BEFORE THE STATE CORPORATION COMMISSION

OF THE STATE OF KANSAS

DIRECT TESTIMONY

OF

MICHAEL J. STADLER

WESTAR ENERGY

DOCKET NO. ______________

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Michael J. Stadler, 818 South Kansas Avenue, Topeka, Kansas 66612.

Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

A. Westar Energy, Inc. I am Executive Director, Tax.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT EXPERIENCE.

A. I received a Bachelor of Business Administration degree with a major in Accounting from Washburn University. I am a Certified Public Accountant. I joined Westar in 1977 and have held the positions of Manager of Federal Income Tax, Manager of Tax Department and Director of Taxation prior to my current position. I have completed the Stone & Webster Utility Management Course and I am a member of the American Institute of Certified Public Accountants and the Edison Electric Institute Taxation Committee.

Q. WHAT ARE YOUR PRESENT RESPONSIBILITIES WITH WESTAR?

A. I have the overall supervisory responsibility for Westar's tax function.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY BEFORE THIS COMMISSION?

A. Yes. I have testified on several occasions, most recently in Docket No. 01-WSRE-949-GIE.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to address the income tax component in cost of service and the deferred income taxes deducted from rate base. Specifically, I will address (1) the Commission's directive to treat as cost-free capital the assumed level of unamortized deferred taxes related to the recovery of the premium that The Kansas Power and Light Company (KPL) paid when it acquired the Kansas Gas and Electric Company (KG&E) in 1992, (2) the income tax effect of each of the pro forma adjustments in Section 9 of Westar North's and South's Minimum

Filing Requirements (MFRs), and (3) the tax exhibits in Section 11 of Westar North's and South's MFRs.

I will also sponsor the following pro forma tax adjustments in Westar North's and South's MFRs:

Westar North: Section 9, Adjustment Nos. 26, 30, 31 and 32.

Westar South: Section 9, Adjustment Nos. 26, 30, 31, and 32.

III. MERGER PREMIUM

Q. IN WESTAR'S LAST RATE CASE THE COMMISSION MADE CERTAIN ADJUSTMENTS RELATED TO ACCUMULATED DEFERRED INCOME TAXES (ADIT) THAT WERE BOOKED BY WESTAR AS A RESULT OF THE MERGER ACQUISITION PREMIUM PAID IN THE 1992 KPL – KG&E MERGER. PLEASE DESCRIBE THE ADJUSTMENTS.

A. In its Order on the Application in Docket No. 01-WSRE-436-RTS dated July 25, 2001, the Commission reduced Westar South's rate base by $66,295,177 and Westar North's rate base by $16,698,284 million to reflect ADIT related to the merger premium paid by KPL to acquire KG&E. The total rate base adjustment was $82,993,461. Coupled with the related deferred tax adjustment, this adjustment reduced revenues by $12.7 million.

Q. DID WESTAR MAKE THESE ADIT RATE BASE ADJUSTMENTS IN DETERMINING THE COST OF SERVICE IN THE CURRENT APPLICATION?

A. No.

Q. PLEASE EXPLAIN WHY YOU HAVE NOT MADE THE ADIT ADJUSTMENTS.

A. The ADIT adjustments were based on two critical, but incorrect assumptions: (i) that customers had provided Westar $82,993,461 in cost-free capital in connection with the merger acquisition premium; and (ii) that Westar was earning a return on the present value of the deferred income tax payments. Additionally, as I will discuss, the ADIT adjustments virtually eliminated the 50/50 merger savings sharing opportunity for Westar that was an essential component of the Commission's order approving the merger.

Westar is asking the Commission to take a fresh look at the appropriateness of the ADIT adjustments going forward. Regulatory decisions are seldom made in a vacuum, and regulatory agencies must take a broad and comprehensive view of the rates approved in a general rate proceeding, evaluating both the need for and overall merits of a change in rates. We respectfully ask the Commission to reexamine the merits of the adjustment, including the correctness of the fundamental assumptions it relied upon and other facts and circumstances that existed then and now. To assist in the Commission's reconsideration, we are providing additional information and what we hope is a clearer presentation of the underlying facts regarding the merger acquisition premium.

Q. PLEASE SUMMARIZE THE FACTS RELATING TO THE COMMISSION'S APPROVAL OF THE KPL/KG&E MERGER AND THE ADIT ADJUSTMENTS.

A. KPL paid an acquisition premium of approximately $490 million to purchase KG&E. In the 1991 merger proceeding, the Commission concluded the merger was in the public interest and found that we could recover on an after-tax basis $312 million of the acquisition premium amortized over a 40-year period if we demonstrated that we had achieved an appropriate level of merger savings. The $312 million represented the net present value of then-anticipated merger savings.

The annual amortization amount was approximately $7.8 million ($312 million/40 years). Because of the current tax liability occasioned by this recovery, the annual amortization was grossed up to $12.9 million so we would actually be able to recover the $7.8 million amortization amount.

The Commission held that any additional recovery related to the acquisition premium would be determined in the next rate proceeding and that savings above $12.9 million would be shared on a 50/50 basis between the merged companies and our customers. The Commission's 1991 Order stated:

> The sharing of savings will commence when the amortization of the AP begins in August 1995 or whenever rates go into effect after the first general rate proceeding . . . whichever is later. The sharing of savings will be on a 50/50 basis between ratepayers and shareholders after taxes. In light of the Commission's determination to allow recovery of only $312 million AP, as opposed to the entire $388 million or larger AP [ultimately $490 million], and the decision to extend the amortization period to 40 years, ratepayers will be assured a greater level of the savings once amortization begins in 1995. At this time, the Commission is not allowing the AP to be put in the rate base. **The Applicants' only opportunity to earn a return of or on the allowed AP will be from merger-related savings.** All savings above the allowed amortization will be shared 50\50 between customers and shareholders.

Order, Consolidated Docket Nos. 172,745-U, 174,155-U, p. 83 (November 14, 1991). (Emphasis added).

Q. DID THE COMMISSION SUBSEQUENTLY DETERMINE THE LEVEL OF MERGER SAVINGS TO BE SHARED BETWEEN WESTAR AND ITS CUSTOMERS?

A. Yes. The Commission's next Rate Order was issued in 1997. Docket Nos. 193,306-U and 193,307-U. In that Order, the Commission found that we had achieved merger-related savings of $40 million on an annual basis and – implementing the sharing mechanism adopted in the 1991 Order – permitted us to recover approximately $26.5 million of these savings. The $26.5 million was calculated by adding the original $12.9 million annual amortization and one-half of the savings above that amount ($40 million minus $12.9 million divided by 2 or $13.5 million).

Q. WERE THE ADIT ADJUSTMENTS MADE IN THE 436 DOCKET CONSISTENT WITH SOUND INCOME TAX AND REGULATORY PRINCIPLES AND PRACTICES?

A. No. The Commission was presented a flawed set of assumptions on which it relied in ordering the adjustments. As I stated earlier, those erroneous assumptions were (i) that customers had provided Westar $82,993,461 in cost-free capital and (ii) that Westar is earning a return on the present value of the deferred income tax payments.

Q. WHY ARE THE ADIT ADJUSTMENTS WRONG?

A. The rationale for the rate base adjustments, as advanced by the Staff in Docket No. 01-WSRE-436-RTS, and as articulated in the Commission's Order on Application in that proceeding, was that customers had made an $82,993,461 cost-free loan to Westar through the future annual recovery of $26,475,985 in merger savings through rates. This $82,993,461 amount was determined by multiplying (i) the present value of $26,475,985 in annual merger savings recovery (as authorized in Docket Nos. 193,306-U and 193,307-U), which was calculated to be $208,644,237, by (ii) the marginal income tax rate of 0.397775. This is a meaningless and ultimately misleading computation. It has no bearing on the concept of cost-free capital.

Q. WHY IS THAT?

A. The $490 million premium to acquire KG&E is not deductible for income tax purposes. However, Westar must pay income taxes on recovery of the merger acquisition premium. The income taxes represent a real cost that must be borne by Westar. We recorded the tax obligation on the merger premium at the time of the acquisition. The tax obligation of $311 million was recorded as deferred income taxes. Westar actually pays these taxes as the premium is amortized. An accounting entry – not customers – provided the deferred income taxes. Therefore, there is and was no cost-free loan in connection with ***these*** deferred income taxes.[1] Consequently, none of these deferred taxes should be deducted from rate base. These deferred income taxes are different from the deferred income taxes that are a product of accelerated tax depreciation, which I will discuss later.

Q. PLEASE DESCRIBE THE KPL/KG&E MERGER TRANSACTION.

A. On October 28, 1990, KPL, KG&E and KCA Corp. (an acquisition corporation) entered into an Agreement and Plan of Merger under

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[1] Westar does not dispute the propriety of treating plant-related deferred income taxes as cost-free capital, but the "deferred income taxes" recognized by the Commission in the 436 Docket bear no relation to those properly recognized in the ratemaking process.

which KPL agreed to acquire KG&E through the merger of KG&E with and into KCA.

Pursuant to the terms of the Agreement, each outstanding share of KG&E common stock was converted into the right to receive either (1) $32 in cash; (2) approximately $32 of KPL common stock; or (3) a combination of cash and KPL common stock with a combined value of approximately $32. Under the Agreement, approximately 56% of the total consideration exchanged for the KG&E common stock was KPL common stock, with the remaining approximately 44% exchanged for cash.

The acquisition was consummated on March 31, 1992. The total value of the cash and common stock offer was $1,024,171,195. However, when added to the cash that KPL agreed to pay for the outstanding KG&E preferred stock of $19,664,610 and the amount that KPL paid for direct acquisition costs and other accruals of $66,050,037, the purchase price totaled $1,109,885,842.

For financial accounting purposes, the book value of KG&E common and preferred stock at the closing date was $619,824,446. As a result, KPL recorded an acquisition premium of $490,061,396 before income taxes. Through an accounting entry, the acquisition premium was subsequently grossed-up for income taxes in the amount of $310,910,058. The income tax component recognized that the amortization of the acquisition premium is not tax deductible and would result in Westar having to pay additional income taxes (to the extent it recovers any portion of the premium out of merger savings). The total acquisition premium was $800,971,454.

Q. HOW WAS THE ACQUISITION OF KG&E TREATED FOR INCOME TAX PURPOSES?

A. The acquisition structure qualified as a tax-free forward triangular reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D) of the Internal Revenue Code of 1986, as amended.

Because it was a tax-free reorganization, the surviving entity of the merger (KCA) assumed the tax basis of KG&E's assets. However, due to the structure of the acquisition, KPL was not able to step-up the tax basis of KCA's stock to a level equal to the purchase price. As a result, KPL's tax basis in the KCA (new KG&E) stock equaled the tax basis in KG&E's assets. KCA was renamed to Kansas Gas and Electric Company at closing.

Q. WHY IS THE INCOME TAX TREATMENT OF THE KG&E ACQUISITION IMPORTANT?

A. The acquisition premium will never be deductible for income tax purposes because it does not have a tax basis. For income tax purposes, the acquisition premium disappeared in the acquisition.

Consequently, there will never be a book-tax timing difference which creates accumulated deferred income taxes.

Q. ARE YOU SAYING THAT ADIT CAN RESULT FROM REASONS OTHER THAN BOOK-TAX TIMING DIFFERENCES?

A. Yes.

Q. WHY DID WESTAR RECORD DEFERRED INCOME TAXES ON THIS TRANSACTION?

A. Although there is no book-tax timing difference, Westar recorded deferred income taxes on the transaction to recognize its obligation to pay income taxes on revenues collected in rates as the authorized acquisition premium is being amortized to expense over 40 years. The tax obligation arises because the amortization expense is ***not*** deductible for income tax purposes. This results in a current tax payment to the federal and state governments on the revenues collected in rates (i.e., out of the approved merger savings) to cover the amortization expense.

Q. PLEASE EXPLAIN THE CONCEPT OF COST-FREE CAPITAL.

A. The concept of cost-free capital evolved out the ratemaking treatment of deferred income taxes, the origin of which is book-tax timing differences. Deferred income taxes are normally created because of differences between straight-line depreciation (book depreciation) that is used for ratemaking purposes and the accelerated depreciation (tax depreciation) that may be used for federal income tax purposes. What this means is that for ratemaking purposes income taxes reflect taxable income determined based on book depreciation even though the amount of income taxes actually paid by the utility during a test year was based on tax depreciation. This is called "income tax normalization." Federal tax law requires utilities that use accelerated depreciation for tax purposes to use income tax normalization in the ratemaking process. The way in which this works is best shown by an example.

Suppose that a utility builds a power plant that costs $500 million with a book life of 40 years and book depreciation rate of 2.5% (one divided by 40 years – with zero salvage and removal cost – which is, of course, a simplifying assumption). Under the system of accelerated depreciation allowed for purposes of determining income taxes, tax depreciation would be computed on a different, accelerated schedule. Table 1 shows the book and tax depreciation rates that would be used in this example.

TABLE 1 – COMPARISON OF BOOK AND TAX DEPRECIATION RATES

Year	Book Depreciation Rate	Tax Depreciation Rate
1	1.250%	3.750%
2	2.500%	7.219%
3	2.500%	6.677%
4	2.500%	6.177%
5	2.500%	5.713%
6	2.500%	5.285%
7	2.500%	4.888%
8	2.500%	4.522%
9	2.500%	4.462%
10	2.500%	4.461%
11	2.500%	4.462%
12	2.500%	4.461%
13	2.500%	4.462%
14	2.500%	4.461%
15	2.500%	4.462%
16	2.500%	4.461%
17	2.500%	4.462%
18	2.500%	4.461%
19	2.500%	4.462%
20	2.500%	4.461%
21	2.500%	2.231%
22	2.500%	0.000%
23	2.500%	0.000%
24	2.500%	0.000%
25	2.500%	0.000%
26	2.500%	0.000%
27	2.500%	0.000%
28	2.500%	0.000%
29	2.500%	0.000%
30	2.500%	0.000%
31	2.500%	0.000%
32	2.500%	0.000%
33	2.500%	0.000%
34	2.500%	0.000%
35	2.500%	0.000%
36	2.500%	0.000%
37	2.500%	0.000%
38	2.500%	0.000%
39	2.500%	0.000%
40	2.500%	0.000%
41	1.25%	0.000%
TOTAL	100.00%	100.000%

As can be seen from Table 1, the book depreciation rates are lower and cover a longer period of time than the tax depreciation rates. What this means is that for income tax purposes, the plant is depreciated faster than for book purposes. However, this is mainly a timing issue as the same amount of tax will ultimately be paid over the life of the plant. Under accelerated tax depreciation, less tax is paid in the early years than under straight line book depreciation because the deductions for depreciation expense are higher using accelerated tax depreciation. Conversely, more tax is paid in later years when the depreciation expense goes to zero under accelerated tax depreciation, but still continues under the straight line book depreciation method.

The key to understanding accumulated deferred income taxes is to recognize that ***for ratemaking purposes*** income taxes are calculated using book depreciation rates, but for purposes of calculating the amount of income taxes currently paid by the utility, income taxes are calculated using the tax depreciation rates. Therefore, in the early years in the life of a power plant (or other depreciable property) an amount for income taxes greater than the amount actually paid by the utility will be reflected in utility rates. In the later years in the life of a power plant, an amount for income taxes less than the amount actually paid will be reflected in utility rates. The difference between the amount of income taxes reflected in rates and the amount actually paid by the utility is referred to as deferred income taxes. The accumulated balance of these sums is referred to as *accumulated* deferred income taxes. In this example, ADIT represents cost-free capital to the utility and is generally removed from rate base or is included as cost-free capital in a utility's capital structure.

Q. CAN YOU PROVIDE A SIMPLE EXAMPLE OF AN ACCUMULATED DEFERRED INCOME TAX CALCULATION AND HOW IT WOULD AFFECT RATE BASE?

A. Yes. Continuing with the example from Table 1 the book depreciation on a $500 million power plant in the first year of service would be $6.25 million (or $500 million x 1.250%) and the tax depreciation would be $18.75 million (or $500 million x 3.750%). If the income tax rate is 40%, then the difference in depreciation rates creates a deferred income tax for that year of $5 million (or [$18.75 million – $6.25 million] x 40% = $5 million). Thus, absent any further adjustment, $5 million more in income taxes would be included in the utility's revenue requirements than actually paid. But there is a further compensating adjustment. This amount is considered to be "cost-free capital" by regulators and is hence deducted from rate base because the utility's customers (and not the utility) would have advanced the deferred amounts.

The following Table 2 shows the buildup and eventual decline of the ADIT balance over the life of the power plant.

TABLE 2 – ADIT EXAMPLE
(Dollars in Millions)

Year	Book Depreciation	Tax Depreciation	Annual Deferred	Accumulated
1	1.250%	3.750%	$ 5.00	$ 5.00
2	2.500%	7.219%	$ 9.44	$ 14.44
3	2.500%	6.677%	$ 8.35	$ 22.79
4	2.500%	6.177%	$ 7.35	$ 30.15
5	2.500%	5.713%	$ 6.43	$ 36.57
6	2.500%	5.285%	$ 5.57	$ 42.14
7	2.500%	4.888%	$ 4.78	$ 46.92
8	2.500%	4.522%	$ 4.04	$ 50.96
9	2.500%	4.462%	$ 3.92	$ 54.89
10	2.500%	4.461%	$ 3.92	$ 58.81
11	2.500%	4.462%	$ 3.92	$ 62.73
12	2.500%	4.461%	$ 3.92	$ 66.65
13	2.500%	4.462%	$ 3.92	$ 70.58
14	2.500%	4.461%	$ 3.92	$ 74.50
15	2.500%	4.462%	$ 3.92	$ 78.42
16	2.500%	4.461%	$ 3.92	$ 82.35
17	2.500%	4.462%	$ 3.92	$ 86.27
18	2.500%	4.461%	$ 3.92	$ 90.19
19	2.500%	4.462%	$ 3.92	$ 94.12
20	2.500%	4.461%	$ 3.92	$ 98.04
21	2.500%	2.231%	$ (0.54)	$ 97.50
22	2.500%	0.000%	$ (5.00)	$ 92.50
23	2.500%	0.000%	$ (5.00)	$ 87.50
24	2.500%	0.000%	$ (5.00)	$ 82.50
25	2.500%	0.000%	$ (5.00)	$ 77.50
26	2.500%	0.000%	$ (5.00)	$ 72.50
27	2.500%	0.000%	$ (5.00)	$ 67.50
28	2.500%	0.000%	$ (5.00)	$ 62.50
29	2.500%	0.000%	$ (5.00)	$ 57.50
30	2.500%	0.000%	$ (5.00)	$ 52.50
31	2.500%	0.000%	$ (5.00)	$ 47.50
32	2.500%	0.000%	$ (5.00)	$ 42.50
33	2.500%	0.000%	$ (5.00)	$ 37.50
34	2.500%	0.000%	$ (5.00)	$ 32.50
35	2.500%	0.000%	$ (5.00)	$ 27.50
36	2.500%	0.000%	$ (5.00)	$ 22.50
37	2.500%	0.000%	$ (5.00)	$ 17.50
38	2.500%	0.000%	$ (5.00)	$ 12.50
39	2.500%	0.000%	$ (5.00)	$ 7.50
40	2.500%	0.000%	$ (5.00)	$ 2.50
41	1.25%	0.000%	$ (2.50)	**$ 0.00**
	100.00%	100.000%		

As Table 2 shows, there is a gradual buildup and eventual decline of the amount of ADIT subtracted from rate base over time, with the amount ultimately going to zero. The ADIT amounts represent "cost-free capital" to the utility and consequentially should be deducted from rate base.

Q. WHAT ABOUT THE $82,993,461 ADIT AMOUNT COMPUTED IN THE LAST RATE REVIEW RELATED TO THE MERGER PREMIUM? SHOULD THAT AMOUNT BE DEDUCTED FROM RATE BASE?

A. No. Unlike plant-related ADIT, merger savings produced no cost-free capital. Because customers provided no cost-free capital, there is no basis for a rate base ADIT offset. Merely multiplying the present value of the merger savings recovery by the marginal income tax rate did not create cost-free capital. Westar was authorized to recover $26.5 million in "merger savings" through rates, but Westar is paying income taxes on this entire amount. At no time during the period over which the merger premium is being amortized do customers pay a component of income taxes in rates that exceeds the amount Westar pays in taxes. Consequently, there is no timing difference because the amount of taxes Westar pays and the amount Westar collects in rates are identical.

As a result, customers are not providing – ***nor have they ever provided*** – "cost-free capital" or a "cost-free loan" to Westar in connection with the amortization of the merger premium. In 1992, Westar did indeed record, as an accounting entry, $310,910,058 in deferred income taxes, which it will eventually have to pay in federal and state income taxes. Customers, however, did not contribute those deferred income taxes. Such ADIT balances did not build up over time due to book-tax timing differences. One hundred percent of ***these*** ADIT balances resulted solely from accounting entries. In fact, I calculated the amounts of those very entries.

Consequently, because customers did not provide cost-free capital to Westar, the income taxes on the present value of the $26.5 million annual revenue requirement must not be deducted from rate base.

Q. IN ADOPTING THE ADIT ADJUSTMENTS, THE COMMISSION'S ORDER ON RATE APPLICATIONS IN DOCKET NO. 01-WSRE-436-RTS STATED: "THE DEFERRED INCOME TAXES ARE COLLECTED BEFORE THE APPLICANTS ARE REQUIRED TO PAY INCOME TAX EXPENSE FOR THE AMORTIZATION OF THE [ACQUISITION PREMIUM]." IS THE STATEMENT CORRECT?

A. No. The premium that KPL paid to acquire KG&E was $490,061,396. This amount is not deductible for income tax purposes and, therefore, income taxes will be required to be paid on the amount of revenue included in rates to amortize the premium. The income taxes on the merger premium were $310,910,058, which, as I stated, were recorded as deferred income taxes in Account 114. Thus, the total merger acquisition premium recorded by Westar was $800,971,455. The $310.9 million amount represented a future cost associated with the merger premium that was booked as deferred income taxes but would be paid in the future by Westar.

In other words, the $310.9 million amount represented a future obligation on the part of Westar to pay income taxes. When the deferred income tax amount was established, customers did not provide ***any*** of the $310.9 million that was recorded. Therefore, these tax dollars were not collected from customers prior to being paid by Westar. Westar is required to pay these income taxes in the same year that they are paid by customers. The Commission was, therefore, incorrect in stating that the deferred income taxes are collected before Westar is required to pay income tax expense for the amortization of the acquisition premium.

Q. DO THE ADIT ADJUSTMENTS MADE IN THE LAST RATE REVIEW ALLOW WESTAR TO RECOVER $26.5 MILLION IN MERGER-RELATED SAVINGS?

A. No. Because of the rate base and deferred income tax adjustments that were made in Westar's last rate case in connection with the merger premium, we were only allowed to recover $13.8 million through rates, and not the $26.5 million that the Commission authorized in Docket Nos. 193,306-U and 193,307-U. In our last rate case, the $26.5 million was in effect reduced by rate base adjustments and the related deferred income tax adjustments. The rate base adjustments resulted in a reduction in revenue requirements of $10,320,568 ($82,993,461 x (9.0836% + 3.3518%)).

Additionally, the Commission reduced deferred income taxes during the test year by $2,382,815 – or $1,903,393 for Westar South and $479,422 for Westar North. (*See,* Order, Docket No. 01-WSRE-436-RTS, p. 36.)

As a consequence of these adjustments, Westar was only allowed to recover $13,772,602 of the costs associated with the merger premium. By allowing the recovery of $13.8 million, the Commission essentially reversed its rulings in Docket Nos. 172,745-U, 174-155-U, 193,306-U and 193,307-U that authorized Westar to recover 50% of the savings above $12.9 million. As a result of the ADIT adjustments, Westar was only allowed to recover an additional $820,632 in merger savings ($13,772,602 - $12,951,970). Thus, the "opportunity" to earn a return of and on the merger savings contemplated by the 1991 Order and upon which KPL and KG&E relied in consummating the merger transaction was effectively nullified.

Q. IS WESTAR EARNING A FULL RETURN ON THE ACQUISITION PREMIUM?

A. Absolutely not. No matter from what perspective one looks at it, we are not earning a full return on the acquisition premium. In its initial Merger Order in Docket Nos. 172,745-U and 174,155-U, the Commission allowed Westar to recover $312 million of the merger premium, resulting in amortization expenses of $12.9 million beginning in 1995. As of September 30, 2000, $273 million of the $312 million merger premium authorized by the Commission would have remained unamortized. If Westar had been granted a full return on this $273 million unamortized balance, then the revenue requirement using the rate of return authorized by the Commission in the last rate case would have been $46.9 million, calculated as follows:

(1)	Unamortized Merger Premium	$273,000,000
(2)	Return on Unamortized Balance (9.0836% x (1))	$ 24,800,000
(3)	Income Taxes on Return (3.3518% x (1))	$ 9,200,000
(4)	Amortization originally authorized	$ 12,900,000
(5)	Revenue Requirement ((2)+(3)+(4))	$ 46,900,000

Because the ADIT adjustments effectively permit Westar to recover only $13.8 million related to the merger premium, Westar earns virtually no return on the $312 million merger acquisition premium authorized by the Commission. Even when it was recovering $26.5 million in merger savings, Westar was earning nothing close to a full return on the Commission-authorized acquisition premium.

IV. PRO FORMA TAX ADJUSTMENTS

Q. PLEASE EXPLAIN PRO FORMA ADJUSTMENTS NO. 26 IN SECTION 9 OF WESTAR NORTH'S AND SOUTH'S MFRS, RELATED TO REAL ESTATE AND PERSONAL PROPERTY TAXES.

A. Adjustments No. 26 annualize the real estate and personal property taxes for pro forma end-of-period plant in service. These adjustments were determined by using estimated 2005 assessed values and 2004 tax levies. The adjustments increase the real estate and personal property taxes for Westar North and South by $5,404,652 and $1,542,309, respectively.

Q. WILL ALL THE PRO FORMA ADJUSTMENTS IN SECTION 9 AFFECT INCOME TAXES?

A. Yes. All revenue and expense adjustments, summarized on Schedule 9-B and individually identified throughout Sections 9 and 10, affect the income tax component in cost of service. With exceptions, all of the revenue and expense adjustments affect current income taxes.

The income tax component includes current income taxes, deferred income taxes and the unamortized investment tax credit. Current income taxes represent the taxes currently payable to the federal and state governments. Deferred income taxes are taxes reported currently but payable to the federal and state governments at some future date. The unamortized investment tax credit represents the tax credits remaining to be amortized and flowed through to customers over the lives of the related properties.

Q. PLEASE EXPLAIN PRO FORMA ADJUSTMENTS NO. 30 IN SECTION 9 OF WESTAR NORTH'S AND SOUTH'S MFRS, RELATED TO PRIOR YEAR TAX ADJUSTMENTS.

A. Prior year tax adjustments reflect the differences between the estimated amounts recorded on the books and the actual amounts reported in the filed income tax returns. The prior year adjustments are recorded on the books after the income tax returns are filed. These adjustments eliminate the impact of the prior year tax adjustments recorded on the books of Westar North and South during the test year. These adjustments increase net operating income for Westar North by $4,234,466 and decrease net operating income for Westar South by $4,083,456.

Q. PLEASE EXPLAIN ADJUSTMENTS NO. 31 IN SECTION 9 OF WESTAR NORTH'S AND SOUTH'S MFRS, RELATED TO ELIMINATIONS AND ADJUSTMENTS.

A. These adjustments are necessary to correct taxes other than income taxes and the test year calculation of income taxes for Westar North and South. The adjustments recognize known and measurable changes and annualize or synchronize revenue and expense items where appropriate. Specifically, the adjustments eliminate the effects of (1) certain lobbying expenses, (2) tax reserves for potential assessments of property, sales and income taxes, (3) organizational costs for Protection One Data Systems, Inc. and trademark costs for Westar Wind, (4) the property tax surcharge, (5) the accrual for the refund of the cost savings related to the purchase power agreement with Westar Generating's State Line Combined Cycle plant, (6) the accrual for the KCC ordered rate rebates to customers, (7) the compensation deduction for disqualified dispositions of stock under the Employee Stock Purchase Plan, (8) revenues from electric plant leased to others, and (9) gains and losses from dispositions of utility plant. The net effect of these adjustments decreases net operating income for Westar North by $8,578,013 and increases net operating income for Westar South by $1,957,194.

Q. PLEASE EXPLAIN ADJUSTMENTS NO. 32 IN SECTION 9 OF WESTAR NORTH'S AND SOUTH'S MFRS, RELATED TO INTEREST SYNCHRONIZATION.

A. These adjustments synchronize test year interest expense used in computing taxable income with the rate base. These amounts were determined by applying the weighted cost of debt for Westar North and South at the end of the test year to the adjusted rate base for each respective company. The net effect of these adjustments is to increase current income taxes $29,984,806 for Westar North and decrease current income taxes by $5,932,000 for Westar South. There is no adjustment to deferred income taxes.

Q. WHICH OF THE PRO FORMA ADJUSTMENTS DO NOT AFFECT CURRENT INCOME TAXES?

A. Generally speaking, the pro forma adjustments for depreciation and amortization expense will not affect current income taxes. Rather, these pro forma adjustments affect deferred income tax.

Adjustments No. 23 in Westar North's and South's MFRs annualize tax straight-line depreciation. The annualized tax straight-line depreciation was computed by applying existing book straight-line depreciation rates to each vintage year's tax depreciable basis of property. The existing depreciation rates were approved by the KCC in Docket No. 01-WSRE-436-RTS.

Adjustments No. 24 in Westar North's and South's MFRs also annualize tax straight-line depreciation for the test year. This annualized tax straight-line depreciation was computed by applying proposed book straight-line depreciation rates to each vintage year's tax depreciable basis of property. The proposed depreciation rates are sponsored by Mr. Spanos in this rate proceeding.

Adjustments No. 4 in Westar North's and South's MFRs reflect recovery over a 10-year period of the difference in depreciation expense that Westar North and South recorded for financial reporting purposes over the KCC approved depreciation expense in Docket No. 01-WSRE-436-RTS during the period August 2001 through March 2002.

Q. WILL ANY OF THE PRO FORMA ADJUSTMENTS IN SECTION 9 OF WESTAR NORTH'S AND SOUTH'S MFRS AFFECT THE AMORTIZATION OF INVESTMENT TAX CREDITS?

A. Adjustments Nos. 4, 23, 24, and 28 and in Section 9 of Westar North's MFR and of Westar South's MFR increase the amount of investment tax credits amortized to income. These adjustments recognize that the investment tax credits should be amortized over the remaining lives of the property as used in the utility's books of accounts, which create the reserve. These adjustments are consistent with prior practices of this Commission.

Q. WILL THE IMPLEMENTATION OF THE SEPARATE TRANSMISSION DELIVERY CHARGE IMPACT INCOME TAXES?

A. Yes. As discussed in Mr. Seelye's testimony, all transmission cost of service items have been removed from Westar North's and South's revenue requirements and replaced with separate transmission revenue requirement based on a formula rate methodology authorized by the Federal Energy Regulatory Commission (FERC).

From a tax standpoint, appropriate adjustments have been made to (1) remove the transmission related accumulated deferred income taxes from the cost-free rate base items, (2) adjust the test year income tax component in cost of service for the tax effects of transmission related revenues and costs removed from the test year, (3) include an additional tax allowance to provide for a ratable recovery of the previously flowed through tax benefits over the remaining life of the transmission property, and (4) remove the transmission related investment tax credits.

Q. WHY IS AN ADDITIONAL TAX ALLOWANCE REQUIRED FOR TRANSMISSION RELATED PROPERTY?

A. As discussed earlier, Westar North and South have reduced rates charged to retail customers to reflect the tax benefits associated with certain accelerated tax deductions. Under flow through accounting, it was probable that the net future increase in income taxes payable would be recovered from customers when these temporary tax benefits reverse. The removal of all transmission cost of service items from cost of service has created a situation where the previously flowed through tax benefits would be unrecovered because the FERC formula methodology assumes that the retail customer has already paid the future tax liability through past tax normalization accounting practices. Therefore, to avoid this situation and to achieve an equitable sharing of tax benefits between jurisdictions, the tax allowance adjustment allows recovery of the previously flowed through tax benefits from the retail customers who previously received the tax benefits.

Q. HOW DID YOU CALCULATE THE ADDITIONAL TAX ALLOWANCES?

A. In computing the additional tax allowances, I followed the FERC catch-up method called the "South Georgia Method." For Westar North, the additional tax allowance is $570,310. For Westar South, the additional tax allowance is $549,907.

Q. WHY SHOULD THIS COMMISSION ALLOW WESTAR NORTH AND SOUTH TO RECOVER THE ADDITIONAL TAX ALLOWANCE IN COST OF SERVICE?

A. This adjustment for transmission related book-tax differences is conceptually sound, generally accepted and appropriate because it results in the proper assignment of annual costs, timely economic cost recovery, and the creation of appropriate reserves for future tax requirements.

V. SECTION 11

Q. WOULD YOU PLEASE DESCRIBE SECTION 11 IN WESTAR NORTH'S AND SOUTH'S MFRS?

A. These sections contain the supporting schedules for the test year provisions and pro forma adjustments for taxes chargeable to Westar North's and South's electric operations and are shown on Schedule 9-A, Lines 16 through 19 for Westar North and on Schedule 9-A, Lines 16 through 19 for Westar South. Each of the schedules in Section 11 was based on Westar North's and South's book and tax accounting records for the twelve months ended December 31, 2004.

Q. PLEASE DESCRIBE THE SCHEDULES INCLUDED IN SECTION 11 OF WESTAR NORTH'S AND SOUTH'S MFRS.

A. Schedules 11-A present the taxes chargeable to Westar North's and South's electric operations for the test year ended December 31, 2004. These schedules show book taxes, pro forma adjustments, and pro forma adjusted taxes. Pro forma adjusted taxes for Westar North's and South's electric operations are $65,555,033 and $70,409,734, respectively. Appropriate support for each of the taxes is found on succeeding schedules.

Q. PLEASE DESCRIBE THE DIFFERENT KINDS OF TAXES CHARGEABLE TO WESTAR NORTH'S AND SOUTH'S ELECTRIC OPERATIONS.

A. Taxes chargeable to electric operations include taxes of all types – taxes other than income taxes as well as income taxes. The most significant of these is income taxes.

Q. PLEASE DESCRIBE SCHEDULE 11-B FOR BOTH WESTAR NORTH AND SOUTH THE DIFFERENT KINDS OF TAXES OTHER THAN INCOME TAXES CHARGEABLE TO ELECTRIC OPERATIONS FOR THE TEST YEAR.

A. Schedule 11-B for both Westar North and South is a summary of the taxes other than income taxes that are chargeable to Kansas electric operations for the test year. Taxes other than income taxes consist of federal and state payroll taxes, real estate and personal property taxes and other taxes. Payroll taxes include Social Security and Medicare taxes, federal unemployment tax, Kansas unemployment tax, and worker's compensation. Other taxes include corporate franchise taxes. The pro forma adjustments to payroll taxes are sponsored by Mr. Kongs.

Pro forma adjusted taxes other than income taxes are $47,326,655 and $32,700,611 for Westar North and South, respectively, compared to $54,110,405 and $35,179,748 for Westar

North and South, respectively, for the test year ended December 31, 2004.

Q. WHAT IS THE PURPOSE OF SCHEDULES 11-C THROUGH 11-G?

A. Schedules 11-C through 11-G detail Westar North's and South's calculation of the income tax component in cost of service.

Q. WHAT IS SHOWN ON SCHEDULES 11-C THROUGH 11-E?

A. Schedule 11-C for both Westar North and South is the derivation of taxable income for Westar North's and South's electric operations for the test year ended December 31, 2004. The Schedule shows the differences between revenues and expenses recognized for book purposes and those recognized for income tax purposes. The differences are referred to as book-tax differences and generally originate in one period and reverse or turn around in one or more subsequent periods. The reported differences are individually described on Schedule 11-D and reflect the tax practices of Westar North and South. Taxable income has been adjusted to a level consistent with pro forma revenues, expenses and book-tax differences for both Westar North and South. Pro forma adjusted taxable income for the test year for Westar North's and South's electric operations is $48,574,753 and $109,815,546, respectively.

Schedule 11-E shows the calculation of state and federal current income taxes for Westar North's and South's electric operations. Pro forma adjusted current income taxes for Westar North's and South's electric operations are $19,321,822 and $43,681,878, respectively.

Q. PLEASE DESCRIBE SCHEDULE 11-F FOR BOTH WESTAR NORTH AND SOUTH.

A. Schedule 11-F is the provision for deferred income taxes and investment tax credits for Westar North's and South's electric operations for the test year ended December 31, 2004. Deferred income taxes for both companies have been adjusted to reflect the level of book-tax differences in the test year. Pro forma adjusted deferred income taxes for the test year are $1,616,673 for Westar North and ($3,416,674) for Westar South. Pro forma investment tax credits are ($2,710,117) and ($2,556,082) for Westar North and South, respectively.

Q. PLEASE DESCRIBE SCHEDULE 11-G FOR BOTH WESTAR NORTH AND SOUTH.

A. Schedule 11-G is the total income tax provision for Westar North's and South's electric operations for the test year ended December 31, 2004. Total income taxes equal the sum of current income taxes and deferred taxes for both Westar North and South. Total income taxes are calculated by multiplying the composite income tax rate for each company by pretax income as adjusted for book-tax differences for which no deferred income taxes have been provided. Pro forma adjusted total income taxes for the test year are $18,228,377 and $37,709,124 for Westar North and South, respectively.

Q. **PLEASE DESCRIBE SCHEDULE 11-H AND 11-I FOR BOTH WESTAR NORTH AND SOUTH.**

A. Schedule 11-H displays the accumulated deferred income taxes for Westar North and South. For Westar North, the accumulated deferred income taxes include accounts 281 and 282, excluding the SFAS 109 accounts. For Westar South, the accumulated deferred income taxes include accounts 190, 282, and 283, excluding the SFAS 109 accounts. The schedule shows amounts deferred, credited to income, adjustments and the accumulated balance for each year.

Schedule 11-I shows the accumulated investment tax credits for Westar North and South. The schedule displays amounts deferred, credited to income, adjustments and the accumulated balance for each year.

Q. **THANK YOU.**