Petitioner's Exhibit No. 24



**INDIANA-AMERICAN WATER COMPANY, INC.**

**IURC CAUSE NO. 45870**

**REBUTTAL TESTIMONY**

**OF**
**MICHAEL FARRELL**





**August 8, 2023**

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## I. INTRODUCTION

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

A. My name is Michael Farrell, and my business address is 75 Arlington Street, Boston, Massachusetts 02116.

**Q. On whose behalf are you submitting this rebuttal testimony?**

A. I am submitting this testimony on behalf of Indiana-American Water Company ("INAWC" or the "Company"), a wholly-owned subsidiary of American Water Works Company, Inc. ("American Water").

**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 Senior Director in our 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.

**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 & Director, Accounting. Following the merger of NSTAR and Northeast Utilities – forming Eversource in 2012 – I was named 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. At various times 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 Willis Towers Watson in 2016 as a Director in WTW's Retirement practice. I was promoted to my current position in 2020. I am a Certified Public Accountant ("CPA") in the Commonwealth of Massachusetts.

**Q. What is the purpose of your Rebuttal Testimony?**

A. I will respond to the testimony of Indiana-American Water Company, Inc. Industrial Group ("Industrial Group") Witness Gorman. Mr. Gorman is recommending that the prepaid pension asset and other post-retirement employee benefits ("OPEB") asset be removed from the Company's capital structure for ratemaking purposes. Mr. Shimansky will also be responding to a portion of Mr. Gorman's position.

**Q. Is there a basic reason cited by Mr. Gorman to support his proposals to eliminate the net prepaid pension and OPEB assets from the capital structure?**

A. Yes. Mr. Gorman has mistakenly concluded that the source of the prepaid pension asset is not the Company's investors. Mr. Gorman ignores the fact that the Company has followed generally accepted accounting principles ("GAAP") to record its annual pension costs and cash pension plan contributions. This accounting has resulted in a prepaid pension asset on the Company's balance sheet. Any asset on the Company's balance sheet is inherently financed through the Company's capital structure until it is recognized as expense on the Company's income statement. My testimony will explain the accounting standards for pension costs and pension cash contributions.

In addition, Mr. Gorman does not address the clear economic benefits to customers resulting from the Company's pension plan contributions and OPEB asset. It is those cash contributions that have resulted in the existence of the prepaid pension asset in the first place. The benefits are substantial — lowering pension costs and providing a source of accumulated deferred income tax ("ADIT") As provided by Witness Ciullo, the ADIT associated with the Company's prepaid pension asset and prepaid OPEB asset is $1,687,610 and $1,647,921 respectively. The lower pension and OPEB expense and accelerated income tax deductions directly lower costs to customers.

Further, to the extent that a prepaid pension asset is excluded from the calculation, it would be inequitable to include the ADIT balance related to prepaid pension in rate base. It is a well-known regulatory principle that the inclusion in the capital structure of ADIT should only include ADIT for book-tax differences included elsewhere in the revenue requirement determination.

**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 No. 87 ("SFAS 87") in 1985, there was inconsistency among plan sponsors in their accounting for pension benefits provided to employees. 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. These assumptions are revised over time as actual experience and projections of future conditions result in revisions to the company's projected pension benefit obligation. Because of the long-term nature of the obligation, companies are not required to reflect the effect of assumption changes in earnings as they occur. Those gains and losses are amortized over future periods. This is sometimes referred to as "smoothing" gains and losses into earnings over time.

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

A. Yes. As noted above, under SFAS 87, plan sponsors are required to record the cost of providing pension benefits as those benefits are earned by employees while 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 difference in timing 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 cumulative amounts contributed to the plan (cash) and the cumulative amount reflected on the income statement (expense) resides 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 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 in which 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 through the income statement.

**Q. You mentioned the smoothing of gains and losses for 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 an unrecognized gain or loss. The unrecognized gain or loss is then amortized to expense over the future periods. For a company with a prepaid pension balance, the amortization of an unrecognized loss would have the effect of increasing expense and reducing the prepaid pension asset.

**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 its pension plan each year. These gains/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 (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, the FASB issued SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans."

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

The primary directive of SFAS 158 is that companies must reflect the actual funded status of their plans on the face of their balance sheet. 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 on their balance sheet and the plan funded status – previously the unrecognized loss or gain – within accumulated other comprehensive income ("AOCI"). Under GAAP, AOCI represents revenue, expenses, gains and losses that will not be included within the determination of net income until a future accounting period. Total AOCI appears in the equity section of the balance sheet. Losses in AOCI reduce a company's common equity.

Beginning in 2009, all accounting standards were codified under the Accounting Standards Codification ("ASC"). The existing accounting requirements for defined benefit pension and other postretirement plans were codified in ASC 715, which remains 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 historic 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 expensed and amounts contributed to its plans by the company must be funded and financed through company-provided resources. The fact that actuarial gains and losses are recorded on the company's balance sheet has not changed that requirement.

**Q. Please explain how are pension costs calculated under GAAP versus how contributions to the pension trust are determined.**

A. For accounting purposes under GAAP, an employee's pension is "accrued" (recognized as an expense) over the period in which the employee provides service to the company. The components of the calculation include 1) service cost, 2) interest cost, 3) expected return on plan assets and 4) certain amortizations (Note: while service costs and interest costs are positive values in the annual calculation, <u>the expected return on plan assets reduces the pension expense.</u> Amortizations can be either positive or negative). Estimates of the amount that the employee will eventually receive as a pension payment are developed by actuaries considering several different factors. The expense is recognized each year of the employee's service, with a corresponding increase to the pension liability. Once the employee retires, the accrual of service cost stops and pension payments begin. Over time, pension expense (which considers investment returns on pension assets) will equal the pension benefits paid to retirees (plus expenses of the plan).

**Q. Please explain further how contributions to the pension trust are determined.**

A. In order for companies to be able to make the pension payments to retirees, companies must contribute cash to the plan prior to the time such retiree payments are to occur through establishing a pension trust. This is the "funding" part of the equation. The ***Employee Retirement Income Security Act of 1974 (ERISA)*** established laws governing pension trust funding requirements and the deductibility of such amounts is based on the Internal Revenue Service ("IRS") rules. The IRS sets minimum and maximum funding requirements and imposes penalties and other limitations for less well-funded pension plans. The Pension Benefit Guarantee Corporation ("PBGC") requires participant notices for missed contributions and additional reporting for less well-funded plans.

Assets in the pension trust cannot be removed for any purpose other than retiree pension payments and appropriate plan-related expenses. Amounts in the fund are invested in securities and other vehicles to earn a return—thus reducing the amount that eventually needs to be contributed to the fund in order to have enough cash accumulated to fund the retiree benefits once they commence. If, for example, $50,000 was needed to fund pension benefits for an employee that will retire in 10 years (the payments beginning in year 11), it is possible to contribute less than $50,000 to the pension trust as long as the earnings on the amounts invested produce the required $50,000 when payment to the retiree becomes due. Further, the sooner that contribution is made, the longer that contribution is available to earn investment return within the plan, again requiring less than would be needed if the contribution is delayed. The sooner and greater the contribution, the less the company will be required to contribute over time to be able to make the pension payments.

**Q. Why was ERISA enacted?**

A. Without getting into the details of the complex ERISA funding rules, it is important to understand the ERISA objectives. The reason Congress enacted ERISA was because of outside pressures resulting from companies' inability to pay promised pensions to rank-and-file workers. ERISA was, in part, designed to help improve that benefit security for businesses, including the establishment of minimum funding standards. ERISA minimum funding requirements are established by Congress, and do not necessarily always reflect a strict actuarial approach to fully funding pension plans and are subject to the vagaries of the political process (unlike the accrual accounting rules established by the Financial

Accounting Standards Board (FASB)). As a result, minimum funding rules include mechanisms for deferral of funding for plan changes and adverse experience, allowance of usage of prior years' funding to satisfy current year requirements (e.g., "credit balances"), interest rate and other funding "relief" provisions, and even waivers of funding requirements for which companies may apply. These are funding considerations, not GAAP accounting considerations.

**Q. Can you explain the economic benefit that customers receive from the Company's pension plan contributions?**

A. The bottom line is that pension plan contributions lower costs for customers. This occurs in 2 ways. The first benefit to customers is that cash pension plan contributions reduce pension expense. After the Company contributes cash to the pension trust, those assets are prudently invested to ultimately meet its obligations to retirees and beneficiaries. Those investments earn returns so that the total cash contributed to the plan will be less than the total of the pension benefits paid. The estimate of long-term investment returns is reflected in pension expense through the expected return on assets ("EROA"). EROA is calculated annually and directly reduces net periodic pension cost. As EROA lowers pension expense, all investment returns go to the benefit of customers by reducing the costs they pay for the Company's pension plan. The Company receives no benefit from those investment returns.

**Q. What is the second benefit that customers receive from the Company's cash contributions to its pension plan?**

A. As noted above, income tax deductions related to a company's pension plan are determined separately from the pension expense that is recorded on a company's accounting books. For income tax purposes, the Company takes an income tax deduction on its tax return in the year that the actual cash contribution is made. In other words, the economic benefit of the tax deductibility of the Company's pension plan occurs when the Company contributes cash to the plan – not when it books (and reflects in regulatory accounting) its pension expense. As with other circumstances where the timing of tax deductions is different from the timing of book expense (e.g., utility plant depreciation), the financing value of the income tax benefits should accrue to the benefit of customers. To ensure that customers receive 100% of the economic benefit of the accelerated tax deductions, the Company also reflects in its capital structure the related ADIT liability. This again reduces costs to customers.

**Q. Please summarize the difference between Pension Accounting/Ratemaking and Pension Contributions.**

A. It has been the same for INAWC as with most regulated entities. The revenue requirement includes recovery of pension expense as determined in accordance with GAAP, while contributions to the pension trust are determined based on ERISA. ERISA requirements have minimum funding levels to ensure that funds will be available to pay pension benefits. ERISA rules governing contributions are unrelated to the GAAP requirements to accrue pension costs.

**Q. You have testified that pension expense determined under GAAP is a different calculation than contributions to the pension trust under ERISA. Is that correct?**

A. Yes. GAAP pension expense is meant to accrue the pension cost of an employee over the period in which the employee provides service to the company and that expense is typically included as a recoverable cost of providing service to customers. When a company makes contributions in excess of GAAP pension expense (whether or not such contributions are above or equal to ERISA minimums), a prepaid pension asset results.

**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. Let's assume that the Company books $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% and the Company's rate recovery is based on the pension expense booked in accordance with ASC 715.

First, the Company will record the non-cash pension expense of $1,000 and bill customers rates that will reflect the expense of $1,000 based on its approved base rate cost of service. The non-cash expense (and the receipt of cash from customers) reduces the prepaid pension regulatory asset by $1,000.

Second, the Company will contribute $2,500 of cash into the pension plan based in part 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%, the Company will realize a $625 ($2,500 x 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 x 25%) to reflect the credit to income tax expense that is booked related to the pension expense booked for accounting purposes.

**Q. Thus far you have been discussing the accounting and funding of pensions. Are OPEB's treated the same way?**

A. From an accounting perspective, yes. From a contribution/funding perspective, no. In addition to pensions, many employers provide other retiree benefits such as for medical costs and life insurance, and the accounting rules for OPEB's are similar to those of pensions. However, the contributions for OPEB's are not governed by ERISA and the PBGC in the same manner as pensions, so companies that pre-fund OPEBs (including most regulated utility companies) do so on a basis that meets other objectives. For example, a common funding policy for regulated utility companies could be to fund the annual net periodic benefit cost accrued each year, subject to tax limitations.

**Q. With that background, let's move to the specific point that Mr. Gorman raises to which you are responding. Mr. Gorman claims that the prepaid pension asset should be removed "because it reflects funds provided by ratepayers through rate revenue" (Gorman, p. 40). How do you respond?**

A. As I have stated, the entire prepaid pension asset represents the cumulative difference between Company contributions to the pension trust and cumulative pension expense. The entire balance represents investor supplied funding and, as a result, is entitled to a return, which supports the Company's position of including the prepaid pension asset as a negative zero cost component of the capital structure. The same is true of the OPEB asset.

**Q. Mr. Gorman's Table 7 shows years when pension expense has been negative and he also contends that the "OPEB asset was created exclusively through negative expense" (Gorman Direct p. 41). Would a negative pension or OPEB expense give rise to a prepaid pension or OPEB asset?**

A. In a situation where the pension or OPEB expense is negative, the "other side of the pension credit entry" is to a prepaid pension asset (or OPEB as the case may be). Typical reasons for a negative pension expense are expected return on plan assets in excess of other components of pension cost and positive plan experience (e.g., lower than expected health care cost increases or participation rates).

In all cases, the prepaid asset represents the cumulative difference between what has been contributed to the pension/OPEB plans and what has been expensed under the accounting rules. It makes no difference whether the asset is the result of an additional contribution or negative expense resulting from past contributions.

**Q. Can the Company access these pension assets?**

A. No. And this is an important point. ERISA requirements do not permit employers to access funds from an ongoing pension or OPEB plan other than for the payment of benefits under that plan.

**Q. Does this conclude your Rebuttal Testimony?**

A. Yes.

## VERIFICATION

I, Michael Farrell, Senior Director with Willis Towers Watson, affirm under penalties of perjury that the foregoing representations are true and correct to the best of my knowledge, information and belief.

Michael Farrell

Date: 8-6-23