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Cost Accounting Standards Board
Office of Federal Procurement Policy
725 17th Street, NW
Room 9013
Washington, DC 20503

RE: CAS Pension Harmonization ANPRM

Prudential Retirement is pleased to have this opportunity to provide comments regarding the CAS Pension Harmonization Advance Notice of Proposed Rulemaking (ANPRM). Prudential Retirement provides complete and customized retirement solutions for companies, including delivering actuarial consulting services.

We commend the CAS Board for addressing the complex issues concerning harmonizing pension costs under the CAS 412/413 requirements with the minimum funding requirements under the Pension Protection Act (PPA) of 2006. We believe the ANPRM reflects an excellent approach for addressing these important issues.

One of the Board's stated harmonization goals is to mitigate pension cost volatility; however, our analysis indicates that significant volatility occurs under the proposed CAS requirements. We respectfully suggest the following to reduce the pension cost volatility:

1. Minimum Actuarial Liability (MAL) Interest Rate: Clarify that the discount rate for determining the MAL and Minimum Normal Cost (MNC) can be determined using a best estimate assumption over the *long term* of yields on high-quality corporate bonds, not only using a *spot* settlement rate.
2. Cost Based Trigger for MAL Adjustment: Modify the requirements so the adjustments for the difference between the MAL and Actuarial Accrued Liability (AAL) and their associated normal costs are applied if the *cost* is larger, instead of if the *liability* is larger.

We modeled various scenarios based on the ANPRM methodology. Our modeling is based on a hypothetical plan that we believe has characteristics typical of many large contractor pension plans. The assumptions and methods for our modeling are outlined in Appendix A. In general, we have assumed a hypothetical plan that is 90% funded, with liabilities of \$1,000 million and assets of \$900 million invested in a 60% equity (40% bond) portfolio. This modeling, and the conclusions we have drawn from our results, provides the basis for our comments.

Our analysis relates primarily to the application of the MAL. Charts I – VIII ignore transition to analyze the long term ANPRM methodology. These charts illustrate CAS Cost Volatility, Mandatory Prepayment Credits (MPC) and the MAL Adjustment Trigger. We also analyzed the impact of transition in Charts IX – X, and we provided comments on the effective date.

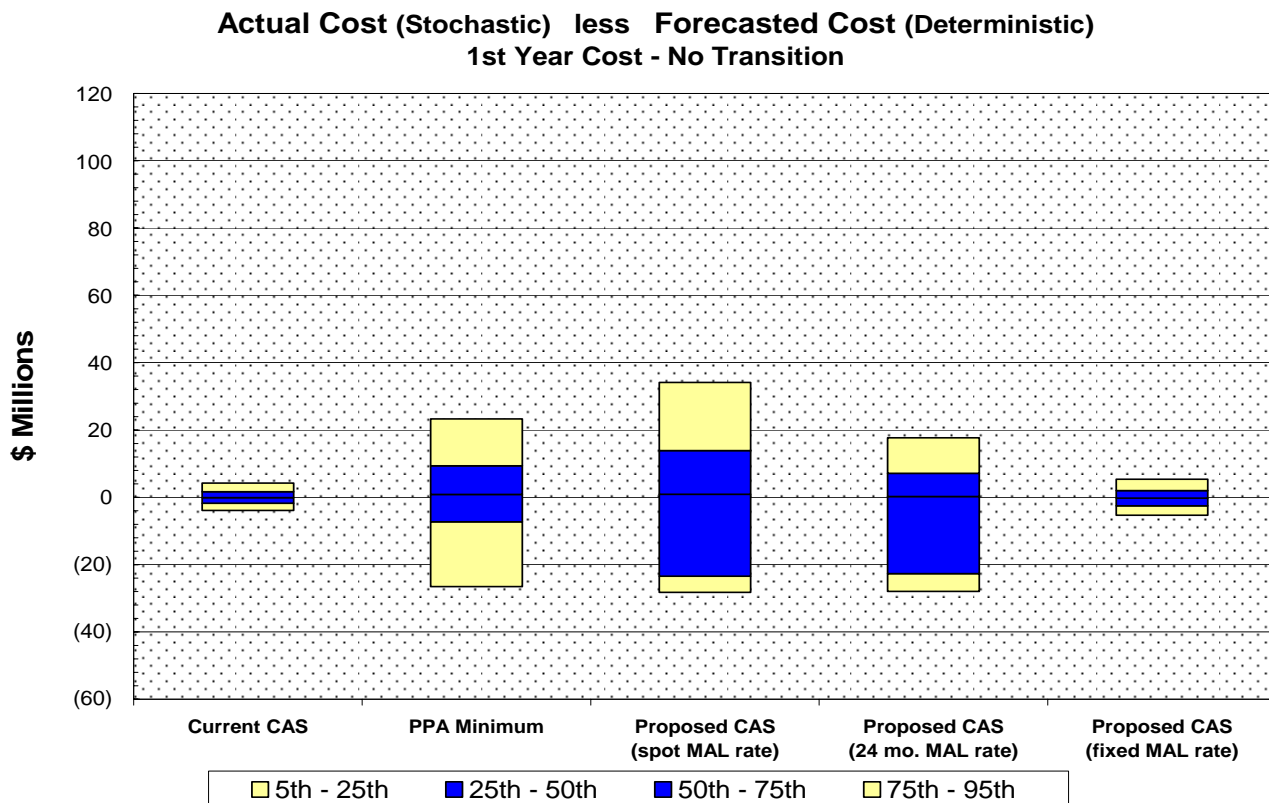
CAS Cost Volatility

Cost volatility was compared under 5 scenarios:

1. Current CAS Requirements (prior to harmonization)
2. PPA Minimum
3. Proposed CAS Requirements (using a spot interest rate for the MAL assumption)
4. Proposed CAS Requirements (using a 24-month smoothed interest rate for the MAL assumption)
5. Proposed CAS Requirements (using a fixed, long term interest rate for the MAL assumption)

Chart I illustrates the difference between the actual year 1 cost (as stochastically modeled) and the forecasted year 1 cost (as deterministically modeled). Cost volatility is illustrated by the size of the bars, e.g., wider bars indicate increased cost volatility and reduced cost predictability.

Chart I

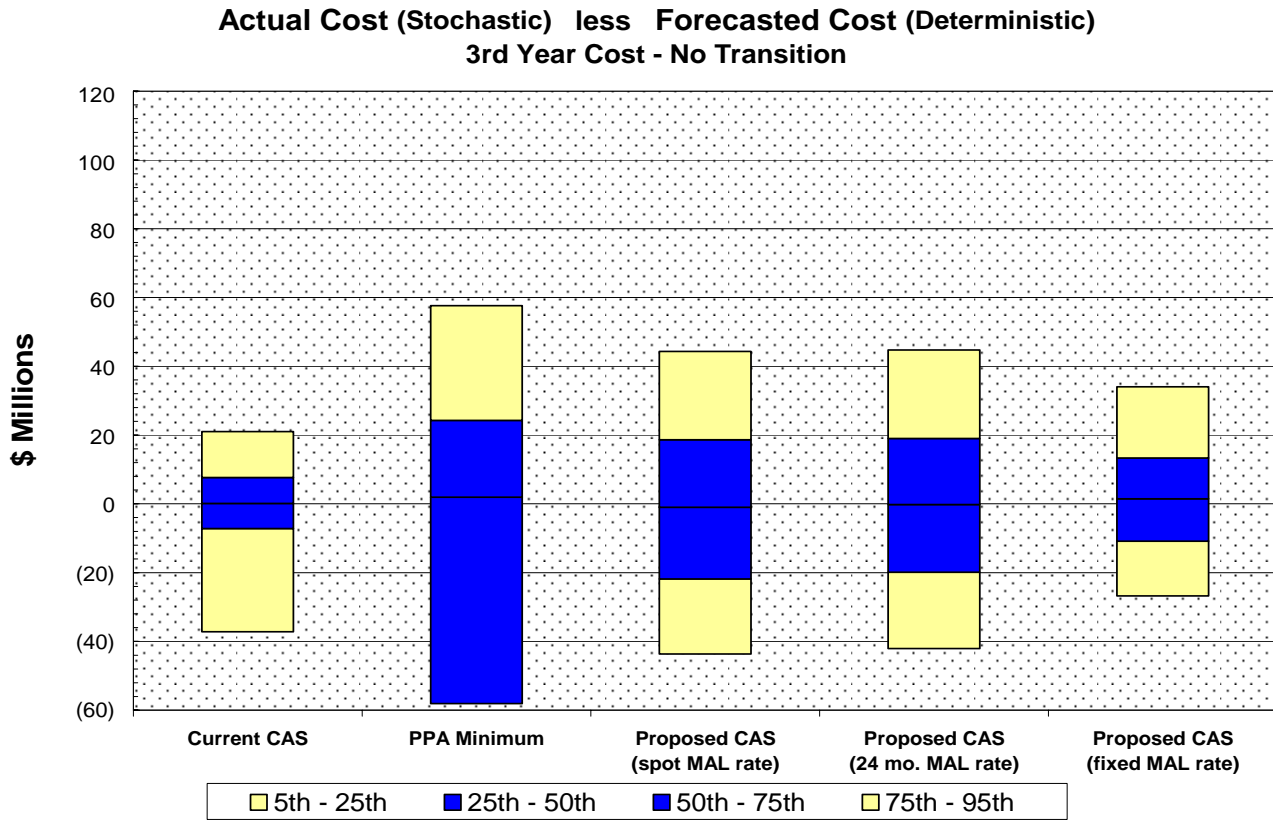


Compared to the current CAS, the proposed CAS with a spot MAL interest rate increases cost volatility by approximately 700%. This is primarily driven by the volatility of the interest rates used to determine the MAL, the liability based trigger for the MAL adjustment, and by the shorter gain/loss amortization (10 years vs. 15 years).

Volatility is reduced by using a 24-month smoothed bond rate (as allowed under PPA) instead of a spot rate. Volatility is significantly reduced by utilizing a fixed, long term bond rate assumption. With a fixed bond rate, first year costs would be only slightly more volatile than under the current CAS (prior to harmonization).

Chart II illustrates the difference between the actual year 3 cost (as stochastically modeled) and the forecasted year 3 cost (as deterministically modeled). Chart II is similar to Chart I, except it examines costs in year 3 instead of year 1.

Chart II

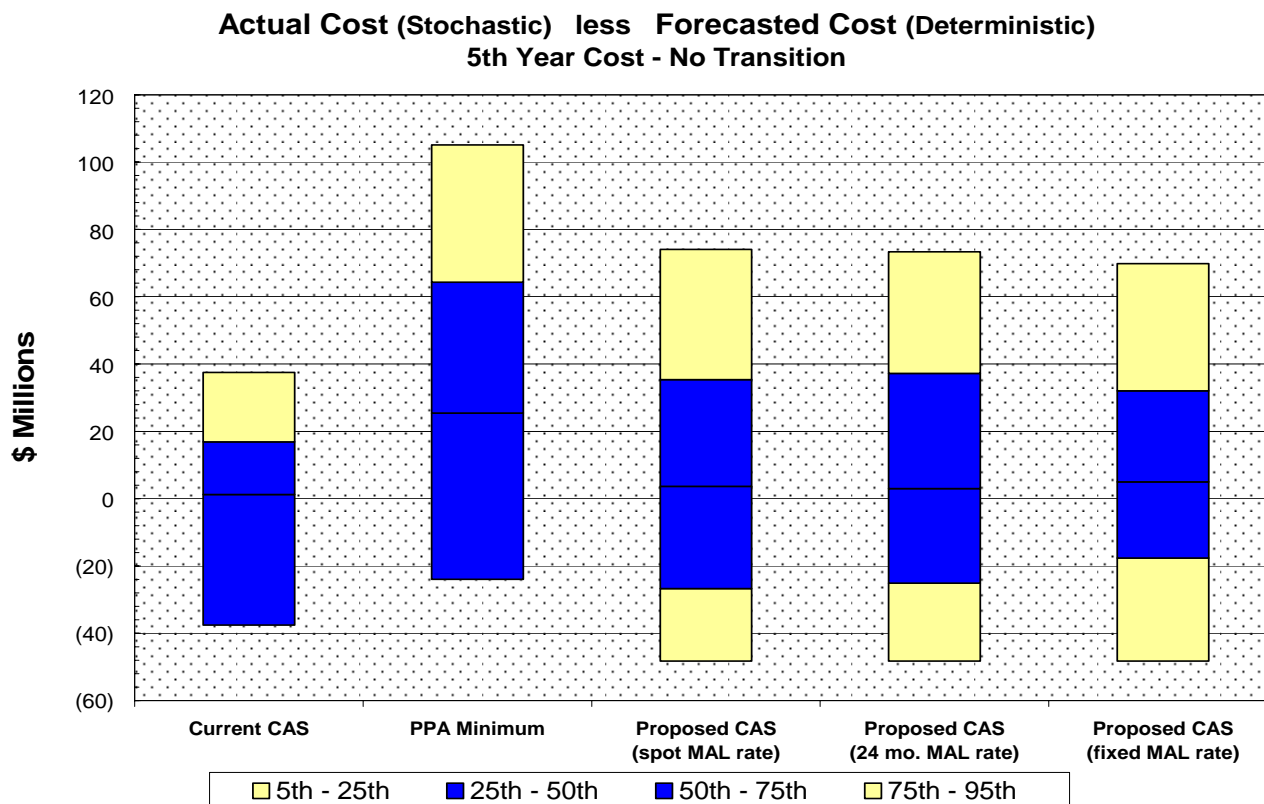


Cost volatility increases by projecting costs to year 3 instead of year 1, primarily due to the volatility of investment returns.

Utilizing a fixed MAL interest rate continues to be an effective means to reduce cost volatility in year 3 compared to a spot or 24-month smoothed interest rate. The proposed CAS cost with a fixed MAL interest rate is slightly more volatile than the current CAS cost (prior to harmonization) primarily due to the shorter gain/loss amortization period and the amortization of MPC back into CAS costs.

Chart III is similar to Charts I and II, except it examines costs in year 5 instead of years 1 and 3:

Chart III



Utilizing a fixed interest rate continues to reduce cost volatility in year 5 compared with a spot or 24-month smoothed interest rate. However, the volatility reduction is not as significant as in years 1 or 3 primarily because most of the cost volatility is investment related. In addition, amortization of MPC back into CAS costs is more pronounced by the fifth year.

In summary, utilizing a fixed, long term MAL interest rate assumption significantly reduces cost volatility compared to a spot or 24-month smoothed interest rate, particularly in the first 3 years. It is not entirely clear if the MAL interest rate outlined in the ANPRM allows for all 3 interest rate scenarios (spot, 24-month smoothed, and fixed). We recommend that the Board clarify that all 3 scenarios are allowed – especially the use of a fixed, long-term assumption.

Some additional comments regarding a fixed long-term MAL interest rate assumption:

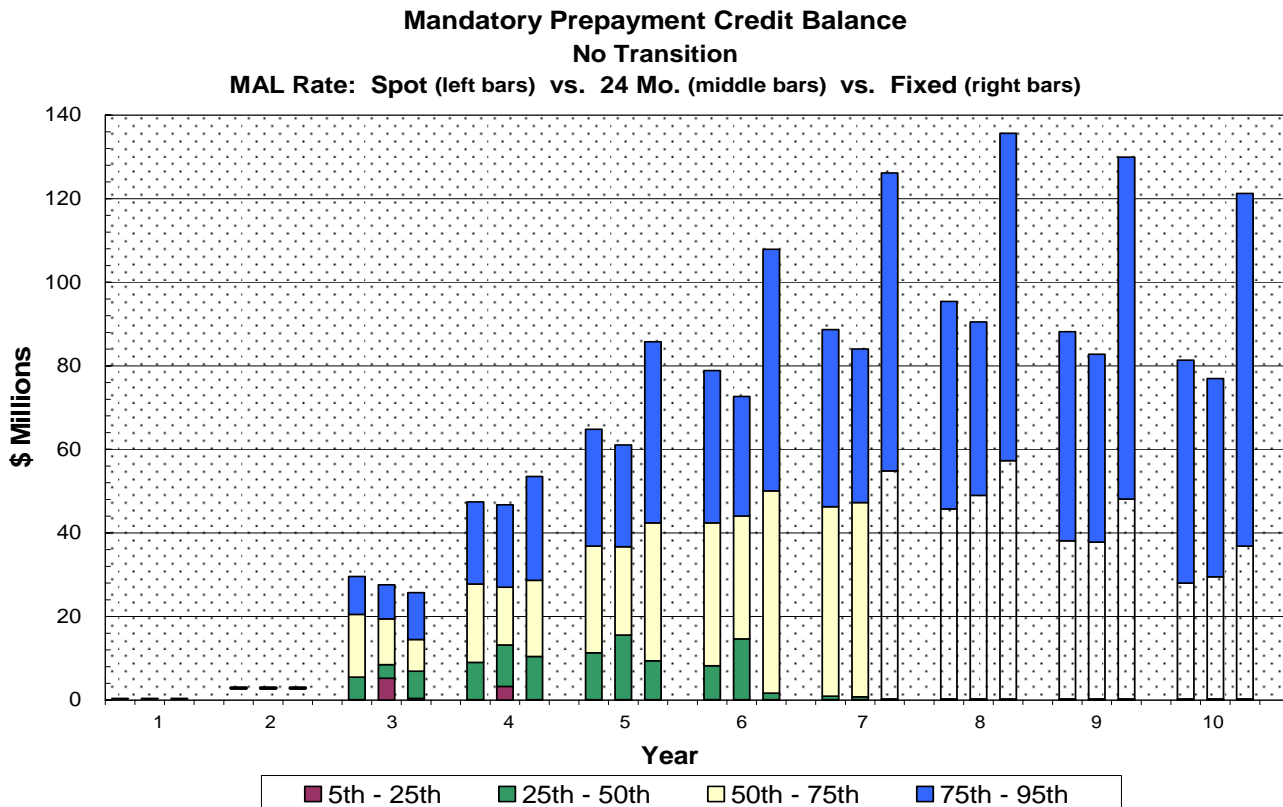
1. If contractors were to rely on spot rates only for the MAL assumption, additional complexity arises when computing pricing forecasts. For example, should contractors use the current spot rate for the forecast? Should they use a long term assumption for the forecast period? Or should the current rate trend toward a long term assumption during the forecast period?
2. A long term assumption aligns with the Board’s stated belief that pension cost should be viewed in the long term. A long term assumption enhances predictability, and a long term view is consistent with all other assumptions a contractor will continue to make (for example, the AAL discount rate). By allowing for a MAL adjustment, the Board has essentially accomplished the primary goal of harmonization. By mandating that this adjustment will be based on a floating assumption basis, the Board may be deviating from other important goals and objectives.

- The fixed interest rate assumption should be a best estimate over the long term of yields on high-quality corporate bonds. It should be selected in the same manner as all other assumptions selected by the contractor, and should bear a consistent relationship with the other assumptions.

Mandatory Prepayment Credit (MPC)

Chart IV illustrates the range and likelihood of Mandatory Prepayment Credits (MPC), ignoring transition, under the proposed CAS rules.

Chart IV



Although the MPC will be relatively small in most scenarios, there is the potential for some build-up due to differences under the CAS and PPA requirements in the asset smoothing and gain/loss amortization periods. For example, in years 6-8, there is a 25% chance that the MPC is at least \$40 to \$50 million.

Chart IV also shows the difference in the MPC balance under the proposed rules that results from using a spot rate, a 24 month smoothed rate, and fixed long term rate for the MAL interest assumption. The MPC balance that results under these three options is relatively similar 75% of the time (as noted by the tops of the yellow bars). A larger MPC balance can result with the use of a fixed MAL rate (as shown by the increase in the blue bars on the right). This reflects a trade-off for enhanced cost predictability.

Finally, Chart IV shows that the MPC balance peaks and starts to decline by year 10. This results from the 5-year MPC amortization, which brings the MPC balance back into costs.

Although MPC balances are likely to exist, the proposed methodology is closely harmonized with PPA. The median MPC balance that results is very close to zero. Any MPC balances that build-up due to differences in asset smoothing periods or bond rate assumptions may not be overly significant. Also, there is a mechanism in place, amortization of the MPC, to correct any excess build up.

We did not model any voluntary prepayment balances. Also, we assumed that any PPA credit balances that were created by CAS costs in excess of the PPA minimum were not waived. However, it is important to note that the ANPRM may discourage any advance funding which would create voluntary prepayment balances. This could result since voluntary prepayments would presumably create PPA credit balances. Any PPA credit balances would lower future PPA minimum contributions which would make the creation of MPC less likely.

The Board may want to consider alternate approaches for the application of mandatory and voluntary prepayment credits.

Minimum Actuarial Liability (MAL) Adjustment “Trigger”

As currently proposed, the MAL adjustment is only applied (or “triggered”) when the MAL exceeds the AAL. When this occurs, the AAL is adjusted, as well as the NC. We recommend that in order to reduce cost volatility the Board consider a “cost based” trigger instead. The cost trigger would adjust for the difference between the MAL and AAL, and their associated normal costs, if:

$$[\text{the MAL less AAL amortized over 10 years}] \text{ plus } [\text{the MNC less NC}] \text{ exceeds } \$0.$$

Consider the following example in Chart V, with the proposed CAS liability trigger:

Chart V

Proposed CAS – Liability Trigger (\$ in millions)

	AAL	NC	MAL	MNC	Asset	Calculated CAS Cost				
						MAL Adj.	Adjusted AAL	NC	Amort.	Cost
Year 1	1,000	20	990	40	900	No	1,000	20	13.8	33.8
Year 2	1,000	20	1,010	40	900	Yes	1,010	40	15.2	55.2
									% Change:	63%

Notes: MAL Adjustment: [MAL - AAL] > 0
 Amortization payment reflects 10-year payment of unfunded liability at 8.00%

The only difference between the Year 1 and Year 2 valuation results shown in Chart V is that the MAL increased by 2% from \$990 million (just below the AAL) to \$1,010 million (just above the AAL). This small liability change results in a 63% increase in cost.

Chart VI below is the same as Chart V above, except it reflects an alternative cost based trigger:

Chart VI

Alternate CAS – Cost Trigger (\$ in millions)

	AAL	NC	MAL	MNC	Asset	Calculated CAS Cost				
						MAL Adj.	Adjusted AAL	NC	Amort.	Cost
Year 1	1,000	20	990	40	900	Yes	990	40	12.4	52.4
Year 2	1,000	20	1,010	40	900	Yes	1,010	40	15.2	55.2
									% Change:	5%
Notes: MAL Adjustment: [MAL - AAL amortized over 10-yrs] + [MNC - NC] > 0 Amortization payment reflects 10-year payment of unfunded liability at 8.00%										

In Chart VI, the change in the MAL from just below the AAL to just above the AAL is simply reflected as a small increase in the amortization cost. The 2% change in the MAL increases the total cost by only 5%, much less than the 63% increase that occurred with the liability trigger.

One other issue exists with the proposed liability based MAL trigger. An inequity can result in the application of the requirements at the segment level, especially when a contractor has an inactive segment.

Consider a contractor who maintains an inactive segment (Plan 1) and a contractor who maintains an identical plan (Plan 2) but without an inactive segment, as in Charts VII and VIII. Chart VII reflects the proposed CAS liability trigger and Chart VIII reflects the alternative cost trigger.

Chart VII

Proposed CAS – Liability Trigger (\$ in millions)

		AAL	NC	MAL	MNC	Asset	Calculated CAS Cost				
							MAL Adj.	Adjusted AAL	NC	Amort.	Cost
PLAN 1											
Seg - 1	Active	500	20	410	40	450	No	500	20	6.9	26.9
Seg - 2	Inac.	500	0	600	0	450	Yes	600	0	20.7	20.7
	Total	1,000	20	1,010	40	900		1,100	20	27.6	47.6
PLAN 2											
Segment - All		1,000	20	1,010	40	900	Yes	1,010	40	15.2	55.2
Notes: MAL Adjustment: [MAL - AAL] > 0 Amortization payment reflects 10-year payment of unfunded liability at 8.00%											

Chart VIII

Alternate CAS – Cost Trigger (\$ in millions)

							Calculated CAS Cost				
		AAL	NC	MAL	MNC	Asset	MAL Adj.	<u>Adjusted</u>		Amort.	Cost
							AAL	NC			
PLAN 1											
Seg - 1	Active	500	20	410	40	450	Yes	410	40	(5.5)	34.5
Seg - 2	Inac.	500	0	600	0	450	Yes	600	0	20.7	20.7
Total		1,000	20	1,010	40	900		1,010	40	15.2	55.2
PLAN 2											
Segment - All		1,000	20	1,010	40	900	Yes	1,010	40	15.2	55.2
Notes: MAL Adjustment: [MAL - AAL amortized over 10-yrs] + [MNC - NC] > 0 Amortization payment reflects 10-year payment of unfunded liability at 8.00%											

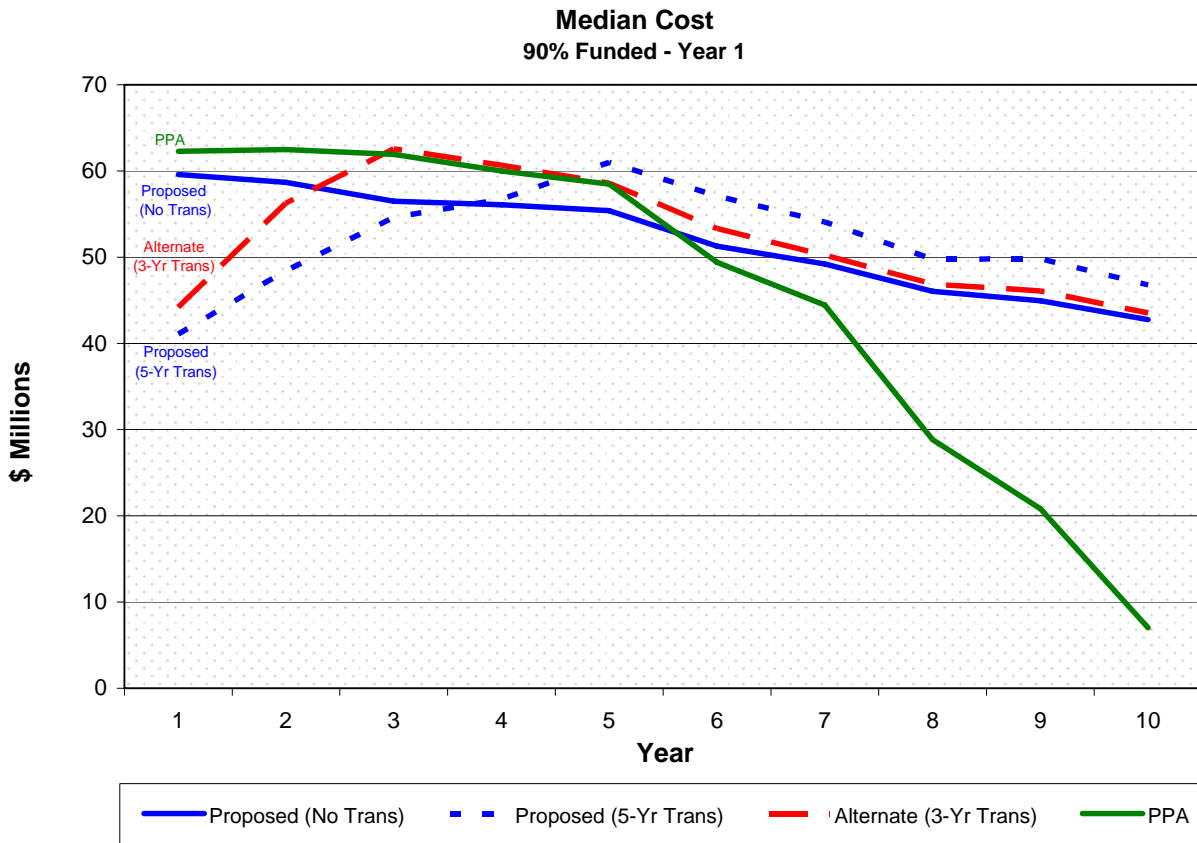
The liability trigger results in different costs for Plan 1 and Plan 2 while the cost trigger results in the same cost for both plans. Accordingly, a cost based trigger would treat contractors with and without inactive segments more equitably. In addition, a cost based trigger harmonizes with PPA better than a liability trigger since it is more likely to produce plan level CAS costs closer to PPA minimum contributions.

The preceding cost trigger analysis depends on the relationship between the long term liabilities (AAL and NC) and the minimum liabilities (MAL and MNC). These liability relationships depend on many factors such as the plan demographics and plan design. Although the liability relationships for some contractor pension plans will differ from those shown in Charts V – VIII, we believe the relationships used in these charts are typical of many contractor pension plans.

Transition

Chart IX shows the projected median cost ignoring transition, as well as including transition. For comparison, the PPA Minimum contribution and an alternate cost reflecting a 3-year transition are also shown:

Chart IX



The CAS Costs on Chart IX reflect a 24-month smoothed rate for the MAL assumption for each of the scenarios.

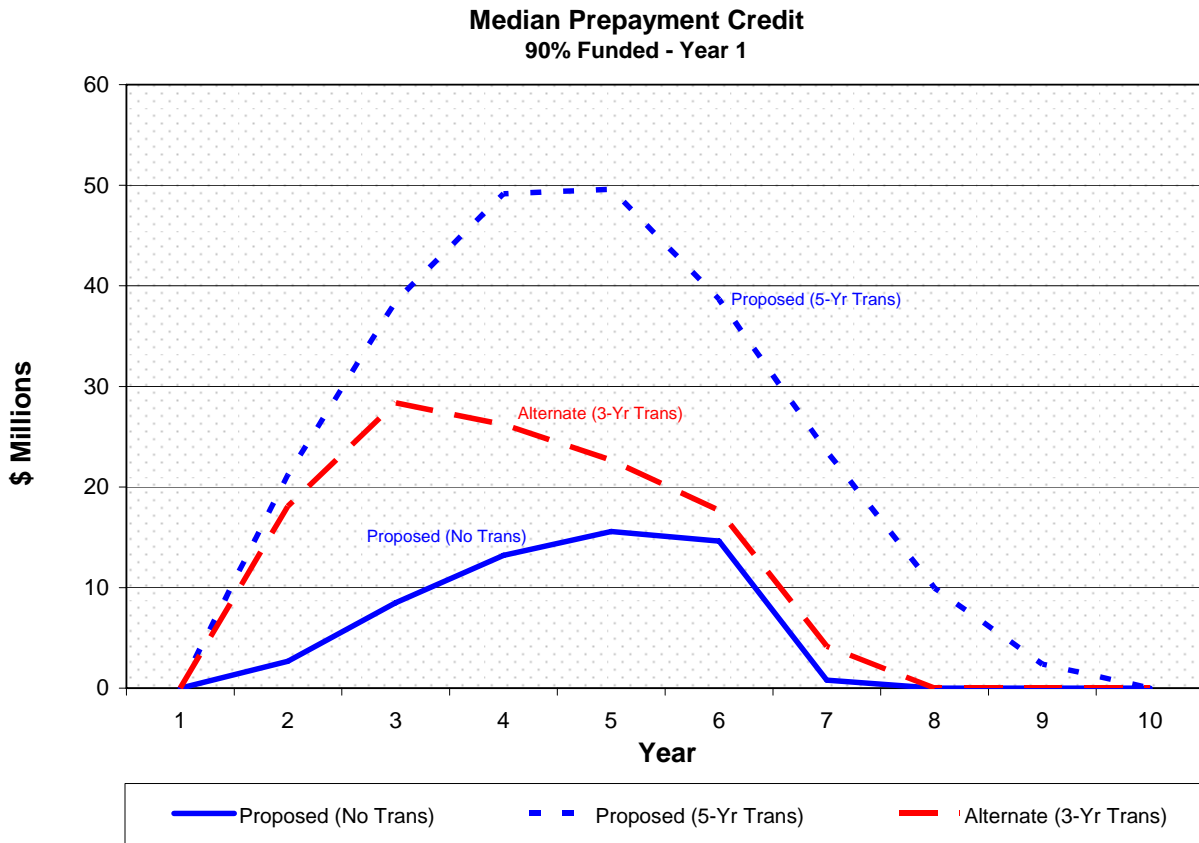
The alternate 3-year transition reflects 33.3% of the MAL adjustment in year 1, 66.7% in year 2, and 100% thereafter. Additionally, the alternate 3-year transition reflects no transition phase-in for gain/loss or MPC amortization, i.e. gains/losses are always amortized over 10 years and MPC are always amortized over 5 years.

Chart IX shows that with no transition, the proposed CAS Cost is slightly lower than the PPA minimum contribution in year 1; this is primarily due to the longer amortization period (10 years vs. 7 years). The CAS cost with no transition begins to exceed the PPA minimum after year 5; this is primarily due to amortization of the MPC and the higher Assignable Cost Limit (125% of AAL).

With transition, the proposed CAS cost and the alternate 3-year transition cost are significantly lower in the first few years. This is primarily due to the phase-in of the MAL adjustments.

Chart X shows the median prepayment credit balance that will be built up due to a transition phase-in:

Chart X



Under the proposed transition rules, a significant MPC builds up in the early years and peaks in years 4 and 5. Note that the median balance is not recovered through the MPC amortization adjustment mechanism until about year 10. Under the alternate 3-year transition, the median MPC peaks in year 3 and closely aligns with the proposed CAS cost (no transition) by year 6.

One of the transition goals is to minimize undue immediate budget impacts on the federal government. We are not in a position to comment on how the ANPRM satisfies this goal. However, harmonization would be best achieved by having no phase-in of the MAL instead of the proposed 5-year phase-in. Note that there is no analogous phase-in of the excess of the Target Liability over the AAL in the PPA funding rules, and 100% of the unfunded liability under PPA must be funded over 7 years.

If a phase-in must be maintained for cost goals outside the scope of harmonization, a phase-in period as short as possible would reduce the transition induced build-up of large MPC balances. The alternate 3-year transition illustrates the sensitivity of reducing the phase-in period.

A few other transition items appear to add more complexity than necessary. For example, the gain/loss amortization period could immediately move to 10 years rather than be phased-in. This would be simpler to administer, better harmonize with PPA, and not materially impact costs.

Also, the amortization of the MPC amounts could always be 5 years. If there were no phase-in, there would be no excessive transition induced MPC build-up, and the ongoing 5-year payment schedule could apply.

Finally, existing MPC amounts at transition merit separate consideration. We would expect contractors who were not eligible for the delayed effective date to have the most significant build up of MPC amounts. Again, if there are no other MAL phase-in adjustments, perhaps the 5-year amortization mechanism would work even for existing MPC balances at transition.

Effective Date

The effective date of the new CAS harmonization requirements is not entirely clear. The PPA language appears to imply an effective date of January 1, 2011 while the proposed ANPRM may imply an effective date of January 1, 2010. If the final CAS regulations were issued prior to January 1, 2010, we respectfully suggest an effective date of January 1, 2011. This would allow actuarial consulting firms sufficient time to update their valuation software to reflect the new CAS requirements, including application at the segment level, and for contractors to recognize the new requirements.

Summary

In order to reduce cost volatility, we respectfully suggest clarification that the discount rate for determining the Minimum Actuarial Liability (MAL) and Minimum Normal Cost (MNC) can be determined using a best estimate assumption over the *long term* of yields on high-quality corporate bonds, not only using a *spot* settlement rate.

We also suggest modifying the requirements so the adjustments for the difference between the MAL and AAL and their associated normal costs are applied if the *cost* is larger, instead of if the *liability* is larger.

Prudential Retirement appreciates this opportunity to comment on the CAS Pension Harmonization ANPRM. We would be pleased to discuss any questions that you may have regarding our comments.

Sincerely,

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**APPENDIX A
ASSUMPTIONS & METHODS**

Initial Valuation Information

	Discount Rate	Method	Amount (\$ in millions)
Actuarial Accrued Liability (AAL)	8.0%	EAN	\$1,000
Normal Cost (NC)	8.0%	EAN	20
Minimum Actuarial Liability (MAL) and Target Liability	6.2%	Unit Credit	1,010
Minimum Normal Cost (MNC) and Target Normal Cost	6.2%	Unit Credit	40
Actuarial Asset			\$900
Market Asset			900
Credit Balance			0
Prepayment Credit Balances			0
Approximate MAL Duration			12

Modeling Assumptions & Methods

Asset Allocation: 60% Equity / 40% Fixed

Stochastic Variables:

Expected Return on Plan Assets	8.0%
Standard Deviation in Expected Return	11.8%
Expected PPA Effective Discount Rate	6.2%
Standard Deviation of Discount Rate	0.9%

Funding Method:

Cost Accounting Standards (CAS)	5-year asset smoothing
Pension Protection Act (PPA)	24-month interest and 3-year asset smoothing †

Segment Accounting: None

Funding Policy: Maximum of CAS Cost or PPA Minimum

† Reflects asset smoothing in proposed PPA technical corrections legislation