Direct Testimony and Schedules
Michael F. Farrell

Before the Minnesota Public Utilities Commission

State of Minnesota

In the Matter of the Application of Minnesota Power
for Authority to Increase Rates for Electric Utility
Service in Minnesota

Docket No. E015/GR-26-199

Exhibit _____

INDEPENDENT CONFIRMATION OF THE PREPAID PENSION ASSET

November 2, 2026

TABLE OF CONTENTS

Page

I. INTRODUCTION AND QUALIFICATIONS 1

II. REQUIRED ACCOUNTING FOR DEFINED BENEFIT PENSION PLANS 5

III. ACCOUNTING FOR PENSION EXPENSE AND CASH CONTRIBUTIONS BY RATE-REGULATED UTILITIES 8

IV. THE FINANCIAL EFFECT OF A UTILITY'S PENSION PLAN AND ITS INTERACTION WITH THE RATEMAKING PROCESS 12

V. CONCLUSION 19

I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Michael F. Farrell, and my business address is 125 High Street, Boston, Massachusetts 02110.

Q. By whom are you employed and in what position?

A. I am employed by Willis Towers Watson ("WTW"), a global consulting firm that works with many employers on the financial management of their pension and other postretirement ("OPEB") plans, including half of Fortune 1000 utilities who sponsor pensions. I am a Managing Director in WTW's Retirement practice where I serve as the North American Accounting Leader. In this role, I consult with clients on benefits accounting issues and provide benefits accounting training (including training to regulated public utilities) and accounting and financial reporting updates to client and non-client finance personnel. Most of the guidance that I provide to WTW consultants and clients involves the accounting and financial reporting issues around pensions and OPEB plans – including the utility ratemaking implications of pensions and OPEB plans.

Q. Please describe your educational background and professional experience.

A. I graduated from Bentley University (formerly Bentley College) in Waltham, Massachusetts, in 1987 with a Bachelor of Science degree in Accounting. In 1987, I joined the independent accounting firm of Coopers & Lybrand where I worked in the Public Utilities and Financial Services practices as an Audit Manager until 1994, when I left to accept a position as a Senior Financial Analyst for New England Electric System ("NEES"). At NEES, I was responsible for the revenue requirements of Massachusetts Electric Company. I joined Boston Edison in 1996 as Financial Reporting Manager. After the formation of NSTAR in 1999, I was promoted to Assistant Controller and Director, Accounting. Following the merger of NSTAR and Northeast Utilities – forming Eversource in 2012 – I was named the Director, Revenue and Regulatory Accounting. While at NSTAR and Eversource, I was responsible for the accounting, budgeting, and ratemaking implications of the company's employee benefit plans. I also

served as the lead revenue requirements witness in the 2015 base rate case of NSTAR Gas. During my time in the utility industry, I was a member of the EEI Accounting Standards Committee, the EEI Corporate Accounting Committee, and the EEI-FERC Liaison Committee. I joined WTW in 2016 as a Director in its Retirement practice. I was promoted to my current position in 2020.

I am a Certified Public Accountant ("CPA") in the Commonwealth of Massachusetts. I have included my qualifications in MP Exhibit ___ (Farrell), Direct Schedule 1.

Q. On whose behalf are you testifying?

A. I am submitting this Direct Testimony before the Minnesota Public Utilities Commission ("Commission") on behalf of ALLETE, Inc. ("ALLETE"), d/b/a Minnesota Power ("Minnesota Power" or the "Company").

Q. Have you previously testified before the Commission?

A. Yes. I provided Rebuttal Testimony in response to the intervenor direct testimony in Minnesota Power's 2021 Rate Case, Docket No. E015/GR-21-335 ("2021 Rate Case"), and Direct Testimony in the Company's 2023 Rate Case, Docket No. E015/GR-23-155 ("2023 Rate Case"), regarding the Company's compliance with Generally Accepted Accounting Principles ("GAAP") and the nature of the prepaid pension asset. In both of the 2021 and 2023 Rate Cases, I also submitted an Affidavit attached to the Company's Initial Comments, a Second Affidavit attached to the Company's Reply Comments, and a Third Affidavit attached to the Company's Response Comments regarding the prepaid pension asset.

Q. Have you previously testified before other regulatory commissions?

A. Yes. I have testified several times before other state regulatory authorities and the Federal Energy Regulatory Commission ("FERC"). The topics of that testimony are included in MP Exhibit ___ (Farrell), Direct Schedule 2, and include:

- Serving as the revenue requirements witness supporting the cost of service in both electric and gas distribution rate proceedings;

- Pricing the sale of streetlights to municipalities;
- Centralized service company allocations;
- Formation of a holding company corporate structure;
- Employee benefits issues related to generation divestitures;
- Accounting for and recovery of pension and other postretirement costs, including a return on prepaid balances;
- Unregulated subsidiary cross-subsidization.

Q. What is the purpose of the testimony you are presenting on behalf of Minnesota Power?

A. My testimony addresses three areas:

1. The accounting requirements for defined benefit pension and other postretirement benefits under Accounting Standards Codification ("ASC") 715-30 and ASC 715-60;
2. The accounting requirements promulgated by FERC related to pension plans of rate-regulated utilities; and
3. The financial effect of a utility pension plan and its interaction with the ratemaking process.

I will explain why the Company has appropriately accounted for its pension and OPEB plans in accordance with GAAP and the accounting regulations of FERC's Uniform System of Accounts. In addition, I will explain that amounts contributed to the Company's pension plan in excess of amounts collected from customers are – in fact – funded by the Company's shareholders. And since the resulting prepaid pension balance is funded by shareholders, it is appropriate for the Company to recover the carrying charges it incurs from customers.

Q. Are you sponsoring any exhibits in this proceeding?

A. Yes. I am sponsoring the following schedules to my Direct Testimony:

- MP Exhibit ___ (Farrell), Direct Schedule 1 – Farrell Experience; and
- MP Exhibit ___ (Farrell), Direct Schedule 2 – Representative Utility Testimony.

Q. Please summarize your testimony.

A. First, I explain, in general terms, the accounting requirements that all pension plan sponsors must follow. These accounting requirements are promulgated by the Financial Accounting Standards Board ("FASB"). Those requirements are not unique to rate-regulated companies.

Second, I will speak more specifically about the unique accounting that rate-regulated utilities are required to follow. This guidance was issued by FERC several years ago. It requires rate-regulated utilities to record a regulatory asset on their balance sheet related to actuarial losses (net of gains). As a result, the cumulative difference between the actual Company-funded contributions and the annual expense amounts booked to the Company's income statement is recorded on the Company's balance sheet as a regulatory asset.

Third, because the accounting and overall financial effects of pension plans can be a complex issue, I will provide an example to demonstrate the effect of Company-funded pension contributions and how they interact with the recovery of pension expense from customers.

Lastly, I confirm that the Company's prepaid pension asset is entirely funded by shareholders and explain why a return on the asset is necessary to compensate shareholders for the loss of the time value of money on the cash contributions they have advanced to fund the pension trust.

Q. Do you have any additional commentary on the Company's request in this case?

A. Yes. As explained in the Direct Testimony of Company witness Tara L. Anderson, in the remand proceeding for the Company's 2021 Rate Case, the Commission recently denied a return on the prepaid pension asset and ordered the Company to propose a true-up mechanism for pension expense in its next rate case, in lieu of requesting a return on the prepaid pension asset. While I am providing this testimony based on case

preparations prior to the Commission's decision, it is my understanding that the Company will propose a true-up mechanism in this case consistent with the Commission's decision.

II. REQUIRED ACCOUNTING FOR DEFINED BENEFIT PENSION PLANS

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

A. In this section of my testimony, I will briefly describe the history of the accounting standards issued by FASB that govern the accounting for pension plans. In addition, I will explain the way a plan sponsor's income statement and balance sheet are affected by its pension plans.

Q. Can you briefly describe the history of the accounting treatment for pension plans under GAAP?

A. Yes. Prior to the issuance of Statement of Financial Accounting Standards ("SFAS") 87 in 1985, there was inconsistency among plan sponsors in their accounting for pension benefits provided to retirees. With the issuance of SFAS 87, companies are required to reflect the cost of providing pension benefits to employees on their income statement during the time that those employees provide service to the company. Because of the long-term nature of the pension promise to employees, companies must make assumptions about future economic and demographic conditions in order to estimate the benefits that will be provided in retirement. These assumptions are revised over time as actual experience and projections of future conditions result in revisions to the company's projected pension obligation. Because of the long-term nature of the obligation, companies are not required to reflect the effect of assumption changes in pension expense as they occur. Those gains and losses are reflected in the funded status of the plan immediately but are amortized into pension expense over future periods. This is sometimes referred to as "smoothing" or "normalizing" gains and losses into pension expense over time.

Q. Can you explain the concept of "prepaid pension"?

A. Yes. As noted above, under SFAS 87, plan sponsors are required to expense the cost of providing pension benefits as those benefits are earned by employees as they provide service to the company. While the SFAS 87 provides guidance for this expense recognition, the funding requirements for pension plans are regulated by the Internal Revenue Service ("IRS"). Those funding regulations typically result in a timing difference between the recognition of cost for accounting and financial reporting purposes and the requirements to make cash contributions to pension plans. As a company records its pension expense, it debits (increases) expense and credits (increases) its pension liability. When a company makes a cash contribution to its plan, it debits (decreases) its pension liability and credits (decreases) its cash balance. Therefore, under SFAS 87, the difference between the amounts contributed to the plan (cash) and the amount reflected on the income statement (expense) reside as either a prepaid asset (when the cumulative cash contributions are greater than the cumulative expense recognized) or a liability (when the cumulative cash contributions are less than the cumulative expense recognized).

Q. Are there other examples in GAAP where a company is required to record the difference between cash expenditures and income statement expenses as an asset or liability on its balance sheet?

A. Yes. One such example is for fixed assets such as utility plant. When a company undertakes a capital project, it must utilize cash to pay for the necessary employee, contractor, and materials costs. However, those costs are not recognized on the income statement or recovered from customers through rates in the same accounting period that the cash cost is incurred. The construction cost is depreciated (expensed) and recovered from customers over the useful life of that constructed asset. As the project is depreciated, the carrying value on the balance sheet is reduced. Therefore, the carrying value each year represents the cumulative difference between the cash cost of the fixed asset and the amount recognized as expense – and recovered from customers – through the income statement.

Q. You mention the smoothing of gains and losses of pension plans above. How did SFAS 87 deal with those gains and losses?

A. When actual plan experience is different from the accounting assumptions or when circumstances require that those assumptions are changed, the effect on the calculated funded status of the plan is required to be tracked as a gain or loss that is not immediately recognized as expense. The unrecognized gain or loss is then amortized to expense over future periods. For a company with a prepaid pension balance, the amortization of an unrecognized loss has the effect of increasing expense and reducing the prepaid pension asset over time.

Q. How has the accounting for pension plans changed since the issuance of SFAS 87?

A. As noted above, under SFAS 87, plan sponsors were required to measure their plan obligations and assets and determine the actuarial gains and losses of their pension plans each year. These gains and losses are amortized to expense over future periods. As calculated, the unrecognized gain or loss represents the difference between the funded status of a pension plan (projected benefit obligation minus the fair value of plan assets) and the prepaid pension asset (or liability) that was presented on the company's balance sheet. There were concerns that the requirements of SFAS 87 "failed to communicate the funded status of those plans in a complete and understandable way" (SFAS 158 – Reasons for Issuing This Statement).[1] In reaction to those concerns in 2006, FASB issued SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans."

The primary directive of SFAS 158 is that a company must reflect the actual funded status of its plans on the face of their balance sheet. Prior to SFAS 158, the funded status of a plan was only disclosed in a company's financial statement footnotes. Since SFAS 158 did not change the methodology for the determination of pension expense, companies were directed to recognize the difference between the amounts previously

[1] SFAS 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, available at: https://fasb.org/Page/ShowPdf?path=fas158.pdf&title=FAS+158+%28as+issued%29&acceptedDisclaimer=true&Submit= (Sept. 2006).

on their balance sheet and the plan funded status – previously the unrecognized loss or gain – within other comprehensive income ("OCI"). Under GAAP, OCI represents revenue, expenses, and gains and losses that will not be included within the determination of net income until a future accounting period. Total OCI appears in the equity section of the balance sheet as accumulated other comprehensive income ("AOCI"). Losses accounted for in AOCI reduce a company's common equity.

Beginning in 2009, all accounting standards were codified under the ASC. The accounting and financial reporting requirements of SFAS 87 and SFAS 158 were codified in ASC 715 – ASC 715-30 for pensions and ASC 715-60 for OPEB – which remain in effect today.

Q. Why is this history relevant for ratemaking purposes?

A. I believe that it is important to understand that the changes in the accounting standards have not changed the relevant aspects of ratemaking. The funding requirements for pension plans are not affected by the historical changes in the accounting standards. Therefore, the economic effect that a pension plan has on a plan sponsor has not changed. The difference between the amounts collected from customers over time (expense) and the amounts contributed to its plans by the Company must be funded through Company-provided resources. The fact that actuarial gains and losses are recorded on the Company's balance sheet has not changed that requirement.

III. ACCOUNTING FOR PENSION EXPENSE AND CASH CONTRIBUTIONS BY RATE-REGULATED UTILITIES

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

A. In this section of my testimony, I will summarize the unique accounting requirements for pension plans that must be followed by rate-regulated utilities. These accounting requirements are promulgated by FASB and FERC.

Q. Are regulated utilities required to follow the accounting and financial reporting guidance in SFAS 158, which was codified in ASC 715?

A. Yes. Like all other companies subject to GAAP in the United States, regulated utilities are required to reflect the funded status of their plans as a liability (underfunded plans) or an asset (overfunded plans) on their balance sheets. In addition, actuarial gains and losses must be recorded through OCI.

Q. What accounting guidance did FERC provide to utilities regarding the implementation of SFAS 158?

A. In March 2007, FERC issued AI07-1-000, "Commission Accounting and Reporting Guidance to Recognize the Funded Status of Defined Benefit Postretirement Plans." In this order, FERC reiterated that jurisdictional utilities were required to adopt the accounting and financial reporting requirements within SFAS 158 by recording the funded status of their plans on the balance sheet – consistent with all other sponsors of defined benefit pension plans. In addition, FERC addressed the situation where a utility's rates for the recovery of costs related to its pension and other postretirement plans are based on net periodic pension and other postretirement benefit costs determined in accordance with SFAS 87 and SFAS 106. FERC ruled that such utilities should record a regulatory asset (or liability) for the amount that would otherwise be recorded to OCI. This accounting reflects the fact that those losses will be reflected in customer rates as those losses (or gains) are amortized through pension expense in future periods. Therefore, a utility's shareholder equity – and its total balance sheet position – was not affected by the adoption of SFAS 158.

Q. Does FERC define a regulatory asset under its Uniform System of Accounts?

A. Yes, in part FERC defines Account 182.3 – Other Regulatory Assets as follows:

> The amounts included in this account are to be established by those charges which would have been included in net income, or **accumulated other comprehensive income**, determinations in the current period under the general requirements of the Uniform System of Accounts but for it being

probable that such items will be included in a different period(s) for the purposes of developing rates that the utility is authorized to charge for its utility services.[2]

Q. Do you know whether Minnesota follows the FERC Uniform System of Accounts?

A. Yes. In general, it is my understanding that Minnesota law provides that a public utility that maintains its accounts in accordance with the system of accounts prescribed by a federal agency (such as FERC) is in compliance with the system of accounts prescribed by the Commission.[3] The Commission has also issued a rule directing utilities to follow the Uniform System of Accounts with certain clarifications also set forth in the rules.[4]

Q. Does FASB provide a similar definition of regulatory assets?

A. Yes. ASC 980-340-25-1 provides that "rate actions of a regulator" can provide evidence of the existence of an asset when an incurred cost will be included as an allowable cost for ratemaking purposes in a future period. An incurred cost includes amounts that would otherwise be charged to expense or OCI – such as actuarial losses experienced by a pension plan.

Q. In your experience, how do regulated utilities account for actuarial gains and losses of their pension and OPEB plans?

A. Virtually all utilities record a regulatory asset in lieu of a charge to OCI to account for actuarial gains and losses.

Q. You have stated that it is appropriate to record a regulatory asset for amounts that would otherwise be charged to OCI. How does this relate to the prepaid pension asset on the Company's balance sheet?

A. The difference between the prepaid pension asset (cumulative cash contributions in excess of cumulative expense) and the plan's funded status (projected benefit obligation

[2] *See* 18 CFR § 367.1823(b).
[3] Minn. Stat. § 216B.10, subd. 1 (2025).
[4] Minn. R. 7825.0300.

minus fair value of plan assets) represents actuarial losses that will be amortized through pension expense and recovered from customers in future periods. Therefore, the regulatory asset has two components. The first component is equal to the pension liability on the balance sheet. The Company is not seeking a carrying charge for this component as it did not result from a cash outlay by the Company (i.e., its investors) nor does it change expense, so customers also had no additional cash outlays.

The second component of the regulatory asset is the difference between the cumulative Company-funded contributions and the cumulative pension expense recognized. Since the Company receives reimbursement from customers based on pension expense alone, the cumulative amount above expense represents pension plan contributions that the Company's shareholders must finance. The Company is requesting a return for that portion of the Company's regulatory asset, which complies with GAAP (as previously discussed).

Q. Does ALLETE have a regulatory asset on its balance sheet related to the difference between cumulative Company-financed pension contributions and pension cost as determined under ASC 715 (referred to as a prepaid pension asset), and if so, can you quantify it?

A. Yes, ALLETE has a regulatory asset related to its prepaid pension. WTW calculates ALLETE's prepaid pension asset and the defined benefit portion (Plan B and Plan C) of the prepaid pension asset. As of December 31, 2025, the balance is $143.2 million for ALLETE ($105.6 million Minnesota Power regulated; $93.7 million MN Jurisdictional). This information is included in MP Exhibit ___ (Anderson), Direct Schedules 1 and 7.

Q. Is "prepaid pension asset" a recognized term under GAAP?

A. Yes. Paragraph 35 of SFAS 87 states the following: "A liability (unfunded accrued pension cost) is recognized if the net periodic pension cost pursuant to this Statement exceeds amounts the employer has contributed to the plan. An asset (prepaid pension asset) is recognized if the net periodic pension cost is less than amounts the employer

has contributed to the plan." Since the issuance of SFAS 158, which requires that all companies – including rate-regulated utilities – recognize the funded status of their plans on their balance sheet, Minnesota Power has been reflecting its prepaid pension asset in Account 182.3 – Other Regulatory Assets.

Q. In summary, what does the prepaid pension asset represent?

A. The prepaid pension asset represents the excess of the Company's cumulative pension plan contributions over its cumulative pension expense recognized on its income statement since inception of the plan. Because the Company's primary source of operating cash flow is the rates that it collects from customers, the excess amount must be financed by the Company's shareholders.

IV. THE FINANCIAL EFFECT OF A UTILITY'S PENSION PLAN AND ITS INTERACTION WITH THE RATEMAKING PROCESS

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

A. In this section, I will discuss the relationship between the Company's legal obligation to fund its pension plan and its pension expense under GAAP. This includes the effect on the Company's operating cash flow due to the effect of these transactions on income taxes and customer rate recovery.

Q. What effect does the Company's pension plan have on its cash flow from operations?

A. As previously noted, there is an inherent mismatch between the timing of pension expense recognition on a plan sponsor's income statement under ASC 715 and cash contributions under Employee Retirement Income Security Act ("ERISA") funding requirements. ASC 715 expense provides the most appropriate basis for rate recovery because it is more predictable and consistent than the ERISA funding rules. However, because the recognition of pension expense during a year is not based on the level of cash contributions during the same period, pension expense is considered a non-cash expense. As such, it is added back to the Company's net income for the determination

of cash flow from operations. Similarly, the cash contributions that the Company makes to its pension plan are a reduction to operating cash flow.

Q. How do utility rates affect cash flow from operations?

A. As a rate regulated utility, the Company's primary source of operating cash flow is the payments that it receives from its customers for the provision of electric service. Included in those rates is a provision for pension expense. Because pension expense is a non-cash expense, the Company receives cash from customers before any consideration of the actual cash contributions made to the pension trust. Because pension expense and pension contributions are determined using different methodologies and do not typically equal one another in any given year in light of the requirements of the Pension Protection Act, the cumulative amount of expense recovered from customers through rates will rarely match the cumulative cash contributions made by the Company to fund the pension plan. The recognition that there can be a difference between accrual accounting and cash outlays – and including the difference in rate base – is a fundamental process in utility ratemaking, such as with respect to deferred income taxes and cash working capital.

For example, income tax deductions are often realized on the Company's income tax return before accounting standards require recognition on the Company's income statement. To the extent that the Company has realized greater income tax deductions than expense it has recognized on the Company's income statement, the Company records a deferred income tax liability on its balance sheet. The deferred income tax liability is included as a reduction to rate base.

Similarly, the Company performs a lead-lag study as part of its base rate filings. The purpose of that study is to ensure that the financing cost (and benefit) of the timing difference between the collection of costs from customers and the payment of costs by the Company is included in rate base.

The same concept exists for cash contributions to the pension plan. The Company is required to use its corporate resources to fund its pension plan. To the extent that contributions exceed expense (and therefore recoveries), the Company must finance those contributions by incurring debt or by issuing equity to its shareholders. The above-mentioned Company receipts (via rates) for pension expense and its cash contributions vary from year to year. If, at a point in time, cumulative receipts and cumulative contributions perfectly matched, there would be no regulatory asset or liability (i.e., no prepaid). However, due to their different natures and methods of calculation, the cumulative amounts practically only perfectly match when a plan is terminated and no longer exists. Until that point, the cumulative difference is reflected by the fact that there is an asset (prepaid pension regulatory asset) on the Company's balance sheet.

Q. How is the Company's financing of cash pension plan contributions affected by income taxes?

A. The Company receives an income tax deduction equal to the pension plan cash contribution. Because the cash contribution is not an expense for accounting purposes, the Company must record deferred income taxes on its balance sheet by applying the income tax rate to the difference between the cumulative amount of cash contributed and the non-cash expense recognized. The tax deduction that is received results in positive operating cash flow for the Company.

Q. Do the deferred income taxes on the Company's balance sheet affect the return that the Company requires to be made whole for its cash pension plan contributions?

A. Yes. The prepaid pension regulatory asset balance for which the Company incurs financing costs must be net of the related deferred tax balance. This ensures that customers receive the financial benefit of the income tax deduction that the Company receives from the pension plan contributions.

Q. Can you more fully explain the interaction between pension expense, pension plan cash contributions, income tax deductions, and the amounts recovered from customers?

A. Yes. Assume that the Company records $1,000 of pension expense and makes $2,500 of cash pension plan contributions in a given year. For purposes of this example, the effective tax rate is 25 percent and the Company's rate recovery is based on the pension expense booked in accordance with ASC 715.

First, the Company records the non-cash pension expense of $1,000 and bills customers $1,000 based on its approved base rate cost of service. Assuming that the Company receives all amounts that it bills to customers, the Company has a positive cash flow from operations of $1,000. The non-cash expense and the receipt of cash from customers reduces the prepaid pension regulatory asset by $1,000.

Second, the Company contributes $2,500 of cash into the pension plan based on the statutory funding requirements for the year. The $2,500 contribution is a direct reduction in operating cash flow and increases the prepaid pension regulatory asset on the balance sheet.

Finally, the Company will include the $2,500 cash contribution as a deduction on its federal and state income tax returns. Based on the assumed effective tax rate of 25 percent, the Company will realize a $625 ($2,500 × 25%) cash benefit as a reduction in its income tax liability. The $625 cash benefit is reflected on the balance sheet as a deferred income tax liability. That deferred income tax liability is then reduced by $250 ($1,000 × 25%) to reflect the credit to income tax expense that is booked related to the pension expense booked for accounting purposes.

Q. Using the numbers in this example, on what balance should the Company receive a return?

A. The Company should receive a return based on the net cash that it has expended to fund its pension benefits as shown below.

Operating cash inflow from customers	($1,000)
Operating cash outflow from cash pension plan contributions	$2,500
Net change in prepaid pension regulatory asset	$1,500
Net change in deferred income taxes ($250 – $625)	($375)
Amount financed by shareholders	$1,125

In this example, the Company has been required to obtain financing of $1,125 – which reflects the actual cash contributions made to the pension plan reduced by the amounts collected from customers and the net income tax deduction received. The entirety of this amount, including all its components, is included on the Company's balance sheet and requires debt and equity financing.

Q. Is the Company requesting specific rate recovery for its prepaid pension balance?

A. To be clear, Minnesota Power is not requesting recovery of the prepaid pension balance itself (i.e., the cumulative cash contributions in excess of cumulative expense). This recovery occurs naturally over time as pension expense and Company contributions to the plan become aligned – the total pension expense over the lifetime of a pension plan will exactly equal the required Company contributions required to provide benefits to the Company's retirees. Therefore, the recovery of pension expense through rates enables the Company to recover its plan contributions over time. This recovery already exists in the Company's base rates. However, during the time periods when the Company's cumulative cash contributions exceed cumulative expense, this difference is financed by the Company's shareholders who lose the time value of money on those funds while they are committed to the pension fund. A return on this difference is necessary to compensate investors for the cash contributions they have advanced to fund the pension trust.

Q. Does the fact that the Company invests its pension plan contributions change your conclusion that the prepaid pension regulatory asset is financed by Company shareholders?

A. No, quite the contrary. Because the Company is required to fund its pension plan well in advance of the time that the pension benefits will be paid to retirees, the Company invests those funds in a prudent manner. All of the returns on these investments can only be used to reduce ongoing pension expense (and pension expense recovery from customers) and future pension cash contributions. In fact, the return on plan assets is an explicit component of pension expense, reducing expense – and customer rates – by its full value.

Q. Can you expand on the financial benefit of pension plan contributions and who receives that benefit?

A. Yes. Under Minnesota Power's current rate construct, customers receive all of the financial benefits of the Company's pension plan contributions but incur none of the financing costs. The Company contributes cash to its pension plan, and such amounts are deposited to the pension trust fund and restricted solely for the payment of benefits to retirees under the plan. While those funds are held in the trust, the Company invests those funds on a tax-free basis. The investment earnings in the trust reduce the Company's pension expense and future cash contributions. This reduction in contributions is passed directly to customers through lower pension expense (via the expected return on assets ("EROA") component of pension expense). Therefore, the financial benefit of pension contributions (lower pension expense) is realized by customers while the financial cost of the pension contributions (financing costs) is incurred by the Company (i.e., its investors) without reimbursement.

Q. Do you have any additional commentary on why it is fundamental that the prepaid pension regulatory asset has been funded by the Company's shareholders and not by its customers?

A. The Company's base rates, as determined by the Commission, are designed to recover the operating expenses (e.g., operations and maintenance ("O&M") expenses,

depreciation and amortization, taxes) and a reasonable return on rate base. Pension expense is included in rates at a representative level consistent with other operating expenses. While pension expense is a non-cash expense, the collection from customers is revenue that results in operating cash flows to the Company. The determination of Company contributions to the plan is separate from the calculation of expense and collections from customers. When the Company makes contributions to the plan, it reduces cash flows. In a year when pension expense is less than plan contributions, the reduction in cash flows directly affects the Company's financing costs. The objective of Minnesota Power's proposal in this proceeding is simply to make it whole for the actual financing cost that it incurs due to the timing difference between the pension expense collected from customers and the amounts contributed to the plan – net of the income tax benefit that it receives. The Company expects that future pension expense will exceed the required contributions. Over time this will have the effect of reducing the prepaid pension regulatory asset.

Q. What is the effect on the prepaid pension asset in years in which the Company has pension income (negative pension expense)?

A. Based on my review of MP Exhibit ___ (Anderson), Direct Schedule 1, I have noted that there have been years in which the Company has had pension income. Generally speaking, this occurs when the expected return on the plan's investments exceeds the service cost and interest cost during any of those years. When the Company has investment income, this will increase the prepaid pension regulatory asset – and, when pension income is taken into account for ratemaking, it reduces costs to customers. In order to assess the effect of those years, I reviewed MP Exhibit ___ (Anderson), Direct Schedule 1, which demonstrates that the cumulative Company-funded plan contributions significantly exceed the Company's recognized pension expense and the Company's receipts from customers.

Q. What is your response to those who would say that the Company has not demonstrated that the prepaid pension asset has been funded by Company shareholders?

A. In considering this question, I referred to MP Exhibit ___ (Anderson), Direct Schedule 1. This schedule illustrates the annual pension plan contributions, pension expense, and pension recovery in rates from 1987 (the initial adoption of SFAS 87) through 2027 (with 2026 and 2027 being estimated). It shows a prepaid pension asset of $93.7 million at the end of 2025. The exhibit also reflects that the prepaid pension asset is the result of Company contributions of $176.8 million and cumulative pension expense of $88.3 million (from 1994 – the first year pension expense is known to be collected in rates – through 2025 actuals). In addition, it shows that the Company has recovered only $54.5 million of pension expense from its customers. Looking at those numbers, the Company's shareholders have financed pension contributions of $122.3 million (contributions of $176.8 million less $54.5 million rate recovery). Since pension expense is a base rate recovery item – rather than recovered through a tracker – the Company recognizes that it is not owed a carrying charge for base rate variances. Since the Company has collected only $54.5 million, it is simply not reasonable to conclude that customers have funded $176.8 million of contributions. Including the prepaid pension asset in rate base compensates the Company for the financing costs incurred for pension plan contributions while recognizing that this is not a rate reconciling mechanism.

V. CONCLUSION

Q. What is your conclusion regarding the Company's proposal for its prepaid pension asset?

A. The Company is required by law to contribute funds to its pension plan to fund employees' retirement benefits, and the cumulative Company funding in excess of cumulative expense results in a prepaid pension asset. Accordingly, the Company incurs carrying charges to fund the prepaid pension asset – just like it does for any asset on its balance sheet. As a regulated utility, the Company should recover a carrying charge

(return) for its prepaid pension in order for it to be made whole for the true financial effect to the Company of its plan.

First, the Company's accounting for its pension and OPEB plans – as presented on its audited financial statements – is entirely in accordance with GAAP and the guidance of FERC and the FERC Uniform System of Accounts. It is also consistent with the accounting practices of utilities across the country.

Second, because the Company's cash collections from customers are based on a non-cash expense item, it is appropriate to reconcile the cash timing difference by providing an appropriate carrying charge to the Company. This is consistent with the treatment of other non-cash expenses such as utility plant depreciation and income taxes.

Third, the Company's prepaid pension asset is entirely funded by shareholders who should be compensated for the loss of the time value of money on the cash contributions they have advanced to fund the pension trust.

The fairest ratemaking outcome is to allow the Company to earn a return on the actual contributions that it makes over the lifetime of its plans while recognizing the timing of contributions and pension expense is rarely in sync. Since the most effective and consistent ratemaking option is to include pension expense in the O&M component of the base rate revenue requirement, in order to make the Company whole for its actual costs incurred due to the timing difference between actual contributions and recovery of pension expense from customers, the difference between the cumulative contributions and the amount included in rates as pension expense should be included in base rates. I therefore recommend that the Commission approve the Company's request.

Q. Does this complete your Direct Testimony?

A. Yes.



Michael Farrell, CPA

Managing Director, Retirement – North American Accounting Leader

Relevant Experience/Specialization

Michael Farrell is a managing director in Willis Towers Watson's Boston office, where he serves as the firm's North American Accounting Leader and as a member of our Global Accounting Team. In his role, Mike consults with clients on benefits accounting issues (under US GAAP and IFRS) and provides benefits accounting training and updates to client and non-client finance personnel. As a specialist in the utility industry, he provides guidance to regulated companies on the ratemaking and accounting issues unique to the industry. He has over 30 years of experience in accounting, financial reporting and SEC reporting.

Prior to joining Willis Towers Watson in 2016, Mike was assistant controller of NSTAR and, after its merger with Northeast Utilities, director of regulatory accounting for Eversource Energy. During this time, Mike was responsible for all aspects of accounting, budgeting and forecasting for the company's defined benefit pension and other postretirement benefit plans. In his role, he also testified before the Massachusetts Department of Public Utilities on multiple occasions regarding the accounting and rate recovery of costs related to pensions and OPEBs. In addition, he performed as a cost-of-service rate case witness in both gas and electric proceedings. Mike began his career by spending seven years in the audit practice of Coopers & Lybrand, where he specialized in public utilities and financial services.

Education and Credentials

Michael holds a B.S. in accounting from Bentley University and is a Certified Public Accountant in Massachusetts.

He is the volunteer treasurer and a board member of the National Pancreas Foundation.

Representative Utility Testimony of Michael F. Farrell, CPA

- DPU 95-40 – Investigation by the Department of Public Utilities on its own motion as to the propriety of the rates and charges for tariffs filed on March 14, 1995 to become effective April 1, 1995 by Massachusetts Electric Company **(Electric base rate revenue requirement)**

- DTE 97-63 – Petition of Boston Edison Company and Boston Edison Mergeco Electric Company, Inc. for approval by the Department of Telecommunications and Energy of a merger in accordance with an agreement and plan of merger **(Corporate reorganization into a holding company structure)**

- DPU 97-95 – Investigation by the Department of Public Utilities, on its own motion, into Boston Edison Company's compliance with the Department's order in DPU 93-7 **(Unregulated subsidiary cross-subsidization)**

- DPU 10-126 – Compliance filing of NSTAR Electric Company pursuant to the order of the Department of Public Utilities in D.T.E./D.P.U. 06-82-A, related to cost recovery of the Company's Capital Projects Scheduling List Program **(Demonstration that direct and indirect program costs are incremental to costs recovered in base rates)**

- DPU 10-125, 11-91, 12-113, 13-184 – Petition of NSTAR Electric Company and NSTAR Gas Company for approval of their annual pension and postretirement benefits other than pensions adjustment factor **(Recovery of pension and OPEB costs including return on prepaid pension)**

- DPU 14-150 – Petition of NSTAR Gas Company for approval by the Department of Public Utilities of an increase in rates **(Gas distribution rate revenue requirement)**

- Docket No. E015/GR-21-335 – In the Matter of the Application of Minnesota Power for the Authority to Increase Rates for Electric Utility Service in Minnesota **(Rebuttal testimony in support of the company's pension-OPEB accounting and recovery of a return on prepaid costs, and affidavits regarding the company's prepaid pension asset)**

- IURC Cause No. 45870 – Petition of Indiana-American Water Company, Inc. for authority to increase its rates and charges for water and wastewater utility service **(Rebuttal testimony in support of the inclusion of prepaid pension and OPEB in utility capital structure for ratemaking purposes)**

- Docket No. E015/GR-23-155 – In the Matter of the Application of Minnesota Power for the Authority to Increase Rates for Electric Utility Service in Minnesota **(Direct testimony in support of the company's pension-OPEB accounting and recovery of a return on prepaid costs, and affidavits regarding the company's prepaid pension asset)**

- Docket No. 25-0084 – Proposed General Increase in Gas Delivery Rates of Ameren Illinois Company **(Rebuttal testimony in support of the recovery of postretirement benefits other than pension)**

- DPU 26-50 – Petition of Boston Gas Company dba National Grid for approval by the Department of Public Utilities of an increase in rates **(Pension and postretirement benefits other than pensions panel)**