,000)	40%	($6,000)	($42,000)
15	Year 8	$15,000	$0	($15,000)	40%	($6,000)	($48,000)
16	Year 9	$15,000	$0	($15,000)	40%	($6,000)	($54,000)
17	Year 10	$15,000	$0	($15,000)	40%	($6,000)	($60,000)
18	Year 11	$0	$150,000	$150,000	40%	$60,000	$0
19	Total	$150,000	$0	($150,000)		($60,000)	$0

Schedule SMT 2