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PREVENTING THE NEXT PENSION COLLAPSE: LESSONS FROM THE UNITED AIRLINES CASE

HEARING

BEFORE THE

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PREVENTING THE NEXT PENSION COLLAPSE: LESSONS FROM THE UNITED AIRLINES CASE

TUESDAY, JUNE 7, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Hatch, Lott, Kyl, Bunning, Baucus, Rockefeller, Bingaman, Lincoln, Wyden, and Schumer.

Also present: John O'Neill and Mark Prater, Republican staff; Bill Dauster and Judy Miller, Democrat staff.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Well, good morning, everybody. We surely appreciate the attention to this very important problem that this hearing is about, dealing with the pensions of our major corporations.

So, specifically, today we are here to understand a tragedy, the bankruptcy of United Airlines and the massive losses in their employee pension funds.

I think that is very clear, so we should make no mistake about it, the losses are devastating: $9 billion dollars of under-funding in just one company's pension plan.

If I could put it in perspective, $9 billion is how much it would cost this committee to offset the Alternative Minimum Tax next year for 6 million taxpayers. Nine billion dollars is how much it would cost to send more than 1.5 million students to the University of Iowa.

The questions that we are asking are really very, very simple questions: how did this happen? Why did it happen? And, most importantly, how can this committee stop it from ever happening again?

The story that we will hear brings to mind another corporate catastrophe, the collapse of Enron. Like Enron, workers' lives and retirements have been ruined. Like Enron, the facts scream out the need for reform and the need to restore confidence in our economic system.

Like Enron and the phony accounting they used to hide their losses, we will learn that United's pension plans used illusory investment gains, kept on their books a year after it was clear that they would never materialize, to hide and disguise the true financial condition of their pension plans.

But there is a very significant difference. Unlike Enron, everything that United did was perfectly legal. In fact, what they did is accepted practice by pension plans everywhere.

Today, we will hear about the so-called "smoothing" techniques which allow pension plans to credit paper investment gains and then carry them into the future as long as 5 years, even if those paper investment gains have long since evaporated.

As the stock market plummeted in 2000, 2001, 2002, United used these smoothing techniques to make their pension plans look like the late 1990s stock market boom had never ended.

This meant that the plans were not only deteriorating rapidly, it also meant that United was not required to make additional contributions because, on paper, everything looked all right.

The fuzzy math does not stop here. In addition to allowing plans to book phantom investment gains, United was able to use stale, non-market interest rates to value pension liabilities, thereby further disguising funding deficits.

In other words, our pension laws tell these companies, take off the green eye shades and put on rose-colored glasses.

I am sure that many of you who are here today would like to be able to ignore your own investment losses—and by the way, I hope you did not have too many of those—but we all know that putting blinders on does not work.

Putting blinders on is exactly what United did, not only on themselves, but also on their employees, who were left powerless to know that their pensions were going down the drain. Unfortunately, by the time the blinders come off and anyone figures out what is really going on, it is often way too late, $9 billion too late in this case.

I am sure some will try to argue that United is a unique case. In fact, the testimony we hear today will make it clear that nothing could be further from the truth. There is nothing unique about United. The same blinders that United put on are used by companies everywhere.

Many of those companies want to do the right thing. They ignore the blinders and voluntarily fund their plans well. But, unfortunately, there are some that do not do that. This committee should not turn a blind eye to the damage that has been done.

The PBGC's deficit stands at $23 billion. More importantly, the committee needs to have a clear view of future damages that will result if the status quo is maintained. Without real reform, we will hear today that the PBGC's deficit could increase exponentially.

Pension plans of other airlines, some of whom are represented here today, are billions and billions under-funded. These airlines promised benefits that were too rich, and they and their unions refused to reign in those benefits even after it became painfully clear that the companies could not afford them.

It does not end with the airlines. Across dozens of industries, there are hundreds of billions of dollars of pension promises unfunded. The facts are alarming. The time to act is now.

Tinkering with the current rules will not do it. Another temporary Band-Aid will not take care of the problem. This committee rose to the occasion after Enron. We worked together. We did not shy away from tough reform. I am confident that we will rise to the occasion again.

We must act to restore public confidence in private pensions, with faith that the bad actors will not leave their employees high and dry, in faith that these bad actors will not be able to continue to pass their compensation costs onto employers, and for God's sake, not onto the American taxpayers.*

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

This hearing, obviously, is very timely, and I appreciate you holding it. It is timely because of the recent action by United Airlines, and also the report we are going to hear from Mr. Walker with respect to the GAO's findings.

The current pension funding system clearly is broken, and we need to fix it. Employees have lost billions of dollars of pensions that they have earned. The funding rules did not secure their retirement income. We know that the rules are broken because employees and retirees are being hurt. We need to fix those rules.

In fixing the rules, our goal should be the goal of ERISA, the Employee Retirement Income Security Act. ERISA created PBGC and the funding rules to protect employees. We need to fix the funding rules so that they do protect employees as they were intended to.

Today we will hear from pilots, machinists, flight attendants who face the loss of benefits that they have earned. One of the cardinal rules of ERISA is that earned benefits cannot be taken away. Accrued benefits are protected, except when an employer is in financial distress and the benefits are not funded. United and U.S. Air employees have learned about this exception the hard way.

In our current broken system, when that exception kicks in, the employer who is responsible for funding the benefits is the only one who does not pay. Employees and retirees pay dearly through lost benefits.

Other, more responsible employers—that is, employers who are funding benefits for their own employees—pay through higher PBGC premiums, and taxpayers may ultimately pay.

Who does not pay? The company that made the promises, the company that benefitted from the services for which compensation was deferred. That, my friends, is a broken system.

Think about what a defined benefit plan is supposed to be. When employees learn about the private employer-based pension system, they hear about defined benefit plans versus defined contribution plans.

For employees, one of the selling points for defined benefit plans is that employers bear the risk. The plan defines the benefit and the employer is responsible for funding that benefit. No matter how long you live, no matter what the markets do, the employee gets that benefit.

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*For more information on this topic, *see also* "Present Law and Background Relating to Employer-Sponsored Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation (PBGC)," Joint Committee on Taxation staff report, February 28, 2005 (JCX–03–05).

Looking at United Airlines' plan terminations, this standard definition sounds like some sort of cruel joke. The employer did not bear the risk. The employees bear the risk and other employers bore it, an outcome that ERISA surely did not intend, that employees are fully bearing that risk.

So, funding rules must be changed, not to protect the PBGC, but to protect employees. In the process, we will help assure PBGC's future health.

So, let us not forget our priorities. PBGC was set up to protect employees, active and retired. Funding rules were set up to protect employees. We need to fix this broken pension system to protect employees.

Let us learn from the witnesses whom we have assembled here and let us use what we learn to make the defined benefit system a system that delivers benefits to employees when they retire, funded by the employers that promise them. The employees worked hard and earned those benefits and deserve no less.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Now we go to the first panel. We have with us the Comptroller General of the United States, David Walker. That is the Government Accountability Office that he heads.

The second testimony will come from the executive director of the Pension Benefit Guaranty Corporation, Bradley Belt. Then last on the first panel, we welcome once again to the committee Dr. Douglas Holtz-Eakin, executive director of the Congressional Budget Office.

We will go with Mr. Walker, Mr. Belt, and Dr. Holtz-Eakin. Is that the understanding we had?

Mr. WALKER. That is, Mr. Chairman.

The CHAIRMAN. So go in the order you were introduced.

Senator LOTT. Mr. Chairman, could I inquire, are they being asked to make a 5-minute statement and submit the rest of their statements for the record?

The CHAIRMAN. Let me ask my staff. Yes, the 5-minute rule. Then your entire statement will be put in the record.

Proceed, please.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, Mr. Chairman, Senator Baucus, other Senators. It is a pleasure to be here with you today to discuss the funding of defined benefit pension plans and the implication of those rules on the PBGC's financial integrity, the retirement security of American workers and retirees, and American taxpayers.

Because PBGC guarantees participant benefits, there is concern that the expected continued termination by large plans of bankrupt sponsors will push the PBGC insurance program more quickly into insolvency, generating pressure on the Congress, and ultimately the taxpayers, to provide financial assistance to the PBGC and plan participants.

Given these concerns, the GAO put the PBGC on its high-risk list for its single-employer insurance program in July of 2003.

The PBGC's situation is an example of the need for Congress to reconsider the role of government organizations, programs, and policies in light of changes that have occurred over the years, in this case, since PBGC's establishment in 1974.

Importantly, Mr. Chairman, as you and I discussed, the PBGC's challenges bear many similarities to the challenges facing our Social Security system. Both programs have adequate current revenues and assets to pay promised benefits for a number of years, yet both face large and growing accumulated deficits on an accrual basis. As a result, timely action to address both private pension and Social Security reform is critically needed.

In pursuing such reforms, consideration should be given to the interactive effect of such reforms and how they contribute to the Nation's large and growing fiscal challenge, key demographic economic and workforce trends, and the economic security of Americans in their retirement years.

If I can, Mr. Chairman, with the help of your technology, I will show you a few pictures which say a lot. The first one demonstrates that PBGC has gone from an accumulated surplus of $9.7 billion in fiscal year 2000 to an accumulated deficit of $23.3 billion in fiscal 2004.

The next one—and by the way, all of these are in my testimony, Mr. Chairman—demonstrates that, based upon GAO's recently released report of pension funding from 1995 to 2002, overall funding levels deteriorated, yet most plans are still well-funded.

However, the degree of under-funding has increased significantly in the aggregate, and it is concentrated in a few companies and a few industries.

Importantly, 2002 was the most recent data that we had available in order to conduct this analysis, which demonstrates that we do not have enough timely and useful information for Congress to make informed decisions, as well as other key policymakers.

The next one demonstrates that under-funding among all defined benefit plans and those considered reasonably possible for termination by the PBGC has increased dramatically since the year 2000.

This one demonstrates that average contribution levels have been modest and that cash contributions were virtually non-existent until year 2002, in part because of the way that the rules currently work.

The next one shows that for the largest 100 defined benefit pension plans, that plans that are less than 90-percent funded rarely have to pay the additional funding contribution.

The next one—and this is very important—Bethlehem Steel and LTV. The bottom line on this chart is that, despite the fact that these plans had large and growing under-funded amounts, and despite the fact that they terminated, resulting in some of the largest losses in the history of the PBGC, that the sponsors made zero cash contributions several years before their termination—and that was legal—and they had large credit balances still available to them. The system is clearly broken.

This next chart demonstrates that plan sponsors that have non-investment grade debt, or speculative grade debt, represent by far the largest exposure to PBGC, to show that those that have had that status for a number of years often result in the largest losses. These are non-investment grade, as determined by the various rating entities.

Senator BAUCUS. Does the green represent that?

Mr. WALKER. Yes. Correct. That represents the percentage of losses. So in other words, a vast majority of their losses do not just relate to the funding status of the plan, which obviously would be the case, but also the financial strength of the sponsor. One proxy for that financial strength is whether or not they have investment grade debt or not, as determined by the markets.

Last, and in summary, Mr. Chairman and Senators, we have done a tremendous amount of work in this area, and additional GAO work is going to be published within the next week or two and in the coming months.

In summary, the evidence is clear. Reform of the current funding rules is urgently necessary. However, it needs to be an important part of more comprehensive pension reform. Other reforms are necessary as well.

Finally, while most plan sponsors are responsible and most plans have decent funding levels, some have not been responsible and have very large and growing under-funded plans.

As you know, Mr. Chairman, the law represents the floor of acceptable behavior, not the desired state. Unfortunately, when it comes to pension funding, too many high-risk companies do what is legally permissible rather than what is right when deciding how much money to put in their pension plan. In addition, all too frequently employees and retirees are at risk, and they are in the dark.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Walker.

[The prepared statement of Mr. Walker appears in the appendix.]

The CHAIRMAN. Now, Mr. Belt?

STATEMENT OF BRADLEY D. BELT, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. BELT. Thank you, Mr. Chairman, Ranking Member Baucus, and members of the committee. I commend you for holding this timely hearing and for your continued leadership on retirement security policy issues. I also want to commend the GAO and the CBO for the important work their agencies are doing on pensions.

Just a little over 3 months ago, administration colleagues joined me before this committee to discuss the problems facing the pension system and the administration's proposed solutions. My full testimony addresses these issues in much greater detail.

I would like to note that much has happened just since that time to bolster the case for enacting the administration's reform proposal as promptly as possible. For example, the recently filed 4010 reports provided by companies with pension plan shortfalls exceeding $50 million shows that the amount of under-funding grew dramatically during the past year, from $279 billion to $354 billion, a 27-percent increase. Overall, the plans had an average funded ratio of 69 percent.

Averages can be deceiving, of course. Most of these companies do not present an imminent risk of loss to the insurance program, but there has also been a substantial increase in the amount of under-funding in plans sponsored by weaker companies.

These risks are not limited to airlines. The insurance program also faces substantial exposure from other industries, most notably the automotive sector. The challenges facing this industry sector have been well-reported.

Indeed, in addition to deterioration of the credit quality of major industry players, eight auto parts suppliers with under-funded plans have filed for bankruptcy in recent months, three of them just since the last committee hearing.

As pension plan assets in this industry fall short of pension promises by $55 to $60 billion, this is a troubling trend. All this is occurring against the backdrop of United Airlines' pension situation, which has garnered widespread attention, and with good reason.

The United pension plans are poised to saddle the insurance program with a record claim of $6.6 billion, and cost plan participants more than $3 billion in promised benefits. A pension default of this scale merits closer scrutiny for the important lessons it offers about pension reform.

The first lesson is that the current pension funding rules, as noted by Comptroller General Walker, simply fail to ensure that companies honor the commitments they have made to their workers and retirees. If the rules worked, the pension insurance program would not have faced 23 defaults in excess of $100 million in just the past 3 years.

United, as you noted, Mr. Chairman, is unique only insofar as its size and visibility have drawn needed attention to these flawed rules.

My written testimony contains charts analyzing United's four main pension plans over the period 1998 to 2003. Among the findings is that, from 2000 onward, when the actual funded status of each of the company's pension plans was deteriorating and the financial health of the company was becoming more precarious, the company was putting little, if any, cash into the plans, was rarely required to make a deficit-reduction contribution, was never required to provide notices to participants of the funding shortfalls, was almost never required to pay a variable-rate premium, and was usually able to report that it was fully funded on a current liability basis.

This rosy picture stands in sharp contrast with what we know to be the true status of the United plans: an aggregate funding shortfall of $10 billion and a funded ratio of only 41 percent.

How can this be? One major flaw with the current funding rules is the use of so-called "credit balances." Just at the point in time when contributions to United's plans were most needed, the company was able to use credit balances built up during the 1990s' bull market to avoid putting cash into the plans.

Remarkably, notwithstanding the fact that the United pilots plan is under-funded by almost $3 billion, the company has not been required to make a cash contribution to that plan for the past 5 years.

Another critical flaw is the ability to smooth assets and liabilities. Those who want to retain these mechanisms argue that they are necessary to reduce volatility. But, of course, volatility is not reduced, it is simply masked, hidden from the view of participants.

The smoothed asset and liability numbers that feed into current liability calculations allow the company to report a distorted funded ratio, and thereby avoid the deficit-reduction contribution, the variable-rate premium, and the notice to participants. And, as the GAO report highlights, these problems are not unique to United.

The second principal lesson is that the operation of ERISA in the bankruptcy context leads to bad outcomes. There is an undeniable tension between ERISA and the Bankruptcy Code. One law is designed to ensure that benefit obligations to workers and retirees are fulfilled. The other is designed to let companies walk away from their obligations and make a fresh start.

In the real world, the interplay of these two laws leads to the assumption of significant liabilities by the pension insurance program. Caught in the middle are workers and retirees who risk losing promised benefits, as well as premium payers and taxpayers who run the risk of having to pay for costly corporate pension defaults, and the government ends up subsidizing the labor costs of weaker companies at the expense of their stronger rivals.

All of these outcomes are undesirable, but they are all too predictable, given the rules currently in place.

Mr. Chairman, the administration's proposal attempts to balance competing considerations while greatly reducing the chances of another United-style pension tragedy. The elements are simple: accurate measurement of plan liabilities, robust plan funding, a strengthened insurance backstop, and meaningful disclosure to workers and retirees.

We look forward to working with Congress over the coming weeks to ensure that these components are part of the reform package.

Thank you for inviting me to testify. I would be pleased to answer your questions.

The CHAIRMAN. Thank you, Mr. Belt.

[The prepared statement of Mr. Belt appears in the appendix.]

The CHAIRMAN. Now, Dr. Holtz-Eakin?

STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. HOLTZ-EAKIN. Chairman Grassley, Senator Baucus, members of the committee, the CBO is pleased to be here today to discuss this topic.

Let me echo the comments of Mr. Walker and Mr. Belt in discussing how one could address the key issue, which is to shape a stronger future for the PBGC, and more importantly, defined benefit pension plans.

I put up the chart behind you, which is the future under our projection of the PBGC's on-budget fund, to organize my remarks. Probably the key feature of this is that, in contrast to the past where there is 1 year in which outlays exceed receipts, the future is one in which the ever-increasing net outlays will ultimately, if they continue, exhaust the PBGC's assets and place it in uncharted territory. This budgetary future is a reflection—and I want to emphasize, an imperfect reflection—of the underlying challenges that face defined benefit pension plans and the PBGC.

The general under-funding is quite large. The PBGC estimates that the vast majority of plans are under-funded, and that the aggregate under-funding could be as much as $450 billion in single-employer plans, maybe $600 billion for all plans.

The PBGC itself, in contrast to this fairly benign picture at the moment, indicates that it has assets which fall short of its liabilities by $23 billion, and this is quite likely to get much larger and not to shrink.

An important part of this picture is the distinction between those things which have been inherited from the past and those things which are malleable in the future. Part of these future outflows reflect things which are sunk, costs from plans that have already been terminated, or will be, so they are over in either actuality or in effect, and these costs cannot be avoided.

Most of the recent PBGC claims are concentrated in a few industries. Nine of the ten largest claims are from airlines or steel, and account for nearly 70 percent of PBGC's claims. The focus point of this hearing, United Airlines, is only the most recent example of this.

In all of those industries, the competitiveness of firms offering DB plans has deteriorated significantly and made it unlikely to be able to get new resources for pensions by raising revenues through its customers.

As a result, the key issue in these circumstances will be who pays. Policy changes to augment funding in these circumstances would likely impose new costs on sponsors, the shareholders, and increase the chances of bankruptcy reorganization or liquidation.

The PBGC's assumption of those benefit liabilities might impose losses on workers, either because the PBGC insurance's maximum benefit is below their promise, or because the PBGC itself may fall short of assets to fund them.

Now, sponsors could try to restrain these costs and impose them on workers by limiting benefit accruals or freezing plans, or the final candidate in these circumstances would be the American taxpayer, to the extent that the Congress were to alter the rules and provide more resources.

The key issue then is, looking forward, how to avoid arriving at the same situation. DB plans are a form of employee compensation whose key characteristic is that it is deferred, and as a result, the elapse of time allows for the advent of adverse economic circumstances, either for the firm, for the industry, or for the economy as a whole.

In those circumstances, there are really two ways to provide this compensation more securely. One is for firms to self-insure, that is, to fund more fully their promises. In that case, there are a variety of policy options available to the Congress to strengthen pension funding rules. The current rules are clearly too flexible. I think the GAO's report is a telling witness to this. As Mr. Belt mentioned, there is too much in the way of smoothing that masks the situation that is actually an economic reality. It would be desirable to move to market values and permit a closer matching of asset and liability values, and thus allow hedges in these pension plans.

The alternative way to provide insurance is to purchase it, and in this case that means buying pension insurance from the PBGC, and their employers will only make sensible decisions if they are charged prices that more appropriately represent the cost of that insurance. And there the list of policy options has been laid out: largely increasing premiums, having those premiums reflect the risk of the underlying pension plans, and more closely matching the price for event insurance to its cost.

In both circumstances, I think it would be desirable to improve transparency, allowing market participants to more correctly evaluate the current valuation of assets and liabilities in the pension plan. It will improve shareholder monitoring, it will improve worker monitoring, and allow better performance overall.

Improving the presentation of the PBGC itself will allow the Congress to more carefully monitor the scale of the taxpayer commitment to this kind of an insurance system and allow the Congress to decide, in time to make these decisions, the exposure of the taxpayer to future possible losses.

Thank you for the chance to be here today, and I look forward to your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

The CHAIRMAN. We will have 5-minute rounds. It is my understanding that we are going to have a vote at noon, so a couple of things I would like to urge the members to do. Try to keep your questions within 5 minutes. That applies to me as well.

But secondly, and more importantly, when noon comes, Senator Baucus normally chairs when I cannot chair, and he has to be gone. So, I would like to have a member volunteer to carry on after 12 o'clock if we are not finished by that time. So would somebody volunteer to do that, please?

I am going to start out now with a question, and I am going to start with Mr. Belt. We are, obviously, through this hearing, focusing a lot of attention on pension funding rules. With the situation described, that is rightfully the right way to do it.

But as I followed some of the recent high-profile cases that have been coming to the door of your agency, this seems like a crazy system where a company can just dump its pension plan on the government and then skate out of bankruptcy like nothing ever happened.

Are there things that we here in Congress could look at to strengthen your hand in dealing with some of these pension terminations, and hopefully to stop plans from ever terminating in the first place?

Now, what I need from you, Mr. Belt, is ideas that go beyond anything the administration might suggest. So, you are here as an expert witness to help us do our job in Congress.

I do not expect you to say anything contrary to what the administration would propose, but surely we need every idea we can get from you that goes beyond what the administration might propose.

Mr. BELT. Thank you, Mr. Chairman.

Clearly, as I indicated in my oral statement, there is a tension between ERISA and the Bankruptcy Code right now. As a practical matter, the PBGC is often faced with a situation where the ERISA law seems to say one thing, the Bankruptcy Code says something else, and the Bankruptcy Code ends up trumping ERISA, at least as interpreted by the bankruptcy judge. We have had that happen in a number of instances.

As you know, I testified to this when I appeared about 3 months ago when United first missed its pension contributions or failed to make legally required pension contributions last summer of about $74 million.

Ordinarily, outside the bankruptcy context, we could file a lien and enforce that lien against the company, but because of the operation of the Bankruptcy Code, our ability to enforce that lien was automatically stayed. That is one area where the Bankruptcy Code trumped the requirements of ERISA. That is one administration proposal that we have advanced to specifically address that situation.

There are other examples where we have encountered difficulties, quite frankly. I know one of the issues, for example, that the flight attendants had raised, concerns the analysis of requiring each of the pension plans in United to be looked at on a plan-by-plan basis, which is exactly what we do and is exactly what, in our view, ERISA requires.

However, there have been courts that have held that companies are free to look at these pension plans on an aggregated basis. Another situation that typically arises is, for example, in the calculation of the PBGC claim. That is provided statutorily and by regulation under ERISA.

The bankruptcy courts have found the wherewithal to establish their own standards, and, at least in one recent case, they actually said that rather than discounting the liabilities of some annuity-pricing market or a risk-free rate, they had to be discounted at almost 10 percent, which makes no sense whatsoever when you are trying to defease liabilities.

So, there are a host of situations like that where certainly tools available to the PBGC could be strengthened. Congress may want to consider looking at some of the criteria for companies entering the distress termination process.

It is not a slam-dunk, it is not automatic, but it is ultimately in the discretion of the bankruptcy judge as to whether they can be persuaded by the company whether they can exit Chapter 11 with their pension plans intact. Of course, we would be delighted to work with you, the members, and your staff to look at some of those issues.

The CHAIRMAN. I am glad you offered your staff's advice, because we think your hearts are in the right place and we need the help. So, I look forward to that.

My last question is to Mr. Belt and to Mr. Walker. You both pointed to so-called smoothing techniques as a leading cause of today's pension crisis. Those rules are complex and arcane. So could you explain, in short detail, exactly how those rules work, or do not work, if that is a better way for you to say it?

Mr. WALKER. Basically, Mr. Chairman, those rules allow plan sponsors to be able to amortize over a number of years certain types of experiences that they have. For example, investment gains and losses. Also, changes in promised benefits.

The difficulty is, as you properly pointed out in your opening statement, that in the last several years we have seen the combination of two events: 1) declines in asset values; and 2) declines in interest rates, which means that the amount of money it takes to buy out the liabilities has gone up. The combined effect of reduced assets and increased liabilities means the bottom line hemorrhages.

However, these smoothing techniques allow the companies to be able to amortize these gains over a number of years. These are past gains which could have evaporated.

Specifically, gains could have turned into losses—and dramatically increased losses—yet plan sponsors are not required, under current law, to consider that in determining how much money they have to contribute to their plan.

Mr. BELT. If I might add, Mr. Chairman, the rules allow assets to be smoothed over a 5-year period and the liabilities to be discounted using a 4-year weighted interest rate.

So as a consequence, what we are really saying is, let us take a look at a point in time, try to understand what the current financial status of the pension plan is, and it is nowhere to be found.

PBGC can get that information, but that information is not available to workers and retirees. They are looking back 4 to 5 years ago and pretending that what existed at that point in time in the markets is relevant to the economic environment of today.

That is clearly what we see reflected in the charts we have in my testimony with respect to United Airlines, and those provided in the Comptroller General's testimony. It is that companies are able to report that they are, so-called, fully funded, or they meet that so-called full-funding limitation, which is a misnomer if there ever was one, when in fact, on a current economic market basis, they may be deeply in the hole and getting more deeply in the hole as every day goes by.

Not only that, because all these other rules are tied off this current liability measure, that is the reason they have not had to make deficit-reduction contributions. They have not had to send out notices to participants or pay the variable-rate premium.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Mr. Belt, I wonder if you, or any of you, can discuss a little bit the difference between at-risk liability and ongoing liability. Some of the discussion here is based on at-risk, and those numbers clearly are high—way too high—and some of the ongoing liability is also high, but maybe not quite as high.

If you could just tell us the distinction between the two and the degree that that distinction, in your judgment, is important.

Mr. BELT. Ongoing and at-risk liability measures are those that are provided under the administration's pension reform proposal. Essentially, the ongoing liability measure is one that tracks very similarly with current accounting measures of liability, basically, what are accrued benefits, measured, again, using market value of assets and the corporate bond rate as the discount rate applied against a yield curve.

So, there are meaningful funding targets, taking into consideration that that company, because of its financial health, is likely to be around for a period of time, so we will look at that pension plan a little bit differently than situations in which companies are entering financial difficulty.

In that case, the at-risk liability measure takes into account changes in behavior that happen in the real world, in the marketplace. When companies get into financial difficulty, you often start seeing employees take early retirement subsidies.

Senator BAUCUS. I guess the main point being here, there are differences, because some companies are at risk and some not, so we have the different calculations. The main point being, when we talk only about the at-risk liabilities, that is bad. But the ongoing may not be quite so bad, but it is slightly healthier.

Mr. Walker?

Mr. WALKER. If I can, Senator. The difficulty that we have right now is that there are a number of complex, competing and confusing calculations in connection with pension funding.

For example, the calculations that are used for funding purposes, which allow for the smoothing, typically provide a more optimistic view of what the funding status of the plan is.

The calculations that are required in accordance with Generally Accepted Accounting Principles, and have to be included in the 10(k) filings for public companies, are on a different basis and typically would provide a somewhat more conservative view of the funding status. The PBGC's calculations, which are on a termination basis, are usually much worse, depending upon the facts and circumstances. That is part of the problem.

Senator BAUCUS. What is the solution?

Mr. WALKER. The solution is, we need to have streamlined and simplified rules for determining what should be used for calculating these numbers and disclosing these numbers to plan participants and beneficiaries, because right now you have inconsistent, confusing, and competing numbers that maximize the risk to benefit security of American workers and retirees in the PBGC.

Senator BAUCUS. Do you think that the rules should be the same as applied to each of the three different reportings?

Mr. WALKER. Not necessarily. I do, however, believe that we clearly need to strengthen the rules that relate to transparency. In other words, the type of funding information that would be reported to plan participants and beneficiaries—namely, current workers and retirees, and the government—needs to be more reflective of the current reality, not these smoothing techniques that are currently used because it leaves a huge expectation gap and results in real problems for all stakeholders.

Senator BAUCUS. How important is the yield curve here? Because that is a little bit of a hang-up. In the whole scheme of things, as long as there is not too much smoothing, do we need a yield curve adjustment?

Mr. WALKER. As you know, we have issued a report concerning the different methods that could be used in calculating the potential obligations and related plan activity, which we can again make available to this committee. That is a very contentious issue.

It is interesting, because one of the reasons that the administration and others have had to consider alternative calculations is because the Federal Government is out of the business of issuing 30-year bonds. Guess what? We are probably going to be back pretty soon, given our current deficit situation.

Senator BAUCUS. Right.

Mr. BELT. Senator Baucus, if I might.

Senator BAUCUS. Yes.

Mr. BELT. The yield curve simply provides a more accurate way to measure the liabilities. It is a recognition of the fact that companies are paying out benefit payments, and will pay out benefit payments, at different points in time.

If you price those liabilities on a market basis, there are different interest rates that are charged, just as if you are buying a house, you can get a 30-year loan at one rate, a 15-year loan at another rate, and so on down, and you can get a completely different loan for a 1-year ARM, a 3-year ARM, or a 5-year ARM.

Senator BAUCUS. Should there be any smoothing?

Mr. WALKER. I think the answer is potentially yes, but clearly not to the degree that we have today. I think the other thing that one has to keep in mind is, we need to target these rules better to make sure that those plans and those plan sponsors that represent a true risk to benefit security and to the PBGC, and potentially, ultimately, the taxpayers, are treated appropriately.

We cannot have a one-size-fits-all approach. So, in many situations where you are dealing with a plan and a sponsor that do not represent a true risk, that could be justified, but it would not be justified in circumstances where we may simply be delaying the inevitable.

Senator BAUCUS. Is 90 days sufficient smoothing?

Mr. BELT. Mr. Chairman, I would perhaps tend to make the point a little more strongly than the Comptroller General did. I think there is a real risk in smoothing what I would characterize as the inputs, the calculation of assets and liabilities to determine the current financial condition of the pension plan.

If the concern is about contribution volatility, recognizing what the assets and liabilities are at any point in time that are going to lead to fluctuations in required contributions, then perhaps one could talk about, in a rational way, providing some anti-volatility mechanism on the output side.

But we live in a mark-to-market world, and are clearly trending more in that direction. I think there is a real danger in pretending what is a current economic reality today is not there, and we are going to rely on something from the past.

Senator BAUCUS. My time is up, but go ahead, Mr. Walker.

Mr. WALKER. Real quickly. When I am speaking of smoothing, I am talking about contributions. I think it is critically important that you provide a full, fair, accurate, and timely view of the true economic condition of the plan to the government and to the participants and beneficiaries.

Senator BAUCUS. And transparent.

Mr. WALKER. Correct.

Senator BAUCUS. Thank you.

The CHAIRMAN. Now we go to Senators Lott, Wyden, and Kyl, who are the next three.

Senator LOTT. Mr. Chairman, I just want to thank the panel for being here this morning. Since most of the testimony I am interested in hearing this morning, and the questions I would like to ask, really, are for the last three witnesses, I am going to defer asking any questions of this panel at this time because I am very concerned about being able to get to the three key witnesses that we would like to hear from this morning.

The CHAIRMAN. All right.

Then we now go to Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Thank all three of you.

Mr. Belt, it seems to me that as the airlines try to work out their financial and pension problems, the sacrifices are rarely shared. For example, if other airlines followed the lead of United and U.S. Air, the airline executives get to fly again with their pension benefits intact, while workers get grounded with smaller pensions.

My question to you is, how is it possible that the airline companies can, in effect, put the executives' pension in a lock-box while they discharge the workers' pensions? Maybe this is the Enron accounting that the Chairman was talking about. But if you could tell us how this is the case, that would be helpful.

Mr. BELT. Everything that has been done by the airlines, at least as far as we can ascertain, is consistent with the laws that Congress has enacted at this point in time. We believe there are a number of areas that the laws do need to be changed.

There are some limitations on executives being able to line their own pension plans while not funding the rank-and-file's pension plans. The administration has actually recommended, as part of its reform proposal, that that be tightened. But again, we are not aware, in contrast to situations like Enron and other areas of corporate malfeasance, that companies are not fully complying with or taking advantage of the rules that are allowed under current law under ERISA, under the Bankruptcy Code.

Senator WYDEN. That is what concerns me, is they are taking advantage of the current rules. I am not accusing anybody of lawbreaking. But is this tax law? Trust fund law? What is it? It seems that the executive pensions are intact, yet the workers' pensions get shellacked.

Mr. BELT. Yes. That is primarily an issue of the tax law, our Internal Revenue Code, with regard to qualified versus non-qualified plans.

Senator WYDEN. I just want us to have on the record how it is that we have this double standard.

Mr. WALKER. Senator Wyden, as you probably recall, I used to be head of the PBGC, and I was Assistant Secretary of Labor for Pensions and Health. I think what you are referring to is non-qualified plans.

You can have certain top executives and highly compensated individuals that could be covered by a plan, a deferred compensation plan, that is not covered by the PBGC, that is not subject to the funding rules, and that provides for lucrative and supplemental retirement benefits as compared to the normal plan.

There are techniques that can, and have, been used by companies in order to provide enhanced security for those benefits, including in the event of bankruptcy, such things as secular trusts and other types of vehicles, which I would be happy to talk to you about if you would like.

Senator WYDEN. Now, Mr. Belt, the airlines often threaten to drop what I call the equivalent of "the bomb." They say, if you do not bail us out we are going to file for Chapter 7 bankruptcy. If you do not let us terminate the pensions, we are going to Chapter 7 bankruptcy. Then Congress invariably gives the airlines pretty much what they want.

Do you really think the airlines would "drop the bomb" without being able to default on their pension obligation?

Mr. BELT. There is no question there is a concern, as I indicated in my oral statement, that the interaction of ERISA and bankruptcy law, right now, leads to bad outcomes. That is likely to continue, absent a change in law. I think we do need to recognize that there is, in fact, a statutory procedure in place before companies are able to shed their pension liabilities onto the government.

Now, I think you could have a discussion as to whether all those criteria are as they should be, but a policy decision has been made that companies, in certain circumstances, should be able to shed their pension liabilities on the government, and because there is a maximum guarantee limit, employees inevitably may be hurt.

They can reemerge from Chapter 11, sans those pension liabilities, and fly off into the distance, having the government subsidize their labor costs on an ongoing basis. Again, that is an operation of the current law.

Now, what they have to prove to a bankruptcy judge, and PBGC is not the determining entity in this case, is that they would not be able to emerge from Chapter 11 and get a fresh start if they maintained any of their pension plans.

Senator WYDEN. Finally, we have received reports, and heard concerns, that the Department of Treasury and the Department of Transportation may have encouraged United into defaulting on its pension plan to PBGC. Do any of you three have any information with respect to something like that?

Mr. WALKER. No.

Mr. BELT. No.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Kyl had to go to a leadership meeting, so he has asked permission to put a short statement in the record, and he will have a couple of questions that he will submit for answer in writing.

[The prepared statement of Senator Kyl appears in the appendix.]

[The questions appear in the appendix.]

The CHAIRMAN. Now I see Senator Schumer is here. He had been here previously, but was not able to stay, and has come back now. So it is Schumer, then Bunning, then Rockefeller.

Senator SCHUMER. Thank you, Mr. Chairman.

I would like to, first, just ask a few questions on the overall health of the PBGC, and then follow-up with some questions. I am concerned about the growing problem that the PBGC is facing as more and more companies face financial difficulties and drop their pension plans in order to return to profitability.

I learned recently that only half of the $450 billion of pension under-funding, as calculated by the PBGC, has ever been disclosed to employees and investors through their annual statements to the SEC. There have been stories in the newspaper about that.

I understand that the publicly disclosed pensions and liability statements submitted to the SEC by companies in general—not these, in particular—are dramatically different than what the PBGC requires to be submitted to them. It is difficult for workers, stockholders, and others to get accurate information in that environment.

So, my first question is, how do we remedy this problem and allow those who have an interest in the company that is not management to know the truth about the retirement investments, particularly the workers who will put the money in?

Mr. BELT. That is a good question, Congressman. Senator Schumer. My apologies.

Senator SCHUMER. I was a Congressman for 18 years, and I was proud to be that.

Mr. BELT. That has been a core element of the administration's reform proposal, to shed a little sunlight on pension finances, because this is an area that has been cloaked in darkness for far, far too long. There is no question about that.

The stakeholders that are most in need of information, material, timely, and relevant information about the financial status of the pension plans, have been effectively denied much of that information.

Even a lot of the information that the regulators get is very stale and untimely, and that is one of the issues that GAO has looked at, noting that the principal source of information filed by all pension plans, by the time we get it, that information is more than 2 years old. It is very difficult to make informed life, policy, or business decisions in a dynamic marketplace environment with that kind of stale information.

So, a core element of the administration's reform proposal is, indeed, to shed a little sunlight on pension finances and make sure that workers and retirees, as well as shareholders and regulators, get relevant, timely information.

Senator SCHUMER. Anyone else?

Dr. HOLTZ-EAKIN. I think this is a really important issue. We rely, in our ongoing work, on publicly available information, and we often find ourselves calling the staff at PBGC to try to reconcile differences because the numbers do not line up. So, it is very important to be able to get a little transparency and be able to make the proper comparisons across these different sources.

Senator SCHUMER. Thank you.

Mr. WALKER. Senator, I think it is absolutely critical that plan participants, beneficiaries, and appropriate government agencies receive more timely and market-based information on the true financial condition of their pension plans. Absolutely critical.

Senator SCHUMER. Well, thank you. I believe one of the reasons we are in such a mess here is because this information has never been timely. It is just so outrageously unfair to employees not to know the status of the money that they have put in year after year after year.

Here is my second question. So, I have looked at some of your testimony, and it strikes me that you cannot separate the issue of the pension problems at the airlines from the whole issue that we have been discussing here in hearings before, and that is Social Security.

The administration has made a proposal—I find it inadequate—for reforming defined benefit pension plans. But at the same time, they want to privatize and, in my judgment radically change, Social Security, phasing out over a long period of time the basic intergenerational transfer that we have had.

Now, the airline pensions were supposed to be a promise to the workers: you work this many years and you get a pension. You do the same with Social Security: you work this many years and you will get a Social Security benefit. But, of course, that depends on how well one's privatization is fully implemented, in good part, how well the stock market does.

So my next question is for Mr. Belt. How do you explain the PBGC's sudden reversal of its position on whether or not United could afford to continue funding the pension plan for its flight attendants?

I understand that, on April 4th, you sent a letter to the flight attendants' lawyer saying that the AFA plan can, and should, be maintained by the company upon emergence from Chapter 11. Then you changed your mind and you recommended termination a week later.

What does this say about the change, not only the dramatic change we can see in pension plans, but the need for having a baseline of support for people in terms of Social Security and not making that more risky?

Mr. BELT. Senator Schumer, there are a number of issues you raised that are very important ones. Let me, first, note that obviously the administration and the President are committed to strengthening all retirement systems in this country, not only Social Security, but the defined benefit system, as well enhancing private savings. The administration has put forth proposals to do each of those things.

With respect to the flight attendant situation in the United context, let me first note that that is a matter, as you know, that is the subject of litigation right now, so I need to discuss it at a somewhat higher level.

There is no question, in PBGC's view, in my view, that it would be optimal for companies to fund the pension promises they make to their workers and maintain those pension plans on an ongoing basis.

The fact of the matter is, under current law, companies have the legal right to pursue the distress termination, to seek to shed their pension liabilities onto the government. That is the law, the structure and framework, that Congress has put in place. United was taking advantage of that situation as, in my view, far too many companies have done in recent years.

As I noted, we have had 23 corporate pension defaults in excess of $100 million claims in just the last 3 years, so it is not unique to United Airlines. But the bottom line is, the company can move to shed its pension liabilities.

PBGC uses all the tools at its disposal, but it does not ultimately make the decision—the bankruptcy judge does—to hold the companies to account to make sure they are fully complying with their ERISA requirements, as we have done at that.

I will also use the bully pulpit to keep the pressure on the company. I suspect you will hear management perhaps complain, in United's situation, that I was doing that fairly extensively last summer and through the fall.

There is no question that, from a financial standpoint, in the interest of the overall pension insurance program, all the stakeholders would have been better off had the company been able to maintain at least the flight attendants' plan, also the MAPC plan, the ground plan and the pilots' plan. But that is not where the law is.

We concluded that the judge would find as he did, that the company would meet the distress criteria, that they would not be able to emerge from Chapter 11 with those pension plans intact. That is not a determination the PBGC makes. We sat down unilaterally with the flight attendants, we sat down unilaterally with the machinists, and all the unions.

We sat down multilaterally with the unions and the company, trying to find resolutions to these issues, but none ultimately were forthcoming that were satisfactory to all the participants. So, ultimately, we took the action that was necessary to protect the overall interest of the pension insurance program.

I am responsible for looking out not only for the flight attendants in United, as indeed I am responsible—that is a set of stakeholder interests I am responsible for looking out for—but we are specifically supposed to make sure that we have resources available to cut benefit checks, and that includes the flight attendants at Braniff, TWA, Pan Am, and Eastern. We are providing their benefit checks today.

We may have to—and I hope this does not happen—provide benefit checks to flight attendants in Northwestern, Delta, American, and Continental. I hope that never comes to pass, but we need to look at all the system's stakeholder interests.

I am supposed to also look out for the premium payers. That is explicit in our statutory mandate. I am supposed to be self-financing and look out for the American taxpayers' interests. That is explicit in the statute as well. We are in the position of having to balance often competing interests.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman. I would like permission to enter my opening statement into the record.

The CHAIRMAN. Yes. Without objection.

[The prepared statement of Senator Bunning appears in the appendix.]

Senator BUNNING. I think you all are familiar with last spring when the Congress enacted legislation that contained some funding relief for the airline industry. Would you all like to comment on what impact this legislation had on the health of their pension plans, if any?

Mr. BELT. It ultimately did not help. The representations, as I understand it, at that point in time, were that, if that relief were to be provided to the airlines, they would be able to meet their pension obligations.

Senator BUNNING. What did they do with the money?

Mr. BELT. It simply was a policy of forbearance, so they did not have to meet minimum required contribution requirements that otherwise would have been in place.

Senator BUNNING. In other words, they spent it on something else. Since they did not have to contribute to the pension program, they used it for other purposes. Is that correct?

Mr. BELT. That is correct.

Senator BUNNING. All right.

Would our government witnesses comment on the Employee Pension Preservation Act that has been introduced by Senators Isakson and Rockefeller and is supported by much of the airline industry? If passed, is the legislation likely to help the airline industry? And what impact, if any, could it have on the PBGC if any more of the airline pension plans end up being taken over by the agency?

Mr. BELT. Thank you, Senator Bunning. I will start on that one.

As you know, the emphasis of the administration's reform proposals is to strengthen the funding rules, not weaken them, and not to provide a separate set of rules for certain companies or industry sectors, but apply the same set of rules to everybody.

Certainly from a personal standpoint, wearing the hat that I do now, I am always delighted to look at creative solutions for dealing with problems we are facing.

I think, in analyzing proposals like that, there need to be a couple of guideposts. One is, does it simply put off the day of reckoning to another day down the road, and is there a potential for the problem to be worse at that point in time compared to where we are today?

The second guidepost would be, does it lessen or exacerbate the moral hazard that exists in the system already? That is, would it encourage further irresponsible behavior?

My concern, at least as I understand the bill at this point in time, is it would not satisfy either of those two guideposts. There are a number of ways in which it limits the potential exposure to the pension insurance program from further losses.

Contrary to the claims of some of the proponents, however, it does not eliminate those risks or losses. There are a number of ways in which a potential loss to the pension insurance program could grow, and could grow substantially over time.

Second, it seems to me that you have to ask yourself the question as to whether it sends the right message. If the way to get special funding rules is to get in a deep hole in the first place, might that encourage other companies, not only in the airline sector, to pursue the same course of action?

Senator BUNNING. Mr. Walker?

Mr. WALKER. Several thoughts, Senator. Number one, I think it is important to keep in mind who bears the risk. The risk right now is borne by participants and beneficiaries, to the extent that all their benefits are not guaranteed, and by the sponsors of healthy defined benefit plans who, by definition under the current law, since PBGC is supposed to be self-sustaining, ultimately over time will have to bear larger premium payments unless the government decides to provide revenues.

As you know, the PBGC is not backed by the full faith and credit of the U.S. Government. It has the ability to borrow $100 million. Nonetheless, there is a potential contingent liability because of what we found in the S&L situation, where the taxpayers jumped in in order to protect the account holders of that time.

Congress may be under pressure to do the same thing with regard to the pension system. I think it is important to keep in mind that some relief may well be necessary from the current deficit-reduction contribution rules, but it is important to keep in mind that they need to be targeted, they need to be risk-related, and we need to make sure that you are not just delaying and increasing the amount of losses that otherwise are going to be imposed on all responsible parties.

The last thing. One of the things that Congress is going to need to consider is whether or not to treat legacy costs differently for the airline industry and certain other industries. If you look at PBGC's historical losses, and also their prospective exposures, they are concentrated primarily in a relatively small number of companies.

Senator BUNNING. I want to interrupt you, because you are using all my time.

Mr. WALKER. Sorry about that.

Senator BUNNING. I want to know why we should reward lousy management.

Mr. WALKER. I do not think we should reward lousy anything. I think we have some very perverse incentives under the current system.

Senator BUNNING. Over-promising benefits to people that they cannot deliver. I have been involved in pension programs a long time, and that has been the case, not only in steel, in coal, but in many other companies.

But the airline industry is just recent and it is falling down, not out of the sky, but falling down as far as delivering benefits that have been promised by over-promising executives.

Thank you.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman. I will not get into debating with the Senator or members of the panel on what I think is a very good bill that Senator Isakson and I have put forward.

First, I want to get something straight, because it is always important, I think, for those who watch this on C-SPAN or listen to it. Mr. Walker, when you give your testimony, it is not cleared by OMB or by the administration. Dr. Holtz-Eakin, when you give your testimony, it is not cleared by the administration or by OMB. Is that correct?

Dr. HOLTZ-EAKIN. That is correct.

Senator ROCKEFELLER. Mr. Belt, when you give your testimony, it has to be cleared by the administration, usually OMB. Am I right?

Mr. BELT. That is correct, Senator.

Senator ROCKEFELLER. That is a very important point that people need to understand, that we have witnesses. There is this sort of instinct that there is a free exchange of ideas, and in fact there really is not.

I mean, you were talking about the Social Security system, which I happen to think is very inadequate in terms of the President's proposal, as a really good thing. That was advocacy.

So, I think that we need to understand that there are those, like Comptroller Generals, IGs, and the rest who can speak their mind, but there are others who cannot speak their mind. They work for the Federal Government, they are paid by the taxpayers, but they cannot say what they think if they happen to think differently than what the administration thinks.

The administration has a very corporate point of view and one does not deviate from that point of view. I will give you a chance to respond if you want, Mr. Belt, but I think you are caught.

Mr. BELT. The one thing I have never previously been accused of, Senator, is not speaking my mind.

Senator ROCKEFELLER. Well, that may be. But you are being at this point, because you are not free to go beyond what the administration will allow you to say.

Mr. BELT. Everything that is in my testimony is what I very fervently, at a personal level, believe both as a policy matter, and in the public interest as well as wearing the hat that I do as head of the PBGC.

Senator ROCKEFELLER. Well, I congratulate you, but my point stands.

Mr. Belt, I have very serious concerns about the pension reform proposals that would create an incentive, from my point of view, for employers to exit the defined benefit program, and I would like to talk about that for a minute.

You praise what the administration is doing to make the situation of the PBGC better. My view is somewhat different. They have focused on rules that would supposedly improve the financing of the PBGC, but specifically they have proposed increasing employer premiums, in this case, on an industry with which this country cannot do without more than any other industry that I can think of, except possibly the electric power industry. You are also imposing additional funding requirements on companies that are obviously struggling financially.

Now, I am very concerned that, in an effort to shore up the PBGC, that in fact the administration's proposals are doing more harm than they are good, and by quite a strong measure.

If employers with healthy pension plans determined that the new rules and premiums are too intrusive and too expensive, they are going to get out. I mean, I have seen this for years, as has Senator Bunning, on coal, steel, and other areas. They are going to get out. They are going to leave the system.

Any insurance plan is just like that. When healthy participants leave the system, then obviously the remaining risk is all the greater for those who do remain. So, I would think it would set in motion a kind of death spiral for the PBGC, the rules which the administration is proposing to make it healthier. So how would the administration encourage employers to stay in the defined benefit pension system, or does it simply say that no longer has merit?

Mr. BELT. To that latter point, Senator Rockefeller, the administration believes very strongly that the way you stabilize the defined benefit system and perhaps encourage new entrants into the system is, first and foremost, getting rid of the pension overhang, the $23 billion deficit.

It is difficult for a CEO or CFO to make a decision, with that deficit overhang hanging out there, to establish a new defined benefit plan if they are at risk of having to pay the premiums to make up for that loss.

Senator ROCKEFELLER. But how do you do that when you increase the cost of their so doing?

Mr. BELT. I would be happy to address that, Senator.

The second point is that we want to greatly simplify the system. As Comptroller General Walker noted and as we have testified to before, the current regulatory system is extraordinarily complex. The administration proposal would greatly reduce those complexities, increase simplicity in the system.

Third, we recommend having Congress reconcile the challenges or the legal issues with respect to cash balance plans, because the real vitality in the future for defined benefit plans is going to be dealing with hybrid structures like cash balance plans.

I would note that there has been a steady erosion of the defined benefit system under current law, from a peak of about 112,000 plans of about 20 years ago to fewer than 30,000 single-employer plans today, and from 40 percent of the workforce being covered by DB plans, to fewer than 20 percent today. Under current law, a number of plans are being frozen, either hard freezes or soft freezes.

So, I would respectfully disagree with the premise that maintaining the status quo is going to save the defined benefit system. We believe you have to get rid of that overhang in a responsible and measured way, clarify the legal status of cash balance plans and simplify the system.

We think if you do those things, you can provide a level playing field and make it a rational economic, legal, and regulatory decision for a company to not only maintain the defined benefit plan, but perhaps establish new ones.

With respect to the premiums, the issue is, there are losses in the system. There are going to be future losses. Right now, the way the legal structure is, current law, our only source of revenues is premiums, like any insurance system.

If you want to have premiums be lower, that is certainly fine. But the question that Doug posed was, who pays? Who is going to pay for those losses? That is the trade-off that I think we are facing as a policy matter.

Senator ROCKEFELLER. Mr. Chairman, I recognize I am over my time. But you would have, then, one of the two or three absolute necessities of the economic survival of America go further into the impossibility of emerging from bankruptcy, if they are already there, by increasing what they have to pay in the name of something called equity, fairness for all?

Mr. BELT. It is ultimately a policy decision as to how you allocate both the past cost, as well as future costs. It is a policy decision that Congress is going to have to make.

With respect to the premiums issue, again, I would also doubt that the proposed premium increase, I have not seen any analysis—and we have repeatedly requested it—that that is going to drive anybody into Chapter 11.

The total amount of premium revenues collected by the PBGC from the flat-rate premium is about $600 million a year. That would be another $300 million that we would get from the proposed increase in the flat-rate premium.

That is relative to tens of billions of dollars of contributions that need to be made into the plan, plus that flat-rate premium has not increased since 1991. I believe that that has really been advanced as an argument to say that the administration's proposal has all these counterproductive effects.

But I have not seen that analysis, and I do not believe an additional $300 million a year in premium revenues paid by the entire defined benefit system sponsor base is going to drive anybody into bankruptcy.

The CHAIRMAN. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, certainly, for bringing us together to discuss such an important issue. I am grateful that, as we on the Finance Committee continue to address the solvency of Social Security, it is a positive thing that we are finding time also to be concerned about the other legs of that three-legged stool, the pension plans and the personal savings.

So, I am not amazed, because the Chairman and the Ranking Member are always incredibly thorough, but I am very pleased that we are having the discussion today, and very pleased that you are here to help us look through this issue.

I am hopeful that this can be the beginning of really a more comprehensive approach in dealing with the current savings crisis that we are facing—I know Mr. Walker mentioned that—and we have to be more comprehensive as we are focusing on these issues, not just in Arkansas, but all across the country. So, we are grateful to you all.

Mr. Walker, in your written testimony you did make some interesting correlations, I think, regarding the similarities between the PBGC and Social Security. You talked about both programs having adequate current revenues and assets to pay promised benefits for a number of years, yet both face large and growing accumulated deficits on an accrual basis.

I guess, thinking that maybe technically that is probably correct, I guess I have a little bit of concern with that correlation. I do not know. Maybe you might agree, I do not know.

But there is a drastic difference between Social Security, which I think as a Nation we have a tremendous responsibility to provide for our elderly and disabled, and then the PBGC, which hopefully we would never have to pay because our private employers will live up to their obligations and to their responsibilities to their employees.

So, I guess the current state of the pension plan funding in the private sector is in such dire straits, that it is just a given that the government is ultimately going to have to pick up the tab, to the extent that we can, for more and more of these defined benefit plans in the future.

Do the current rules just not allow employers the ability or flexibility to manage their plans in as responsible a manner as they need to? Is there too much flexibility?

Mr. WALKER. The fact of the matter is, as Senator Bunning said, if people make a promise, they should be required to deliver on their promise, absent extraordinary conditions. The fact of the matter is, the current rules are not adequate to help ensure that people, in fact, do deliver on their promises.

When companies end up getting in trouble, there are a number of ways in which they can legally cut back or eliminate what they have to contribute, and divert those resources to other priorities. The current system is not adequate.

But with regard to Social Security, what I was talking about was, if you look at the financial condition of the PBGC insurance system and Social Security, there are stark similarities.

In fact, if you look at the chart that Doug put up, the fact is that right now you have a situation where you are going to cross a line when you are going to face significantly negative cash flows that are going to grow indefinitely into the future.

You are correct that the Federal Government has a direct responsibility for Social Security. It does not have a direct responsibility for the PBGC. But I do not think we should take comfort in that. Based upon the trends that we are seeing, it is highly likely that you would be faced with a possible taxpayer bail-out unless fundamental and dramatic reform is enacted sooner rather than later.

Senator LINCOLN. Well, where those lines criss-cross on the PBGC actually occur sooner than they do on Social Security, so in essence maybe there is more of an urgency to deal with, whether it is flexibility or too much flexibility, in making sure that these employers have the ability to provide the pension or the obligations, as Senator Bunning has mentioned, that they have made.

Mr. WALKER. It does cause it sooner. But interestingly, we have already crossed it for Medicare.

Senator LINCOLN. Oh, I know. I guess that is for another day and another hearing, but I am with you on that.

Dr. Holtz-Eakin, I guess I am looking at two distinct components to the conversation we are having today and the continued viability of the external insurance that is provided through the PBGC, and the adequacy of the self-insurance through funding and accounting rules.

Which, I guess, in your opinion, do you think would play the largest role, or should play the largest role, in this discussion? Would it be prudent to discuss one without the other?

Dr. HOLTZ-EAKIN. I think there are complements and that they ought to be considered simultaneously. Firms can either internalize the costs of making sure that their compensation is delivered in the future—those are the funding rules—or they can go to external sources like the PBGC, and, if so, it has to be priced in a way that makes them cognizant of the promises they have made, so they make adequate preparation for it. So, you have to do them at the same time and make sure firms see what they have done.

Senator LINCOLN. So, in essence, there has to be a hammer, too.

Dr. HOLTZ-EAKIN. This is a part of labor compensation. It differs only because of the time lag between when the compensation is awarded and when it is received by the workers. In between, you have to have a way to enforce that contract, and they have to have incentives to comply. External and internal have to line up.

Senator LINCOLN. Well, thank you, gentlemen. You all have been very helpful, and I hope we will continue this discussion.

Thanks, Mr. Chairman.

The CHAIRMAN. Senator Bingaman? Then we will call the next panel.

Senator BINGAMAN. Thank you. Thank you all very much for being here.

Mr. Belt, let me just ask, one part of your proposal—as I understand it—that I have difficulty with is, you limit this preferential funding of executive compensation in cases where the sponsor has junk bonds and is 40 percentage points below required funding, but you do not similarly limit preferential funding of executive compensation when the sponsor is bankrupt. Why would you not do it in both cases?

Mr. BELT. That, I believe—and I will have to check and get back to you on that—if you are referring to that matrix that we had put out——

Senator BINGAMAN. Right.

Mr. BELT [continuing]. That should be also in the bankrupt context as well.

Senator BINGAMAN. Oh, it should?

Mr. BELT. Yes.

Senator BINGAMAN. All right. Because the matrix does not show that.

Mr. BELT. Currently, companies in bankruptcy cannot fund executive compensation without approval of the bankruptcy courts, so the proposal does not specify bankruptcy as a trigger for the restriction.

Senator BINGAMAN. All right.

Mr. BELT. If I am incorrect in that regard, we will certainly let you know as soon as possible.

Senator BINGAMAN. Thank you.

Mr. Walker, let me ask you, since you have spent much of your career on this set of issues, you have reviewed the administration's defined benefit funding proposals.

Could you give us any specific suggestions? If we were to go ahead and enact those proposals, in your view, would that resolve the problem, or are there things that we ought to do in addition that are not included there, or are there some things included there that we should not do?

Mr. WALKER. I think there are a number of provisions in the administration proposal that have merit. If I can, let me summarize what I think you need to do by category, and I would be happy to provide more details later.

First, you need to strengthen the funding rules and make them tougher for plans that represent a real risk, but provide additional flexibility for tax-deductible contributions in good times.

You need to enhance the accuracy and timeliness of reporting the true funding condition and contribution obligations of pension plans to participants and to the government.

You need to place additional payment restrictions on the payment of certain types of benefits when a plan is significantly under-funded, such as lump sums, and additional restrictions on the ability to increase benefits, and potentially consider plan freezes when a plan is significantly under-funded.

PBGC needs reforms with regard to their premium levels, and to make it a more truly risk-based premium, as well as the nature of their guarantees for certain types of benefits, like shut-down benefits. They also need to have a more meaningful role in high-risk situations than they have right now.

You need to consider whether or not to treat legacy costs of airline, steel, auto, and other industries differently than other situations. Last, you need to lift the cloud of uncertainty with regard to hybrid defined benefit plans like cash balance plans, because they represent the future hope of this system, and right now there is a cloud over them.

I would be happy to get into more specifics. I have testified on this before. We have done work on it. Those are the major elements I believe that the Congress should consider as a package.

Senator BINGAMAN. Is there anything in the proposals that the administration has given us with regard to defined benefit plans that you disagree with?

Mr. WALKER. Senator, if you would not mind, I would like to answer that for the record rather than off the cuff.

Senator BINGAMAN. I would ask, Dr. Holtz-Eakin, if you have any comments on this specific proposal. I do not know if you have studied it in great detail.

Dr. HOLTZ-EAKIN. To the extent we have, we put it out in our analysis of the President's budget in March. Those are the comments for the record, and we would be happy to talk with you in the future.

Senator BINGAMAN. Thank you, Mr. Chairman.

The CHAIRMAN. All right. We thank this panel. I know it took a long time, but you can see the interest that we have in this issue. I thank each of you for participating.

It is now my privilege to call the second panel, so would you please come while I am introducing you.

Patricia Friend, international president of the Association of Flight Attendants will be our first speaker; Mr. Robert Roach, general vice president of transportation, International Association of Machinists and Aerospace Workers; followed by Captain Duane Woerth, president of the Air Line Pilots Association. Then we will also hear from Mr. Glenn Tilton, chairman, president and chief executive officer of United Airlines; Mr. Douglas Steenland, president and chief executive officer of Northwest Airlines; and Mr. Gerald Grinstein, chief executive officer of Delta Air Lines.

We will start with you, Ms. Friend.

STATEMENT OF PATRICIA A. FRIEND, INTERNATIONAL PRESIDENT, ASSOCIATION OF FLIGHT ATTENDANTS—CWA, AFL-CIO, WASHINGTON, DC

Ms. FRIEND. Thank you, Mr. Chairman. Thank you for the invitation to testify today.

I do appreciate having the opportunity to share our views with the committee on this issue. It is an issue that has a profound impact on hundreds of thousands of working women and men in the aviation industry.

My name is Patricia Friend, and I am the international president of the Association of Flight Attendants-CWA, AFL-CIO. We represent 46,000 active flight attendants at 26 airlines.

Our active and retired flight attendants at United Airlines, numbering approximately 28,000, are currently the only flight attendants at a major airline represented by AFA that still have a defined benefit pension plan.

As you all know, that changed early last month when a Bankruptcy Court judge ruled, at the request of United Airlines' management, to approve an agreement between United and the Pension Benefit Guaranty Corporation, under which the agency is expected, in exchange for a $1.5 billion payment from United Airlines, to terminate our pension plan.

We were shocked and outraged by this decision after the earlier announcement by the PBGC that our plan can, and should be, maintained as United emerges from bankruptcy.

I would like to take just a few moments to remind everyone here today that this issue has a human dimension which so often gets overlooked in the important discussion of financial facts and figures.

Many of our members are now looking at the possibility of working many years longer than they had intended, and for those recently retired, many are now trying to figure out how they can pay for the basic necessities of life.

These are not careless people who fail to plan for their retirement. They did everything right. They worked hard, they saved as much as they could, and they invested when possible. Their only mistake was one of trust. They trusted the retirement promises that United made for decades.

Our members have made repeated financial concessions over the past several years in order to keep our airlines alive and profitable. We, the employees, have given decades of our lives to these companies. We have much more at stake in the airlines' survival than do most members of upper-level management.

Management comes and goes in this industry, and often with huge financial incentives to do so. United's current CEO, Glenn Tilton, for example, can leave the company at any time and still collect his bankruptcy-proof $4.5 million pension.

We have tried repeatedly to negotiate with this company on alternatives to save our pension plan, but each proposed solution was rejected out of hand. The company seeks only termination.

They refuse to look at each pension plan individually, but rather insist on lumping them all together. We believe that each plan should be judged on its own viability. Both ERISA and the Bankruptcy Code envision such an evaluation. As you heard from one of the previous witnesses, we also worked with the PBGC to find an alternative to termination that would allow our plan to survive.

There has been much discussion today about how we can achieve a long-term fix to the pension crisis rocking the airline industry. There have been some reasonable proposals brought forward which deserve some serious debate and possible enactment into law.

I strongly urge each and every member of this committee to co-sponsor S. 1158, the Stop Terminating Our Pensions Act, or STOP Act. This legislation, versions of which have been introduced in both the House and the Senate, would only cover those plans whose plan sponsors are currently in bankruptcy and whose unfunded liability, on a termination basis, is $1 billion or more.

Passage of this legislation is needed immediately. It would give us time to return to the bargaining table with United Airlines to try to find a solution to this problem.

This 6-month moratorium would also give you, the distinguished members of this committee, and the rest of your Senate colleagues the time to debate and consider the various proposals to strengthen and protect defined benefit pension plans in this country.

Please give us the time that we need to try to save our pensions. I urge the U.S. Senate to consider and pass the STOP Act as quickly as possible.

In closing, and returning to the human side of this issue, I leave you with the words of one of our members who recently wrote to the House Education and Workforce Committee:

“My name is Jaime Manley. I am a 46-year-old woman. I am a wife. I am a mother of four young children. I am the daughter of a proud World War II and Korean War veteran.

“I am also a daughter of a liberated 1960s feminist who worked to put food on the table for her family. I am a sister, an aunt, a friend, and a neighbor. I am honest, hard-working, faithful.

“I am college-educated, community-oriented, and family-driven. I am the girl next door. I am exactly what United Airlines sought when they hired me as a flight attendant 21 years ago. I am their past, but also United Airlines’ future.

“I am a promise broken. I am despair. Can you see my face yet? I am sad, I am worried. I am the face of 20,000 flight attendants who may lose their defined benefit pension. I am a burden to the taxpayers. I am Jaime Manley.”

We remain resolute in our determination to save our pension plan at United. For me as a United flight attendant, this is also a very personal issue. Please send a message to Jaime Manley and all the flight attendants at United Airlines: pass the STOP Act and work diligently to find a solution to our pension crisis.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Friend appears in the appendix.]

The CHAIRMAN. Mr. Roach?

STATEMENT OF ROBERT ROACH, JR., GENERAL VICE PRESIDENT, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS, UPPER MARLBORO, MD

Mr. ROACH. Thank you, Mr. Chairman and members of the committee, for the opportunity to speak to you today.

My name is Robert Roach, Jr. I am the General Vice President of Transportation for the International Association of Machinists and Aerospace Workers. I am appearing on behalf of the international president, Thomas Buffenbarger.

The Machinists Union represents more than 100,000 U.S. airline workers in almost every classification, including ramp service, mechanics, public contact, and flight attendants.

As a TWA employee myself, my pension plan and the pensions of 36,500 other participants were terminated on January 1, 2001. For 30 years of service, I will receive a PBGC check of approximately $205 a month, which is 50 percent less than the pension check my father received in 1973 for 25 years of work in his industry.

The airline industry is a cyclical business. Any time the economy slows or fuel prices temporarily decline, the transportation industry is affected. Instead of raising ticket prices to cover these added costs, it has become acceptable for airlines to erode employee wages and benefits.

Current pension funding laws do not help. Companies are not required to put money into pension plans, even when they are not 100-percent funded, and in most cases when they can afford it. Consequently, corporations must put in enormous sums to catch up. This loophole must be closed.

This problem was identified by the IAM at United Airlines in 2000. If United heeded the IAM's warnings 5 years ago, 30,000 people would have had their pensions protected from the airline's failure to manage its pension plans and its business.

We advised United Airlines in 2000, the current management at that time, that we did not believe, based on actuarial information, that their pension plan was fully funded, as they had indicated.

We had advised and proposed that they freeze their current plans in order to avoid further erosion and go into a well-funded, multi-employer plan. This proposal was denied by United Airlines, basically because it would have to fund that multi-employer plan on a monthly basis rather than not pay, as has been previously discussed today.

Pension plans are not perks by airlines, they are deferred compensations earned through hard work, negotiated reduced wages in exchange for retirement income. U.S. Airways, the only surviving plan, is the multi-employer IAM national pension plan that we have successfully negotiated for our fleet service employees or members.

While our members enjoy the security of participating in a fully funded pension plan, the employer has the benefit of predictable, regular pension contributions. Multi-employer pensions are established and run only for the purpose of providing retirement benefits. Since the contributions are collectively bargained, employers cannot simply decide to stop funding these plans in order to free up cash for other purposes.

At Continental Airlines, where we have identified a pension problem today, we proposed they fully fund that pension plan. That proposal has been denied by Continental Airlines. We have now proposed that they go into a multi-employer plan, and hopefully we will be successful in negotiating that for our Continental flight attendant members.

Northwest Airlines has said without drastic legislation or reform, it, too, will have to terminate its pension plans. Congress must find ways to assist corporations with unfunded plans to become more involved in multi-employer plans.

We believe that well-funded, well-managed multi-employer plans may be the answer, if we can get some of these companies that have single-employer plans that are not being well-managed into multi-employer plans.

But these multi-employer plans that are well-financed and well-managed need to be incentivized, and the Congress needs to help in that area, to help the PBGC think outside the box and do some things to protect those pensions.

For example, the IAM and United Airlines had agreed to a proposal which would have saved the PBGC, in our opinion, $500 million. The cost of terminating the IAM pension plans at United is $1.4 to $1.5 billion. We believe that we could have saved that plan and moved into a multi-employer plan for about $1 billion. That was denied by the PBGC, based on the current law or current policy.

Failure to address this problem today will result in government assisting participants in these plans either through funding the PBGC or through welfare or other government programs at a later date.

Congress created the PBGC to act as a safety net for companies that could not meet their pension obligations. The pension benefits for more than 34 million workers are now at risk because corporations that were not legally required to pay into these plans did not do so, and can ill afford to make these payments today.

Those that can afford to pay today are considering dumping their pension liabilities on the Federal Government and the taxpayers, simply to be competitive. This is not acceptable to the Machinists Union, and it should not be acceptable to this committee. And I am sure it is not acceptable to the American people, the American taxpayer who ultimately will pay this bill.

The Machinists Union supports a moratorium on the PBGC-initiated terminations to give Congress time to examine this pressing problem and craft a solution. Congress must make bankruptcy a less attractive mechanism to dump pension plan obligations on the PBGC.

Under current bankruptcy laws, a company can shed its pension obligations and simply restructure and prosper, and the Federal Government and taxpayers are still left with the company's pension liabilities.

Long-term pension reform is necessary and must protect benefits, while making pension funding more predictable for companies. The Machinists Union is prepared to work with Congress to protect the earned pension benefits of the American workers.

I thank this committee for inviting us to participate in these proceedings and for listening to our concerns.

Senator LOTT. Mr. Chairman?

The CHAIRMAN. Yes?

Senator LOTT. I am going to have to leave. I just would like to ask that my statement that I had for this hearing be included in the record at the beginning of the hearing.

I would like to apologize to our remaining four witnesses. I really wanted to hear what you had to say, but unfortunately we now are jammed up on our schedule with a critical vote at 12 o'clock.

So, I have already read your testimony. I think you have some suggestions on how we get out of this problem. So far, we have heard a lot about what has happened, but I want to know what we are going to do in the future.

So, thank you for being here. We will look forward to hearing from you and working to try to come up with a solution.

[The prepared statement of Senator Lott appears in the appendix.]

The CHAIRMAN. Captain Woerth?

STATEMENT OF CAPT. DUANE E. WOERTH, PRESIDENT, AIR LINE PILOTS ASSOCIATION, INTERNATIONAL, WASHINGTON, DC

Captain WOERTH. Thank you, Mr. Chairman. I am Duane Woerth, president of the Air Line Pilots Association.

In light, again, of your vote, I am going to be very direct, if I may. And certainly my written testimony is lengthy, and I am sure you will allow it to be entered into the record.

I would like to talk about the solution. I would like to thank Senator Rockefeller and Senator Isakson for introducing what I think is a very pragmatic and timely solution to the pension problem facing the aviation industry, in particular.

I represent the pilots at U.S. Airways, and that was a tragedy. I represent the pilots of United Airlines, and that is a tragedy. I also represent the pilots of Northwest, Delta, and Continental Airlines, and I really believe if the framework of S. 861, introduced by Senator Isakson and Senator Rockefeller, is adopted and embraced in some pension legislation this year in a timely manner, that we can do three things: we can keep those other airlines out of bankruptcy and protect the shareholders and creditors. But more importantly, we can prevent the termination and loss of that earned income, those earned benefits for all those employees. It is possible.

The third thing that comes from that bill is, because of the non-bankruptcy, non-pension plan termination, because of the freeze element and the long-term amortization, the Pension Benefit Guaranty Corporation will not be faced with absorbing all those unfunded liabilities and those other problems that will eventually be in front of the Congress.

So, I have plenty of blame to go around. We have learned for a long time about the failed pension rules. We have heard these government witnesses in multiple other hearings in front of your committee, in front of the Commerce Committee.

There are plenty of things wrong with the pension funding rules. I am trying to focus our attention and the attention of this committee. I am very, very grateful that you are having this hearing, Mr. Chairman.

If we can focus on those elements of the aviation industry, and one of the things that you asked in having this hearing was, what are the lessons learned from, particularly United, but also the previous U.S. Air bankruptcy?

What we have learned is all these legacy carriers were on the same path. U.S. Airways and United got there first, but I can tell you with absolute certainty, Delta Air Lines, Continental Airlines, Northwest Airlines, and eventually American Airlines are on that same path. Without the action of a very pragmatic Finance Committee taking the lead and getting something to the floor of the Senate, the same tragedy is going to occur again.

I think this committee has always acted extremely responsibly and pragmatically and moved necessary legislation, and taken action before a tragedy. Now we certainly know the absolute, positive outcome that is going to happen, and it cannot be prevented without your action.

I thank you for holding this hearing, Mr. Chairman, and I will answer any questions you may have.

The CHAIRMAN. Thank you.

[The prepared statement of Captain Woerth appears in the appendix.]

The CHAIRMAN. Mr. Tilton?

STATEMENT OF GLENN F. TILTON, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, UNITED AIRLINES, CHICAGO, IL

Mr. TILTON. Mr. Chairman, Senator Baucus, and distinguished members of the Finance Committee, thank you for inviting me and United Airlines to testify today.

The topic of today's hearing is, "Preventing the Next Pension Collapse: Lessons Learned from the United Airlines Case." I can tell you, as I have been the chairman and chief executive officer at United Airlines since September of 2002, what precisely we have learned from our case, as we have dealt with the industry's business and its financial realities.

As my colleagues on the panel will attest, while the Nation's retirement system is facing a significant crisis, as we have discussed this morning, the airline industry is undergoing its own crisis.

Major carriers have massive legacy costs, as was mentioned a moment ago. All the carriers are squeezed in a vice between lower yields and higher fuel costs. Not surprisingly, predictions that the U.S. airlines would return to profitability this year did not come to pass.

United has done most of the hard work necessary to put its financial house in order and to prepare to compete as a viable, sustainable enterprise. During this time, as my colleagues on the panel have already stated, our employees have set record operating performance results, and it is counterintuitive for a company in our situation.

Throughout the restructuring, as was mentioned a moment ago by the Senator, United has worked tirelessly to preserve our employees' defined benefit pension plans. We devoted 14 months to constructing a business plan to secure an Air Transportation Stabilization Board loan guaranty on terms that would have allowed our company to preserve its pension plans.

A year ago, the ATSB rejected United's final loan guaranty application for a modified $1.1 billion, advising us instead to pursue exit financing from Chapter 11 with the financial and capital markets.

When we did, it became very clear that, given continued pressures on revenue and record fuel prices, United Airlines could not meet the financial targets necessary to be financeable without the termination of pension plans and further labor cuts.

Even so, we worked with our unions, our actuarial experts, our financial and legal advisors, our board of directors, our creditors committee, and in fact every one of our stakeholders, to scrutinize every alternative that would allow us to meet our financial targets and keep our pensions.

Last year, we told our labor groups and other constituents that we would examine any alternative to pension termination and replacement that was viable. By January of this year, no workable alternatives were found. We extended the search for another 4 months and, despite everyone's efforts, we failed to find viable alternatives to termination and replacement.

When it became clear to the management team of the company, the board of directors, and the creditors committee that the termination and replacements of our pension plan was the only viable option, we proceeded to court.

At the same time, we were in discussions with the Pension Benefit Guaranty Corporation. It was decided that the best route at this time was an involuntary termination by the PBGC, whereby the PBGC obtained securities and a stake in United's future.

In our view, the PBGC settlement is fair and equitable to all. It provides cost savings and stability necessary for United to exit from bankruptcy, and it is superior to the recovery that the PBGC would receive as a creditor. That does not change the simple fact that this has been extremely difficult for our employees and our retirees, and is certainly not an outcome to be desired by anyone.

As the prior panel said, since United began offering pension plans to its employees in 1941, the company has done everything required by law and more to safeguard those plans for United's employees.

And since the Employee Retirement Income Security Act inception in 1974, we followed fully the rules and regulations and paid for our PBGC premiums and plan contributions, even while in bankruptcy, until the ATSB's final rejection of our loan guaranty application last summer.

From the outset of the bankruptcy process, our mission has been to enable United Airlines to succeed as an entire enterprise. Without success for the enterprise, the rest is academic for United Airlines and our employees.

Without termination and replacement of pensions, United's future and the jobs of 62,000 employees will disappear, along with the economic contributions to hundreds of communities, our business relationships with hundreds of suppliers and partners, and United's continuing wage and benefit payments, including replacement retirement plans, and the pension plans would still be terminated.

United's unions understand the industry and economic realities that we face, and all but one have agreed to the retirement plan changes that must be made. We now have agreements in place on long-term labor cost savings with all of our unions, ratified or in principle, and with every union group but the Association of Flight Attendants on pension changes. We continue to meet with the AFA on the discussion of replacement plans. I met as recently as last week with the president of the AFA personally.

These agreements have moved United forward significantly in our restructuring, and they set the stage for our exit from Chapter 11. The choice we faced with United was quite simple: for our employees, it is keeping jobs and replacing their existing pension plans with consensually negotiated replacement plans, or losing jobs and terminating pensions.

Mr. Chairman, we at United agree with many of the policy issues that you and House Chairmen Thomas and Baynor have identified, and in particular, we support your commitment to having a comprehensive approach to solving these problems.

We have learned from United's restructuring over the many years that reform of the pension laws cannot succeed if it is done incrementally or piecemeal. There really is no quick fix.

Thank you.

The CHAIRMAN. Thank you, Mr. Tilton.

[The prepared statement of Mr. Tilton appears in the appendix.]

Now, Mr. Steenland?

STATEMENT OF DOUGLAS M. STEENLAND, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORTHWEST AIRLINES, MINNEAPOLIS, MN

Mr. STEENLAND. Mr. Chairman, Senator Baucus and members of the committee, thank you for the opportunity to testify today.

Northwest is the world's fourth largest airline, with over 70,000 pension plan participants in our three defined benefit pension plans.

Today, Northwest and other airlines' defined benefit plans are in critical condition. As you know, both United and U.S. Airways have already terminated their defined benefit plans in bankruptcy and transferred them to the PBGC. Absent immediate action by the Congress, the defined benefit plans at Northwest and at other carriers may very well suffer the same fate.

Mr. Chairman, I am convinced that there is a sensible path out of the difficulty we all find ourselves in. Let me tell you how we got here and how we can get out.

At the end of 1999, the airline industry's defined benefit plans were more than 100-percent funded, on average. In 2000, Northwest plans, in the aggregate, were also more than 100-percent funded.

Today, that same funding level for airline defined benefit pension plans has dipped to less than 60 percent. At the end of 2004, Northwest plans were also funded at less than 60 percent. This is the case, even though Northwest contributed half a billion dollars more than the minimum contribution requirements over the past 10 years.

Why has this happened? Among other things, 3 years of stock market declines, record low interest rates, and September 11, which began the current airline industry crisis.

As a result of these events, the deficit-reduction contribution, or DRC, rules kicked in and required that Northwest and other carriers make massive additional contributions to our defined benefit plans that we cannot afford.

It is difficult to overstate how profoundly the DRC has impacted the funding, or more precisely the under-funding, or our defined benefit plans. It is as if Congress had issued an edict to homeowners with 30-year mortgages that if the value of their homes dropped below 80 percent of the purchase price for whatever reason, their loan and mortgage would be accelerated so that the balance would now be due in just 3 to 5 years.

Worse yet, that accelerated funding kicks in at a time when homeowners cannot repay their loans because of the very same adverse circumstances that caused the value of their homes to drop.

In fact, when the DRC kicked in for the airline industry, the industry was, and remains today, in the midst of its worst financial crisis ever. The reasons for this are well-known.

In short, the current funding rules are too volatile, unpredictable, inflexible, and too expensive for our company to survive and compete in the modern deregulated airline industry that demands we deliver service to our customers at a competitive price.

Northwest has concluded that defined benefit pension plans simply do not work for an industry that is as competitive as we are and that is as vulnerable to forces ranging from terrorism to international oil prices.

Given this reality, absent legislation, Northwest could be faced with a stark choice. We can follow United Airlines and U.S. Airways, file for bankruptcy, and apply to terminate our defined benefit plans. We all know that this is a lose-lose approach.

Our retirees' and our workers' pensions will be reduced to the PBGC guaranty level, and the PBGC will be left to assert a claim for pension under-funding that will be satisfied in the Bankruptcy Court process for pennies on the dollar.

Alternatively, Congress can enact legislation that allows us to fully fund our defined benefit plans and to make a gradual and orderly transition from defined benefit plans, while at the same time protecting our employees, retirees, and the PBGC.

Working with our labor unions and other airlines, we have developed a proposal that would allow us to follow the second course. We are grateful to Senator Isakson and Senator Rockefeller for introducing legislation that would embrace these ideas.

Specifically, the proposal would do the following: stop adding to the under-funding of airline plans by requiring airlines and their affected unions to freeze their plans, thereby ceasing future benefit accruals. In that regard, Mr. Chairman, it is at least Northwest's intent that we would adopt a hard freeze of our pension plans.

Second, we would protect the PBGC by freezing the PBGC guaranty. Finally, we would permit airlines to refinance the frozen and already existing pension obligation by extending the term of this pension "mortgage" from its current DRC-imposed 3- to 5-year period to a longer amortization period.

Under this proposal, retirees and plan participants would receive the benefits that they had earned to the date of the freeze. Retirees would be protected. In addition, the PBGC will be in better shape financially, since its liability will be capped and each payment that an airline makes to the plan will reduce that liability. The alternative is pennies on the dollar that the PBGC would receive.

To summarize, Mr. Chairman, we are not seeking a subsidy or a bail-out from the government, just the opposite. We are asking for a responsible alternative to current law that would let us pay our pension obligations ourselves, versus shifting those obligations onto a government agency.

Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Steenland appears in the appendix.]

The CHAIRMAN. Now, Mr. Grinstein?

STATEMENT OF GERALD GRINSTEIN, CHIEF EXECUTIVE OFFICER, DELTA AIR LINES, ATLANTA, GA

Mr. GRINSTEIN. Thank you, Mr. Chairman and Senator Baucus, for calling this hearing. I know it is on short notice.

I am here in support of the bill introduced by Senators Isakson and Rockefeller, S. 861, and I am representing 85,000 active and retired employees of Delta, who in turn have 85,000 dependents. So, I am speaking on behalf of 170,000 people who have an interest in this legislation.

Behind me in the room—and this shows you the level of trust we have developed at Delta that I am comfortable sitting here with them behind me—we have representatives of the retired non-pilots. Cathy Cone is a former flight attendant; Jim Gray is representing the retired pilots of Delta; Bill Morey represents the active employees; and Mike Pinho, the Air Line Pilots Association. They all have a vital interest in this.

What I would like to do is just have my written statement included in the record, and speak a little bit about the legislation.

The CHAIRMAN. It will be included.

[The prepared statement of Mr. Grinstein appears in the appendix.]

Mr. GRINSTEIN. I think it is important to know that at Delta we have terminated our pilot pension plan, defined benefit plan, and they are now on a defined contribution plan that was negotiated last year.

Our non-pilot employees are on a 7-year transition, beginning in 2003, from a defined benefit plan to a cash balance plan.

The situation that we confront in our industry has grown even more urgent since U.S. Airways and United Airlines shed approximately $15 billion in pension obligations in an effort to secure financing needed to emerge from Chapter 11. These moves place additional competitive pressure on Delta and other legacy carriers facing large, immediate funding contributions at a time when we can least afford them.

As a result, airlines are at a crossroads. Without changes to the current rule, airlines will almost certainly be forced into bankruptcy and the transfer of additional pension liabilities to the PBGC.

Alternatively, if Congress chooses to move swiftly to pass legislation that provides a manageable, affordable pension funding schedule, airlines will have a far greater chance to continue, out of court, the business transformation the new marketplace requires.

The decisions made now about the pension funding crisis will be far-reaching and profound. They will affect the future of airline employees and retirees, the Pension Benefit Guaranty Corporation, the traveling public, and the major network airlines that, despite financial challenges, continue to serve as the backbone of our Nation's air transportation system.

Delta believes S. 861, the Employee Pension Preservation Act, offers a workable solution to the crisis by balancing the interests of all parties. First, employees and retirees would have a greater chance of receiving the full pension benefits they have earned rather than see those benefits reduced, perhaps significantly, in a transfer of liabilities to the PBGC.

Second, S. 861 places a primary focus on protecting the PBGC. Let me state clearly and emphatically, Delta is not seeking a subsidy. Instead, we are pursuing an opposite course, one that significantly limits additional PBGC liabilities and allows us to continue funding the benefits our employees and retirees are counting on.

Also, by making it less likely that airlines will transfer additional unfunded liabilities, the bill decreases the risk of a taxpayer-funded bail-out of the PBGC.

Third, S. 861 would benefit the traveling public by providing a solution that supports stability in our Nation's air transport system as the industry undergoes massive change.

Importantly, it is the network carriers with the heaviest pension funding requirements that provide the vast majority of international air service, as well as the primary link between small and rural communities and the world.

Of Delta's 202 domestic destinations, 50 percent are small cities with limited service options: Parkersburg, WV; Meridian, MS; St. George, UT; Portland, ME; Twin Falls, ID; Ft. Smith, AR; Helena, MT; Casper, WY; and Medford, OR are all examples of communities not served by the low-cost carriers whose business models focus on the high-density markets.

Finally, S. 861 would benefit Delta and other airlines by removing an enormous barrier to our ability to access capital markets, a key component in completing the transformation process outside of bankruptcy.

Delta understands the need for transformation and has not been idle. We are taking responsibility for changing our business model to respond to a new marketplace. Compared to 2002, our company is now one-third more productive and cost-effective.

Reaching this point required the hard work and sacrifice of Delta people, including the loss of 23,000 jobs, or a 30-percent reduction in staffing, as well as cuts in pay and benefits throughout the company, and at every level of the company.

Delta, Northwest and other airlines are working together to help prevent further pension collapses and the associated hardships. Record high fuel prices, fierce competition, and a pension funding obligation of $2.6 billion over the next 3 years for Delta alone make changes to current pension rules crucial to this effort.

We look forward to working with this committee to establish a solution that avoids a disorderly, chaotic restructuring of the industry and instead supports a stronger, healthier air transportation system for this Nation and the public it serves.

Thank you. I am available for any questions you may have.

Senator BAUCUS. Thank you very much. Chairman Grassley is going to go vote and come back. He will be back in about 10, 15 minutes.

I have a question for you, Mr. Tilton. I do not understand, frankly, why United did not join in with Delta and Northwest with respect to the legislation that is now being discussed. My understanding is, United was part of the team, then bailed out, decided not to join with the other carriers.

Mr. TILTON. Senator Baucus, very clearly, time had certainly just moved on for United Airlines and we found ourselves in the agreement, as I mentioned in my testimony, with the PBGC seeking a solution that is the very solution that my two colleagues have suggested that they would like to avoid by not filing for the protection of the court, and then determining whether or not they have the ability to sustain their pensions.

Senator BAUCUS. But I understand Delta——

Mr. TILTON. We are without objection.

Senator BAUCUS. Delta and Northwest are not in bankruptcy. They have the same problems as United did then.

Mr. TILTON. Right.

Senator BAUCUS. Why did you not join in with Delta and Northwest and try to get Congressional relief?

Mr. TILTON. Actually, I think that was more a function of simply timing. We had really moved well into the chronology that I described to you before the initiative that my two colleagues have——

Senator BAUCUS. But why did you not seek something like that to avoid terminating the plans?

Mr. TILTON. Well, for the period of 14 months while we sought to secure a loan guaranty, our view in the company was that the most responsible fiduciary for us was to pursue the loan guaranty.

Senator BAUCUS. And that was declined.

Mr. TILTON. And that was declined.

Senator BAUCUS. So then why did you not pursue the other option?

Mr. TILTON. Well, because at that point, frankly, we were running out of options within the conduct of our restructuring and our bankruptcy, and it was incumbent upon the company to talk to the PBGC about the exit from bankruptcy of the company.

This, in our view, despite the fact that it is appropriate for companies that have not yet entered bankruptcy, would not be a solution to the difficulties that we have while we are in bankruptcy.

Senator BAUCUS. Well, let us say you are out of bankruptcy, just for the sake of argument, and this legislation would have passed. How much would that help you? Could you continue the benefits under the pension plans?

Mr. TILTON. Well, the PBGC has already made the decision.

Senator BAUCUS. I am not talking about PBGC. This is just a big, hypothetical question here.

Mr. TILTON. I do not know the hypothetical answer, Senator.

Senator BAUCUS. What is your best guess?

Mr. TILTON. My sense is, in talking to the PBGC, there is at least the possibility that a plan could be restored, and they have the authority to do so if indeed the funding, the reform, pension reform, were to provide the company different circumstances than those that we face today.

Senator BAUCUS. So if the legislation were to pass, would you seek restoration?

Mr. TILTON. It is actually the responsibility of the PBGC.

Senator BAUCUS. Would you seek it, I asked?

Mr. TILTON. We would, if, in fact, we had the opportunity with a particular constituent group to do so to the benefit of the constituent group. We may. But at the end of the day, each one of the unions have presented us with a plan for themselves, say the pilots and the machinists, that we have under consideration and we are now pursuing.

Senator BAUCUS. That is in the context of bankruptcy.

Mr. TILTON. Well, it actually works best for them now, so the consensual negotiations that we have underway may well be preferable to seeking restoration.

I think the point that is being made is, to go back to defined benefit plans—take my colleague's testimony to my left—it is not likely for a company that finds itself with legacy obligations, such as network airlines. As we have negotiated defined contribution plans as our colleagues have at Delta, it is probably a more appropriate future for our companies. Since they are consensually negotiated with the recipients of the plans, I would say it is a better outcome, Senator.

Senator BAUCUS. Mr. Grinstein, on the legislation, a concern I have with it, frankly, is that the stretch-out period is awfully long, 25 years. To what degree can that be shortened up?

Another question is, it assumes a certain higher interest rate than is actually the case, because companies get to assume their own higher rate, which lowers their contributions. There is a lot of talk here about mark-to-market and reality, and so forth. Are those provisions that need to be addressed in this legislation?

Mr. GRINSTEIN. Well, I think that there are some moveable pieces. There are dials that can be worked and that we can talk about. I mean, we have a rough idea of the kind of payments that we can afford under the viability plan, and I suspect that this hearing is the beginning of a dialogue to see if we can work that out.

The time period that was selected reflects the long life of that pension obligation, but if the committee feels that it has to be shorter or if there is a change in the interest rate, then I think that can be discussed. But as I say, under the viability plan, we have a level of payment that we believe we can afford and meet all of the obligations that we have.

Senator BAUCUS. What about restricting lump-sum payments? Because right now, with lump-sum payments, I guess the pilots can take out 50 percent in a lump sum, which clearly drained the assets of the plan, which creates more jeopardy for those that stay.

Mr. GRINSTEIN. Senator, I think there is a better solution, and that is to adopt a plan like this. The problem with stopping the lump sum is that you will create a run on the bank.

Once something like that is pending, you will have a massive number of people trying to take their lump sums and leave, and it would make it very difficult to run the company if that occurred.

So if we had a consistent policy and they knew that payments were going to be made and it was affordable by the company, I think that is a much better signal than the other one.

Could I correct one thing? I misspoke, which is why they try to keep me on a text instead of shooting my mouth off.

Senator BAUCUS. Join the club. [Laughter.]

Mr. GRINSTEIN. I said that we had terminated the pilot pension plan. In negotiations, we froze the defined benefit plan and transferred them to a defined contribution plan.

Senator BAUCUS. How much is the solution to the pension problems going to give significant stability to the airline industry? I mean, particularly the hub-and-spoke guys, the network carriers. Just generally, is this 10 percent of the problem? Is it 50 percent of the problem? Ninety percent? I am just curious, for the foreseeable future.

Mr. STEENLAND. I think, Senator, it is the one problem we have that we cannot resolve ourselves. This requires a legislative solution. We clearly have other challenges facing us as we transform ourselves from legacy enterprises that had our foundations created in a regulated environment to an unregulated environment, but those are challenges that we can address through collective bargaining and through negotiations with vendors. This problem requires a legislative change. This is something that we cannot fix ourselves.

Senator BAUCUS. Senator Wyden, I think you are next.

Senator WYDEN. Thank you, Mr. Chairman.

Gentlemen, what I am concerned about, and I want to ask this of the three presidents, is the double standard with respect to pensions.

In fact, Mr. Woerth told *Fortune* magazine, "While thousands of pilots will retire with only a fraction of the pension benefits they earned and expected, airline executives can look forward to retirement knowing that their nest eggs are solid gold."

Now, these executives include the gentleman sitting at the middle of the witness table. I have a worker, for example, Mr. Tilton, in Tigard, OR who is going to get $138 a month after her health insurance premiums.

What do you all propose to do as part of this pension reform effort to eliminate the double standard so that people can say, look, these sacrifices are truly shared? And I would like a response from you, Mr. Tilton, Mr. Steenland, and Mr. Grinstein.

Mr. TILTON. I really, Senator, cannot speak to the legislation, and would propose that my colleagues do that. I will tell you that Captain Woerth will have to explain to me, in fact, what he meant, because in the distressed termination process the most ill-affected of employees in the distressed termination process are the senior executives of the company in a proportionate context.

The PBGC, if you can imagine, the threshold guaranty of some $46,000 a year, applies to a senior executive of the firm who could, in fact, be making several hundred thousand dollars a year. So, in fact, the senior executives, long-serving of the company, suffer a greater loss than any other employee.

Senator WYDEN. Is your pension, Mr. Tilton, shielded from a default in creditors? Just a yes or no.

Mr. TILTON. I have no pension with United. I have no United pension, nor will I have a United pension.

Senator WYDEN. I was under the impression——

Mr. TILTON. I realize that you were.

Senator WYDEN [continuing]. That you were going to receive $4.5 million in what is called a lifetime trust fund. Is that accurate?

Mr. TILTON. No, that is not a lifetime trust fund. Upon my appointment to the position in 2002, I had a value at-risk in the contract I had with my prior employer.

During the negotiations with the board of directors, the creditor committee, and the court, I asked them to protect that value at-risk that I had earned for 32 years with a different employer.

For the record, I have no United pension, nor, since I have not been with United for 5 years, Senator, will I have a United pension, because I am considered by Mr. Bradley Belt to be a non-vested employee.

Senator WYDEN. But you do, in fact, as part of the agreement to come to United, have $4.5 million that will be secure. Is that correct?

Mr. TILTON. That is correct. Of the $4.5 million that was negotiated with the creditor committee and with the court, Senator, $3 million of that has already been dispersed to me, and $1.5 million remains on the condition that I stay with the company for an additional year.

Senator WYDEN. The worker in Tigard is going to have $138 a month, you are going to have $4.5 million as part of what you have correctly said was worked out when you came to United.

Mr. TILTON. Earned elsewhere.

Senator WYDEN. My question is, what would you propose to do to eliminate what clearly seems to be a double standard? I would just like to have each one of you comment.

Mr. TILTON. What we have proposed at United is, upon exit, the employee value proposition include, in large measure, components of compensation that are usually reserved only for executives.

That includes profit-sharing and equity in the new company upon emergence from Chapter 11. Senator, I think that is a very compelling thing for us to propose to the employees.

Senator WYDEN. I would like to see this in the legislation. I mean, you all are coming to Congress once again, asking for Congress to help, and I am going to do everything I can to make sure there is no double standard written into the law.

Mr. Steenland and your colleague?

Mr. STEENLAND. At Northwest, Senator, the answer is easy: there is no double standard. All employees are in the same boat. In fact, the salary plan is taking the lead with respect to looking to get frozen. We have already started the process to freeze the salaried plan as a first step in the process.

Senator WYDEN. So you would support writing into any legislation a prohibition that would shield, for example, executives when the workers have their benefits cut? I mean, I guess, gentlemen, you all are saying that this is no problem.

Fortune magazine wrote in some detail otherwise, that at U.S. Airways, Steven Wolf took his pension in lump sum of $15 million when he stepped down in March, 2002, 6 months before the company filed for Chapter 11. You all keep saying that there is no problem here. I want to make sure that if Congress steps in and legislates again, that it is locked into the law that there is no double standard. I would just like a yes or no.

Mr. STEENLAND. I can only speak for Northwest. There is no double standard there.

Senator WYDEN. Mr. Grinstein?

Mr. GRINSTEIN. Well, I would say the same is true at Delta. I do not want to pretend to be a goody two-shoes, but none of our senior executives have contracts. I do not have a contract. I have no retirement plan, I have no bonus plan, I have no pension plan.

Senator WYDEN. I am aware that you took responsible steps before you joined the plan.

You will support legislation that there be no double standard?

Mr. GRINSTEIN. I am against double standards.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Yes.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you.

The CHAIRMAN. Senator Wyden, will you tell Senator Frist to hold the vote for Senator Rockefeller? Because he stayed here so I could go vote.

Senator ROCKEFELLER. Just two quick questions, and the others I will submit for the record.

[The questions appear in the appendix.]

Senator ROCKEFELLER. First, to Duane Woerth. With respect to this bill that Senator Isakson and I have offered, there was a similar experience with Air Canada, was there not, that you are very familiar with?

Captain WOERTH. Yes, there was.

Senator ROCKEFELLER. The time might have been a little bit shorter, but the stretch-out period was longer and I believe it made a difference.

Could you explain that?

Captain WOERTH. Thank you, Senator. I can. It actually goes to Senator Baucus' question as well, as to how important pension amortization is to the capital markets. When Air Canada, which was about 65 percent of the total marketplace of Canada, was in bankruptcy and was unable to secure exit financing, the single reason was nobody would finance Air Canada's exit from bankruptcy with the current pension funding rules in Canada, which are similar to ours. They just would walk away. When the parliament of Canada understood that if they would give them a long-term amortization of the pension funding—the defined benefit plans of Air Canada—this would unlock the door. The capital markets would fund Air Canada, and in fact there would be competitive bids. That is exactly what happened. The day that the parliament passed long-term amortization of the unfunded liabilities of Air Canada, four proposals came to Air Canada. Forty-one days after that, they exited bankruptcy. That is how important the capital markets looked at the unfunded liability problem. When a solution is provided—in that case by parliament, and hopefully in this case by our Congress—I think the results will be the same.

Senator ROCKEFELLER. Thank you very much.

Ms. Friend, this is a friendly question for you, but it has a point to it. You are advocating, as I understand it, legislation that would prevent the PBGC from taking over the flight attendants' pension plan.

But the Bankruptcy Court, which is fairly significant, has agreed with a whole lot of experts who have determined that United Airlines cannot emerge from bankruptcy protection without terminating all of its pension plans.

So my question to you is, does your union's position on pensions not put at risk all of the flight attendants' jobs? If United cannot attract investors, we have just heard that from Captain Woerth, and emerge from bankruptcy—and maybe it will not be 41 days, but it would certainly be an advantage—the flight attendants, the pilots, the machinists, and all United personnel may ultimately lose both their pensions and their jobs.

How do you respond to that? Am I wrong?

Ms. FRIEND. Well, in fact, because of the back-room deal that United Airlines and the PBGC made, United Airlines was never actually required to put on evidence in the Bankruptcy Court——

Senator ROCKEFELLER. Am I wrong?

Ms. FRIEND [continuing]. That failure to terminate the pensions would, in fact, prevent them from exiting bankruptcy. The question in front of the court was, should the agreement be approved? That is one of our objections, that they never actually had to prove the standard that is required.

Senator ROCKEFELLER. The Bankruptcy Court has so ruled that all unions have to agree. Everyone has, including Mr. Roach's. Not the membership, but the leadership. You are holding this whole thing up, I think.

Ms. FRIEND. The day that the flight attendants can hold up the progress of a corporation is a day that we will certainly be——

Senator ROCKEFELLER. It is here.

Ms. FRIEND [continuing]. Finally recognized for our position in this industry.

The Bankruptcy Court approved an agreement. That is what the Bankruptcy Court approved.

I would like to respectfully point out that, in light of the fact that Mr. Tilton has indicated that it is possible to have these plans restored, and that the other two CEOs and Captain Woerth, and you, Senator, have indicated that there is a viable possible legislative solution, that that makes the passage of the STOP Act, the 6-month moratorium, even more important, because we can use that period of time to pass this other, more comprehensive legislation and perhaps prevent the kind of tragedies that Senator Wyden was referring to.

Mr. TILTON. If I could, Senator, let me just speak to the bankruptcy judge's comments, specifically to your point. Judge Wiedoff said, "The least bad of the available choices for him here, for me, has got to be the one that keeps an airline functioning and keeps employees being paid."

As I said, United Airlines has come to the point of decision making, not to the point of stall, or of delay, or of moratoriums. We are certainly ahead of the circumstances that my colleagues speak to, and it really is time for us not to do, candidly, what everybody in this industry has done in the past, which is wait for things to get better, because frankly I do not believe they are going to get better, Senator.

Senator ROCKEFELLER. I would agree with that.

I apologize, and I thank all of you. I have to go vote.

The CHAIRMAN. Thank you all for being patient under the circumstances of a vote and people that would like to stay and answer questions, because I assume, as Mrs. Lincoln told me she was going to submit some questions for answer in writing and would not be able to come back, there are probably others of the same mind.

[The questions appear in the appendix.]

The CHAIRMAN. I am going to start with Mr. Grinstein and Mr. Steenland. You are willing to freeze your pension plans in connection with being given more time to fund them. There is nothing in the law preventing you from freezing your plans today.

In light of the very serious financial problems at both your companies and the severe funding deficit of your pension plans, I would like to know why you have not moved to freeze your plans already, or at least tried to reduce future accrual rates.

Mr. GRINSTEIN. Well, I will answer for Delta. As I indicated, with our pilots, we negotiated last October a freezing of the defined benefit plan and it was converted to a defined contribution plan. So in the case of the pilots, that has taken place.

In the case of our non-pilot employees, the defined benefit plan is in the process of being frozen. There is a 7-year transition to a cash balance plan. So, both of those steps really have been taken.

The CHAIRMAN. Mr. Steenland? I asked the question because of the authority of you to unilaterally freeze your plans. In other words, right now, before they get worse. Go ahead.

Mr. STEENLAND. Well, unfortunately, we do not have the unilateral authority. In the case of the salaried plan, we have an application pending in front of the IRS to get their permission to freeze our plan, and we are hoping that they will act upon it very expeditiously.

As to our other plans, the ability to impose a freeze is subject to collective bargaining, and we are in the middle of negotiations with our pilot group and other unions with respect to the elements of what a freeze would look like. If we had the unilateral right to freeze, we would do so promptly and we would have done so already.

The CHAIRMAN. I think you used the words "cash balance plan."

Mr. GRINSTEIN. I was the one that used that. Yes, sir.

The CHAIRMAN. That is not a defined benefit plan.

Mr. STEENLAND. Well, I think it is, but it is different from a traditional defined benefit plan. You do not get the annuity benefit of it.

The CHAIRMAN. Now, my variation of the question that I just asked is, why does it take so long, considering knowledge of how serious the problems are going to be? As Mr. Tilton has said, the future does not look very good. But it has not looked good for a long time.

In other words, it is inconceivable to me how you were not working sooner to find a solution before things reached the full-blown crisis that they are today. Everyone has known that these pension plans are severely under-funded. Everyone has known that these companies are in severe financial distress. That has been the case for some time.

I would like to ask the union leaders why you have not been working earlier to reign in future benefit promises, at least until the funding levels of these plans improve.

Ms. FRIEND. In our last round of concessionary bargaining with the bankrupt United Airlines, we in fact did cap the benefit accrual. No matter how long you work at United Airlines, you cannot accrue a benefit for more than 35 years of continuous service, so we have done that.

The CHAIRMAN. Mr. Roach and Captain Woerth?

Mr. ROACH. As indicated, we proposed to United Airlines in 2000 to freeze that plan and go into a multi-employer plan. We made similar proposals to Northwest Airlines and to Continental Airlines. We recognized this problem in 2000, and we were having discussions and made proposals in order to rectify the situation long before we got here.

As I indicated, as a TWA employee, the plan was frozen for 9 years, and that is why I only get $205 as a retiree from TWA. So this organization recognized the problem a long time ago and tried to initiate steps to correct the problem.

But because of the fact that the correction to the problem would require the airlines to start paying as they should have been paying, as was the testimony from the government, for the previous 5 to 7 years, they were not interested in a fix at that time.

Testimony before a presidential emergency board revealed, back in 2002, I believe it was, or 2001, that United Airlines came to this organization and proposed massive pension increases. We indicated we wanted the pension plan to be frozen at that time rather than these massive pension increases, because we recognized at that time, upon information and belief from our actuaries, that there was no way this was going to get paid. So, we recognized the problem. We made proposals.

We continue to make proposals to rectify the problem and hopefully, through Congress, through the Senate, and through working with these carriers, that we will find a solution to this problem. But we know the problem is there and we do not have our head in the sand. We are trying to fix the problem.

The CHAIRMAN. Captain Woerth?

Captain WOERTH. Thank you, Senator. First, in two of the three airlines that are still in the most serious jeopardy, we have already negotiated a pension plan freeze at Delta. We have also negotiated a pension plan freeze at Continental, and it is under discussion at Northwest.

Prior to this, we have also, out of all these carriers, negotiated massive pay decreases in an attempt to keep the cash flows going so the airlines can continue to operate while we do negotiate. At Delta, it was over a billion dollars a year from the pilots alone.

So, we have continued to do this kind of bargaining. As we have worked with the Congress in looking at pension funding relief that resulted last year, we got a deferment.

We were seeking more, but we got what we got and we are back looking for pension funding rules that will accommodate the concessions that have already been made, and the good faith bargaining to freeze pension plans and move to another system.

S. 861 is a transition rule to a defined contribution plan, and I want to say to Robert, we certainly have no objections to anything that accommodates multi-employers, either.

The CHAIRMAN. Yes.

Mr. Steenland, then Mr. Grinstein, your definition of a freeze as it applies to your company. We will start with you at Northwest.

Mr. STEENLAND. We are in the process of negotiating a freeze, Senator. But in that regard, our intent—and we are willing and prepared—is to operate with respect to a so-called hard freeze.

The CHAIRMAN. All right. Meaning?

Mr. STEENLAND. A hard freeze would, in essence, truly cap the PBGC's liability, which we think is an appropriate public policy coming out of this bill.

The CHAIRMAN. Mr. Grinstein?

Mr. GRINSTEIN. Yes. The freeze that we have been talking about is a freeze from the point of view of the PBGC. Ours is what is called a soft freeze, but it limits the number of years. But we are obligated at Delta to pay on an annual basis whatever increase is there, so from the PBGC's point of view, it is a freeze and the obligation going ahead is on us.

I want to make it clear, in case it is not clear, the obligation that we are talking about is for the past, it is not for the future. Our past liability is frozen.

The CHAIRMAN. But then future benefits can accrue under what you just said?

Mr. GRINSTEIN. No. The company is obligated to pay, on an annual basis, any increase that occurs.

The CHAIRMAN. All right.

Go ahead, Senator Bunning.

Senator BUNNING. That is a very interesting observation, since you are on the verge of bankruptcy. Any increase or any freeze means a freeze, but it does not mean a freeze.

Mr. GRINSTEIN. Well, it does mean a freeze from the point of view of the PBGC. Theirs would be frozen.

Senator BUNNING. How in the world, all of a sudden, you throw your pension program onto the PBGC and you have increased your benefits in the meantime? Somehow it does not make any sense.

I am going to ask you a question about the Isakson-Rockefeller bill, which two of you seem to support. I have a number of questions.

Please explain your thinking about the decision to allow your pension benefit plans to grow during a period when your companies are having problems meeting your existing obligations. Why do you feel it makes sense for Congress to allow you to increase benefits, while at the same time providing your industry with relief from payment obligations?

Mr. STEENLAND. I will speak on behalf of Northwest, Senator. We are not proposing any benefit increases with respect to the existing pension plan.

Senator BUNNING. You may not be, but your colleague from Delta?

Mr. GRINSTEIN. No. I mean, all we have are agreements that we have negotiated with our employees.

Senator BUNNING. But if you want to really get your financial house in order, can you tell me, sir, in the last 2½ years, how many dollars has Delta Air Lines lost?

Mr. GRINSTEIN. Yes, I can tell you how much Delta Air Lines has lost in the last several years.

Senator BUNNING. Would you like to bring it out?

Mr. GRINSTEIN. Well, we lost $5 billion last year.

Senator BUNNING. Five billion?

Mr. GRINSTEIN. Yes.

Senator BUNNING. And how long can a company operate, bleeding $5 billion out the front door? How long?

Mr. GRINSTEIN. Senator, obviously, bleeding only stops—I am sure Dr. Frist would understand that——

Senator BUNNING. I am not sure anybody would understand how bad management——

Mr. GRINSTEIN. But the point is——

Senator BUNNING. No. You are going to listen.

Mr. GRINSTEIN. All right.

Senator BUNNING. How bad management at Delta Air Lines has cost the employees of Delta not only their pensions, but reduced pensions, reduced pay, and reduced everything. You blame it on everybody but your own management group.

Now, I know you have not been there very long, but I knew your past management group pretty well. I knew when you bought ComAir and ComAir was operating completely profitably, to the point where you paid—I never have figured that one out—cash for their stock.

Now you are coming to us and you want us to allow you to do something that I do not think is in the best interests of Delta Air Lines. We want to freeze or reduce your costs, and we want you to do it on your own, because we do not want to force the Federal Government down your throat.

You are going to come to us with your pension program, like United Airlines did, and add $6.6 billion in losses to the PBGC. We do not want Delta to have to do that.

Now, I know you have taken some remedy steps to avoid that, but we do not think you have taken enough.

Mr. GRINSTEIN. Let me try to answer it this way. There are certain things that we can move and certain things that we can change, and we are working on that. As I mentioned in my direct statement, in the last 10 months we have taken $2 billion of costs out of the company, which is an enormous amount.

Senator BUNNING. Thanks to your employees.

Mr. GRINSTEIN. Thanks to all of us, every employee and every person at every level in the company. That was one source of it.

Being smarter, more efficient, and utilizing technology better is another piece of it. Changing the business processes was another piece of it. It is not just one level or one attack, it is going at the problem from every possible angle, including the way you run your system.

We had to make some very tough choices. We had to end our hub at Dallas-Ft. Worth, which was not an easy thing to do. We had to completely reschedule the way we flew Atlanta.

We, in 1 day, rescheduled 51 percent of the airline, and improved dramatically customer satisfaction. So at the same time that we are cutting the costs, we are making significant improvements in the way we take care of our passengers.

But at the same time, fuel has moved up dramatically and has spiked, as you know, at about $58. That was something that was not possible for us to anticipate. If we had had 1999 fuel levels, we would have been a profitable company, but we do not have that.

So, that is something that neither you nor I, I guess, can do anything about, but we can attack the problems that we can move. We can come to you and say, not looking at past mistakes, but what does it take to keep you going and make it a viable airline and continue to operate?

What we want to do is be able to honor the promises that we have made through our pension plans by having this legislation spread those payments out over a longer period of time. But there is probably a lot of blame that can go around for the past. The truth of the matter is, our job—my job, our collective job—is to focus on what we can do to make this company operate in the future.

Senator BUNNING. Well, I hope so, because I have 8,000 constituents who work for your company, and their livelihood depends on whether you survive or whether you do not survive, and I see them on a daily basis.

I hope that your airline is able to avoid Chapter 11, but at the rate of losses, I do not know how that is going to be possible. I am worried about the employees' pension and the suggestions that all of you, and everybody here, have made to make our laws better so what has happened cannot happen again. That is the main thing that this committee is holding these hearings for.

My God, it does not do any good to promise a pilot, an attendant, a mechanic, or anybody in management a certain amount of money if you cannot deliver it in the future. If you cannot stay current with your benefit plans, then you have over-committed somehow.

I can give you chapter and verse on other pensions that are doing quite well, in spite of the fact that fuel costs are very high—not necessarily airlines, but certain other things. Thank you for your time.

The CHAIRMAN. I have just one additional question, then I will call on Senator Wyden.

Mr. Grinstein, you say that the PBGC is protected under the Isakson bill, but it is my understanding that that bill allows the airlines to pick their own interest rate for valuing pension liabilities. Is not the end result of that that if a plan terminates, the PBGC could end up with a bigger liability?

Senator BUNNING. It would.

Mr. GRINSTEIN. Well, if my understanding is correct, and I think my colleague to the right is probably a little more versed in this than I am, we have operated for a number of years under the accrued liability interest rate.

In answer to an earlier question, I indicated that that was one of the dials that I thought we would have a discussion about with the committee as they consider this legislation and what changes they want to have to it.

But the accrued liability level is the way it has been operated for a long time. If we went to the current liability method, I am not sure that we could afford to accommodate the payments that would be due.

The CHAIRMAN. All right.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Mr. Chairman, thank you for your thoughtfulness in terms of giving me this opportunity for some additional questions.

Mr. Tilton, has United discussed its pension obligations and the possibility of defaulting on them with the Department of Transportation, the Department of the Treasury, or any other agency other than the PBGC?

Mr. TILTON. Yes. I think that, in all probability, Senator, what you speak to is the fact that the Department of the Treasury, the Department of Transportation, and the Federal Reserve are the governing body, the governing agencies, of the ATSB Loan Guaranty process.

So in the course of the company's multi-month—as a matter of fact, longer than a year, 14 months—experience of applying for a loan guarantee, which at the end of the negotiation was down to $1.1 billion of guarantee and $900 million at-risk, we had lengthy conversations with representatives from the Treasury and from the Department of Transportation, and from the Federal Reserve.

Senator WYDEN. Did any of those agencies ever suggest steps or recommend to United that your company default on its pension plan?

Mr. TILTON. It is my understanding that, during the deliberations that took place on the occasion of our negotiated $1.1 billion of loan guarantee, the issue of our default was discussed by that body.

Certainly in the course of our deliberations with them, questions were put to the company on many occasions: is your restructuring sufficient without the termination of your defined benefit plans?

There were those certainly on staff, and those associated with the judgment that was going to be made, about our loan guarantee application that suggested to us that they were of a view that the defined benefit plans would have to be terminated for us to be financeable, and ultimately viable.

Senator WYDEN. So, several of these government agencies, on the basis of what you said, did, in fact, recommend that United default on its pension plan.

Mr. TILTON. I would put it another way, Senator.

Senator WYDEN. Could I have a yes or no answer to the question? Did one of the agencies——

Mr. TILTON. I am not them, Senator. So what I am saying is, they begged the question of us: are you financeable and are you viable with the current defined benefit plans?

Our view was that it was our fiduciary duty to do everything we could to sustain them. So, obviously we were in a different place than those who were making the judgment on the loan guarantee.

Senator WYDEN. I have a question for the three of you executives, and I hope we can get a direct answer to this one. What I would like to know from the three of you executives is whether or not, over the last 10 years, your company shifted funds out of the pension plan.

Now, if you did, I would like to know how often. If you did not, then please just inform me of that fact.

Mr. Tilton?

Mr. TILTON. No.

Mr. STEENLAND. No.

Mr. GRINSTEIN. No.

Senator WYDEN. All right.

My last question then for the three of you executives goes to something I am very interested in in terms of the reform legislation that might be considered.

What I would like to ask the three of you is, if you could get a loan for your company from the government in exchange for an equity interest in the company, and this loan would allow you to emerge from the bankruptcy process without discharging your pension obligations, would you take this loan?

Mr. Tilton?

Mr. TILTON. Well, Senator, I think I just answered the question. We pursued that loan for 14 months and we were denied.

Senator WYDEN. All right.

But, I mean, we are going to be talking about legislation here. As you know, we looked on the previous, after-9/11 airline legislation. It is something that I think is a tool for accountability.

That is, in effect, the government can take an equity interest, at least in this case, with respect to the Pension Benefit Guaranty Corporation. So, I am hearing you say that you would be agreeable to our doing that in this legislation as well.

Mr. TILTON. Well, Senator, beyond the legislation, which is really the appropriate purview of my two colleagues, I am about to have, as you know, a government agency with a significant equity stake in United Airlines to facilitate our exit.

Senator WYDEN. Right. But I am going to assume you will generally be supportive.

Mr. Steenland?

Mr. STEENLAND. I think, for Northwest, Senator, the right answer is to freeze the defined benefit plan and then transition into the defined contribution plan. Defined benefit plans, I think from the company's perspective and from our employees' perspective, really do not work in the airline business. The business is too volatile.

The pension program works a lot better where we have a pay-as-you-go plan where, every month, every paycheck, the pension contribution is made, it goes into the employee's account or it goes into an account that is insulated, and we are better off making the transition and transitioning now from the defined benefit world to a pay-as-you-go form of plan.

Senator WYDEN. I understand that is your preference. With respect to legislation, though, would you be supportive of legislation that would, in effect, provide this tool that I think would ensure some real accountability?

Mr. STEENLAND. Well, again, what we are looking to address is the broken DRC provisions. Our goal is to come up with a way to preserve our existing pension plans, short of having to terminate them. So, we need DRC relief in order to do that. If there is a proposal that the committee puts forward that permits that to happen, we will clearly look at it in good faith.

Mr. GRINSTEIN. My answer would be the same.

Senator WYDEN. Again, we would like to work with you in this area, because I think that the Chairman and Senator Baucus have made certainly a conciliatory effort to address the airline industry's concerns.

What I want to do is make sure that we do not just repeat, every 5 to 10 years, the same things that have put us in this mess before. I will tell you, I see a remarkable resemblance to some of what you all have said today, to what has been said repeatedly in the past.

That is why I asked you about something that we have known to work. After 9/11, when the government said it was going to take an equity position with respect to providing assistance to the airlines, we saw that was not abused. That is why I want to get the same sort of approach into the Pension Benefit Guaranty Corporation legislation that we will consider shortly.

Mr. Chairman, you have been very gracious in terms of giving me this extra time, and I thank you.

The CHAIRMAN. I have no additional questions. I just want to thank all of you for spending this time here. Obviously, as you know, in the case of airlines as well as a lot of other industries, because of financial conditions, it is necessary for us to pass legislation.

But we intend to go way beyond passing just the legislation that is necessary to keep an important industry, and an important segment of our economy, viable. Thank you all very much.

[Whereupon, at 12:49 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

TESTIMONY OF BRADLEY D. BELT

Executive Director

PENSION BENEFIT GUARANTY CORPORATION

Before the Committee on Finance

United States Senate

June 7, 2005

Chairman Grassley, Ranking Member Baucus, and Members of the Committee: I want to commend you for holding this timely and important hearing and your continued leadership on retirement security policy issues.

Just a little over three months ago, my colleagues, Assistant Secretary of the Treasury for Economic Policy, Mark Warshawsky, and Assistant Secretary of Labor for the Employee Benefits Security Administration, Ann Combs, and I appeared before this Committee to discuss the challenges facing the defined benefit pension system and the pension insurance program, as well as the Administration's proposals for meeting these challenges. In a supplement to this testimony, I again describe in detail why comprehensive pension reform is so urgently needed and how the Administration's comprehensive reform proposal will stabilize the defined benefit system, strengthen the insurance program, and protect the retirement benefits earned by tens of millions of American workers. I also address the claims made by some commentators regarding the Administration's proposals.

For this hearing, you have asked what lessons can be learned from the United Airlines pension situation. As discussed more fully below, United offers important, albeit painful, lessons that illustrate the flaws in current law and which should guide us in reforming the defined benefit system and pension insurance program.

But first, I would like to briefly highlight new information and marketplace developments in the three months since the last hearing that amplify the growing pressures on the insurance program and provide further evidence why the comprehensive reform measures proposed by the Administration should be enacted as promptly as possible.

The most recent source of information about the financial status of certain pension plans comes from 4010 reports that are required to be filed by companies with pension plans underfunded by more than $50 million. The filing deadline for most companies is April 15, and PBGC has now aggregated the information from those reports. While the number of companies required to file such reports grew only modestly, the amount of underfunding reported by the 4010 filers grew by 27 percent as compared to a year ago – from $279 billion to $354 billion. These 1,108 plans covering 15 million workers and retirees had $786.8 billion in assets to cover over $1.14 trillion in liabilities, for an average funded ratio of 69 percent.

Summary of Pension Underfunding Filings

	2000	2001	2002	2003	2004
Number of Plans	221	747	1058	1051	1108
Underfunding (Dollars in billions)	$19.91	$110.94	$305.88	$278.99	$353.73
Funded Ratio	82.8%	80.0%	65.1%	69.7%	69.0%

Fortunately, not all of that underfunding is in plans sponsored by weak companies. Still, as I stated in my prior testimony, at the end of fiscal year 2004, PBGC estimated that non-investment grade companies sponsored pension plans with combined underfunding of $96 billion, almost three times as large as the amount recorded at the end of fiscal year 2002. We anticipate that this number will increase significantly by the end of fiscal year 2005 due to growing underfunding in financially weak companies. I would also note that PBGC has approximately 350 active bankruptcy cases, a record for the agency, 36 of which have been opened in the past four months. Of the open cases, 37 have underfunding claims of $100 million or more, including six in excess of $500 million.

And, the growing financial challenges being faced by certain companies and industry sectors are a subject of almost daily coverage in the nation's newspapers. We have previously testified about the extent of pension funding problems faced by the "legacy" carriers in the airline industry. In addition to the potential $10 billion in losses from US Airways and Continental, the other legacy carriers - Delta, Northwest, American, and Continental - have plans with total underfunding of $22 billion. Losses continue - in first quarter earnings reports, Delta reported a loss of $1.1 billion, Northwest a loss of $458 million, Continental a loss of $184 million, and American a loss of $162 million. Delta has publicly warned that the company may have to consider bankruptcy. If it does, it may follow United and US Airways and seek to terminate its defined benefit pension plans.

The pension insurance program also faces substantial exposure from other industries, the largest of which is the automotive sector. Assets of pension plans sponsored by this industry fall short of pension promises by $55-$60 billion. Credit rating agencies in May downgraded the debt of General Motors and Ford to below investment-grade status. While the manufacturers have substantial liquidity, their financial problems may cascade down to other companies in the automotive industry. For example, some auto supply firms have had their credit lines restricted because of the downgrades in the debt ratings of General Motors and Ford. At least a dozen auto suppliers' credit ratings have been downgraded to below investment-grade status. More significantly, half a dozen automotive parts suppliers have filed for bankruptcy in recent months - three of them since the last Committee hearing. These bankrupt companies sponsor defined benefit plans with more than $800 million in unfunded pension obligations that would become a loss to the pension insurance system should those companies' plans terminate during their bankruptcies.

I would now like to turn to the focus of this hearing - the implications of the proposed United pension plan terminations for the stakeholders in the defined benefit system. In my view, there are two broad lessons stemming from the United pension situation.

The first lesson is that the current funding rules are demonstrably flawed. Simply put, they have failed to ensure that companies make good on the commitments they make to their workers and retirees. Indeed, the funding rules even allow companies to make new benefit promises when their plans do not have enough assets to meet existing obligations. United, US Airways, Bethlehem Steel, LTV, and National Steel would not have presented claims in excess of $1 billion each - and with funded ratios of less than 50 percent - if the rules worked. Given its size and visibility, United provides an illustrative, if tragic, case study of the shortcomings of the current funding rules.

Provided below are four charts covering United's four pension plans from 1998 to 2003. During the period from 2000 onward, when the true funded status of each of the company's pension plans was deteriorating and the financial health of the company was becoming more precarious, the company:

- put little if any cash into the plans;
- rarely made a deficit reduction contribution;
- never provided any notices of underfunding to participants; and
- almost never paid a variable rate premium.

Yet the company still could claim that its plans were "fully funded" on a current liability basis.

United Airlines Ground Employees Plan

Termination Benefit Liability Funded Ratio 32%

Unfunded Benefit Liabilities $ 2.8 billion

As of March 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	101%	95%	100%	99%	104%	58%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	Y $303.5 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	N
Actual Contributions	$50.0 million	$50.0 million	$0	$0	$0	$52.4 million
Prior Year Credit Balance	$333.2 million	$316.5 million	$323.4 million	$318.1 million	$324.8 million	$333.7 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Pilot Plan

Termination Benefit Liability Funded Ratio 50%
Unfunded Benefit Liabilities $ 2.9 billion
As of December 30, 2004

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	100%	98%	102%	98%	102%	80%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y $6.7 million
Actual Contributions	$15.0 million	$40.0 million	$0	$0	$0	$0
Prior Year Credit Balance	$346.2 million	$393.3 million	$496.6 million	$513.1 million	$560.5 million	$525.5 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Management, Administrative and Contract Personnel Plan

Termination Benefit Liability Funded Ratio 39%
Unfunded Benefit Liabilities $ 2.3 billion
As of May 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	98%	94%	95%	93%	96%	71%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	Y $149.0 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y $4.4 million
Actual Contributions	$50.0 million	$44.9 million	$0	$0	$0	$56.3 million
Prior Year Credit Balance	$162.1 million	$156.7 million	$143.2 million	$156.4 million	$104.4 million	$44.3 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Flight Attendant Plan

Termination Benefit Liability Funded Ratio 42%
Unfunded Benefit Liabilities $ 1.9 billion
As of May 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	91%	88%	91%	88%	94%	75%
Was the company required to make a deficit reduction contribution?	N	N	N	Y $212.3 million	N	Y $187.9 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	N
Actual Contributions	$84.9 million	$65.0 million	$0	$0	$0	$24.7 million
Prior Year Credit Balance	$254.4 million	$311.6 million	$357.9 million	$357.8 million	$289.8 million	$262.6 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

This rosy picture is clearly in contrast with what we know to be the true status of the United plans – currently with an aggregate shortfall of almost $10 billion and an aggregate funded ratio of only 41 percent. There are several aspects of the current funding rules that contributed to this disaster scenario, but I would single out two in particular, which were also noted in GAO's report released last week. [1]

One is the use of so-called credit balances. Just at the point in time when contributions to the plans were most needed as asset values were falling and liabilities growing, the company was able to use credit balances built up during the 1990s bull market to avoid putting cash into the plans. Remarkably, notwithstanding the fact that the United pilots plan is underfunded by almost $3 billion, the company has not made, and has not been required to make, a cash contribution to that plan for the years 2000 through 2004 (and none would have been required until the end of this year). Some have argued that without credit balances, companies will have no incentive to make more than the required minimum contribution during good times. As discussed more fully in the supplement to my testimony, we believe the Administration's proposal provides ample incentives to appropriately fund pension plans.

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[1] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 22 (May 2005).

The other aspect of the funding rules that merits mention is the ability to "smooth" assets and liabilities. (Plans can smooth assets over 5 years and can smooth liabilities based on a four-year weighted average interest rate.) Those who want to retain these mechanisms argue that it is necessary to reduce volatility. But, of course, the volatility isn't reduced, it is simply masked – hidden from the view of participants. The smoothed asset and liability calculations not only allowed companies to report a distorted funded ratio, it also enabled them to avoid the deficit reduction contribution (DRC) requirements, the variable rate premium, and the notice to participants. I would emphasize that these issues are hardly unique to United Airlines.

The second lesson is that the termination of underfunded pension plans adversely affects stakeholders in the defined benefit system. It can have particularly harsh consequences for workers and retirees. Their expectations of a secure future may be shattered, because in underfunded plans not all promised benefits are guaranteed. While United employees, in the aggregate, should receive about 80 percent of their accrued pension benefits, they could still lose more than $3 billion in accrued benefits and would not accrue any future benefits that they had been counting on receiving. Many United employees, especially pilots, would be hard hit by the maximum guarantee limit.

Other companies that sponsor defined benefit plans also pay a price through higher premiums. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must, under current law, be covered by higher premiums. Not only will healthy companies be subsidizing weak companies with underfunded plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its ongoing labor costs onto the government. This is clearly at issue in the airline industry. The CEOs of the legacy carriers have publicly stated that this scenario will give United an unfair advantage and may cause them to seek to terminate their pension plans.

Finally, taxpayers are at risk of being called upon to bail out the pension insurance program if losses continue to mount.

Mr. Chairman, the Administration is committed to strengthening the pension insurance program and keeping defined benefit plans as a viable option for employers and employees. This requires a careful balancing of interests and inevitably will require trade-offs among various stakeholder interests. We believe the Administration proposal strikes an appropriate balance and will best protect the pension benefits earned by workers and retirees, minimize the need for future premium increases, and lessen the possibility that taxpayers will have to be called upon to rescue the insurance program.

PBGC

Protecting America's Pensions

June 7, 2005

SUPPLEMENT TO TESTIMONY BY BRADLEY D. BELT:

CHALLENGES FACING THE DEFINED BENEFIT SYSTEM AND PENSION INSURANCE PROGRAM AND THE ADMINISTRATION'S PROPOSALS FOR MEETING THOSE CHALLENGES

Introduction

Private-sector defined benefit plans have been and are intended to be a source of stable retirement income for more than 44 million American workers and retirees. Unfortunately, as I discuss more fully below, the defined benefit system is under severe stress – the number of defined benefit plans has fallen precipitously over the past two decades, the percentage of the workforce covered by such plans has dropped by half, and, in many cases, benefits are being frozen or the plans are being closed to new participants.

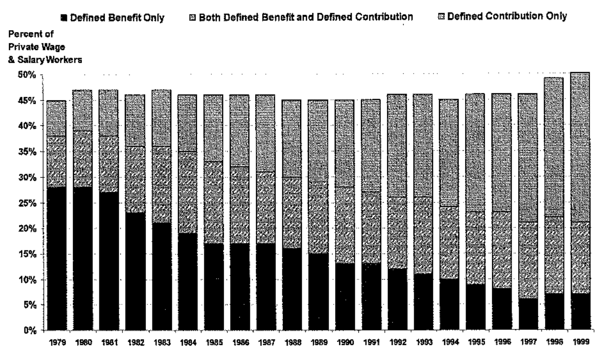
More ominously, there have been a growing number of instances in which plans have been terminated by their sponsors with assets far insufficient to pay the promised benefits. This results in lost benefits for a number of participants in those plans, threatens the long term financial solvency of the insurance program, requires sponsors that have acted responsibly to pay higher premiums, and potentially could lead to a call for a rescue of the program with taxpayer funds.

I would emphasize that this has occurred under the current statutory and regulatory framework. In order to stop the hemorrhaging in the system, to put the insurance program on a sound financial footing, and to best protect the benefits of millions of workers and retirees, the Administration believes that comprehensive pension reform is critically needed. If we do nothing or merely tinker at the margins the inevitable outcome will be a continued erosion of this important retirement security leg and continued large losses for participants, premium payers and potentially taxpayers.

State of the Defined Benefit System

Traditional defined benefit pension plans, based on years of service and either final salary or a flat-dollar benefit formula, provide a stable source of retirement income to supplement Social Security. The number of private sector defined benefit plans reached a peak of 112,000 in the mid-1980s. At that time, about one-third of American workers were covered by defined benefit plans.

Pension Participation Rates 1979 - 1999



Source: U.S. Department of Labor
Employee Benefit Security Administration
Abstract of 1999 Form 5500 Annual Reports

In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate or freeze their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. In the remaining 2,000 cases, companies with underfunded plans shifted their pension liabilities to the PBGC.

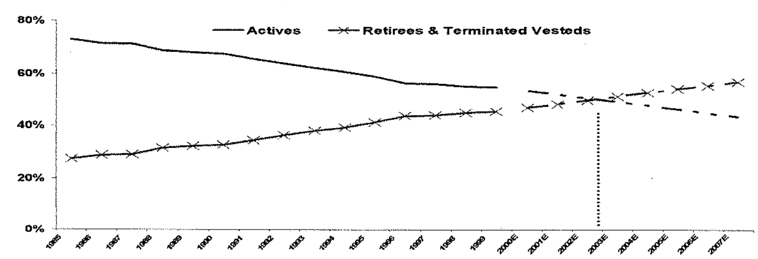
Of the roughly 30,000 defined benefit plans that exist today, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers. Some of these sponsors also face challenges due to structural changes in their industries and growing competition from both domestic and foreign companies.

In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured single-employer plans has increased. In 1980, there were about 28 million covered participants, and by 2004 this number had increased to about 35 million. But these numbers mask the downward trend in the defined benefit system because they include not only active workers but also retirees, surviving spouses, and separated vested participants. The latter three categories reflect past coverage patterns in defined benefit plans. A better forward-looking measure is the trend in the number of active participants, who continue to accrue benefits. That trend is moving downward.

In 1985, there were about 22 million active participants in single-employer defined benefit plans. By 2002, the number had declined to 17 million. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 28 percent of total participants in single-employer defined benefit plans, a number that has grown to about 50 percent today.

In a fully advance-funded pension system, demographics wouldn't matter. But when $450 billion of underfunding must be spread over a declining base of active workers, the challenges become apparent.

Participants in Defined Benefit Pension Plans
[1985 - 2007est.]



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1999 Form 5500 Annual Reports Spring 2004

The decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system are impacting retirement income security. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly "freezing" their plans. Surveys by pension consulting firms show that a significant number of their clients have frozen their plans or are considering instituting some form of plan freeze.[1]

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[1] See, e.g., Aon Consulting, *More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So*, Oct. 2003; Hewitt Associates, *Survey Findings: Current Retirement Plan Challenges: Employer Perspectives* (Dec. 2003).

Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program. [2]

Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants in defined benefit plans.[3] Unfortunately, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees.[4]

The Role of the PBGC

The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to guarantee private-sector, defined benefit pension plans. Indeed, the Corporation's two separate insurance programs—for single-employer plans and multiemployer plans—are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 defined benefit plans that have failed since 1974. In this role, it is a vital source of retirement income and security for more than 1 million Americans who would have lost benefits without PBGC's protection, but who currently are receiving or are promised benefits from the Corporation.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Employee Benefits Security Administration (EBSA). Treasury and EBSA deal with both defined benefit plans and defined contribution benefit plans, including 401(k) plans. PBGC guarantees benefits of defined benefit plans only and serves as trustee for underfunded defined benefit plans that terminate. PBGC is also charged with administering and enforcing compliance with the provisions of Title IV of ERISA, including monitoring of standard terminations of fully funded plans.

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[2] Some of the trends in the defined benefit system are captured in a PBGC publication issued less than two weeks ago, the *Pension Insurance Data Book* 2004 (available at www.pbgc.gov). The *Data Book* shows that since PBGC's inception in 1974, 68 percent of its losses were incurred in the five years from 2000 through 2004. As a result of all these recent terminations, PBGC's annual benefit payments have almost tripled, from a little over $1 billion in 2001 to $3 billion in 2004.

[3] Table S-35, PBGC Pension Insurance Data Book 2004 (April 2005).

[4] *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

PBGC is a wholly-owned federal government corporation with a three-member Board of Directors—the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans (generally only pennies on the dollar). The annual insurance premium for single-employer plans has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the amount of a plan's unfunded vested benefits, measured on a "current liability"[5] basis.

The PBGC's statutory mandates are: (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants; (2) to provide for the timely and uninterrupted payment of pension benefits to participants; and (3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. In addition, implicit in these duties and in the structure of the insurance program is the duty to be self-financing. *See, e.g.*, ERISA § 4002(g)(2) (the United States is not liable for PBGC's debts).

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing with no recourse to general tax revenue. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability, which can pit the interests of participants in a particular plan against the interests of those in all plans the PBGC must insure. The PBGC strives to achieve the appropriate balance among these competing considerations, but it is inevitably the case that one set of stakeholder interests is adversely affected whenever the PBGC takes action. This conflict is most apparent when PBGC determines that it must involuntarily terminate a pension plan to protect the interests of the insurance program as a whole and the 44 million participants we cover, even though such an action may adversely impact participants in the plan being terminated.

The pension insurance programs administered by the PBGC have come under severe pressure in recent years due to an unprecedented wave of pension plan terminations with substantial levels of underfunding. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled $14.7 billion for the year, and the program ended the year with a

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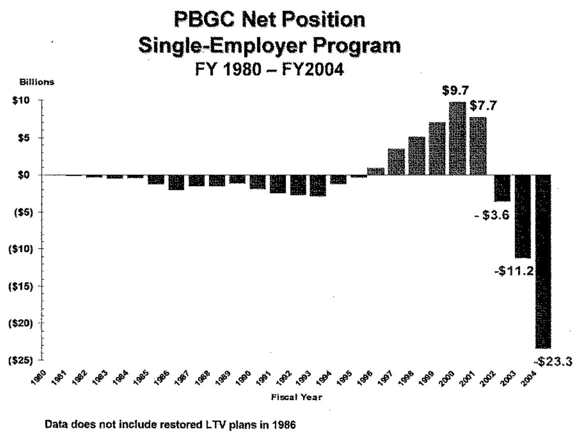
[5] Current liability is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if a plan terminates.

deficit of $23.3 billion. That is why the Government Accountability Office has once again placed the PBGC's single employer insurance program on its list of "high risk" government programs in need of urgent attention.



Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with $62 billion in liabilities and only $39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the resources to fully satisfy its benefit obligations.

The most recent snapshot taken by the PBGC finds that corporate America's single-employer pension promises are underfunded by more than $450 billion. Almost $100 billion of this underfunding is in pension plans sponsored by companies that face their own financial difficulties, and where there is a heightened risk of plan termination.

Of course, when the PBGC is forced to take over underfunded pension plans, we will provide the pension benefits earned by workers and retirees up to the maximum amounts established by Congress. Unfortunately, notwithstanding the guarantee provided by the PBGC, when plans terminate many workers and retirees are confronted with the fact that they may not receive all the benefits they have been promised by their employer, and upon which they have staked their retirement security. In an increasing number of cases, participants lose benefits that were earned but not guaranteed because of legal limits on what the pension insurance program can pay. It is not unheard of for participants to lose two-thirds of their promised monthly benefit.

For example, a steelworker in the Bethlehem Steel plan, like many other steelworkers, started working just before his 20th birthday. He worked until he was 50 years old and retired, like many other steelworkers, under his plan's 30-and-out provision with a $3,600 per month pension. About 6 months later, the PBGC trusteed the Bethlehem Steel plan. Although the maximum monthly benefit for plans terminating in 2003 was about $3,600, we are required by law to reduce the maximum benefit for workers who start receiving their pension benefits before age 65. As a result, this worker's benefits were cut by two-thirds to about $1,200 per month.

Other companies that sponsor defined benefit plans also pay a price when underfunded plans terminate. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must ultimately be covered by higher premiums. Not only will healthy companies that are responsibly meeting their benefit obligations end up making transfer payments to weak companies with chronically underfunded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers.[6] If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of time. As I will discuss in more detail, the status quo statutory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

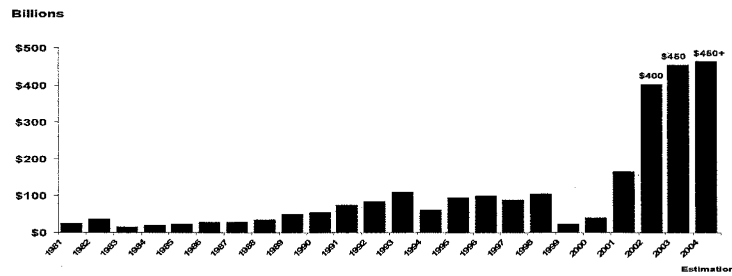
Mounting Pressures on the Pension Safety Net

These broad defined benefit trends, and financial market and business cycles, combined with flawed funding rules, have translated into severe financial pressures on the pension insurance program. In addition to the $23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than $50 billion. Two years later, as a result of a combination of factors, including declining

[6] See page 3, *Pension Tension*, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total underfunding exceeded $400 billion.[7] As of September 30, 2004, we estimate that total underfunding exceeds $450 billion, the largest number ever recorded.

Total Underfunding
Insured Single-Employer Plans



PBGC estimates from Form 5500 and Section 4010 Filings

Not all of this underfunding poses a major risk to participants and the pension insurance program. Indeed, the vast majority of companies that sponsor defined benefit plans are financially healthy and should be capable of meeting their pension obligations to their workers. At the same time, the amount of underfunding in pension plans sponsored by financially weaker employers has never been higher. As of the end of fiscal year 2004, the PBGC estimated that non-investment-grade companies sponsored pension plans with $96 billion in underfunding, almost three times as large as the amount recorded at the end of fiscal year 2002.

The losses incurred by the pension insurance program to date have been heavily concentrated in the steel and airline industries. These two industries, however, have not been the only source of claims, nor are they the only industries posing future risk of losses to the program.

The PBGC's best estimate of the total underfunding in plans sponsored by companies with below-investment-grade credit ratings and classified by the PBGC as "reasonably possible" of termination is $96 billion at the end of fiscal 2004, up from $35 billion just

[7] See page 14, *The Magic of Pension Accounting, Part III*, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005). "[F]rom 1999 to 2003 the pension plan assets grew by $10 billion, a compound annual growth rate of less than 1%, while the pension obligations grew by $430 billion, a compound annual growth rate of roughly 10%." See also page 2, *Pension Tension*, Morgan Stanley (Aug. 27, 2004). "DB sponsors were lulled into complacency by inappropriate and opaque accounting rules, misleading advice from their actuaries causing unrealistic return and mortality assumptions, and mismatched funding of the liabilities, and the two decades of bull equity markets through the 1990s veiled true funding needs."

two years earlier. The current exposure spans a range of industries, from manufacturing, transportation and communications to utilities and wholesale and retail trade. Some of the largest claims in the history of the pension insurance program involved companies in supposedly safe industries such as insurance ($529 million claim for the parent of Kemper Insurance) and technology ($324 million claim for Polaroid).

Reasonably Possible Exposure
(Dollars in Billions)

Principal Industry Categories	FY 2004	FY 2003
Manufacturing	$ 48.4	$ 39.5
Transportation, Communication & Utilities	30.5	32.9
Services & Other	7.9	2.5
Wholesale and Retail Trade	5.8	4.3
Agriculture, Mining & Construction	1.9	1.8
Finance, Insurance & Real Estate	1.2	1.1
Total	$95.7	$82.1

Some have argued that current pension problems are cyclical and will disappear once equity returns and interest rates revert to historical norms. Perhaps this will happen, perhaps not. The simple truth is that we cannot predict the future path of either equity values or interest rates. It is not reasonable public policy to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves. Similarly, it is not reasonable public policy to base pension funding on the expectation that interest rates will increase dramatically.[8] The consensus forecast predicted that long-term interest rates would have risen sharply by now, yet they remain near 40-year lows.[9]

[8] See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005). "Unfortunately things are likely to get worse before they get better. . . As of the beginning of February, the Moody's AA long term corporate index was below 5.50% and 30-year Treasuries were below 4.5%."

[9] Long-term rates have declined in Japan and Europe - to 2.5 percent and 4.0 percent, respectively - two economies facing the same structural and demographic challenges as the United States. See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005).

And a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an all-time high, with more than 90 percent of the exposure unhedged.[10]

More important, while rising equity values and interest rates would certainly reduce the amount of current underfunding, this would not address the underlying structural flaws in the pension insurance system.

How Did We Get Here?

Unfortunately, the current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. They are the result of fundamental flaws in the statutory and regulatory framework governing defined benefit plans and the pension insurance program. If we want to retain defined benefit plans as a viable option for employers and employees and avoid insolvency of the insurance program, fundamental changes are needed.

The defined benefit pension system is beset with structural flaws that undermine benefit security for workers and retirees and leave premium payers and taxpayers at risk of inheriting the unfunded pension promises of failed companies.

The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded. Some companies that have complied with all of the statutory funding requirements have still ended up with plans that are less than 50 percent funded when they terminated.

A second structural flaw is what economists refer to as "moral hazard." Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance and premium methods.

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality.
The PBGC's record deficit and the historic levels of pension underfunding underscore these structural defects – flaws that must be corrected to better protect workers' benefits, responsible plan sponsors from further premium increases, and taxpayers from being called upon to rescue the pension insurance program.

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[10] See page 1, *Defined Benefit Pension Plans' Interest Rate Exposure at Record High,* Seth Ruthen, PIMCO (Feb. 2005).

Weaknesses in Current Funding Rules

The current defined benefit pension funding rules, which micromanage annual cash flows to the pension fund, are in need of a complete overhaul. Current rules are needlessly complex, don't reflect economic reality, and don't ensure that plans become well funded. Some of the pressing problems with the funding rules are described below.

- Current measures of liabilities and assets are not accurate and meaningful.

  - The original ERISA funding targets were set too low and can be manipulated. Under current funding rules, there is no uniformity in liability measures. In addition, a plan actuary has substantial discretion in selecting actuarial assumptions that are used to determine liabilities. For example, the actuary must assume an interest rate that reflects future investment earnings on plan assets; an actuary will commonly assume the high rate of return that is anticipated from investments in equities. As a result, companies can report that their pension plans are fully funded when in fact they are substantially underfunded using a more meaningful and accurate measure of liability. In a study released last week, GAO found that from 1995 to 2002, because of this actuarial discretion, underfunding may actually have been more severe and widespread than reported. [11]

  - The later deficit reduction contribution rules are also ineffective. The deficit reduction contribution rules, adopted in 1987, override the minimum funding requirements for many underfunded plans and require accelerated contributions to plans. These rules are based on "current liability," which is a somewhat more standardized measure of liability. It is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. Employers can avoid having to make deficit reduction contributions by maintaining plan funding at 90 percent of current liability.

    The interest rate used in determining current liability can be selected from a corridor that is based on an average of interest rates over the prior 48 months, and thus can be significantly out-of-date during periods of rapidly changing interest rates. In addition, the current liability is measured using a long-term interest rate that does not take into account the actual timing of when benefit payments will be due under the plan, which often is considerably sooner.

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[11] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 15 (May 2005).

- Risk of plan termination is not recognized in funding. The same funding rules apply regardless of a company's financial health. PBGC studied 41 of its largest claims that represented 67 percent of total gross claims. Over 90 percent of these largest claims against the insurance system were from plans sponsored by companies that had junk-bond credit ratings for 10 years prior to termination. Yet current funding targets do not reflect the substantial risk of termination and losses to plan participants and the pension insurance system posed by financially weak employers. As the recent GAO report notes, speculatively rated sponsors represent greater risks to the PBGC. Plan sponsors that are in financial distress may have a more limited time horizon and place other financial priorities above funding their pension plans. [12]

- Asset values are smoothed. Current funding rules permit the use of an actuarial value of plan assets, which is determined under a formula that "smooths" fluctuations in the market value of assets by averaging the value over a number of years. These smoothing mechanisms were created in an attempt to reduce the year-to-year fluctuations of plan contribution requirements. Masking current market conditions is an imprudent and unnecessary way to avoid volatility in funding contributions, it obscures the funded status of a plan, and it distorts the risks posed to participants and shareholders. The recent GAO report notes that, by smoothing annual contributions and liabilities, a plan's reported level of funding may be distorted. [13]

- Underfunded plans have too long to make up shortfalls and employers can take funding holidays without regard to a plan's funding level.

  - Amortization periods are long. The current law 30-year amortization period for plan amendments is too long given the default risk for many plan sponsors. Furthermore, collectively bargained plans often increase benefits every few years and as a result are perennially underfunded. The deficit reduction contribution override – with amortization periods from four to seven years – was designed to address this problem, but its effectiveness has been limited.

  - Funding rules allow companies with unfunded pension liabilities to take funding holidays or reduce their required contributions. Under current law, companies can build up a "credit balance," for example, by contributing more

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[12] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 4 (May 2005).

[13] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p.22 (May 2005).

than the minimum required amount or by favorable investment performance of pension assets. They can then treat the credit balance as an offset to the minimum funding requirement for the current year. This allows a plan to take a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market, and regardless of the current funded status of the plan.

- The result is that some sponsors are able to avoid making any contributions to plans that may be hundreds of millions or even billions of dollars underfunded. According to the recent GAO study, from 1995 to 2002 on average 62 percent of the 100 largest plans each year received no cash contributions, including 41 percent of plans that were underfunded. [14] Bethlehem Steel made no contributions to its plan for the three years immediately preceding plan termination. US Airways made no contributions for the four years immediately before terminating.

- Maximum deductible contributions are set too low.

  The current funding rules prohibit tax-deductible contributions whenever the plan's assets exceed the greater of the plan's accrued liability and the plan's current liability. In some cases, a plan sponsor may be in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. As a result, a sponsor's ability to build up an adequate surplus in good economic times to provide a cushion for bad times is constrained.

- Underfunded plans are allowed to increase benefits.

  Under current funding rules, sponsors of badly underfunded plans can continue to provide for additional accruals and, in many situations, even make benefit improvements. Restrictions apply only if the actuarial value of a plan's assets would be less than 60 percent of current liability after a plan amendment increasing benefits; in that case, the employer is required to post security in the amount by which the assets are less than 60 percent, but only to the extent this amount exceeds $10 million. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likelihood of losses for participants and the

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[14] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 11 (May 2005).

PBGC. Plan assets are depleted when seriously underfunded plans allow retiring employees to elect lump sums and similar accelerated benefits.

Several failed pension plans provide cases in point for the structural defects in the current funding rules. Bethlehem Steel's plan was 84 percent funded on a current liability basis, but turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. Despite these funding levels, for a number of years prior to termination, Bethlehem Steel was not required to make a deficit reduction contribution, and for the three years immediately preceding termination it relied on credit balances to avoid making contributions.

Bethlehem Steel

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	78%	91%	99%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a Variable Rate Premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.9 million	$ 8.1 million	$0	$0	$0
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn

US Airways' pilots' plan was 94% funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. Similarly, US Airways was not subject to a deficit reduction contribution for six years leading up to the year of termination and relied on credit balances to avoid making any contributions for the four years immediately before terminating.

Moral Hazard

A second structural weakness in the current defined benefit system is that there is little to prevent financially weak employers from creating unfunded pension costs that they can shift to the insurance system if the company fails. This is what economists call "moral hazard."

A fundamental principle of insurance design is to eliminate or minimize moral hazard. That is why banks have risk-based capital standards, drivers with poor driving records face higher premiums, smokers pay more for life insurance than non-smokers, and homeowners with smoke detectors get lower rates than those without.

The current insurance program is replete with moral hazards. Benefits can be increased as long as the plan is at least 60 percent funded, regardless of the financial capacity of the company. Management and workers in financially troubled companies may agree to increase pensions in lieu of wage increases. For a company, the cost of wage increases is immediate, while the cost of new pension benefits is spread out over 30 years. In addition, labor may choose to bargain for wages or other benefits rather than for full funding of a plan because of the federal backstop.[15] If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund.

Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders (but not necessarily participants) and much of the downside risk being shifted to other premium payers. In the recent report, GAO notes that moral hazard from the presence of PBGC insurance may cause financially troubled sponsors to alter their funding behavior, which would increase PBGC's exposure. [16]

The standard insurance industry safeguards against moral hazard are risk-based underwriting and risk-based premiums. These safeguards are absent from the pension insurance program. Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance underwriting methods. It cannot turn away bad risks and it cannot charge more for them. As a result, there has been a tremendous amount of cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

Consider: Bethlehem Steel presented a claim of $3.7 billion after having paid only $60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United Air Line's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a claim on the fund of roughly $6.6 billion.

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[15] See page 3, *The Most Glorious Story of Failure in the Business*, James A. Wooten, 49 Buffalo Law Rev. 683 (Spring/Summer 2001). "Termination insurance would shift default risk away from union members and make it unnecessary for the UAW to bargain for full funding."

[16] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 34 (May 2005).

Transparency

A third structural weakness is that the current funding and disclosure rules shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private-sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two-and-a-half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC receives more timely and relevant information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose if an underfunded plan was terminated are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of company pensions. More can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

Congress added new requirements in 1994 expanding disclosure to participants in certain limited circumstances, but our experience tells us that these disclosures are not adequate. The notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. Workers in many of the plans we trustee are surprised when they learn that their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including certain early retirement benefits.

What Needs to be Done?

The Administration believes that comprehensive pension reform is needed to address the problems and challenges noted above. We have proposed several reforms to the single-employer defined benefit system that are intended to improve pension security for workers and retirees, stabilize the defined benefit system, and put the federal pension insurance program on a solid financial footing. The President's proposal has three primary elements:

- First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises.

- Second, premiums must be increased and made more risk-related, and protections must be provided against unreasonable losses due to sponsor bankruptcy and shutdown.

- Third, disclosure to workers, investors and regulators about pension plan status must be improved.

Administration's Proposed Changes in Funding Rules

The President's solution to today's systemic pension underfunding begins with fundamental reform of the rules governing plan funding. The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

(1) Meaningful and Accurate Measures of Liabilities and Assets

In order to encourage plan sponsors to manage volatility and to pre-fund benefits in good times, the Administration's proposal will use more accurate measures of plan assets and liabilities and base funding targets on the plan sponsor's financial health. Liabilities will be measured on an accrual basis using a single standard liability measurement concept. Within this single measure, a plan's accrued liability will reflect whether the plan is likely to remain ongoing or poses a risk of termination. "Ongoing liability" will be measured using assumptions that are appropriate for a financially healthy plan sponsor (investment-grade rated) while "at-risk liability" will be measured using assumptions that are appropriate for a less healthy plan sponsor (below-investment-grade rated) that is more likely to default on pension obligations in the short to medium term.

Ongoing liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay (salary projections are not taken into account in determining the level of accrued benefits). Expected benefit payments will be discounted using a corporate bond spot yield curve that will be published by the Treasury Department. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the current liability measure under current law, plans will be required to recognize expected lump sum payments in computing their liabilities.

At-risk liability measures liabilities that accrue as a plan heads towards termination because of the deteriorating financial health of the plan sponsor. At-risk liability includes the present value of accrued benefits under an ongoing plan, plus additional costs that arise when a plan terminates. These costs include acceleration in early retirements, increases in lump sum elections when available, and the administrative costs associated with terminating a plan.

Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: (i) they should reflect the timing of future payments, and (ii) they should be based on current market-determined interest rates for similar obligations. The corporate bond yield curve will reflect the timing of future payments by matching appropriate market interest rates to the time structure of a pension plan's projected cash flows. The Department of the Treasury will derive discount rates from a spot yield curve based on high grade (AA) corporate bond rates averaged over 90 business days. It recently published a white paper[17] detailing its methodology that is available on the Treasury Department web site.

Under the Administration's proposal, asset values used in determining minimum required and maximum allowable contributions will be based on market prices on the valuation date. No smoothed actuarial values of assets will be used, as they mask the true financial status of the pension plan.

(2) *Funding Targets and Credit Ratings*

Under the Administration's proposal, accrued liability (appropriately measured as described above) serves as a plan's funding target. Plans sponsored by financially healthy firms (investment-grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below-investment-grade rated) will use 100 percent of at-risk liability as their funding target.

A sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's controlled group has NO senior unsecured debt that is classified as investment grade by at least one of the nationally recognized rating agencies.

(3) *Funding Accrued Benefits*

Under the proposal, if the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year will equal the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments will be required in amounts that amortize the funding shortfall

[17] Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of the Treasury, Office of Economic Policy, White Paper, February 7, 2005.

over a seven-year period. This will extend the amortization periods for many underfunded plans from as little as four years under the deficit reduction contribution, which will counteract the effect of other funding changes that may increase costs under the proposal.

The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in seven annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of the future amortization payments is less than the funding target, that shortfall is amortized over the following seven years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base is established for that year and the total amortization payment for the next year is the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, the amortization charges will cease and all existing amortization bases will be eliminated.

(4) Increased Deductibility

The Administration-proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. These new funding requirements are matched with new opportunities to pre-fund obligations on a tax-preferred basis. Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed to current underfunding in the pension system. The Administration proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax-deductible contributions.

The first cushion allows funding to 130 percent of the funding target and is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability value fluctuations that occur over a business cycle. A second funding cushion allows plan sponsors to pre-fund for salary and benefit increases. In addition, plans will always be able to deduct contributions that bring a plan's funding level up to at-risk liability.

(5) Credit Balances

The Administration proposal eliminates credit balances. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have in many cases resulted in plans having lengthy funding holidays, while becoming increasingly underfunded. Some companies have avoided making cash contributions for years through the use of credit balances, heedlessly ignoring the substantial contributions that may be required when the credit balances are used up.

(6) *Benefit Restrictions*

The Administration believes that companies should make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these hollow promises that harm workers by putting their retirement security at risk.

Under the reform proposal, plans with financially weak sponsors that are funded at a level less than or equal to 80 percent of their targets will be restricted from offering lump sums or increasing benefits. If funding is less than or equal to 60 percent of target liabilities, accruals will also stop and there will be no preferential funding of executive compensation. Plans with healthy sponsors will be restricted from increasing benefits if they are funded at a level less than or equal to 80 percent of their funding target and from offering lump sums if they are at a level less than or equal to 60 percent of their funding target. Underfunded plans with sponsors in bankruptcy will also be subject to benefit limits.

These proposals will create a strong incentive for employers to adequately fund their plans – making it more likely that workers' retirement expectations will be met.

Administration's Proposed Changes to Restore PBGC to Financial Health

Reforming PBGC's Premium Structure
The Administration proposes a more rational premium structure that will meet the program's long-term revenue needs, provide incentives for full funding of covered plans, and better reflect the different levels of risk posed by plans of strong and weak companies.

There are two fundamental problems with the PBGC premiums. First, the premium structure does not adequately reflect risk. Second, the current premium structure does not raise sufficient revenue to cover expected losses.

By law, the principal funding source for the insurance program is the premiums paid to PBGC by covered plans. Premium rates are prescribed by law. While claims against the program have skyrocketed, premium revenue has not kept pace. The $19 per participant flat-rate premium has not been increased in 14 years, not even to reflect wage growth over that period. Because the number of participants has remained relatively stable, the flat-rate premium has not been a source of additional premium revenue.

Premium revenue growth in recent years has come only from the variable-rate premium (VRP). While the VRP charge of $9 per $1,000 of unfunded vested current liability appears reasonable, the VRP does not raise the amount of revenue it should for two reasons. First, the "full funding limit" exemption generally relieves plans that are funded for 90 percent of current liability, from paying a VRP. As a result, less than 20 percent of participants are in plans that pay a VRP. The full funding limit exemption is also why some of the companies that saddled the insurance fund with its largest claims ever paid no VRP for years prior to termination. In addition, VRP revenue is artificially low because current liability understates liabilities at plan termination, often dramatically so. In the last several years, premium revenue has not even been sufficient to pay monthly benefits in trusteed plans, let alone pay the underfunding in new terminations.

Under the Administration proposal, the flat per-participant premium will be immediately adjusted to $30 initially to reflect the growth in worker wages since 1991, when the current $19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages during this period, even as the premium was frozen. Going forward, the flat rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a more risk-based premium would be charged based on the gap between a plan's funding target under the proposed funding reforms and its assets. As noted earlier, the funding target is a more accurate measure of liability than current liability, capturing the sponsor's financial condition. Moreover, the current "full funding limit" exemption would be eliminated, so that all underfunded plans would pay the risk-based premium. The PBGC Board - which consists of the Secretaries of Labor, Treasury and Commerce - would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC's financial condition. Charging underfunded plans more gives employers an additional incentive to fully fund their pension promises.

Protections Against Unreasonable Losses
The proposal also provides the PBGC with better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs.

1. Protections in Bankruptcy

The Corporation faces special problems when a plan sponsor enters bankruptcy. Guarantees continue to grow even though plan sponsors may no longer be making contributions. A lien automatically arises against the assets of a plan sponsor and members of its controlled group if required pension contributions of $1 million or more are missed. However, because the automatic stay and avoidance provisions of the Bankruptcy Code prevent PBGC from perfecting liens for missed required contributions in bankruptcy, companies are able to avoid making contributions to the plan as otherwise required by federal law, and can do so without consequence. As a result, plan participants and the PBGC insurance program both may suffer greater losses if an underfunded plan later terminates while the plan sponsor or members of its controlled group are in a bankruptcy proceeding.

The PBGC guarantee limit would be frozen when a company enters bankruptcy, and PBGC would be allowed to perfect liens for missed required pension contributions against companies in bankruptcy.

2. Contingent Liability Benefits

There are also inadequate protections for the insurance program against accrual of potentially large, and unfunded, contingent liability benefits. One example is when a plan sponsor provides plant shutdown benefits -- benefits triggered by a plant closing or other similar condition. The Administration believes that shutdown benefits are severance benefits that should not be paid by pension plans. These benefits generally are not funded until the shutdown occurs, by which time it is often too late, and no PBGC premiums are paid for them. However, despite the lack of funding, shutdown benefits may be guaranteed if the shutdown occurs before the plan termination date, often imposing large losses on the insurance program.

The Administration proposal would prospectively eliminate the guarantee of certain unfunded contingent liability benefits and prohibit such benefits under pension plans. These severance benefits generally are not funded and no PBGC premiums are paid for them. Such benefits could continue to be provided outside the pension plan.

Administration's Proposed Improvements in Disclosure

The financial health of defined benefit plans must be transparent and fully disclosed to workers and their families who rely on promised benefits for a secure and dignified retirement, as well as to investors and shareholders who need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

Provide broader dissemination of plan information

Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, subject to existing Freedom of Information Act protections for corporate financial information, including confidential "trade secrets and commercial or financial information."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets, and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Provide more meaningful and timely information

The President's proposal would change the information required to be disclosed on the Form 5500 and summary annual report (SAR). Plans would be required to disclose their ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability, and its at-risk liability.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated from two months to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year -- February 15 for a calendar year plan.[18] If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Responses to Concerns Raised about the Administration's Proposals

Several questions have been raised regarding the impact of the Administration's proposals on defined benefit plans and their sponsors. Many of the questions posed and issues raised have merit and warrant careful consideration and a delicate balancing of interests. Some of these objections, however, do not withstand scrutiny.

Will Employers Exit the System?

The most frequent general complaint we have heard is that the Administration's proposal does not provide enough incentives for plan sponsors to remain in the defined benefit system.

[18] Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due 7 months after the end of the plan year (July 31 for calendar year plans), with a 2 ½ month extension available (October 15 for calendar year plans).

The Administration believes that defined benefit plans should remain a viable option for companies that want to provide guaranteed retirement benefits to their employees. Unfortunately, in our view, the current funding system is not sustainable in the long run. Defined benefit sponsors are aware that the complexities of the current system and the funding rules allow some sponsors to transfer the risks of their funding and investment decisions to the insurance system. We want to eliminate artificial impediments that unnecessarily and avoidably raise the costs of offering DB plans. And, we believe that the Administration's proposal would revitalize the system by placing both the insurance program and individual pension plans on a solid financial footing.

Numerous meetings have been held with stakeholders over the past two years to gain a better understanding of the issues of concern to them, and, as a result, have incorporated many of the key elements sought by plan sponsors and others. For example, there have long been complaints about regulatory complexity and excessive costs associated with compliance with overly burdensome rules and regulations. We agree with this assessment, and the Administration's proposal greatly simplifies and streamlines the pension funding rules. Sponsors said they wanted to be able to use a corporate bond rate, rather than the risk-free Treasury rate, to discount liabilities. The Administration believes that the measure of pension liabilities should be based on market rates of interest for quality corporate bond issuers and this view is reflected in the Administration's proposal. They said they want greater flexibility to fund up their plans in good economic times, to provide a cushion during more lean times. The Administration's proposal significantly increases the ability of sponsors to make tax deductible contributions to their plans. Some sponsors have complained about the cliff effect of the deficit reduction contribution rules, which in some cases requires funding deficits to be made up in as few as three years. The Administration proposal provides seven years to amortize funding deficits.

Risk and Volatility

There are a few more specific issues that have been raised about the Administration's proposal. One is that it would increase volatility and make contributions more unpredictable. The fact is that the risk and volatility associated with defined benefit plans stems from the investment and business decisions made by plan sponsors, along with changes in longevity and retirement patterns, none of which are changed by the Administration's proposal. Companies have the means under current law to manage these risks in accordance with their own risk tolerances. And, the Administration's proposal provides additional tools to manage volatility, including amortization over seven years and the enhanced ability to prefund benefits in good economic times.

What is not acceptable is to mask risk or pretend that it doesn't exist by artificially smoothing asset and liability values and distorting current economic reality. That is precisely what has allowed the funding gaps we've experienced. Ultimately, it is participants, shareholders, other companies, and potentially taxpayers, that stand to lose. Companies should be free to take risks and make business decisions that they believe to be in the best interests of their stakeholders, so long as the impact of those risks and decisions is transparent and the costs cannot be readily transferred to participants or other third parties.

Yield Curve

Another issue relates to the use of a yield curve in discounting liabilities. Some commenters support the use of a corporate bond rate, but object to applying those bond rates against a yield curve. They argue that it is unnecessarily complex and will create unpredictable funding obligations.

The Administration believes that discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because it recognizes the real costs of operating defined benefit pension plans. Accurate measurement of liabilities does not advantage one type of plan sponsor over another, as is the case under current law with a single rate. The pension benefit obligations that make up plan liabilities are not changed in any way by use of the yield curve.

The yield curve simply recognizes that older plans must make a relatively high proportion of benefit payments in the near future. Conversely, use of the yield curve also recognizes that younger plans will make a high proportion of benefit payments in the more distant future. Current law, by using a single long-term bond rate to discount all future payments, largely ignores this fact and therefore measures liabilities inaccurately.

Yield curves are regularly used in valuing other financial instruments, including mortgages and certificates of deposit, and therefore will not pose a difficult technical challenge for actuaries. There is no evidence that implementation of the yield curve will cause significant increases in pension plan expenses, but to avoid any sudden changes in cash flow demand, the Administration's proposal includes a three-year transition period to the yield curve.

Credit Ratings

Some have objected to the use of credit ratings to determine funding and premium levels. It is not clear whether the principal concern is with the use of the ratings agencies themselves, or with the concept of incorporating credit risk into the funding and premium requirements.

As to the former point, it should be noted that a company's cost of capital is, to a significant degree, derived from the rating agencies' calculation of creditworthiness. That leads to the second point - the concept of credit risk itself. As discussed more fully above, it is both reasonable and fair to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations. At-risk funding targets are likely to be higher than ongoing targets, so the Administration provides a five-year phase-in period to the higher target for any plan whose sponsor becomes financially weak. The funding target during the phase-in period will be a weighted average of the ongoing and at-risk targets. Other provisions designed to reduce the effects of the proposal on financially weak firms include a three-year transition period to the yield curve and an extension of the amortization periods for many underfunded plans from as little as four years (under the deficit reduction contribution) to seven years.

Credit Balances

Another criticism that has been leveled against the Administration proposal is that sponsors will have no incentive to make more than the minimum required contributions if they can't take advantage of credit balances. First, I want to reiterate that the credit balance feature of current law allowed companies like Bethlehem Steel, US Airways, and United (PBGC's largest claims) to avoid making contributions to their plans for several years prior to their termination - notwithstanding the fact that they were already substantially underfunded and the amount of grew significantly during the run-up to termination. Allowing companies to take "funding holidays" when they are underfunded (other than through the waiver process) does not make business or policy sense and runs counter to the whole notion of steadily improving the funding status of underfunded plans.

Moreover, we believe that sponsors would have ample incentive under the Administration's proposal to make more than the minimum required contribution without the use of credit balances. First, they would be able to generate a larger tax deduction. Second, they would shorten the relevant amortization period. And, third, their risk-based premiums would be lowered.

PBGC Premiums

A number of issues have been raised about the Administration's proposed changes to the structure and level of premiums that finance the pension insurance program. The argument has been made that the increase in and indexing of the flat per-participant premium puts an inappropriate burden on employers with well-funded plans; that the provision to adjust the risk-based premium may result in greater volatility and burden on financially stressed companies; and that the solution should be limited to improved funding rules, not increased premiums.

Understandably, plan sponsors would rather not pay greater premiums or subsidize underfunded plans of financially weak sponsors. However, the deficit in the pension insurance single-employer fund is already substantial and likely will grow, which imperils the ability of the PBGC to meet its long run commitments to participants in terminated plans. The fact is that under current law, the PBGC is supposed to be self-financing; the agency does not receive any taxpayer monies and its obligations are not backed by the full-faith-and-credit of the United States. At the same time, PBGC has very little control over its primary revenues and expenses. Congress sets PBGC premiums, ERISA mandates coverage for all defined benefit plans whether they are adequately funded or not, and companies sponsoring insured plans can transfer their unfunded liability to the PBGC as long as they meet the statutory distress criteria.

Plan funding reforms, by themselves, will not eliminate PBGC's deficit. The Congressional Budget Office scored the Administration's premium proposal as raising $18 billion of revenue over five years. This was based on the assumption that the risk-based premium is assessed against all underfunding, that the flat- rate reforms are enacted, and that total premium revenue will cover expected future claims and amortize the PBGC's $23 billion deficit over 10 years.

The issue ultimately is who pays for past and future claims. The Administration believes that companies that make the promises to their workers should pay for them, which is why we have put so much emphasis on strengthening the funding rules. But, changes to premiums are still necessary to compensate for the losses that have and inevitably will occur. The Administration believes that the proposed balance between the flat per-participant premium and the risk-based premium for plan underfunding is reasonable. The proposed increase in the flat per-participant premium is only to reflect wage growth since the last increase in 1991 and in the future.

The risk-based premium rate would be established by the PBGC's Board on a periodic basis. This is similar to the approach taken in the federal bank insurance program. Since 1993, the Board of Directors of the Federal Deposit Insurance Corporation has reviewed and adjusted semiannually the premium rates that it assesses each insured bank and thrift. Moreover, the FDIC uses a risk-based premium system that assesses higher rates on those institutions that pose greater risk to the insurance funds.

Premiums also need to be viewed in context - relative to contributions that sponsors will have to make to their plans. The fact is that premiums are and would continue to be a very small percentage of pension costs for most employers. Total premiums collected by the PBGC have averaged about a billion dollars a year. Plan contributions have averaged more than $20 billion per year (constant dollars) - twenty times higher than premiums. Estimates are that companies contributed more than $70 billion to their plans in 2003.

Conclusion

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, "the Company has done everything required by law"[19] to fund its pension plans, which are underfunded by nearly $10 billion.

It is difficult to imagine that healthy companies would want to continue in a retirement system, or that prospective employers would want to become part of a retirement system, in which the sponsor-financed insurance fund is running a substantial deficit. By eliminating unfair exemptions from risk-based premiums and restoring the PBGC to financial health, the Administration's proposal will revitalize the defined benefit system.

That, Mr. Chairman, is precisely why the rules governing defined benefit plans are in need of reform. At stake is the viability of one of the principal means of predictable retirement income for millions of Americans. The time to act is now. Thank you for inviting me to testify. I will be pleased to answer any questions.

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[19] Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

Responses to Questions for the Record From Bradley D. Belt Senate Committee on Finance Hearing, June 7, 2005

Senator Grassley

1. **When the Administration discusses the use of a "yield curve" as an interest rate replacement for the 30-year Treasury rate, what does the Administration mean by the term "yield curve"? Does the Administration consider the interest rate replacement in legislation recently introduced by Representative John Boehner (R-OH) to be a "yield curve"?**

In simplest terms, a "yield curve" is a graph of a select group of bonds showing yields (that is, interest rates) on the vertical axis and years until maturity on the horizontal axis. Yield curves have many uses for analyzing fixed income securities. For a pension plan, the yield curve can be used to discount the future pension benefit payments from the plan to derive their present value. Each pension plan has a specific schedule of future benefit payments based on the plan formula and the participant demographics. The actuary must discount each future payment to determine the present value of accrued benefits. (The present value ideally represents how much money the plan would need today in order to pay benefits in the future.) Under current law, the same discount rate is used for all the future benefit payments. For example, a benefit to be paid in 2010 is discounted at the same rate as a payment that will not be made until 2030.

The Administration believes, and most economists agree, that the discount rate used to discount future payments should vary depending on how many years into the future the benefit payment will be made. For example, a payment to be made in five years should be discounted using the discount rate at the maturity of five years. A payment that's scheduled to be made in 30 years should be discounted using the 30-year discount rate.

To ensure that future payments are discounted appropriately, the Administration proposal provides that the Secretary of the Treasury will issue each month a set of applicable discount rates for the various maturities. These rates will be taken from the yield curve (averaged over 90 business days) for high-quality corporate bonds. Under the proposal, this yield curve would replace the 30-year Treasury rate for discounting future payments and lump sum calculations. In the usual situation of an upwardly sloping yield curve, higher interest rates would be used to discount benefit payments expected to be made further in the future, with lower interest rates applying to benefit payments made in the near term.

H.R. 2830 (Representative Boehner's bill) retains the concept that discount rates should vary according to the times when the pension benefit payments will be made, but only to a limited extent. Instead of varying discount rates for each future year in which benefits will be paid, the bill provides for only three discount rates for all the future benefit payments of the plan (one rate for payments due in 0 to 5 years, a second rate for payments due in 5 to 20 years, and a third rate for payments due in more than 20 years). Three data points are not enough to reflect the full yield curve. Although using three discount rates is an improvement over current law, it does not provide as accurate a measurement of present pension liability as would the full yield curve.

Moreover, the three discount rates in H.R. 2830 are derived from a 3-year weighted average of the yield curve. However, the central purpose of using a yield curve is to arrive at a measure of present pension liability that is accurate relative to current markets. A 3-year time span for averaging is far too long to reflect current market conditions. In contrast, the Administration proposal is to average the yield curve over 90 business days, which will accurately mirror contemporaneous market movements without being excessively influenced by the special factors of a particular day.

We are also concerned about the credit quality of the bonds underlying the yield curve as described in H.R. 2830. The Administration proposal is to use high quality (AA) corporate bond rates.

2. As the Finance Committee prepares to examine comprehensive pension funding reform legislation to prevent future pension defaults such as the one at United Airlines, could you provide the Administration's views on the importance of changes in law in the following areas:

- **Accurate measurement of pension liabilities for all purposes, including elimination of "smoothing" techniques related to interest rate and asset valuations used to measure liabilities.**
- **Requiring pension plan's liability target to take into account the financial health and creditworthiness of the plan sponsor.**
- **The treatment of "credit balances".**
- **The replacement of the 30-year Treasury rate with a "yield curve" within the parameters described in the answer to Question 1.**

Changes to current law in each of these areas, as has been proposed by the Administration, are needed to protect the benefits of workers and retirees, as well as the interests of responsible premium payers and taxpayers.

- *Meaningful and accurate measures of liabilities and assets.* It is critically important that all of the stakeholders in the defined benefit system know the true financial condition of pension plans. This requires accurate measures of both assets and liabilities, using current market prices. However, current law allows plan sponsors to smooth assets over five years and smooth liabilities using a four-year weighted average interest rate. These "smoothing" mechanisms mask risk and volatility and provide a distorted view of the true financial condition of pension plans. These smoothing mechanisms have also allowed sponsors to characterize plans as fully funded when they are, in fact, substantially underfunded on a market value basis.

Simply put, asset and liability values from prior years have no bearing on the current funded status of a pension plan.

The Government Accountability Office (GAO) and the Congressional Budget Office have also criticized the smoothing of assets and liabilities. The GAO report notes that, by smoothing annual contributions and liabilities, a plan's reported level of funding may be distorted.[1] And, the Securities and Exchange Commission came to the same conclusion regarding smoothing mechanisms available under accounting rules. In its recent report on the accounting treatment of off-balance sheet obligations, including pension plans, the SEC notes that smoothing mechanisms "render financial statements more difficult to understand and reduce transparency." The report further concludes that "investors are better served by seeing any volatility that exists."[2] What is true for investors and other users of financial information is also true for participants in defined benefit pension plans. Assets and liabilities need to be marked-to-market to provide an accurate picture of the financial condition of pension plans.

- *Funding targets and credit ratings.* There are two factors that determine whether a pension plan is likely to file a claim against the insurance system. The first is the likelihood that a sponsor of a plan with unfunded obligations will default resulting in a claim against the system. The second is the degree to which plan liabilities are unfunded. This is a direct measure of the exposure of potential loss to the system if a claim is filed. Plans that are and remain funded pose very little risk because they do not expose the system to loss. Plans that have unfunded liabilities but are sponsored by firms that are financially healthy - implying that they can fund their obligations fully - pose some risk to the system. Such plans expose the system to potential losses, but the likelihood that the sponsor will default on its unfunded obligations is relatively small. Plans with unfunded obligations that are sponsored by financially weak firms pose the greatest risk of loss because they expose the system to their underfunding and the probability of sponsor default is relatively high. Based on historical default rates, non-investment grade companies are about 20 times more likely to default than investment grade companies.[3] The risk of plan termination (sponsor default) is not recognized in the current funding rules. The same funding rules apply regardless of a company's financial health. PBGC studied 41 of its largest claims that represented 67 percent of total gross claims. Over 90 percent of these largest claims against the insurance system were from plans sponsored by companies that had junk-bond credit ratings for 10 years prior to termination. As a recent GAO report notes, speculatively rated sponsors represent

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[1] United States Government Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p.19 (May 2005).
[2] United States Securities and Exchange Commission, "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implication, Special Purpose Entities, and Transparency of Filings by Issuers" pp. 5, 108 (July 2005).
[3] Standard & Poor's *Annual Default Study: Corporate Defaults Poised to Rise in 2005*, page 18, Table 13, 5-year cumulative default rates.

greater risks to the PBGC. Plan sponsors that are in financial distress may place other financial priorities above funding their pension plans.[4]

Under the Administration's proposal, the likelihood that a sponsor will default on its pension obligations, as measured by its financial health, is used to determine a plan's funding target. Plans with healthy sponsors have funded targets equal to a measure of their accrued liability (appropriately measured as described above), which is called ongoing liability. This target exposes the insurance system to potential losses; however, because the probability of such sponsors defaulting is believed to be small, this is considered an acceptable risk. Less healthy plan sponsors (below-investment-grade rated) will use 100 percent of at-risk liability as their funding target. This target recognizes the significantly higher default risks that such plans impose on the insurance system. Generally, a sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's controlled group has NO senior unsecured debt that is classified as investment grade by at least one of the nationally recognized rating agencies.

- *Eliminate credit balances.* The Administration proposal eliminates funding "holidays" for underfunded plans. Under current law, plans that have built up so-called credit balances can take a contribution holiday regardless of the current funded status of the plan. During these holidays, a plan's funding level may drop significantly. (See attached example comparing the Administration's proposal with the manner in which credit balances would apply under H.R. 2830.) Many of PBGC's largest claims came from plans in this situation. For example, neither Bethlehem Steel nor US Airways were required to make cash contributions in the few years leading up to their terminations. And remarkably, notwithstanding the fact that the United pilots' plan is underfunded by almost $3 billion, the company was not required to make a cash contribution to that plan for the years 1996 through 2004. In fact, during that time period, the pilots' plan credit balance was used in lieu of cash to satisfy over $350 million in funding requirements. In all of these situations, the plans were severely underfunded upon plan termination, and as a result participants lost (or will lose) a significant portion of their promised benefits. Allowing companies to stop making contributions when their plans are underfunded does not make business or policy sense and runs counter to the whole notion of steadily improving the funded status of underfunded plans.

It should be noted that while some of the current problems with credit balances stem from letting credit balances grow with a specified rate of interest regardless of actual market returns, simply marking them to market would not fully address the problem. For example, had credit balances been marked-to-market since 1996, the United pilots' plan contribution holiday would have lasted almost as long as it did under current law. Under a mark-to-market approach (keeping all other components of current law unchanged), it appears that the contribution holiday

[4] United States Government Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 31 (May 2005).

would have ended in 2004, just one year sooner than when it actually did end and still much too late to ensure adequate funding upon termination.

Also, the argument has been made that companies will not have any incentive to contribute more than legally required minimums unless the additional contributions are allowed to generate credit balances. We disagree. Under the Administration's proposal, there are ample incentives for plan sponsors to contribute more than the minimum required amount.

By contributing more than required, funding targets will be reached sooner. Once that happens, amortization charges are eliminated and the minimum required contribution is reduced to the normal cost (the cost of benefits accruing in the coming year). If excess contributions result in a plan exceeding its funding target (i.e., put the plan into a surplus position), the surplus can be used, dollar for dollar, to offset the normal cost.

In addition to shortening the amortization period, more contributions mean less underfunding and less underfunding has many positive *immediate* consequences. For example:

- PBGC risk-related premiums are directly tied to the amount of underfunding. Thus, contributing more than required one year results in lower premiums the very next year.
- The size of new shortfall bases is tied to the amount of underfunding. Thus, contributing more than required one year may result in lower funding requirements the very next year.

Finally, it's important to note that the increased tax-deductible limits under the Administration's proposal enable sponsors to contribute and deduct amounts well in excess of the required amount.

- *Use of yield curve to value liabilities.* It is important to use a yield curve to value pension liabilities because a yield curve is the most accurate way possible to value payments like pension benefits that are paid out over many years. As noted in the answer to Question 1, using a single interest rate for payments made over a multi-year period distorts the value. Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: (i) they should reflect the timing of future payments, and (ii) they should be based on current market-determined interest rates for similar obligations. The corporate bond yield curve will reflect the timing of future payments by matching appropriate market interest rates to the time structure of a pension plan's projected cash flows. The Department of the Treasury will derive discount rates from a spot yield curve based on high grade (AA) corporate bond rates averaged over 90 business days. It recently published a white paper detailing its methodology that is available on the Treasury Department web site.

Senator Kyl

1. **Congress provided substantial relief from the deficit reduction contribution for 2004 and 2005. How much has that increased the underfunding of the airline pension plans that took advantage of this relief?**

In 2004, six major airlines elected to receive this funding relief. As a result, these airlines' required pension contributions were about $1.3 billion less than would otherwise have been required. So far in 2005, required contributions for three of these airlines were more than $1.1 billion less than would otherwise have been required. Underfunding in the airline pension plans grew. Two of the airlines given relief on their required pension contributions are now in Chapter 11 and are terminating their underfunded pension plans.

2. **What is the Administration's assessment of S. 861?**

The "Employee Pension Preservation Act of 2005" (S. 861) would allow commercial passenger airlines to elect special rules under which they would freeze benefit accruals under their defined benefit plans in exchange for the ability to stretch out funding of unfunded accrued liabilities over 25 years. The bill contemplates that, going forward, airline employees would earn benefits under a defined contribution plan.

The bill raises several important policy issues. It would effectively grant the legacy airlines, by operation of law, an unsecured 25-year loan from their plans, the risks of which would be borne by their workers and retirees and PBGC premium payers. The proponents of the bill have asserted that it would protect the pension insurance program from any additional expense or loss. However, this is not the case. While the bill purports to require plans to be frozen and caps the maximum guarantee level, thereby limiting further liability growth, there are several ways in which losses to the insurance program could increase.

For example, a plan's unfunded accrued liabilities could be understated because plan liabilities would be measured using interest rate, mortality and retirement assumptions selected by the plan actuary, and plan assets could be depleted because there are no prohibitions on lump-sum distributions and annuity purchases. In addition, the bill permits plans to provide additional accruals if immediately funded, thus allowing a weak company to use its limited cash to fund new liabilities rather than more rapidly fund the plan's existing liabilities.

More generally, the Administration is opposed to industry-specific pension funding relief. It would create a bad precedent, encouraging every industry with defined benefit pensions to seek similar legislative relief in the event they face difficult economic times. It could also create incentives for financially distressed sponsors to allow their plans' funding to deteriorate.

Senator Rockefeller

1. **If Delta Airlines entered bankruptcy and sought to terminate all of its defined benefit pension plans, what would be the cost to the PBGC of covering unfunded, guaranteed benefits?**

Based on publicly available information, PBGC estimates that its liability for unfunded guaranteed benefits if Delta's two major defined benefit plans terminated would be more than $7 billion. This estimate was derived by using the market value of the plans' assets and adjusting the liabilities based on PBGC's assumptions for termination liability. PBGC estimates that Delta's two plans have approximately $7 billion in assets and $14 billion in guaranteed benefits.

In addition to the cost to the pension insurance program, Delta's workers and retirees would lose about $3.5 billion in benefits that are not guaranteed by the pension insurance program.

2. **In an effort to avoid the scenario described above, doesn't it make sense for Congress to provide some funding flexibility to struggling airlines (contingent on holding the PBGC harmless) so that they can maintain their plans, keep their promises to workers, and save the PBGC money? Is the administration willing to work with Congress to craft legislation to help employers meet their pension obligations?**

We do not believe that providing industry-specific relief from minimum funding requirements is the best way to protect benefits earned by workers and retirees or the insurance system as a whole. As noted in my response to Senator Kyl's Question 2, there are several problems with the approach taken in S.861. Among other things, it allows too long a time period to amortize existing liabilities and fails to provide an accurate funding target. In addition, its "hold harmless" provisions fall short of their objective. The proponents of the bill have asserted that the bill would protect the pension insurance program from any additional expense or loss. However, this is not the case. While the bill would require plans to be frozen and cap the maximum guarantee level, thereby limiting further liability growth, as noted in my response to Senator Kyl's Question 2, there are several ways in which losses to the insurance program could increase. More important, industry-specific pension funding relief sets a bad precedent.

While developments in the airline industry are cause for concern, they are symptomatic of a broader and deeper set of problems confronting workers, plan sponsors, and the pension insurance program. What is needed is comprehensive pension reform that will ensure that all companies keep the promises they have made to their workers and retirees. The Administration has put forth a comprehensive proposal for reform that will protect the pension promises of workers and retirees and ensure that employers meet their obligations in a reasonable fashion. We look forward to working with Congress to achieve these goals.

<u>Senator Lincoln</u>

1. **Mr. Belt, as you are well aware, ERISA established funding requirements and set forth rules for employers to follow regarding pension plan management. These rules were established to ensure that employers would have the required assets to meet the promises they had made to their employees for retirement security. In addition, as a safety net, ERISA established the PBGC. Under the PBGC, the government takes up the slack if an employer doesn't follow through on their promise. So, my question to you: are you concerned that Congress and the Administration might place too much of an emphasis on shoring up PBGC to our ultimate detriment? To what extent do you believe we are letting these employers and plan managers off the hook if we primarily focus legislative attention on shoring up PBGC, as opposed to addressing minimum funding requirements or the valuation of assets or any of the host of other pension plan funding proposals that have been laid on the table in recent years that could have an impact on self-insurance by employers?**

The Administration proposal is a comprehensive reform package that focuses on strengthening the pension funding rules. These funding reforms are intended to ensure, as you state, that employers have the required assets to meet the pension promises they made to their employees. Without adequate funding, workers and retirees may lose promised benefits because of statutory limits on PBGC's insurance coverage. Further, without adequate pension funding, the unmet funding obligations of failed companies for guaranteed benefits get shifted to companies that have responsibly met their pension obligations. The prospect of increases in pension cost-shifts is destabilizing to the defined benefit system. So we must fix the funding rules for both these reasons.

It is also important to note that "shoring up" the PBGC simply means that the agency has the resources available to continue to make benefit payments to participants in terminated plans, without requiring a taxpayer bailout. PBGC does not have its own economic interests - the agency is simply a pass through for the stakeholders in the defined benefit system.

A premium increase is needed to fund expected claims on the insurance program and to retire its existing $23 billion deficit. PBGC's premiums have not kept pace with the growth in claims or pension underfunding. The flat-rate premium of $19 per participant has not been raised in 14 years, since 1991. And as long as plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the risk-based premium. That is why some of the companies that saddled the insurance fund with its largest claims ever paid no variable-rate premium for years prior to termination. In fact, less than 20 percent of participants are in plans that pay a risk-based premium.

2. If PBGC were to exhaust all of its holdings, what would happen?

Under current law, the PBGC receives no taxpayer money and its obligations are not backed by the full faith and credit of the U.S. government. Additionally, the PBGC cannot raise pension insurance premiums - such a step requires Congressional action. If the PBGC's assets were exhausted and Congress chose not to take any action, participants of terminated plans to whom the PBGC makes pension payments would simply lose their future benefits (except for the portion that could be paid by incoming premiums). If future premium revenues prove to be insufficient to cover past or future losses, then Congress one day will have to address the question of who pays for the unfunded benefits of these participants. In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers. If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

The Administration believes there is a better approach: fix the funding rules now to require companies to fully fund the promises they have made to their workers. That is the best "insurance policy" for plan participants, premium payers, and ultimately taxpayers.

Credit Balance Example

Consider two pension plans that are both 90% funded. Both have funding targets of $100 million, assets with a market value of $90 million and a normal cost of $12 million. Let us assume further that, although both plans have the same amount of assets, they have very different contribution histories. Plan A's sponsor has always contributed only the minimum required amount, while Plan B's sponsor usually contributed more. The accumulated value of excess contributions to Plan B (i.e., the credit balance) is $10 million.

The Administration contends that both plans should be required to contribute the same amount because both plans are currently in the same situation. How they got there is irrelevant. Whether assets grew to $90 million because of favorable investment performance or because of additional contributions, the result is the same: there are $90 million of assets currently available to pay benefits with a present value of $100 million. Therefore, the required contribution for both plans should be the sum of the normal cost plus a seven-year amortization of the $10 million shortfall.

Under H.R. 2830 Plan B's funding requirement would be different than that of Plan A solely because excess contributions were made in the past. An illustration follows:

Plan B's Minimum Required Contribution (in millions)		
	Administration's Proposal[a]	H.R. 2830
Minimum Required Contribution		
1. Normal Cost	$ 12.0	$ 12.0
2. Funding Shortfall		
a. Funding Target	$100.0	$100.0
b. Assets (reduced by credit balance under H.R. 2830)	- $ 90.0	- $ 80.0
c. Funding Shortfall [(a) –(b)]	$ 10.0	$ 20.0
3. Amortization charge [7-year amortization of (2c)]	$ 1.5	$ 3.0
4. Minimum required contribution		
a. Before reflecting credit balance [(1)+(3)]	$ 13.5	$ 15.0
b. Credit balance	N/A	- $ 10.0
c. After reflecting credit balance [(a) –(b)]	$ 13.5	$ 5.0
Year-end Funded Percentage[b]		
5. Funding Target [((1)+(2a)) x 1.05]	$118	$118
6. Assets [($90 +(4c))x 1.05]	$109	$100
7. Funded percentage	92%	85%

a. Under the Administration's Proposal, this is the minimum required contribution for both plans.
b. Assumes minimum required contribution is made and asset performance is in line with yield curve (5% for this example).

This example shows that if only $5 million is contributed to Plan B, its funded percentage would drop from 90% this year to 85% next year. This result is unacceptable. Funding rules should continually move plans closer to their funding target, not further away.

STATEMENT FOR SENATOR BUNNING

Senate Committee on Finance

Preventing the Next Pension Collapse: Lessons from the United Airlines Case

7 June 2005

Thank you, Mr. Chairman.

I would like to welcome our knowledgeable witnesses to the committee today. I look forward to a meaningful discussion of the current state of single-employer defined benefit pension plans.

I am especially interested in hearing what our witnesses think we can learn from the United Airlines situation as we begin to examine broader issues of reform in this important area.

The Finance Committee has an important task that we must address—protecting the health of our pension system.

Recent events and the current economic situation make the integrity of our pension system extremely important for both the beneficiaries and the insurers.

As my fellow committee members and our witnesses know, my State is home to thousands of current and former Delta Airlines employees.

Given the current grave situation facing that airline and its pension plans, I am particularly interested in understanding the United case and will be carefully examining what we can learn from it.

I have a number of questions, and I am looking forward to hearing your responses.

Thank you.

TESTIMONY OF

PATRICIA A. FRIEND
INTERNATIONAL PRESIDENT

ASSOCIATION OF FLIGHT ATTENDANTS –
CWA, AFL-CIO

BEFORE

THE COMMITTEE ON FINANCE

U.S. SENATE

WASHINGTON, DC

JUNE 7, 2005

Thank you, Mr. Chairman, for the invitation to testify today on the current serious pension crisis. I appreciate having the opportunity to share our views with the committee on this issue, an issue that has such a profound impact on hundreds of thousands of working women and men in the aviation industry. The pension crisis is especially important to the women and men who serve as flight attendants.

My name is Patricia Friend and I am the International President of the Association of Flight Attendants-CWA, AFL-CIO. AFA represents 46,000 active flight attendants at 24 airlines. Our active and retired flight attendants at United Airlines – numbering approximately 28,000 – are currently the only flight attendants at a major airline represented by AFA with a defined benefit pension plan. Let me repeat that only one, United Airlines, has the vestiges of a defined benefit plan.

As you all know, that changed early last month when a bankruptcy court judge ruled, at the request of United Airlines management, to approve an agreement between United and the Pension Benefit Guarantee Corporation under which the agency is expected to terminate our pension plan. We were shocked and outraged by this decision after the earlier announcement by the PBGC that our plan "can and should be maintained" as United emerges from bankruptcy. Instead of defending and preserving our pension plan, they announced in bankruptcy court that they intended to take over the flight attendant pension plan.

What changed? Why did the agency reverse course and abandon the flight attendant pension plan? There can be only one explanation: United agreed to pay the agency 1.5 billion dollars to settle its bankruptcy claim. That is not an outcome that this Congress ever envisioned when it enacted ERISA. That is an abuse that leaves thousands of flight attendants with only a fraction of the retirement they have earned.

We remain resolute in our determination to save our pension plan at United. For me, as a United flight attendant, and our members at United, both active and retired, this especially hits home.

We have heard some thoughtful and well-informed testimony today on the financial status of pension plans in the airline industry and the long-term viability of those plans. We have also heard about the financial ramifications of the United pension terminations – and potentially other pension terminations – on the financial health of the PBGC. Already over 20 billion dollars in debt, the PBGC will absorb as much as 9 billion dollars in additional debt from United's plans, and untold billions more as other airlines and other companies follow United's lead.

I would like to take a few moments to remind everyone here today that this issue has a human dimension, which so often gets overlooked in the important discussion of financial facts and figures. There are real people who are suffering or will suffer due to the profound reduction of promised retirement benefits. Many of our members are now looking at the possibility of working many years longer than they had intended. For those recently retired, many are now trying to determine how they can pay for the basic necessities of life. These are not careless people who failed to plan for their retirement. They did everything right – they worked hard, saved as much as they could, invested when possible. Their only mistake was one of trust: they trusted the retirement promises United made for decades.

United's decision, blessed by the bankruptcy court, to turn our pensions over to the PBGC means that over two thirds of United flight attendants will loose over one-half of their promised pension benefit. These same employees have made repeated financial concessions over the past several years to keep our airlines alive and profitable. Now they are trying hard just to survive and to provide for themselves and their families with a greatly reduced income. With the elimination of much of their guaranteed retirement income the burden is now even greater on them to save more for retirement. But, of course, saving more is nearly impossible because of the drastic reductions in salaries they have already been forced to agree to just to keep the airline flying.

For many, putting food on the table or setting aside money for retirement is a monthly decision. As one of our members recently stated, "The possible loss of hundreds of dollars a month in old age changes a dignified retirement into a subsistence-level retirement." Or, for another two of our members, a married couple that have together over 70 years of loyal service to the company, who had hoped to retire in seven years, find they now must work for at least an additional 15 years. For individuals who have had to work many years to finally make over $40,000 a year, a cut of hundreds of dollars and in some cases thousands of dollars a month is a severe blow. For some it means a rent payment will be missed, or a car payment, or that prescriptions will go unfilled. For others it means they must now re-enter the job market with skills that are no longer in demand.

I have had some Members of Congress ask me why we are fighting so hard to save our pensions. They say that United will not emerge from bankruptcy unless they terminate the pensions they promised to us and that we have earned over years of hard work and sacrifice. They've asked if we really think that liquidation of our company would be better for us in the long run. They have implied that we, as the obstinate labor union, by requesting that our pensions be saved, are only going to cause the eventual failure and liquidation of our employer. Let me remind the members of this Committee, that we, the employees that have given decades of our lives to this company, have much more at stake in seeing it survive than do most members of upper level management. They have come in to run the company for a few years and then leave and go to another industry. Or, in the case of United's Chief Executive Officer, Glenn Tilton, leave the company at any time and still collect his bankruptcy-court-protected $4.5 million pension plan, All while remaining the most highly compensated CEO in the industry even though he is at the helm of a carrier in bankruptcy. Where is the shared sacrifice in that equation?

As I stated, we have made hundreds and hundreds of millions of dollars in concessions to United management – and at other airlines – to see our carriers survive. We have borne the brunt of the bad business decisions made repeatedly by management at the airlines. We have reluctantly, but willingly, made those sacrifices at the bargaining table. Now, all we are fighting for at United is the one thing that we have worked so hard for over the years as a labor union – a guaranteed retirement income in return for years of dedicated service to the company.

We have tried to work with the company and negotiate a possible solution to keep our pensions intact. In fact, over the past months, AFA suggested five potential sources of funding that would permit the Flight Attendant plan to remain intact:

1) An estimated $150-250 million in common stock to be received in bankruptcy representing both (i) the value of AFA's unsecured claims arising from prior wage reductions and (ii) the value of PBGC's claim were the flight attendant plan terminated

2) $165 million in payments that United proposed to make to a defined contribution plan in lieu of the payments to the flight attendant plan

3) A note of like tenor to the note received by Airline Pilots Association from United in conjunction with termination of the pilots' plan

4) Application to the IRS for minimum funding waivers; and

5) If necessary, a contribution from the PBGC in an amount sufficient, when combined with the other funding sources, as outlined in my first four points, to fund United's minimum funding contributions through December 31, 2010.

All these proposals were rejected by United without the opportunity of lengthy discussion.

Those most responsible for putting United and other airlines in the precarious financial situation they are in are refusing to make the management level cuts they promised. Or in the case of US Airways, where our members lost their pensions earlier this year, they are instituting management retention bonuses.

Again, I ask, where is the shared sacrifice? Why are those most at fault in driving our carriers into bankruptcy or near bankruptcy – management making bad business decisions based on bad business models – why are *they* the only ones not sharing in this sacrifice? They continue to line their pockets while we stand accused of wanting to see our lifelong employers go out of business, leaving us unemployed and with very few opportunities for new careers in the profession and industry we love. Unlike others, we cannot move from the oil industry to the airline industry to some other industry with a golden parachute to help us on our way.

When one of our members asked Glenn Tilton why he thought it was appropriate to keep his 4.5 million dollar pension when we were being asked to give up ours, he said simply: "it's part of my contract." Well, excuse me for thinking that remark a little arrogant, but you should know – and Mr. Tilton should know – my pension is part of my contract too.

Our concerns with United's termination of the flight attendant pension plan and the PBGC's decision to not challenge the termination are numerous. However, simply put, we do not believe that termination of the pension is necessary for the survival of United airlines. We have tried repeatedly to negotiate with the company on other alternatives to save our defined benefit pension plan or to explore means to preserve the plan. In fact, we are the only work group that even offered to pay for part of the plan ourselves. However, each and every time United has told us that there is no option available other than termination. They have refused to look at the pension plans individually, but rather, prefer to lump them all together. We believe that each plan should be judged on its own viability – both ERISA and the bankruptcy code envision such an evaluation. However, the deal struck between United and the PBGC pre-empted just such a review.

AFA also had been working with the PBGC to find an alternative to termination that would allow our plan to survive. We were completely blindsided by their decision, after accepting 1.5 billion dollars from United, to allow termination of our plan. This was especially troubling in light of the fact that on April 4th, the PBGC, in a letter to AFA's actuaries, stated that the PBGC believed that, and I quote, "...the AFA plan can and should be maintained by the company upon emergence from Chapter 11. Based upon available information, we continue to believe that the interests of the participants and the pension insurance program would best be served by the continuance of the AFA plan."

Why did the PBGC change its position so shortly after that letter? That is a question for which no one has an adequate answer. In fact, in a *USA Today* article from mid-May, a spokesperson for the PBGC stated that the PBGC still believed that it would be best for the flight attendants and the government if United did not terminate the plan. The spokesperson went on to reiterate that they believed that United would eventually convince the bankruptcy court judge to allow for termination over the agency's objections. Does this not go counter to the provisions of ERISA, when creating the PBGC outlined that the number one purpose of the PBGC was "to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants?" Let me point out that it states "for the benefit of their participants" not "for the benefit of the corporation."

By accepting a 1.5 billion dollar payment and then standing silently by, I believe that the PBGC failed in its number one purpose of encouraging the continuation and maintenance of voluntary private pension plans for the benefit of their participants. The PBGC simply turned its back on its legal obligations and obligation to the participants of United's pension plans. This Congress should have been outraged by the action of the PBGC. Instead, the overwhelming majority of Congress, both Republicans and Democrats, has acted like the PBGC and, to date, stood silently by while hundreds of thousands of United employees and retirees see their pensions decimated.

If United management is successful in their efforts to terminate our pension plans, no one should be under any illusion: all the other legacy carriers *will* attempt to dump their pension plans as well. With an already huge deficit of $23 billion in unfunded liabilities, the PBGC will simply find itself deeper and deeper in debt. If you, the distinguished members of this Committee, and United States Senators allow for this to go forward, you are simply creating the possibility of a massive taxpayer bailout of the PBGC at a time when the federal government can least afford such an expense. That responsibility is in your hands.

As I stated at the beginning of my testimony, our members at United are the only remaining group at a major airline represented by AFA with a defined benefit pension plan. There has been much discussion today about how we can achieve a long-term fix to the pension crisis rocking the airline industry. There have been some reasonable proposals brought forward which deserve some serious debate and possible enactment into law. Ideas such as extending the amortization period for payments and allowing companies to pay in more during economically profitable years, among other suggestions that were brought forward today are all possibilities that deserve serious debate and may help solve the long term funding problems for pensions.

However, if something is not done immediately to stop the termination of United's pension plans, AFA cannot be a part of those long-term fix discussions. If nothing is done now, we will no longer represent any workers with a defined benefit pension plan. That is why I strongly urge each and every member of this Committee to cosponsor S. 1158, the Stop Terminating Our Pensions Act, or STOP Act. This legislation, versions of which have been introduced in both the House and Senate, would only cover those plans whose plan sponsors are in bankruptcy reorganization currently, and whose unfunded liability on a termination basis is $1 billion or more. All four union employee pension plans at United are covered by these caveats.

The bill would put in place a moratorium for any termination of covered plans initiated by the PBGC under ERISA 4042. It does not affect terminations under ERISA 4041. The essential difference between these sections is whether workers have a say in the process. Under 4041, a termination is voluntary and allowed only after the employer has fully bargained with the unions in good faith. Under 4042, the PBGC may ignore the collective bargaining process and terminate plans on its own. In the United case, the PBGC has struck a deal with the employer to terminate the plans without regard to the collective bargaining process.

The length of the moratorium is six months. This would allow Congress the valuable time needed to explore further solutions to the crisis at United. It allows time for the employer and the unions to honor the collective bargaining process and seek out alternative solutions to plan termination.

Passage of this legislation is needed immediately for us to return to the bargaining table with United Airlines in order to find an internal solution to this problem. We strongly believe that the flight attendant pension plan can be saved and is viable, as the PBGC itself recently stated. We simply want every available opportunity to find a consensus with the company. This six-month moratorium would give you, the distinguished members of the Committee and the rest of your Senate colleagues, the time to debate and consider the various proposals to strengthen and protect defined benefit pension plans in this country. You can help prevent hundreds of thousands of other workers from loosing their pensions and ten of billions of dollars being dumped on the taxpayers by allowing this moratorium to pass.

Please give us the time we need to try and save our pensions. I urge the United States Senate to consider and pass S. 1158, the STOP Act as quickly as possible. If you do not, then you have turned your backs on the over 120,000 United employees who are now facing a bleak and uncertain retirement future.

In conclusion, I would like to return to the human side of this issue by leaving you with the words of one our members who recently wrote to the House Education and Workforce Committee in support of the House version of S .1158. They are:

"My name is Jayme Manley. I am a 46-year-old woman. I am a wife. I am a mother of four young children. I am a daughter of a proud WWII and Korean War Veteran. I am a daughter of a liberated 1960's feminist who worked to put food on the table for her family. I am a sister, aunt, friend, and neighbor.

I am honest, hard-working, faithful. I am college educated, community orientated, and family driven. I am 'the girl next door.' I am exactly what United Airlines sought when hiring me as a Flight Attendant 21 years ago. I am their past, but also United Airlines' future! I am a promise broken. I am despair! Can you see my face yet? I am sad. I am worried. I am the face of 20,000 Flight Attendants who may lose their defined pension benefit. I am a burden to the taxpayers. I am Jayme Manley."

Please send a message to Jayme Manley and all the flight attendants of United Airlines. Pass the STOP Act and work diligently to find a solution to our pension crisis. Thank you.

TESTIMONY OF GERALD GRINSTEIN

Chief Executive Officer

DELTA AIR LINES

BEFORE A HEARING OF THE

UNITED STATES SENATE COMMITTEE ON FINANCE

On

Preventing the Next Pension Collapse: Lessons from the United Airlines Case

June 7, 2005

Delta Air Lines, Inc.
1275 K Street NW
Suite 1200
Washington, DC 20005

Testimony of Gerald Grinstein
Chief Executive Officer
Delta Air Lines

Before a Hearing of The Senate Committee on Finance

Washington, DC
June 7, 2005

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today. My name is Jerry Grinstein. I have served on Delta Air Lines' Board of Directors since 1987 and have been Chief Executive Officer since 2004.

On behalf of the 80,000 active and retired employees of Delta Air Lines and their families, we appreciate the spotlight that you Mr. Chairman, Senator Baucus, and the other members of the Finance Committee are putting on the crisis facing the airline industry and its pension plans. The current pension funding rules are not workable in the current airline environment and they need to be fixed. Those rules require funding contributions on a schedule that can be volatile and unmanageable, with the most significant contributions often occurring at precisely the time a company can least afford it. For an airline like ours that is transforming itself -- thanks in large part to the sacrifice and hard work of Delta people -- to survive in the rapidly evolving world of commercial air transportation, the pension funding quagmire creates a potentially insurmountable barrier to our ability to restructure successfully outside of court supervision. That in turn adds instability to the major hub-and-spoke carriers who provide a vital link in our nation's transportation system, especially for small communities.

The continued leadership of this Committee will be crucial in crafting a set of rules that allow Delta and other traditional national network carriers to pay their employees the retirement benefits they have earned over many years of work while at the same time providing the Pension Benefit Guaranty Corporation (PBGC) a greater margin of protection from unexpected liabilities. Such liabilities have arisen recently as competitive pressures reshaping our industry have caused some airlines to enter bankruptcy, then to transfer their very large pension obligations to the PBGC as part of their effort to exit the process. As this committee works toward comprehensive improvements in our nation's retirement system, we urge you to craft a narrow, targeted solution to the unique pension situation facing many of our nation's airlines as they work hard to transform themselves outside of bankruptcy.

Delta stands ready to meet the challenges of a permanently and fundamentally changed aviation marketplace. We have a business strategy that sets us firmly on course for long-term viability and we have accomplished much over the last few years. However, one of the two biggest factors that will determine whether we can successfully complete our transformation outside of bankruptcy is the pension cloud now hanging over our company and many other traditional legacy carriers.

In 2004, with the help of this Committee, Congress provided airlines with temporary relief from the current law "deficit reduction contribution" requirements. These difficult requirements threatened to exhaust our airline's liquidity reserves by forcing large, immediate contributions to our pension plans when we could least afford it. Congress recognized that bankruptcies would have a greater adverse impact on employees and could result in the transfer of unfunded pension benefit obligations to the PBGC. Because everyone understood that a comprehensive solution was needed, the 2004 funding relief for airlines was intended to be only a temporary, stopgap measure.

The Isakson-Rockefeller bill (S. 861) provides a framework that balances the need for reasonable and affordable pension funding requirements for airlines, while still protecting the PBGC. Under this legislation, airlines that limit their pension liabilities by freezing pension benefits (or agreeing to immediately fund any future benefit accruals) and freezing growth in the PBGC guarantee, would still be required to fund their unfunded pension liabilities. However, they would be allowed to do so on an affordable schedule over the next 25 years using stable, long-term assumptions. The legislation would give airlines a greater chance to transition to a less volatile pension plan structure in a way that fully honors the benefits earned by airline workers over many years.

The Isakson-Rockefeller bill provides airlines the time to complete the transformation required to survive in today's economy in a responsible fashion that protects employees, the government, and our national economy. Let me emphasize at the outset that the Isakson-Rockefeller bill does not involve any kind of a Federal bailout for Delta or any of the other airlines. Delta is not seeking to avoid its obligations to our employees; what we seek is a solution that helps us to honor them. In contrast, two carriers now in bankruptcy -- United and US Airways -- have received court recognition of the immense competitive pressure to eliminate pension obligations in order to attract financing. The termination of those pension plans – which involves shifting of massive liabilities to the PBGC – might be characterized as a bailout but the Isakson-Rockefeller bill will simply allow airlines to fund their pension plans themselves.

DELTA'S LONG ROAD TO RECOVERY

The nation's airlines have been hit by a series of crises, starting with September 11 and its aftermath to the latest plague on our industry – record high fuel costs. Since the year 2000, the nation's airlines have lost close to $33 billion – Delta alone has lost $8.5 Billion and now has over $20 Billion in long term debt. Several carriers, including two that represent over 20 percent of the U.S. airline market, are operating in bankruptcy. With newer low-cost carriers now claiming 30 percent of the domestic travel market, it is clear that the traditional legacy carriers must bring their operating costs into line with these competitors -- competitors that do not provide defined benefit pension plans. The traditional national network airlines understand that we have no choice but to reduce costs or cease to exist.

Delta began making tough but necessary changes in 2002, and by the end of 2004, we had achieved $2.3 billion in annual revenue and cost benefits. However, appreciating that we were not in a cyclical downturn, but rather in a permanently and fundamentally changed aviation marketplace – due, in part, to changed customer preferences, low-cost carriers, and online fare shopping – we launched a new strategic plan in September 2004 that focuses on winning back customer trust and achieving viability. We are on our way to doing both Our goals are to improve the customers' travel experience and also build on the $2.3 billion already achieved to reach a total of $5 billion in annual revenue and cost improvements by 2006, as compared to

2002. In the face of harsh financial realities and increasingly fierce competition, the people of Delta Air Lines are proving their mettle as we transform our company into the right airline for a new era. While a long, tough road still lies ahead, we already have made remarkable progress. We have now targeted all components of that $5 billion goal. A crucial element of the savings has been the shared sacrifice of all of Delta's employees, including, regrettably, the loss of jobs. Today, Delta's workforce is about 56,000 – a decrease of 23,000 employees since September 11, 2001. The job reductions have been spread across the entire company, with our executive ranks trimmed by 25 percent during that period. Delta now has the lowest ratio of total Officer and Director level positions to total employees among the six largest airlines.

In 2001 Delta was a leader in compensation in our industry. Since that time our people have taken the painful steps necessary to adjust our pay and benefits going forward to levels more realistic for the changed environment in which we operate. Last fall, Delta pilots approved a contract providing a crucial $1 billion in annual savings including a one third pay cut for five years with no snap back provisions. Delta's other employees also have experienced their fair share of pay cuts – with a company wide pay cut of 10 percent in January – following 5 years with no general increase to our pay plans. As of April 1, 2005, Delta's frontline employee groups rank in the bottom tier of the largest airlines in top of scale pay rates. In 2004, Delta's top 5 executives ranked third to last in total cash compensation among major carriers, including Southwest, AirTran and Jet Blue.

Part of our plan has also been to trim benefits across the board. We have achieved substantial savings in our health care benefits – totaling more than $300 million over the 2003-2005 period. Premiums for family coverage for Delta employees increased from zero in 2002 to approximately $2400 per year in 2005.

We have also reduced future pension benefit accruals for both pilots and non pilots in order to proactively rein in our future expenses for retirement benefits. In 2003, Delta converted its traditional defined benefit final average earnings plan for non-pilots to a cash balance plan, which resulted in significant pension cost reduction. Unlike many companies who have undertaken such a transition, however, we did not ignore the interests of our employees in this conversion. To address the concerns of long term employees who are close to retirement, Delta is providing a seven year transition period during which employees will earn the better of the two benefits. It is important to both Delta and its employees that the Isakson-Rockefeller bill preserves Delta's ability to maintain this transition period.

As part of the pilot negotiations concluded last year, Delta's pilots agreed to freeze service accrual under their defined benefit plan and implement a significantly less costly defined contribution plan. This freeze will also result in significant annual savings for Delta. Because of the significant pay reductions agreed to by the pilots, there is minimal benefit accrual expected in this plan for several years. Once again however, it is important to both Delta and its pilots that S. 861 preserves this "soft freeze" approach agreed to in good faith by both parties.

In addition to these steps, we have reduced other benefits such as paid vacation and sick leaves with the net effect that Delta employees are working longer and harder for much less – all in an effort to regain a competitive position in a marketplace that has fundamentally changed.

We have also attained significant savings and debt restructuring assistance from vendors, suppliers, aircraft lessors, debt holders and others.

These actions have already made our airline fully one-third more productive and cost-effective, without diminishing Delta's ability to generate revenue. At the same time, Delta has achieved high levels of customer satisfaction despite the sometimes massive changes occurring throughout our operations. Delta was ranked among the top three airlines by J.D. Power and Associates 2005 Airline Satisfaction study and second in customer satisfaction in a recent Department of Transportation report.

Delta has made great progress in improving our cost structure -- and those accomplishments have been possible only with the support of Delta people at every level, throughout the company. Despite this extraordinary effort, however, our company's most recent financial results show continued high losses. A key cause of those disappointing results is skyrocketing fuel prices – which have jumped by as much as 30 percent since the first of the year. Fuel is Delta's second highest expense after salary and benefits. With every one cent increase in average jet fuel cost per gallon adding $25 million to Delta's annual costs, higher fares can offset only a fraction of the impact of the increased fuel costs. If you factor out the high fuel costs, a dramatically different financial picture emerges at Delta. Excluding fuel and special items, Delta has succeeded in reducing unit costs for mainline operations by almost 13 percent during the last quarter when compared to the previous year.

The low-cost carriers' basic advantage is just that – low costs. While the going is rough and often painful, Delta and other legacy carriers are tenaciously pursuing their own cost reductions and we show no signs of stopping. We can and will continue to work to control our costs – and as I have said – the employees of Delta have stepped up to make cost control a reality. When we finally reach our desired cost structures, we will be a formidable competitor, but we can only achieve that end if the problems and uncertainty surrounding our pension plans are resolved.

THE PENSION CLOUD

Without changes in the pension funding rules, all of our efforts to transform ourselves out of court could be to no avail. There is no question that the single biggest uncertainty that may well determine whether or not Delta can successfully restructure outside of bankruptcy court is the pension cloud that hangs over the company.

At Delta, we maintain two primary defined benefit pension plans – the Pilots Retirement Plan and the Delta Retirement Plan for our non-pilot employees and these plans have historically been well funded. We measure the ERISA funded status of these plans as of July 1 of each year. As recently as July 1, 2001, both these plans had a funded status ratio of 100% or better for ERISA current liability purposes. Largely as a result of a short period of negative and below expected investment returns and a steady fall in the interest rate used for measuring liabilities, however, the funded status of our defined benefit plans has taken a turn for the worse. The result is that the funded status for both plans declined to about 75% for current liability purposes at July 1, 2004, the most recent ERISA funding measurement date. Thus, Delta's qualified defined benefit pensions, which had no current liability under-funding as of July 1, 2001, are under-funded by approximately $2.6 billion dollars on a current liability basis as of July 1, 2004. This increase in liability did not result from failing to make contributions to the plans. We have not sought a funding waiver and have always made required contributions. For 2005, the estimated funding for those plans is about $275 million, most of which has already been paid. Without changes in the funding rules, we project that we will be required to contribute a total of $2.6 billion to our qualified defined benefit pension plans from 2006 to 2008. Simply put, we cannot afford a cash crunch of this magnitude, certainly not in the current economic environment confronting airlines, and no amount of sacrifice of future compensation can solve this problem since the vast majority of this funding relates to service already accrued in the past.

Now, some have asked why we didn't put more money in the pension trusts in the late 1990s when we were making money. That is a good question, and the simple answer is that the pension funding rules discouraged additional funding of plans that were determined to be fully funded. As the members of this committee know, pension funding rules are designed both to keep plans funded, by requiring a minimum annual funding, and also to keep companies from avoiding income tax by putting excess cash into plans on a tax-favored basis. The determination of minimum and maximum tax deductible funding is completed once per year and for the late '90s, the minimum required contribution as well as the maximum deductible contribution for Delta's plans were both zero.

Although the Bush Administration has proposed various reforms to the pension funding rules, including lower required contributions for some plans, these proposals will not be sufficient to solve the unique and immediate problems for the airlines. Indeed, some of these proposals could push airlines into bankruptcy and accelerate the transfer of unfunded pension liabilities to the PBGC.

As recent events amply demonstrate, transferring such liabilities to the PBGC has a number of onerous results.

- Employees and retirees can lose benefits they have already earned because PBGC's insurance program covers only basic pension benefits and is subject to annual dollar caps.

- In a bankruptcy scenario, airline employees (and employees of companies dependent on airlines) are likely to suffer further reductions in pay, benefits and jobs and airline creditors and investors will inevitably lose money.

- Each new airline bankruptcy exacerbates the risk of a downward spiral where airlines race to shed their pension obligations because courts have approved their competitors doing so.

- A further string of bankruptcies among the national network carriers – and the resulting disruption and chaos that would ensue – will hurt the economy, and weaken our vital air transportation network, including especially service to smaller cities which are generally not served by low-cost carriers.

- Finally, transferring further liabilities to PBGC will, at a minimum lead to higher PBGC premiums on those employers that voluntarily maintain plans (potentially undermining the entire defined benefit system) and could ultimately lead to a taxpayer bailout of the agency.

Absent an appropriate legislative resolution, economic reality and competitive pressures are likely to force other major airlines with defined benefit pensions to follow the bankruptcy path that United and US Airways have recently followed. We at Delta don't want that result and are working very hard to avoid it. It is not what is best for our company, for our employees, for our customers, for our shareholders or for our country.

THE ISAKSON-ROCKEFELLER SOLUTION (S. 861)

We are at a crossroads. We cannot control the world we live in, but we must adapt to it. There are two paths Delta and other traditional carriers can follow. The first path some would paint as the easy road for corporate executives to take – file bankruptcy, dump pension liabilities on the PBGC and emerge a nimbler competitor on the other side. That view ignores the many painful realities that bankruptcy entails, but the fact is that bankruptcy courts have recognized that additional financing to successfully exit the process is nearly impossible when legacy pension funding costs have not been dealt with. Their actions in the United and US Airways cases have further altered the competitive landscape in a profound way, helping those carriers rid themselves of billions in liabilities, which makes them poised to be much more effective competitors.

The second path is to evolve and adapt to the new world airlines must survive in. Delta is committed to making the tough choices that will make it possible for our company to survive. The path we want to follow involves honoring the commitments we have made to our employees and retirees over the 75 years that Delta has been in existence. Our ability to follow this path is directly linked to Congressional action to give us pension funding rules that will enable us to resolve this crisis responsibly.

S. 861, the Isakson-Rockefeller bill (and its House companion – H.R. 2106), provide the type of change in pension law that is needed to allow airlines to take the right path. The theory of the bill is quite simple. When an airline commits to freeze a plan or immediately pay for any newly accrued benefits and institutes protection for the PBGC, the government will not require very large contributions that may have the counterproductive effect of driving the airline into bankruptcy. Under this legislation, airlines that freeze pension accruals would still be required to fund the existing unfunded pension liabilities, but would be allowed to do so under a more affordable schedule over the next 25 years using stable, long-term assumptions. Under the bill, the airlines would continue to make sizeable contributions each year to reduce their otherwise frozen unfunded liability, thus reducing the potential future liability for the PBGC. The goal is to establish a payment schedule for the unfunded liability that is both more affordable and practical -- properly balancing the interests of four stakeholders – employees, the federal government, the companies and the traveling public.

A number of strict requirements -- beyond the required freeze -- would be imposed on airlines that choose this approach – all designed to protect the PBGC. For example, any benefit increases above the frozen level would have to be funded immediately and no successor defined benefit plan would be permitted. In addition, the PBGC's guaranteed level of benefits would be limited to the amount the PBGC would have guaranteed had the plan terminated instead of freezing. In other words, the PBGC monthly benefit guarantee would not increase beyond the level in effect when the plan froze.

The approach taken in S. 861 (and H.R. 2106 a House companion bill) has a number of advantages for employees, the federal government and the parties that finance the PBGC, and it decreases the likelihood of PBGC insolvency.

- **For Employees and Retirees.** Employees benefit because they will receive the full benefits they have accrued prior to the freeze rather than often seeing their benefits reduced if liabilities were transferred to the PBGC. Moreover, finding a solution to the airlines' current pension crisis means that airlines are more likely to return to economic health (by restructuring outside of bankruptcy), preserve jobs and fund their own pension commitments rather than relying upon the PBGC to do so.

- **For the Financial Backers of the PBGC.** The PBGC and those companies paying PBGC premiums benefit because the approach in S. 861 provides airlines with a way to maintain their pension programs and continue to fund their pension benefits and pay PBGC premiums without having to resort to shifting liabilities to the PBGC. Just as important, addressing the airline pension problem significantly decreases the likelihood of the need for a taxpayer bailout of the PBGC. Even if an airline electing to use the provisions of S. 861 should later falter, the PBGC (and the taxpayers) should be better off because PBGC's benefit guarantees are fixed at the time of the pension freeze, airlines will have made intervening contributions to close their pension funding gaps, and any subsequent benefit accruals will have been immediately 100 percent funded.

- **For the Traveling Public and the Economy.** The traveling public which relies on our nation's air transportation system for business and personal travel and as the engine of our economy would benefit from a stable, healthy, competitive airline industry which includes the network carriers who provide the vital link to and from small cities as well as an important source of jobs.

- **For Delta and Other Major Network Airlines.** Once the pension funding schedule is based on a more manageable, affordable schedule, the nation's carriers would be able to honor employees' already hard-earned pension benefits and at the same time continue to pursue, outside of court supervision, the transformation plans now underway that are essential for survival in the new aviation marketplace.

Let me emphasize once again that the path we propose does not involve Federal subsidies for Delta. To the contrary, we believe it is the other path – the one that others have been forced to follow – that involves a form of subsidy by relying on the PBGC to fulfill benefit promises that the bankrupt company cannot. We think the path we want to take is a better path -- better for the PBGC, better for our employees, better for our customers, better for the overall air transportation system and better for the economy as a whole.

ACTION IS NEEDED NOW

The help of this Committee is required to follow that better path. Existing pension rules require airlines to make huge contributions at a time when we can least afford it. In order to have a much greater chance to transform ourselves outside of bankruptcy, the existing rules must be changed. As they are today and as they would be under the Administration's proposals, pension funding rules only push us closer to following in the footsteps of United and US Airways – and we have seen where the realities of the marketplace lead when that happens.

To some extent, the legacy airlines are responsible for the situation we now face – not having adequately anticipated the impact of low-cost carriers or the internet fare shopping. However, the problems faced by the airline industry are clearly not entirely of our own making. No one could have anticipated the attacks of September 11, 2001 or its aftermath. We could not have anticipated fuel costs rising to unprecedented levels. We could not have anticipated a string of our major competitors marching into bankruptcy court and shedding billions of dollars of pension obligations and potentially emerging from bankruptcy free of those liabilities to compete with us.

Our industry has fundamentally and structurally changed and we need the help of this committee to walk the path that makes sense – for all our stakeholders. Excess capacity, fuel prices, the economy, bankruptcy developments, possible sales of assets or other actions, plus a hundred more possibilities, all could create long chains of actions and reactions within the airline industry. But if we can know that our future pension funding obligations will be reasonable and affordable, then we will have the opportunity to compete with discount carriers (and with United and US Airways) on a more level playing field, while also having the chance to provide the pension benefits our employees and retirees have earned over their careers.

CONCLUSION

The perilous issues facing our industry, including those I've just reviewed, matter not only to airlines and airline employees, but also to the public who depends upon them. The U.S. air transportation system provides a vital service for businesses and other organizations as well as families and friends across our nation.

It is clear that airlines must transform in order to survive in today's economy. Delta has embraced that change. With prompt adoption of S. 861, this can be done in a responsible fashion that protects employees, the government and our national economy. The alternative may be an industry in continued distress and a wholesale shift of airline pension liabilities to the PBGC.

Mr. Chairman and members of the Committee, we thank you for the opportunity to present our views. We look forward to working with the Committee on a resolution of the pension funding challenges facing our nation's airlines.

CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

Defined-Benefit Pension Plans: Current Problems and Future Challenges

before the
Committee on Finance
United States Senate

June 7, 2005

This statement is embargoed until 10 a.m. (EDT) on Tuesday, June 7, 2005. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Grassley, Senator Baucus, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss questions that the termination of United Airlines' pension plans raises about private defined-benefit pensions in the United States and the issues confronting the Pension Benefit Guaranty Corporation (PBGC). Defined-benefit pensions are an important aspect of labor compensation for millions of people in the United States today, as they will continue to be for decades to come. Recent experience suggests three key observations:

- In structuring future policy, it is important to distinguish between the portion of pension underfunding and resultant PBGC liabilities that is an unchangeable legacy of the past and the portion of underfunding—and the attendant claims to be assumed by PBGC in the future—that may be reduced over time by changes in policy.

- With regard to legacy underfunding, the essential policy question is how to distribute the costs of the shortfall among shareholders, workers, and, perhaps ultimately, taxpayers.

- With regard to the future of the defined-benefit pension system, the key challenge is to design the appropriate mix of incentives for self-insurance (such as appropriate standards for funding) and for purchased insurance (such as that provided by PBGC) to ensure that workers will receive the portion of their compensation promised in the form of a defined-benefit pension—despite changes in a firm's fortunes, the growth or decline of an industry, and the overall performance of the economy.

For workers employed by a company that provides a defined-benefit plan, the promised annuity is often a substantial part of their compensation and an important aspect of their planned retirement income. However, the long period between when the compensation is earned and when the annuity is paid increases the potential for adverse economic events in the interim. Therefore, in the absence of a system of insurance, the availability of benefits from defined-benefit plans depends on the adequate funding of those benefits.

Lawmakers initially became concerned about workers' receipt of promised pension benefits after the failure of several large plans in the 1960s, which eventually led to the enactment in 1974 of the Employee Retirement Income Security Act (ERISA). That law specified minimum standards that pension plans must meet regarding participation, accrual of benefits, vesting, and funding. Along with those standards, PBGC was created to insure pension beneficiaries against the loss of promised benefits as a result of a plan's inadequate funding. At the end of 2004, PBGC insured the pension benefits of more than 44 million workers and retirees. It had assumed responsibility for paying the benefits of about a million workers and retirees whose plans had terminated without sufficient funds to pay all insured benefits.

Since the enactment of ERISA, the percentage of active workers covered by defined-benefit plans has declined substantially, whereas coverage under defined-contribution plans has risen.[1] On the basis of forms filed each year by employers, the Department of Labor estimated that in 1980, about 40 percent of all private wage and salary workers participated in a defined-benefit plan, 19 percent were in some type of defined-contribution plan, and 11 percent participated in both kinds of plans.[2] By 2004, the Bureau of Labor Statistics reports, 21 percent of all workers in private industry were participating in a defined-benefit plan, 42 percent were participating in defined-contribution plans, and 13 percent were participating in both.[3]

Despite the decline in the share of workers that defined-benefit plans now cover, such plans are likely to remain a major source of income for many retired workers and their families well into the future. A study based on the Social Security Administration's Model of Income in the Near Term estimated that 53 percent of current retirees (those born between 1926 and 1935) were members of families that received income from defined-benefit pensions, whereas 46 percent received income from retirement accounts (including individual retirement accounts).[4] As retired workers who are covered by defined-benefit plans are replaced by workers covered by defined-contribution plans, those percentages will gradually reverse, according to the study's authors. For retirees born late in the baby boom (around 1960), an estimated 40 percent will receive income from defined-benefit pensions, and 59 percent will receive income from retirement accounts.

The Scale of Pension Underfunding

At present, the underfunding of defined-benefit pension plans is a pervasive and sizable phenomenon. PBGC estimates that the vast majority of plans are currently

1. A defined-benefit plan is an employment-based retirement plan that promises retirees a certain benefit upon retirement, regardless of the plan's investment performance. Under a defined-contribution plan, such as a 401(k) plan, benefits in retirement depend on what employers and employees have contributed and on the investment performance of those funds.

2. Department of Labor, Employee Benefits Security Administration, "Abstract of 1999 Form 5500: Annual Reports," *Private Pension Plan Bulletin*, no. 12 (Summer 2004).

3. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004* (November 2004).

4. Barbara A. Butrica, Howard M. Iams, and Karen E. Smith, "The Changing Impact of Social Security on Retirement Income in the United States," *Social Security Bulletin*, vol. 65, no. 3 (2003/2004).

underfunded to some degree. The agency's best estimate of total underfunding (on a termination basis) among all insured plans is $600 billion—$450 billion for single-employer plans and $150 billion for multiemployer plans.[5] Of course, all estimates of underfunding are just that: estimates. As such, they are sensitive to projections about interest rates, future returns on assets, retirement ages, and life expectancies. A shift in those factors—especially in interest rates—could have a substantial effect on projections of underfunding.

The Financial Condition of the PBGC

Part of the challenge presented by efforts to reform the defined-benefit pension system are the different terms used to describe the system's problems and the various methods used to measure them. As a federal agency, PBGC's finances are part of the federal budget, which is presented and tracked largely on a cash basis; however, the financial condition of pension plans is usually stated in accrual terms.[6] Both methods use such terms as liabilities and assets, obligations, and deficits, although cash and accrual accounting approach those measurements in different ways. The two methods can and, in fact, do produce different and often conflicting measures of PBGC's financial condition.

Cash Accounting

PBGC's resources are divided between two funds: an on-budget fund for receipts of premiums and outlays for benefits and administrative costs, whose transactions since 1980 have been included in federal budget totals; and a nonbudgetary trust fund, in which the assets of terminated plans are held until used to help pay benefits. According to the government's cash accounting, PBGC ran a cumulative on-budget surplus of more than $12 billion from 1981 through 2004. (The only year in which PBGC incurred a cash deficit, amounting to $229 million, was in 2003.) An observer looking only at PBGC's on-budget accounts, as the federal budget does, might conclude that the agency was on a firm financial footing. That conclusion would be misleading, however, because it ignores the agency's long-term financial picture.

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5. By law, the funding rules and insurance system treat pension plans sponsored by a single employer differently than those sponsored by more than one firm, which are referred to as multiemployer plans. Although both types of plans are experiencing similar problems, PBGC underwrites much more liability for single-employer plans. As a result, most pension reform efforts concentrate on such plans.

6. Cash accounting recognizes, or takes account of, transactions when cash inflows or outflows occur. Accrual measures recognize costs in the period in which they are incurred, even though the cash flows do not occur until some time in the future.

Accrual Accounting and Exposure to Underfunding

PBGC's overall fiscal health is better measured by looking at the agency's net financial position—the difference between the actuarial value of its assets and the present value of its liabilities.[7] Under accrual accounting, the value of PBGC's assets is based on the current fair market value of all cash, bonds, equities, and other holdings of its budgetary and nonbudgetary funds. Its liabilities are calculated as the estimated present value of all future benefits that PBGC is obligated to pay on behalf of plans that have already been terminated, plans whose termination is pending, and plans that PBGC has identified as likely to be terminated.

From the time it began operations in 1975 through 1995, PBGC's net financial position—on an accrual basis—was in deficit. In other words, the total value of the assets it had on hand was not sufficent to cover its projected future benefit payments. (Use of the term "deficit" here should not be confused with annual cash-flow deficits or surpluses.) Starting in 1996, however, PBGC's net financial position moved into positive territory, reaching a peak of $10 billion in 2000. The agency's financial position moved back to one of deficits in 2002, reaching a record shortfall of $23.5 billion by the end of 2004.

PBGC's net financial position essentially measures how the resources available to the agency at a given point in time compare with the pension obligations already on its books as well as additional claims from plans whose termination in the near future it considers "probable." Included in the net deficit figure of $23.5 billion is $17 billion in claims from plans that the agency has classified as likely to be terminated.

Another measure of PBGC's financial situation is the amount of underfunding among plans for which the agency considers default "reasonably possible." In 2004, PBGC's exposure to claims from such plans stood at $96 billion. (That "reasonably possible" termination category primarily includes plans sponsored by firms that the financial markets consider to be experiencing some financial distress—indicated by credit ratings below investment-grade—but that are not already included in the "probable" category.) According to PBGC, exposure to claims from plans in the "reasonably possible" termination category has risen dramatically, from about $5 billion in 2000 to more than $96 billion today.

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7. The present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. Market interest rates are the basis of the discount rate used to calculate the net present value of plans' liabilities. Interest rates and the present-value calculation of liabilities are inversely related (lower interest rates lead to higher valuations of pension liabilities and vice versa).

PBGC's Solvency

Although PBGC's fiscal health is best measured in accrual terms, the shortfall between liabilities and benefits will eventually affect the agency's annual bottom line, as measured on a cash basis. Thus far, PBGC has experienced an on-budget deficit only in 2003; it is too early to tell whether the agency will record a cash deficit or a surplus this year. But under its current funding rules and premium structure and the assumptions of the Congressional Budget Office's (CBO's) current economic forecast, there is little doubt that PBGC will soon start running cash deficits for the foreseeable future (see Figure 1). In CBO's projections, the combination of rising benefit obligations and level premium income causes the agency's on-budget fund to be completely exhausted in about 2013.

No precedent exists for how PBGC would proceed if its on-budget fund became insolvent. However, CBO's expectation is that the agency would cover its expenses by increasing the percentage of benefits and other expenses being paid out of its nonbudgetary trust fund. Although CBO does not formally estimate the value of the assets held by that fund, there is a significant likelihood that all of PBGC's assets will be exhausted within the next 20 years.

Under current law, no substantial source of funds is available to PBGC if the agency runs out of money. ERISA makes it clear that PBGC is not backed by the full faith and credit of the U.S. government and has no authority to call upon general revenues to pay benefits. Therefore, if PBGC exhausted all of its holdings, either benefit payments would be drastically cut—perhaps in excess of 90 percent—or lawmakers would have to provide direct assistance from the Treasury.

Problems and Policy Issues: Legacy Costs

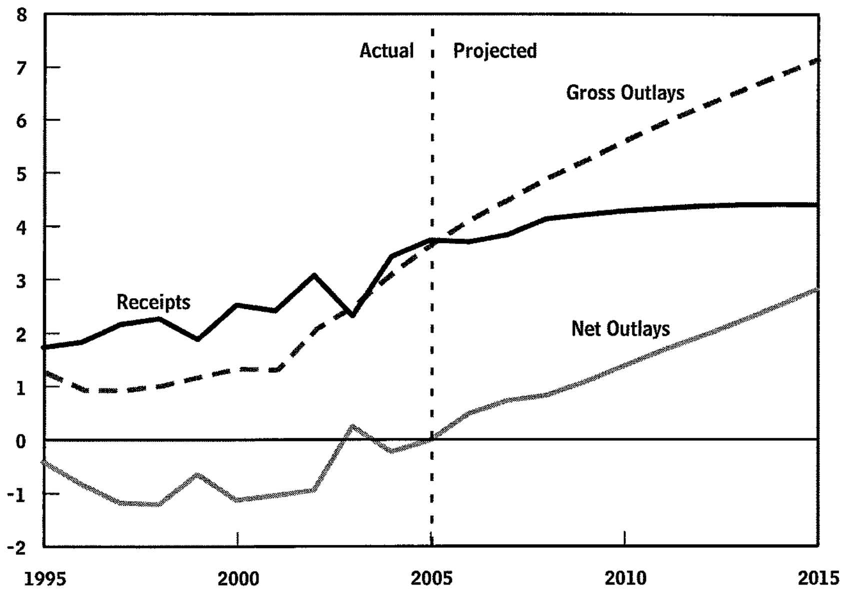
Most of the claims that PBGC has recently assumed have been concentrated in a few industries. Nine of the 10 largest claims in the agency's history have come from the airline or steel industries, which account for nearly 70 percent of the dollar value of PBGC's total claims. The most recent example is United Airlines.

In those industries, among others, the competitive position of firms that offer defined-benefit pension plans has deteriorated significantly. That deterioration is likely to prevent such companies from bringing new resources to their under-funded pensions by raising prices and garnering additional revenues from their customers. Changes in policy that require augmented pension funding would impose new costs on sponsors (and consequently losses for shareholders), probably increasing the chances of further bankruptcy filings for purposes of reorganization or liquidation.

Figure 1.

Outlays and Receipts of the Pension Benefit Guaranty Corporation, Fiscal Years 1995 to 2015

(Billions of dollars)



Source: Congressional Budget Office.

Note: Data for 1995 through 2004 come from *Budget of the United States Government, Fiscal Year 2006*. Figures for 2005 through 2015 are CBO's baseline projections.

In such circumstances, PBGC's assumption of the firm's pension liability might impose losses on workers, either through the limitations on maximum pension benefits that the law mandates or because PBGC itself might have insufficient assets to fully honor current insurance arrangements. Alternatively, plan sponsors could restrain costs by modifying their plans to reduce benefit accruals for current workers or by freezing their plans entirely. Indeed, either of those scenarios could transpire under current law.

Problems and Policy Issues: The Future of Defined-Benefit Pensions

The recent experience of defined-benefit pension plans in the steel and airline industries provides lessons for improving policy in the future. Specifically, it is impossible to fully anticipate the nature of shifting economic conditions at the level of the firm, the industry, or even the economy as a whole. In that case, if workers and firms wish to continue to use defined-benefit pensions as a component of compensation, it will be important to ensure that those firms either "self-insure" (adequately fund) such compensation or that external insurance (in particular, that provided by PBGC) be structured to provide suitable incentives.

Strengthening Pension Funding Rules

The current rules governing pension funding were intended to ensure that firms contributed adequate resources to pay promised benefits by the time the benefits came due, while also providing firms with some flexibility as to when and how they made those contributions. However, certain features of those rules may have led to systematic underfunding among a number of defined-benefit plans. Many firms whose pension plans were recently taken over by PBGC used those features to make small or no contributions to their plans in the years leading up to the plans' termination—at which point they presented PBGC with billions of dollars in claims.

In some cases, the funding rules discourage sponsors of plans that are considered fully funded from making additional contributions that could provide them with a greater cushion to absorb the effects of adverse market conditions. In other cases, firms that sponsor underfunded plans are sometimes allowed to reduce or suspend contributions that would serve to make those plans better funded.

For example, the law permits sponsors to make contributions in excess of those required and then to use those amounts as a credit against contributions required in the future—even if subsequent events (such as a drop in the stock market) reduce or eliminate the value of the excess contributions. In addition, some of the formulas used to determine a plan's current liabilities—and therefore the sponsor's contributions—are based on the assumption that the firm sponsoring the plan will stay in business indefinitely. Under such an assumption, the measure of liability will not take into account the full costs that may be incurred by plans nearing termination (such as costs related to the increased number of workers who accept early retirement benefits, the promise of shutdown benefits, or lump-sum payouts), all of which can increase the costs to PBGC in the event that it takes over the plan.[8]

Funding requirements that allow for the long-term smoothing of both asset values and discount rates are among the funding rules that have contributed to wide-

8. Shutdown benefits are a form of pension benefit provided to employees when a particular plant or company closes down and ceases operation. They are not included in most calculations of a plan's liabilities, and sponsors do not currently pay premiums for such benefits.

spread underfunding. Under the current set of rules, plans' liabilities are assessed on the basis of a four-year weighted average of interest rates; the actuarial value of assets relies on a smoothing method as well. Those rules are designed to dampen the fluctuations in contributions that sponsors would otherwise face in volatile financial markets. However, in rapidly changing markets, the reported funding ratios (assets to liabilities) might be markedly different from those that would be calculated using current market values. In recent years, that has led plans to appear better funded than they actually are. (Of course, in a different economic environment, the reverse could be true.) Some observers have suggested that using current market values of liabilities and assets would encourage plans to invest their assets in a way that better matched the liabilities' duration with the income projected to be received from assets. Such matching would help immunize plans from financial fluctuations and thus moderate the volatility of required contributions.

Pricing Pension Insurance

The underpricing of PBGC's insurance—that is, the current premium structure—is a key factor in the agency's present financial difficulties. Premium revenue is the only source of income available to PBGC to cover the shortfall between the liabilities of terminated plans and the value of their assets. CBO expects that under current law, premium income will remain relatively flat—at around $1 billion annually—whereas benefit payments resulting from both past and future claims will rise from about $3.5 billion this year to more than $10 billion in 2015.

A contributing factor to that pattern is that the premium rate paid by sponsors of multiemployer plans has remained constant since 1988, and rates for the two types of premiums charged for single-employer plans have not changed in more than a decade. (One of those premiums is an amount levied per plan participant; the other is calculated on the basis of a plan's underfunding.)[9] The rates for the premiums are set by statute, and PBGC cannot adjust them, as most insurance providers can, for the losses that past history leads it to expect. The underpricing of PBGC's insurance may also exacerbate a phenomenon known as moral hazard, by which the very existence of insurance leads firms to promise more benefits to workers or provide less funding to their pension plans than they might have in the absence of insurance.

In principle, insurance for defined-benefit pension plans could be provided either through the private sector or by the government. If private markets were used, they would charge premium rates that reflected the likelihood that the insured

9. The premium that is levied on underfunding does not always work as intended. Because of loopholes in the premium rules, many plans that are underfunded are not actually required to pay premiums on their underfunding.

event would occur. A fully funded plan with an economically strong sponsor would represent a low potential claim to the insurer and would be charged a smaller premium than an underfunded plan with a financially struggling sponsor—which would present a higher risk and pay commensurately higher premiums.

By contrast, the current practice is to supply pension insurance through PBGC, which is not allowed to fully tailor its premiums to the risks it faces in insuring plans that vary in their likelihood of termination. Although the law specifies that significantly underfunded plans must pay a variable-rate premium based on the amount of their underfunding, the agency is not permitted to distinguish between profitable sponsors that pose little risk of termination and distressed sponsors that threaten the agency with a large-scale claim.

Another issue relevant to the pricing of pension insurance is how premiums should be changed to reflect past versus future claims against PBGC. The estimated shortfall for past claims, as well as some imminent losses, is $23.5 billion. With estimated underfunding of $96 billion residing in plans that are classified as having a reasonable possibility of default, it is realistic to expect that PBGC will soon be taking on billions of dollars more in claims. If premiums were set so as to lessen or eliminate the agency's accumulated deficit as well as to accurately reflect its exposure to future claims, ongoing sponsors would be charged substantially more than actuarially fair rates. That kind of system might lead some sponsors of well-funded plans to freeze or terminate their plans, thus actually worsening PBGC's finances by reducing its premium collections. In considering how to finance PBGC in coming years, it would be useful to consider the following as separate issues: (1) how to price pension insurance to cover future risks and provide the proper economic incentives to firms in managing their pension plans, and (2) how to pay for losses that have already been incurred.

The notion that premiums should reflect risk also leads to the conclusion that the measures a firm takes to reduce risk should result in the lowering of its premiums. For example, under such an approach, sponsors that had good credit ratings would face lower premium rates than less creditworthy firms. Similarly, the premium structure should take other factors into account as well, including PBGC's access to nonpension assets in bankruptcy court and contingent liabilities such as shut-down benefits.

Promoting Transparency in Funding and Accounting Rules

The transparency of the risks within the defined-benefit pension system is another important consideration. Markets work best when full information is available to all of their participants. The current pension system does not do a very good job of providing the kind of information that would be helpful to investors and plans' participants as well as to policymakers and taxpayers. Funding levels are measured in different ways for different purposes, and information about potential underfunding that is filed with PBGC and other government agencies (such as the Internal Revenue Service) often lags years behind. In some instances, PBGC receives more recent and detailed information about seriously underfunded plans but is prevented by confidentiality laws from releasing those data.

Those delays force investors and plans' participants to rely on corporate reports for timely information about a plan's funding status. However, in issuing their annual reports, firms are allowed to use a variety of interest rates to discount the cost of their pension liabilities.[10] In many cases, companies use a higher interest rate to calculate their plans' liabilities for corporate financial reports than they use to report liabilities to government agencies or to the plan's participants. The higher discount rate makes pension liabilities appear smaller to those who use annual reports to value companies on the basis of their assets and liabilities. The use of different discount rates combined with lack of transparency about funding levels can cause investment markets to undervalue the cost of providing pension benefits; it may also lead workers to underestimate the likelihood that their promised pensions might not be delivered in full.

10. The discount rates used in corporate financial reports are governed by the Financial Accounting Standards Board.

Dr. Douglas Holtz-Eakin Responses for the Record
Senate Committee on Finance
"Preventing the Next Pension Collapse: Lessons from the United Airlines Case"
Committee hearing, June 7, 2005

From Senator Grassley

In CBO's opinion, has the existence of so-called "smoothing" techniques under current law contributed significantly to the widespread funding of pension plans? Could you clarify CBO's views on the importance of reforming pension funding rules so that they require an accurate measurement of pension liabilities? In particular, could you provide any views on the effect of so-called "smoothing" mechanisms related to interest rate and asset valuations in calculating pension liabilities, and whether such smoothing mechanisms should be eliminated? Is an accurate measurement of liabilities equally important for all purposes (e.g., disclosure, calculation of liabilities for contribution purposes, etc.)?

Answer. Efforts in law and regulation to smooth year-to-year pension plan contributions by smoothing changes in measured pension liabilities and assets are a significant source of plan underfunding and costs to the Pension Benefit Guaranty Corporation (PBGC).

Under current valuation practices, measured plan funding levels are substantially less volatile than actual funding levels. This means that during "good" economic conditions (high and rising equity prices, income and production) measured levels of overfunding tend to be less than actual overfunding. (That is, overfunding is understated.) Similarly, during bad economic conditions (falling and low equity prices, income and production, usually accompanied by low interest rates), measured underfunding understates actual underfunding. On average, it might seem that these biases cancel one another and that on balance, smoothing does not affect the average level of underfunding or PBGC costs.

However, underfunding is understated precisely when plans are at highest risk to be terminated and turned over to PBGC. (Plans are rarely terminated when economic conditions are good and the level of overfunding is understated) That is, during bad economic conditions when plan sponsors are most likely to experience financial distress and to put insurance claims to PBGC, those plans are most likely to be underfunded in excess of measured and reported levels. That understatement permits sponsors to limit plan contributions and to avoid the full variable rate premiums that they would otherwise have to pay. Thus, smoothing understates the extent of underfunding and thereby increases the actual gap between measured and termination underfunding.

Plan sponsors tend to take full advantage of the discretion they have under the smoothing and other provisions of law (for example, the use of credit balances) to minimize plan contributions and variable rate premiums as they approach bankruptcy. Two widely-publicized examples of the discrepancy between measured and actual underfunding for terminated plans are those of Bethlehem Steel and US Airways Pilots' Plans. Bethlehem's measured funding level as reported in 2001 was 84 percent, but at termination in 2003 its funding level was 45 percent. The US Airways Plan had a measured funding ratio of 94 percent in 2001 but only 35 percent at termination in 2003.

The use of lagged interest rates to calculate a single discount rate for liabilities of varying maturities and the use of historical asset values contribute to the mismeasurement of plan funding levels. The use of corporate rates in plan years 2004 and 2005, rather than Treasury rates, is also a contributing factor to the level of underfunding.

One partial solution to the conflict between the desire by sponsors to smooth plan contributions and the broader interest in accurate measures of plan assets, liabilities, and funding levels would be to require accurate measurement but to continue to permit firms to spread deficit reduction contributions over several years. This change could increase the ability of policy makers, employees, and stock holders to monitor the financial condition of pension plans. This might increase pressure on sponsors to fully fund plans, but would leave PBGC with much of its current risk exposure.

From Senator Rockefeller

I would like you to address the question of how we can continue to encourage employers to stay in the defined benefit pension system.

These benefits are extremely valuable to workers. Generations of retirees have depended on pension benefits that are predictable and will last their lifetimes.

I am concerned that proposals to increase premiums and impose new volatile funding requirements on employers will encourage them to leave the system, making the system's funding problems worse.

What reforms can Congress enact that will shore up the system with also encouraging employers to offer defined benefit pensions?

Answer. Pensions of all kinds are critical instruments toward achieving the goal of providing retirement income. Much of the legislation before the Congress has focused on ensuring that promises made between employers and employees are actually kept through tightened pension funding rules. Whether and how a particular form of pension coverage should be offered to workers raises a number of issues. Defined benefit pensions and defined contribution pensions offer different types of incentives for different employers and workers. The DB plans offer a specified level of payments in retirement for workers, while DC plans provide specified levels of deposits in retirement accounts. In industries where life-long attachment to a particular employer is common, DB plans are often the preferred mode of coverage. Where movement of workers among employers or industries is the standard, DC plans are often preferred because of the portability of benefits.

Some analysts have maintained that the administrative costs of complying with ERISA have encouraged the shift in coverage toward DC plans. Perhaps a comprehensive review of ERISA requirements would reveal some areas where administrative burdens could be reduced without significantly affecting the law's effectiveness.

Critics of the current system also point to the lack of guidance on the creation of cash balance pension plans or the conversion of existing DB plans to cash balance plans as an impediment for employers considering that form of DB plan. Cash balance plans are sometimes referred to as hybrid plans because they entail elements of both traditional DB and DC plans.

From Senator Lincoln

Should United Airlines successfully shed its pension plans, how likely do you believe it is that similarly situated airlines will be forced to shed their pension obligations through a PBGC bailout solely in order to keep pace with their competitors.

Answer. The airline industry is undergoing numerous changes as the older companies are facing the challenges of competing with newer carriers with different cost structures. Many of the older carriers such as United have older workforces with higher salaries and provide their workers with defined pension benefits. More recent entrants to the industry typically have a lower cost structure with a younger workforce and defined contribution pension plans.

Whether other so-called "legacy" carriers will follow the path of United is a matter of speculation. Many analysts suspect that more of these airlines will file for bankruptcy in the relatively near future. However, the unfunded liabilities of pension plans are just one of a myriad of factors that would influence an airline to file for bankruptcy. And sponsors of unfunded pension plans are not allowed to terminate those plans without filing for bankruptcy.

Testimony of Sen. Johnny Isakson for Submission to the Senate Committee on Finance

June 7, 2005

Chairman Grassley, Sen. Baucus, and distinguished members of the Senate Finance Committee, thank you for the opportunity to submit testimony for the Committee's hearing on the pension funding crisis in America. I applaud the Committee's willingness to call attention to this issue, and appreciate the opportunity to express my support for your efforts. I also urge your consideration of legislation I have introduced with Sen. Rockefeller, S.861, the "Employee Pension Preservation Act of 2005".

Airline employees face a threat to their earned pensions as a result of pension funding laws that make pension funding schedules unpredictable and volatile. At the core of the problem is the requirement for airlines to make substantial pension funding payments in a short period of time. In the 108th Congress, temporary pension funding relief was approved that allowed some airlines to avoid a bankruptcy filing. However, these deferred payments combined with unprecedented stock market declines and historically low interest rates have triggered a dramatic and unanticipated increase in required contributions to these plans, and significantly higher funding requirements. In cases where airlines do not have the cash on hand to make these payments, the airlines are being forced to choose between eliminating their pension plans or filing bankruptcy, which leads to the employee pension plans being dissolved.

This dramatic increase in required pension contributions is occurring at a time when the airline industry can least afford it. High fuel costs and overcapacity in the industry have driven down profits. Airline balance sheets are severely stretched, and airlines are struggling to meet additional pension obligations and reduce debt. Airlines do not have the ability to seek investors on Wall Street or sell bonds to raise cash. It is not unreasonable to expect to see other airlines seek protection through bankruptcy or be forced to terminate their pension plans. In fact a recent Bear-Stearns analysis, which I will submit for the record, found that pension funding liabilities are the single greatest threat to the future viability of the legacy carriers. We do not want to see a repeat of what happened at United Airlines earlier this year and US Airways last year. Airline employees deserve to have their earned pensions protected, while ensuring their airlines remain viable.

Airlines with defined benefit plans and their employees have come to Sen. Rockefeller and I and asked us to help them find a way to protect the interests of airline employees and their pensions by allowing their employers to make their required pension payments in a more predictable and manageable way. S. 861 is a common-sense, industry-specific approach that is supported by airline employees, their unions, and their employers. Enactment of this proposal is crucial to protecting the earned pension benefits of thousands of airline workers, and to maintaining a healthy and viable airline industry. To give the Committee an idea of the number of airline employees that S. 861 would help, in my state of Georgia alone we estimate that nearly 40,000 earned pensions are threatened by this looming funding crisis.

Under S.861, airlines are given the ability to fund their pension obligations to their employees on a more manageable and stabilized schedule over a period of 25 years using more stable, long-term assumptions. Any airline that chooses this option must agree to limit its pension liabilities by totally freezing current benefits, or by paying for new benefits immediately. The airline cannot pursue either funding option without first winning an affirmative vote from any union representing its employees.

This legislation protects the interest of the American taxpayer by limiting the liability of the Pension Benefit Guaranty Corporation, the federal agency responsible for funding pensions when companies terminate their pension plans. The bill caps the PBGC liabilities at current limits.

Our goal is to establish a payment schedule for unfunded liability that is affordable and practical. The legislation properly balances the interests of all three stakeholders: employees, taxpayers, and airlines. A 25-year payment schedule would ensure that the short term funding requirement is responsibly spread over a period of time that is more manageable for the airlines. Airlines continue to make sizeable contributions each year to reduce their liability, and ensure benefits that the employees have accrued are paid out.

S.861 is the sensible approach. The airline industry is going through a severe, but hopefully short-term, problem caused by a "Perfect Storm" of adverse events. I urge the Committee to consider S.861, which seeks to ensure the airline industry will recover and will continue to pay its pension obligations. S .861 presents a solution that gives relief to the airlines and their defined benefit plans, while at the same time protecting earned employee pension benefits, the PBGC, and the taxpayer.

I thank the Committee for its leadership in this area, and appreciate the opportunity to submit written testimony as part of the record.

BEAR STEARNS

Equity Research

MARCH 2005

Airlines

Fear and Loathing on the Pension Front
Competitive and Legislative Uncertainties Abound

- **PENSION FUNDING DEFICITS DRIVE UP LIQUIDITY RISK.** We estimate the non-bankrupt U.S. network airlines' defined benefit (DB) pension plan funding shortfall at $14 billion, with plan benefit obligations of $35 billion and plan assets of just $21 billion. Combined with weak yields and high oil prices, the status quo on pension cash contributions could drive more legacy-cost airlines into Chapter 11.

- **FEARING LARGER CASH CONTRIBUTIONS.** We estimate aggregate pension cash contributions should rise just 3% in 2005, to $1.3 billion; however, 2006 contributions could rise another 113%, to $2.7 billion, barring a legislative remedy. Given the limitations of pension accounting/modeling and the uncertainty surrounding the year-end expiration of the Pension Funding Equity Act of 2004 (PFEA), we provide detailed sensitivity tests in this report.

- **LOATHING UNITED TERMINATIONS AND PFEA EXPIRATION.** We believe airline managements must abhor the idea of United Airlines terminating its DB pension plans and emerging from bankruptcy leaner, meaner, and free of billions in liabilities. Worry is also growing about the expiring PFEA, which currently allows for lower cash contributions via postponed deficit reduction contributions and a higher discount rate.

- **CAPITOL HILL: A CRITICAL FACTOR.** Congressional action (or inaction) in the next 12 months will play a key role in whether airlines contribute more than 40% of projected operating cash flow to employee pension plans in 2006. We see meaningful differences in pension-related risk and, in descending order, rank the carriers as follows: Delta, Northwest, Continental, AMR, and Alaska Air.

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Executive Summary

Lingering in the back of every airline CEO's mind is the following worst-case pension scenario:

United Airlines succeeds in terminating its defined benefit pension plans, ridding itself of billions in obligations and eventually emerging from Chapter 11 with unit costs within range of low-cost carriers (LCCs). Then, at year-end, the Pension Funding Equity Act expires without any follow-on legislative relief. Combined with the cash flow pressures from weak yields and high oil prices, the required cash contributions to pension plans take liquidity down to bankruptcy risk levels. At the same time, the cost of capital rises (or access to capital shuts down) because the capital markets view legacy airlines as having an even greater margin disadvantage versus a swath of the industry beyond just the LCCs, and, ultimately, it is much tougher to go on outside of Chapter 11, let alone begin the long, hard work of repairing over-leveraged, distressed balance sheets.

From an equity market perspective, such a scenario could be part of what the industry needs — no more life lines and another liquidity crunch, so that more costs are stripped out and/or consolidation takes place, essentially letting the natural forces of the free market work more efficiently. However, if history is any guide, legislators won't be able to resist stepping into the ring, and some additional measure of relief will be granted.

In this report, we examine pension and other post-employment benefit problems facing the U.S. airline industry, with detailed analysis of the following:

- **Pension Funding: An Awful Situation That Could Become Worse.** We examine pension funding deficits and required cash contributions, with breakdowns and comparisons of defined benefit, defined contribution, profit sharing, and health care costs.

- **The Sizable Valuation Implications of Pension Funding Deficits.** We test earnings, cash flow, and valuation sensitivity to changes in interest rates, market return assumptions, and unfunded liability capitalization.

- **Pension Plans in Limbo.** There is uncertainty about the fate of United Airlines' defined benefit pension plans and the expiration of the Pension Funding Equity Act at year-end.

- **Legal Ruminations.** We discuss current law, new legislative proposals, access to funding waivers, and the potential effect of all on cash flows.

- **Retiree Health Care: A Growing Problem.** We explore the potential health care funding crisis.

- **How Do the Airlines Stack Up?** We measure the meaningful differences between pension and OPEB (retiree health care obligations) costs, and their relationship to operating cash flow and unrestricted cash balances.

- **Company Pension Profiles.** We present pension summaries for Alaska Air, AMR, Continental, Delta, and Northwest, with comments on United Airlines and US Airways.

- **Pensions 101.** A fast tutorial on this complicated subject should help those in need of a primer.

- **Appendix.** In a series of exhibits, we focus on cash burn and oil sensitivity.

Pension Funding

AN AWFUL SITUATION THAT COULD BECOME WORSE

Pension Contributions Should Represent 50% of 2005 Operating Cash Flow with Oil at $46, 78% with Oil at $50

We estimate that the legacy airlines have defined benefit pension plans that are underfunded to the tune of $14 billion ($35 billion in plan benefit obligations versus $21 billion in plan assets) and will require about $1.3 billion in cash contributions this year, or $1.79 per share on average (assuming UAL does not terminate its plans, the total could be $2 billion, or $3 per share). These contributions represent about 50% of our operating cash flow forecast and 13% of the combined unrestricted cash balances.

This appears awful, but matters could become much worse next year. In 2006, barring a new legislative remedy, we believe the required cash contributions could increase 113%, to $2.7 billion, representing 45% of operating cash flow and 36% of existing cash with oil at $40/bbl and 79% of operating cash flow and 47% of cash with oil at $50. (Absent a replacement of PFEA 2004, pension discounting next year would revert to the 30-year Treasury yield, current-year DRC [deficit reduction contribution] requirements would be due in full, and the DRC deferrals from 2004-05 would need to be repaid in the near term.)

With regard to aggregate noncash P&L pension expenses, the outlook is also troublesome, since we project $1.6 billion in expenses in 2005 for Alaska Air, AMR, Continental, Delta, and Northwest ($2.35 per share on average).

We Believe Delta and Northwest Have the Greatest Pension Risk

Our analysis suggests that pension-related risk among legacy carriers operating outside of Chapter 11 is as follows, in ascending order: Alaska Air, AMR, and Continental, with Northwest and Delta bringing up the rear. In Exhibit 1 below, we set out our estimates for each carrier's funding deficit, defined benefit contributions, and pension expenses. We look at the costs on a unit basis for easy comparison and consider the relationship of the cash contributions/expenses to operating cash flow, unrestricted cash balances, and net earnings.

All told, if yields don't improve and oil remains above $45/bbl, the lack of a legislative band-aid for the pension funding problem could drive at least one more legacy carrier into bankruptcy, in our opinion:

- **Delta.** Based on our cash burn analysis, with $50 oil, Delta will be down to $1.1 billion by the end of this year (below its critical $1.5 billion level); however, even if we assume the carrier sells Comair and ASA for as much as $500 million, $50/bbl oil and pension obligations (barring a legislative fix) will chew up that cash by second-half 2006.

- **Northwest.** Northwest's situation is also troubling. Although the carrier has a larger unrestricted cash balance than Delta, without debt refinancing and pension law change, $50 oil could bring the carrier down to a critical $1.1 billion by mid-

2006 (with an 80% debt refi assumption, the carrier could survive until 2008), based on our analysis.

- **Continental.** Continental is only slightly better off. We estimate the carrier will be down to $1.1 billion (its bankruptcy risk valuation level) by early 2008 if we assume 80% debt refi and $50 oil. If the carrier fails to get its tentative labor deals ratified and is unsuccessful in refinancing its principal debt maturities in 2005, then the carrier will reach a bankruptcy-risk cash level in second-half 2005, in our estimation.

- **AMR.** AMR looks considerably stronger. Not even including the potential value from AMR's subsidiaries (American Eagle and American Beacon), with oil at $50, no change in pension law, and no debt refinancing, the carrier has enough cash to remain above its critical $1.5 billion level until 2007. Assuming AMR can refinance 80% of its principal debt maturities, we believe the carrier has a several-year liquidity cushion.

- **Alaska Air Group.** By any measure, Alaska Air Group has substantially less liquidity and pension risk, and we rank the carrier at the top of the heap. Even without any debt refinancing, we believe Alaska Air Group is nearly cash flow neutral with $50/bbl oil.

For more detail, please see our company pension profile section beginning on page 29 and our oil sensitivity cash burn in Exhibits 31-38 in the Appendix.

Our estimates are based on a generic pension model, which is highly dependent on assumptions about year-end discount rates, annual market performance, and contribution levels. Actual company results may differ.

Exhibit 1. Pension Summary — Cash Impact ($ in millions, except per share data)

	ALK	AMR	CAL[1]	DAL[2]	NWAC	Total/	UAL[3]	US Air[4]	AAI	AWA	FRNT[5]	JBLU	LUV
Plan Type	DB/DC	DB/DC	DB/DC	DB/DC	DB Plan	Average	DB/DC	DB/DC	DC Plan	DC Plan	DC Plan	DC Plan	DC Plan
12/31/2004													
Plan Assets (GAAP)	607	7,335	1,281	6,842	5,425	21,490	6,961	1,749	NA	NA	NA	NA	NA
Plan Benefit Obligations (PBO) (GAAP)	910	10,022	2,863	12,140	9,245	35,180	13,117	2,748	NA	NA	NA	NA	NA
PBO Pension Overfunded (Underfunded)	(303)	(2,687)	(1,582)	(5,298)	(3,820)	(13,690)	(6,156)	(999)	NA	NA	NA	NA	NA
ABO Pension Overfunded (Underfunded)	(161)	(1,823)	(1,131)	(5,239)	(3,565)	(11,919)	(5,692)	(971)	NA	NA	NA	NA	NA
Post Retirement Obligations (APBO)	(76)	(3,152)	NA	(1,835)	(921)	(5,984)	(3,069)	(1,369)	NA	NA	4	NA	80
2004 Assumed Rate of Return on Plan Assets	8.00%	9.00%	9.00%	9.00%	9.50%	8.90%	9.00%	8.01%	NA	NA	NA	NA	NA
2004 Assumed Discount Rate for Obligations	5.75%	6.00%	5.75%	6.00%	5.90%	5.88%	6.25%	6.00%	NA	NA	NA	NA	NA
2004 Asset Allocation: Equity/Fixed Income (remainder=other)	71%/29%	52%/38%	66%/28%	50%/28%	74%/20%	63%/29%	60%/35%	50%/41%	NA	NA	NA	NA	NA
2005E Revenue	2,847	19,638	10,352	15,701	11,854	60,393	NA	NA	1,326	2,467	843	1,647	7,183
2005E Operating Cash Flow (Oil at $46/bbl Base Assumption)	302	1,089	307	454	333	2,485	NA	NA	19	-12	-6	135	864
2005E Operating Cash Flow (Oil at $50/bbl)	278	784	181	208	147	1,598	NA	NA	6	-54	-13	120	853
2006E Revenue	2,967	20,161	10,837	16,662	12,315	62,942	NA	NA	1,648	2,602	NA	2,226	7,828
2006E Operating Cash Flow (Oil at $40/bbl Base Assumption)	332	1,982	798	1,558	1,214	5,884	NA	NA	60	24	NA	197	998
2006E Operating Cash Flow (Oil at $50/bbl)	267	1,149	511	546	897	3,371	NA	NA	11	-48	NA	145	923
2004 GAAP PBO Funding Status	67%	73%	45%	56%	59%	61%	53%	64%	NA	NA	NA	NA	NA
2004 GAAP ABO Funding Status	79%	80%	53%	57%	60%	66%	55%	64%	NA	NA	NA	NA	NA
2004 ABO per 2004 FTEs	12,448	20,099	29,383	75,763	90,616	47,560	98,991	39,427	NA	NA	NA	NA	NA
2004E P&L DB Pension Expense[6]	78	427	293	549	444	1,791	500	66	NA	NA	NA	NA	NA
2005E P&L DB Pension Expense[6]	89	380	227	440	500	1,637	NA	NA	NA	NA	NA	NA	NA
2005E DB Pension CASM	0.34¢	0.20¢	0.26¢	0.28¢	0.53¢	0.29¢	NA	NA	NA	NA	NA	NA	NA
2005E After-Tax EPS Impact	(2.12)	(1.51)	(2.20)	(2.22)	(3.70)	(2.35)	NA	NA	NA	NA	NA	NA	NA
2004 DB Expense	78	427	293	549	444	1,791	693	66	NA	NA	NA	NA	NA
2004 Defined Contribution & Profit Sharing Expense	25	163	30	150	NA	368	40	186	9	11	5	19	200
2004 Retirement (Health Care) Costs	9	264	NA	76	98	447	364	105	NA	NA	1	NA	18
2004 DB CASM	0.31¢	0.23¢	0.35¢	0.38¢	0.49¢	0.34¢	0.48¢	0.12¢	NA	NA	NA	NA	NA
2004 DC & Profit Sharing CASM	0.10¢	0.09¢	0.04¢	0.10¢	NA	0.07¢	0.03¢	0.33¢	0.08¢	0.04¢	0.07¢	0.10¢	0.26¢
2004 OPEB CASM	0.04¢	0.14¢	NA	0.05¢	0.11¢	0.08¢	0.25¢	0.19¢	NA	NA	0.01¢	NA	0.02¢
2004 Total DB, DC, OPEB CASM	0.44¢	0.46¢	0.38¢	0.53¢	0.59¢	0.49¢	0.75¢	0.63¢	0.08¢	0.04¢	0.08¢	0.10¢	0.28¢
Unrestricted Cash Balance (12/31/04)	874	2,929	1,460	1,799	2,459	9,521	1,300	738	334	306	149	449	1,305
2004E DB Pension Cash Contributions[6]	49	467	0	455	253	1,224	127	29	NA	NA	NA	NA	NA
2005E DB Pension Cash Contributions[6]	58	310	192	275	420	1,255	NA	NA	NA	NA	NA	NA	NA
2006E DB Pension Cash Contributions[7] Plan Freeze and 20-Yr Amort.	4	45	44	202	133	429	NA	NA	NA	NA	NA	NA	NA
2006E DB Pension Cash Contributions[7] Bush Proposal (7-Yr Amort.)	71	314	288	726	704	2,103	NA	NA	NA	NA	NA	NA	NA
2006E DB Pension Cash Contributions[7] PFEA expires (5-Yr Amort.)	76	377	356	962	901	2,672	NA	NA	NA	NA	NA	NA	NA
2005E After-Tax Projected Pension Cash per Share Impact	(1.38)	(1.24)	(1.86)	(1.39)	(3.11)	(1.79)	NA	NA	NA	NA	NA	NA	NA
2005E Pension Cash Contribution to 4Q04 Cash Balance	7%	11%	13%	15%	17%	13.2%	NA	NA	NA	NA	NA	NA	NA
2005E Pension Cash Contribution to 2005E Op. Cash Flow	19%	28%	63%	61%	126%	50.5%	NA	NA	NA	NA	NA	NA	NA
2005E Pension Cash + Debt Mat. + Net Capex to 2005E Op. Cash Flow	93%	159%	327%	310%	411%	233.3%							
2006E (20-Yr Amort.) Pension Cash Contribution to 2006E Op. Cash Flow	1%	2%	6%	13%	11%	7.3%	NA	NA	NA	NA	NA	NA	NA
2006E (7-Yr Amort.) Pension Cash Contribution to 2006E Op. Cash Flow	21%	16%	36%	47%	58%	35.7%	NA	NA	NA	NA	NA	NA	NA
2006E (5-Yr Amort.) Pension Cash Contribution to 2006E Op. Cash Flow	23%	19%	45%	62%	74%	45.4%	NA	NA	NA	NA	NA	NA	NA
2006E (20-Yr Amort.) Pension + Debt Mat. + Net Capex to '06E Op. Cash Flow	57%	80%	94%	94%	112%	90.7%	NA	NA	NA	NA	NA	NA	NA
2006E (7-Yr Amort.) Pension + Debt Mat. + Net Capex to '06E Op. Cash Flow	77%	93%	124%	128%	159%	119.2%	NA	NA	NA	NA	NA	NA	NA
2006E (5-Yr Amort.) Pension + Debt Mat. + Net Capex to '06E Op. Cash Flow	78%	97%	133%	143%	175%	128.9%	NA	NA	NA	NA	NA	NA	NA

DB = defined benefit pensions, where employer bears investment risk. DC = defined contribution pensions plan such as 401(k), where the employee assumes the investment risk. PBO = projected benefit obligation (assumes future wage inflation). ABO = accumulated benefit obligation (pension obligations already accrued; if a plan were frozen, this would be GAAP analogous amount). APBO = accumulated post retirement benefits obligation. OPEB includes post-employment health care benefits — medical, dental, vision, hearing, and other health-related benefits, whether provided separately or through the pension plan. Other benefits include life insurance, disability, long-term care, etc., when provided separately from a defined benefit pension plan. Operating cash flow = net income + D&A + pension expense; assumes no impact from change in net working capital.

(1) Continental's 2005E required pension contribution is $307 million; however, in the table above, which focuses on cash, we exclude $65 million in stock contributed in the first quarter and assume $50 million in savings from ratification of labor deals. Similarly, pension expense is $315 million, though it is expected to decline by $90 million upon ratification of tentative labor agreements.

(2) Delta froze its DB plan as of 12/31/04, eliminating future service accruals, though wage increases will still be factored into benefit calculations. 2004 pension expense excludes curtailment charges.

(3) UAL contributed $17 million and $110 million during the first and second quarters of 2004 ($700 million was estimated to be due last year), respectively, to its plans; however, the carrier currently does not expect to make any contributions to its pension plans before exiting from bankruptcy and intends to terminate its plans. UAL's information is as of 2003 except for cash.

(4) Effective February 1, 2005, the PBGC was appointed trustee of US Airways AFA, IAM, and CE plans. In 2004, prior to entering Chapter 11, the carrier had been obligated to contribute $155 million to its plan.

(5) FRNT is on a March fiscal year-end. FY2006 = 2005.

(6) Based on 2004 company 10k, third-quarter 2004 10Q data, fourth-quarter 2004 conference calls, company guidance, and Bear, Steams & Co. Inc. estimates.

(7) Bear Stearns' forecasts: 2006 forecasted pension cash contributions assume expiration of the Pension Funding Equity Act of 2004. Three scenarios (assuming an even amortization repayment schedule): 1) assumes plan freezes and a 20-year DRC amortization, 2) assumes a seven-year DRC amortization (Bush proposal), and 3) assumes PFEA expires and a five-year DRC amortization.

Actual company results may vary considerably. Please see our September 2003 Airline Pension report for more information.

Note: Firms may be able to contribute limited amounts of stock in certain circumstances instead of cash. In addition, firms may apply for IRS waivers that could allow them to spread payments out over five or so years. Furthermore, interest rate changes, asset returns, and legislative changes could have significant impacts on these forecasts.

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance; First Call.

While ERISA and the Internal Revenue Code rules dictate funding periods ranging from as few as three to as many as 30 years, after surveying our companies and for purposes of this report, we assume for simplifying reasons that deficit reduction contributions are repaid in five years under current law and would continue to be due in this time frame should PFEA expire without replacement.

The Sizable Valuation Implications of Pension Funding Deficits

SHOULD INVESTORS CAPITALIZE THE UNFUNDED PORTION OF THE PENSION LIABILITY?

Pension funding deficits pose some important valuation considerations. Should investors capitalize the unfunded portion of a company's pension liability, which would be tantamount to assuming it has to issue debt to fund its plans? This is not an easy decision, as interest rates, pension asset returns, and many other variables could reduce or even eliminate current funding deficits down the road.

As a tool for those who choose to book the funding shortfall, we provide our current EV/EBITDAR forecasts with and without the 2004 ABO funding gap in the context of the carriers' historical means. Not surprisingly, inclusion of pension deficits leads to more expensive valuations, with Northwest's and Delta's expanding by roughly 30% each.

Exhibit 2. Pension Deficit Could Affect Valuation

	2006E EV/EBITDAR			Historical EV/EBITDAR
	Without Pension	Incl. Pension	% Chg.	Without Pension
AMR	6.0x	6.6x	10%	5.2x
CAL	7.5x	8.1x	9%	5.6x
DAL	6.8x	8.7x	27%	4.6x
NWAC	5.6x	7.5x	34%	4.7x
ALK	4.9x	5.2x	6%	7.8x

Note: Only includes the 2004 ABO underfunding amount, assumes borrowed underfunded amount to make plan whole.
EV= equity market capitalization + total debt, incl. operating leases less unrestricted cash.

Source: Bear, Stearns & Co. Inc. estimates.

VALUATION SENSITIVITY TO DISCOUNT RATES AND MARKET RETURN ASSUMPTIONS

What are the implications for P/E, P/EBITDA, and EV/EBITDAR as discount rate and market return assumptions change? In the exhibit below, we isolate the EPS and P/E impact of a 50-basis-point (bp) change in the discount rate or the rate of return assumption used to measure pension plan expenses. All told, valuations could appear to be 3%-35% more expensive or 3%-21% cheaper thanks to a 0.5%-point change in the underlying pension expense input.

Exhibit 3. Valuation Sensitivity to Discount Rate Changes

	2006/7 P/E Sensitivity:								
		0.5% Change in the Pension Discount Rate				0.5% Change in the Assumed Rate of Return			
	No Change	-50 Bps	% Chg.	+50 Bps	% Chg.	-50 Bps	% Chg.	+50 Bps	% Chg.
AMR	8.5x	11.5x	33%	7.5x	-20%	9.4x	15%	7.2x	-12%
CAL	9.5x	12.5x	35%	7.5x	-21%	9.5x	6%	8.5x	-5%
DAL	4.5x	5.5x	22%	3.5x	-15%	4.7x	19%	3.4x	-14%
NWAC	6.5x	7.5x	31%	5.5x	-19%	6.6x	19%	4.8x	-14%
ALK	9.5x	9.5x	7%	8.5x	-6%	9.0x	3%	8.6x	-3%

Note: ALK, AMR, CAL, and NWAC are off of 2006 estimates. DAL assumes a hypothetical normalized 7% op. margin in 2007.

Source: Bear, Stearns & Co. Inc. estimates; company reports; First Call.

STOCK OPTIONS WILL ALSO HIT VALUATIONS THIS YEAR

Per SFAS No. 123R, U.S. airlines will be required to expense stock options using a fair value method beginning in the third calendar quarter this year. As a result, we expect some valuation headwinds for the profitable segment of the industry that utilizes stock options to a greater extent than the legacy carriers. Our 2005 and 2006 EPS estimates already take into account option expense for the U.S. airlines in our coverage; however, we suspect that the First Call mean may not fully reflect fair value option expense at present. Therefore, all else equal, estimates may be susceptible to downward pressure as the Street begins to incorporate option expenses into its second-half 2005/full-year 2006 estimates.

Further, option expense has broader implications than just added labor expense and hence lower net income. For instance, JetBlue expects to book a higher tax rate this year (47% versus 40% in previous years) due to its heavy reliance on incentive stock options, which generally do not provide for corporate tax deductibility.

Exhibit 4. Beware! Stock Option Expense Should Affect Valuation this Year

Stock Options Expenses: SFAS 123R			2004		First Call 2006 Mean P/E	
	Co. Disclosed 2H05E		Per Share	$ Mil.	Assuming No Option Expense	Less Option Expense
AMR	undisclosed		$0.40	$64	NM	NM
CAL	$9-15mn	$0.13	$0.09	$6	12.9x	18.2x
DAL	"may be material"		$0.29	$38	NM	NM
NWAC	already expensed		already expensed		NM	NM
AAI			$0.03	$2	19.5x	19.5x
ALK	$2-3mn	$0.09	$0.17	$5	9.3x	9.9x
AWA	"material impact"		$0.16	$6	NM	NM
FRNT			$0.05	$2	NM	NM
JBLU	$11mn	$0.10	$0.17	$19	30.0x	45.0x
LUV	$20mn	$0.02	$0.08	$74	22.6x	24.2x

Note: Net of tax figures. FRNT is FY 2004.

Source: Company reports; Bear, Stearns & Co. Inc. estimates; First Call.

Pension Accounting in SEC Crosshairs

In October 2004, the SEC began an informal inquiry into the accounting assumptions used for pension plans. Northwest Airlines and five other large defined benefit plan sponsors were among those queried for internal information regarding their pension and other post-retirement plans. While the criteria for the SEC's selection remain unclear, a cursory observation suggests that the aggregate pension obligation relative to a company's market capitalization may have been one screen applied. At first blush, Northwest stands out because of its expected rate of return assumption, which has exceeded that of its peers and the S&P 500 average by 50-150 basis points (bps) over the past three years. Nevertheless, when we examine plan asset allocations (see Exhibit 5 below), we discover that Northwest is more heavily weighted to equities than its peers.

Exhibit 5. Pension Accounting (GAAP) Assumptions

	Actual Discount Rates					Actual Expected Rate of Return				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
ALK	7.50%	7.25%	6.75%	6.00%	5.75%	10.00%	10.00%	8.00%	8.00%	8.00%
AMR	7.75%	7.50%	6.75%	6.25%	6.00%	9.50%	9.50%	9.25%	9.00%	9.00%
CAL	8.00%	7.50%	6.75%	6.25%	5.75%	9.50%	9.50%	9.50%	9.00%	9.00%
DAL	8.25%	7.75%	6.75%	6.13%	6.00%	10.00%	10.00%	10.00%	9.00%	9.00%
NWAC	7.90%	7.50%	6.75%	6.25%	5.90%	10.50%	10.50%	10.50%	9.50%	9.50%
S&P 500 Average	7.12%	6.59%	6.07%	NA		NA	9.07%	8.86%	8.34%	NA

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Pension accounting has often been the subject of investor concern, since changes in assumptions and realized market rates can materially affect a company's P&L. However, all the red ink in the airline industry in recent years seems to suggest that carriers are hardly making aggressive assumptions in order to boost net profits. In addition, if the SEC inquiry results in any sort of corrective action, it should only be a

GAAP accounting issue, since the SEC does not oversee pension cash funding guidelines — the Department of Labor (through ERISA) and the IRS do.

Exhibit 6. Pension Plan Asset Allocation

	ALK	AMR	CAL	DAL	NWAC	UAIR	UAL
Total Equity	71%	52%	66%	50%	74%	50%	60%
Fixed Income	29%	38%	28%	28%	20%	41%	35%
Other: Private Equity, Real Estate, Etc.	NA	10%	6%	22%	7%	9%	5%
Total	100%	100%	100%	100%	100%	100%	100%

Note: ALK, AMR, CAL, DAL, NWAC, and UAIR as of 2004; UAL as of 2003.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

That said, should companies feel the need to reduce their expected rate of return assumptions as a result of the SEC's scrutiny, the income statement effect could be noticeable. For example, using our pension forecasting models, leaving all else equal, we estimate the expense impact could range from \$3 million to \$36 million, or \$0.07-\$0.20 per share, for each one-half-percentage-point (50-bp) decrease in the expected rate of return assumption used for GAAP pension accounting. For example, should Continental lower its expected rate of return assumption by 50 bps, we would expect a \$7 million increase in costs, or a \$0.07 per share negative impact.

Exhibit 7. Pension Expense and Pension Liability Sensitivity

50-Basis-Point Decline in Assumptions:					
	ALK	AMR	CAL	DAL	NWAC
	Effect on P&L Pension Expense from Change in Expected Return Assumption				
(mns)	(\$3)	(\$36)	(\$7)	(\$35)	(\$27)
EPS	(\$0.09)	(\$0.14)	(\$0.07)	(\$0.18)	(\$0.20)
	Effect on P&L Pension Expense from Change in Discount Rate Assumption				
(mns)	(\$9)	(\$68)	(\$35)	(\$40)	(\$40)
EPS	(\$0.21)	(\$0.27)	(\$0.34)	(\$0.20)	(\$0.30)
	Effect on GAAP PBO Pension Liaibility				
(mns)	\$55	\$623	\$256	\$750	\$700
% 2004 PBO	6%	6%	9%	6%	8%

Note: Assumes 36% tax rate.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Pension Plans in Limbo

UAL/US AIR AND LEGISLATIVE UNCERTAINTY

Fear surrounding airline pension funding deficits is exacerbated by uncertainty about the fate of United Airlines' defined benefit pension plans and the expiration of the PFEA at year-end. United Airlines' DB plans are about $6 billion underfunded, and the carrier has about $4 billion in minimum cash contributions due through the end of the decade. In July 2004, the carrier began skipping its required cash contributions and is working toward terminating its pension plans this May. While the carrier announced it has four offers for $2-$2.5 billion in exit financing, our sense is that the delivery of those funds is predicated on a successful resolution of the pension matter. At the same time, investors are concerned about the expiration of the PFEA and the potential for increases in already onerous pension cash contributions.

While United works toward a May termination of its pension plans (US Airways terminated its plans in January), the nonbankrupt airlines painfully watch their progress and reiterate the mantra of labor parity to their own work groups. By the end of the second quarter, we expect to have a better idea about UAL's attempt to scuttle its plans, but legislative uncertainty could linger through the year and even up until April 15, 2006, the deadline for calendar 2006's first pension installment.

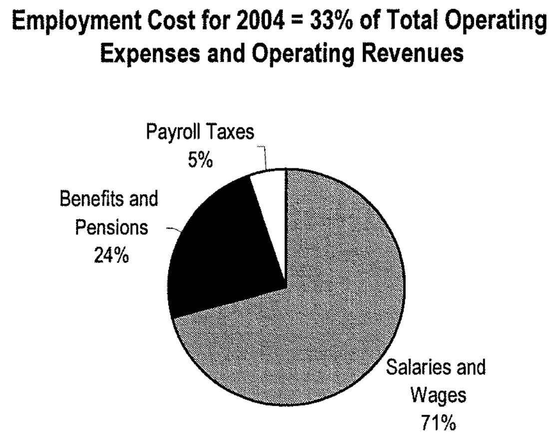
HOW DID IT GET SO BAD?

A Perfect Storm

There are three major forces behind the airlines' pension problems:

- First, during the good times, the airlines negotiated generous packages with the unions — more than they can deliver through a full business cycle.
- Second, pension law effectively caps funding levels, which limits companies' ability to fortify plan assets during good years. (Despite running sizable funding deficits, many companies were not required to contribute much cash, if any, to their pensions prior to 2003.)
- Third, the combination of poor stock market performance and low interest rates helped to widen the gap between plan assets and liabilities. The market declines of 2000-02 shrank pension plan assets at the same time that lower interest rates boosted liabilities. (Lower interest rates increase the present value of projected benefit obligations [PBO] and poor market returns decrease the value of plan assets, while higher interest rates lower the present value of obligations and higher stock market returns increase the value of plan assets.)

Exhibit 8. Pension and Benefits Account for a Quarter of All Labor Costs



Note: Major and national passenger airlines for 12 months ended 3Q04.
Source: ATA.

What's more, despite positive asset returns in 2004, our 60%/40% pension fund proxy had pension assets up 8% (however, the average airline DB plan returned 12% last year), and interest rates finished down from 2003 levels, largely negating asset returns by increasing the present value of plan obligations and leaving pension plan funding levels right around last year's low water mark (see Exhibits 9 and 10 below). Hence, pension plans are still in dire straits. For example, Northwest mentioned that its plan assets rose more than 14% in 2004, yet its ABO shortfall was still $3.5 billion, up from $3.3 billion in 2003. Looking out to 2005 discount rates, due to the four-year weighted average calculation methodology, it is unclear how much rates might change by year-end even though more Fed rate hikes are coming down the pike.

Exhibit 9. Interest Rate Decline Could Offset Asset Gains in 2004

Interest Rates for Current Liability Funding Calculations		
Basis-Point Change from Previous Year-End		
12/31/2004	6.10%	***-0.45***
12/31/2003	6.55%	*-0.56*
12/31/2002	7.11%	*-0.23*
12/31/2001	7.34%	

2004 Proxy Pension Fund Return		Weighting
Lehman U.S. Bond Composite Index	4.5%	*40%*
S&P 500 Index Total Return	11%	*60%*
Aggregate Return	**8.4%**	

Note: Corporate bond weighted average interest rate as per the Pension Funding Equity Act of 2004. Lehman Allocation = 33% U.S. government, 33% investment grade corporates, 33% mortgages. The average airline DB plan returned 12% in 2004.
Source: Bear, Stearns & Co. Inc. estimates; Internal Revenue Service; Bloomberg.

Exhibit 10. Interest Rate Decline Could Offset Asset Gains in 2004

		2004E Incremental Funding Level Impact (in % points)					
		Discount Rate for 2004					
		6.0%	6.2%	6.4%	6.6%	6.8%	7.0%
2004 Forecasted Market Return	1%	-6%	-4%	-2%	1%	3%	6%
	4%	-5%	-2%	0%	2%	5%	8%
	7%	-3%	-1%	2%	4%	7%	10%
	10%	-1%	1%	3%	6%	9%	12%
	13%	0%	3%	5%	8%	11%	14%
	16%	2%	4%	7%	10%	13%	16%

Composite = ALK, AMR, CAL, DAL, NWAC.

Source: Bear, Stearns & Co. Inc. estimates.

Legal Ruminations

In response to the looming year-end expiration of a temporary fix to funding rules, players in several corners have espoused remedies of both a short- and long-term nature. In early January, the Bush Administration unveiled a set of proposals to simplify and strengthen funding rules (shore up the federally insured pension funding system [PBGC]), including: 1) higher premiums, 2) duration-matched discount rates, 3) risk-based liability measures, and 4) more leverage for the PBGC in the Chapter 11 process. ALPA, the largest pilots union, as well as Northwest Airlines CEO Douglas Steenland, have called for freezing DB plans and much longer amortization periods for making up funding shortfalls (versus today's often much shorter time frame).

While ERISA and the Internal Revenue Code rules dictate funding periods ranging from as few as three to as many as 30 years, after surveying our companies and for purposes of this report, we assume for simplifying reasons that deficit reduction contributions are repaid in five years under current law and would continue to be due in this time frame should PFEA expire without replacement.

For its part, Congress could proffer its own set of measures and/or embrace the Administration's proposals to one degree or another. Rep. John Boehner (R-Ohio) is expected to continue the charge for pension reform in the House this term. In the Senate, Finance Committee Chair Chuck Grassley (R-Iowa) has already reintroduced pension legislation. While we applaud moves to freeze DB plan liabilities, we note that the trend to offer generous replacement DC plans can be just as costly, if not more so, in terms of current pension expenses and contributions.

CURRENT LAW TO EXPIRE IN 2005

The Pension Funding Equity Act (PFEA) of 2004

The PFEA, signed into law in April 2004, provided for significant deficit reduction contribution deferrals, which are ERISA-mandated accelerated pension funding requirements. The airlines received an 80% DRC reprieve in 2004 and 60% this year. In addition, the law changed the discount rate benchmark used to determine normal contributions from the 30-year Treasury to a 20-plus-year high-grade corporate bond series (AAA, AA, A). (A rise in the discount rate has the effect of lowering the present value of future liabilities, in turn reducing annual cash funding requirements.) We believe that the combined effect of switching to a corporate bond discount rate and an 80% deferral saved the airlines an estimated $1 billion in cash last year.

This year, despite the 60% DRC deferral and higher discount rate, the carriers ex UAL will still need to fund $1.3 billion in pension contributions, up from $1.2 billion in 2004, or 50% of our estimated operating cash flow for the group. Absent a replacement of PFEA 2004, pension discounting next year would revert to the 30-year Treasury yield, the current-year DRC requirements would be due in full, and the DRC deferrals from 2004-05 could become due in as short as three to five years. All of this could set the stage for a massive cash crunch in the next year or two unless oil prices crater and yields suddenly rebound.

LEGISLATIVE PROPOSALS

Bush Administration Proposes Pension Overhaul, But Not Enough to Spare Airlines

On January 10, Secretary of Labor Elaine Chao outlined the Bush Administration's pension reform initiatives. In our view, the salient issues for airline pensions in the President's proposal are: 1) higher standard premiums (from $19 per participant up to $30), plus additional risk-based premiums for severely underfunded plans; 2) seven-year amortization periods for making up unfunded liabilities versus today's potentially shorter time frame; 3) duration-matching yield curves for liability discounting; 4) requiring financially-weak sponsors to use a more conservative funding measure; 5) empowering the PBGC to perfect liens in bankruptcy proceedings; 6) disallowing lump-sum distributions at severely underfunded plans; and 7) freezing PBGC guarantee levels once a sponsor enters bankruptcy.

Exhibit 11. Administration's Proposals Seen as Largely Negative for Airlines

	Impact on Airlines	Notes
DRC Amortization (7 years)	Positive	Better than today's 3-5 year minimum
Duration-matched discount rate	Unclear	Plans with durations over 23 years could benefit
At-Risk Liability Measure	Negative	Non-investment grade likely = higher liabilites = higher DRC payments
Increase in Flat-Rate Premiums	Negative	Would increase to $30 from $19 per participant
Change in Variable-Rate Premiums	Unclear/Negative	Today, $9 per $1,000 of underfunding vs. weak financial sponsors' pay based on at-risk liability
PBGC Lien Perfection in Ch. 11	Negative	Could reduce assets available for other creditors

Note: U.S. legacy carriers are rated non-investment grade by the major credit agencies as of February 2005.

Source: Bear, Stearns & Co. Inc. estimates.

While the full potential effect of enacting the Administration's proposals is uncertain at this time, our initial take is that the airlines would see little benefit, and could perhaps suffer even more financial pressure under the Bush plan. For example, under the Bush proposal, the seven-year amortization period would likely leave carriers such as Delta and Northwest (and UAL, if does not succeed in terminating its plans in Chapter 11) with hefty pension cash obligations each year. Similarly, requiring duration matching could in fact enervate funding levels, depending on plan duration levels. For example, a plan with a duration under 23 years as of December 2004 would have used a lower rate than the current corporate bond rate had the Administration's plan been in effect at the time.

Further, other provisions, such as higher premiums, PBGC superpriority in bankruptcy proceedings, and prohibition of lump-sum payouts at deeply underfunded plans should strengthen plans; however, should early retirement-eligible employees fear enactment of the anti-lump sum payout provision, a cascade of early retirements could ensue, similar to what occurred at Delta last year, which could serve to weaken a sponsor's financial position.

Exhibit 12. Administration's Seven-Year Amortization Offers Scant Relief and Would Need to Double to Provide Meaningful Cash Flow Assistance

Illustration of DRC Burden: Hypothetical Amortization Schedules (per year contribution)

	ALK	AMR	CAL	DAL	NWAC	UAL
ABO Shortfall	(161)	(1,823)	(1,131)	(5,239)	(3,565)	(5,692)
5 Years 2006-2010	(17)	(181)	(178)	(806)	(533)	(885)
7 Years 2006-2012 (Bush proposal)	(12)	(130)	(127)	(576)	(381)	(632)
15 Years 2006-2020	(6)	(60)	(59)	(269)	(178)	(295)
20 Years 2006-2025	(4)	(45)	(44)	(202)	(133)	(221)
25 Years 2006-2030	(3)	(36)	(36)	(161)	(107)	(177)

Note: Assumes 2004 ABO shortfall is equal to 2004 current liability funding level and funding level rises to 90% over stated period. 2004 likely reduced funding gaps a touch as assets rose, offset by declining interest rates. CAL has reached tentative labor agreements, which, if ratified, could freeze its DB plans and significantly lower pension funding requirements. UAL figures use 2003 ABO.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Airline employees have also taken a less-than-favorable view of the Administration's plan, as evidenced by United's pilot union chief, Mark Bathurst, who remarked that "taken as a whole, [the Bush proposal] would make it much more costly for United to maintain its current pension plans." Nor is it just the unions — Scott Yohe, Delta's senior vice president of government affairs, declared, "The Administration's proposal would not help us. The primary reason is not the seven years, but the interest rate assumption, which would not give us the kind of relief we are looking for in terms of the funding obligations we have got in the near term."

Northwest Airlines CEO and ALPA President Make Proposal

One of the more outspoken airline executives on pension issues has been Northwest's CEO, Douglas Steenland. Along with Duane Woerth, president of ALPA and a former PBGC director, Northwest's chief penned a *Wall Street Journal* article espousing a three-phase process:

- First, companies and their unions would agree to freeze the existing defined benefit plan accruals (i.e., no further benefit accruals would be allowed).

- Next, concurrent with the defined benefit freeze, the parties would establish a replacement defined contribution plan. While a replacement plan would likely be partially company funded, the investment performance risk rests with the employees.

- Last, Congress would need to amend ERISA to permit plan sponsors to meet their DRC requirements over a much longer time period than today's potentially shorter time frame (e.g., three to five years).

The first two steps can be accomplished by the companies under existing law, as evidenced by Delta's November 2004 pilot contract and Continental's recent tentative agreements. However, the ultimate success of such a move, from a cash flow perspective, appears to rest on the extension of DRC amortizations.

Senate Finance Bill Reintroduced: NESTEG (S.219)

On January 31, 2005, Senate Finance Committee Chairman Chuck Grassley and ranking member Max Baucus reintroduced their pension reform legislation from last year, titled The National Employee Savings and Trust Equity Guarantee (NESTEG) Act. For airlines, the main thrust of NESTEG is replacing the 30-year Treasury Bond-based discount rate with a corporate bond-based yield curve. As we mentioned earlier in regard to the Administration's proposal, depending upon the duration of a given pension plan, a switch to a yield curve could adversely affect plan sponsors by raising liabilities and, in turn, plan expenses. For example, at a Senate Finance Committee hearing on March 1, 2005, witnesses from The Business Roundtable noted that the Administration's yield curve proposal could "increase pension liabilities for a typical mature plan by 10% or more. In some cases, the immediate liability increase could be even greater. For large plans, this could cost billions of dollars."

FUNDING WAIVERS — ADMINISTRATIVE RELIEF

In times of duress, airlines can petition federal administrative agencies for pension funding waivers. The Department of Labor's (DOL) Employee Benefits Security Administration has the authority to allow exemptions to certain ERISA rules, such as contributions of in-kind securities to a DB plan. For its part, the IRS has the authority to grant waivers deferring current contribution requirements to the following year. Northwest Airlines was a beneficiary of these agencies' administrative power in 2003, when the IRS permitted it to defer $454 million in 2003 minimum funding requirements. Funding waivers are limited to three in 15 years, and repayments are generally made over a five-year period. In return for this deferral, Northwest's plans received liens on some Northwest planes, landing slots, and routes.

Similarly, the DOL emphasized that its decision to exempt additional firms would be made on an individualized basis after a thorough review of each situation. However, in order to obtain a waiver, a sponsor must demonstrate that it is experiencing *temporary* hardship, and given the current state of the industry, it may be more challenging to convince the government of such a transitory misfortune. As United highlighted in its court filings (see exhibit below), the medium-term effect of a waiver is likely to only enlarge cash funding needs, as sponsors are required to repay the waived amount plus interest to the plan generally over five years.

Exhibit 13. Waivers Only Delay Funding Temporarily, Leading to Increased Total Contributions
($ in billions)

United Airlines Minimum DB Funding Contributions	No Waiver	Waiver
2005E	$1.2	$0.2
2006E	$1.0	$0.4
2007E	$1.5	$1.0
2008E	$0.6	$1.4
2009E	$0.1	$1.2
2010E	$0.0	$0.5
Total	**$4.4**	**$4.8**

Source: United Airlines.

Exhibit 14. Waivers Remain a Possible Near-Term Funding Alternative: 2006-08?

IRS Waivers Remaining	
(sponsors permitted to 3 per 15 year period for each plan, spreads payment out over 5 years)	
ALK	3
AMR	3
CAL	3
DAL	3
NWAC	2 or 3
UAL	3

Note: NWAC used one waiver in 2003 for its contract and salaried plans, leaving two for those plans and three for other plans.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Nevertheless, we would not be surprised if most carriers applied for IRS waivers for 2006 plan-year contributions, especially if Congress is slow to enact replacement legislation for PFEA 2004.

NONCASH CONTRIBUTIONS

In-kind contributions are another avenue available for satisfying some contribution needs, though they may require DOL approval. For example, in 2003, the DOL authorized Northwest to contribute stock in its then-privately held subsidiary, Pinnacle, to its DB plans in lieu of cash to satisfy its $223 million of 2002 funding requirements. Our sense is that the DOL is leery of allowing illiquid, noncash asset contributions to meet funding requirements.

AMR possesses several assets that it could monetize to meet some of its pension funding needs. For example, sole ownership of American Beacon Advisors, a money manager (with $37 billion in assets under management as of January 2005), could provide a decent cash boost. As a reference, see Exhibit 15 below, which illustrates potential values for asset management firms based on assets under management. It is difficult to home in on the true value of American Beacon Advisors as more than 50% of the assets are related to AMR, while a similar percentage is also managed by third parties, suggesting lower margins for the company as opposed to actively managed in-house funds. In addition, AMR could spin off its regional affiliate, American Eagle, which it also owns outright, similar to what its legacy peers Continental and Northwest did in 2002-03 with their regional entities. (See Exhibit 16 below for theoretical regional affiliate values based on publicly available revenue and market values for publicly traded peers.)

Exhibit 15. Hypothetical Values for Asset Management Firms

	Assets Under Management (AUM) (US$ in billions)			
	$15	$20	$25	$30
Price to AUM Ratio	**Implied Value of Asset Management Unit (US$ in millions)**			
1.5%	$225	$300	$375	$450
2.0%	$300	$400	$500	$600
2.5%	$375	$500	$625	$750
3.0%	$450	$600	$750	$900
3.5%	$525	$700	$875	$1,050
4.0%	$600	$800	$1,000	$1,200

American Beacon Advisors directly managed or served as fiduciary or financial advisor for $37.6 billion in assets at 1/31/05 consisting of $17.3 billion under active management and $20.3 billion as named fiduciary or financial adviser.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Exhibit 16. Regional Units Could Potentially Help Fund Pension Plans

Parent (former)	CAL	NWAC	**AMR**		**DAL**	
	XJT	PNCL	**Eagle + Exec.**	SKYW	**ASA + Comair**	**Mean**
ASMs (billions)	4.77	2.22	4.54	1.70	8.59	
Revenue (millions)	$1,461	$581	$1,820	$1,067	$2,117	
EBT Margin Actual **(Assumed)**	13%	11%	**6%**	12%	**6%**	**12%**
P/E Actual **(Assumed)**	6.6x	4.2x	**7.1x**	10.4x	**7.1x**	**7.1x**
Actual **(Implied)** Market Cap.	$604	$223	**$496**	$1,012	**$577**	
Assuming 12% EBT Margin			**$988**		**$1,149**	
10% of 2003 DB Plan Assets = Potential Contribution Ceiling			**$734**		**$684**	

Note: Second-half 2004 Scheduled ASMs from OAG via BACK Aviation; Revenue = 12 months ended 9/30/04. Comair and ASA revenues 12 months ended 6/30/04 using OD1A data. Market capitalization for XJT, PNCL, and SKYW as of 3/10/05. As reference, NWAC contributed $350 million (roughly 7% of total GAAP plan assets at 12/03) worth of privately held Pinnacle shares to its defined benefit plans in 2003. CAL contributed $100 million of XJT to its DB plans (approximately 8% of GAAP plan assets at 12/03), which was freely tradable. DAL paid over $2 billion for Comair and ASA according to media reports. Assumes 36% tax rate for wholly owned subsidiary implied market value calculations.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Ins and Outs of Noncash Contributions

Publicly traded securities — such as those of a sponsor's own equity, an affiliate, or other marketable securities — do not require a special exemption from the DOL, as was the case in Northwest's contribution in 2003. However, limitations still exist. For instance, the pension fund cannot own more than 25% of the entire equity, at least 50% of the equity must be in hands of shareholders unaffiliated with the parent company, and no more than 10% of plan assets may be invested in employer (and subsidiary) stock. That said, Continental contributed shares in former subsidiary ExpressJet in 2003 and did so again in January 2005 to mitigate the pension cash outflow. While recognizing the strategic value of regional subsidiaries, Delta CEO Gerald Grinstein acknowledged on December 15, 2004 that "you do not have to own them to get all of the benefits."

As in Northwest's case, companies may also try to obtain a DOL exemption that permits them to contribute prohibited transactions (illiquid, nontradable assets). For instance, U.S. Steel was permitted to contribute timber rights to its pension plans in 2003. However, a sponsor that proposes using a cashless asset with no ready market would need to supply an appraisal of the asset's worth, as well as convince the DOL that the assets could not be liquidated and that the pension plan would undertake no undue risk by accepting those assets (Northwest gave its pension plan put options so that it could put the Pinnacle stock back to Northwest at a given price).

FREEZING DB PLANS A LA DELTA PROVIDES LITTLE HELP FOR FUNDING LEVELS

Delta Air Lines' latest pilot deal, signed in November 2004, provided for a freeze of the pilots' defined benefit plans as of December 31, 2004, eliminating future service accruals; however, future wage increases will still get factored into pilots' final pension obligations. As a result of the partial freeze, Delta's DB liabilities should only grow due to salary inflation and interest accretion. Underscoring the uncertain future of airline DB benefits, on February 11, 2005, Northwest's pilot union leadership resolved to explore the possibility of freezing its plan to better protect its long-term viability. Momentum for plan freezes has seemingly picked up, as Continental disclosed that its recent tentative labor agreements contain some defined benefit plan freezes. While freezing a plan is most certainly more palatable for labor than termination, we believe that freezes do not go far enough to shore up cash flow needs and would still leave carriers that implement them at massive disadvantages to others that *do* terminate their plans.

UAL acknowledged in court filings (September 2004) that freezing its plans as of December 31, 2004 would only reduce its total cash outlay through 2008 by $875 million, leaving total cash contribution needs at $3.2 billion, a still-hefty sum that could certainly crimp liquidity. What's more, the estimated savings *exclude* the costs associated with any replacement plans that would most likely be established (north of $100 million per year). Recent history suggests some sort of company contributory defined contribution plan (some carriers' plans only match employees' contributions to a certain extent, while other plans contribute a specified amount of a person's salary). In addition, cash contribution needs are still driven by asset returns (the average return assumption was 8%-9%) and interest rates.

Furthermore, we examined carriers' PBO and ABO funding levels to get a sense of the potential funding level benefit should carriers freeze the salary inflation portion of their DB plans. For most of the carriers (see Exhibit 1), we found an average five-percentage-point improvement in 2004 funding levels (from 61% funded to 66% funded), which, in our view, underscores the limited improvement in funding levels (which determine cash funding needs) likely to be derived from the DB plan freeze in the near term.

PLAN TERMINATIONS

While three types of plan terminations exist under current law (distress, involuntary, and standard), for all intents and purposes, only the former two are relevant to the airline industry.

First of all, a standard termination requires a plan sponsor (in this case, an airline) to fully fund its plans either through lump-sum payouts or the purchase of annuities sufficient to satisfy all of its liabilities. In light of the substantial funding deficits (totaling $14 billion at Alaska Air, AMR, Continental, Delta, and Northwest) and the likely high cost required to acquire annuities, this form of termination appears to be out of reach.

Second, involuntary terminations arise when the PBGC itself terminates a pension plan after it reaches a certain level of distress (inability to make current payments to retirees, etc.), which would be a dream come true for plan sponsors, though the sponsor (and its equity) would likely find itself in a terminal condition before the PBGC would step in (e.g., PBGC taking over pension plans for United's pilots and ground workers). Distressed terminations, on the other hand, require carriers to demonstrate to the PBGC their inability to continue operations without abrogating their pension plans (to pass the distress test, a bankrupt sponsor may try to prove that "unless the plan is terminated [the plan sponsor], will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process.").

In addition, since airline pension plans are part and parcel of collective bargaining agreements, union consent is needed unless a bankruptcy judge nullifies the contract, all of which suggests that a distress termination outside of Chapter 11 is highly unlikely.

Retiree Health Care — A Growing Problem

ANOTHER DRAIN ON THE CARRIERS' COFFERS

While smaller in size than defined benefit pension obligations, another percolating benefit cost/liability problem for legacy airlines is retiree health care obligations. We estimate aggregate retiree health care obligations will be $726 million this year. While ERISA requires that pension plans meet established funding levels, retiree health care plans lack any similar funding requirement. For that reason, most carriers also have substantial unfunded accumulated post-retirement benefit obligations.

For example, 4% was the highest funding level among the legacy carriers with retiree health care (OPEB) obligations shown below at year-end 2004. As a result, retiree funding needs are met almost entirely from the corporate balance sheet and operating cash flow (as opposed to plan assets set aside, as in the case of pension plans). In addition, health care costs have been growing at a steady clip (up 8% in 2004) and are expected to rise an additional 6.6% this year, according to the bellwether Mercer survey. Some carriers began limiting their OPEB exposure several years ago by capping annual benefits. Nevertheless, the obligations loom large.

Based on the latest data available, AMR, Delta, and UAL each anticipated $190-$235 million in annual retiree health care funding needs through 2008. Given the meaningful sums of cash that these benefits divert from a carrier's coffers and the moves at UAL and US Airways in bankruptcy to streamline these expenses, we suspect that the other carriers will need to address these issues in the short to medium term.

Without ERISA funding guidelines, this is a pay-as-you-go scheme that could run into trouble as companies shrink and retirees' population rise. In addition to the carriers shown below, both Alaska and Frontier offer OPEB, although future payment forecasts are unavailable at this time (for historical information, see Exhibit 1). Further, Continental Airlines disclosed that its recent tentative labor agreements provide for some medical benefits to "eligible retirees" until they are eligible for Medicare, an apparent departure of past practice, wherein, unlike its legacy peers, the carrier did not offer retiree medical benefits (though this likely made the DB freeze more palatable for labor). As a result of offering retiree medical coverage, Continental expects to record $25 million in expenses in 2005 related to this plan.

Exhibit 17. Retiree Health Care (OPEB) Funding Liabilities and Plan Payout Forecast

	AMR	Delta	Northwest	US Airways	UAL	LUV
	Postretirement Benefit Payments from Plan Assets and Current Assets					
2005	$193	$188	$45	$63	$225	$2
2006	$187	$189	$48	$66	$235	$3
2007	$195	$191	$52	$71	$230	$5
2008	$201	$171	$55	$75	$235	$7
2009	$208	$163	$60	$74	$235	$9
2010 to 2014	$1,119	$669	$360	$421	$1,152	$78
Total - 2014	**$2,103**	**$1,571**	**$620**	**$770**	**$2,312**	**$104**
2004 APBO Unfunded Liability ($ mns)	($3,152)	($1,835)	($921)	($1,369)	($3,069)	($80)
2004 APBO Funded Status (%)	**4%**	**0%**	**1%**	**0%**	**4%**	**0%**
2004 P&L Expense	$264	$76	$98	$105	$364	$18
2004 P&L Expense per Share	**$1.05**	**$0.38**	**$0.73**	**$1.23**	**$2.05**	**$0.01**
2004 OPEB CASM	**0.14¢**	**0.05¢**	**0.11¢**	**0.19¢**	**0.25¢**	**0.02¢**
2005E Payment as % of 4Q Cash Balance	**7%**	**10%**	**2%**	**NA**	**NA**	**0%**
2005E Payment as % of '05 Op. Cash Flow	**18%**	**41%**	**14%**	**NA**	**NA**	**0%**
2005E Payment as % of '05 Pension Contribution	**62%**	**68%**	**11%**	**NA**	**NA**	**NA**

Note: UAL's information is as of 2003. In addition, the payment schedule is through 2004-08 and 2009-13.
OPEB includes post-employment health care benefits: medical, dental, vision, hearing, and other health-related benefits whether provided separately or through the pension plan; other benefits: life insurance, disability, long-term care, etc., when provided separately from a defined benefit pension plan. APBO = accumulated postretirement benefit obligation. Assumes 36% tax rate for 2004 expense per share.

Source: Bear, Stearns & Co. Inc.; company filings.

How Do the Airlines Stack Up?

WE FIND MEANINGFUL DIFFERENCES BETWEEN PENSION AND OPEB COSTS

Last year, all the carriers in our coverage satisfied their required pension contributions. Nevertheless, the latest company guidance suggests hefty sums will be required in 2005, with Northwest leading the pack with $420 million in contributions. AMR, Delta, and Continental are not far behind with $310 million, $275 million, and $192 million (helped by a $65 million contribution in stock in January 2005 and its tentative labor agreements), respectively, in projected pension funding requirements in 2005, while Alaska should contribute close to $60 million.

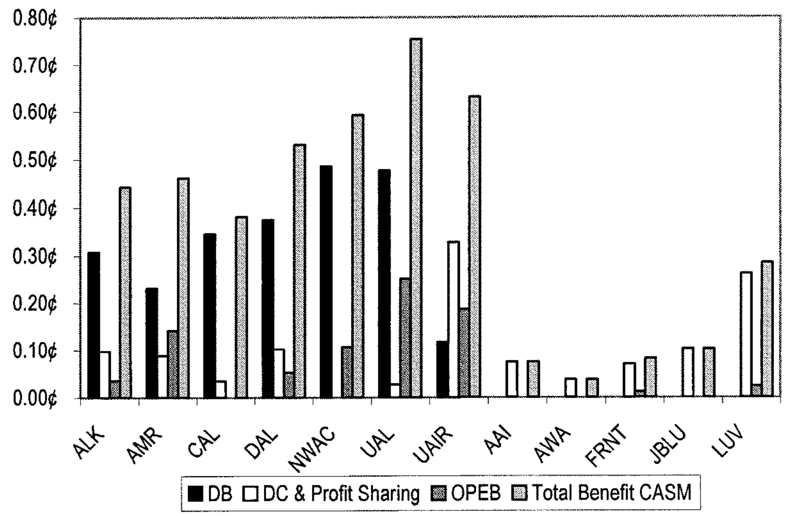
We believe that these contribution requirements should be considered in light of operating cash flow and other potential cash uses, such as debt maturities and unfinanced capital expenditures. Viewed in this way, we see that pension cash contributions will eat up a substantial portion of operating cash flow in 2005 (an aggregate 50%) and also represent a meaningful percentage of most carriers' unrestricted cash balances, 13% in total.

Based on our current 2005 estimates, Alaska appears to have the lowest pension cash contribution-to-operating-cash-flow ratio (19%) as well as the best pension cash-to-unrestricted cash balance ratio (7%). Northwest Airlines, on the other hand, has both the highest pension cash contribution-to-operating cash flow ratio (126%) and a pension contribution-to-cash balance ratio of 17%. Overall, we expect airlines to have an average $1.79 per share cash drag in 2005 due to DB pensions, representing 50% of their estimated 2005 operating cash flow and 5%-45% of their recent share prices. As we detail below, it could get much worse in 2006.

Pension, 401(k), Profit Sharing, and Retiree Health Approach $0.01 of CASM at Some Carriers

In the exhibit below, we depict the components of non-salary labor unit costs. For some airlines, these non-wage benefits amount to close to $0.01 of cost per available seat mile (CASM). Nevertheless, we also note that for LCCs such as Southwest and JetBlue, which utilize defined contribution and profit-sharing schemes, their respective non-salary labor CASM approximates the legacies' DB CASM. Put another way, replacing DB plans with healthy DC and profit-sharing programs may not be the answer to the near-term cash crunch, though the longer-term benefits are less disputable.

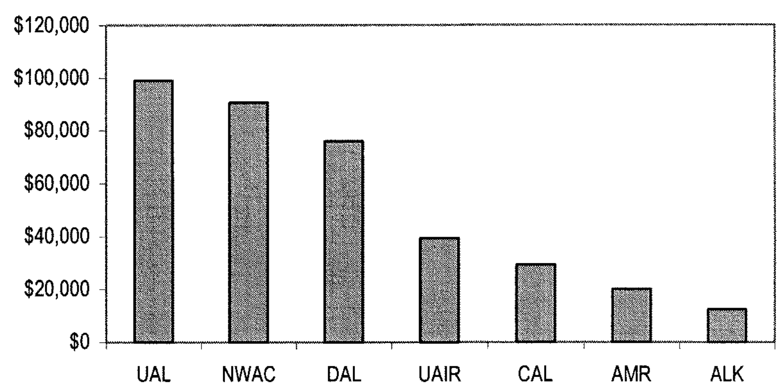
Exhibit 18. 2004 Pension, Profit-Sharing, and Retiree CASM (as reported)



Note: UAL is as of 2003.

Source: Bear, Stearns & Co. Inc. estimates.

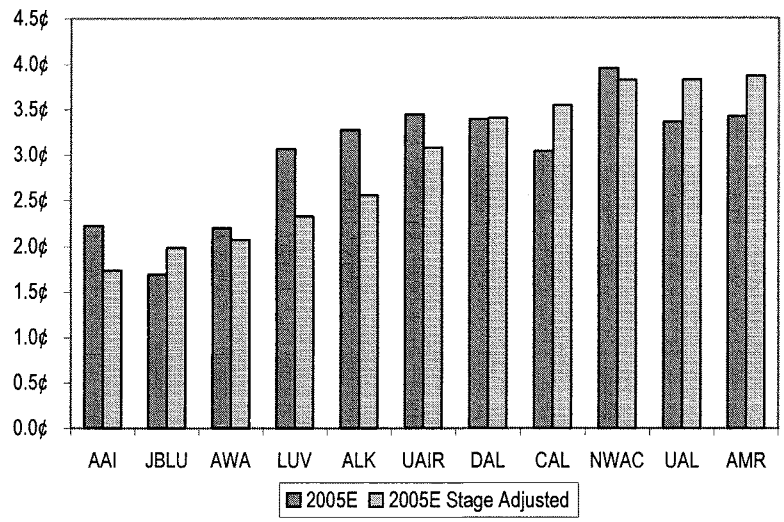
Exhibit 19. 2004 Unfunded ABO per Employee



Note: UAIR's defined benefit plans were terminated effective February 1, 2005 and UAL is attempting to do the same. UAL is calculated using 2003 ABOs and 2004 FTEs.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Exhibit 20. 2005E Labor CASM



Note: Stage-adjusted to 1,000 miles. UAIR and UAL are Not Rated. Using third-quarter 2004 stage as per Form 41 data

Source: Bear, Stearns & Co. Inc. estimates.

In 2005, given expiring pension legislation (plan years beginning after December 28, 2005 would revert to prior pension law), we expect Congress to attempt to replace current discount rate guidelines. In addition, airline labor leaders have recently espoused a mechanism whereby airlines could spread out their deficit reduction contributions over many years. Further, with UAL working to terminate its DB pension plans and US Airways having successfully ditched its own, those carriers not operating under the auspices of Chapter 11 (22), could find themselves at a substantial disadvantage, particularly given the significant hurdles required for terminating a plan outside of bankruptcy: 1) meeting PBGC's "financial distress" test, and 2) obtaining labor union consent to the changes.

Exhibit 21. Pension Cash Contribution Estimates ($ in millions)

	Required Pension Cash Contributions				
	ALK	AMR	CAL	DAL	NWAC
2004	$49	$467	$0	$455	$253
2005E	$58	$310	$192	$275	$420
2005E Pension Cash as % of Op. Cash Flow	19%	28%	63%	61%	126%
2006E Plan Freezes and 20-Yr Amort.	$4	$45	$44	$202	$133
2006E Bush Proposal (7-Yr Amort.)	$71	$314	$288	$726	$704
2006E PFEA Expires and 5-Yr Amort.	$76	$377	$356	$962	$901
2006E Plan Freezes and 20-Yr Amort. as % of Op. Cash Flow	1%	2%	6%	13%	11%
2006E Bush Proposal (7-Yr Amort.) as % of Op. Cash Flow	21%	16%	36%	47%	58%
2006E PFEA Expires and 5-Yr Amort. as % of Op. Cash Flow	23%	19%	45%	62%	74%

Note: 2004 and 2005 from company guidance and Bear Stearns estimates. 2006 hypothetical figures from Bear Stearns. Calculation methodology: Uses 2004 ABO funding level for ALK, AMR, CAL, DAL, and NWAC; 2006 DRC amortization is arrived at by assuming funding needed to achieve 90% ABO funding level (analogous to ERISA's current liability measure): 1) begin 2006 with 2005 estimated contribution amount, and haircut by 50% to arrive at non-DRC assumed contribution for 2006; 2) add estimated DRC amortizations deferred from 2004 and 2005 (2003 as well if any); and 3) add 2006 DRC amortization estimate. NWAC includes amortization from 2003 waived amount of $454 million. CAL has reached tentative labor agreements, which, if ratified, could freeze its DB plans and significantly lower pension funding requirements.

Source: Bear, Stearns & Co. Inc. estimates.

Company Pension Profiles

ALASKA AIR GROUP

Exhibit 22. Alaska Air's Pension Summary
($ in millions, except CASM data)

2004 PBO Funding Status	67%
2004 PBO Underfunding	($303)
2004 Defined Benefit Pension Expense	$78
2004 Defined Contribution + Profit-Sharing Expense	$25
2004 Retirement Health Care Expense (OPEB)	$9
2004 DB, DC, OPEB CASM	0.44¢
2005E DB Pension Cash Contributions	$58
2005E Operating Cash Flow (oil avg. $46/bbl)	$302
2004 Unrestricted Cash Balance	$874
2006E DB Pension Cash Contributions Base Case	$71
2006E Operating Cash Flow (oil avg $40/bbl)	$332

Source: Bear, Stearns & Co. Inc. estimates; company reports.

We believe Alaska Air Group has the least pension risk among our legacy carrier coverage universe. Our estimates suggest that Alaska Air's pension is underfunded by $300 million, or 33% on a PBO basis (21% on an ABO basis), better than the 41% average among the legacies; also, the $58 million in required cash contributions as a percentage of operating cash flow is 19%, well below the 50% group aggregate. Further, our estimated required contributions over the next two years are just 15% of the carrier's fourth-quarter 2004 unrestricted cash balance, versus the 34% group average.

For example, 2005 cash contributions are only expected to rise 18%, to $58 million, versus 66% at Northwest. In addition, the smaller carrier has lower absolute pension liabilities (liabilities are one-tenth the size of AMR's) and cash pension contributions are likely to be less meaningful for Alaska Air than the rest of the bunch. For instance, Alaska Air's 2005 cash contributions amount to just 7% of its fourth-quarter 2004 unrestricted cash balance, roughly one half of the other carriers' 13% average. Looked at as a percentage of 2005 estimated operating cash flow, Alaska Air's cash funding needs are half those of its nearest competitor.

Our sense is that given Alaska Air's relatively superior funding levels, stronger balance sheet (71% net debt to total invested capital versus the 114% average at the four nonbankrupt legacy airlines), and less burdensome near-term cash funding needs, the carrier is less likely to freeze its plans despite being in contract negotiations with the majority of its labor groups. While we estimate that Alaska Air enjoys a 28% labor CASM advantage to the network carriers, plan terminations at other carriers would reduce its current advantage to 19% for 2005 on a stage-adjusted basis.

AMR CORPORATION

Exhibit 23. AMR's Pension Summary
($ in millions, except CASM data)

2004 PBO Funding Status	73%
2004 PBO Underfunding	($2,687)
2004 Defined Benefit Pension Expense	$427
2004 Defined Contribution + Profit-Sharing Expense	$163
2004 Retirement Health Care Expense (OPEB)	$264
2004 DB, DC, OPEB CASM	0.46¢
2005E DB Pension Cash Contributions	$310
2005E Operating Cash Flow (oil avg. $46/bbl)	$1,089
2004 Unrestricted Cash Balance	$2,929
2006E DB Pension Cash Contributions Base Case	$314
2006E Operating Cash Flow (oil avg $40/bbl)	$1,982

Source: Bear, Stearns & Co. Inc. estimates; company reports.

We rank AMR's pension risk behind Alaska's, but ahead of Northwest's, Delta's, and Continental's. We estimate that AMR's pension is underfunded by $2.7 billion, or 27% on an PBO basis (20% on an ABO basis), better than the 41% average among the legacies; also, the $310 million in required cash contributions as a percentage of operating cash flow is 28%, below the 50% group aggregate. Further, our estimated required contributions over the next two years are 21% of the carrier's fourth-quarter 2004 unrestricted cash balance, versus the 34% group average.

AMR will likely contribute $310 million (absent legislative relief in 2005, the sum would have been much greater) in cash to its pensions in 2005, 11% of the company's unrestricted cash level, according to its December 31 balance sheet. This sizable cash outlay equates to roughly 28% (better than the group aggregate of 50%) of our 2005 operating cash flow estimate, equivalent to $1.24 in cash per share.

With its credit facility recently renegotiated, AMR should be able to easily meet 2005's cash obligations. In fact, AMR made a first installment in January 2005 of $42 million. However, looking to 2006, assuming no new pension legislation, we forecast cash contributions will rise 22%, to $377 million, or 19% of our operating cash flow estimate (our 2006 cash flow estimate assumes $40/bbl oil). To relieve this burden, AMR could seek IRS waivers should Congress fail to produce additional laws that benefit airlines with DB plans.

In addition, we expect AMR to seriously consider selling its investment arm, which it attempted to do in 2003, but pulled it off the market when bids failed to meet expectations. As a reference to that unit's potential value, we looked at M&A activity in the asset management industry over the past couple of years and concluded that its current assets under management imply a value of $400-$750 million for the money manager depending on the amount of assets ultimately transferred and relative performance (assumes price to assets under management of 2%-3% and total assets sold of $20-$25 billion).

Exhibit 24. Hypothetical Values for Asset Management Firms

		Assets Under Management (AUM) (US$ in billions)			
		$15	$20	$25	$30
		Implied Value of Asset Management Unit (US$ in millions)			
Price to AUM Ratio	1.5%	$225	$300	$375	$450
	2.0%	$300	$400	$500	$600
	2.5%	$375	$500	$625	$750
	3.0%	$450	$600	$750	$900
	3.5%	$525	$700	$875	$1,050
	4.0%	$600	$800	$1,000	$1,200

American Beacon Advisors directly managed or served as fiduciary or financial advisor for $37.6 billion in assets at 1/31/05, consisting of $17.3 billion under active management and $20.3 billion as named fiduciary or financial adviser.

Source: Bear, Stearns & Co. Inc. estimates.

In addition, AMR might be tempted to spin off part of its regional subsidiaries, just as Continental and Northwest did in 2002 and 2003. Given the right market conditions, that could conceivably raise $500 million to $1 billion, depending on the carrier's profit margin. (See the table below for potential margins and multiples.)

Exhibit 25. Regional Units Could Potentially Help Fund Pension Plans

Parent (former)	CAL XJT	NWAC PNCL	**AMR Eagle + Exec.**	SKYW	**DAL ASA + Comair**	**Mean**
ASMs (billions)	4.77	2.22	4.54	1.70	8.59	
Revenue (millions)	$1,461	$581	$1,820	$1,067	$2,117	
EBT Margin Actual **(Assumed)**	13%	11%	**6%**	12%	**6%**	**12%**
P/E Actual **(Assumed)**	6.6x	4.2x	**7.1x**	10.4x	**7.1x**	**7.1x**
Actual **(Implied)** Market Cap.	$604	$223	**$496**	$1,012	**$577**	
Assuming 12% EBT Margin			**$988**		**$1,149**	
10% of 2003 DB Plan Assets = Potential Contribution Ceiling			**$734**		**$684**	

Note: Second-half 2004 Scheduled ASMs from OAG via BACK Aviation; Revenue = 12 months ended 9/30/04. Comair and ASA revenues 12 months ended 6/30/04 using OD1A data. Market capitalization for XJT, PNCL, and SKYW as of 3/10/05. As reference, NWAC contributed $350 million (roughly 7% of total GAAP plan assets at 12/03) worth of privately held Pinnacle shares to its defined benefit plans in 2003. CAL contributed $100 million of XJT to its DB plans (approximately 8% of GAAP plan assets at 12/03), which was freely tradable. DAL paid over $2 billion for Comair and ASA according to media reports. Assumes 36% tax rate for wholly owned subsidiary implied market value calculations.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

CONTINENTAL AIRLINES

Exhibit 26. Continental's Pension Summary
($ in millions, except CASM data)

2004 PBO Funding Status	45%
2004 PBO Underfunding	($1,582)
2004 Defined Benefit Pension Expense	$293
2004 Defined Contribution + Profit-Sharing Expense	$30
2004 Retirement Health Care Expense (OPEB)	NA
2004 DB, DC, OPEB CASM	0.38¢
2005E Required DB Pension Contributions	$307
2005E DB Pension Cash Contributions	$192
2005E Operating Cash Flow (oil avg. $46/bbl)	$307
2004 Unrestricted Cash Balance	$1,460
2006E DB Pension Cash Contributions Base Case	$288
2006E Operating Cash Flow (oil avg $40/bbl)	$798

Note: 2005 pension contributions exclude $65 million in stock and assume $50 million in savings from labor deals.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

We believe Continental's pension risk is higher than Alaska Air's and AMR's, but lower than both Northwest's and Delta's. We estimate that Continental's pension is underfunded by $1.6 billion, or 55% on a PBO basis (47% on an ABO basis), worse than the 41% average among the legacies; also, the $192 million in required cash contributions as a percentage of operating cash flow is 63%, a touch above the group aggregate of 50%. Further, our estimated required contributions over the next two years are 33% of the carrier's fourth-quarter 2004 unrestricted cash balance, in line with the group average.

Continental started out 2004 with the best-funded pension plan of the legacy carriers, on a current liability basis (cash purposes). Originally, Continental intended to contribute $300 million to maintain a 90% current liability status (a level that precludes DRC requirements). (Current liabilities are measured using ERISA/IRC formulas analogous to the GAAP ABO [Accumulated Benefit Obligation], which differs from the PBO [Projected Benefit Obligation], since it makes no assumption about future compensation levels, making it generally lower than the PBO.) However, bruising fuel prices and weak yields made liquidity preservation a top priority, and, in turn, Continental availed itself of the Pension Funding Equity Act (PFEA) of 2004, thereby eliminating its cash contribution in 2004.

The year 2005 looks more troublesome, though the carrier did use $65 million of ExpressJet equity as an initial contribution in January. Assuming Continental achieves its stated $50 million in pension contribution savings resulting from tentative labor agreements, we estimate cash contributions of $192 million, or $1.86 per share, representing 63% of our operating cash flow estimate, higher than 50% group aggregate. Nevertheless, as a percentage of its December 2004 unrestricted cash balance, 2005's pension requirements amount to a more manageable 13%, in line with the group's average. After January's ExpressJet contribution, based on ownership levels as of February 7, we estimate that Continental could potentially contribute another $65 million in ExpressJet shares (at which point we estimate plan assets would hit ERISA's 10% ownership cap permissible for pension plans) to its DB plans, further reducing cash outflow to roughly $127 million. (Continental has publicly stated its intention to unwind its ownership of XJT shares.)

DELTA AIR LINES

Exhibit 27. Delta's Pension Summary
($ in millions, except CASM data)

2004 PBO Funding Status	56%
2004 PBO Underfunding	($5,298)
2004 Defined Benefit Pension Expense	$549
2004 Defined Contribution + Profit-Sharing Expense	$150
2004 Retirement Health Care Expense (OPEB)	$76
2004 DB, DC, OPEB CASM	0.53¢
2005E DB Pension Cash Contributions	$275
2005E Operating Cash Flow (oil avg. $46/bbl)	$454
2004 Unrestricted Cash Balance	$1,799
2006E DB Pension Cash Contributions Base Case	$726
2006E Operating Cash Flow (oil avg $40/bbl)	$1,558

Source: Bear, Stearns & Co. Inc. estimates; company reports.

We believe Delta has one the highest pension risk profiles among the legacy carriers operating outside of Chapter 11. While its funding deficit is the worst in the industry, its contributions as a percentage of cash flow are slightly below Northwest's. We estimate that Delta's pension is underfunded by $5.3 billion, or 44% on a PBO basis (43% on an ABO basis), greater than the 41% average among the legacies; also, the $275 million in required cash contributions as a percentage of operating cash flow is 61%, a notch above the 50% group aggregate. Further, our estimated required contributions over the next two years are a sizable 56% of the carrier's fourth-quarter 2004 unrestricted cash balance, versus the 34% group average.

On November 11, 2004, Delta's pilots ratified a new labor agreement principally calling for a 32.5% wage cut combined with a partial freezing of its defined benefit plan and subsequent creation of a defined contribution replacement plan. While the contract permitted Delta to avoid a potential fourth-quarter 2004 bankruptcy filing, the carrier has only scratched the surface regarding its pension underfunding. Despite freezing its pilot DB plan, Delta will still need to contribute hundreds of millions of dollars per year as a result of the $4 billion plus funding gap. What's more, the latest collective bargaining agreement established a new defined contribution requiring company funds, which will likely offset some of the potential cash savings.

For 2005, we estimate defined benefit pension cash contributions of $275 million (nonqualified DB plans will add another $65 million, while defined contribution plans could total $110 million), which is roughly 60% of our projected operating cash flow in that year. Further, as a percentage of its fourth-quarter 2004 cash balance, Delta's 2005 pension needs sit at roughly 15%, in line with the group average.

In light of the still-substantial pension obligations, Delta continues to face a formidable challenge — meeting its legally mandated funding requirements. The company posted the largest absolute funding gap of the nonbankrupt carriers in 2004, with an ABO underfunding of $5.2 billion versus runner-up Northwest's $3.6 billion in already-accrued unfunded liabilities. That said, we expect the company to pursue any and all non-termination outlets available to mitigate its pension burden. For example, in mid-December 2004, CEO Gerald Grinstein indicated Delta would work with Congress to devise a mechanism that would stretch out pension funding payments. Similarly, CFO Michael Palumbo has drawn analogies to funding deferrals obtained at both TWA and PanAm. In addition, we would not be surprised if Delta looked to spin off part of its regional subsidiaries, Comair and ASA, which it paid $2 billion-plus for in the 1980s and 1990s. (For more on this topic, see the exhibit below.)

Exhibit 28. Regional Units Could Potentially Help Fund Pension Plans

Parent (former)	CAL	NWAC	**AMR**		**DAL**	
	XJT	PNCL	**Eagle + Exec.**	SKYW	**ASA + Comair**	**Mean**
ASMs (billions)	4.77	2.22	4.54	1.70	8.59	
Revenue (millions)	$1,461	$581	$1,820	$1,067	$2,117	
EBT Margin Actual **(Assumed)**	13%	11%	**6%**	12%	**6%**	**12%**
P/E Actual **(Assumed)**	6.6x	4.2x	**7.1x**	10.4x	**7.1x**	**7.1x**
Actual **(Implied)** Market Cap.	$604	$223	**$496**	$1,012	**$577**	
Assuming 12% EBT Margin			**$988**		**$1,149**	
10% of 2003 DB Plan Assets = Potential Contribution Ceiling			**$734**		**$684**	

Note: Second-half 2004 Scheduled ASMs from OAG via BACK Aviation; Revenue = 12 months ended 9/30/04. Comair and ASA revenues 12 months ended 6/30/04 using OD1A data. Market capitalization for XJT, PNCL, and SKYW as of 3/10/05. As reference, NWAC contributed $350 million (roughly 7% of total GAAP plan assets at 12/03) worth of privately held Pinnacle shares to its defined benefit plans in 2003. CAL contributed $100 million of XJT to its DB plans (approximately 8% of GAAP plan assets at 12/03), which was freely tradable. DAL paid over $2 billion for Comair and ASA according to media reports. Assumes 36% tax rate for wholly owned subsidiary implied market value calculations.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

NORTHWEST AIRLINES

Exhibit 29. Northwest's Pension Summary
($ in millions, except CASM data)

2004 PBO Funding Status	59%
2004 PBO Underfunding	($3,820)
2004 Defined Benefit Pension Expense	$444
2004 Defined Contribution + Profit-Sharing Expense	NA
2004 Retirement Health Care Expense (OPEB)	$98
2004 DB, DC, OPEB CASM	0.59¢
2005E DB Pension Cash Contributions	$420
2005E Operating Cash Flow (oil avg. $46/bbl)	$333
2004 Unrestricted Cash Balance	$2,459
2006E DB Pension Cash Contributions Base Case	$704
2006E Operating Cash Flow (oil avg $40/bbl)	$1,214

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Northwest's cash contributions as a percentage of operating cash flow rank the highest among the legacy carriers. We estimate that Northwest's pension is underfunded by $3.8 billion, or 41% on a PBO basis (40% on an ABO basis), in line with the legacy average; also, the $420 million in required cash contributions as a percentage of operating cash flow is a whopping 126%, well above the 50% group aggregate. Further, our estimated required contributions over the next two years total

46% of the carrier's fourth-quarter 2004 unrestricted cash balance, versus the 34% group average.

In 2002-03, Northwest demonstrated to the markets its ability to tackle near-term pension requirements through cash, pension waivers, and noncash contributions. However, in doing so, the Minneapolis-based carrier expended several precious resources that may be difficult, if not impossible, to replicate this time around. In 2003, Northwest sought administrative relief and received permission to fund its pension plans with $223 million (for the 2002 plan year) in a subsidiary's stock and amortize 2003's payment of $454 million over five years. The Pension Funding Equity Act of 2004 reduced Northwest's 2004 cash contribution to $253 million. For 2005, the carrier expects pension needs to rise to $420 million, which amounts to 126% of our forecasted operating cash flow for the same year (more than double the group aggregate). However, as a percentage of fourth-quarter 2004's unrestricted cash balance, Northwest's pension cash requirements come in at 17%, only a touch north of the group average.

After successfully monetizing its regional subsidiary in 2003, Northwest is left with only an 11% stake, valued at roughly $25 million, hardly enough to make a meaningful dent in pension cash needs. Meeting 2005's pension needs should not present any extreme difficulties for the carrier, though turning to 2006, things may get uncomfortable should Congress allow the current legislation to expire without any replacement. The pilots union appears to understand the severity of the situation, as it recently agreed to discuss a possible DB freeze with the company in order to ensure the plan's sustainability. The pilots' freeze initiative could establish an important precedent for other unions that are in negotiations.

Aside from union concessions, the carrier still possesses two pension waivers (three remain for the pilots' plan) that it could apply for beginning in 2006 should Congress not act.

Notwithstanding the availability of additional pension waivers, we believe it could be more difficult to convince the IRS of the carrier's temporary financial hardship this time around (are the industry's current woes truly temporary?) as well as meet any additional collateral requirements that could be required. We note that in the first waiver application, Northwest was obligated to grant its pension plans liens on some domestic slots, international routes, aircraft, and engines, likely leaving less unencumbered assets for another round of waivers.

On a related front, Northwest received an informal request from the SEC regarding its pension plan accounting (GAAP) assumptions. Our initial take is that while it is a noncash issue, Northwest's asset allocation (74%-20% equities/fixed income versus 63%-29% average at other carriers) is likely behind the higher return expectation. Should Northwest move to reduce its expected rate of return assumption by 50 bps, all else equal, we estimate that it could negatively affect expenses by roughly $27 million, or $0.20 per share.

UNITED AIRLINES AND US AIRWAYS (BOTH NOT RATED)

US Airways terminated its remaining defined benefit plans in January 2005 (in its first stint in bankruptcy, US Airways terminated its pilots' defined benefit pension plan). The much larger United appears to be in a more tenuous situation, as the PBGC preemptively moved in late December 2004 to terminate the pilots' plan, in hopes that relief from cockpit crew DB plans would allow the airline to maintain the remainder of its plans, something UAL vigorously opposes. United's pilots union agreed in its latest contract (ratified in January) not to fight its DB plan's termination, in return for a healthy DC plan and a $550 million convertible note to supplement the pension benefit losses. The large convertible note could pose a sticking point for other unions and potential exit financiers. However, punting the pilots' plan alone could save $1.3 billion (30% of total pension cash obligations due through 2008) in cash contributions. Subsequently, the PBGC also moved in mid-March to take over the UAL ground workers pension plan, which is estimated to require the greatest funding contributions of all of UAL's plans through 2008, at $1.4 billion. Relieved of the responsibility for its two costliest plans, UAL could find it tougher to convince a judge of the need to terminate the remaining plans.

UAL faces substantial pension contributions in the coming years. It continues to hemorrhage cash, similar to the other legacy airlines, and the difficulty in attracting exit financing has all but sealed the fate of its defined benefit plans, in our view. Through 2009, UAL estimated it would have to contribute more than $4 billion. Should UAL also succeed in terminating all of its defined benefit plans, while also reducing wage rates, and exit with low-cost carrier-like costs, the second-largest U.S. airline would pose a formidable challenge for fellow legacy and LCC carriers alike, in our opinion. In addition, any changes made to UAL's pension plans are likely to ripple through the industry given the carrier's size, spurring modifications at other airlines.

Exhibit 30. There Appears to Be No Way Around Huge Cash Drain Except Termination

UAL Minimum DB Funding Contributions (US$ in millions)[1]	No Waiver	Waiver
2005E	$1,200	$200
2006E	$1,000	$400
2007E	$1,500	$1,000
2008E	$600	$1,400
2009E	$100	$1,200
2010E	$0	$500
Total	**$4,400**	**$4,800**

US Airways Minimum DB Funding Contributions (US$ in millions)[2]	No Waiver	Freeze & Waiver
2005E		$32
2006E		$59
2007E		$177
2008E		$213
2009E		$248
Total	**$987**	**$728**

(1) Company reports dated 12/15/04; due to rounding, breakdown as shown in millions does not foot with company-disclosed total of $4.8 billion.
(2) Court fillings 12/13/04; assumes IAM/AFA plan freezes 1/1/05 and waivers from 2004-06 as well as waivers for the CE plan from 2007-09.

Source: Bear, Stearns & Co. Inc. estimates; company reports.

Pensions 101

A QUICK OVERVIEW

As plan assets fall at the airlines, pension obligations become an issue, particularly for those carriers with "defined benefit" plans, which differ from 401k plans because the DB sponsor bears all the investment risk by guaranteeing a retirement amount. Carriers with defined benefit plans include Alaska Air Group, American Airlines, Continental, Delta, Northwest, United, and US Airways. Southwest, JetBlue, AirTran, Frontier, and America West do not offer defined benefit plans, though they do provide defined contribution plans partially funded by the carriers themselves.

On top of regular maintenance contributions, federal pension law requires companies to contribute additional assets unless the pension plan's funded status is at least 90% or the funded liability is currently at least 80% and was at least 90% in two consecutive years out of the past three. However, DRC funding rules are such that companies often have limited amounts of time to make up the shortfall and, under some circumstances, may contribute limited amounts of stock rather than cash. (In 2003, and again in January 2005, Northwest and Continental used stock to fund portions of their pension plans, and we expect AMR, Continental, and Delta to consider future cash funding alternatives.)

Over on the P&L, pension accounting permits the use of smoothing mechanisms that spread out recognition of income and expenses. Accordingly, it reduces the volatility of pension earnings (costs). What's more, the income or expense items in a given year are largely determined by the previous year's assumptions and plan realizations. For the most part, this suggests that companies have substantial visibility with regard to their current-year pension expense (and contributions) and to a lesser extent for the following year. Of course, the variability of key inputs, such as the discount rate, in pension forecasting makes longer-term estimates much less reliable. In addition, the legislative uncertainty only adds to the uncertainty of contribution forecasts beyond this year.

In terms of the balance sheet, if a plan's Accumulated Benefit Obligation (ABO) exceeds plan assets, then, at a minimum, the company must record the unfunded amount on its balance sheet.

Another important factor in pension calculations is the mortality rates mandated by federal law. Pension plans currently use the 1983 Group Annuity Mortality Table, which some argue fails to accurately reflect current longevity norms. The Secretary of the Treasury is empowered to update mortality figures based on projected trends and DB plans' actuarial experience. As a result, the Department of Treasury and the IRS are reviewing the mortality tables, which could lead to longer benefit stream assumptions.

In summary, defined benefit plans affect earnings through net pension costs (found in labor expenses at airlines), cash flows due to required cash contributions, and balance sheet equity due to any minimum pension liability charges (excess of accumulated benefit obligations over the fair value of plan assets). Conversely, pension accounting can provide a boost to earnings, as occurred in the late 1990s, when assets outperformed return expectations.

ERISA: BACKGROUND

There are three federal entities that administer and enforce ERISA for corporate pension plans: the Department of Labor (DOL), the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC). The DOL's Employee Benefits Security Administration has the authority to allow exemptions to certain ERISA rules, such as contributions of in-kind securities to a DB plan. For its part, the IRS has the authority to grant waivers deferring current contribution requirements to the following year. The PBGC was created by ERISA to insure continuity of defined benefit plans and the orderly payment of benefits. Often this entails the PBGC taking over a failed DB plan. For example, as part of US Airways' two bankruptcies, the PBGC agreed to assume responsibility for all of its DB plans and ensure that retirees receive benefits. For this insurance, plan sponsors pay premiums to the PBGC, which increase with the size of their funding gap.

We note that pension payments are required on a quarterly basis. Each quarterly payment must be 25% of the annual amount, and it is due within 8.5 months of the plan's year-end. These payments are due on the fifteenth day of the fourth, seventh, tenth, and thirteenth month from the beginning of the plan year. Thus, a December year-end company would make its quarterly payments on April 15, July 15, October 15, and January 15, one month after the plan's year-end.

Appendix: Cash Burn and Oil Sensitivity

Exhibit 31. Cash Burn with No Debt Refinancing

With NO Debt Refinancing
As of 3/11/05

Cash Flow/Burn 2005E (US$ millions)	AMR[2]	CAL	DAL[3]	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[4]
2005E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,004	$686	$1,191	$889	$182	$897	$61	$375	$114	$16
Operating CF (after-tax) $35/bbl	$1,699	$560	$945	$704	$166	$886	$46	$351	$72	$9
Operating CF (after-tax) $40/bbl	$1,394	$433	$699	$518	$151	$875	$32	$327	$30	$1
Operating CF (after-tax) $45/bbl (Base Case)	$1,089	$307	$454	$333	$135	$864	$19	$302	($12)	($6)
Operating CF (after-tax) $50/bbl	$784	$181	$208	$147	$120	$853	$6	$278	($54)	($13)
Operating CF (after-tax) $55/bbl	$479	$55	($38)	($38)	$104	$842	($7)	$254	($96)	($21)
Cash Obligations										
Net Capex	$517	$170	$500	$200	$100	$380	$73	$170	$45	$35
DB Pension Contributions[5]	$310	$192	$275	$420	NA	NA	NA	$58	NA	NA
Cash From Financings	$0	$0	($250)	($107)	$0	($296)	$0	$0	($20)	$0
Debt Maturities	$910	$688	$630	$749	$105	$146	$14	$54	$102	$17
Liquidity										
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
Unrestricted Cash Balance at Calendar 3Q04	$3,135	$1,539	$1,446	$2,541	$517	$1,876	$339	$879	$417	$160
2005E Cash Flow (Burn) Oil @ $30/bbl	**$267**	**($364)**	**$36**	**($373)**	**($24)**	**$668**	**($25)**	**$94**	**($12)**	**($36)**
Cash Flow (Burn) per Day $30/bbl	$0.7	($1.0)	$0.1	($1.0)	($0.1)	$1.8	($0.1)	$0.3	($0.0)	($0.1)
2005E End of Year Unrestricted Cash $30/bbl	$3,196	$1,096	$1,835	$2,086	$425	$1,973	$309	$968	$294	$113
Months of Cash Left with Oil at $30/bbl from YE 2004 to Threshold	CF Pos.	12+	CF Pos.	12+	12+	CF Pos.	12+	CF Pos.	12+	12+
2005E Cash Flow (Burn) Oil @ $35/bbl	**($38)**	**($490)**	**($210)**	**($559)**	**($39)**	**$656**	**($40)**	**$70**	**($54)**	**($43)**
Cash Flow (Burn) per Day $35/bbl	($0.1)	($1.3)	($0.6)	($1.5)	($0.1)	$1.8	($0.1)	$0.2	($0.1)	($0.1)
2005E End of Year Unrestricted Cash $35/bbl	$2,891	$970	$1,589	$1,900	$410	$1,961	$294	$943	$251	$106
Months of Cash Left with Oil at $35/bbl from YE 2004 to Threshold	12+	11	12+	12+	12+	CF Pos.	12+	CF Pos.	12+	12+
2005E Cash Flow (Burn) Oil @ $40/bbl	**($343)**	**($617)**	**($456)**	**($744)**	**($55)**	**$645**	**($54)**	**$45**	**($97)**	**($51)**
Cash Flow (Burn) per Day $40/bbl	($0.9)	($1.7)	($1.2)	($2.0)	($0.1)	$1.8	($0.1)	$0.1	($0.3)	($0.1)
2005E End of Year Unrestricted Cash $40/bbl	$2,586	$843	$1,343	$1,715	$395	$1,950	$280	$919	$209	$98
Months of Cash Left with Oil at $40/bbl from YE 2004 to Threshold	12+	9	8	12+	12+	CF Pos.	12+	CF Pos.	12+	12+
2005E Cash Flow (Burn) Oil @ $45/bbl (Base Case)	**($648)**	**($743)**	**($701)**	**($930)**	**($70)**	**$634**	**($68)**	**$21**	**($139)**	**($58)**
Cash Flow (Burn) per Day $45/bbl	**($1.8)**	**($2.0)**	**($1.9)**	**($2.5)**	**($0.2)**	**$1.7**	**($0.2)**	**$0.1**	**($0.4)**	**($0.2)**
2005E End of Year Unrestricted Cash $45/bbl	**$2,281**	**$717**	**$1,098**	**$1,529**	**$379**	**$1,939**	**$266**	**$895**	**$167**	**$91**
Months of Cash Left with Oil at $45/bbl from YE '04 to Threshold	**12+**	**7**	**5**	**12+**	**12+**	**CF Pos.**	**12+**	**CF Pos.**	**9**	**12+**
2005E Cash Flow (Burn) Oil @ $50/bbl	**($953)**	**($869)**	**($947)**	**($1,115)**	**($86)**	**$623**	**($81)**	**($3)**	**($181)**	**($65)**
Cash Flow (Burn) per Day $50/bbl	($2.6)	($2.4)	($2.6)	($3.1)	($0.2)	$1.7	($0.2)	($0.0)	($0.5)	($0.2)
2005E End of Year Unrestricted Cash $50/bbl	$1,976	$591	$852	$1,344	$364	$1,928	$254	$871	$125	$84
Months of Cash Left with Oil at $50/bbl from YE 2004 to Threshold	12+	6	4	12+	12+	CF Pos.	12+	12+	7	12+
2005E Cash Flow (Burn) Oil @ $55/bbl	**($1,258)**	**($995)**	**($1,193)**	**($1,301)**	**($101)**	**$612**	**($93)**	**($27)**	**($223)**	**($73)**
Cash Flow (Burn) per Day $55/bbl	($3.4)	($2.7)	($3.3)	($3.6)	($0.3)	$1.7	($0.3)	($0.1)	($0.6)	($0.2)
2005E End of Year Unrestricted Cash $55/bbl	$1,671	$465	$606	$1,158	$348	$1,917	$241	$847	$83	$76
Months of Cash Left with Oil at $55/bbl from YE 2004 to Threshold	12+	6	3	12+	12+	CF Pos.	12+	12+	6	12+

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. Incorporates hedge positions.
(2) Assumes AMR has to repurchase $104 million facilities bond due in 4Q05.
(3) Assumes drawdown on $250 million of available Amex prepayment.
(4) FRNT is in 2006 March-ending fiscal year, base assumption oil at $43.75/bbl for FY2006.
(5) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 32. Cash Burn Assuming 80% Debt Refinancing

With Debt Refinancing of 80% of Maturing Amount
As of 3/11/05

Cash Flow/Burn 2005E (US$ millions)	AMR[2]	CAL	DAL[3]	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[4]
2005E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,004	$686	$1,191	$889	$182	$897	$61	$375	$114	$16
Operating CF (after-tax) $35/bbl	$1,699	$560	$945	$704	$166	$886	$46	$351	$72	$9
Operating CF (after-tax) $40/bbl	$1,394	$433	$699	$518	$151	$875	$32	$327	$30	$1
Operating CF (after-tax) $45/bbl (Base Case)	$1,089	$307	$454	$333	$135	$864	$19	$302	($12)	($6)
Operating CF (after-tax) $50/bbl	$784	$181	$208	$147	$120	$853	$6	$278	($54)	($13)
Operating CF (after-tax) $55/bbl	$479	$55	($38)	($38)	$104	$842	($7)	$254	($96)	($21)
Cash Obligations										
Net Capex	$517	$170	$500	$200	$100	$380	$73	$170	$45	$35
DB Pension Contributions[5]	$310	$192	$275	$420	NA	NA	NA	$58	NA	NA
Cash From Financings	$0	$0	($250)	($107)	$0	($296)	$0	$0	($20)	$0
Debt Maturities	$182	$138	$126	$150	$21	$29	$3	$11	$20	$3
Liquidity										
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
Unrestricted Cash Balance at Calendar 3Q04	$3,135	$1,539	$1,446	$2,541	$517	$1,876	$339	$879	$417	$160
2005E Cash Flow (Burn) Oil @ $30/bbl	**$995**	**$186**	**$540**	**$226**	**$61**	**$784**	**($14)**	**$136**	**$69**	**($22)**
Cash Flow (Burn) per Day $30/bbl	$2.7	$0.5	$1.5	$0.6	$0.2	$2.1	($0.0)	$0.4	$0.2	($0.1)
2005E End of Year Unrestricted Cash $30/bbl	$3,924	$1,646	$2,339	$2,685	$510	$2,089	$320	$1,010	$375	$127
Months of Cash Left with Oil at $30/bbl from YE 2004 to Threshold	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	12+	CF Pos.	CF Pos.	12+
2005E Cash Flow (Burn) Oil @ $35/bbl	**$690**	**$60**	**$294**	**$41**	**$45**	**$773**	**($29)**	**$112**	**$27**	**($30)**
Cash Flow (Burn) per Day $35/bbl	$1.9	$0.2	$0.8	$0.1	$0.1	$2.1	($0.1)	$0.3	$0.1	($0.1)
2005E End of Year Unrestricted Cash $35/bbl	$3,619	$1,520	$2,093	$2,500	$494	$2,078	$305	$986	$333	$119
Months of Cash Left with Oil at $35/bbl from YE 2004 to Threshold	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	12+	CF Pos.	CF Pos.	12+
2005E Cash Flow (Burn) Oil @ $40/bbl	**$385**	**($66)**	**$48**	**($145)**	**$30**	**$762**	**($43)**	**$88**	**($15)**	**($37)**
Cash Flow (Burn) per Day $40/bbl	$1.1	($0.2)	$0.1	($0.4)	$0.1	$2.1	($0.1)	$0.2	($0.0)	($0.1)
2005E End of Year Unrestricted Cash $40/bbl	$3,314	$1,394	$1,847	$2,314	$479	$2,067	$291	$962	$290	$112
Months of Cash Left with Oil at $40/bbl from YE 2004 to Threshold	CF Pos.	12+	CF Pos.	12+	CF Pos.	CF Pos.	12+	CF Pos.	12+	12+
2005E Cash Flow (Burn) Oil @ $45/bbl (Base Case)	**$80**	**($192)**	**($197)**	**($330)**	**$14**	**$751**	**($57)**	**$64**	**($57)**	**($44)**
Cash Flow (Burn) per Day $45/bbl	**$0.2**	**($0.5)**	**($0.5)**	**($0.9)**	**$0.0**	**$2.1**	**($0.2)**	**$0.2**	**($0.2)**	**($0.1)**
2005E End of Year Unrestricted Cash $45/bbl	**$3,009**	**$1,268**	**$1,602**	**$2,129**	**$463**	**$2,056**	**$278**	**$938**	**$248**	**$105**
Months of Cash Left with Oil at $45/bbl from YE '04 to Threshold	**CF Pos.**	**12+**	**12+**	**12+**	**CF Pos.**	**CF Pos.**	**12+**	**CF Pos.**	**12+**	**12+**
2005E Cash Flow (Burn) Oil @ $50/bbl	**($225)**	**($319)**	**($443)**	**($516)**	**($1)**	**$740**	**($69)**	**$40**	**($100)**	**($52)**
Cash Flow (Burn) per Day $50/bbl	($0.6)	($0.9)	($1.2)	($1.4)	($0.0)	$2.0	($0.2)	$0.1	($0.3)	($0.1)
2005E End of Year Unrestricted Cash $50/bbl	$2,704	$1,141	$1,356	$1,943	$448	$2,045	$265	$914	$206	$97
Months of Cash Left with Oil at $50/bbl from YE 2004 to Threshold	12+	12+	8	12+	12+	CF Pos.	12+	CF Pos.	12+	12+
2005E Cash Flow (Burn) Oil @ $55/bbl	**($530)**	**($445)**	**($689)**	**($702)**	**($17)**	**$729**	**($82)**	**$16**	**($142)**	**($59)**
Cash Flow (Burn) per Day $55/bbl	($1.5)	($1.2)	($1.9)	($1.9)	($0.0)	$2.0	($0.2)	$0.0	($0.4)	($0.2)
2005E End of Year Unrestricted Cash $55/bbl	$2,399	$1,015	$1,110	$1,757	$432	$2,034	$252	$890	$164	$90
Months of Cash Left with Oil at $55/bbl from YE 2004 to Threshold	12+	12+	5	12+	12+	CF Pos.	12+	CF Pos.	9	12+

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. Incorporates hedge positions.
(2) Assumes AMR has to repurchase $104 million facilities bond due in 4Q05.
(3) Assumes drawdown on $250 million of available Amex prepayment.
(4) FRNT is in 2006 March-ending fiscal year, base assumption oil at $43.75/bbl for FY2006.
(5) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 33. Cash Burn with No Debt Refinancing and PFEA Expiration (Five-Year Amortization)

With NO Debt Refinancing & PFEA Expiration (5-Yr Amortization)
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$377	$356	$962	$901	NA	NA	NA	$76	NA	NA
Debt Maturities	$1,328	$533	$733	$994	$108	$604	$10	$57	$100	$18
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$2,281	$717	$1,098	$1,529	$379	$1,939	$266	$895	$167	$91
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$871**	**($14)**	**$7**	**($592)**	**($47)**	**$43**	**$89**	**$137**	**($63)**	**($18)**
Cash Flow (Burn) per Day $30/bbl	$2.4	($0.0)	$0.0	($1.6)	($0.1)	$0.1	$0.2	$0.4	($0.2)	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$3,152	$703	$1,105	$937	$332	$1,983	$355	$1,033	$104	$73
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	Ch. 11 Risk	CF Pos.	9	59	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	11
2006E Cash Flow (Burn) Oil @ $35/bbl	**$483**	**($139)**	**($330)**	**($751)**	**($73)**	**$6**	**$65**	**$105**	**($99)**	**($29)**
Cash Flow (Burn) per Day $35/bbl	$1.3	($0.4)	($0.9)	($2.1)	($0.2)	$0.0	$0.2	$0.3	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $35/bbl	$2,764	$578	$767	$779	$306	$1,945	$331	$1,000	$68	$62
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	Ch. 11 Risk	Ch. 11 Risk	7	38	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	7
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$67**	**($260)**	**($667)**	**($909)**	**($99)**	**($31)**	**$40**	**$72**	**($135)**	**($41)**
Cash Flow (Burn) per Day $40/bbl	**$0.2**	**($0.7)**	**($1.8)**	**($2.5)**	**($0.3)**	**($0.1)**	**$0.1**	**$0.2**	**($0.4)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$2,348**	**$457**	**$430**	**$620**	**$280**	**$1,908**	**$307**	**$967**	**$32**	**$50**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold[5]	**CF Pos.**	**Ch. 11 Risk**	**Ch. 11 Risk**	**6**	**28**	**454**	**CF Pos.**	**CF Pos.**	**Ch. 11 Risk**	**5**
2006E Cash Flow (Burn) Oil @ $45/bbl	($350)	($380)	($1,004)	($1,067)	($125)	($69)	$16	$39	($171)	($52)
Cash Flow (Burn) per Day $45/bbl	($1.0)	($1.0)	($2.8)	($2.9)	($0.3)	($0.2)	$0.0	$0.1	($0.5)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$1,932	$337	$93	$462	$254	$1,871	$283	$934	($4)	$39
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	27	Ch. 11 Risk	Ch. 11 Risk	5	22	207	CF Pos.	CF Pos.	Ch. 11 Risk	4
2006E Cash Flow (Burn) Oil @ $50/bbl	**($766)**	**($547)**	**($1,342)**	**($1,226)**	**($151)**	**($106)**	**($8)**	**$6**	**($207)**	**($63)**
Cash Flow (Burn) per Day $50/bbl	($2.1)	($1.5)	($3.7)	($3.4)	($0.4)	($0.3)	($0.0)	$0.0	($0.6)	($0.2)
2006E End of Year Unrestricted Cash $50/bbl	$1,515	$170	NM	$304	$228	$1,833	$258	$902	($40)	$28
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	12	Ch. 11 Risk	Ch. 11 Risk	4	18	134	253	CF Pos.	Ch. 11 Risk	3
2006E Cash Flow (Burn) Oil @ $55/bbl	**($1,182)**	**($715)**	**($1,679)**	**($1,384)**	**($177)**	**($144)**	**($32)**	**($26)**	**($243)**	**($75)**
Cash Flow (Burn) per Day $55/bbl	($3.2)	($2.0)	($4.6)	($3.8)	($0.5)	($0.4)	($0.1)	($0.1)	($0.7)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$1,099	$2	NM	$145	$202	$1,796	$234	$869	($76)	$16
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	8	Ch. 11 Risk	Ch. 11 Risk	4	16	99	62	272	Ch. 11 Risk	3

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 34. Cash Burn with No Debt Refinancing and Bush Pension Proposal (Seven-Year Amortization)

With NO Debt Refinancing & Bush Proposal (7-Yr Amortization)
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$314	$288	$726	$704	NA	NA	NA	$71	NA	NA
Debt Maturities	$1,328	$533	$733	$994	$108	$604	$10	$57	$100	$18
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$2,281	$717	$1,098	$1,529	$379	$1,939	$266	$895	$167	$91
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$935**	**$54**	**$243**	**($395)**	**($47)**	**$43**	**$89**	**$143**	**($63)**	**($18)**
Cash Flow (Burn) per Day $30/bbl	$2.6	$0.1	$0.7	($1.1)	($0.1)	$0.1	$0.2	$0.4	($0.2)	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$3,216	$771	$1,340	$1,135	$332	$1,983	$355	$1,038	$104	$73
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	13	59	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	11
2006E Cash Flow (Burn) Oil @ $35/bbl	**$547**	**($72)**	**($95)**	**($553)**	**($73)**	**$6**	**$65**	**$110**	**($99)**	**($29)**
Cash Flow (Burn) per Day $35/bbl	$1.5	($0.2)	($0.3)	($1.5)	($0.2)	$0.0	$0.2	$0.3	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $35/bbl	$2,828	$645	$1,003	$976	$306	$1,945	$331	$1,005	$68	$62
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	Ch. 11 Risk	Ch. 11 Risk	9	38	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	7
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$130**	**($193)**	**($432)**	**($711)**	**($99)**	**($31)**	**$40**	**$77**	**($135)**	**($41)**
Cash Flow (Burn) per Day $40/bbl	**$0.4**	**($0.5)**	**($1.2)**	**($1.9)**	**($0.3)**	**($0.1)**	**$0.1**	**$0.2**	**($0.4)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$2,411**	**$524**	**$666**	**$818**	**$280**	**$1,908**	**$307**	**$972**	**$32**	**$50**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold[5]	**CF Pos.**	**Ch. 11 Risk**	**Ch. 11 Risk**	**7**	**28**	**454**	**CF Pos.**	**CF Pos.**	**Ch. 11 Risk**	**5**
2006E Cash Flow (Burn) Oil @ $45/bbl	($286)	($313)	($769)	($870)	($125)	($69)	$16	$44	($171)	($52)
Cash Flow (Burn) per Day $45/bbl	($0.8)	($0.9)	($2.1)	($2.4)	($0.3)	($0.2)	$0.0	$0.1	($0.5)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$1,995	$405	$329	$660	$254	$1,871	$283	$940	($4)	$39
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	33	Ch. 11 Risk	Ch. 11 Risk	6	22	207	CF Pos.	CF Pos.	Ch. 11 Risk	4
2006E Cash Flow (Burn) Oil @ $50/bbl	**($702)**	**($480)**	**($1,106)**	**($1,028)**	**($151)**	**($106)**	**($8)**	**$12**	**($207)**	**($63)**
Cash Flow (Burn) per Day $50/bbl	($1.9)	($1.3)	($3.0)	($2.8)	($0.4)	($0.3)	($0.0)	$0.0	($0.6)	($0.2)
2006E End of Year Unrestricted Cash $50/bbl	$1,579	$237	NM	$501	$228	$1,833	$258	$907	($40)	$28
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	13	Ch. 11 Risk	Ch. 11 Risk	5	18	134	253	CF Pos.	Ch. 11 Risk	3
2006E Cash Flow (Burn) Oil @ $55/bbl	**($1,119)**	**($648)**	**($1,443)**	**($1,187)**	**($177)**	**($144)**	**($32)**	**($21)**	**($243)**	**($75)**
Cash Flow (Burn) per Day $55/bbl	($3.1)	($1.8)	($4.0)	($3.3)	($0.5)	($0.4)	($0.1)	($0.1)	($0.7)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$1,162	$70	NM	$343	$202	$1,796	$234	$874	($76)	$16
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	8	Ch. 11 Risk	Ch. 11 Risk	4	16	99	62	337	Ch. 11 Risk	3

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 35. Cash Burn with No Debt Refinancing and Pension Plan Freeze/20-Year Amortization Proposal

With NO Debt Refinancing & Pension Plan Freeze / 20-Yr Amortization Proposal
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$45	$44	$202	$133	NA	NA	NA	$4	NA	NA
Debt Maturities	$1,328	$533	$733	$994	$108	$604	$10	$57	$100	$18
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$2,281	$717	$1,098	$1,529	$379	$1,939	$266	$895	$167	$91
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$1,203**	**$298**	**$768**	**$176**	**($47)**	**$43**	**$89**	**$209**	**($63)**	**($18)**
Cash Flow (Burn) per Day $30/bbl	$3.3	$0.8	$2.1	$0.5	($0.1)	$0.1	$0.2	$0.6	($0.2)	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$3,484	$1,015	$1,865	$1,705	$332	$1,983	$355	$1,104	$104	$73
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	59	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	11
2006E Cash Flow (Burn) Oil @ $35/bbl	**$815**	**$172**	**$430**	**$17**	**($73)**	**$6**	**$65**	**$176**	**($99)**	**($29)**
Cash Flow (Burn) per Day $35/bbl	$2.2	$0.5	$1.2	$0.0	($0.2)	$0.0	$0.2	$0.5	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $35/bbl	$3,096	$889	$1,528	$1,547	$306	$1,945	$331	$1,071	$68	$62
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	38	CF Pos.	CF Pos.	CF Pos.	Ch. 11 Risk	7
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$398**	**$51**	**$93**	**($141)**	**($99)**	**($31)**	**$40**	**$143**	**($135)**	**($41)**
Cash Flow (Burn) per Day $40/bbl	**$1.1**	**$0.1**	**$0.3**	**($0.4)**	**($0.3)**	**($0.1)**	**$0.1**	**$0.4**	**($0.4)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$2,680**	**$768**	**$1,191**	**$1,388**	**$280**	**$1,908**	**$307**	**$1,039**	**$32**	**$50**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold[5]	**CF Pos.**	**CF Pos.**	**CF Pos.**	**37**	**28**	**454**	**CF Pos.**	**CF Pos.**	**Ch. 11 Risk**	**5**
2006E Cash Flow (Burn) Oil @ $45/bbl	($18)	($69)	($244)	($299)	($125)	($69)	$16	$111	($171)	($52)
Cash Flow (Burn) per Day $45/bbl	($0.0)	($0.2)	($0.7)	($0.8)	($0.3)	($0.2)	$0.0	$0.3	($0.5)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$2,263	$648	$854	$1,230	$254	$1,871	$283	$1,006	($4)	$39
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	526	Ch. 11 Risk	Ch. 11 Risk	17	22	207	CF Pos.	CF Pos.	Ch. 11 Risk	4
2006E Cash Flow (Burn) Oil @ $50/bbl	**($434)**	**($236)**	**($581)**	**($458)**	**($151)**	**($106)**	**($8)**	**$78**	**($207)**	**($63)**
Cash Flow (Burn) per Day $50/bbl	($1.2)	($0.6)	($1.6)	($1.3)	($0.4)	($0.3)	($0.0)	$0.2	($0.6)	($0.2)
2006E End of Year Unrestricted Cash $50/bbl	$1,847	$481	$516	$1,072	$228	$1,833	$258	$973	($40)	$28
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	22	Ch. 11 Risk	Ch. 11 Risk	11	18	134	253	CF Pos.	Ch. 11 Risk	3
2006E Cash Flow (Burn) Oil @ $55/bbl	**($850)**	**($404)**	**($918)**	**($616)**	**($177)**	**($144)**	**($32)**	**$45**	**($243)**	**($75)**
Cash Flow (Burn) per Day $55/bbl	($2.3)	($1.1)	($2.5)	($1.7)	($0.5)	($0.4)	($0.1)	$0.1	($0.7)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$1,431	$313	$179	$913	$202	$1,796	$234	$940	($76)	$16
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	11	Ch. 11 Risk	Ch. 11 Risk	8	16	99	62	CF Pos.	Ch. 11 Risk	3

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 36. Cash Burn with Debt Refinancing of 80% of Maturing Amount and PFEA Expiration (Five-Year Amortization)

With Debt Refinancing of 80% of Maturing Amount & PFEA Expiration (5-Yr Amortization)
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$377	$356	$962	$901	NA	NA	NA	$76	NA	NA
Debt Maturities	$266	$107	$147	$199	$22	$121	$2	$11	$20	$4
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$3,009	$1,268	$1,602	$2,129	$463	$2,056	$278	$938	$248	$105
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$1,934**	**$413**	**$594**	**$203**	**$40**	**$527**	**$97**	**$183**	**$17**	**($3)**
Cash Flow (Burn) per Day $30/bbl	$5.3	$1.1	$1.6	$0.6	$0.1	$1.4	$0.3	$0.5	$0.0	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$4,943	$1,680	$2,195	$2,332	$503	$2,583	$374	$1,121	$265	$101
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	109
2006E Cash Flow (Burn) Oil @ $35/bbl	**$1,545**	**$287**	**$256**	**$45**	**$13**	**$489**	**$72**	**$150**	**($19)**	**($15)**
Cash Flow (Burn) per Day $35/bbl	$4.2	$0.8	$0.7	$0.1	$0.0	$1.3	$0.2	$0.4	($0.1)	($0.0)
2006E End of Year Unrestricted Cash $35/bbl	$4,555	$1,555	$1,858	$2,173	$477	$2,545	$350	$1,088	$229	$90
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	30	24
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$1,129**	**$166**	**($81)**	**($114)**	**($13)**	**$452**	**$48**	**$118**	**($55)**	**($26)**
Cash Flow (Burn) per Day $40/bbl	**$3.1**	**$0.5**	**($0.2)**	**($0.3)**	**($0.0)**	**$1.2**	**$0.1**	**$0.3**	**($0.2)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$4,138**	**$1,433**	**$1,521**	**$2,015**	**$451**	**$2,508**	**$326**	**$1,056**	**$193**	**$79**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold[5]	**CF Pos.**	**CF Pos.**	**15**	**109**	**298**	**CF Pos.**	**CF Pos.**	**CF Pos.**	**10**	**14**
2006E Cash Flow (Burn) Oil @ $45/bbl	$713	$46	($418)	($272)	($39)	$414	$24	$85	($91)	($38)
Cash Flow (Burn) per Day $45/bbl	$2.0	$0.1	($1.1)	($0.7)	($0.1)	$1.1	$0.1	$0.2	($0.2)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$3,722	$1,314	$1,183	$1,856	$425	$2,471	$302	$1,023	$157	$67
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	3	45	97	CF Pos.	CF Pos.	CF Pos.	6	9
2006E Cash Flow (Burn) Oil @ $50/bbl	**$297**	**($121)**	**($755)**	**($431)**	**($65)**	**$377**	**$0**	**$52**	**($127)**	**($49)**
Cash Flow (Burn) per Day $50/bbl	$0.8	($0.3)	($2.1)	($1.2)	($0.2)	$1.0	$0.0	$0.1	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $50/bbl	$3,306	$1,146	$846	$1,698	$399	$2,433	$278	$990	$121	$56
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	CF Pos.	27	2	29	58	CF Pos.	CF Pos.	CF Pos.	5	7
2006E Cash Flow (Burn) Oil @ $55/bbl	**($120)**	**($289)**	**($1,092)**	**($589)**	**($91)**	**$340**	**($24)**	**$19**	**($163)**	**($60)**
Cash Flow (Burn) per Day $55/bbl	($0.3)	($0.8)	($3.0)	($1.6)	($0.2)	$0.9	($0.1)	$0.1	($0.4)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$2,889	$979	$509	$1,540	$372	$2,396	$253	$957	$85	$44
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	151	11	1	21	41	CF Pos.	88	CF Pos.	4	6

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 37. Cash Burn with Debt Refinancing of 80% of Maturing Amount and Bush Pension Proposal (Seven-Year Amortization)

With Debt Refinancing of 80% of Maturing Amount & Bush Proposal (7-Yr Amortization)
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$314	$288	$726	$704	NA	NA	NA	$71	NA	NA
Debt Maturities	$266	$107	$147	$199	$22	$121	$2	$11	$20	$4
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$3,009	$1,268	$1,602	$2,129	$463	$2,056	$278	$938	$248	$105
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$1,997**	**$480**	**$829**	**$401**	**$40**	**$527**	**$97**	**$188**	**$17**	**($3)**
Cash Flow (Burn) per Day $30/bbl	$5.5	$1.3	$2.3	$1.1	$0.1	$1.4	$0.3	$0.5	$0.0	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$5,006	$1,748	$2,431	$2,529	$503	$2,583	$374	$1,126	$265	$101
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	109
2006E Cash Flow (Burn) Oil @ $35/bbl	**$1,609**	**$354**	**$492**	**$242**	**$13**	**$489**	**$72**	**$155**	**($19)**	**($15)**
Cash Flow (Burn) per Day $35/bbl	$4.4	$1.0	$1.3	$0.7	$0.0	$1.3	$0.2	$0.4	($0.1)	($0.0)
2006E End of Year Unrestricted Cash $35/bbl	$4,618	$1,622	$2,093	$2,371	$477	$2,545	$350	$1,093	$229	$90
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	30	24
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$1,193**	**$233**	**$155**	**$84**	**($13)**	**$452**	**$48**	**$123**	**($55)**	**($26)**
Cash Flow (Burn) per Day $40/bbl	**$3.3**	**$0.6**	**$0.4**	**$0.2**	**($0.0)**	**$1.2**	**$0.1**	**$0.3**	**($0.2)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$4,202**	**$1,501**	**$1,756**	**$2,212**	**$451**	**$2,508**	**$326**	**$1,061**	**$193**	**$79**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold	**CF Pos.**	**CF Pos.**	**CF Pos.**	**CF Pos.**	**298**	**CF Pos.**	**CF Pos.**	**CF Pos.**	**10**	**14**
2006E Cash Flow (Burn) Oil @ $45/bbl	$776	$114	($182)	($75)	($39)	$414	$24	$90	($91)	($38)
Cash Flow (Burn) per Day $45/bbl	$2.1	$0.3	($0.5)	($0.2)	($0.1)	$1.1	$0.1	$0.2	($0.2)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$3,785	$1,381	$1,419	$2,054	$425	$2,471	$302	$1,028	$157	$67
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	7	165	97	CF Pos.	CF Pos.	CF Pos.	6	9
2006E Cash Flow (Burn) Oil @ $50/bbl	**$360**	**($54)**	**($520)**	**($233)**	**($65)**	**$377**	**$0**	**$57**	**($127)**	**($49)**
Cash Flow (Burn) per Day $50/bbl	$1.0	($0.1)	($1.4)	($0.6)	($0.2)	$1.0	$0.0	$0.2	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $50/bbl	$3,369	$1,214	$1,082	$1,896	$399	$2,433	$278	$995	$121	$56
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	CF Pos.	60	2	53	58	CF Pos.	CF Pos.	CF Pos.	5	7
2006E Cash Flow (Burn) Oil @ $55/bbl	**($56)**	**($221)**	**($857)**	**($391)**	**($91)**	**$340**	**($24)**	**$25**	**($163)**	**($60)**
Cash Flow (Burn) per Day $55/bbl	($0.2)	($0.6)	($2.3)	($1.1)	($0.2)	$0.9	($0.1)	$0.1	($0.4)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$2,953	$1,046	$745	$1,737	$372	$2,396	$253	$963	$85	$44
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	322	15	1	32	41	CF Pos.	88	CF Pos.	4	6

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Exhibit 38. Cash Burn with Debt Refinancing of 80% of Maturing Amount and Pension Plan Freeze/20-Year Amortization Proposal

With Debt Refinancing of 80% of Maturing Amount & Pension Plan Freeze / 20-Yr Amortization Proposal
As of 3/11/05

Cash Flow/Burn 2006E (US$ millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT[2]
2006E Operating Cash Flow[1]										
Operating CF (after-tax) $30/bbl	$2,787	$1,045	$2,232	$1,531	$249	$1,073	$108	$398	$95	$35
Operating CF (after-tax) $35/bbl	$2,398	$919	$1,895	$1,373	$223	$1,035	$84	$365	$60	$24
Operating CF (after-tax) $40/bbl (Base Case)	$1,982	$798	$1,558	$1,214	$197	$998	$60	$332	$24	$12
Operating CF (after-tax) $45/bbl	$1,566	$679	$1,220	$1,056	$171	$961	$36	$300	($12)	$1
Operating CF (after-tax) $50/bbl	$1,149	$511	$883	$897	$145	$923	$11	$267	($48)	($10)
Operating CF (after-tax) $55/bbl	$733	$344	$546	$739	$119	$886	($13)	$234	($84)	($22)
Cash Obligations										
Net Capex	$210	$170	$530	$228	$188	$426	$10	$128	$59	$35
DB Pension Contributions[3]	$45	$44	$202	$133	NA	NA	NA	$4	NA	NA
Debt Maturities	$266	$107	$147	$199	$22	$121	$2	$11	$20	$4
Liquidity										
Estimated Unrestricted Cash Balance at Calendar 4Q05[4]	$3,009	$1,268	$1,602	$2,129	$463	$2,056	$278	$938	$248	$105
Unrestricted Cash Balance at Calendar 4Q04	$2,929	$1,460	$1,799	$2,459	$449	$1,305	$334	$874	$306	$149
2006E Cash Flow (Burn) Oil @ $30/bbl	**$2,266**	**$724**	**$1,354**	**$971**	**$40**	**$527**	**$97**	**$255**	**$17**	**($3)**
Cash Flow (Burn) per Day $30/bbl	$6.2	$2.0	$3.7	$2.7	$0.1	$1.4	$0.3	$0.7	$0.0	($0.0)
2006E End of Year Unrestricted Cash $30/bbl	$5,275	$1,992	$2,956	$3,100	$503	$2,583	$374	$1,193	$265	$101
Months of Cash Left with Oil at $30/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	109
2006E Cash Flow (Burn) Oil @ $35/bbl	**$1,877**	**$598**	**$1,017**	**$813**	**$13**	**$489**	**$72**	**$222**	**($19)**	**($15)**
Cash Flow (Burn) per Day $35/bbl	$5.1	$1.6	$2.8	$2.2	$0.0	$1.3	$0.2	$0.6	($0.1)	($0.0)
2006E End of Year Unrestricted Cash $35/bbl	$4,886	$1,866	$2,618	$2,941	$477	$2,545	$350	$1,160	$229	$90
Months of Cash Left with Oil at $35/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	CF Pos.	30	24
2006E Cash Flow (Burn) Oil @ $40/bbl (Base Case)	**$1,461**	**$477**	**$680**	**$654**	**($13)**	**$452**	**$48**	**$189**	**($55)**	**($26)**
Cash Flow (Burn) per Day $40/bbl	**$4.0**	**$1.3**	**$1.9**	**$1.8**	**($0.0)**	**$1.2**	**$0.1**	**$0.5**	**($0.2)**	**($0.1)**
2006E End of Year Unrestricted Cash $40/bbl	**$4,470**	**$1,745**	**$2,281**	**$2,783**	**$451**	**$2,508**	**$326**	**$1,127**	**$193**	**$79**
Months of Cash Left with Oil at $40/bbl from YE '05 to Threshold	**CF Pos.**	**CF Pos.**	**CF Pos.**	**CF Pos.**	**298**	**CF Pos.**	**CF Pos.**	**CF Pos.**	**10**	**14**
2006E Cash Flow (Burn) Oil @ $45/bbl	$1,045	$358	$342	$496	($39)	$414	$24	$156	($91)	($38)
Cash Flow (Burn) per Day $45/bbl	$2.9	$1.0	$0.9	$1.4	($0.1)	$1.1	$0.1	$0.4	($0.2)	($0.1)
2006E End of Year Unrestricted Cash $45/bbl	$4,054	$1,625	$1,944	$2,624	$425	$2,471	$302	$1,094	$157	$67
Months of Cash Left with Oil at $45/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	97	CF Pos.	CF Pos.	CF Pos.	6	9
2006E Cash Flow (Burn) Oil @ $50/bbl	**$628**	**$190**	**$5**	**$337**	**($65)**	**$377**	**$0**	**$124**	**($127)**	**($49)**
Cash Flow (Burn) per Day $50/bbl	$1.7	$0.5	$0.0	$0.9	($0.2)	$1.0	$0.0	$0.3	($0.3)	($0.1)
2006E End of Year Unrestricted Cash $50/bbl	$3,637	$1,458	$1,607	$2,466	$399	$2,433	$278	$1,062	$121	$56
Months of Cash Left with Oil at $50/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	CF Pos.	CF Pos.	58	CF Pos.	CF Pos.	CF Pos.	5	7
2006E Cash Flow (Burn) Oil @ $55/bbl	**$212**	**$23**	**($332)**	**$179**	**($91)**	**$340**	**($24)**	**$91**	**($163)**	**($60)**
Cash Flow (Burn) per Day $55/bbl	$0.6	$0.1	($0.9)	$0.5	($0.2)	$0.9	($0.1)	$0.2	($0.4)	($0.2)
2006E End of Year Unrestricted Cash $55/bbl	$3,221	$1,290	$1,270	$2,308	$372	$2,396	$253	$1,029	$85	$44
Months of Cash Left with Oil at $55/bbl from YE 2005 to Threshold[5]	CF Pos.	CF Pos.	4	CF Pos.	41	CF Pos.	88	CF Pos.	4	6

(1) Operating Cash Flow = Net Income + D&A + pension expense; assumes no impact from change in net working capital.
Assumes crude price of $40/bbl in 2006. Incorporates hedge positions.
(2) FRNT is in 2007 March-ending fiscal year, base assumption oil at $40/bbl for calendar 2006.
(3) Assumes no additional noncash (stock of subsidiary) contribution to DB pension plans.
(4) Assumes crude price of $49/bbl in 1Q05 and $45/bbl in 2Q-4Q05. For no debt refinancing scenario in 2006, assumes no debt refinancing in 2005. For debt refinancing scenario in 2006, assumes debt refinancing in 2005.
(5) Chapter 11 risk: operating with cash burn and cash balance is below threshold cash level.

(US$ in millions)	AMR	CAL	DAL	NWAC	JBLU	LUV	AAI	ALK	AWA	FRNT
Estimated Unrestricted Cash Concern Level	**$1,500**	**$1,000**	**$1,500**	**$1,100**	**$150**	**$750**	**$100**	**$300**	**$200**	**$75**

As points of reference, we note that AMR achieved its last-minute deal with labor last April with $1.2 billion (7% of LTM sales) in unrestricted cash and equivalents, UAL filed for Chapter 11 on 12/9/02 with $1.3 billion (9% of LTM sales) in unrestricted cash and equivalents (YE 2002), and US Air entered Chapter 11 on 8/11/02 with close to $900 million in cash (3Q02 balance was $900 million) (13% of LTM sales).

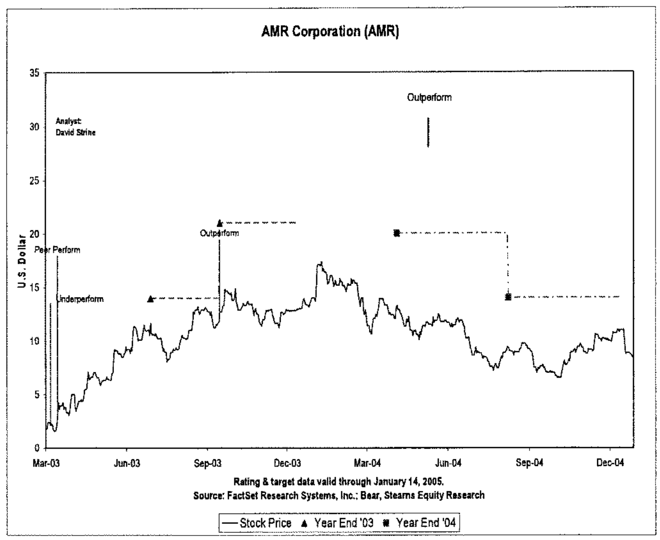
Source: Bear, Stearns & Co. Inc. estimates; company reports; company guidance.

Subject companies under coverage mentioned in this report:
Sector Rating — Market Weight

Alaska Air Group (ALK-29; Outperform)
AMR Corp. (AMR-8.97; Peer Perform)
Continental Airlines (CAL-12; Peer Perform)
Delta Air Lines (DAL-4.33; Peer Perform)
Northwest Airlines (NWAC-6.98; Outperform)

Addendum

Important Disclosures

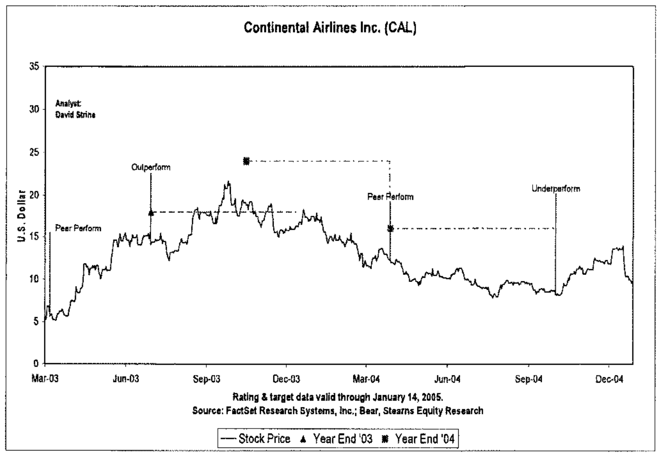


BSC Recommendation History since March 19, 2003 for:
AMR Corporation (AMR) - U.S. Dollar

Date	Stock Price	Rating	Target
**Analyst: David Strine			
24-Mar-03	2.38	UNDERPERFORM	---
01-Apr-03	2.10	PEER PERFORM	---
16-Jul-03	10.56	PEER PERFORM	14.00
03-Oct-03	11.75	OUTPERFORM	21.00
22-Apr-04	13.12	OUTPERFORM	20.00
26-Aug-04	9.42	OUTPERFORM	14.00
20-Oct-04	6.49	PEER PERFORM	---

Addendum

Important Disclosures

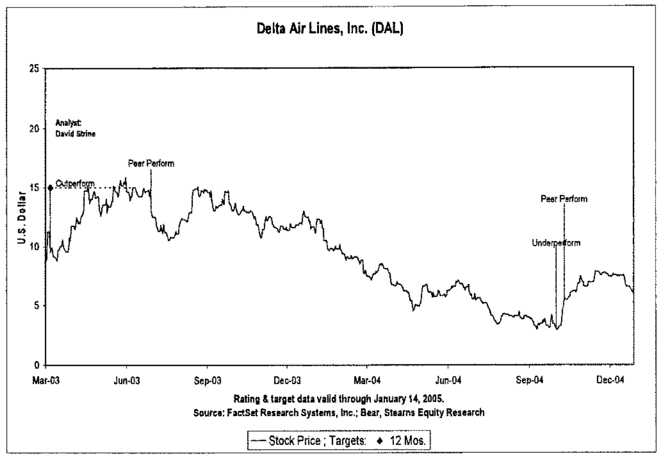


BSC Recommendation History since March 19, 2003 for:
Continental Airlines Inc. (CAL) - U.S. Dollar

Date	Stock Price	Rating	Target
**Analyst: David Strine			
24-Mar-03	6.82	PEER PERFORM	---
17-Jul-03	15.47	OUTPERFORM	18.00
03-Nov-03	19.10	OUTPERFORM	24.00
15-Apr-04	12.36	PEER PERFORM	---
19-Oct-04	8.71	UNDERPERFORM	---
25-Jan-05	9.51	PEER PERFORM	---

Addendum

Important Disclosures

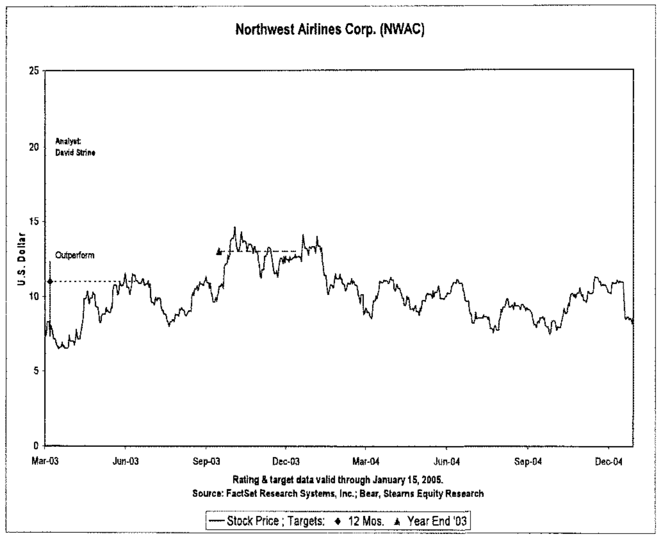


BSC Recommendation History since March 19, 2003 for:
Delta Air Lines, Inc. (DAL) - U.S. Dollar

Date	Stock Price	Rating	Target
**Analyst: David Strine			
24-Mar-03	11.25	OUTPERFORM	15.00
17-Jul-03	14.85	PEER PERFORM	15.00
19-Oct-04	3.11	UNDERPERFORM	---
28-Oct-04	4.94	PEER PERFORM	---

Addendum

Important Disclosures



BSC Recommendation History since March 19, 2003 for:
Northwest Airlines Corp. (NWAC) - U.S. Dollar

Date	Stock Price	Rating	Target
**Analyst: David Strine			
24-Mar-03	8.30	OUTPERFORM	11.00
03-Oct-03	10.16	OUTPERFORM	13.00
10-Mar-05	7.10	OUTPERFORM	11.00

Addendum

Important Disclosures

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Peer Perform (P) — Stock is projected to perform approximately in line with analyst's industry coverage universe over the next 12 months.
Underperform (U) — Stock is projected to underperform analyst's industry coverage universe over the next 12 months.

Ratings for Sectors (vs. regional broader market index):
Market Overweight (MO) - Expect the industry to perform better than the primary market index for the region (S&P in the U.S.) over the next 12 months.
Market Weight (MW) - Expect the industry to perform approximately in line with the primary market index for the region (S&P in the U.S.) over the next 12 months.
Market Underweight (MU) - Expect the industry to underperform the primary market index for the region (S&P in the U.S.) over the next 12 months.

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Underperform (Sell): 12.7%/6.3%

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David Strine

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Statement of Senator Kyl
Senate Finance Committee
June 7, 2005

Mr. Chairman, thank you for holding today's hearing on the funding problems of airline pension plans.

For too long, airlines have made promises to their employees that they could not keep. Companies and unions would agree to increased pension benefits down the road in exchange for labor concessions today. Now, after we find out that the airlines haven't been funding those pension promises, the airlines are coming to Congress seeking a longer period of time—25 years!—to make good on those promises. Given the changing nature of the airline industry, it is unclear which of the existing airlines will even still be operating in 25 years.

I have great concerns about "bailing out" the airlines in this manner, especially since Congress just gave them funding relief a year and a half ago. In addition to believing that 25 years is far too long a time to make up funding shortfalls, I have several other concerns with the airlines' proposal. For example, the proposal lets airlines continue to accrue additional liabilities in their plans, which only adds to the potential liability for the PBGC and taxpayers. Further, it allows them to increase benefits if they "pay for" the increase. This makes no sense—if the airlines have cash to pay for increased benefits, they should use that money to fund their existing liabilities.

The problem of pension under-funding stretches beyond airlines to other industries that have large defined benefit pension plans with significant numbers of retirees, particularly when compared to their current workforce. I hope members of this Committee will think very carefully about our obligations to American taxpayers before we grant any company or any industry additional relief from their pension funding obligations.

Again, Mr. Chairman, thank you for holding today's hearing.

Opening Statement of Senator Trent Lott
Senate Finance Committee Hearing:
Preventing the Next Pension Collapse
June 7, 2005

Thank you, Mr. Chairman, for holding this important hearing today. I'm particularly grateful to have the opportunity today to hear from the CEO's of three major U.S. airlines, United, Delta, and Northwest. Recently, United, which has been in bankruptcy for some time, terminated its pension plan, thus saddling the PBGC with some $6.5 billion in unfunded pension liabilities. Absent action by Congress, the pension plans at Delta and Northwest could well meet the same fate in the near future.

The current pension funding laws are badly outdated, and have allowed companies to legally underfund pension plans to the tune of $450 billion. There is widespread agreement that major reforms are needed, and many others have spoken as to the reasons for that. However, I do believe, Mr. Chairman, that the Administration's proposed plan is shortsighted as regards a major sector of our economy, the airlines.

The pension plans at Delta and Northwest are in critical condition: we have seen their numbers, and we know what their deficit reduction contributions will be under current law. In addition, the Administration's proposal, while providing an extra two years, does not solve the problem. If Congress were to enact the Administration's proposal as-is, there is no doubt in my mind that several major carriers will be forced to terminate their plans in bankruptcy. Upon termination, the entire burden of the plans will shift to the PBGC.

If, on the other hand, airlines freeze their defined benefit plans, thus allowing no more liabilities to accrue, we should work to give them a reasonable length of time to pay what they owe. Every payment they make will represent a reduction in any liability to the PBGC.

In view of that, any pension reforms we do must take into account the real world effects those reforms will have on major pension plans. We have a responsibility to ensure that our pension reforms do not cause billions of dollars to be dumped onto the PBGC.

Some have inaccurately criticized any efforts to allow the airlines to pay what they owe as a "bailout" of the industry. Mr. Chairman, if done responsibly, a pension bill will have the precise opposite effect: it will save the federal government from having to bail out the PBGC, which itself is underfunded by billions of dollars. As this Committee considers fundamental pension reform legislation, we have a duty to draw from past experience, and do everything we can to allow good actors to pay the obligations they owe. If done correctly, that will represent a win for the airlines, their employees, the PBGC, and, ultimately, U.S. taxpayers.

The Administration's plan seems to not take into account that Delta, Northwest, and others are teetering on the brink. I look forward to the testimony of Mr. Grinstein and

Mr. Steenland, but I can tell you that we are going to have to be sensitive to the airline industry when we do a pension bill. There is no way that a bill that may guarantee the immediate bankruptcy of those airlines is good for anybody – the PBGC, airlines, their employees, or the taxpayers.

Thank you, Mr. Chairman. I look forward to hearing from our witnesses today.

Senator Barack Obama and Senator Richard Durbin
Joint Statement
United States Senate Finance Committee
Preventing the Next Pension Collapse: Lessons from the United Airlines Case
Tuesday, June 7, 2005

Mr. Chairman and Senator Baucus, thank you for allowing us to submit written testimony for this hearing.

United Airlines is a great company based in Elk Grove Village, Illinois, and it is made up of great people. Since the company filed for Chapter 11 bankruptcy in December of 2002, its employees have made hundreds of millions of dollars in concessions in wages and benefits in order to help get the airline back on its feet – including taking big hits to their pensions. These concessions have disrupted the lives and dreams of thousands of our constituents.

They have every reason to be angry and frustrated. Many stand to lose 25 to 50 percent of their pensions. Yet despite their frustrations, United's employees made United one of only four major carriers to improve service over the last two years, according to an Airline Quality Rating study of 14 major airlines released in April. And that should be a lesson to all of us. No matter how tough things have become -- even as their employer has broken some of its commitments to them -- United employees have kept their commitment to their customers.

We know this because we are loyal and frequent customers.

We met last week with United CEO Glen Tilton and Greg Davidowitch from the Flight Attendants union. The flight attendants are fighting the takeover of their defined benefit pension plan by the government. We made some progress on outlining the issues that the two parties need to work together to address, and they told us they would meet again. The meeting helped us to better understand the current situation this company and its employees face.

Both employees and management are in a difficult place. Employees are hurting, but United says it had no other option. Unless it can terminate its pension plans, it cannot emerge from bankruptcy, the company says.

As it stands, the Pension Benefit Guaranty Corporation (PBGC) has moved to terminate and absorb all of the United pension plans, relieving the airline of promises it made to its employees. In exchange, United has agreed to provide the PBGC with compensation.

In that transfer, most workers will lose some of the retirement benefits that they were promised. In many cases, those losses will require dramatic changes in lifestyle and much hardship. Also, the additional liability of acquiring the plans places another strain on the PBGC, increasing the likelihood of a taxpayer bailout at some point in the future.

In order to understand the lessons learned from the United Airlines case, we need to answer a number of key questions:

Regarding United's strategic decision to aim to shed its pensions:
· Did United have any other choice given the competition in today's airline market?
· If not, does it necessarily follow that because it had to break some of its pension promises that it had to break all of its pension promises?

Regarding the bankruptcy process and the deal cut between United and the PBGC:
· Is it fair that the PBGC and United management could cut a deal on transferring pension benefits to the PBGC without the unions fully participating in those negotiations?
· Was the PBGC's decision itself a good deal for workers or the agency? Did the deal merely reduce the short term liability of the PBGC while simultaneously encouraging others to follow the same roadmap by filing for bankruptcy and seeking to offload their pension plans, thus worsening the long term PBGC fiscal situation?

Lastly, regarding the implications of the United case for broader pension reform:
· Why was United able under current pension law to make promises on pensions so far outside their ability to afford them?
· How are we as a nation going to bear the costs of compensating employees if the PBGC cannot carry the debt?
· Can we change the defined benefit pension incentives without discouraging employers from providing their workers with retirement benefits?
· And, is the bankruptcy process a fair and efficient system for companies with legacy costs to manage those costs in an age of increasing competition?

A Government Accountability Office report of May 31 raises some of these same questions about how easy it is for some companies to exploit the rules of the current pension funding system by avoiding pension plan underfunding penalty fees by using credits instead of cash, and making calculations of how much plans are underfunded too opaque. This report merits a serious look by Congress.

It is also interesting to note that about 70 percent of PBGC's losses to date come from pension plans in two industries – airlines and steel -- that cover fewer than five percent of the people protected by PBGC. Experts tell us the auto industry is next. Perhaps there is a need to consider the industries which pose the highest risk of defaulting on their plans separately from the industries that are managing their plans appropriately.

We believe that a key lesson learned from the United pension crisis is that the bankruptcy courts are not the best forum for ensuring an equitable outcome for workers in the management of legacy costs. In this case, the bankruptcy process has led to more broken pension promises than may have been necessary, lowered employee morale, and may have led to the PBGC absorbing more debt than it can or should.

The challenge for Congress is to act. We need a plan for companies with long held legacy costs to establish a payment plan for fulfilling as many of their promises as possible. We also need to create a process that is fairer and faster than the bankruptcy courts for other legacy cost companies to manage those costs.

The United pension crisis – and it is a crisis for many United workers -- also highlights the need to strengthen existing mechanisms and create new ones for workers to save for retirement. Social Security may be the only thing that will keep some of United's lower paid workers out of unacceptably difficult financial circumstances if the company's pension obligations are fully transferred to the PBGC. We also need to work to ensure that these guaranteed benefits, which are a last resort for many, are not slashed.

We want to close with some words of encouragement for United management and its employees. We have met and spoken with many of you. We encourage you to get together to complete the process in a way that restores employee confidence in the company. If there is any way our offices can be of assistance in that process, we stand ready to help.

Thank you Mr. Chairman and members of the Committee. We look forward to today's testimony and working with you in the future on the important issue of retirement and pension security.

Testimony of Robert Roach, Jr.

General Vice President of Transportation

International Association of Machinists

and

Aerospace Workers

Before The

Senate Committee on Finance

"Preventing the Next Pension Collapse:

Lessons from the United Airlines Case."

June 7, 2005

Testimony of
Robert Roach, Jr., General Vice President of Transportation

International Association of Machinists and Aerospace Workers

Before the

Senate Committee on Finance

"Preventing the Next Pension Collapse:

Lessons from the United Airlines Case."

June 7, 2005

Thank you, Mr. Chairman, and members of this Committee for the opportunity to speak to you today. My name is Robert Roach, Jr., General Vice President of Transportation for the International Association of Machinists and Aerospace Workers (IAM). I am appearing at the request of International President R. Thomas Buffenbarger. The Machinists Union represents more than 100,000 U.S. airline workers in almost every classification, including Ramp Service workers, Mechanics, Public Contact employees and Flight Attendants.

You are hearing testimony this morning from labor leaders, airline executives and government witnesses on the effects of pension termination. But I am probably the only person testifying from first-hand experience. As a TWA employee, my pension plan and the pensions for 36,500 other participants were terminated on January 1, 2001. I will receive a pension check from the Pension Benefit Guaranty Corporation (PBGC), so I know the importance of ensuring this vital agency remains solvent. For thirty years of service, I will receive a pension check of approximately $205.00 a month.

Today, every airline with a government-insured defined benefit pension plan is looking to shed their commitments onto the PBGC and, ultimately, the American taxpayer. If one of our members walked away from their financial commitments like the airlines are doing, they would be held accountable. In contrast, airline executives who abandon billion dollar obligations and induce personal bankruptcies receive accolades from Wall Street. This greed-driven support for hurting American workers and taxpayers must stop.

The airline industry is a cyclical business. Any time the economy slows or fuel prices temporarily climb, the transportation industry is affected. It happens every recession, and it's the employees who bear the brunt of management's poor planning. Instead of raising ticket prices to cover these added costs, it has become acceptable for airlines to erode employee wages and benefits.

Current pension funding laws don't help. The rules create a countercyclical funding burden. Companies aren't required to put money into pension plans even when they are not 100% funded and, in most cases, when they can afford it. Consequently, a day of reckoning comes when corporations must put in enormous sums to catch up. In the case of United, when that time came the airline was in bankruptcy and could not afford to pay the billions of dollars that would have been required to fund the plan. This loophole should be closed.

This is a problem the IAM identified at United Airlines in 2000. We went to United with a proposal to freeze the current plan, which was then properly funded and transfer our members into the IAM National Pension Plan, a multi-employer plan that requires a defined contribution from an employer and provides a defined benefit for participants.

Unfortunately for the 30,000 active and retired IAM members at United, the management at that time refused to relinquish control of the pensions to a plan jointly-administered by both union and management trustees. If United heeded the IAM's warnings five years ago, 30,000 people would have had their pensions protected from the airline's failure to manage its pension plans and its business.

Pensions are not perks offered by airlines – they are deferred compensation for decades of maintaining a 365-day a year, 24 hour a day operation. Pension benefits were earned through hard work at negotiated reduced wages in exchange for retirement income. There are laws preventing a company from refusing to pay wages for work performed by their employees, but no such laws exist to ensure contractually agreed-to terms for retirement compensation are kept.

Over the course of two US Airways bankruptcies, the carrier successfully shed most of its defined benefit pension plans. The only surviving plan is the multi-employer IAM National Pension Plan that we successfully negotiated for our Fleet Service members. While our members enjoy the security of participating in a fully-funded pension plan, the employer has the benefit of predictable, regular pension contributions. Multi-employer pension plans are established and run only for the purpose of providing retirement benefits. Since contributions are collectively bargained, employers cannot simply decide to stop funding these plans in order to free up cash for other purposes.

At Continental Airlines, management refused an IAM proposal to fully-fund their defined benefit plan for our Flight Attendants. We are, hopefully, now negotiating for the stability and security of a fully-funded, multi-employer plan as a replacement for Continental's underfunded plan.

Northwest Airlines has said that without drastic legislative reform, it too will have to terminate its pension plans.

Congress should find ways to allow corporations with under-funded pension plans to become involved in multi-employer pension plans, such as the IAM National Pension Plan, and find a way to reward the multi-employer plans that absorb other plans' liabilities. Failure to address this problem today will result in the government assisting the participants of failed plans through welfare and other government programs at a later date.

The IAM has been successful in negotiating replacement plans for our members, but it isn't in anyone's best interest for one multi-employer plan to absorb all the industry's failed pension plans. Congress must, therefore, act to protect single employer plans by providing an avenue for these plans' participants to be involved in a multi-employer plan without adversely affecting that plan.

On behalf of the more than 100,000 airline employees that the IAM represents, I am here asking for your help.

Congress created the PBGC to act as a safety net for companies that could not meet their pension obligations. Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) stated that part of the PBGC's mission is "to encourage the continuation and maintenance of defined benefit pension plans." That visionary action that allows the PBGC to protect the pension benefits for more than 34 million workers is now at risk because corporations that were not legally required to pay into their plans did not do so and can now ill afford to make those payments. Those that can afford to pay today are considering dumping their pension liabilities on the federal government and the taxpayers simply to be competitive. This is not acceptable to the Machinists Union, it should not be acceptable to this Committee and I am sure the American taxpayers who ultimately will have to pay for the broken promises made by corporate America won't find it acceptable.

The Machinists Union supports a moratorium on PBGC-initiated terminations to give Congress time to examine this pressing problem and craft a solution. This would prevent the wholesale dumping of airline pensions.

Currently, the PBGC has no power in bankruptcy to collect money it is owed. A company can simply refuse to pay and force the PBGC to initiate a pension termination to prevent a plan from accruing further pension liabilities.

Congress must make bankruptcy a less attractive mechanism to dump pension obligations on the PBGC. The PBGC needs to have the ability to enforce pension funding rules on a level basis – whether or not a plan sponsor is in bankruptcy – and attach liens on a sponsor's assets in distress terminations.

Under current bankruptcy laws, a company can shed its pension obligations, successfully restructure and prosper, and the federal government and the taxpayers are still left with the company's pension liabilities.

The PBGC is required by statute, not choice, into a financial relationship with companies that sponsor pension plans, but unlike other bankruptcy stakeholders does not benefit from a restructured company's success. In bankruptcy, PBGC claims are treated just like any other unsecured claim. This is not fair to the plan's beneficiaries, the PBGC or the American taxpayer. Therefore, PBGC claims should be given priority over other unsecured claims.

The PBGC should have the authority and willingness to implement creative labor-management solutions to preserve pension benefits. At United Airlines, the IAM and United negotiated a proposal that would have included restoration funding by the PBGC and transferring United's pension liabilities to the IAM National Pension Plan. It would have left United in substantially the same position as it is today, following termination, and would have saved the PBGC $500 million dollars while preserving pension benefits for our members. Unfortunately, the PBGC rejected the deal.

Congress must level the playing field between carriers that have already walked away from their plans and those who might be tempted to do so. Funding relief is needed for airlines to avoid even more bankruptcies and pension terminations, but must it be done in a way that fosters benefit security for workers and retirees.

Congress also needs to clarify the PBGC's authority to restructure a company's pension obligations when their plans are in trouble. Restoration funding orders can be a useful tool to save pension plans that might otherwise terminate.

Long-term pension funding reform is necessary and must protect benefits while making pension funding more predictable for companies, but immediate action is needed to prevent unnecessary pension terminations out of a perceived competitive need. The Machinists Union is prepared to work with Congress to protect the earned pension benefits of American workers.

I thank the Committee for inviting us to participate in these proceedings and listening to our concerns.

I look forward to your questions.

STATEMENT OF SENATOR ROCKEFELLER

SENATE FINANCE COMMITTEE
JUNE 7, 2005

Mr. Chairman,

Thank you very much for holding this hearing today. I am extremely concerned about the financial pressures faced by our airlines. If this Congress fails to act to improve pension funding rules then many more airline employees may face the same nightmare experienced by employees of United Airlines who have lost substantial pension benefits.

Let me be clear, if Congress does not act by this summer, several more air carriers may well be in bankruptcy by the end of the year. By keeping airlines out of bankruptcy, thousands of employees nationwide keep their jobs, pension payments to retirees continue at promised levels, and the airlines don't have to turn to the Federal government for relief. We must keep working in this direction to avoid a fiasco that could rival the $200 billion savings-and-loan bailout of the 1980s."

I recently met with executives from the Philips Electronics company. Philips covers 75,000 employees and retirees in their defined benefit pension plans, and the company has made extraordinary investments to keep those plans healthy and well funded. This is just one example of the many employers who are willing to invest in valuable benefits for their employees. Unfortunately, employers around the country are finding it increasingly difficult to comply with sometimes arbitrary funding rules, and to maintain the balances in their pension plans. As we have just seen with the case of United Airlines, when companies cannot keep their promises, everyone loses.

I strongly believe in guaranteed pension benefits – checks that retirees can count on, checks that they cannot outlive, checks that do not decline when the stock market goes down. For generations, guaranteed pensions have been an important benefit provided by employers and valued by workers. Before it is too late, Congress needs to take steps to shore up the pension system and make sure it will be there for future generations.

In order to fundamentally strengthen the defined benefit pension system we must keep in mind the needs of each group with a stake in this debate – workers, employers, and taxpayers. Certainly, workers deserve better than what has happened to the pilots, flight attendants and mechanics at United Airlines. Pension promises must be fully and accurately funded. As the pension benefits are earned, employers must invest money to make sure that their promises can be kept.

But I understand that simply blaming employers and requiring them to pay more does not solve the problem. Companies need clear, reasonable funding rules that do not cripple their enterprises. Greater flexibility and predictability for pension contributions can relieve many of the headaches that executives face when trying to maintain their pension plans. I have very serious concerns about some reform proposals that would increase the funding uncertainty and make it more difficult for companies to estimate the costs of providing pension benefits.

And certainly, in order to protect taxpayers, Congress must act to shore up the Pension Benefit Guaranty Corporation, or PBGC. This year the PBGC announced that its pension obligations exceed its expected income by more than $23 billion. For the sake of all the retirees who depend on benefit payments from the PBGC, and to prevent the need for a taxpayer bailout of the agency, this deficit must be addressed.

Last year, Congress enacted temporary changes to the pension funding calculations. I hope that this committee will take action soon to provide permanent, comprehensive pension reforms. With Senator Isakson, I have introduced the Employee Pension Preservation Act of 2005, legislation to provide significant funding relief for airlines. My legislation could help other airlines from following in the footsteps of United which had all of its pension plans terminated. Under my bill, airlines with underfunded plans would still be required to fully fund all of their pension promises, but would be given a longer time frame to make payments than allowed under current law.

The Isakson-Rockefeller bill offers one constructive, creative solution for severely underfunded pension plans. Mr. Chairman, I hope that you will find it to be helpful to this committee's work. I look forward to working with you and all of my colleagues on this committee to enact pension reforms that improve the defined benefit pension system. Thank you again for holding this hearing.

Testimony of Douglas Steenland
President and Chief Executive Officer
Northwest Airlines, Inc.

Before the Senate Committee on Finance

June 7, 2005

Mr. Chairman, Senator Baucus and members of the Committee, thank you for the opportunity to testify today. My name is Doug Steenland, and I am the President and Chief Executive Officer at Northwest Airlines, on whose behalf I am speaking today.

Northwest is the world's fourth largest airline, with approximately $11 billion in operating revenues, 39,000 employees and an additional 30,000 people that participate in our defined benefit pension plans. Northwest has 70,339 plan participants in our three defined benefit plans.

Since before deregulation of our industry, Northwest and other airlines have provided employees traditional defined benefit pension plans, which pay retirees a specified amount every month. Today, however, Northwest's and other airlines' defined benefit plans are in critical condition. As you know, both United Airlines and US Airways have already terminated their defined benefit plans in bankruptcy and transferred them to the PBGC. Absent immediate action by Congress, the defined benefit plans at Northwest and at other carriers may very well suffer the same fate.

Mr. Chairman, I am convinced that there is a sensible path out of the difficulty we all find ourselves in. Let me tell you how we got here, and how we can get out.

At the end of 1999, airline industry defined benefit plans held $32.6 billion in assets to support $32.0 billion in projected benefit obligations ("PBO"). In other words, the defined benefit plans of the major airlines were more than 100 percent funded, on average. Northwest's plans, in the aggregate, were more than 100% funded through 2000.

Today, that same PBO funded level for airline defined benefit plans has dipped to less than 60 percent. At the end of plan year 2004, the plans of the major airlines had only $29.8 billion of assets to support PBO of $50.6 billion. At the end of 2004, Northwest's plans were also funded at less than 60 percent. We have $5.5 billion of assets to support PBO of $9.2 billion.

What happened?

- First, for the first time since before the Second World War, the equity markets declined for three consecutive years, decimating pension plan investment performance.

- Second, market interest rates, which are used to discount pension liabilities to a present value, fell to 40-year lows. Because of the inverse relationship between discount rates and the value of pension liabilities, the measured present value of defined benefit plan liabilities skyrocketed.

- Third, based on the ostensibly sound funded condition of our plans and the then prosperous times for the industry, the airlines and their unions agreed to increase pension benefits.

- Fourth, after September 11th, 2001, the airlines did not have access to the capital markets to the extent that we would have needed to fund our plans.

As a result of these events, the deficit reduction contribution or DRC rules kicked in and required that Northwest and other carriers make massive additional contributions to its defined benefit plans that we could not afford. In fact, the DRC requires a company to make very large catch-up contributions to its defined benefit plans at a time when the company can least afford to make those payments.

It is difficult to overstate how profoundly the DRC has impacted the funding or, more precisely, the underfunding – of our defined benefit plans. It is as if Congress had issued an edict to homeowners with 30 year mortgages that, if the value of their homes drop below 80% of the purchase price (for whatever reason), their loan will be accelerated such that the balance will become due in just three to five years. Worse yet, the accelerated funding kicks in at a time when homeowners will likely find it most difficult to repay the loans because of the very same adverse economic circumstances that caused the value of their home to drop. On top of that the DRC imposes an artificially low interest rate which results in overstating pension liabilities.

In fact, when the DRC kicked in, the airline industry was, and remains today, in the midst of its worst financial crisis ever. The reasons for this are well known, and include: (i) record high oil prices; (ii) the effects of September 11; (iii) the effects of the Iraq war; (iv) SARS, and (v) price competition in major markets from the so-called "low-cost carriers" – which, among other things, do not provide their employees a defined benefit pension plan. The so-called low cost carriers all provide defined contribution plans and are therefore not subject to the DRC.

In short, the current funding rules are too volatile, unpredictable, inflexible and expensive for our company to survive and compete in the modern, deregulated airline industry that demands that we deliver service to our customers at competitive prices.

Defined benefit plans are one of the last vestiges of the airline regulation era. Northwest has concluded that defined benefit plans simply do not work for an industry that is as competitive and as vulnerable to forces, ranging from terrorism to international oil prices, that are largely beyond its control, as the airline industry.

Given this reality, Northwest could be left with a stark choice:

- We can follow United Airlines and US Airways, file for bankruptcy and apply to terminate our defined benefit plans. We all know that this is a lose-lose approach: our retirees' and workers' pensions will be reduced to the PBGC guarantee level, and the PBGC will be left to assert a claim for pension underfunding that will be satisfied in the bankruptcy process with "pennies on the dollar"; or

- Congress can enact legislation that allows us to fully fund our defined benefit plans, and to make a gradual and orderly transition from defined benefit plans, while at the same time protecting our employees, retirees, and the PBGC.

Working with our labor unions and other airlines, we have developed a proposal that would allow us to follow the second course. We are grateful to Senator Isakson and Senator Rockefeller for introducing legislation that embraces these ideas. The proposal would provide stable, predictable funding rules that airlines can afford, while at the same time protecting plan participants and capping the exposure of the PBGC. Specifically, the proposal would:

- stop adding to the underfunding of airline plans by encouraging airlines and their affected unions to "freeze" their plans, ceasing future benefit accruals;

- in addition to freezing future accruals, protect the PBGC from any worsening of its exposure by freezing the PBGC guarantee; and

- permit airlines to "refinance" frozen and already-existing pension obligations by extending the term of our pension "mortgage" from its current DRC 3-5 year amortization period to a longer amortization period.

Under this proposal, retirees and plan participants would not have their benefits cut to the PBGC guarantee level. They would receive the benefit they had earned to the date of the freeze. Retirees would be protected. In addition, the PBGC will be in better shape financially since its liability will be capped, and each payment that an airline makes to the plan will reduce that liability. The alternative is the "pennies on the dollar" it would receive under the termination of our plans in bankruptcy. Finally, the airlines would have a better chance of avoiding the cost of a bankruptcy.

We are thankful for your efforts in 2004 to provide temporary pension funding relief of the DRC to the airlines. This legislative effort recognized that the DRC is broken and needs to be fixed.

We respect and appreciate the Administration's proposals to reform the pension funding rules. But these rules are still too expensive, too volatile and too unpredictable for the airline industry. As a result, we must respectfully urge Congress to enact an airline proposal along the lines I have described.

To summarize, Mr. Chairman, we are not seeking a "subsidy" or a "bailout" from the government. Just the opposite. We are asking for a responsible alternative to current law that lets us pay our pension liabilities ourselves, versus shifting those obligations onto a government agency.

I appreciate the opportunity to present our views to the Committee, and I am available to answer any questions that you may have.

Statement of
Glenn F. Tilton
Chairman, President and CEO of United Airlines
Before The Senate Finance Committee

Washington, DC
June 7, 2005

Mr. Chairman, Senator Baucus, and distinguished members of the Finance Committee, thank you for inviting me to testify today.

The topic of today's hearing is, "Preventing the Next Pension Collapse: Lessons from the United Airlines Case." As the Chairman, President and CEO of United Airlines, I can tell you precisely what lessons we have learned, as we have dealt with this industry's business and financial realities.

As my colleagues on the panel have stated, while the nation's retirement system is facing a significant crisis, the airline industry is undergoing its own extraordinary transformation.

The Internet, price transparency and the impact of low cost carriers have permanently changed the industry, which has suffered staggering financial losses exceeding $32 billion over the last four years.

The major carriers have massive legacy costs. All the carriers are squeezed in a vise between lower yields and higher fuel costs. Not surprisingly, predictions that the U.S. airline industry would return to profitability have not come true.

Just three years ago, United was a flawed and a failing business... months away from bankruptcy. We had an uncompetitive cost structure; restrictive labor agreements; a lack of alignment between management, employees and customers; and a governance structure that fundamentally weakened United.

Since then, United has done most of the hard work necessary to put our financial house in order and to prepare to compete as a viable, sustainable enterprise.

- ✓ We are on track to realize reductions of $7 billion annually, through long-term labor cost savings and significant other cost reductions.
- ✓ We have better focused our products to meet the demands of the U.S. market, and reallocated our fleet to international markets where yields are higher.
- ✓ We are posting industry-competitive revenue performance.
- ✓ And we now have a normal governance structure.

During this time, our employees have set record operating performance results. That's counterintuitive for a company in restructuring, and that is to our employees' credit.

We have maintained our service for the flying public in our hub cities, and in the medium and small towns we serve from coast to coast, providing important commercial connectivity and critical access to global markets.

Throughout our restructuring, United has worked tirelessly to preserve our employees' defined benefit pension plans. We devoted 14 months to constructing a business plan to secure an Air Transportation Stabilization Board (ATSB) loan guarantee on terms that would have allowed United to keep its pension plans.

A year ago, the ATSB rejected United's final loan guarantee application for $1.1 billion, advising us instead to pursue exit financing with the financial and capital markets. When we did, it was very clear that, given continued pressures on revenue and record fuel prices, United could not meet the financial targets necessary to be finance-able without the termination of pension plans and further labor cuts.

Even so, we worked with our unions, actuarial experts, financial and legal advisors, Board of Directors, Creditors' Committee – in fact, all stakeholders – to scrutinize every alternative that would allow us to meet our financial targets and keep our pensions.

Last year, we told our labor groups and other constituents that we would examine any alternative to pension termination and replacement to see if it was viable. By January of this year, no workable alternatives were found. We extended the search for another four months, and despite everyone's efforts, we failed to find viable alternatives to termination and replacement.

When it became clear to the management team, the Board of Directors and the Creditors' Committee that the termination and replacement of our pension plans was the only viable option, we prepared to go to court. At the same time, we were in discussion with the Pension Benefit Guaranty Corporation (PBGC). It was decided that the best route at this time was an involuntary termination by the PBGC, whereby the PBGC obtained securities and a share in United's future potential.

The PBGC settlement is fair and equitable to all, provides cost savings and stability necessary for United to exit from bankruptcy and is superior to the recovery that the PBGC would receive as a creditor. But that does not change the fact that this has been extremely difficult for our employees and retirees and is not an outcome to be desired.

Since United began offering pension plans to its employees in 1941, we have done everything required by law – and more – to safeguard those plans for United's employees. And since the Employee Retirement Income Security Act's inception in 1974, we followed fully the rules and regulations and paid our PBGC premiums and plan contributions even while in bankruptcy, until the ATSB's final rejection of our loan guarantee application last summer.

From the outset of the bankruptcy process, our mission has been to enable United as a whole to succeed. Without success for the enterprise, the rest is academic.

To quote Bankruptcy Court Judge Wedoff on the United/PBGC agreement: "The least bad of the available choices here has got to be the one that keeps an airline functioning, that keeps employees being paid."

Without termination and replacement of pensions, United's future and the jobs of 62,000 employees would disappear, along with the economic contributions to hundreds of communities, our business relationships with hundreds of suppliers and partners, and United's continuing wage and benefit payments, including replacement retirement plans... and the pension plans would still be terminated.

United's unions understand the industry and economic realities that we are facing, and all but one have agreed to the retirement plan changes that must be made. We now have agreements on long-term labor cost savings with all our union groups, ratified or in principle, and with every union group but the Association of Flight Attendants on pension changes.

These agreements have moved United forward significantly in our restructuring and set the stage for our exit from bankruptcy.

The impact of this action on our retirees and employees will not be as dramatically negative as some have portrayed. All vested participants will continue to receive guaranteed benefit payments. In particular, most current retirees will not see dramatic reductions in their monthly benefits, and many retirees will not experience any reductions at all.

For example, retired flight attendants, the group that is by far the least impacted – represented or not – will receive approximately 100 percent of everything they are receiving today.

For current employees (except pilots), the impact of a termination could be substantially mitigated by working until age 65, the traditional retirement age in most pension plans.

The choice we faced for our employees was keeping jobs and replacing their existing pension plans with consensually negotiated replacement plans... or losing jobs and terminating pensions.

Unlike my colleagues on the panel today, United is in Chapter 11, seeking exit financing in order to keep our company in business for our employees, retirees and our customers. We know for certain that the cost of continuing our defined benefit pension plans was not finance-able ...the cost is simply unsustainable.

Mr. Chairman, we at United agree with many of the policy issues that you and House Chairmen Thomas and Boehner have identified.

In particular, we support your commitment to taking a comprehensive approach to solving these problems. We have learned from United's restructuring that reform of the pension laws cannot succeed if it is done piecemeal. There is no "quick fix."

Pension reform must consider the daunting economic reality and volatility the airline industry and other U.S. industries are facing today. Short-term moratoriums are falsely based on the hope that "if you wait it out, things will get better."

A lesson we at United have certainly learned, is that there is no moratorium on business and financial reality.

Thank you and I would be happy to take any questions.

# # #

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
United States Senate

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PRIVATE PENSIONS

Revision of Defined Benefit Pension Plan Funding Rules Is an Essential Component of Comprehensive Pension Reform

Statement of David M. Walker
Comptroller General of the United States

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Accountability * Integrity * Reliability

GAO-05-794T

June 7, 2005

PRIVATE PENSIONS

Revision of Defined Benefit Pension Plan Funding Rules Is an Essential Component of Comprehensive Reform

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-05-794T, a testimony before the Committee on Finance, United States Senate

Why GAO Did This Study

Pension funding rules are intended to ensure that defined benefit (DB) plans have sufficient assets to pay promised benefits to plan participants. However, recent terminations of large underfunded plans, along with continued widespread underfunding, suggest weaknesses in these rules, which may threaten the retirement income of these plans' participants, as well as the future viability of the Pension Benefit Guaranty Corporation (PBGC) single-employer insurance program, the federal program that insures certain benefits of the more than 34 million participants in over 29,000 plans. The program has gone from having a $9.7 billion accumulated surplus at the end of fiscal year 2000 to a $23.3 billion accumulated deficit as of September 2004, including a $12.1 billion loss for fiscal year 2004. In addition, financially weak companies sponsored DB plans with a combined $96 billion of underfunding as of September 2004, up from $35 billion 2 years earlier. Addressing PBGC's challenges by way of comprehensive pension reform provides a real opportunity to address our long-term fiscal problems and to reconfigure our retirement security systems to bring them into line with 21st century needs and realities.

This testimony provides GAO's observations on weaknesses in DB pension funding rules and on how such rules should be amended as an integral part of comprehensive changes to the DB pension system.

www.gao.gov/cgi-bin/getrpt?GAO-05-794T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

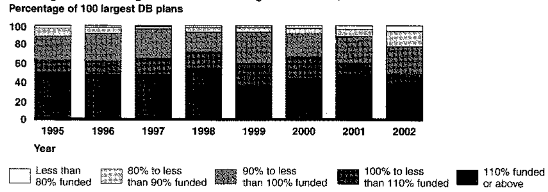
What GAO Found

From 1995 to 2002, most of the 100 largest DB plans annually had assets that exceeded their current liabilities, although on average many plans were underfunded, with liabilities exceeding plan assets. By 2002, however, over half of the 100 largest plans were underfunded, and almost one-fourth of plans were less than 90 percent funded. Further, because of leeway in the actuarial methodology and assumptions that sponsors may use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported. Additionally, on average over 60 percent of sponsors of these plans made no annual cash contributions to their plans during the period.

One key reason for such limited cash contributions is that the current funding rules allow a sponsor to satisfy minimum funding requirements without necessarily making a cash contribution each year, even though the plan may be significantly underfunded. Further, very few sponsors of underfunded plans were required to pay an additional funding charge (AFC), a funding mechanism designed to reduce severe plan underfunding.

Our analysis confirms the notion that plans sponsored by financially weak companies pose a significant risk to PBGC, as these plans were generally more likely to be underfunded, be subject to an AFC, and use assumptions to minimize contributions than plans sponsored by stronger firms.

Funding Levels among the Annual 100 Largest DB Plans, 1995–2002
Percentage of 100 largest DB plans



Source: GAO analysis of PBGC Form 5500 research data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our recent report on the rules that govern the funding of defined benefit (DB) plans and the implications of those rules for the problems facing the Pension Benefit Guaranty Corporation (PBGC) and the DB pension system generally.[1] In recent years, the PBGC has encountered serious financial difficulties. Prominent companies, such as Bethlehem Steel, U.S. Airways, and United Airlines, have terminated their pension plans with severe gaps between the assets these plans held and the pension promises these plan sponsors made to their employees and retirees. These terminations, and other unfavorable market conditions, have created large losses for PBGC's single-employer insurance program—the federal program that insures certain benefits of the more than 34 million participants in over 29,000 plans. The single-employer program has gone from a $9.7 billion accumulated surplus at the end of fiscal year 2000 to a $23.3 billion accumulated deficit as of September 2004, including a $12.1 billion loss for fiscal year 2004. In addition, financially weak companies sponsored DB plans with a combined $96 billion of underfunding as of September 2004, up from $35 billion as of 2 years earlier. Because PBGC guarantees participant benefits, there is concern that the expected continued termination of large plans by bankrupt sponsors will push the program more quickly into insolvency, generating pressure on the Congress, and ultimately the taxpayers, to provide financial assistance to PBGC and pension participants.

Given these concerns, we placed the PBGC's single-employer program on GAO's high-risk list of agencies and programs that need broad-based transformations to address major challenges. In past reports, we identified several categories of reform that the Congress might consider to strengthen the program over the long term. We concluded that the Congress should consider comprehensive reform measures to reduce the risks to the program's long-term financial viability and thus enhance the retirement income security of American workers and retirees.[2]

More broadly, pension reform represents a real opportunity to address part of our long-term fiscal problems and reconfigure our retirement

[1]See GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, GAO-05-294 (Washington, D.C.: May 31, 2005).

[2]See GAO, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90 (Washington, D.C.: Oct. 29, 2003).

security systems to bring them into the 21st century.[3] This opportunity has many related pieces: addressing our nation's large and growing long-term fiscal gap; deciding on the appropriate role and size of the federal government—and how to finance that government—and bringing the wide array of federal activities into line with today's world. Continuing on our current unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. We therefore must fundamentally reexamine major spending and tax policies and priorities in an effort to recapture our fiscal flexibility and ensure that our government can respond to a range of current and emerging security, social, economic, and environmental changes and challenges. The PBGC's situation is an excellent example of the need for the Congress to reconsider the role of government organizations, programs, and policies in light of changes that have occurred since PBGC's establishment in 1974.

PBGC's challenges bear many similarities to the challenges facing our Social Security system. Both programs have adequate current revenues and assets to pay promised benefits for a number of years; yet, both face large and growing accumulated deficits on an accrual basis. As a result, timely action to address both private pension and Social Security reform is needed. In pursuing such reforms, consideration should be given to the interactive effects of any such reforms and how they contribute to addressing our nation's large and growing fiscal challenge, key demographic, economic and workforce trends, and the economic security of Americans in their retirement years.

Our recent work on DB pension funding rules provides important insights in understanding the problems facing PBGC and the DB system. To summarize our findings, while pension funding rules are intended to ensure that plans have sufficient assets to pay promised benefit to plan participants, significant vulnerabilities exist. Although from 1995 to 2002 most of the 100 largest DB plans annually had assets that exceeded their current liabilities, by 2002 over half of the 100 largest plans were underfunded, and almost one-fourth of plans were less than 90 percent

[3]See GAO, *21st Century Challenges: Re-Examining the Base of the Federal Government,* GAO-05-325SP (Washington, D.C.: Feb. 2005).

funded.[4] Further, because of leeway in the actuarial methodology and assumptions that sponsors may use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported. Additionally, on average over 60 percent of sponsors of these plans made no annual cash contributions to their plans. One key reason for this is that the funding rules allow a sponsor to satisfy minimum funding requirements without necessarily making a cash contribution each year, even though the plan may be underfunded. [5] Further, very few sponsors of underfunded plans were required to pay an additional funding charge (AFC), a funding mechanism designed to reduce severe plan underfunding. Finally, our analysis confirms the notion that plans sponsored by financially weak firms pose a particular risk to PBGC, as these plans were generally more likely to be underfunded, to be subject to an additional funding charge, and to use assumptions to minimize or avoid cash contributions than plans sponsored by stronger firms.

Background

In DB plans, formulas set by the employer determine employee benefits. DB plan formulas vary widely, but benefits are frequently based on participant pay and years of service, and typically paid upon retirement as a lifetime annuity, or periodic payments until death. Because DB plans promise to make payments in the future and because tax-qualified DB plans must be funded, employers must use present value calculations to estimate the current value of promised benefits.[6] The calculations require making assumptions about factors that affect the amount and timing of

[4]We analyzed DB pension data for the 100 largest plans as ranked by current liabilities reported on Schedule B of the Form 5500 for the years 1995 to 2002. The Form 5500 is a disclosure form that private sector employers with qualified pension plans are required to file with the Internal Revenue Service (IRS), Labor's Employee Benefit Security Administration (EBSA), and PBGC. While our sample of plans represented only a small portion of the total plans in the single-employer program, it constitutes approximately 50 percent of the total liabilities and about 28 percent of the total participants among DB plans that filed a Form 5500 in 2002. For more information on our methodology, see appendix I of GAO-05-294.

[5]An underfunded plan does not necessarily indicate that the sponsor is unable to pay current benefits. Underfunding means that the plan does not currently have enough assets to pay all accrued benefits, the majority of which will be paid in the future, under the given actuarial assumptions about asset rate of return, retirement age, mortality, and other factors that affect the amount and timing of benefits.

[6]Present value calculations reflect the time value of money—that a dollar in the future is worth less than a dollar today, because the dollar today can be invested and earn interest. Using a higher interest rate will lower the present value of a stream of payments because it implies that a lower level of assets today will be able to fund those future payments.

benefit payments, such as an employee's retirement age and expected mortality, and about the expected return on plan assets, expressed in the form of an interest rate. The present value of accrued benefits calculated using mandated assumptions is known as a plan's "current liability." Current liability provides an estimate of the amount of assets a plan needs today to pay for accrued benefits.

The Employee Retirement Income Security Act of 1974 (ERISA), and several amendments to the law since its passage, established minimum funding requirements for sponsors of pension plans in order to try to ensure that plans have enough assets to pay promised benefits. Compliance with the minimum funding requirements is recorded through the plan's funding standard account (FSA). The FSA tracks events that affect the financial health of a plan during that plan year: credits, which reflect improvements to the plan's assets, such as contributions, amortized experience gains, and interest; and charges, which reflect an increase in the plan's financial requirements, such as the plan's normal cost and amortized charges such as the initial actuarial liability, experience losses, and increases in a plan's benefit formula.[7,8]

ERISA and the Internal Revenue Code (IRC) prescribe rules regarding the assumptions that sponsors must use to measure plan liabilities and assets. For example, for plan years 2004 and 2005, the IRC specifies that the interest rate used to calculate a plan's current liability must fall within 90 to 100 percent of the weighted average of the rate on an index of long-term investment-grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.[9] Similarly, rules dictate that sponsors report an "actuarial" value of assets that must be based on reasonable assumptions and must take into account the assets' market value. This value may differ in any given year, within a specified range,

[7]Normal cost is the cost of pension benefits allocated to a specific plan year.

[8]Plans may amortize experience gains or losses over a 5-year period. Changes in the terms of the plan arising from plan amendments may be amortized over a 30-year period. Thus, these events continue to affect the FSA and plan funding for several years after they occur.

[9]The rate used to calculate current liability has usually been based on the 30-year Treasury bond rate, with the allowable range above and below the 4-year weighted average varying in different years. The Pension Funding Equity Act of 2004 replaced the Treasury bond rate with the corporate index for plan years 2004 and 2005. See IRC section 412(b)(5)(B)(ii)(II). For further discussion of rates used to discount pension liabilities, see GAO, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations,* GAO-03-313 (Washington, D.C.: Feb. 27, 2003).

from the current market value of plan assets, which plans also report. While different methodologies and assumptions will change a plan's reported assets and liabilities, sponsors eventually must pay the amount of benefits promised; if the assumptions used to compute current liability differ from the plan's actual experience, current liability will differ from the amount of assets actually needed to pay benefits.[10]

Funding rules generally presume that the plan and the sponsor are ongoing entities, and plans do not necessarily have to maintain an asset level equal to current liabilities every year. However, the funding rules include certain mechanisms that are intended to keep plans from becoming too underfunded. One such mechanism is the AFC, introduced by the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). The AFC requires sponsors of plans with more than 100 participants that have become underfunded to a prescribed level to make additional plan contributions in order to prevent funding levels from falling too low. With some exceptions, plans with an actuarial value of assets below 90 percent of current liabilities are affected by the AFC rules. [11]

In addition to setting funding rules, ERISA established PBGC to guarantee the payment of the pension benefits of participants, subject to certain limits, in the event that the plan could not.[12] Under ERISA, the termination of a single-employer DB plan may result in an insurance claim with the single-employer program if the plan has insufficient assets to pay all

[10]A plan's current liability may differ from its "termination liability," which measures the value of accrued benefits using assumptions appropriate for a terminating plan. For further discussion of current versus termination liability, see GAO-04-90, appendix IV.

[11]A single-employer plan may be subject to an AFC in a plan year if plan assets fall below 90 percent of current liabilities. However, a plan is not subject to an AFC if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for at least 2 consecutive of the 3 immediately preceding years. To determine whether the AFC applies, the IRC requires sponsors to calculate current liabilities using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(l)(9)(C).

[12]Some DB plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer active participants.

benefits accrued under the plan up to the date of plan termination.[13] PBGC may pay only a portion of a participant's accrued benefit because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee benefits above a certain amount, currently $45,614 annually per participant at age 65.[14] Additionally, benefit increases arising from plan amendments in the 5 years immediately preceding plan termination are not fully guaranteed, although PBGC will pay a portion of these increases.[15] Further, PBGC's benefit guarantee amount is limited to the monthly straight life annuity benefit the participant would receive if she were to commence the annuity at the plan's normal retirement age.[16] Sponsors of PBGC-insured DB plans pay annual premiums to PBGC for their coverage. Premiums have two components: a per participant charge paid by all sponsors (currently $19 per participant) and a "variable-rate" premium that some underfunded plans pay based on the level of unfunded benefits.[17]

[13]The termination of a fully funded DB plan is called a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company, under which the insurance company agrees to pay all accrued benefits, or by paying lump-sum benefits to participants if permissible. The termination of an underfunded plan, termed a distress termination, is allowed if the plan sponsor requests the termination and the sponsor satisfies other criteria. Alternatively, PBGC may initiate an "involuntary" termination. PBGC may institute proceedings to terminate a plan if the plan has not met the minimum funding standard, the plan will be unable to pay benefits when due, a reportable event has occurred, or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a).

[14]This guarantee level applies to plans that terminate in 2005. The amount guaranteed is adjusted (1) actuarially for the participant's age when PBGC first begins paying benefits and (2) if benefits are not paid as a single-life annuity. Because of the way ERISA allocates plan assets to participants, certain participants can receive more than the PBGC guaranteed amount.

[15]The guaranteed amount of the benefit amendment is calculated by multiplying the number of years the benefit increase has been in effect, not to exceed 5 years, by the greater of (1) 20 percent of the monthly benefit increase calculated in accordance with PBGC regulations or (2) $20 per month. See 29 C.F.R. 4022.25(b).

[16]For more on PBGC guarantee limits, see Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 1999* (Washington, D.C., Summer 2000), pp. 2-14.

[17]The additional premium equals $9.00 for each $1,000 (or fraction thereof) of unfunded vested benefits. However, no such premium is charged for any plan year if, as of the close of the preceding plan year, contributions to the plan for the preceding plan year were not less than the full funding limitation for the preceding plan year.

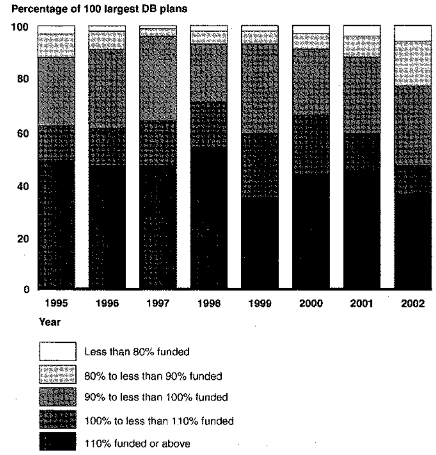
The recent decline of PBGC's single-employer program has occurred in the context of the long-term stagnation of the DB system. The number of PBGC-insured plans has decreased steadily from approximately 110,000 in 1987 to about 29,000 in 2004. While the number of total participants in PBGC-insured single-employer plans has grown approximately 25 percent since 1980, the percentage of participants who are active workers has declined from 78 percent in 1980 to 50 percent in 2002. Unless something reverses these trends, PBGC may have a shrinking plan and participant base to support the program in the future.

Many of the 100 Largest Plans' Liabilities Exceeded Plan Assets from 1995 to 2002, and Few Sponsors Were Required to Make Cash Contributions

From 1995 to 2002, while most of the 100 largest plans had sufficient assets to cover their plan liabilities, many did not. Furthermore, because of leeway in the actuarial methodology and assumptions sponsors can use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported at the end of the period. Because of flexible funding rules permitting the use of accounting credits other than cash contributions to satisfy minimum funding obligations, on average 62.5 of the 100 largest plans each year received no cash contributions from their sponsors.

Although as a group, funding levels among the 100 largest plans were reasonably stable and strong from 1996 to 2000, by 2002, more than half of the largest plans were underfunded (see fig. 1). Two factors in the deterioration of many plans' finances were the decline in stock prices and prevailing interest rates. From 2000 to 2002, stock prices declined sharply each year, causing a decline in the value of many plans' pension assets. In addition, over the sample period, 30-year Treasury bond rates, which served as the benchmark for the rate used by plans to calculate pension liabilities, generally fell steadily, raising current liabilities. The combination of lower asset values and higher pension liabilities had a serious, adverse effect on overall DB plan funding levels.

Figure 1: Almost One-Fourth of the Largest Pension Plans Were Less than 90 Percent Funded on a Current Liability Basis in 2002



Source: GAO analysis of PBGC Form 5500 research data.

Rules May Allow Reported Funding Levels to Overstate Current Funding Levels

Accurate measurement of a plan's liabilities and assets is central to the sponsor's ability to maintain assets sufficient to pay promised benefits, as well as to the transparency of a plan's financial health. Because many plans chose allowable actuarial assumptions and asset valuation methods that may have altered their reported liabilities and assets relative to market levels, it is possible that funding over our sample period was actually worse than reported for a number of reasons. These include the use of above-market rates to calculate current liabilities and actuarial measurement of plan assets that differ from market values.

Reported current liabilities are calculated using a weighted average of rates from the 4-year period before the plan year. While this allows sponsors to smooth fluctuations in liabilities that sharp swings in interest rates would cause, thereby reducing volatility in minimum funding requirements, it also reduces the accuracy of liability measurement because the rate anchoring reported liabilities is likely to differ from current market values. To the extent that the smoothed rate used to calculate current liabilities exceeds current rates, the 4-year smoothing could reduce reported liabilities relative to those calculated at current market values. Further, rules allowed sponsors to measure liabilities using a rate above the 4-year weighted average.[18] The 4-year weighted average of the reference 30-year Treasury bond rate exceeded the current market rate in 76 percent of time in the months between 1995 and 2002, and the highest allowable rate for calculating current liabilities exceeded the current rate in 98 percent of those months. Sponsors of the plans in our sample chose the highest allowable interest rate to value their current liabilities 62 percent of the time from 1995 to 2002. For example, an interest rate 1 percentage point higher than the statutorily required interest rate would decrease the reported value of a typical plan's current liability by around 10 percentage points.

As with liabilities, the actuarial value of assets used for funding may also differ from current market values. Under the IRC, actuarial asset values cannot be consistently above or below market, but in a given year may be anywhere from 80 to 120 percent of market asset levels. Among the plans we examined, on average each year, 86 percent reported a different value for actuarial and market assets. On average, using the market value instead of the actuarial value of assets would have raised reported funding levels by 6.5 percent each year. However, while the market value exceeded the actuarial value of assets during the late 1990s, when plan funding was generally strong, in the weaker funding year of 2002 market assets dipped below actuarial assets. In 2001 and 2002, calculating plan funding levels using market assets would have greatly increased the number of plans below 90 percent funded each year. A similar calculation for 2002 would have drastically increased the number of large plans below 80 percent

[18]In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year, beginning with the 1995 plan year, to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The top of the permissible range was increased to 20 percent above the weighted average rate for 2002 and 2003. For 2004 and 2005, the Congress changed the reference rate from the 30-year Treasury bond rate to a rate based on long-term investment-grade corporate bonds, and reset the allowable range for plans to 90 to 100 percent of this rate.

funded, from 6 to 24. Thus, we see some evidence that using actuarial asset values lowered the volatility of reported funding levels relative to those using market asset values. However, the use of the actuarial value of assets also may have disguised plans' funded status as their financial condition worsened.

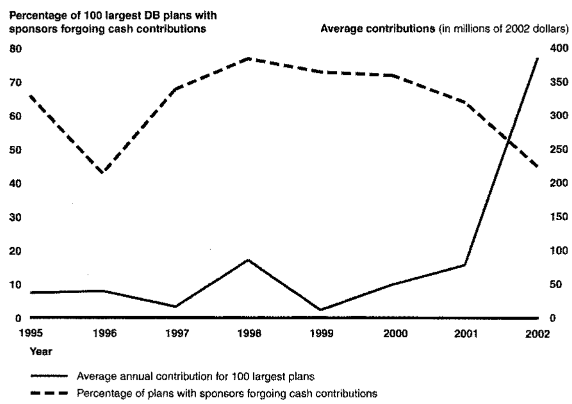
Two large plans that terminated in 2002 illustrate the potential effects of discrepancies between reported and actual funding. The Bethlehem Steel Corporation in 2002 reported that its plan was 85.2 percent funded on a current liability basis; yet, the plan terminated later that year with assets of less than half of the value of promised benefits. The PBGC single-employer program suffered a $3.7 billion loss as a result of that termination, its largest ever at the time. Similarly, LTV Steel Company reported that its pension plan for hourly employees was over 80 percent funded on its Form 5500 filing for plan year 2001. When this plan terminated in March, 2002, it had assets equal to 52 percent of benefits, a shortfall of $1.6 billion.

Most Sponsors of Large Plans Did Not Make Annual Cash Contributions, but Satisfied Funding Requirements through Use of Accounting Credits

For the 1995 to 2002 period, the sponsors of the 100 largest plans each year on average made relatively small cash contributions to their plans. Annual cash contributions for the top 100 plans averaged approximately $97 million on plans averaging $5.3 billion in current liabilities, with figures in 2002 dollars.[19] This average contribution level masks a large difference in contributions between 1995 and 2001, during which period annual contributions averaged $62 million, and in 2002, when contributions increased significantly to almost $395 million per plan. Further, in 6 of the 8 years in our sample, a majority of the largest plans made no cash contribution to their plan (see fig. 2). On average each year, 62.5 plans received no cash contribution, including an annual average of 41 plans that were less than 100 percent funded.

[19] For the 100 largest plans that we examined, all dollar figures are reported in constant 2002 dollars.

Figure 2: Most Large Plans Received No Annual Cash Contribution, 1995-2002



Source: GAO analysis of PBGC Form 5500 research data.

Note: Average contributions for 2002 are largely driven by one sponsor's contribution to its plan. Disregarding this $15.2 billion contribution reduces the average plan contribution for 2002 from $395 million to $246 million.

The funding rules allow sponsors to meet their plans' funding obligations through means other than cash contributions. If a plan has sufficient FSA credits from other sources, such as an existing credit balance or large interest or amortization credits, to at least match its FSA charges, then the plan does not have to make a cash contribution in that year.[20] Because meeting minimum funding requirements depends on reconciling total

[20]If FSA credits exceed charges in a given plan year, the plan's FSA registers a net "credit balance" that may be carried forward to the next plan year; conversely, a prior year's funding deficiency also carries forward. The FSA credit balance at year-end is equal to the FSA credit balance at the beginning of the year plus FSA credits less FSA charges. Compliance with the minimum funding standard requires that the FSA balance at the end of the year is non-negative. An existing credit balance accrues interest and may be drawn upon to help satisfy minimum funding requirements for future plan years, and it, therefore may offset the need for future cash contributions.

annual credits and charges, and not specifically on cash contributions, these other credits can substitute for cash contributions.

From 1995 to 2002, it appears that many of the largest plan sponsors relied more heavily on other FSA credits than on cash contributions to meet minimum funding obligations. The average plan's credit balance carried over from a prior plan year totaled about $572 million (2002 dollars) each year, and 88 percent of plans on average carried forward a prior credit balance into the next plan year from 1995 to 2002. Not only could these accumulated credit balances help a plan to meet minimum funding obligations in future years, but they also accrue interest that augments a plan's FSA credits and further helps meet minimum funding requirements. In contrast, annual cash contributions averaged only $97 million, in 2002 dollars. On average each year, cash contributions represented 90 percent of the minimum required annual funding (from cash and credits).[21] However, this average figure was elevated by high levels of contributions by some plans in 1995, 1996, and 2002. From 1997 to 2000, when funding levels were generally strong, cash contributions averaged only 42 percent of minimum required annual funding. During these years, a majority of plans in our sample received no cash contribution.

Cash contributions represented a smaller percentage of annual minimum required funding during years when plans were generally well funded, indicating that in these years more plans relied more heavily on credits to meet minimum funding obligations. In addition to large credit balances brought forward from prior years, sponsors were able to apply funding credits from other sources, such as net interest credits ($42 million per plan per year, on average), and credits from the excess of a plan's calculated minimum funding obligation above the plan's full funding limitation ($47 million).[22] Other plan events result in plan charges, which reflect events that increase the plan's obligations. For example, plans reported annual amortization losses, which could result from actual investment rates of return on plan assets below assumed rates of return (including outright losses) or increases in the generosity of plan benefits; these net amortization charges averaged almost $28 million in our sample. Funding credits, offset by charges, may help satisfy a plan's minimum

[21] Minimum required annual funding equals annual total FSA charges, less net amortization credits and interest applied to these amortization credits.

[22] Full funding limitation rules set a ceiling for minimum annual funding requirements for a plan each year, based on the plan's liabilities.

funding obligation, substituting for cash contributions, and may explain why a significant number of sponsors made zero cash contributions to their plans in many years.

The FSA credit accounting system provides some advantages to DB plan sponsors. Amortization rules require the sponsor to smooth certain events that affect plan finances over several years, and accumulated credit balances act as a buffer against swings in future funding requirements. These features often allow sponsors to better regulate their annual level of contributions, compared to annual fluctuations if funding were based strictly on yearly differences between the market value of plan assets and current liabilities. Similarly, current-law measurement and funding rules provide a plan with some ability to dampen volatility in required funding caused by economic events that may sharply change a plan's liabilities or assets. Pension experts told us that this predictability and flexibility make DB sponsorship more attractive to employers.[23]

However, the FSA accounting system, by smoothing annual contributions and liabilities, may distort a plan's funding level. For example, suppose a sponsor accrues a $1 million credit balance from making a contribution above the required minimum in a year. Suppose then that this $1 million purchases assets that lose all of their value by the following year. Even though the plan no longer had this $1 million in assets, the sponsor could still use that credit balance (plus interest on the credit balance) to reduce this year's contribution to the plan. Because of amortization rules, the sponsor would have to report only a portion of that lost $1 million in asset value as a plan charge the following year. Similarly, sponsors are required to amortize the financial effect of a change in a plan's benefit formula, which might result in increased benefits and therefore a higher funding obligation, over a 30-year period. Thus, even though higher benefits would immediately raise a plan's obligation to fund, the sponsor must spread this effect in the plan's FSA over 30 years. This disconnection between the reported and current market condition of plan finances raises the risk that plans will not react quickly enough to deteriorating plan conditions. Further, it reduces the transparency of plan financial information to stakeholders, such as participants, and investors.

[23]There are investment techniques, such as purchasing fixed income assets whose payouts match the plan's expected payouts, which could make pension funding relatively predictable, even without FSA smoothing. One possible reason that such techniques are not widely used may be they are believed to be more expensive, over the long term than an asset allocation with significant equity investment exposure.

The experience of two large plans that terminated in a severely underfunded state help illustrate the potential disconnection between FSA accounting and the plan's true funded status. As stated earlier, the Bethlehem Steel Corporation and LTV Steel Company both had plans terminate in 2002, each with assets approximately equal to 50 percent of the value of benefits. Yet each plan was able to forgo a cash contribution each year from 2000 to 2002 by using credits to satisfy minimum funding obligations, primarily from large accumulated credit balances from prior years. Despite being severely underfunded, each plan reported an existing credit balance in 2002, the year of termination.

Full Funding Limitation Rule May Have Allowed Some Plan Sponsors to Forgo Plan Contributions

Another possible explanation for the many instances in which sponsors made no annual cash contribution regards the full funding limitation (FFL). The FFL is a cap on minimum required contributions to plans that reach a certain funding level in a plan year.[24] However, the FFL does not represent the contribution that would raise plan assets to the level of current liability. The FFL represents a "maximum minimum" contribution for a sponsor in a given year—a ceiling on the sponsor's minimum funding obligation for the plan. Between 1995 and 2002, rules permitted some plans with assets as low as 90 percent of current liability to reach the FFL, meaning that a plan could be considered fully funded without assets sufficient to cover all accrued benefits. The FFL is also distinct from the plan's annual maximum tax-deductible contribution. Because sponsors may be subject to an excise tax on contributions above the maximum deductible amount, the annual maximum contribution can act as a real constraint on cash contributions.

Flexibility in the FFL rule has allowed many plan sponsors to take steps to minimize their contributions. In our sample, from 1995 to 2002 approximately two-thirds of the sponsors in each year made an annual plan contribution at least as large as the plan's FFL. However, in 65 percent of these instances, the sponsor had chosen the highest allowable rate to calculate current liability; using a lower rate to calculate current

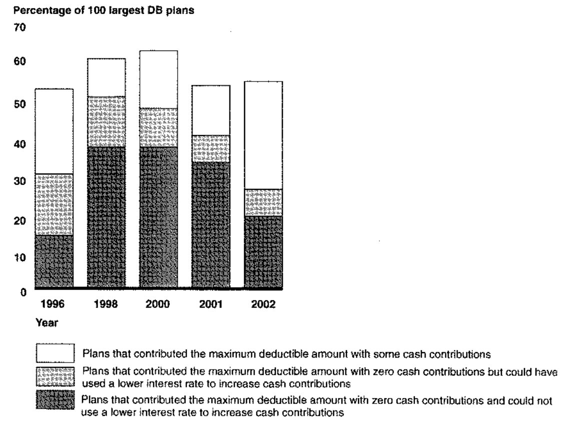
[24] As with other funding rules, determining a plan's FFL is complicated. From 1995 to 2002, the FFL equaled the higher of (1) 90 percent of the plan's current liability or (2) the lower of (a) the accrued plan liability or (b) 150 to 170 percent (depending on the year) of the current liability. As of the 2004 plan year, the 150 to 170 percent measure no longer factors in the determination of the FFL. For our sample of plans, an average of 4 plans per year were above 150 to 170 percent (depending on the year) of the current liability and had an FFL of zero. This means the sponsors of these plans were most likely unable to make additional contributions unless they paid an excise tax.

liability may have resulted in a higher FFL and, therefore, may have required a higher contribution. Further, the FFL was equal to zero for 60 percent of plans each year, on average. This means that these plans were permitted to forego cash contributions as a result of the FFL rule. This reflects the fact that if a plan's FFL equaled zero, that plan had assets at least equal to 90 percent of current liabilities that year and would not be required to make an additional contribution.

The interaction between the FFL rule and the annual maximum tax-deductible contribution also has implications on the amount that plan sponsors can contribute. In some years, the maximum deductible contribution rules truly constrained some sponsors from making any cash contribution. In 1998, 50 of the 60 plans that contributed to the maximum deductible amount had a maximum deductible contribution of zero (see fig. 3). This meant that any cash contribution into those plans that year would generally subject the sponsor to an excise tax.[25] For 37 of these plans, this was the case even if the sponsor had chosen the lowest statutorily allowed interest rate for plan funding purposes, which would have produced the highest calculated current liabilities. This constraint did not apply to as many plans in some other years. For example, in 1996, 52 plans contributed the maximum deductible amount. Thirty of these plans had a maximum deductible contribution of zero. Fourteen of the plans in this situation could not have made any additional contributions. However, the other 16 could have made at least some contributions by choosing a lower interest rate to raise their maximum deductible contribution level.

[25] For years after 2001, an employer may elect not to count contributions as nondeductible up to the full-funding limitation that is based on the accrued liability. Therefore, it could be possible for a sponsor to contribute more than the maximum deductible amount and still avoid the excise tax. See 26 U.S.C. 4972(c)(7).

Figure 3: For Selected Years from 1996 to 2002, Most Sponsors Contributed the Plan's Maximum Deductible Amount, Which for a Number of Plans Was Zero



Source: GAO analysis of PBGC Form 5500 research data matched to PBGC study on maximum deductible cash contributions.

Note: Years of analysis are not continuous, as the PBGC study on maximum deductible contributions was conducted for years shown. Information on maximum deductible contributions is missing for between 7 and 17 plans each year. Data for these plans were either missing or incomplete to calculate the plan contributions with respect to the maximum deductible contribution.

Very Few Sponsors of Underfunded Large Plans Paid an AFC from 1995 to 2002

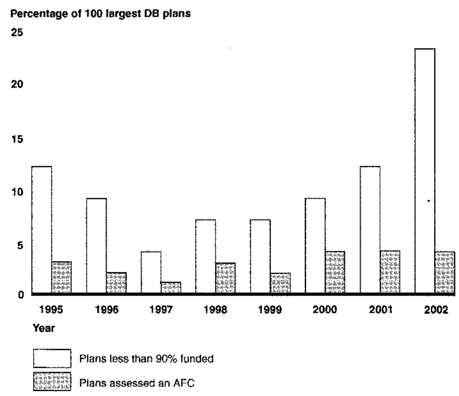
Funding rules dictate that a sponsor of a plan with more than 100 participants in which the plan's actuarial value of assets fall below 90 percent of liabilities, measured using the highest allowable interest rate, may be liable for an AFC in that year. More specifically, a plan that is between 80 and 90 percent funded is subject to an AFC unless the plan was at least 90 percent funded in at least 2 consecutive of the 3 previous plan years. A plan with assets below 80 percent of liabilities, calculated using the highest allowable rate, is assessed an AFC regardless of its funding history.[26]

Despite the statutory threshold of a 90 percent funding level for some plans to owe an AFC, in practice a plan needed to be much more poorly funded to become subject to an AFC. While about 10 plans in our sample each year had funding below 90 percent on a current liability basis, on average fewer than 3 plans each year owed an AFC (see fig. 4). From 1995 to 2002, only 6 of the 187 unique plans that composed the 100 largest plans each year were ever assessed an AFC,[27] and these plans owed an AFC a total of 23 times in years in which they were among the 100 largest plans. By the time a sponsor owed an AFC, its plan had an average funding level of 75 percent, suggesting that by the time the AFC was triggered, the plan's financial condition was weak. Further, while we observed 60 instances between 1995 and 2002 in which a plan had funding levels between 80 and 90 percent, only 5 times was a plan in this funding range subject to an AFC. This would indicate that, in practice, 80 percent represented the realistic funding threshold for owing or avoiding the AFC.

[26] The rules for determining the amount of the AFC are complex, but they generally call for sponsors to pay a percentage of their unfunded liability. Under current law, plans that owe an AFC may still apply FSA credits to meet their funding obligation and, therefore, may not be required to satisfy the AFC with a cash contribution.

[27] Unique plans refer to the number of plans we observed with distinct plan identifiers called EINs and PINs. See footnote 9 of GAO-05-294 for further information on why the actual number of completely unrelated plans in our sample may be lower than the 187 reported.

Figure 4: Most Plans Less Than 90 Percent Funded Were Not Assessed an AFC



Source: GAO analysis of PBGC Form 5500 research data.

Even with those plans subject to an AFC, other FSA credits may help a plan satisfy minimum funding obligations. Among plans in our sample assessed an AFC, the average annual AFC owed was $234 million, but annual contributions among this group averaged $186 million, with both figures in 2002 dollars. In addition, 61 percent of the time a plan was subject to an AFC, the sponsor used an existing credit balance to help satisfy its funding obligation. Over 30 percent of the time a plan was assessed an AFC, the funding rules allowed the sponsor to forgo a cash contribution altogether that year. Sponsors that owed an AFC had mixed success at improving their plans' financial conditions in subsequent years, and most of these plans remained significantly underfunded. Among the 6 plans that owed the AFC, funding levels rose slightly from an average 75 percent when the plan was first assessed an AFC to an average 76 percent, looking collectively at all subsequent years. All of these plans were assessed an AFC more than once.

Again, terminated plans provide a stark illustration of weaknesses in the rules' ability to ensure sufficient funding. Bethlehem Steel's plan was assessed an AFC of $181 million in 2002, but the company made no cash contribution that year, just as it had not in 2000 or 2001, years in which the plan was not assessed an AFC. When the plan terminated in late 2002, its assets covered less than half of the $7 billion in promised benefits. LTV Steel, which terminated its pension plan for hourly employees in 2002 with assets of $1.6 billion below the value of benefits, had its plan assessed an AFC each year from 2000 to 2002, but for only $2 million, $73 million, and $79 million, or no more than 5 percent of the eventual funding shortfall. Despite these AFC assessments, LTV Steel made no cash contributions to this plan from 2000 to 2002. Both plans were able to apply existing credits instead of cash to fully satisfy minimum funding requirements.

Large Plans' Sponsors' Credit Ratings Appear Related to Certain Funding Behavior and Represent Risk to PBGC

The recent funding experiences of large plans, especially those sponsored by financially weak firms, illustrate the limited effectiveness of certain current funding rules and represent a potentially large implicit financial risk to PBGC. The financial health of a plan sponsor may be key to plan funding decisions because sponsors must make funding and contribution decisions in the context of overall business operations. From 1995 to 2002, on average, 9 percent of the largest 100 plans were sponsored by a firm with a speculative grade credit rating, suggesting financial weakness and poor creditworthiness.[28]

Financial strength of plan sponsors' business operations has been a key determinant of risk to PBGC. Financially weak sponsors of large, underfunded plans are, by the nature of the insurance offered by PBGC, likely to cause the most financial burden to PBGC and other premium payers. For instance, PBGC typically trustees a plan when a covered sponsor is unable to financially support the plan, such as in the event of bankruptcy or insolvency. Current funding rules, coupled with the presence of PBGC insurance, may create incentives for financially distressed plan sponsors to avoid or postpone contributions and increase benefits. Many of the minimum funding rules are designed so that sponsors of ongoing plans may smooth contributions over a number of years. Sponsors that are in financial distress, however, may have a more

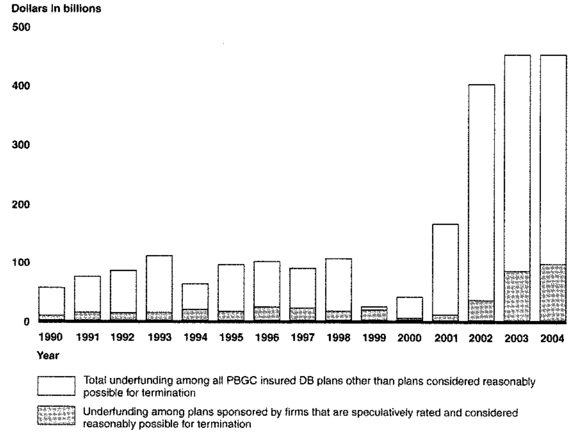
[28]Credit ratings are generally considered to be a useful proxy for a firm's financial health. A credit rating, generally speaking, is a rating service's current opinion of the creditworthiness of an obligor with respect to a financial obligation. It typically takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. Moody's and Standard and Poor's (S&P) are two examples of well-known ratings services.

limited time horizon and place other financial priorities above "funding up" their pension plans. To the extent that the presence of PBGC insurance causes financially troubled sponsors to alter their funding behavior, PBGC's potential exposure increases.

Underfunded plans sponsored by financially weak firms pose the greatest immediate threat to PBGC's single-employer plans. PBGC's best estimate of the total underfunding of plans sponsored by companies with credit ratings below investment grade and classified by PBGC as "reasonably possible" to terminate was an estimated $96 billion as of September 30, 2004 (see fig. 5).[29]

[29] Criteria used for classifying a plan as a reasonably possible termination include, but are not limited to, one or more of the following conditions: the plan sponsor is in Chapter 11 reorganization; funding waiver pending or outstanding with the Internal Revenue Service; sponsor missed minimum funding contribution; sponsor's bond rating is below-investment-grade for Standard & Poor's (BB+) or Moody's (Ba1); sponsor has no bond rating but unsecured debt is below investment grade; or sponsor has no bond rating, but the ratio of long-term debt plus unfunded benefit liability to market value of shares is 1.5 or greater.

Figure 5: Total Underfunding among All DB Plans, and among Those Considered by PBGC as Reasonably Possible for Termination, Has Increased Markedly since 2001



Source: PBGC 2003 annual data book and PBGC 2004 annual report.

Note: Underfunding figures for non-reasonably possible plans represent the end of the calendar year, except for 2004, which represents the end of fiscal year 2004 (September 30, 2004). Figures for reasonably possible plans are taken as of the end of each fiscal year.

Plans Sponsored by Financially Weak Firms Exhibit Riskier Funding Behavior

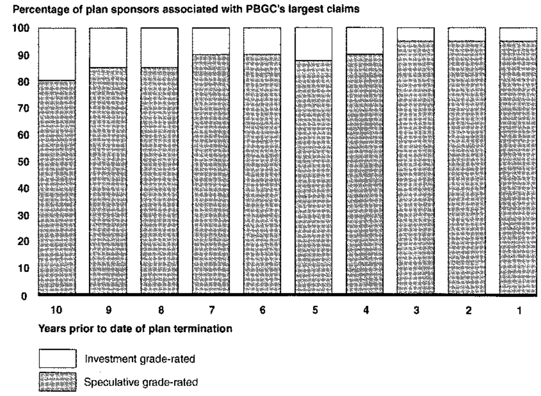
From 1995 to 2002, we observed that plans sponsored by speculative grade-rated firms had lower levels of average funding compared with the average for the 100 largest plans. For instance, the average funding of these plans was 12 percentage points lower on average than the funding level for all plans from 1995 to 2002. Plans sponsored by speculative grade-rated firms were also more likely to be underfunded. From 1995 to 2002, each year, on average, 18 percent of plans sponsored by speculative grade-rated firms had assets that were below 90 percent of current liability. Plans sponsored by nonspeculative grade-rated firms had just over half this incidence, or an average of 10 percent of plans funded below 90 percent of current liability.

Large plans sponsored by firms with a speculative grade rating were also more likely to incur an AFC. While plans sponsored by speculative grade-rated firms accounted for only 9 percent of all plans that we examined over the 1995 to 2002 period, they accounted for just over one-third of all instances in which a sponsor was required to pay an AFC. In contrast, no high investment grade sponsors (those rated AAA or AA) were required to pay an AFC for this period. While the AFC is intended to be a backstop for underfunded plans, to the extent that plans sponsored by speculative grade-rated firms are considered to pose a significant risk for near-term termination, it may not be an effective mechanism for improving a plan's funding level. Plans sponsored by firms that are in financial distress are, by definition, having difficulty paying off debts and may be ill equipped to afford increased contributions to their plan. That is, the AFC itself may be a symptom of plan distress rather than a solution to improve a plan's funding level.

Large plans with sponsors rated as speculative grade were also generally more likely to use the highest allowable interest rate to compute their current liability under the minimum funding rules. While a majority of sponsors from all credit rating categories used the highest allowable interest rate, over the entire 1995 to 2002 period, speculative grade-rated sponsors used the highest rate at an incidence 23 percentage points above the incidence for all other plans in the sample. The use of higher interest rates likely lowers a plan's reported current liability and minimum funding requirement. To the extent that this depresses cash contributions, such plans may have a higher chance of underfunding, thus creating additional financial risk to PBGC.

PBGC's claims experience shows that financially weak plans have been a source of substantial claims. Of the 41 largest claims in PBGC history in which a rating was known, 39 of the plan sponsors involved were credit rated as speculative grade at least 3 years prior to termination (see fig. 6). These claims account for 67 percent of the value of total gross claims on the single-employer program from 1975 to 2004. Most of the plan sponsors involved in these claims were given speculative grade ratings for many more years prior to their eventual termination. Even 10 years prior to plan termination, 33 of these 41 claims involved sponsors rated as speculative grade.

Figure 6: Over 80 Percent of Sponsors Associated with PBGC's Largest Termination Claims Had Speculative Grade Ratings 10 Years Prior to Termination



Source: PBGC.

Note: Based on 41 of PBGC's largest gross claims in which the rating of the sponsor was known, representing over 67 percent of total gross claims from 1975 to 2004. These 41 claims may include sponsors with more than one plan and are not limited to those plans in our sample. Ratings based on S&P rating.

Conclusions

Widely reported recent large plan terminations by bankrupt sponsors and the financial consequences for PBGC have pushed pension reform into the spotlight of national concern. Our analysis here suggests that certain aspects of the funding rules have contributed to the general underfunding of pensions and, indirectly, to PBGC's recent financial difficulties. The persistence of a large number of underfunded plans, even during the strong economic period of the late 1990s, implies that current funding rules are not stringent enough to ensure that sponsors can fund their pensions adequately. Further, the rules appear to lack strong mechanisms to compel sponsors to make regular contributions to their plans, even those that are underfunded or subject to an AFC. Perhaps most troubling is that current rules for measuring and reporting plan assets and liabilities may not reflect true current values and often understate the true degree of underfunding.

The current rules have the reasonable and important goals of long-term funding adequacy and short-term funding flexibility. However, our work shows that although the current system permits flexibility, it also permits reported plan funding to be inadequate, misleading, and opaque; even so, funding and contributions for some plans can still swing wildly from year to year. This would appear not to serve the interest of any DB pension stakeholders effectively. The challenge is determining how to achieve a balance of interests: how to temper the need for funding flexibility with accurate measurement, adequate funding, and appropriate transparency.

Despite flaws in the funding rules, our work here shows that most of the largest plans appear to be adequately funded. Rules should acknowledge that funding will vary with cyclical economic conditions, and even sponsors who make regular contributions may find their plans underfunded on occasion. Periodic and mild underfunding is not usually a major concern, but it becomes a threat to workers' and retirees' economic security in retirement and to PBGC when the sponsor becomes financially weak and the risk of bankruptcy and plan termination becomes likely. This suggests that perhaps the stringency of certain funding rules should be adjusted depending on the financial strength of the sponsor, with stronger sponsors being allowed greater latitude in funding and contributions than weaker sponsors that might present a near-term bankruptcy risk. However, focusing more stringent funding obligations on weak plans and sponsors alone may not be adequate, because strong companies and industries can quickly become risky ones, and, once sponsors and plans become too weak, it may be difficult for them to make larger contributions and still recover.

It should be noted also that while funding rule change is an essential piece of the overall reform puzzle, it is certainly not the only piece. Indeed, pension reform is a challenge precisely because of the necessity of fusing together so many complex, and sometimes competing, elements into a comprehensive proposal. Ideally, effective reform would

- improve the accuracy of plan asset and liability measurement while minimizing complexity and maintaining contribution flexibility;
- develop a PBGC insurance premium structure that charges sponsors fairly, based on the risk their plans pose to PBGC, and provides incentives for sponsors to fund plans adequately;
- address the issue of severely underfunded plans making lump-sum distributions;

- resolve outstanding controversies concerning cash balance and other hybrid plans by safeguarding the benefits of workers regardless of age; and
- improve plan information transparency for PBGC, plan participants, unions, and investors in a manner that does not add considerable burden to plan sponsors.

As deliberations on reform move forward, it will be important that each of these individual elements be designed so that all work in concert toward well-defined goals. Even with meaningful, carefully crafted reform, it is possible that some DB plan sponsors may choose to freeze or terminate their plans. While these are serious concerns, the overarching goals of balanced pension reform should be to protect the retirement benefits of American workers and retirees by providing employers reasonable funding flexibility while also holding those employers accountable for the promises they make to their employees.

As I noted in my opening remarks, PBGC's challenges parallel the challenges facing our Social Security system. While both programs have adequate current revenues and assets to pay promised benefits today, both face large and growing accumulated deficits on an accrual basis. Further, timely action to address both private pension and Social Security reform is needed. However, consideration must be given to the interactive effects of any such reforms and how they contribute to addressing our nation's large and growing fiscal challenge, key demographic, economic and workforce trends, and the economic security of Americans in their retirement years.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions you or other Members of the Committee may have.

Contact and Acknowledgments

For further information, please contact Barbara Bovbjerg at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this testimony. Other individuals making key contributions to this testimony included Charlie Jeszeck, Mark Glickman, and Chuck Ford.

United States Government Accountability Office

GAO

Report to Congressional Committees

May 2005

PRIVATE PENSIONS

Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules

GAO

Accountability * Integrity * Reliability

GAO-05-294

May 2005

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Highlights

Highlights of GAO-05-294, a report to congressional committees

PRIVATE PENSIONS

Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules

Why GAO Did This Study

Pension funding rules are intended to ensure that plans have sufficient assets to pay promised benefits to plan participants. However, recent terminations of large underfunded plans, along with continued widespread underfunding, suggest weaknesses in these rules that may threaten retirement incomes of these plans' participants, as well as the future viability of the Pension Benefit Guaranty Corporation (PBGC) single-employer insurance program. We have prepared this report under the Comptroller General's authority, and it is intended to assist the Congress in improving the financial stability of the defined benefit (DB) system and PBGC. We have addressed this report to each congressional committee of jurisdiction to help in their deliberations. This report examines: (1) the recent funding and contribution experience of the nation's largest private DB plans; (2) the funding and contribution experience of large underfunded plans, and the role of the additional funding charge (AFC); and (3) the implications of large plans' recent funding experiences for PBGC, in terms of risk to the agency's ability to insure benefits.

What GAO Recommends

The Congress should consider broad pension reform that is comprehensive in scope and balanced in effect. However, if features of current regulation are retained, Congress should consider measures to strengthen the AFC and limit the use of funding standard account credits to substitute for cash contributions.

www.gao.gov/cgi-bin/getrpt?GAO-05-294.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

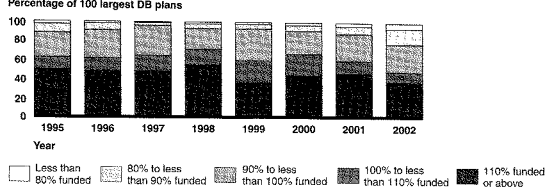
What GAO Found

Each year from 1995 to 2002, while most of the largest DB pension plans had assets that exceeded their current liabilities, 39 percent of plans on average were less than 100 percent funded. By 2002, almost one-fourth of the 100 largest plans were less than 90 percent funded. Further, because of leeway in the actuarial methodology and assumptions sponsors may use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported. Additionally, 62.5 percent of sponsors of the largest plans each year on average made no cash contribution because the rules allow sponsors to satisfy minimum funding requirements through plan accounting credits that substitute for cash contributions.

From 1995 to 2002, only 6 unique plans in our sample were subject to an additional funding charge (AFC), the primary funding mechanism to address underfunding, a total of 23 times. By the time a firm was subject to an AFC, its plan was likely significantly underfunded, and such plans remained poorly funded. By using other funding credits, just over 30 percent of the time sponsors of these plans were able to forgo cash contributions in the years their plans were assessed an AFC. Two very large and significantly underfunded plans terminated without their sponsors owing a cash contribution in the 3 years prior to termination, illustrating further weaknesses in the AFC.

To the extent that financially weak firms sponsor underfunded plans, weaknesses in funding rules create a potentially large financial risk to PBGC and thus retirement security generally. From 1995 to 2002, on average each year, 9 of the largest 100 plans had a sponsor with a speculative grade credit rating, suggesting financial weakness and poor creditworthiness. Plans of speculative grade-rated sponsors had lower average funding levels and were more likely to incur an AFC than other plans. As of September 30, 2004, PBGC estimated that plans of financially weak companies with a "reasonably possible" chance of termination had plans with an estimated $96 billion in underfunding.

Funding Levels among the Annual 100 Largest DB Plans, 1995–2002
Percentage of 100 largest DB plans



Source: GAO analysis of PBGC Form 5500 research data.

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Abbreviations

AFC	additional funding charge
DB	defined benefit
DRC	deficit reduction contribution
ERISA	Employee Retirement Income Security Act
FFL	full funding limitation
FSA	funding standard account
IRC	Internal Revenue Code
OBRA '87	Omnibus Budget Reconciliation Act of 1987
PBGC	Pension Benefit Guaranty Corporation
PRAD	Policy, Research and Analysis Department
S&P	Standard and Poor's

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

May 31, 2005

Congressional Committees

The Pension Benefit Guaranty Corporation's (PBGC) single-employer insurance program is a federal program that insures certain benefits of the more than 34 million worker, retiree, and separated vested participants of over 29,000 private sector defined benefit (DB) pension plans. In recent years, because of unfavorable economic conditions and the collapse of large underfunded pension plans sponsored by well-known firms like Bethlehem Steel, U.S. Airways, and United Airlines, the program's financial condition has worsened significantly. From a $9.7 billion surplus at the end of fiscal year 2000, the program reported a $23.3 billion deficit as of September 2004, including a $12.1 billion loss for fiscal year 2004.[1] In addition, financially weak firms sponsored DB plans with a combined $96 billion of underfunding as of September 2004, up from $35 billion as of 2 years earlier.[2] These figures illustrate both PBGC's current financial difficulties and the ongoing threat underfunded DB pension plans pose to the agency.

The Employee Retirement Income Security Act of 1974 (ERISA), as amended, and the Internal Revenue Code (IRC) prescribe pension funding rules to determine how much a firm sponsoring a DB pension plan (or "sponsor") must contribute to its plans each year.[3] An amendment to ERISA and the tax code added the additional funding charge (AFC), a

[1]This figure represents the excess of the net present value of PBGC's single-employer program's future benefit payments to participants of terminated plans, plus expenses, over the program's assets, plus anticipated losses from probable future terminations. The $23.3 billion deficit for fiscal year 2004 already includes the recent takeover by PBGC of several United Airlines pension plans.

[2]The recent downgrading of the credit ratings for Ford and General Motors to non-investment grade status is likely to raise this $96 billion figure significantly.

[3]For key legislative changes that have affected the single-employer program, see GAO, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90 (Washington, D.C.: Oct. 29, 2003), appendix II.

supplementary charge assessed to sponsors of certain underfunded plans.[4] While these funding rules seek to ensure that plans contain sufficient assets to pay promised pension benefits to plan participants, recent terminations of large and severely underfunded pension plans have called into question their effectiveness.

We have prepared this report under the Comptroller General's authority, and it is intended to assist the Congress in improving the financial stability of the defined benefit system and PBGC. As it may prove helpful in the deliberations of committees with jurisdiction over pension issues, we have addressed this report to each of these committees. In previous reports, we have called for comprehensive DB pension reform that, among other elements, would include changes to the current funding rules to encourage firms to better, and more transparently, fund their plans. We have also called for a range of PBGC insurance program and other related reforms.[5] Because of the risks facing the single-employer program, in July 2003 we placed the program on our high-risk list of government operations facing significant vulnerabilities.[6] Further, there are parallels between the financial problems of the DB pension system and those of Social Security, currently the focus of domestic public policy debate, as well as the broader long-term budgetary challenges facing the federal government.[7]

To assess how well the minimum funding rules have performed and to better understand how key rules work to protect plans from becoming severely underfunded, we will address the following issues: (1) the recent trend in funding and contribution behavior for the nation's largest private

[4]The AFC comprises different additional charges for specific underfunded plan liabilities, including the deficit reduction contribution, or DRC. Because the AFC combines the DRC with other charges and offsets, we refer to the AFC, instead of the DRC, throughout this report as the "bottom line" additional charge that some underfunded plans owe.

[5]Previously reported reforms include strengthening funding rules applicable to poorly funded plans; modifying PBGC single-employer program guarantees; restructuring PBGC premiums; and improving the availability of information about plan investments, termination funding status, and program guarantees. Several variations of reform were discussed within each reform option. For further information, see GAO-04-90.

[6]For further information on the challenges facing PBGC, see GAO, *Pension Benefit Guaranty Corporation Single-Employer Pension Insurance Program: Long-Term Vulnerabilities Warrant High-Risk Designation*, GAO-03-1050SP (Washington, D.C.: Jul. 23, 2003), and *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: Jan. 2005).

[7]See GAO, *21st Century Challenges: Re-Examining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: Feb. 2005).

DB plans, (2) the funding and contribution experience of large underfunded plans and the role of the AFC, and (3) the implications of large plans' recent funding experience for PBGC, in terms of risk to the agency's ability to insure benefits.

Our analysis focused on DB pension data for the 100 largest plans as ranked by current liabilities reported on Schedule B of the Form 5500[8] each year from 1995 to 2002, as well as on financial information on sponsors of these large plans.[9] For details on our scope and methodology, please see appendix I. Our work was done in accordance with generally accepted government auditing standards from November 2003 to May 2005.

Results in Brief

From 1995 to 2002, while most of the 100 largest plans had assets that exceeded their current liabilities, on average 39 of these plans each year were less than 100 percent funded on a current liability basis; that is, their plans' current liabilities exceeded plan assets reported at their actuarial value. Overall, reported plan funding levels were generally stable and strong over the late 1990s, with no more than 9 of the 100 largest plans less than 90 percent funded in any year from 1996 to 2000. However, by 2002 over half of the 100 largest plans were less than 100 percent funded, and approximately one-fourth of plans were less than 90 percent funded. Further, because of leeway in the actuarial methodology and assumptions that sponsors may use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported on the

[8]Form 5500 is a disclosure form that private sector employers with qualified pension plans are required to file with the Internal Revenue Service (IRS), Labor's Employee Benefit Security Administration (EBSA), and PBGC. IRS administers and enforces tax code provisions concerning private pension plans, EBSA enforces ERISA requirements regarding disclosure and other issues, and PBGC insures the benefits of participants in most private sector defined benefit pension plans that are eligible for preferential tax treatment.

[9]These 100 plans are not a "closed group." For example, a plan that is one of the 100 largest plans in one year may not be in the sample of plans if its liabilities are not in the 100 largest plans for other years. Twenty-five plans are in the sample every year from 1995 to 2002, and 51 plans are in at least 7 of the 8 years of the sample. From 1995 to 2002 we witness 187 distinct plan identifiers called the employee identification number (EIN) and plan identification number (PIN). However, the actual number of completely unrelated plans in our sample may be lower than the 187 reported because a number of plan sponsors in our sample merged or changed names. For various reasons, EINs and PINs used to identify Form 5500 filings can change throughout the life cycle of a plan. These changes can occur because of changes in corporate structure, the sale of a division or plant to another firm, or filer error.

Form 5500. Additionally, each year on average 62.5 percent of sponsors of the 100 largest plans made no annual cash contributions to their plans. One key reason for limited or no contributions is that the funding rules allow a sponsor to satisfy minimum funding requirements without necessarily making a cash contribution each year, even though the plan may be underfunded.

From 1995 to 2002, very few sponsors of the 100 largest plans were required to pay an additional funding charge (AFC), a funding mechanism designed to reduce severe plan underfunding. Most of the affected plans were less than 80 percent funded by the time they were assessed an AFC, and those that owed an AFC were likely to remain significantly underfunded and owe the AFC again in the future. Further, sponsors of 2 severely underfunded plans that terminated were sometimes subject to a small or no AFC, and made no cash contributions in the 3 years prior to termination. Because funding rules allow sponsors owing an AFC to use credits other than cash contributions to satisfy funding requirements, sponsors' contributions on average were less than the AFC assessed. Just over 30 percent of the time a plan was assessed an AFC, the sponsor of that plan did not make a cash contribution in the year that the AFC was assessed.

Underfunded plans sponsored by financially weak firms pose a greater risk to PBGC than do other plans. From 1995 to 2002, on average, 9 percent of the largest 100 plans each year had a sponsor with a speculative grade credit rating, suggesting these firms' financial weakness and poor creditworthiness. Firms with a speculative grade credit rating were more likely to sponsor underfunded plans, implying that these plans presented a significant risk to PBGC and other premium payers. As a group, these plans had lower average funding levels and were more likely to incur an AFC. In addition, speculative grade-rated sponsors generally had a higher incidence of using the highest legally allowable interest rate to discount reported plan liabilities. The use of higher interest rates tends to depict plan funding in a more optimistic light. To the extent that the interest rates used by plans are overly optimistic, these plans have the potential to create additional financial exposure and thus risk to PBGC. Of PBGC's 41 largest claims in which the rating of the sponsor was known, 39 have involved plan sponsors that were rated as speculative grade just prior to termination. Among these claims, over 80 percent of plan sponsors were rated as speculative grade 10 years prior to termination. The future outlook is similar: Plans sponsored by companies with speculative grade credit ratings and classified by PBGC as "reasonably possible" for termination represent an estimated $96 billion in potential claims.

Because the current DB pension funding rules appear to expose PBGC and participants to the risk that plans will have insufficient assets to pay promised benefits, this report raises two matters for congressional consideration. To the extent that the current funding framework is retained, these matters regard reforms to the funding rules that might be considered to reduce the number and severity of underfunded plans and the single-employer program's financial exposure.

Background

In DB plans, formulas set by the employer determine employee benefits. DB plan formulas vary widely, but benefits are frequently based on participant pay and years of service, and typically paid upon retirement as a lifetime annuity, or periodic payments until death.[10] Because DB plans promise to make payments in the future, and because tax-qualified DB plans must be funded, employers must use present value calculations to estimate the current value of promised benefits.[11] The calculations require making assumptions about factors that affect the amount and timing of benefit payments, such as an employee's retirement age and expected mortality, and about the expected return on plan assets, expressed in the form of an interest rate. The present value of accrued benefits calculated using mandated assumptions is known as a plan's "current liability." Current liability provides an estimate of the amount of assets a plan needs today to pay for promised benefits.

Before the enactment of ERISA, few rules governed the funding of DB pension plans, and participants had little assurance that they would receive the benefits promised. ERISA, and several amendments to the law

[10]Lifetime annuities may also offer the option of continuing payments to a survivor after the participant's death. Some DB plans also offer the option of taking benefits as a lump-sum payment. For more on pension dispositions, see GAO, *Private Pensions: Participants Need Information on Risks They Face in Managing Pension Assets at and during Retirement*, GAO-03-810 (Washington, D.C.: Jul. 29, 2003). In recent years, some sponsors have converted their traditional DB plans to so-called hybrid, or cash balance, plans. Cash balance plans are a form of defined benefit plan that determines benefits on the basis of hypothetical individual accounts and commonly offer a lump-sum feature. For more information on cash balance plans, see GAO, *Private Pensions: Implications of Conversions to Cash Balance Plans*, HEHS-00-185 (Washington, D.C.: Sept. 29, 2000), and *Cash Balance Plans: Implications for Retirement Income*. HEHS-00-207 (Washington, D.C.: Sept. 29, 2000).

[11]Present value calculations reflect the time value of money—that a dollar in the future is worth less than a dollar today, because the dollar today can be invested and earn interest. Using a higher interest rate will lower the present value of a stream of payments because it implies that a lower level of assets today will be able to fund those future payments.

since its passage, established minimum funding requirements for sponsors of pension plans in order to try to ensure that plans contain enough assets to pay promised benefits. In principle, a sponsor must annually fund the amount required to fund the plan's "normal cost," the amount of earned benefits allocated during that year, plus a specified portion of other liabilities that may be amortized over a period of years.

Compliance with the minimum funding requirements is recorded through the plan's funding standard account (FSA). The FSA tracks events that affect the financial health of a plan during that plan year: credits, which reflect improvements to the plan's assets, such as contributions, amortized experience gains,[12] and interest; and charges, which reflect an increase in the plan's financial requirements, such as the plan's normal cost and amortized charges such as the initial actuarial liability, experience losses, and increases in a plan's benefit formula.[13] If FSA credits exceed charges in a given plan year, the plan's FSA registers a net "credit balance" that may be carried forward to the next plan year; conversely, a prior year's funding deficiency also carries forward. The FSA credit balance at year-end is equal to the FSA credit balance at the beginning of the year plus FSA credits less FSA charges. Compliance with the minimum funding standard requires that the FSA balance at the end of the year is non-negative. An existing credit balance accrues interest and may be drawn upon to help satisfy minimum funding requirements for future plan years, and therefore may offset the need for future cash contributions.

ERISA and the IRC prescribe rules regarding the assumptions that sponsors must use to measure plan liabilities and assets. For example, for plan years 2004 and 2005, the IRC specifies that the interest rate used to calculate a plan's current liability must fall within 90 to 100 percent of the weighted average of the rate on an index of long-term investment-grade corporate bonds during the 4-year period ending on the last day before the

[12]Experience gains and losses reflect, among other things, the difference between actual asset performance and the assumed rates of return on assets for the plan, as reported in previous years.

[13]Plans may amortize experience gains or losses over a 5-year period. Changes in the terms of the plan arising from plan amendments may be amortized over a 30-year period. Thus, these events continue to affect the FSA and plan funding for several years after they occur.

beginning of the plan year.[14] Similarly, rules dictate that sponsors report an "actuarial" value of assets that must be based on reasonable assumptions and must take into account the assets' market value.[15] This value may differ in any given year, within a specified range,[16] from the current market value of plan assets, which plans also report. While different assumptions will change a plan's reported assets and liabilities, sponsors eventually must pay the amount of benefits promised; if the assumptions used to compute current liability differ from the plan's actual experience, current liability will differ from the amount of assets actually needed to pay benefits.[17]

Funding rules generally treat a plan as an ongoing entity, and plans do not necessarily have to maintain an asset level equal to current liabilities every year. However, the funding rules include certain mechanisms that are intended to keep plans from becoming too underfunded. One such mechanism is the AFC, introduced by the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). The AFC requires sponsors of plans with more than 100 participants that have become underfunded to a prescribed level to make additional plan contributions in order to prevent funding levels from falling too low. With some exceptions, plans with an actuarial value of assets below 90 percent of current liabilities are affected by the AFC

[14] The rate used to calculate current liability has usually been based on the 30-year Treasury bond rate, with the allowable range above and below the 4-year weighted average varying in different years. The Pension Funding Equity Act of 2004 replaced the Treasury bond rate with the corporate index for plan years 2004 and 2005. See IRC Section 412(b)(5)(B)(ii)(II). For further discussion of rates used to discount pension liabilities, see GAO, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, GAO-03-313 (Washington, D.C.: Feb. 27, 2003).

[15] 26 U.S.C. 412(c)(2)(A).

[16] Actuarial asset values cannot be consistently above or below market, but in a given year may be anywhere from 80 to 120 percent of the market asset level.

[17] A plan's current liability may differ from its "termination liability," which measures the value of accrued benefits using assumptions appropriate for a terminating plan. Sponsors are required to provide PBGC with termination liability information if, among other things, the aggregate unfunded vested benefits of plans maintained by the contributing sponsor and the members of its controlled group exceed $50 million. See 29 U.S.C. 1310. For further discussion of current versus termination liability, see GAO-04-90, appendix IV.

rules.[18] The rules for determining the amount of the AFC are complex, but they generally call for sponsors to pay a percentage of their unfunded liability. Under current law, plans that owe an AFC may still apply FSA credits to meet their funding obligation and therefore may not be required to satisfy the AFC with a cash contribution.

In addition to setting funding rules, ERISA established PBGC to guarantee the payment of the pension benefits of participants, subject to certain limits, in the event that the plan could not.[19] Under ERISA, the termination of a single-employer DB plan may result in an insurance claim with the single-employer program if the plan has insufficient assets to pay all benefits accrued under the plan up to the date of plan termination.[20] PBGC may pay only a portion of a participant's accrued benefit because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee benefits above a certain amount, currently $45,614 annually per participant at age 65.[21] Additionally, benefit increases arising from plan amendments in the 5 years immediately preceding plan termination are not fully guaranteed, although PBGC will pay a portion of

[18]A single-employer plan may be subject to an AFC in a plan year if plan assets fall below 90 percent of current liabilities. However, a plan is not subject to an AFC if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for at least 2 consecutive of the 3 immediately preceding years. To determine whether the AFC applies, the IRC requires sponsors to calculate current liabilities using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(l)(9)(C).

[19]Some DB plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer active participants.

[20]The termination of a fully funded DB plan is called a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company, under which the insurance company agrees to pay all accrued benefits, or by paying lump-sum benefits to participants if permissible. The termination of an underfunded plan, termed a distress termination, is allowed if the plan sponsor requests the termination and the sponsor satisfies other criteria. Alternatively, PBGC may initiate an "involuntary" termination. PBGC may institute proceedings to terminate a plan if the plan has not met the minimum funding standard, the plan will be unable to pay benefits when due, a reportable event has occurred, or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a).

[21]This guarantee level applies to plans that terminate in 2005. The amount guaranteed is adjusted (1) actuarially for the participant's age when PBGC first begins paying benefits and (2) if benefits are not paid as a single-life annuity. Because of the way ERISA allocates plan assets to participants, certain participants can receive more than the PBGC guaranteed amount.

these increases.[22] Further, PBGC's benefit guarantee is limited to the monthly straight life annuity benefit the participant would receive if she were to commence the annuity at the plan's normal retirement age.[23] Sponsors of PBGC-insured DB plans pay annual premiums to PBGC for their coverage. Premiums have two components: a per participant charge paid by all sponsors (currently $19 per participant), and a "variable-rate" premium that some underfunded plans pay based on the level of unfunded benefits.[24]

Despite the presence of minimum funding rules and the AFC, plan underfunding has persisted. In recent years, the level of total plan underfunding has increased rapidly, from about $39 billion in 2000 to an amount estimated to exceed $450 billion as of September 30, 2004. While the single-employer program has over $39 billion in assets to pay benefits in the near term, it already faces liabilities of over $62 billion. Thus, there is concern that the expected continued termination of large plans by bankrupt sponsors will push the program more quickly into insolvency, generating greater pressure on the Congress, and ultimately the taxpayers, to provide PBGC financial assistance to avoid reductions in guaranteed payments to retirees.[25] Because of concerns about the long-term viability of the single-employer program, as illustrated by its growing accumulated deficit (see fig. 1), in July 2003 we placed the program on GAO's high-risk list of agencies and programs that need broad-based transformations to address major challenges. In October 2003, we identified several

[22]The guaranteed amount of the benefit amendment is calculated by multiplying the number of years the benefit increase has been in effect, not to exceed 5 years, by the greater of (1) 20 percent of the monthly benefit increase calculated in accordance with PBGC regulations or (2) $20 per month. See 29 C.F.R. 4022.25(b).

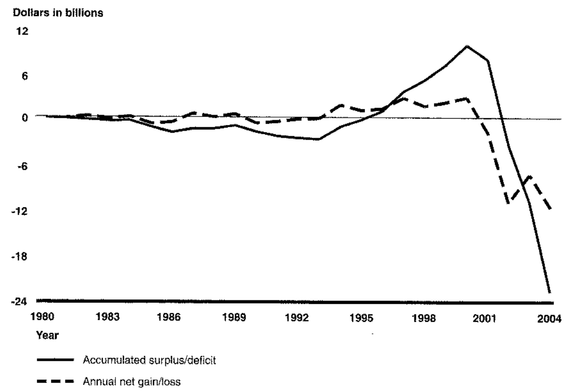
[23]For more on PBGC guarantee limits, see Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 1999* (Washington, D.C., Summer 2000), pp. 2-14.

[24]The additional premium equals $9.00 for each $1,000 (or fraction thereof) of unfunded vested benefits. However, no such premium is charged for any plan year if, as of the close of the preceding plan year, contributions to the plan for the preceding plan year were not less than the full funding limitation for the preceding plan year.

[25]PBGC has available a $100 million line of credit from the U.S. Treasury for liquidity purposes if funds generated from premium receipts and investment activities are insufficient to meet operating cash needs in any period. However, while PBGC is a government corporation under ERISA, it is not backed by the full faith and credit of the federal government. For projections of the magnitude and timing of insolvency of PBGC's single employer program, see, for example, "PBGC: Updated Cash Flow Model from COFFI," Center on Federal Financial Institutions (COFFI) (Washington, D.C.: Nov. 18, 2004).

categories of reform that the Congress might consider to strengthen the program over the long term. We concluded that the Congress should consider comprehensive reform measures to reduce the risks to the program's long-term financial viability.[26] These suggested reforms included strengthening funding rules, along with possibly modifying program guarantees; restructuring PBGC premiums; improving the transparency of plan and program information; and certain other reforms.

Figure 1: Accumulated Surplus/Deficit and Annual Net Gain/Loss of PBGC Single-Employer Program



Source: the Pension Benefit Guaranty Corporation.

GAO has a statutory responsibility for auditing the overall financial position of the executive branch of the U.S. government. In a recent report, we describe the serious challenges facing the nation from current fiscal policies that, if unchecked, will lead to large, escalating, and unsustainable budget deficits.[27] This fiscal challenge stems in part from

[26]GAO 04-90.

[27]See GAO-05-325SP.

increasing obligations of retirement-related programs like Social Security, which faces long-term financial insolvency because of increased life expectancy. Improvements in life expectancy have extended the average amount of time spent by workers in retirement, from 11.5 years in 1950 for the average male worker to 18 years as of 2003.

In February 2005, the Administration proposed several measures designed to strengthen funding for single-employer DB pension plans.[28] The main elements of reform include (1) reforming the funding rules to ensure that sponsors keep their retirement promises; (2) improving disclosure to workers, investors, and regulators about pension plan status; and (3) reforming premiums to better reflect a plan's risk and restoring the PBGC to financial health. The Administration asserts that such changes would shore up the structural problems in the DB system and strengthen the system's financial health.

Many of the 100 Largest Plans' Liabilities Exceeded Plan Assets from 1995 to 2002, and Few Sponsors Were Required to Make Cash Contributions

From 1995 to 2002, while most of the 100 largest plans had sufficient assets to cover their plan liabilities, many did not. On average, each year 39 of these plans were less than 100 percent funded, and 10 had assets below 90 percent of their current liabilities. Reported funding levels for the group generally were stable and strong from 1996 to 2000, but they worsened somewhat in 2001 before deteriorating noticeably in 2002. Furthermore, because of leeway in the actuarial methodology and assumptions sponsors may use to measure plan assets and liabilities, underfunding may actually have been more severe and widespread than reported at the end of the period. Because of flexible funding rules permitting the use of accounting credits other than cash contributions to satisfy minimum funding obligations, on average 62.5 of the 100 largest plans each year received no cash contributions from their sponsors, including 41 percent of plans that were less than 100 percent funded.

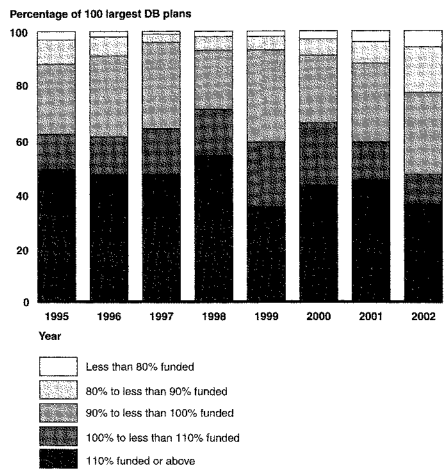
[28]See http://www.dol.gov/ebsa/pdf/SEPproposal2.pdf. Also see GAO-04-90, appendix III, for more discussion of the Administration's earlier pension reform proposal, announced on July 8, 2003.

Many Plans Each Year Were Underfunded, and More Became Underfunded in Recent Years

The 100 largest plans each year from 1995 to 2002 contained mostly well-funded plans. However, on average 39 of these plans each year were less than 100 percent funded; that is, for these plans, current liabilities exceeded the reported actuarial value of assets in the plan. An average of 10 plans each year had asset levels below 90 percent of their current liability, and 3 plans were less than 80 percent funded (see fig. 2).[29]

[29]An underfunded plan does not necessarily indicate that the sponsor is unable to pay current benefits. Underfunding means that the plan does not currently have enough assets to pay all accrued benefits, a portion of which will be paid in the future, under the given actuarial assumptions about asset rate of return, retirement age, mortality, and other factors that affect the amount and timing of benefits.

Figure 2: Almost One-Fourth of the Largest Pension Plans Were Less than 90 Percent Funded on a Current Liability Basis in 2002



Source: GAO analysis of PBGC Form 5500 research data.

As a group, funding levels among the 100 largest plans were reasonably stable and strong from 1996 to 2000. Except for 1999, in no year did more than 39 plans have liabilities exceeding assets, and no more than 9 plans each year were below 90 percent funded. In 2001 there were signs of increased underfunding, and by 2002, more than half of the largest plans were less than 100 percent funded, with 23 plans less than 90 percent funded. Two factors in the deterioration of many plans' finances were the decline in stock prices and in interest rates. From 2000 to 2002, the Standard & Poor's (S&P) 500 stock index declined sharply each year. Given that DB plans on average held approximately half of their assets in stocks from 1995 to 2000,[30] the decline in stock prices meant a sharp decline in the value of many plans' pension assets. In addition, over the sample period, 30-year Treasury bond rates, which served as the benchmark for the rate used by plans to calculate pension liabilities, generally fell steadily, raising liabilities.[31] The combination of lower asset values and higher pension liabilities had a serious adverse effect on overall defined benefit funding levels.

Rules May Allow Reported Funding Levels to Overstate Current Funding Levels

Accurate measurement of a plan's liabilities and assets is central to the sponsor's ability to maintain assets sufficient to pay promised benefits, as well as to the transparency of a plan's financial health. Because many plans chose allowable actuarial assumptions and asset valuation methods that may have altered their reported liabilities and assets relative to market levels, it is possible that funding over our sample period was actually worse than reported for a number of reasons. These include the use of above-market rates that differ from market values and the use of actuarial asset values that may differ from current asset values. Two large plans that terminated in 2002 illustrate the potential discrepancies between reported and actual funding.

Use of an Above-Market Interest Rate to Calculate Liabilities

Reported current liabilities are calculated using a weighted average of rates from the 4-year period before the plan year. This weighting offers sponsors the advantage of being able to smooth fluctuations in liabilities that sharp swings in interest rates would cause, thereby reducing volatility in minimum funding requirements and making funding more predictable. However, the weighting reduces the accuracy of liability measurement because the rate anchoring reported liabilities is likely to differ from current market values. If the rates used to calculate current liabilities are falling, this would have the effect of decreasing the rise in reported liabilities associated with lower rates, making plans appear better funded

[30]See Board of Governors of the Federal System, "Flow of Funds Accounts of the United States," Table L.119.b, Dec. 9, 2004. This approximation likely understates stock holdings as a share of pension assets, as DB plans also held assets in mutual fund shares, which may also contain stocks.

[31]Generally, a lower interest rate will raise plan liabilities, because a lower rate implies a lower rate of return on plan assets, requiring a higher level of assets to pay for benefits. However, in calculating current liabilities, the IRC allowed plans to use an interest rate above the benchmark 4-year weighted average, possibly offsetting the effects of lower rates on current liability. For example, sponsors could pick a rate up to 105 percent of the weighted average 30-year Treasury rate for plans in 1999; in 2002, this upper range was changed to 120 percent of the weighted average. See 26 U.S.C. 412(b)(5)(B).

than they actually were. In a rising interest rate environment, the opposite would be true. However, because rules allowed sponsors to measure liabilities using a rate above the 4-year weighted average, sponsors could reduce plan current liabilities compared with what their value would be if calculated at current rates.[32] The 4-year weighted average of the reference 30-year Treasury bond rate exceeded the current market rate in 76 percent of the months between 1995 and 2002, and the highest allowable rate for calculating current liabilities exceeded the current rate in 98 percent of those months. Sponsors of the plans in our sample chose the highest allowable interest rate to value their current liabilities 62 percent of the time from 1995 to 2002.

Use of Actuarial versus Current Asset Values

Similarly, for assets, the actuarial value of assets used for funding may differ from current market values. The actuarial value of assets cannot be consistently above or below market, but in a given year may be anywhere from 80 to 120 percent of market asset level. In our sample, 86 percent of plans reported a different value for actuarial and market assets. On average, using the market value instead of actuarial value of assets would have raised reported funding levels by 6.5 percent each year. However, while the market value exceeded actuarial value of assets during the late 1990s, when plan funding was generally strong, in the weaker funding year of 2002 market assets dipped below actuarial assets. In 2001 and 2002, calculating plan funding levels using market assets would have greatly increased the number of plans below 90 percent funded each year. A similar calculation for 2002 would have drastically increased the number of large plans below 80 percent funded, from 6 to 24. Thus, we see some evidence that using actuarial asset values lowered the volatility of reported funding levels relative to those using market asset values. However, the actuarial value of assets also may have disguised plans' funded status as their financial condition worsened.

[32]In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year, beginning with the 1995 plan year, to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The top of the permissible range was increased to 20 percent above the weighted average rate for 2002 and 2003. For 2004 and 2005, the Congress changed the reference rate from the 30-year Treasury bond rate to a rate based on long-term investment-grade corporate bonds, and reset the allowable range for plans to 90 to 100 percent of this rate.

Two Terminated Plans Showed Large Differences between Reported and Actual Funding

Some prominent recent plan terminations reveal some extreme discrepancies between reported plan funding levels and market funding levels. The Bethlehem Steel Corporation in 2002 reported that its plan was 85.2 percent funded on a current liability basis, yet the plan terminated later that year with assets of less than half of the value of promised benefits. The PBGC single-employer program suffered a $3.7 billion loss as a result of that termination, its largest ever at the time. Similarly, LTV Steel Company reported that its pension plan for hourly employees was over 80 percent funded on its Form 5500 filing for plan year 2001. When this plan terminated in March, 2002, it had assets equal to 52 percent of benefits, a shortfall of $1.6 billion.[33]

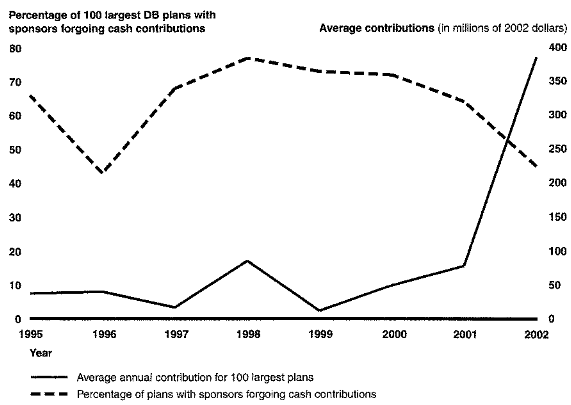
Most Sponsors Most Years Made No Cash Contributions to Plans but Satisfied Funding Requirements through Use of Accounting Credits

For the 1995 to 2002 period, the sponsors of the 100 largest plans each year on average made relatively small cash contributions to their plans. Annual cash contributions for the 100 largest plans averaged approximately $97 million on plans averaging $5.3 billion in current liabilities.[34] This average contribution level masks a large difference in contributions between 1995 and 2001, during which period annual contributions averaged $62 million (in 2002 dollars), and in 2002, when contributions increased significantly to $395 million per plan. Further, in 6 of the 8 years in our sample, a majority of the largest plans made no cash contribution to their plan (see fig. 3). On average each year, 62.5 plans received no cash contribution, including an annual average of 41 percent of plans that were less than 100 percent funded.

[33]Several factors may explain the wide discrepancy between reported funding levels and actual funding levels at termination. Reported funding levels may use an actuarial value of assets, which may exceed the market value at termination. In addition, termination liabilities are valued using a different interest rate than that used for current liabilities. Further, current liabilities and termination liabilities may be measured at different times. Unfunded shutdown benefits may also raise termination liabilities. For more discussion of the differences between termination and current liabilities, see GAO-04-90, appendix IV.

[34]Figures are in 2002 dollars. The $97 million in contributions includes contributions from both employers and employees, although the vast majority of contributions come from employers. For 1995, the data set contains only employer contributions.

Figure 3: Most Sponsors Made No Cash Contribution Most Years



Source: GAO analysis of PBGC Form 5500 research data.

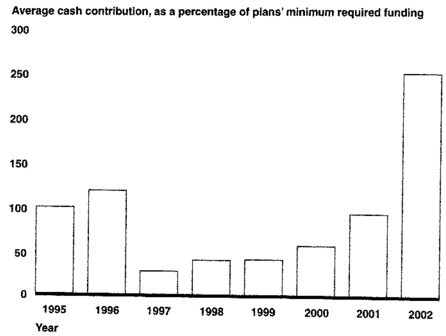
Note: Average contributions for 2002 are largely driven by one sponsor's contribution to its plan. Disregarding this $15.2 billion contribution reduces the average plan contribution for 2002 from $395 million to $246 million.

The funding rules allow sponsors to meet their plans' funding obligations through means other than cash contributions. If a plan has sufficient FSA credits from other sources, such as an existing credit balance or large interest or amortization credits, to at least match its FSA charges, then the plan does not have to make a cash contribution in that year. Because meeting minimum funding requirements depends on reconciling total annual credits and charges, and not specifically on cash contributions, these other credits can substitute for cash contributions.

From 1995 to 2002, it appears that many of the largest plan sponsors substituted a significant amount of FSA credits for cash contributions. The average plan's credit balance carried over from a prior plan year totaled about $572 million (2002 dollars) each year, and 88 percent of plans on average carried forward a prior credit balance into the next plan year from 1995 to 2002. Not only could these accumulated credit balances help a plan to meet minimum funding obligations in future years, but they also accrue interest that further augments a plan's FSA credits. In contrast to large prior-year credit balances, annual cash contributions averaged only $97 million, in 2002 dollars. On average each year, cash contributions represented 90 percent of the minimum required annual funding (from cash and credits).[35] However, this average figure was elevated by high levels of contributions by some plans in 1995, 1996 and 2002. From 1997 to 2000, when funding levels were generally strong, cash contributions averaged only 42 percent of minimum required annual contributions (see fig. 4). During these years, a majority of plans in our sample received no cash contribution (see fig. 5). Cash contributions represented a smaller percentage of annual minimum required funding during years when plans were generally well funded, indicating that in these years more plans relied more heavily on credits to meet minimum funding obligations.

[35]Minimum required annual funding equals annual total FSA charges, less net amortization credits and interest applied to these amortization credits.

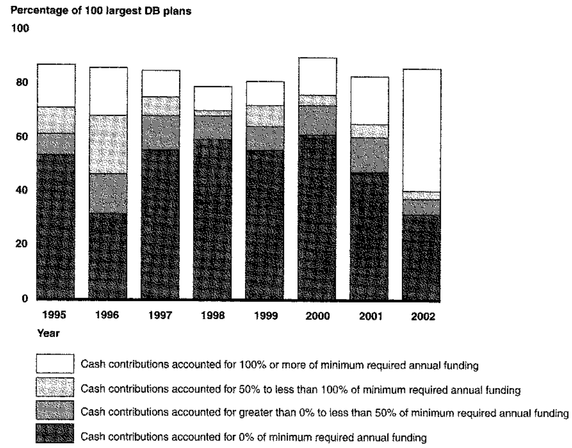
Figure 4: Average Cash Contributions, as a Percentage of Minimum Required Annual Funding, Were Lowest during Strong Funding Years



Source: GAO analysis of PBGC Form 5500 research data.

Note: This figure reports the average percentage across plans for each year. Minimum required annual funding equals total FSA charges, less amortization credits and interest on these credits. Sponsors can use other FSA credits, if applicable, to satisfy minimum funding requirements in lieu of cash. Plans with missing components of the minimum required annual funding calculation or with credits that exceed charges (1 plan per year on average) are excluded from the figure.

Figure 5: Distribution of Average Cash Contributions, as a Percentage of Minimum Required Annual Funding, Illustrates that Plans Relied More Heavily on FSA Credits to Meet Minimum Funding Obligations from 1997 to 2000



Source: GAO analysis of PBGC Form 5500 research data.

Note: Minimum required annual funding equals total FSA charges, less amortization credits and interest on these credits. Sponsors can use other FSA credits, if applicable, to satisfy minimum funding requirements in lieu of cash. Plans with missing components of the minimum required annual funding calculation or with credits that exceed charges (1 plan per year on average) are excluded from the figure.

In addition to large credit balances brought forward from prior years, sponsors added funding credits from other sources. For example, plans reported approximately $42 million (2002 dollars) each year in net interest credits. These credits accrue to a plan's FSA like interest on a bank account, accruing to an existing credit balance at the beginning of the plan year and to other credits, such as contributions, added during the plan year. Rules also allow plans to accrue credits from the excess of a plan's calculated minimum funding obligation above the plan's full funding limitation; these credits averaged $47 million (2002 dollars) from 1995 to 2002.[36] Other plan events result in plan charges, which reflect events that increase the plan's obligations. For example, plans reported annual amortization losses, which could result from actual investment rates of return on plan assets below assumed rates of return (including outright losses) or increases in the generosity of plan benefits; these net amortization charges averaged almost $28 million (2002 dollars) in our sample. Total funding credits, offset by charges, may help satisfy a plan's minimum funding obligation, substituting for cash contributions, and may explain why a significant number of sponsors made zero cash contributions to their plans in many years.

FSA Accounting Rules Can Make Required Contributions Less Volatile but May Obscure Funded Status and Reduce Contributions

The FSA credit accounting system provides some advantages to DB plan sponsors. Amortization rules require the sponsor to smooth certain events that affect plan finances over several years, and accumulated credit balances act as a buffer against swings in future funding requirements.[37] These features often allow sponsors to better regulate their annual level of contributions. In contrast, contributions and funding levels might fluctuate greatly from year to year if funding were based strictly on yearly differences between the market value of plan assets and current liabilities. Thus, a contribution system with an FSA accounting feature may make funding requirements less volatile and contributions more predictable than one in which funding was based entirely on current assets and liabilities. Similarly, current-law measurement and funding rules provide a plan with some ability to dampen volatility in required funding caused by economic events that may sharply change a plan's liabilities or assets. Pension experts told us that this predictability and flexibility make DB sponsorship more attractive to employers.[38]

[36] Full funding limitation rules set a ceiling for minimum annual funding requirements for a plan each year, based on the plan's liabilities.

[37] Some experts argue that since a pension plan represents a long-term financial commitment between a firm and its employees, and since current liability measures include many benefits that will not be paid until far in the future, it makes sense to smooth out year-to-year fluctuations rather than force each plan to balance assets and liabilities at all times.

[38] There are investment techniques, such as purchasing fixed income assets whose payouts match the plan's expected payouts, that could make pension funding relatively predictable, even without FSA smoothing. One possible reason that such techniques are not widely used may be they are believed to be more expensive, over the long term than an asset allocation with significant equity investment exposure.

However, the FSA accounting system, by smoothing annual contributions and liabilities, may distort a plan's funding level. For example, suppose a sponsor accrues a $1 million credit balance from making a contribution above the required minimum in a year. Suppose then that this $1 million purchases assets that lose all of their value by the following year. Even though the plan no longer had this $1 million in assets, the sponsor could still use that credit balance (plus interest on the credit balance) to reduce this year's contribution to the plan. Because of amortization rules, the sponsor would have to report only a portion of that lost $1 million in asset value as a plan charge the following year.[39] Similarly, sponsors are required to amortize the financial effect of a change in a plan's benefit formula, which might result in increased benefits and therefore a higher funding obligation, over a 30-year period. Thus, even though higher benefits would immediately raise a plan's obligation to fund, the sponsor could spread this effect in the plan's FSA over 30 years. This disconnection between the reported and current market condition of plan finances raises the risk that plans will not react quickly enough to deteriorating plan conditions. Further, it reduces the transparency of plan financial information to stakeholders, such as participants, and investors.

The experience of two large plans that terminated in a severely underfunded state help illustrate the potential disconnection between FSA accounting and the plan's true funded status. As stated earlier, the Bethlehem Steel Corporation and LTV Steel Company both had plans terminate in 2002, each with assets approximately equal to 50 percent of the value of benefits. Yet each plan was able to forgo a cash contribution each year from 2000 to 2002, instead using credits to satisfy minimum funding obligations, primarily from large accumulated credit balances from prior years. Despite being severely underfunded, each plan reported an existing credit balance in 2002, the year of termination (see table 1).

[39]Conversely, a plan that experiences a large gain in assets must spread this gain over several years, which would make the plan appear to be more poorly funded that it actually was.

Table 1: FSA Credits and Charges for Bethlehem Steel and LTV Steel Plans, 2000-2002

Figures in millions of dollars

	Bethlehem Steel			LTV Steel		
Year	**2000**	**2001**	**2002**	**2000**	**2001**	**2002**
Additional funding charge	0	0	181.2	2.2	73.3	79.4
Total FSA charges	277.0	281.0	457.9	351.8	342.9	179.4
Prior year credit balance	980.4	710.8	508.3	1294.3	1257.3	1169.2
Cash contribution	0	0	0	0	0	0
Total FSA credits	987.9	789.3	579.6	1609.1	1512.1	1218.5
End-of-year credit balance	710.8	508.3	121.7	1257.3	1169.2	1039.1
Funded percentage (actuarial assets/current liabilities)	85.8%	83.9%	85.2%	88.1%	81.6%	58.4%
Funded percentage at termination (plan assets/future benefits)			48.8%			51.9%

Source: GAO Analysis of PBGC Form 5500 research data.

Note: For funded percentage at termination represents market-valued assets as a percentage of PBGC-guaranteed benefits, plus any additional benefits funded by the plan's assets after allocation under section 4044 of ERISA. These benefits are valued at the PBGC interest rate, which is different than that used to value current liability on Form 5500. For more discussion of the differences between termination and current liabilities, see GAO-04-90, appendix IV.

Full Funding Limitation Rule May Have Allowed Some Plan Sponsors to Forgo Plan Contributions

Another possible explanation for the many instances in which sponsors made no annual cash contribution regards the full funding limitation (FFL). The FFL is a cap on minimum required contributions to plans that reach a certain funding level in a given plan year.[40] However, the FFL does not necessarily represent the contribution that would raise plan assets to the level of current liability. Between 1995 and 2002, rules permitted some plans with assets as low as 90 percent of current liability to reach the FFL, meaning that a plan could be considered fully funded without assets sufficient to cover all accrued benefits. The FFL is also distinct from the

[40] As with other funding rules, determining a plan's FFL is complicated. From 1995 to 2002, the FFL equaled the higher of (1) 90 percent of the plan's current liability or (2) the lower of (a) the accrued plan liability or (b) 150 to 170 percent (depending on the year) of the current liability. As of the 2004 plan year, the 150 to 170 percent measure no longer factors in the determination of the FFL. For our sample of plans, an average of 4 plans per year were above 150 to 170 percent (depending on the year) of the current liability and had an FFL of zero. This means the sponsors of these plans were most likely unable to make additional contributions unless they paid an excise tax.

plan's annual maximum tax-deductible contribution.[41] Because sponsors may be subject to an excise tax on contributions above the maximum, the annual maximum contribution can act as a real constraint on cash contributions. In contrast, the FFL represents a "maximum minimum" contribution for a sponsor in a given year—a ceiling on the sponsor's minimum funding obligation for the plan.

Flexibility in the FFL rule has allowed many plan sponsors to take steps to minimize their contributions. In our sample, from 1995 to 2002 approximately two-thirds of the sponsors in each year made an annual plan contribution at least as large as the plan's FFL. However, in 65 percent of these instances, the sponsor had chosen the highest allowable rate to calculate current liability; using a lower rate to calculate current liability may have resulted in a higher FFL, and therefore may have required a higher contribution. Further, the FFL was equal to zero for 60 percent of plans each year, on average. This means that these plans were permitted to forgo cash contributions as a result of the FFL rule. This reflects the fact that if a plan's FFL equaled zero, that plan had assets at least equal to 90 percent of current liabilities that year and would not be required to make an additional contribution.

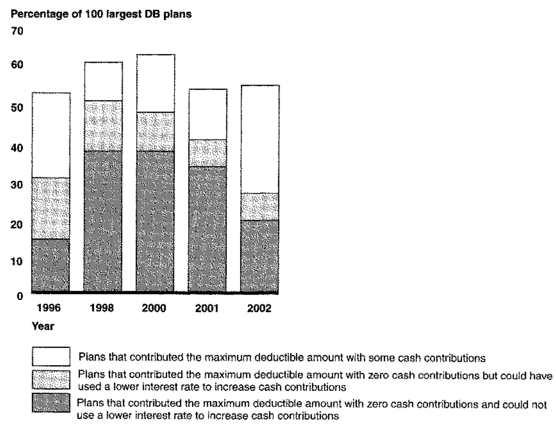
The interaction between the FFL rule and the annual maximum tax-deductible contribution also has implications for the amount that plan sponsors can contribute. In some years, the maximum deductible contribution rules truly constrained some sponsors from making any cash contribution. In 1998, 50 of 60 plans that contributed to the maximum deductible amount had a maximum deductible contribution of zero (see fig. 6). This meant that any cash contribution into those plans that year would generally subject the sponsor to an excise tax.[42] For 37 of these plans, this was the case even if the sponsor had chosen the lowest statutorily allowed interest rate for plan funding purposes, which would have produced the highest calculated current liabilities. This constraint did not apply to as many plans in some other years. For example, in 1996, 52 plans contributed the maximum deductible amount. Thirty of these

[41]A plan's maximum deductible contribution is based on some of the same criteria as the FFL determination. A sponsor may also contribute up to the unfunded current liability level in each year.

[42]For years after 2001, an employer may elect not to count contributions as nondeductible up to the full-funding limitation that is based on the accrued liability. Therefore, it could be possible for a sponsor to contribute more than the maximum deductible amount and still avoid the excise tax. See 26 U.S.C. 4972(c)(7).

plans had a maximum deductible contribution of zero. However, 16 of these 30 could have chosen a lower rate to raise their maximum deductible contribution level.

Figure 6: For Selected Years from 1996 to 2002, Most Sponsors Contributed the Plan's Maximum Deductible Amount, Which for a Number of Plans Was Zero



Source: GAO analysis of PBGC Form 5500 research data matched to PBGC study on maximum deductible cash contributions.

Note: Years of analysis are not continuous, as the PBGC study on maximum deductible contributions was conducted for years shown. Information on maximum deductible contributions is missing for between 7 and 17 plans each year. Data for these plans were either missing or incomplete to calculate the plan contributions with respect to the maximum deductible contribution.

Very Few Sponsors of Underfunded Large Plans Paid an AFC from 1995 to 2002

From 1995 to 2002, an average of only 2.9 of the 100 largest DB plans each year were assessed an additional funding charge, the funding mechanism designed to prevent severe plan underfunding, even though on average 10 percent of plans each year reported funding levels below 90 percent. Over the entire 8-year period, only 6 unique plans that placed among the 100 largest plans in any year from 1995 to 2002 owed an AFC. These 6 plans owed an AFC during the period a total of 23 times in years in which they were among the 100 largest plans, meaning that plans that were assessed an AFC were likely to owe it again. On average, by the time a plan was assessed an AFC, it was significantly underfunded and was likely to remain chronically underfunded in subsequent years. Further, during this period, 2 of these 6 plans that owed an AFC were terminated, each with assets far below promised benefits and each without having had to make a cash contribution in the 3 years prior to termination. As with plans in general, funding rules allowed sponsors owing an AFC to use FSA credits to help meet their funding obligations, in some years allowing sponsors to forgo cash contributions altogether.

Few Plans Were Assessed an AFC, and These Plans Were Likely to Be Very Underfunded

Funding rules dictate that a sponsor of a plan with more than 100 participants in which the plan's actuarial value of assets fall below 90 percent of liabilities, measured using the highest allowable interest rate, may be liable for an AFC in that year. More specifically, a plan that is between 80 and 90 percent funded is subject to an AFC unless the plan was at least 90 percent funded in at least 2 consecutive of the 3 previous plan years.[43] A plan with assets below 80 percent of liabilities, calculated using the highest allowable rate, is assessed an AFC regardless of its funding history.

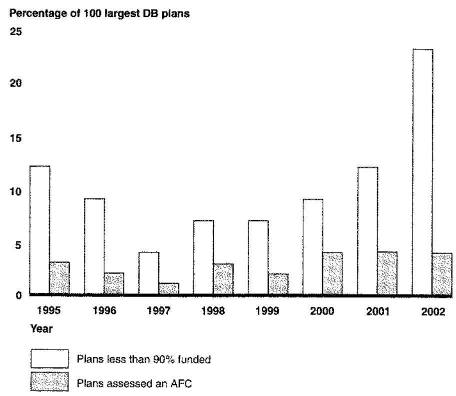
Despite the statutory threshold of a 90 percent funding level for some plans to owe an AFC, in practice a plan needed to be much more poorly funded to become subject to an AFC. While about 10 plans in our sample each year had funding below 90 percent on a current liability basis, on average fewer than 3 plans each year owed an AFC (see fig. 7). From 1995 to 2002, only 6 of the 187 unique plans that composed the 100 largest plans each year were ever assessed an AFC,[44] and these plans owed an AFC a total of 23 times in years in which they were among the 100 biggest plans. By the time a sponsor owed an AFC, its plan had an average funding level of 75 percent, suggesting that by the time the AFC was triggered, the plan's financial condition was weak. Further, while we observed 60 instances between 1995 and 2002 in which a plan had funding levels between 80 and 90 percent, only 5 times was a plan in this funding range subject to an

[43]For example, a sponsor of a plan that is 85 percent funded in 2003 would be exempt from the AFC only if the plan's funding level exceeded 90 percent in 2000 *and* 2001 or in 2001 *and* 2002. See 26 U.S.C. 412(l)(9)(C).

[44]Unique plans refer to the number of plans we observed with distinct plan identifiers called EINs and PINs. See footnote 9 for further information on why the actual number of completely unrelated plans in our sample may be lower than the 187 reported.

AFC. This would indicate that, in practice, 80 percent represented the realistic funding threshold for owing or avoiding the AFC.

Figure 7: Most Plans Less than 90 Percent Funded Were Not Assessed an AFC



Source: GAO analysis of PBGC Form 5500 research data.

AFC rules specify a current liability calculation method that may overstate actual plan funding, relative to using market measures, thereby reducing the number of plans that might be assessed an AFC. To determine if a sponsor owes an AFC, rules dictate that the sponsor calculate current liability using the highest allowable interest rate, which results in a plan's lowest possible measure of current liability. Because the highest allowable rate exceeded current market rates in 98 percent of the months from 1995 to 2002, this likely lowered current liability measures for AFC purposes, which would cause fewer plans to be assessed an AFC. In our sample, 5 plans that reported funding levels below 80 percent on a current liability basis did not owe an AFC, perhaps because current liability does not require the use of the highest allowable interest rate.

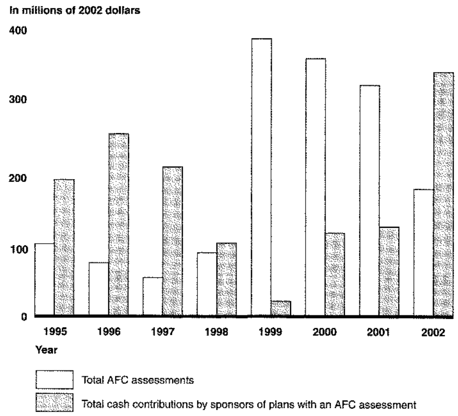
Sponsors that owed an AFC had mixed success at improving their plans' financial conditions in subsequent years, and most of these plans remained significantly underfunded. Among the 6 plans that owed the AFC at least once, funding levels rose slightly from an average 75 percent when the plan was first assessed an AFC to an average 76 percent, looking collectively at all subsequent years. All of these plans were assessed an AFC more than once, and 2 of the 6 plans terminated during the period, each with a severe shortfall of assets relative to promised benefits, creating large losses for PBGC's single-employer insurance program. Further, the AFC was an imperfect mechanism for improving funding of these plans prior to termination. Bethlehem Steel, which terminated its plan in 2002 with a funding level under 50 percent, was subject to an AFC that year, but not from 1997 to 2001. LTV Steel, which terminated its pension plan for hourly employees in 2002 with assets of $1.6 billion below the value of benefits, did have its plan assessed an AFC each year from 2000 to 2002, but for only $2 million, $73 million, and $79 million, or no more than 5 percent of the eventual funding shortfall. Despite these AFC assessments, LTV contributed no cash to its plan during those years, instead using credits to satisfy its funding obligations (see table 1).

Funding Rules Allow Underfunded Plans, Including Those Owing AFC, to Forgo Cash Contributions

While the formula to determine the amount is complex, the AFC equals approximately 18 to 30 percent of the plan's unfunded liability, with more underfunded plans owing a higher percentage than less underfunded plans.[45] However, the funding rules allow sponsors to use other FSA credits, in addition to cash contributions, to satisfy minimum funding obligations, including the AFC. Among plans in our sample assessed an AFC, the average annual AFC owed was $234 million, but annual contributions among this group averaged $186 million, with both figures in 2002 dollars (see fig. 8). In addition, 61 percent of the time a plan was subject to an AFC, the sponsor used an existing credit balance to help satisfy its funding obligation. When it did so, the sponsor drew $283 million from the credit balance—well above what sponsors owing an AFC contributed in cash, on average. Just over 30 percent of the time a plan was assessed an AFC, the funding rules allowed the sponsor to forgo a cash contribution altogether that year.

[45]The AFC represents the required payment in excess of the regular ERISA minimum contribution, plus other possible additional charges. A plan owing an AFC must pay between 18 and 30 percent of the plan's "unfunded new liability," or liability incurred by the plan since the start of 1988, plus other charges based on the plan's normal cost and other unfunded liabilities. See 26 U.S.C. 412(l).

Figure 8: AFC Assessments Sometimes Exceeded Cash Contributions of Plans Subject to AFC, 1995-2002



Source: GAO analysis of PBGC Form 5500 research data.

Again, terminated plans provide a stark illustration of weaknesses in the rules' ability to ensure sufficient funding. Bethlehem Steel's plan was assessed an AFC of $181 million in 2002, but the company made no cash contribution that year, just as it had not in 2000 or 2001, years in which the plan was not assessed an AFC. When the plan terminated in late 2002, its assets covered less than half of the $7 billion in promised benefits. Similarly, LTV Steel made no contributions to its plan from 2000 to 2002, despite being assessed an AFC in each of those years. Both plans were able to apply existing credits instead of cash to satisfy minimum funding requirements.

Large Plans' Sponsors' Credit Ratings Appear Related to Certain Funding Behavior and Represent Risk to PBGC

The recent funding experiences of large plans, especially those plans that are sponsored by financially weak firms, illustrate the limited effectiveness of certain current funding rules and represent a potentially large implicit financial risk to PBGC. From 1995 to 2002, on average, 9 percent of the largest 100 plans had a sponsor with a speculative grade credit rating, suggesting financial weakness and poor creditworthiness. As a group, speculative grade-rated sponsors had lower average funding levels, and were more likely to incur an AFC than other sponsors. In addition, speculative grade-rated sponsors generally had a higher incidence of using the highest legally allowable interest rate to discount reported plan liabilities. Using a higher interest rate lowers a plan's calculated current liabilities and may lower the plan's minimum funding requirement; to the extent that this reduces contributions, using the highest allowable interest rate may raise the chances of underfunding and raise the financial exposure to PBGC. Of PBGC's 41 largest claims since 1975 in which the rating of the sponsor was known, 39 have involved plan sponsors that were rated as speculative grade just prior to termination. Among these claims, over 80 percent of plan sponsors were rated as speculative grade 10 years prior to termination. The future outlook is similar: plans sponsored by companies with speculative grade credit ratings and classified by PBGC as "reasonably possible" of termination represent an estimated $96 billion in potential claims.

Speculative Grade Sponsors More Likely to Have Lower Funding Levels

The financial health of a plan sponsor may be key to plan funding decisions because sponsors must make funding and contribution decisions in the context of overall business operations. During our 1995 to 2002 sample period, we observed between 7 and 13 plans each year with sponsors that had a speculative grade credit rating.[46,47]

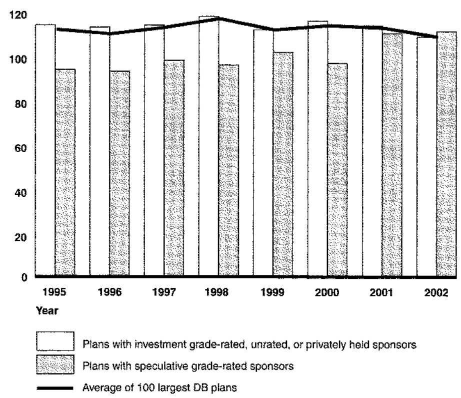
From 1995 to 2002, we observed that plans with speculative grade-rated sponsors had lower levels of average funding compared with the average for the 100 largest plans. For instance, the average funding of plans of sponsors that were rated as speculative grade was 12 percentage points lower on average than the funding level for all plans from 1995 to 2002 (see fig. 9). Applying an alternative measure of plan funding that used the reported market value measure of plan assets, we obtained broadly similar results.[48] Plans of speculative grade-rated sponsors were also more likely to be underfunded. From 1995 to 2002, each year, on average, 18 percent of speculative grade-rated plans had assets that were below 90 percent of current liability. Plans of nonspeculative grade-rated sponsors had just over half this incidence, or an average of 10 percent of plans funded below 90 percent of current liability.

[46]The number of plans per year in our sample sponsored by firms with a speculative grade rating is: 9 plans in 1995; 11 plans in 1996; 7 plans in 1997; 7 plans in 1998; 8 plans in 1999; 8 plans in 2000; 13 plans in 2001; and 12 plans in 2002.

[47]Credit ratings are generally considered to be a useful proxy for a firm's financial health. A credit rating, generally speaking, is a rating service's current opinion of the creditworthiness of an obligor with respect to a financial obligation. It typically takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. Moody's and Standard and Poor's (S&P) are two examples of well-known ratings services. We use S&P ratings throughout our report. S&P long-term credit ratings are divided into several categories ranging from AAA, reflecting the strongest credit quality, to D, reflecting the lowest. Ratings from AA to CCC may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories. The term "investment grade" was originally used by various regulatory bodies to connote obligations eligible for investment by institutions such as banks, insurance companies, and savings and loan associations. Over time, this term gained widespread usage throughout the investment community. Ratings in the four highest categories, AAA, AA, A, BBB, generally are recognized as being investment grade. Debt rated BB or below generally is referred to as speculative grade. Sometimes the term "junk bond" is used as a more irreverent expression for this category of riskier debt.

[48]Using reported market assets as the numerator of the funding percentage, the average funding of plans of sponsors that were rated as speculative grade was 17 percentage points lower on average than the funding level for all plans over the 1995-2002 period.

Figure 9: Plans Sponsored by Firms with a Speculative Grade Rating Generally Had Lower Levels of Funding on a Current Liability Basis



Source: GAO analysis of PBGC Form 5500 research data and COMPUSTAT data.

Large plans sponsored by firms with a speculative grade rating were also more likely to incur an AFC. While speculative grade-rated sponsors accounted for only 9 percent of all sponsors from 1995 to 2002, they accounted for just over one-third (8 of 23) of all instances in which a sponsor was required to pay an AFC.[49] No high investment grade sponsors (those rated AAA or AA) were required to pay an AFC for this period. While the AFC is intended to be a backstop for underfunded plans, for our sample, it affected only those plans that were rated A or lower. The AFC may, to some extent, protect PBGC from additional losses so plans cannot become even more underfunded, especially if the plan is at risk for financial distress. However, to the extent that speculative grade-rated sponsors are considered to pose a significant risk for near-term bankruptcy, the AFC may not be an effective mechanism for improving a

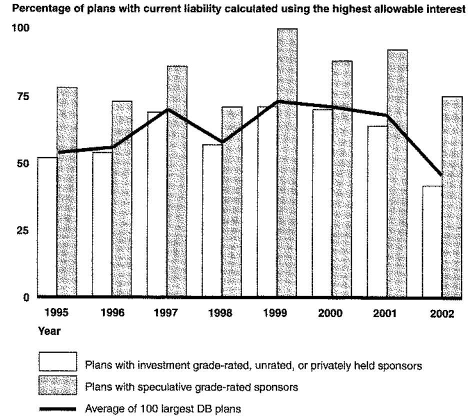
[49]Six sponsors had plans that were assessed an AFC a total of 23 times during the period.

plan's funding level. Plan sponsors that are in financial distress are, by definition, having difficulty paying off debts and may be ill equipped to increase cash contributions to their plan. That is, the AFC itself may be a symptom of plan distress rather than a solution to improve a plan's funding level. AAA or AA rated sponsors, on the other hand, were not assessed an AFC from 1995 to 2002, as they likely had the financial flexibility to increase contributions to avoid consistently falling below funding levels that would have triggered the AFC.

Large plans with sponsors rated as speculative grade were generally more likely to report current liabilities calculated by using the highest allowable interest rate under the minimum funding rules. While a majority of sponsors from all credit rating categories used the highest allowable interest rate over the entire 1995 to 2002 period, speculative grade-rated sponsors used the highest rate at an incidence 23 percentage points above the incidence for all other plans in the sample (see fig. 10). The use of higher interest rates likely lowers a plan's reported current liability and minimum funding requirement. To the extent that this depresses cash contributions, such plans may have a higher chance of underfunding, thus creating additional financial risk to PBGC.

Figure 10: Sponsors with Speculative Grade Ratings Are More Likely to Use the Highest Allowable Interest Rate to Estimate Current Plan Liabilities

Percentage of plans with current liability calculated using the highest allowable interest rate



Source: GAO analysis of PBGC Form 5500 research data and COMPUSTAT data.

Speculative Grade-Rated Sponsors Represent Greater Risks to PBGC

Financial strength of plan sponsors' business operations has been a key determinant of risk to PBGC. Financially weak sponsors are, by the nature of the insurance offered by PBGC, likely to cause the most financial burden to PBGC and other premium payers. For instance, PBGC typically trustees a plan when a covered sponsor is unable to financially support the plan, such as in the event of bankruptcy or insolvency.[50] Current funding rules, coupled with the presence of PBGC insurance, may create certain incentives for financially distressed plan sponsors to avoid or postpone contributions and increase benefits. Many of the minimum funding rules are designed so that sponsors of ongoing plans may smooth contributions over a number of years. Sponsors that are in financial distress, however, may have a more limited time horizon and place other financial priorities above "funding up" their pension plans. To the extent that moral hazard from the presence of PBGC insurance causes financially troubled sponsors to alter their funding behavior, PBGC's potential exposure increases.[51]

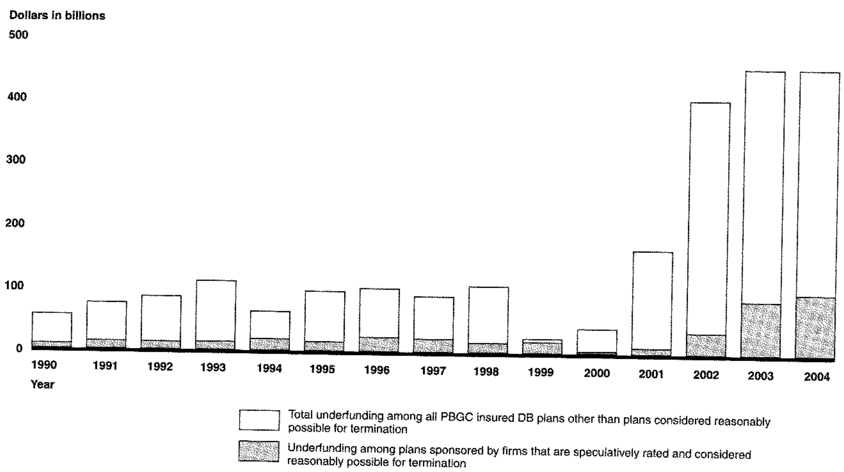
Underfunded plans sponsored by financially weak firms pose the greatest immediate threat to PBGC's single-employer program. PBGC's best estimate of the total underfunding of plans sponsored by companies with credit ratings below investment grade and classified by PBGC as reasonably possible to terminate was an estimated $96 billion as of September 30, 2004 (see fig. 11).[52]

[50]In particular, a distress termination of a single employer's plan may occur if the employer meets one of the following conditions: (1) liquidation in bankruptcy or insolvency proceedings, (2) reorganization in bankruptcy or insolvency proceedings where bankruptcy court determines termination is necessary to allow reorganization, or (3) termination in order to enable payment of debts while staying in business or to avoid unreasonably burdensome pension costs caused by a decline of the employer's covered workforce.

[51]For a discussion of moral hazard incentives, see GAO, *Private Pensions: Airline Plans' Underfunding Illustrates Broader Problems with the Defined Benefit Pension System*. GAO-05-108T (Washington, D.C.: Oct. 7, 2004).

[52]Criteria used for classifying a company as a reasonably possible include, but are not limited to, one or more of the following conditions: The plan sponsor is in Chapter 11 reorganization; funding waiver pending or outstanding with the IRS; sponsor missed minimum funding contribution; sponsor's bond rating is below-investment-grade for Standard & Poor's (BB+) or Moody's (Ba1); sponsor has no bond rating but unsecured debt is below investment grade; or sponsor has no bond rating, but the ratio of long-term debt plus unfunded benefit liability to market value of shares is 1.5 or greater.

Figure 11: Total Underfunding among All DB Plans, and among Those Considered by PBGC as Reasonably Possible for Termination, Has Increased Markedly since 2001



Source: PBGC 2003 annual data book and PBGC 2004 annual report.

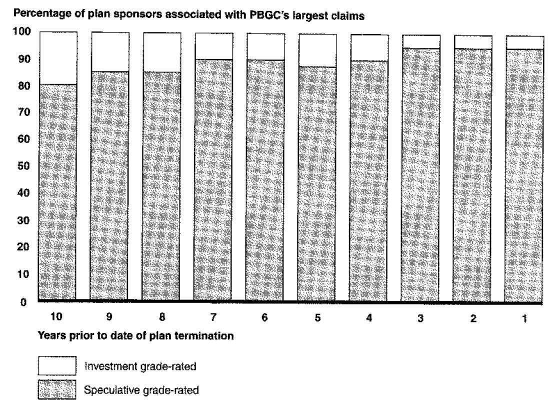
Note: Underfunding figures for non-reasonably possible plans represent the end of the calendar year, except for 2004, which represents the end of fiscal year 2004 (September 30, 2004). Figures for reasonably possible plans are taken as of the end of each fiscal year.

PBGC's claims experience shows that financially weak plans have been a source of substantial claims. Of the 41 largest claims in PBGC history in which a rating was known, 39 of the plan sponsors involved were credit rated as speculative grade 3 years prior to termination (see fig. 12). These claims account for 67 percent of the value of total gross claims on the single-employer program from 1975 to 2004.[53] Most of the plan sponsors involved in these claims were given speculative grade ratings for many more years prior to their eventual termination. Even 10 years prior to plan

[53]Gross claims are the present value of future benefits less trusteed plan assets.

termination, 33 of the 41 plan sponsors involved in the largest gross claims, in which the rating of the sponsor was known, were rated as speculative grade.[54]

Figure 12: Over 80 Percent of Sponsors Associated with PBGC's Largest Termination Claims Had Speculative Grade Ratings 10 Years prior to Termination



Source: PBGC.

Note: Based on 41 of PBGC's largest gross claims in which the rating of the sponsor was known, representing over 67 percent of total gross claims from 1975 to 2004. These 41 claims may include sponsors with more than one plan and are not limited to those plans in our sample. Ratings based on S&P rating.

[54]Speculative grade-rated issues tend to exhibit significant risk compared with other rated issues, even under short time horizons. Historical ratings indicate that speculative grade-rated plans are much more likely to default on obligations than investment grade-rated issues. For instance, over a 3-year period, the highest speculative grade (BB) rated issue defaults roughly 7 percent of the time, or 4.3 times more frequently than the lowest investment grade rating (BBB). Further, even lower-rated speculative grade issuers tend to have even higher default probabilities over a 3-year period—defaulting 19 and 45 percent of the time for B and CCC/C rated companies respectively. Typically, an issued rating does not change much from year to year. For example, looking at S&P ratings over the 1981-2003 period, AAA-rated issuers were still rated AAA 1 year later 88 percent of the time and B rated-issuers remained B 1 year later 74 percent of the time.

Conclusions

Widely reported recent large plan terminations by bankrupt sponsors and the financial consequences for PBGC have pushed pension reform into the spotlight of national concern. Our past work has shown that the roots of these current pension problems are broad and structural in nature, and that the private DB pension system requires meaningful and comprehensive reform. The Administration has already presented a proposal for reform and others may soon emerge from the Congress. While the complexity of the challenges suggests a considerable debate ahead, the emerging consensus that action needs to be taken may be cause for optimism.

Our analysis here examines the effectiveness of certain funding rules and suggests that these rules have contributed to the general underfunding of pensions and, indirectly, to PBGC's recent financial difficulties. The persistence of a large number of underfunded plans, even during the strong economic period of the late 1990s, implies that current funding rules are not stringent enough to ensure that sponsors can fund their pensions adequately. Perhaps even more troubling is that current rules for measuring and reporting plan assets and liabilities may not reflect true current values and may understate the funding problem. Further, the very small number of sponsors of underfunded plans that pay the AFC indicates that the rule needs to be strengthened if it is to serve as the primary mechanism for shoring up assets in underfunded plans.

The current rules have the reasonable and important goals of long-term funding adequacy and short-term funding flexibility so as to reduce annual contribution volatility. However, our work shows that although the current system permits flexibility, it also permits reported plan funding to be inadequate, misleading, and opaque, and even so, funding and contributions for some plans can still swing wildly from year to year. This would appear not to serve the interest of any DB pension stakeholders effectively. The challenge is determining how to achieve a balance of interests: how to temper the need for funding flexibility with accurate measurement, adequate funding, and appropriate transparency. Our work shows that although the current system permits flexibility, it also permits reported plan funding to be inadequate, misleading, and opaque, and even so, funding and contributions for some plans can still swing wildly from year to year. This would appear not to serve the interest of any DB pension stakeholders effectively.

Despite flaws in the funding rules, our work here shows that most of the largest plans appear to be adequately funded. Rules should acknowledge that funding will vary with cyclical economic conditions, and even sponsors who make regular contributions may find their plans underfunded on occasion. Periodic and mild underfunding is not usually a major concern, but it becomes a threat to workers' benefits and to PBGC when the sponsor becomes financially weak and the risk of bankruptcy and plan termination becomes likely. This suggests that perhaps the stringency of certain funding rules can be adjusted depending on the financial strength of the sponsor, with stronger sponsors being allowed greater latitude in funding and contributions than weaker sponsors that might present a near-term bankruptcy risk.[55] However, focusing more stringent funding obligations on weak plans and sponsors is difficult in that strong firms and industries can quickly become risky ones, and once sponsors and plans become too weak, it may be difficult for them to make larger contributions and still recover.

It should be noted also that while change in the funding rules is an essential piece of the reform puzzle, it is certainly not the only piece. Indeed, pension reform is a challenge precisely because of the necessity of fusing together so many complex, and sometimes competing, elements into a comprehensive proposal. Ideally, effective reform would

- improve the accuracy of plan asset and liability measurement while minimizing complexity and maintaining contribution flexibility;
- develop a PBGC insurance premium structure that charges sponsors fairly, based on the risk their plans pose to PBGC, and provides incentives for sponsors to fund plans adequately;
- address the issue of severely underfunded plans making lump-sum payments;
- resolve outstanding controversies concerning cash balance and other hybrid plans by safeguarding the benefits of workers regardless of age; and
- improve plan information transparency for PBGC, plan participants, unions, and investors in a manner that does not add considerable burden to plan sponsors.

[55]The Administration proposal moves in this direction by suggesting sponsors of different financial strength have different funding targets. See *Strengthen Funding for Single Employer Pension Plans*, U.S. Department of Labor, Employee Benefits Security Administration, February 7, 2005.

Developed in isolation, solutions to some of these concerns could erode the effectiveness of other reform components or introduce needless complexity. As deliberations on reform move forward, it will be important that each of these individual elements be designed so that all work in concert toward well-defined goals.

This reform effort should also be understood in the context of the problems facing other components of retirement security and the federal budget generally. For example, Social Security, Medicare, and Medicaid serve the larger population of retired and disabled workers, many of whom are also affected by DB reform. The demographic dynamics of increased longevity in life and retirement affecting the DB system also affect these other programs, intensifying existing fiscal pressures on the federal budget. Thus, DB pension reform, with these other issues, has important implications both for the distribution of retirement income for current and future generations and for our overall success in addressing these broader budgetary challenges.[56]

Even with meaningful, carefully crafted reform, it is possible that some DB plan sponsors may choose to freeze or terminate their plans. Sponsor exit is a serious concern, given the important role DB plans play in providing retirement security. However, this is a natural consequence of the inherent trade-off that exists in a private pension system that on one hand depends on voluntary plan sponsorship and on the other is tax subsidized and backed by federal insurance in order to promote the retirement security of our nation's workers. The overarching goals of balanced pension reform, and particularly of funding rule reform, should be to protect workers' benefits by providing employers the flexibility they need in managing their pension plans while also holding those employers accountable for the promises they make to their employees.

[56]For more discussion, see GAO-04-325SP, pp. 54-57.

Matters for Congressional Consideration

As we have noted in previous reports,[57] the Congress should consider broad pension reform that is comprehensive in scope and balanced in effect. Along with changes in the areas of PBGC's premium structure, lump-sum distributions, shutdown benefits, and other areas, funding rule changes should be an essential element of DB pension reform. Such reform may result in a system with features very different from the framework currently governing DB plans and PBGC. However, significant reforms that would place the DB system and PBGC on a sounder financial footing could also be enacted and could retain many of the features of the current regulatory system. Should the Congress choose to move in this latter direction, this report highlights certain areas where carefully crafted changes could improve plan funding. Specifically, the Congress should consider measures that include

- **Strengthening the additional funding charge**. One way to do this would be to consider raising the threshold levels of funding that trigger the AFC so that any sponsor with a plan less than 90 percent funded would have to make additional contributions. So that plans do not have an incentive to fund just barely above 90 percent, additional consideration may be given for a gradual phase-in of the AFC for plans that are underfunded between 90 percent and 100 percent of current liability. Requiring that financially weak plans that owe an AFC base their contributions on termination liability rather than current liability might add stringency to the minimum funding rules and might be appropriate, since weak sponsors of underfunded plans present a greater risk of distress termination to PBGC than other sponsors. These reforms could be enacted singly or jointly, but each would subject more plans to an AFC, and the reforms would shore up at-risk plans before underfunding becomes severe.

- **Limiting the use of FSA credits toward meeting minimum funding requirements.** We have noted that some sponsors repeatedly relied on FSA credits, such as a prior year credit balance or net interest credits, to avoid making cash contributions to their plans, and that this has been particularly problematic for underfunded plans prior to their

[57]See GAO-04-90; GAO-05-108T; GAO, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-03-873T (Washington, D.C.: Sept. 4, 2003); *Pension Benefit Guaranty Corporation: Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform*, GAO-04-150T (Washington, D.C.: Oct. 14, 2003); *Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding*, GAO-04-176T (Washington, D.C.: Oct. 29, 2003).

termination. While FSA credits may have the benefit of moderating contribution volatility in the near term, they also have the weakness of allowing the sponsors of severely underfunded plans to avoid cash contributions and may contribute to volatility later. The Congress should consider ways, even if it retains the FSA, to scale back the substitution of credits for annual cash contributions.

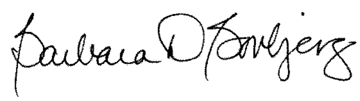
While admittedly an extremely complicated matter, meaningful effective reform must confront the issue of accurate measurement. We found that that the measurement techniques of assets and liabilities that are permitted under current funding rules can result in distortions masking the true funding status of a plan and can permit sponsors to avoid making plan contributions. Techniques that lead to misleading indicators of plan health and impede information transparency are a disservice to all key stakeholders; to plan participants in making retirement decisions; to unions seeking to bargain in the interests of their members; to current and potential shareholders in deciding where to invest; and finally to the public, which is the ultimate protector of employee benefits.

Agency Comments

We provided a draft of this report to the Department of Labor, Treasury, and PBGC. The Department of Labor and PBGC provided written comments, which appear in appendix III and appendix IV. Both the Department of Labor's and PBGC's comments generally agree with the findings and conclusions of our report. Treasury did not provide written comments. The Department of Labor, Treasury, and PBGC also provided technical comments, which we incorporated as appropriate.

We are sending copies of this report to the Secretary of Labor, the Secretary of the Treasury, and the Executive Director of the PBGC, appropriate congressional committees, and other interested parties. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact me at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made contributions are listed in appendix V.



Barbara Bovbjerg, Director
Education, Workforce, and Income Security Issues

List of Congressional Committees

The Honorable Charles E. Grassley
Chairman
The Honorable Max Baucus
Ranking Minority Member
Committee on Finance
United States Senate

The Honorable Michael B. Enzi
Chairman
The Honorable Edward M. Kennedy
Ranking Minority Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable John A. Boehner
Chairman
The Honorable George Miller
Ranking Minority Member
Committee on Education and the Workforce
House of Representatives

The Honorable William M. Thomas
Chairman
The Honorable Charles B. Rangel
Ranking Minority Member
Committee on Ways and Means
House of Representatives

Appendix I: Scope and Methodology

To describe recent pension funding trends, we analyzed data from Schedule B of the Form 5500. This schedule contains information on plan assets, liabilities, contributions, funding standard account (FSA) credits and charges, and additional funding charge (AFC) calculations.

Problems with the electronic data of the Form 5500 are well documented.[1] To mitigate problems associated with the data we used Form 5500 research data from the Pension Benefit Guaranty Corporation's (PBGC) Policy, Research and Analysis Department (PRAD). PRAD analysts routinely and systematically correct the raw 5500 data submitted by plans, and PRAD 5500 data are thought to be the most accurate electronic versions. Although we did not independently audit the veracity of the PRAD data, we performed routine data reliability checks. In instances where the data reliability checks revealed inconsistencies, we contacted a PRAD analyst to check and, if appropriate, correct the electronic data using information provided to PRAD in hard copy.

For our analysis, we worked with a subset of the PBGC research data that included the 100 largest plans, measured by current liability, annually from 1995 to 2002.[2] In 2002, the most recent, nearly complete year of available Form 5500 data, these 100 plans, with average liabilities per plan of $6.7 billion and 94,000 participants, represented approximately 50 percent of the total liabilities and about 28 percent of the total participants of the approximately 30,000 defined benefit (DB) plans that filed a Form 5500 for plan year 2002 as of February 2005. Thus, while our sample data set represents only a small portion of the total plans in the single-employer program, it constitutes a significant proportion of the liabilities of the DB system and the financial risk to PBGC while allowing for more manageable analysis. We did not directly test or compare our sample for generalizability across the entire sample of single-employer plans.

[1]See GAO, *Private Pensions: Participants Need Information on the Risks of Investing in Employer Securities and the Benefits of Diversification*, GAO-02-943 (Washington, D.C.: Sept. 6, 2002); *Retirement Income Data: Improvements Could Better Support Analysis of Future Retirees' Prospects*, GAO-03-337 (Washington, D.C.: Mar. 21, 2003); *Private Pensions: Multiemployer Plans Face Short- and Long-Term Challenges*, GAO-04-423 (Washington, D.C.: Mar. 26, 2004); and *Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition*, GAO-04-395 (Washington, D.C.: Mar. 31, 2004).

[2]Each year, our sample contains a new set of 100 largest plans based on the plan liabilities in that year. That is, from year to year, the 100 largest plans will add and subtract plans from other years' 100 largest plans.

For 1999 and 2002, the best available data do not contain all possible plans, and therefore it is possible that in those years complete data sets would yield slightly different samples for our analysis. The 1999 data we received from PBGC came from a sample that was missing an estimated 2,927 of the 37,536 plans in the single-employer program, because of missing electronic records in that year. The 2002 data came from a sample still missing approximately 300 plans, because of ongoing processing. We believe that neither of these factors significantly affects our findings or our conclusions.

To identify how the AFC is calculated and applied, we studied how the relevant Employee Retirement Security Act of 1974 (ERISA) and Internal Revenue Code (IRC) funding rules are applied, conducted a literature review, and interviewed researchers, government officials, pension actuaries, and pension sponsor groups familiar with pension funding rules. To analyze potential risk to PBGC, we matched sponsor credit ratings from the Standard and Poor's (S&P) COMPUSTAT database, provided to us by PBGC, to the sponsor's pension plan data.[3] PBGC also provided us with detailed calculations to determine plans' full funding limitations for purposes of the minimum funding requirements. Additionally, to analyze effects of maximum deductible contributions, we matched the results from a previously issued PBGC study on the subject to our sample of plans. Our work was done in accordance with generally accepted government auditing standards.

[3]In each year of data we matched the relevant December ratings issue for that year. Plans sponsored by a company subsidiary were given the rating of the parent unless the subsidiary had its own rating. Additionally, the same sponsor may sponsor a number of plans in the largest 100 plans for any given year. We observe a number of sponsors with multiple plans in any given year of our sample.

Appendix II: Statistics for Largest 100 Defined Benefit Plans, 1995-2002

Table 2: Average Plan Size and Funding Levels

(Dollar figures in millions of 2002 dollars)

	Mean	Median
Current liability	$5,341.6	$3,065.7
Actuarial asset levels	$6,019.3	$3,397.9
Number of participants (actual)	80,431	59,508
Plan funding levels[a]	112.7%	106.2%
Plans below 100% funded	38.9	
Plans below 90% funded	10.4	
Plans below 80% funded	2.9	
Funding gap, plans below 100% funded[b]	$425.7	$215.7
Plans using highest allowable interest rate to calculate liabilities	62.0%	

Source: GAO analysis of PBGC Form 5500 research data.

Notes: All figures represent per plan annual averages, from 1995 to 2002, except as described differently. Annual dollar figures adjusted to 2002 dollars using annual consumer price index (CPI) data.

Median figures reported are the average of individual year median values.

For analysis, each year contains that year's 100 largest plans, ranked by current liabilities. From 1995 to 2002, 187 unique plans appear in at least 1 year's sample of 100 largest plans. See footnote 9 in main text for further explanation.

[a]Funding levels calculated using actuarially measured assets as a percentage of current liabilities.

[b]Funding gap equals current liabilities less actuarially valued assets, for underfunded plans.

Table 3: Cash Contributions

(Dollar figures in millions of 2002 dollars)

	Mean	Median
Total cash contributions	$97.4	$9.4
Contributions/minimum funding obligation	90.5%	19.1%
Sponsors forgoing cash contributions	62.5%	
Underfunded plans receiving no cash contribution	41.1%	

Source: GAO analysis of PBGC Form 5500 research data.

Notes: All figures represent per plan annual averages, from 1995 to 2002, except as described differently. Annual dollar figures adjusted to 2002 dollars using annual CPI data.

Median figures reported are the average of individual year median values.

For analysis, each year contains that year's 100 largest plans, ranked by current liabilities. From 1995 to 2002, 187 unique plans appear in at least 1 year's sample of 100 largest plans. See footnote 9 in main text for further explanation.

Table 4: Funding Standard Account (FSA) Credits, Other than Cash Contributions

(Dollar figures in millions of 2002 dollars)

	Mean	Median
Plans drawing down accumulated credit balance	15.4%	
Accumulated credit balance from prior years	$573.7	$123.4
Net amortization credits	-$27.8	$0
Full funding limitation credits	$46.7	$17.0
Net interest credits	$42.2	$4.9

Source: GAO analysis of PBGC Form 5500 research data.

Notes: All figures represent per plan annual averages, from 1995 to 2002, except as described differently. Annual dollar figures adjusted to 2002 dollars using annual CPI data.

Median figures reported are the average of individual year median values.

For analysis, each year contains that year's 100 largest plans, ranked by current liabilities. From 1995 to 2002, 187 unique plans appear in at least 1 year's sample of 100 largest plans. See footnote 9 in main text for further explanation.

Table 5: Full Funding Limitation (FFL)

(Dollar figures in millions of 2002 dollars)

	Mean	Median
FFL amount	$645.6	$24.3
Plans with FFL = 0	60.1%	
Sponsors contributing at least as much as FFL	64.4%	
Instances in which plan making contribution at least equal to FFL used highest allowable interest rate	65.5%	

Source: GAO analysis of PBGC Form 5500 research data.

Notes: All figures represent per plan annual averages, from 1995 to 2002, except as described differently. Annual dollar figures adjusted to 2002 dollars using annual CPI data.

Median figures reported are the average of individual year median values.

For analysis, each year contains that year's 100 largest plans, ranked by current liabilities. From 1995 to 2002, 187 unique plans appear in at least 1 year's sample of 100 largest plans. See footnote 9 in main text for further explanation.

Table 6: Additional Funding Charge (AFC)

Dollar figures in millions of 2002 dollars	Mean	Median
Plans subject to AFC[a]	2.9	
AFC amount assessed	$234.1	$148.2
Current liabilities of plans subject to AFC	$3,836.7	$3,693.6
Funding gap of plan assessed an AFC	$837.1	$953.0
Funded percentage of plan subject to AFC	78.2%	74.7%
Plans below 90% funded subject to AFC	27.7%	
Plans 80 to 90% funded subject to AFC	8.3%	
Cash contribution, plans subject to AFC	$185.7	$118.9
Plans subject to AFC forgoing cash contribution	30.4%	
Plans subject to AFC drawing down credit balance	60.9%	

Source: GAO analysis of PBGC Form 5500 research data.

Notes: Figures in this table represent averages and medians of those plans subject to an AFC for the entire sample period, except as described differently. Annual dollar figures adjusted to 2002 dollars using annual CPI data.

Median figures reported are the average of individual year median values.

For analysis, each year contains that year's 100 largest plans, ranked by current liabilities. From 1995 to 2002, 187 unique plans appear in at least 1 year's sample of 100 largest plans. See footnote 9 in main text for further explanation.

[a]This represents the average annual number of plans subject to an AFC. From 1995 to 2002, we observed 6 unique plans assessed an AFC, all of which had repeat AFC assessments.

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210

May 6, 2005

Ms. Barbara Bovbjerg, Director
Education, Workforce, and Income Security Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Bovbjerg:

The U.S. Government Accountability Office's (GAO) report, "Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," shows the need for comprehensive pension reform. The study documents that a large part of today's severe funding and contribution problems can be traced directly to the funding rules themselves. The report provides a detailed analysis of how specific aspects of the current rules fail to ensure adequate funding. Underfunded plan terminations strain the pension insurance system and jeopardize the retirement security of the 34 million Americans participating in single-employer defined benefit plans. That is why the Administration supports comprehensive reform to improve pension security for workers and retirees.

We agree with GAO's findings that underfunded plans of financially weak plan sponsors create a severe financial risk to the Pension Benefit Guaranty Corporation and to retirement security generally. We also agree that credit balances, funding holidays, and smoothing mechanisms have contributed to the widespread plan underfunding that we see today. Moreover, as your report demonstrates, these mechanisms mask underfunding, so that plan sponsors and participants discover too late and all too suddenly the need for drastic measures to address severe cumulative underfunding.

The Administration appreciates GAO's excellent work in this important area. The Administration's proposal addresses the issues raised in this report within the framework of a comprehensive reform plan, promoting sound funding while providing plan sponsors with the tools to manage volatility. We look forward to working with the Congress to implement these needed reforms.

Sincerely,

Ann L. Combs
Assistant Secretary of Labor

Appendix IV: Comments from the Pension Benefit Guaranty Corporation

PBGC
Protecting America's Pensions
Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

Office of the Executive Director

May 9, 2005

Ms. Barbara Bovbjerg, Director
Education, Workforce and Income Security Issues
U.S. Government Accountability Office
441 G Street NW
Washington, D.C. 20548

Dear Ms. Bovbjerg:

The PBGC is pleased to comment on GAO's draft report, *Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules.*

The report provides compelling evidence of the need for broad pension reform that is comprehensive in scope. It documents the weaknesses in the current pension funding rules that have contributed to severe pension underfunding. It also highlights how underfunded plan terminations strain the pension insurance program and jeopardize the retirement security of the 34 million Americans participating in single-employer defined benefit plans.

As you noted in the report, the Administration recently proposed a comprehensive pension reform package that will strengthen the defined benefit pension system by (1) reforming the funding rules to ensure that sponsors keep their retirement promises; (2) improving disclosure to workers, retirees, investors, and regulators about the funding status of pension plans; and (3) reforming PBGC premiums to better reflect risk.

We strongly agree with GAO that weaknesses in the current funding rules have led to severe pension underfunding that puts workers and retirees at risk. When an underfunded plan terminates, participants can lose as much as half or two-thirds of their promised benefits. We would also note that large losses in the pension insurance program pose risks to plan sponsors and taxpayers.

There are two points the PBGC would like to emphasize. The first is that the underfunding problems addressed in the report have become more severe since the years primarily focused on in the report (1995-2002). At the end of fiscal 2002, PBGC's single-employer program had a deficit of $3.6 billion, which grew to $11.2 billion at the

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end of fiscal 2003 and, as your report notes, to $23.3 billion by the end of fiscal 2004. In addition, the total underfunding in single-employer plans sponsored by financially weak firms grew from $35 billion at the end of 2002 to $96 billion at the end of 2004. This disturbing trend underscores the need for congressional action.

The second point is the need for comprehensive reform of the defined benefit pension system. The GAO report focuses on the weaknesses in the funding rules and the need for funding reform. But it also concludes that funding rule changes are an essential piece of a comprehensive reform package, and warns against adopting individual reforms in isolation. This report refers to GAO's earlier report, *Single-Employer Pension Insurance Program Faces Significant Long-Term Risks (04-90)*, that also concluded that Congress should consider comprehensive pension reform measures. Thus, the GAO's conclusions are consistent with the Administration's comprehensive reform approach that would not only reform the funding rules but also would also improve disclosure and rationalize PBGC premiums.

We appreciate GAO's work in this important area and look forward to working with GAO and the Congress on measures to strengthen the defined benefit system and pension insurance program.

Sincerely,

Bradley D Belt

Bradley D. Belt

Appendix V: GAO Contact and Staff Acknowledgments

Contact

Barbara Bovbjerg (202) 512-7215.

Staff Acknowledgments

In addition to the contact above, Charles A. Jeszeck, Charles J. Ford, Joseph Applebaum, Mark M. Glickman, Scott Heacock, Roger J. Thomas, and Amy Vassalotti made important contributions to this report.

Glossary

Actuarial value of assets—the smoothed value of DB plan assets, reflecting recent market levels of assets. Rules dictate that the reported actuarial assets must be between 80 and 120 percent of market asset levels and cannot be consistently above or below market values.

Additional funding charge (AFC)—a surcharge assessed to DB plans that fail specific funding level requirements that increases the minimum required funding obligation for the plan sponsor.

Credit balance—the excess of credits over charges in a plan's funding standard account, which can be carried forward to meet funding obligations in future years.

Current liabilities—the measured value of a DB plan's accrued benefits using an interest rate and other assumptions specified in applicable laws and regulations.

Defined benefit (DB) pension plan—a pension plan that promises a guaranteed benefit, generally based on an employee's salary and years of service. (A different type of pension plan, a defined contribution, or DC, plan, instead provides an individual account to an employee, to which employers, employees, or both make periodic contributions.)

Employee Retirement Income Security Act of 1974 (ERISA)—the federal law that sets minimum standards regarding management, operation, and funding of pension plans sponsored by private employers.

Full funding limitation (FFL)—a limit on the required amount a sponsor must contribute to a plan each year, dependent on the plan's funding level.

Funded ratio—the ratio of plan assets to plan liabilities.

Funding standard account (FSA)—a plan's annual accounting record, recording events that reflect an increase in a plan's obligations (charges) and those that reflect an increase in the plan's ability to pay benefits (credits).

Maximum deductible contribution—the maximum a sponsor can generally contribute to a plan without facing an excise tax on the excess contribution.

Normal cost—the cost of pension benefits allocated to a specific plan year.

Termination liabilities—the measured value of a DB plan's accrued benefits, using assumptions appropriate for a terminating plan.

Related GAO Products

Pension Benefit Guaranty Corporation Structural Problems Limit Agency's Ability to Protect Itself from Risk, GAO-05-360T. Washington, D.C.: March 2, 2005.

Private Pensions: Airline Plans' Underfunding Illustrates Broader Problems with the Defined Benefit Pension System. GAO-05-108T. Washington, D.C.: October 7, 2004.

Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting. GAO-04-749. Washington, D.C.: August 10, 2004.

Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition. GAO-04-395. Washington, D.C.: March 31, 2004.

Private Pensions: Timely and Accurate Information Is Needed to Identify and Track Frozen Defined Benefit Plans. GAO-04-200R. Washington, D.C.: December 17, 2003.

Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks. GAO-04-90. Washington, D.C.: October 29, 2003.

Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding. GAO-04-176T. Washington, D.C.: October 29, 2003.

Pension Benefit Guaranty Corporation: Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform. GAO-04-150T. Washington, D.C.: October 14, 2003.

Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks. GAO-03-873T. Washington, D.C.: September 4, 2003.

Options to Encourage the Preservation of Pension and Retirement Savings: Phase 2. GAO-03-990SP. Washington, D.C.: July 29, 2003.

Private Pensions: Participants Need Information on Risks They Face in Managing Pension Assets at and during Retirement. GAO-03-810. Washington, D.C.: July 29, 2003.

Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations. GAO-03-313. Washington, D.C.: February 27, 2003.

Answers to Key Questions About Private Pension Plans. GAO-02-745SP. Washington, D.C.: September 18, 2002.

Material for the Congressional Record as Requested by the Senate Finance Committee Follow-up to June 7, 2005 testimony of David M. Walker, Comptroller General of the United States

Senator Grassley

Could you clarify GAO's views on the importance of reforming the pension funding rules so that they require an accurate measurement of pension liabilities? In particular, could you provide any views on the effects of so called "smoothing" mechanisms related to interest rate and asset valuations in calculating pension liabilities, and whether such smoothing mechanisms should be eliminated? Is an accurate measurement of liabilities equally important for all purposes (e.g. disclosure, calculations of liabilities for contribution purposes etc.)?

Improving the accuracy of reported plan financing is an essential component of meaningful pension reform and is critical for the effective operation of a well funded defined benefit pension. Without valid and up-to-date measurement of a plan's assets and liabilities, sponsors do not have an accurate funding target nor is plan funding accurately portrayed to shareholders and participants. This can result in sponsors not funding their plans adequately, and shareholders and participants making poor decisions regarding work, retirement, investment and saving.

As we stated in our recent report,[1] current funding rules allow plan sponsors to smooth both current liabilities and assets. Liabilities are smoothed primarily through the interest rate used to discount future benefits. Rules dictate that sponsors choose a rate based on the 4-year weighted average of the rates on bonds (currently the yield on long-term high-quality corporate bonds), with the most recent year accounting for 40 percent of the weighted average, and rates from 2 to 4 years prior accounting for 60 percent. This weighting formula means that the rate used by sponsors to calculate current liability uses old market information, thus not reflecting current rates exclusively. In addition to interest rate smoothing, measurement rules allow sponsors to pick an interest rate from among a range of values around the 4-year benchmark rate (currently, this range is 90 to 100 percent of the 4-year weighted average of the rate of an index of long-term high-quality corporate bonds). Similarly, plan sponsors can smooth assets based on their market values from the previous 5 years, as long as reported values are within 80 to 120 percent of current market value and over the long-run do not reflect upward or downward biases. Thus, in any given year, a plan's reported assets and liabilities will not necessarily reflect current market conditions, leading to potentially misleading information and possibly obscuring the funded status of a plan.

Further, there is smoothing at work on the contribution side of the ledger. The funding standard account, or FSA, which determines a sponsor's minimum

[1] GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules,* GAO-05-294 (Washington, DC: May 31, 2005).

contribution to its plan each year, contains smoothing mechanisms that allow plans to reduce their cash contributions. Because the FSA allows sponsors to retain credit for prior year contributions in excess of the minimum as "credit balances," sponsors can draw on these credit balances in lieu of contributing cash. Credit balances retain their values (and accrue interest) regardless of the investment performance of the underlying assets purchased by previous years' contributions. Thus, like the interest rate smoothing mechanism that can be applied to liabilities, the FSA inherently distorts the measurement of plan finances by allowing plans to report current-year measurements that are partially based on old values.

Removing or mitigating all of these aspects of plan financing would greatly improve transparency and provide a more accurate funding target for sponsors. However, eliminating interest rate smoothing and the FSA would also likely increase the volatility of contribution requirements. It may be appropriate to allow sponsors some flexibility in determining minimum annual contributions, as long as the plans do not become too underfunded and the sponsor does not show indications of financial weakness that could lead to plan termination. Required minimum funding could allow for some leeway based on the financial health of the sponsor. For instance, plans below a certain level of funding, or those sponsored by at-risk firms, should have more stringent minimum annual requirements, while plans that are well-funded could be given some flexibility with respect to minimum annual contributions. However, it is imperative that measurement reflect current, accurate market measures based on up-to-date and reasonable assumptions.

Furthermore, financial disclosures of a plan's funding that are made to plan participants should reflect current market conditions. If sponsors continue to use different measures of liabilities (for example, current liability versus liability for a terminating plan), disclosures to participants could also include an explanation of these different calculations to emphasize that the appropriate measure of a plan's liabilities may depend on the financial situation of the plan sponsor.

Senator Rockefeller

I would like you to address the question of how we can continue to encourage employers to stay in the defined benefit pension system. These benefits are extremely valuable to workers. Generations of retirees have depended on pension benefits that are predictable and that will last their lifetimes. I am concerned that proposals to increase premiums and impose new volatile funding requirements on employers will encourage them to leave the system, making the system's funding problems worse. What reforms can the Congress enact that will shore up the system while also encouraging employers to offer defined benefit plans?

We share your concern over the possibility that sponsors will freeze or terminate their pension plans, and new employers might not form new DB plans, in response to new rules. However, a competing concern is that the leeway of the current funding rules that sponsors of DB plans value has also encouraged some sponsors to make promises to their workers and retirees that they cannot keep. These unmet promises can result in losses being imposed on plan participants, other plan sponsors, and the PBGC. One of the realities of our voluntary system of private pensions is the difficulty in balancing the incentives necessary to encourage employers to offer defined benefit plans with ensuring that employers deliver on their pension promises to workers and retirees. As you mention, generations of retirees have depended on predictable periodic benefits for the duration of their lives. That dependability obviously relies upon employers offering traditional pensions, but also on their fully funding the commitments they make and have made in those pensions to workers and retirees. As evidenced by the termination of several severely underfunded plans this decade, the existing system allows sponsors to make promises that they cannot keep. This is not because of duplicity on the part of employers, but rather that existing rules do not provide enough assurance that plan sponsors will address pension problems before it's too late. Clearly, weaknesses in the funding rules have contributed to the recent rash of underfunded terminations that call into question how predictable and reliable today's DB benefits are for retirees.

Regarding PBGC premium increases, the flat-rate premium has remained fixed at $19 per participant since 1991. Raising this rate to $30 is undoubtedly a large increase, although when indexed for annual wage growth, it is similar to the $19 charge in 1991. Further, the over $23 billion accumulated deficit facing the PBGC single-employer insurance program is evidence that premiums have not been sufficient to pay for the coverage PBGC provides. However, we share your concern that some employers will choose to terminate their plans rather than paying the higher premiums. In fact, while we believe the premium increase may be justified, we would prefer the premium structure to be more risk-based and to consider certain risk factors more explicitly. Basing premiums on various risk factors, such as a plan's funding level, the financial condition of the sponsor, the nature of the plan's benefit structure and demography, and the riskiness of the plan's asset portfolio, would more fairly and efficiently charge employers for the risk they impose on the PBGC and to other employers. Adjusting the risk premium in this way might keep the flat-rate charge relatively low, and also encourage sponsors to maintain well-funded healthy plans. It might also encourage these strong plans to stay in the system because sponsors of these plans would know that they would be less likely to have to subsidize weaker plans that are more likely to terminate.

We believe there is an inherent tradeoff between shoring up the pension system and giving sponsors broad flexibility in making contributions. More stringent rules regarding funding, measurement, premiums, and disclosure undoubtedly will raise some costs to some sponsors and make some sponsors consider exiting the system, but will also better ensure that participants receive the benefits they are promised. In this regard, the experience of the last 20 years is illustrative. Since the mid-1980s, the single-employer DB system has shrunk by over 80,000 plans. During this period, employers chose to leave the system despite the strong growth in stock prices and the considerable flexibility in the funding rules that allowed many employers to make little or no cash contributions to their plans during the 1990s. To better protect retirement security, we might do best by trying to encourage those features of traditional pensions we value, such as widespread participation, pooled investment risk, and the annuitization of benefits, as well as improved transparency and portability provided by certain hybrid defined benefit plans (eg. cash balance plans), while also designing better rules to ensure that retirees in DB plans receive their benefits. Such hybrid plans may provide a more attractive alternative to traditional final average pay plans for employers and participants; however, the creation of cash balance plans has been hindered by legal issues and an unclear regulatory environment, including the potential for reduced benefit protections for older and long-tenured plan participants.

Senator Bingaman

As specifically as possible, please describe which provisions in the Administration's proposal on DB plan reform cause you concerns or that you feel are either unnecessary or will have a negative impact. As specifically as possible, please provide different approaches to the administration's proposals on DB plan reform that you believe would achieve a more desired result.

The Administration plan proposes significant changes to pension measurement, funding, premiums, and disclosure rules. As with any pension reform that is comprehensive in scope, the proposal would have some tradeoffs and would create some winners and losers among affected parties. In previous reports and testimonies before Congress,[2] GAO has called for comprehensive pension reform. The Administration's plan addresses many of the areas of concern in the DB system to which we have called attention. We recognize that reform will admittedly not be costless, and we share the concerns of those in the Committee that have brought up the prospect of employers' freezing plans or exiting the DB system, as undoubtedly some sponsors will choose to do. However, we believe that reform is necessary to prevent further terminations that cost participants, the PBGC, other sponsors, and potentially taxpayers billions of dollars, and further undermine the retirement security of those that depend on DB benefits. We should also note that the current bill from the House Committee on Education and the Workforce (HR 2830) proposes some similar changes, although with several differences.

More specifically, the Administration proposal would make the following changes:

- Plan asset and liability measurement would conform more closely to market measures.

The Administration proposal would compel sponsors to use a yield curve to discount pension liabilities, and would greatly reduce smoothing inherent in liability

[2] GAO-05-294; *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks,* GAO-04-90, (Washington, D.C.: Oct. 29, 2003); *Private Pensions: The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges,* GAO-05-772T (Washington, D.C.: June 9, 2005.

calculations by replacing the current 4-year weighted average period with a 90-day weighted average. Combined, these measures would have the positive effect of making liability calculations reflect current market conditions much more closely than the current system. Making funding rules more stringent will reduce some of the current rules' year-to-year funding flexibility and predictability and could potentially raise contribution volatility, but will better protect participant benefits and could limit future losses to PBGC. Installing a yield curve to discount plan liabilities would likely raise funding requirements for plans with more retirees and older participants, but at the same time might have the reverse effect for demographically younger plans. In short, a yield curve attempts to more accurately measure liabilities using current conditions, but it could also increase complexity of plan calculations and the annual volatility of liabilities.

- Sponsors of underfunded plans would have to fully fund their plans within seven years.

In our recent report,[3] we identified weaknesses associated with funding leeway for underfunded plans, most notably the lack of stringency in the additional funding charge (AFC) and excessive flexibility with funding standard account (FSA) credits. The Administration proposal would simplify and strengthen funding by setting a clear funding target of 100 percent full funding, as opposed to current rules that allow for some plans to be considered fully funded when they have assets equal to 90 percent of current liabilities. The proposal would also eliminate the substitution of FSA credit balances for required cash contributions. We believe that these measures will reduce the number of badly underfunded plans. While concerns about increased contribution volatility are valid, funding rules could maintain reasonable flexibility for minimum contribution requirements for financially strong sponsors whose plans are not too underfunded. The Administration proposal would attempt to raise the maximum deductible contribution level for plans in order to encourage additional funding in strong economic times; while we agree with efforts to encourage additional funding, our work casts some skepticism as to whether sponsors will take advantage of higher contribution ceilings.

- Raise PBGC flat-rate premiums and make the premium structure more risk-based.

The Administration proposal would raise flat-rate premiums from $19 per participant to $30, the first such increase since 1991. This would of course raise costs for plan sponsors, possibly causing some sponsors to terminate or freeze their plans. However, adjusted for annual wage growth, the new rate would be very similar to the rate in 1991, and PBGC's $23.3 billion deficit attests to the insufficiency of current premium levels. Further, just as financially weak sponsors would have more stringent funding targets than stronger sponsors, weak sponsors would pay higher premiums to reflect the greater risk they pose to PBGC. While this may raise costs to affected sponsors, such rules would also reduce the current system's cross-

[3] GAO 05-294

subsidization from stronger plans and PBGC to weaker plans, and would create additional incentives for sponsors to fund plans adequately during good economic times.

- Make certain information that is currently available only to the PBGC publicly accessible.

The Administration proposal would improve plan disclosure by making certain, currently confidential information filed with PBGC under section 4010 of ERISA, which currently applies to all plans at least $50 million underfunded, publicly available.[4] In addition, the sponsor's Form 5500 would now include total "at-risk" liability for a plan, which should increase the accuracy and transparency of plan financial information. The sponsor would have to furnish plan participants with a summary annual report (SAR), which would include information on the plan's funding status, based on market values, and sponsor's financial health, within 15 days of filing the Form 5500. For a plan with more than 100 participants and with assets below its current liability funding target, the sponsor's deadline for filing the Form 5500, schedule B actuarial statement would also be accelerated under the proposal. GAO has recently issued a report outlining possible reform measures in this area.[5]

- Impose additional restrictions on financially weak sponsors and "at risk" plans

The Administration proposal would restrict the availability of lump sum distributions from severely underfunded plans, which should keep plans at risk of termination from undergoing a "run on the bank" that worsens underfunding. The proposal would also eliminate PBGC's guarantee of shutdown benefits; while these represent potentially valuable benefits to employees of closed factories, current rules generally do not allow employers who offer shutdown benefits to fund them before the shutdown occurs, potentially exacerbating the moral hazard present in PBGC insurance. Another possible option would be to phase in shutdown benefits from the date the shutdown occurs, similar to the 5-year phase-in for other plan benefit increases. Currently shutdown benefits are phased in from the date the benefits are negotiated, rather than the date the shutdown occurs. Requiring shutdown benefits to phase in from the date the shutdown actually occurred could decrease the losses incurred by PBGC from underfunded plans, while allowing workers to keep a portion of the shutdown benefits that were likely to have been negotiated long ago.

There are other areas of pension reform that the Administration's proposal does not address as comprehensively. While it does seek to change PBGC's premium structure

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[4] Section 4010 of ERISA also requires the reporting of plan actuarial and company financial information by employers with plans that have missed required contributions in excess of $1 million, or outstanding minimum funding waivers in excess of $1 million. The Administration proposal would eliminate section 4010(c) of ERISA, which overrides Freedom of Information Act (FOIA) standards. Thus, information filed with the PBGC pursuant to section 4010 would be disclosable, except for confidential "trade secrets and commercial or financial information" under FOIA.

[5] GAO, Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information, GAO-05-491 (Washington, D.C., June 3, 2005).

to consider the financial health of the sponsor, it does not appear to include any provisions for considering the risk factors associated with a plan's benefit structure, demography, or investment portfolio; because these factors can have a large impact on the overall health of the plan, a risk-based premium structure could include these factors. The proposal also does not explicitly deal with the pension system's "legacy" costs, such as those liabilities already incurred from failing sponsors with poorly funded plans or those sponsors with underfunded plans that have reasonable probabilities of failing. Neither does it address the potentially large initial, transition costs to PBGC that could be generated by the termination of underfunded plans by weak sponsors as the new rules are implemented; the Congress may determine that it may want to deal with such costs differently than costs incurred after the new rules are fully implemented.

The proposal also does not address certain other important issues. The first is cash balance plans, which are hybrid DB plans that combine features of both DB and defined contribution (DC) plans. Such hybrid plans could provide a vehicle for renewed interest and growth in DB pensions. However, unresolved age discrimination and other legal issues may make employers reluctant to establish these plans. Other issues, such as permitting plan sponsors to "wear away" older workers' benefits in the event of a conversion from a traditional DB plan to a cash balance plan, can result in significant benefit reductions for some participants and could erode the attractiveness of such plans to experienced workers. In short, comprehensive reform should address the significant issues facing cash balance plans and should resolve the lack of regulatory clarity surrounding such plans.

In addition, comprehensive reform should consider strengthening PBGC's creditor status in the bankruptcy proceedings of sponsors who wish to terminate underfunded pension plans. The Administration proposal currently would enhance the ability of PBGC to pursue claims regarding required pension contributions that had been missed. However, other PBGC claims, which can far exceed those relating to missed payments, would remain on a general unsecured basis. Congress should keep in mind PBGC's status as an unsecured creditor as it considers any reform, especially if reform includes temporary or industry-specific funding relief. Congress could leverage any relief to include provisions to protect PBGC from further financial difficulty. For example, as part of a relief package, Congress could improve PBGC's standing in bankruptcy for any contributions that plans would have otherwise had to pay in the absence of the relief.

STATEMENT OF

CAPTAIN DUANE E. WOERTH, PRESIDENT

AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

BEFORE THE U.S. SENATE COMMITTEE ON FINANCE

ON

PREVENTING THE NEXT PENSION COLLAPSE:

LESSONS FROM THE UNITED AIRLINES CASE

June 7, 2005

Good morning. I am Captain Duane Woerth, President of the Air Line Pilots Association, International, which represents 64,000 airline pilots who fly for 41 U.S. and Canadian airlines. On behalf of ALPA, I want to thank the Committee for giving us the opportunity to present our views about the pension funding crisis facing the U.S. airline industry today.

We firmly believe that S. 861, introduced by Senator Johnny Isakson (R-GA) and Senator Jay Rockefeller (D-WVA) on April 20, 2005, and its companion bill in the House, H. R. 2106, provide the pension funding reforms that we need now to avoid the devastating consequences that distress pension plan terminations wreak on employees, their families and the Pension Benefit Guaranty Corporation.

Pension Crisis Affected by Financial State of U.S. Airline Industry

It is impossible for me to discuss the airline pension funding crisis without starting with the overall financial condition of the domestic airline industry, which remains quite dismal. Our industry has lost over $30 billion in the last four years and is projected to lose at least $5 billion this year. The immediate future does not look much brighter given the volatility in fuel prices and yield performance. Yields continue to deteriorate at an alarming rate, with domestic yields showing no sign of increasing. In fact, domestic yields declined 20% from 2000 to 2004. There is hardly any pricing power in this industry. In the last several weeks, we have seen fuel surcharges take hold. A $2 per barrel swing in jet fuel prices can be offset by a 1% change in unit revenue, yet while fuel was up over $18 a barrel in the first quarter of 2005, unit revenues rose only by 2% . The fuel surcharges may have been successful in offsetting only $4 to $6 of that increased fuel cost.

The outlook remains grim. Recent projections for 2006 are for industry losses of over $1 billion, and that's only if fuel averages $45 a barrel. Every $1 per barrel increase in the price of oil translates into an additional $450 million loss in passenger industry pretax profits and $1 billion in additional losses for the global airlines. IATA, which had been expecting a break-even year for the global airline industry, is now forecasting over $6 billion in losses for 2005.

For the airline industry, the economic factors are compounded by the lingering 9/11 effect: the use of commercial aircraft as weapons of mass destruction depressed the economy and reduced the number of passengers we fly, at the same time security taxes were added to our ticket prices and oil skyrocketed to historic market highs. While traffic and capacity are now back to pre-9/11 levels, we continue to be subjected to burdensome taxes and security fees and now the administration wants to impose another $1.5 billion worth of taxes. The U.S. airlines are already expected to pay the government and airports $15 billion in taxes and fees this year.

When we add to this grim financial condition the factors of historically low interest rates and poor stock market returns, we have a "perfect storm" for the pension woes we currently face. As a result of this witches' brew, we are on guard for even more pension plan terminations and their attendant devastating consequences, potentially affecting hundreds of thousands of workers and their families. But despite this stark reality, ALPA believes these drastic results can be avoided with creativity and foresight – and appropriate legislative reforms, specifically, the reforms set forth in S. 861.

Pension Funding Crisis Created by the "Perfect Storm"

Much has been said and written about the "perfect storm" that has undermined the funding of private defined benefit plans in America. The two key elements of the "perfect storm" are historically low interest rates and poor returns in the stock market. Low interest rates impact pension funding because, as interest rates decline, the value of a pension plan's liabilities increases. And when stock market returns move downward, the value of the plan's assets decreases.

In a perfect world, a plan's funding ratio would always equal 100%, meaning that the plan's assets exactly equal the plan's liabilities. But with historically low interest rates driving plan liabilities up, and investment performance driving plan assets down, the "perfect storm" has set the stage for funding disaster. The more the plan's liabilities exceed the plan's assets; the worse off is the plan's funded status.

Contribution Volatility Created by "Deficit Reduction Contribution" Rules

If a plan's liabilities exceed its assets, ERISA's *regular* funding rules for pension plans were designed, in general, to allow employers to make up that gap with more or less level contributions over extended periods of time. But when a plan's funding gap drops down to a certain level, a *special* funding rule kicks in, requiring the employer to make much larger contributions over a much shorter period of time. This special contribution, known as a "deficit reduction contribution," makes it especially difficult for the employer to close the widening gap between assets and liabilities.

Logically, since a pension plan is a long-term proposition, it should be funded over the long term. This would require reasonably predictable, level, periodic contributions, similar to the way homeowners expect to pay their mortgage. But when a deficit reduction contribution is required, the pattern of required funding shifts in the opposite direction. That is, required funding amounts become extremely volatile, with extraordinarily large contributions required over very brief periods of time – the exact opposite of predictable, periodic contributions over a reasonably longer period of time.

A deficit reduction contribution is always required when a pension plan's funded ratio for the year falls below 80%, and is often required when the plan's funded ratio falls below 90%. Deficit reduction contributions are designed to bring the plan back to the 90% funded level, and while that is a laudable goal, the time the employer is allowed to get there is only three to five years. This is like asking homeowners to pay off their 30-year house mortgage as if it were a car loan – over only three to five years – far too short a time to meet far too large an obligation.

Because of this short time horizon, the contributions an employer must make to a plan when the plan is subject to the special deficit reduction contribution rule are often enormous, and can end up being unaffordable, especially when compared to the amount that would have been required if only the regular funding rules applied. The deficit reduction contribution rule was added to the funding laws in 1987 and strengthened in 1994, in an effort to help prevent underfunded plans from being terminated and their liabilities dumped on the PBGC. Although this is a desirable goal in theory, the strategy to achieve it backfires in the real world if the employer is unable to afford the deficit reduction contribution. In that case, the employer, now in bankruptcy, is forced to terminate the underfunded plan and dump liabilities on the PBGC anyway. No one wins, and the participant certainly loses.

Pension Plans in Bankruptcy

The scenario just discussed is precisely what happened in US Airways' first bankruptcy with respect to the pilots' pension plan. The pilots' plan was the only pension plan of the four maintained by US Airways that was terminated at that time. The Company was unable to emerge from bankruptcy without a distress termination of the pilots' pension plan, due in large part to the deficit reduction contributions projected to be required over the next few years – and a significant portion of that burden was transferred to the PBGC, precisely opposite to the law's intent.

Sadly enough, the US Airways pilots' plan had been soundly funded just *two years* before the Company filed for bankruptcy. The plan went from being over 100% funded in 2000 to only 74% funded by 2002 – due to the "perfect storm" and the funding rules in place which allowed the corporation to bank payment credits due to high pension funding levels. Once the funding level decreased, the requirement for deficit reduction contributions kicked in. However, the Company could not afford to make those payments and emerge from bankruptcy with financing and a viable reorganization plan. As a result, the pilots acquiesced to the Company's "distress termination" of their pension plan. Although a new defined contribution plan was established, it could not replace the benefits active pilots lost under the prior program and it provided nothing to restore what retired pilots had lost.

All told, the active and retired pilots of US Airways lost $1.9 billion in accrued benefits that were not funded by the plan and were not insured by the PBGC. This loss amounts to just over *one-half* of the $3.7 billion in total benefits that pilots had *already earned* as of the time the plan terminated.

With US Airways' second bankruptcy, the three pension plans covering the rest of US Airways' employees have now been terminated and taken over by the PBGC. PBGC has estimated that the assets of these three plans cover only 40% of liabilities. As a result, PBGC has taken on another $2.3 billion in unfunded liabilities for these plans.

We are now witness to the same scenario being played out in the current bankruptcy of United Airlines. All four of United's defined benefit plans are being terminated and taken over by the PBGC. Although the benefits employees and retirees have earned under these plans total approximately $16.8 billion, the plans' assets total only about $7 billion, leaving $9.8 billion in unfunded liabilities. PBGC estimates that it will be on the hook for approximately $6.6 billion of the unfunded amount.

In terms of retirement security, the results for United's employees are devastating. In total, they will lose more than *$3 billion* in accrued benefits – benefits that are neither funded by the plans or nor insured by the PBGC. United's pilots alone will bear fully one-half of this amount, losing *$1.5 billion* in accrued benefits. *On an individual basis the situation is dire, with many pilots completely losing more than 60% of the retirement benefits they had already earned.*

Freezing Plans to Reduce Pension Costs

ALPA's pilots and leaders have not stood idly by and watched as these events threatening their pensions have unfolded. Since the beginning of this pension funding crisis, the pilots and our airlines have taken active and creative steps to explore all available means of reducing or delaying pension costs, within the bounds of current law.

Of course, there is only so much the parties can do through collective bargaining. Most significantly, the parties cannot agree to reduce the benefits that employees have already earned to date under a pension plan, pursuant to the "anti-cutback rule." Since accrued benefits cannot be reduced, the most that ALPA and the airlines can do in collective bargaining, in order to reduce future plan costs, is to agree on changes that eliminate future accruals under the plan. Also known as "freezing" the plan, this is the most drastic step that may be taken to reduce future plan costs, short of a distress plan termination.

Over the past seven months, the pilots of Delta Airlines and Continental Airlines have agreed to freeze their defined benefit plans, thereby eliminating any future accruals under those plans. They have done this with the goal of lowering their airline's costs, which in turn will increase the chances of their airline staying out of bankruptcy and preserving benefits accrued under the pension plans. Pilots at several other airlines are currently considering whether to freeze their defined benefit plans, also.

Funding Even a Frozen Plan Can Be Too Burdensome

Even though a total plan freeze provides the largest possible cost savings to an employer, the employer must *continue to fund the benefits that were earned prior to the freeze.* Funding of accrued benefits under a frozen plan can be extremely burdensome, however, under the deficit reduction contribution rules.

For illustration, let me review a situation involving one of the legacy airlines, one that we believe is typical of the funding results achieved by freezing the defined benefit plan. This airline compared the amount of contributions that would be required over the next 15 years if the plan remained unchanged, to the amount that would be required if the plan were frozen. Over the 15-year period, the contributions required if the plan were frozen would be *less than 1/3* of the contributions required if the plan were not frozen. These are substantial savings, to be sure. But the curious thing is that, due to the deficit reduction contribution rules, fully *100%* of these lower contributions would be due over the next five years only, with *zero* contributions required in the following 10 years, hardly short-term relief.

We believe this example stands as strong evidence that the current funding rules, with the poorly designed deficit funding contribution requirement and resulting volatility of contributions, are simply illogical and do not function as intended.

Pension Funding Equity Act of 2004

In April 2004, Congress passed the Pension Funding Equity Act. In addition to provisions applicable to all defined benefit plans, PFEA contains a special rule for certain defined benefit plans maintained by commercial passenger airlines. In general, the Act granted deferral, for two years only (2004 and 2005 for most airlines), of a portion of the deficit reduction contribution otherwise due for those two years. We understand that most, if not all, of the eligible airlines have elected to use the special rule for their eligible plans. As you know, the temporary nature of the special rule has the effect of exacerbating the plans' funding requirements in 2006 and beyond. We appreciate the fact that Congress was willing to work with us last year to address this problem; but without further reforms, the increased deficit reduction contributions required for 2006 and beyond will be even more costly.

The Solution – S. 861

The devastating consequences of more pension plan terminations in the airline industry can be avoided, if appropriate legislation is enacted now. We firmly believe that S. 861, introduced by Senator Isakson and Senator Rockefeller, provides the required reforms.

We believe the current pension funding crisis is only temporary. Given sufficient time, we believe that interest rates will rise, stock market performance will improve, and airline profitability will return. Sound retirement policy should not allow an employer to break its pension promise to employees, just because of negative economic and financial conditions expected to last only a few short years. This is especially so when such negative conditions are viewed in the context of a pension plan, the duration of which is measured in decades.

Our two-pronged solution is to allow airlines to amortize their pension plans' unfunded liabilities over a longer term and to measure their plans' liabilities using realistic interest rate assumptions determined by the plans' actuaries. The "Employee Pension

Preservation Act" proposed by Senators Isakson and Rockefeller in S. 861 would accomplish this much-needed reform.

We believe that allowing long-term amortization of the present funding gap creates a situation in which all stakeholders win.

First and foremost, it is a win for workers, who will have a greater likelihood of actually receiving the benefits they have already earned under their pension plans. After all, over the course of their careers, employees have given up direct wage compensation in exchange for the promise of deferred retirement benefits.

Secondly, it is a win for the PBGC. Making the reforms available will greatly reduce the chances of more distress plan terminations. A plan that is allowed to become well-funded over time will never be dropped on the PBGC's (and taxpayers') doorstep. But if such a distress plan termination should later occur, S. 861 provides the PBGC a significant limitation on its possible future liability. For a plan that elects coverage under the new rules and later undergoes a distress termination, the PBGC's guarantees are capped at the limits in place during the first year the plan was covered by the new rules.

Finally, it's a win for the airline industry and the traveling public. Of course, it will allow airlines to deliver the benefits they promised to employees. But just as importantly, it will allow the airlines to better manage their cash flow and prepare feasible business plans without being sabotaged by unpredictable deficit reduction contributions. A feasible business plan will, in turn, unlock the door to long-term capital financing of the airlines' business needs and endeavors, and should, in the case of some legacy carriers, help them avoid bankruptcy altogether.

Under current law, the only way an airline can avoid burdensome pension costs is by entering bankruptcy and terminating the plans. But if more and more airlines choose to shed their pension liabilities in bankruptcy, it sets up the potential for the "domino effect," in which all the other legacy carriers are incentivized, or even forced, to file bankruptcy, in order to achieve the same cost savings and "level the playing field." We believe that providing relief from the deficit reduction contribution rules will go a long way toward removing the pension plan termination incentive to enter bankruptcy, and will, as a result, help prevent further bankruptcies in the U.S. airline industry.

Allowing airlines additional time to fund employees' accrued benefits will also give the parties time to step back, review and in some cases completely alter the design of their retirement program – all without the threat of a distress plan termination hanging over their heads. Given the sufficient breathing room made possible by longer amortization of the defined benefit plan liabilities, airlines and employees can craft creative solutions that may provide secure alternatives to pure defined benefit plans. Each airline and employee group must create an individual solution to their individual pension challenge. For some groups, but by no means all, the solution may lie in gradually shifting away from excessive reliance on defined benefit plans as the primary sources of retirement benefits, either by replacing them, or by devising combination plans with a larger defined contribution plan component.

There is one separate but related issue that I must mention, because it is specific to the airline pilot profession. By FAA regulation, we *must* retire at age 60. Therefore, a pilot's "normal retirement age" under our pension plans is defined as age 60. That is the age when a pilot may retire and receive a full, unreduced pension. However, in the case of a pension plan undergoing a distress termination, the PBGC determines its insurance guarantees by applying age 65 as the normal retirement age. As a result, benefits that begin at age 60 are treated as "early retirement" benefits and the PBGC's guarantees for those benefits are reduced. The PBGC's guarantees for benefits beginning at age 60 is only 65% of the amount it guarantees for benefits beginning at age 65. Therefore, we support S. 685, introduced by Senator Daniel Akaka (D-HI) on March 17, 2005. The "PBGC Pilots Equitable Treatment Act" proposed in S. 685 would apply the PBGC's normal retirement age guarantee limit to pilots at their normal retirement age – age 60.

<u>Summary</u>

In summary, we believe that the simple solution of S. 861 to allow long-term funding of pension plan liabilities will allow the airline industry the time it needs to undertake a strategic, deliberate approach that provides employees with a secure retirement, keeps defined benefit plans out of the hands of the PBGC, and maintains healthy airlines. Again Mr. Chairman, I appreciate this opportunity to appear before you, and I would be happy to answer any questions the Committee may have.

COMMUNICATIONS

TESTIMONY OF:

O.V. Delle-Femine
AMFA National Director

For the Senate Committee on Finance
June 7, 2005

"Preventing the Next Pension Collapse:
Relating to United Airlines"

Mr. Chairman, Senator Baucus and members of the Committee, I would like to take this opportunity to thank you for conducting a hearing on such an important topic - and for providing me the opportunity to submit testimony on this issue.

My name is O.V. Delle-Femine, and I am the National Director for the Aircraft Mechanics Fraternal Association (AMFA).

We are the largest labor organization representing FAA licensed A&P mechanics - with over 18,000 members for major carriers including United, Northwest, Southwest, Alaska, ATA, Mesaba, Independence and Horizon Airlines.

Our motto - "Safety in the air begins with Quality Maintenance on the Ground" - is enhanced by our professionalism, skill, expertise - and most importantly to the safety of the flying public. While there are thousands of aircraft in the air each day – these aircraft are also carrying millions of passengers each day.

I am providing testimony on behalf of our membership - one of our represented carriers as you know, United Airlines has just terminated all of its' plans - one of the largest pension terminations in our history. Northwest Airlines is another plan that has serious concerns.

Background: As part of cost-cutting strategies, corporations have found a lawful way of essentially absolving themselves of any responsibility to its employees - one way is through the bankruptcy process. I am sure you all are well aware of the term "fiduciary" which is the highest responsibility a plan sponsor has to its participants. Companies are only doing what is legally, not morally sound. The IRS codes allow the airlines and other corporations to default the pension plans - *without penalties.*

We have seen executives of these companies come and go - often negotiating themselves exorbitant pension plans - while leaving the employees left with virtually nothing to look forward to. Retirees are now looking at re-entering the job market as a result of their lost pension - and increased health insurance costs. Many times corporations while in either serious financial distress or experiencing financial "speed bumps" - have urged its' employees to "stick with us - we'll get through the good and the bad". Well, not this time.

Executives have their golden retirements - essentially bankruptcy proof nest eggs - filled with great benefits including millions of shares of stock options, deferred compensation programs, phantom stocks, variable annuities which are bankruptcy proof; life-time travel benefits, and the list goes on.

As in the case of our membership, and other corporations as well, United Airlines is leaving the employees on the sidelines once again - this time without a pension that was promised. And the retirees with reduced health care benefits, which I stated earlier, are now faced with re-entering the job market to help compensate for their losses. And you ask if there is a double standard.

Enough is enough. Corporations can't possibly take any more from the employees – they have given up enough. These are real people, with families - who have worked decades for their company - all in efforts to help the company grow.

When the committee asked if there is a double standard - the executives in unison said "no". We adamantly disagree with this response.

United Airlines: Over the past seven months, I have spent in concessionary discussions with UAL regarding their $96 million request to again reduce wages and work rules and benefits from our Agreement including the pension plan. We agreed on a concessionary agreement on May 15, 2005, to be presented to our membership and voted on May 31, 2005. It was approved by 59% of the members because they feared that the bankruptcy judge would impose harsher concessions on them.

Bankruptcy codes are not for the employees - it is for the survival of UAL – and other corporations. If we did not reach an agreement this would allow the Judge to make the changes in our Agreement. We thought best to try to squeeze the best agreement we could obtain without the pro-company judge making a ruling on our Agreement.

United used the present laws to drop approximately $9.8 billion dollars in pension liabilities on the PBGC - *without penalty.* The United employees have taken a $3.2 billion dollar hit on their pensions. It cannot be stopped because the ERISA (Employee Retirement Income Security Act - 1976) and the IRS regulations have many loopholes. The PBGC disallowed us to negotiate the pension plan - and while we were in negotiations - allowed UAL to drop four pension plans. There were no safeguards as we had expected to protect our pensions. The retiree's ended up with nothing. Despite the wage reductions employees took over the years, since 1994, they had hopes to keep UAL alive, however their sacrifices did not induce any loyalty or honesty from UAL.

The Employee Stock Option Plan. In 1994, to help save the Company the employees accepted a 14.7% reduction in pay with the stipulation that they would be co-owners and have a seat on the Board of Directors. Being co-owners was a farce because they were not authorized to make decisions. Having a union person on the Board proved nebulous at best. They were sworn to secrecy and couldn't tell their members what was happening in Board decisions. To add insult to injury, the ESOP disallowed members to contribute into the 401(K) due to IRS regulations stating that the ESOP was a qualified pension plan that prohibited contributions. In 2003, they lost the plan and only received pennies on the dollar.

Northwest Airlines:
The Northwest employees have under-funded pension plans by approximately $3.8 billion dollars. We feel the only way they can extricate themselves from the pension default is to do what United Airlines has accomplished - file for bankruptcy and allow the PBGC to take over the Defined Benefit Plan thus having the PBGC - and possibly the U.S. taxpayers pay for the default.

By allowing a corporation to fund their own pension plan with company stock of subsidiaries is even more dangerous. In 2002, Northwest Airlines filed for a waiver of pension liabilities. In 2003, they filed another waiver with the IRS, and also went before the Department of Labor to request an in-kind contribution (to use stock from a wholly owned subsidiary - Pinnacle Airlines) in lieu of cash. As a result, the Company was required issue an IPO on the subsidiary airline and fund the pension plan with the proceeds (in cash). The funding came just short of $96 million. In 2004, Northwest Airlines again filed another pension waiver with the IRS on the funding obligations. In both cases, they did not include all plans on their requests.

Another example, corporations are required by ERISA regulations to notify the participants that they have filed for a waiver. However, there are no requirements to notify participants of the determinations. When we asked Richard Anderson, President & CEO; "as a fiduciary of the plan and as a moral obligation to your employees - what was the final determination of this application?" We received no response.

There has to be more accountability.

Once a corporation is in bankruptcy, employees have no protective laws as we thought. And we have seen this more than enough times to warrant changes in the bankruptcy codes and ERISA regulations; to protect the participants from losing their pension benefits promised through their company. Additionally, to prevent this plan and others from being unnecessarily terminated in the future.

We must now ask Congress to redress the problems facing labor on every carrier who wants to use United Airlines as a template to eradicate their agreements and pension plans without any penalties.

Again, I thank you Mr. Chairman and the Committee for allowing me to provide testimony to this important issue.

APA APFA AmericanAirlines®

June 7, 2005

Honorable Charles Grassley
Honorable Max Baucus
United States Senate
Committee on Finance
Washington, DC

Dear Chairman Grassley and Senator Baucus:

Today the Finance Committee is holding a hearing on the crisis of pensions in the airline industry. Although American Airlines and its employees were not asked to appear as witnesses, we are keenly interested in the issue and are preparing a written statement that we respectfully ask to be entered into the record.

While the media has focused almost exclusively on the crisis precipitated by airlines abandoning or freezing pension plans, American and its employees are following a different path. We are, together, working hard to maintain our defined benefit pension plans. We urge the Committee to enact legislation that would give us the chance to do so.

To be clear, we understand the desire other companies have for legislation that allows companies, through the collective bargaining process, to freeze defined benefit plans and convert to other types of plans. This is a useful tool to have if necessary to prevent more drastic results. But we need legislation that does not *require* us to freeze our pension plans.

We hope not to resort to a freeze or to the termination of our pension plans. We need the help of Congress to enact legislation that provides a realistic and stable interest rate for calculating full funding and a reasonable period of time to amortize the amount necessary to achieve full funding – all without limiting lump sums and other benefits of our plan participants. American's defined benefit plans are the best funded in the airline industry. Our plans have been managed prudently over the years, earning an average return of well over 10 percent. Moreover, we have a history of steadily contributing to our plans even in the years when cash was very short. In the last two years we have contributed over $599 million dollars to our plans.

Honorable Charles Grassley
Honorable Max Baucus
June 7, 2005
Page 2

We fear that in the midst of concern about the potential default of airline plans, Congress will take actions that would inadvertently cause our plans to become just as vulnerable as those currently in trouble. In particular, any legislation that would place greater funding burdens on companies with "below investment grade" credit ratings could have the perverse effect of forcing us to abandon our plans. We do not oppose setting different premium rates for companies with more risk reflected in their pension plans, but the measurement should be the strength of the plan, not the strength of the sponsor. We strongly oppose different funding rules based on a company's credit ratings.

With the help of Congress, we at American have a very realistic chance of returning to our historic status of fully funded defined benefit plans. We will submit a full statement for the record presenting in more detail our legislative and regulatory objectives.

Sincerely yours,

Captain Ralph Hunter
President
Allied Pilots Association

Tommie L. Hutto-Blake
President
Association of Professional Flight Attendants

James C. Little
Int'l. Executive Vice President
Director Air Transport Division
Transport Workers Union

Gerard J. Arpey
Chairman & CEO
American Airlines, Inc.

6-7-05 PREVENTING THE NEXT PENSION COLLAPSE: LESSONS FROM THE UNITED AIRLINES CASE

Senate Committee on Finance
Editorial and Document Section
Rm. SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200

Submitted By: JB Brooks

Distinguished Members:

I have watched the Senate hearings on United Airlines pension default with a mixture of anger and awe. Anger directed toward the current situation which faces hundreds of thousands of United Employees/Retirees and their families, and awe at the ease with which some members of the panel lied about the impact of the UAL case on those individuals—and the future of private sector retirement in general.

The recent deal brokered between UAL and the PBGC is ludicrous, and incredibly, appeared at a point in time when UAL had been specifically charged with negotiating in good faith with employee groups to find ways to preserve pensions. The decision by Judge Wedoff to uphold this "deal" clearly indicates that no one, including the Court, was serious about ensuring that the legal protections included in ERISA and/or Chapter 11 proceedings were being followed. How else could a "new" 1.5B agreement suddenly materialize a mere 11 days after serious "good-faith negotiations" ceased? The PBGC obviously succumbed to the prospect of receiving future cash (not to be shared with participants), in exchange for this irresponsible decision relative to their mandated fiduciary responsibilities. Remember the UAL ESOP Plan? That once valuable leg of retirement planning disintegrated entirely with the bankruptcy filing for thousands of families. Yet this "deal" is the same sort of paper the PBGC has signed up for, tantalized by unscrupulous UAL executives who espouse LOYALTY and RESPECT, but who have never been in one position long enough to understand what those terms actually mean.

Glenn Tilton's testimony that stated that retirees would not be unduly affected by the PBGC is entirely false. Obviously the man has not taken the time to run the PBGC formulas against his own financial picture (of course, why would he with 4.5M socked away after a mere 3 years, combined with his stature as one of the highest paid airline CEO's?). After working for 38 years (63% of my life thus far) for UAL, the PBGC formulas clearly show that if this travesty is allowed, the financial underpinnings of my retirement will be reduced by at least 75%—perhaps 95% (the PBGC formulas are confusing at best and onerous at worst). I would not call that unduly affected! My ability to provide care for my elderly parents will be destroyed. Instead of keeping them at home and off of welfare, it will force them into sub-poverty—expanding already overburdened programs that ensure minimum healthcare and living standards. My ability to retain my home, vehicle, health insurance, life insurance and provide my family with the basic essentials of life (*i.e.,* food) will be severely in question. From the stories I hear, the devastation my family will face is just one of many. And what about the communities where we live? I believe the impact there will be considerable, as well. The reality of the situation is that if UAL is not forced to deal with their business plan in any manner other than dumping pensions in order to balance their checkbook, then you—Congress—are setting the stage for the financial ruin of your constituents—surely you do not believe UAL is the only company that will use this ruse to clean up their bottom line?

As a retiree, it is too late for me to return to the workforce long enough to recoup the enormous losses that I may be subjected to. United has failed to explore the viable alternative solutions that have been presented for the preservation of retiree pensions.

While UAL offers lip service to the fact that they worked to maintain pensions, you have testimony—supported by fact—in this hearing that there are still ways to maintain pensions for retirees without unduly affecting either UAL or the PBGC—or the American taxpayers. Why is no one taking a look at that fact? While active employees may choose to dump their plans, to summarily demolish the livelihood of a retiree is criminal. UAL fully intends to circumvent my retirement contract with this deal—and that should not be allowed to happen.

It is my opinion that H.R. 2327 and the other proposed legislation that is before Congress (H.R. 2106, S. 861 and the Senate companion to H.R. 2327) are necessary to preserve the integrity of a secure private-sector retirement—at least for current retirees. Anything short of this will surely open the floodgates to financial ruin for many, including the greedy PBGC, as other segments of corporate America will attempt to follow the "UAL MODEL" for corporate success!

Sincerely,

JB Brooks

FOR RELEASE
JUNE 7, 2005

CONTACT: ROGER D. HALL[1]
(954) 524-0455

UNITED AIRLINES RETIRED PILOTS INSIST THEIR PENSIONS CAN STILL BE SAVED, AND THAT THE BARGAIN BETWEEN UNITED AND PBGC WAS MISCONCEIVED

In a statement submitted to the hearing before the U.S. Senate Committee on Finance today (June 7, 2005), the United Retired Pilots Benefit Protection Association ("URPBA"),[2] with membership of over 3,100 retired pilots of United Airlines, explained to the Committee that there is no need to terminate the United Pilots Pension Plan which United and PBGC both agreed to terminate, with the consent of the Air Line Pilots Association) (ALPA).

Roger Hall, President of URPBPA, stated that the Pilots Plan could be split into an active pilots plan and a retired pilots plan, and then the active pilots plan could be terminated, leaving the retired pilots plan in place, but frozen. Under asset allocation rules, that mechanism would leave the retired pilots plan fully funded, would give the active pilots the chance to earn back their losses in current and future labor negotiations, and would save PBGC and the government over $750 million.

A copy of the URPBPA statement submitted to the Committee is attached.

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[1] Full name and address of person and organization delivering this statement: Roger D. Hall, President, United Retired Pilots Benefit Protection Association, 1126 South Federal Highway #159, Fort Lauderdale, FL 33316. (Phone: (954) 524-0455)

[2] [2]The United Retired Pilots Benefit Protection Association (URPBPA) is a non-profit Corporation registered in the State of Illinois. It was formed by retired United Airlines' pilots who have extensive experience in representing the pilots of United Airlines. All of the Officers and Directors of the Association work without any financial compensation for the benefit of its members. The Association currently represents over 3,100 of United Airlines retired pilots.

THE COLLAPSE OF UNITED AIRLINES' PILOTS PENSION PLAN – IT COULD HAVE BEEN SAVED, AND, IN LARGE PART, IT STILL CAN BE SAVED

Statement of Roger D. Hall,[1] President of the United Retired Pilots Benefit Protection Association, prepared for inclusion in the record of a hearing on "Preventing the Next Pension Collapse: Lessons from the United Airlines Case," before the United States Senate Committee on Finance, June 7, 200

Mr. Chairman and Senators, the retired United Airlines pilots stand to be the big losers in this collapse. The United Retired Pilots Benefit Protection Association ("URPBPA")[2] represents the largest segment of United's retired pilots – Pilots who worked their entire careers building this airline, relying on United's promise to provide decent security in retirement, and who are now told that they will lose huge portions of their pensions -- in many cases more than 60 percent. For a retiree, that large a percentage loss of income is catastrophic, leading to forced sales of homes and other terrible economic consequences. Our files and member correspondence contain many such heartbreaking stories, and the worst part of it is this: ***it did not need to happen.*** In fact, it still does not need to happen. If you examine what has happened at United, there is a better way -- a way out – and it's still there.

What Actually Happened? A Three-Way Bad Bargain

What actually happened? Clearly, ***this was a bargain.*** It was a bargain between (1) the Air Line Pilots Association ("ALPA," which had renounced any obligation to represent its own retirees), (2) United (which was determined to cut the benefits of its retirees), and (3) the Pension Benefit Guaranty Corporation ("PBGC," which went along with the deal).

Under the bargain, ALPA agreed not to oppose termination of the Pilots Pension Plan, and in exchange United agreed to grant greatly enhanced new pension benefits to active pilots (only), and then to set aside $550 million in debt obligations for later make-ups to active pilots (only). The bargain gave nothing to the retirees – it just cut their pensions, almost to the bone.

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[1] Full name and address of person and organization delivering this statement: Roger D. Hall, President, United Retired Pilots Benefit Protection Association, 1126 South Federal Highway #159, Fort Lauderdale, FL 33316. (Phone: (954) 524-0455)

[2]The United Retired Pilots Benefit Protection Association (URPBPA) is a non-profit Corporation registered in the State of Illinois. It was formed by retired United Airlines pilots who have extensive experience in representing the pilots of United Airlines. All of the officers and directors of the Association work without any financial compensation for the benefit of its members. The Association currently represents over 3,100 of United Airlines retired pilots.

PBGC went along with the deal, and expects to absorb unfunded pilot benefit obligations of over $1 billion. ***But PBGC had a way out of most of it, and they still do, today.***

A Plan Split/Partial Termination Could Save the Retired Pilots' Pensions,
Save Money for the PBGC,
and Still Leave United With the Benefits of Its Bargain

URPBPA has explained to United and PBGC that United can "split" the Pilot Plan into two plans – one for the actives and one for the retirees – and then terminate only the plan for the actives. The allocation of current assets between the two plans is controlled by a provision of ERISA (4044(a)). The split is allowed by a provision of the Internal Revenue Code (IRC 414(l), and Reg 1.414(l)). And the results would be this:

The Retired Pilots Plan would continue, but, using United's actuarial assumptions, it would be fully funded.

And PBGC's absorption of unfunded Pilot pension obligations would be reduced by over $750 million.

And, since the Pilots Plan is still not actually terminated, they can still do this – now.

Why didn't United do it this way, since the main pension funding cost would be eliminated anyway?

Why didn't ALPA demand it, since they could have achieved a decent retirement for their own retirees, without changing the deal for the active pilots?

Why didn't PBGC force this split into the deal it made with United, since it would have lowered the Government's new debt obligation by and saved PBGC over $750 million?[3]

The answers to these questions are difficult to smoke out. United Airlines views their current bankruptcy position as an excellent opportunity to deny retirees and employees the benefits they worked many years to obtain. United maintains that termination of their defined benefit pension plans is the only alternative. They have even gone so far as to insist in their agreement with the PBGC that none of United's Defined Benefit Plans can ever be restored in the future. This means that, even if United emerges from bankruptcy and generates massive profits, retirees will never recover what was taken from them. Such actions are clearly punitive and are not necessary for United to emerge from bankruptcy.

URPBPA would urge the Committee to consider changes to current law that would require companies in bankruptcy to work toward alternatives to outright plan termination

[3] And ***why*** doesn't this Committee demand detailed answers to these questions? URPBPA believes that the proposal we have developed is a viable alternative to catastrophic plan terminations, and we urge the Committee to consider expanding its feasibility and perhaps requiring it when plan sponsors pursue needless plan terminations of defined benefit plans.

thereby avoiding these devastating losses for retirees. Current law makes outright termination an easy way out of their obligations for companies and leaves retirees to suffer financial hardships for the rest of their lives.

Other Changes in Existing Law

The recent actions of United Airlines and PBGC seeking to terminate United's defined benefit plans for all of United's retirees and employees clearly highlight the deficiencies in current laws governing plan termination, plan funding and reporting requirements. Current law needs to be changed to require companies to maintain the funding of the plans at or near full funding levels and to provide strict requirements for plans to return to full funding over a period of time when deficiencies occur. The law should also require that plan participants be provided with quarterly reports on the funding status of their pension plans. And of course, termination needs to be the absolute last resort, not the easy way out.

This Committee obviously recognizes that if United's plans are terminated, other airlines will seek to follow suit. The termination of additional airline defined benefit plans will place greater stress on the PBGC's resources, and even greater stress on the resources of the retirees whose pensions are cut back. URPBPA urges your immediate consideration of changes to current law to prevent these types of occurrences from devastating other retirees and employees.

URPBPA also strongly supports S.1158, the bill introduced by Senator Edward Kennedy and others, that proposes a six-month moratorium on involuntary plan terminations under ERISA 4042, in bankruptcy cases. This ought not to be a mindless stampede, particularly when there are solutions that can be found, and that work.

But first and foremost, we ask this Committee to look at what is happening at United and consider imposing more stringent plan termination standards when there is a feasible alternative to full plan termination. Pension benefit devastation imposes not just a government cost, and not just a corporate cost – there is a human cost that should not be overlooked – particularly when with the application of some intelligence, the parties can achieve a result that is so much better for all concerned.

We have told United this: We understand that in insolvency situations ***business leaders must sometimes make hard and painful decisions.*** If they must, they must, and reasonable people understand that. ***But when devastating cuts are not necessary and management hacks away at retirement security anyway, that is neither understandable nor acceptable. It is an outrage!***

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