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PBGC: Effects of US Air and UAL Terminations

An already insolvent Pension Benefit Guaranty Corporation (PBGC) will soon absorb two airline claims totaling $8.5 billion. US Airways announced at the end of last week that it is seeking to terminate its remaining pension plans, with a claim PBGC has estimated at $2.1 billion. Further, a claim of $6.4 billion, the largest ever from a single firm, is likely to come from UAL. UAL, the parent company for United Airlines, has indicated that it expects to terminate its underfunded pension plans as part of its reorganization. This was first foreshadowed in late July, when the company obtained permission from its bankruptcy judge to skip required pension contributions. Despite being expected, this will still be a major event for PBGC. Taking on UAL will increase its size by roughly one quarter and raise its deficit by more than half from year-end 2003 figures. (Readers unfamiliar with PBGC may wish to visit our website, www.coffi.org, where there is a primer written in non-technical language, as well as a number of analytical pieces.)

Retirees and employees will absorb a $2.1 billion loss at the two airlines, due to limits on PBGC pension guarantees, and employees will no longer earn additional pension benefits. PBGC will assume most of the pension obligations, as well as $8.6 billion in existing pension assets. The assets are sufficient to pay about half of PBGC's new obligations.

This paper is organized around a few questions:

- What is a pension termination?
- How will employees and retirees be affected?
- What are the financial implications for PBGC?

We evaluate the financial implications for PBGC by using COFFI's cash flow model for the corporation. We believe this to be the first, and thus far only, public domain financial model of its type for PBGC. See our website for a detailed explanation of that model in the paper "PBGC: When Will the Cash Run Out".

What is a pension termination?

A "termination" is the ending of a defined benefit pension plan. No additional benefits will be earned by employees and no further contributions will be made by employers.

Normally, pension plans can only be terminated if a qualified insurer is paid to take over the pension promises, which in practice requires that a plan be at least fully funded by legal standards. However, financially distressed firms may terminate an underfunded plan under any of three specific circumstances:

- The sponsor is being liquidated in bankruptcy proceedings.
- The sponsor is reorganizing under Chapter 11 of the bankruptcy law and the bankruptcy judge determines that the firm cannot successfully survive post-bankruptcy without a plan termination.
- The termination is "required to enable payment of debts [by the sponsor] while staying in business or to avoid unreasonably burdensome pension costs caused by declining workforce."

US Airways and UAL are attempting to reorganize under Chapter 11 and apparently believe that their bankruptcy judges will agree that the firm will be unable to reorganize successfully without these pension terminations. Bankruptcy judges have generally granted such requests when pension underfunding represented a significant part of a bankrupt firm's liabilities, as is true for both airlines.

How will employees and retirees be affected?

Pension promises will be frozen in place. Anyone who has not yet vested in their pension plan will receive no pension. (Vesting usually occurs after approximately 5 years of employment with a particular firm.) Employees who have already vested will not receive any increased pension benefits as a result of continued employment or future salary increases. No cost of living adjustment will be granted. PBGC will take over the responsibility for paying the remaining pension benefits, within limits.

UAL employees and retirees are expected to lose $1.9 billion worth of pension benefits due to the legal limits on what PBGC can pay. US Airways employees should lose about $0.2 billion. The level is lower at US Airways partly because its pilots plan, where much of the difference would normally be at an airline, was already terminated two years ago, in the previous bankruptcy. The principal limitation on what PBGC pays is that it is prohibited by law from paying benefits that exceed a cap which is currently set at an annual pension benefit of $44,386 per person.

Additionally, PBGC makes two adjustments to the cap on annual benefit payments in a manner analogous to most pension plans. It adjusts the maximum guarantee down for retirements commencing before age 65 to reflect the number of years the participant is likely to receive benefits. PBGC's formula does not provide early retirement subsidies that might otherwise be available. The amount is also lowered if survivor benefits are elected. These pay a reduced benefit to a surviving spouse rather than ceasing upon the participant's death.

Improvements made to pension benefit formulas within the five years preceding the date of termination are phased in at the greater of: (a) 20% of the improvement per full year since the amendment or (b) a monthly benefit of $20 for each year since the amendment. That is, if a change was introduced slightly over three years ago, only 60% of the increase will be guaranteed, or $60 per month, if this is higher. This does not apply to automatic increases as a result of salary increases received by an individual.

What are the financial implications for PBGC of UAL terminations?

PBGC expects to take a loss of $6.4 billion from UAL's plans. This is based on $15.2 billion in pension obligations, in today's dollars, of which $1.9 billion falls outside the guarantee limits and will be absorbed by retirees and employees. There is approximately $6.9 billion of pension assets available to cover the remaining $13.3 billion. PBGC takes over both the assets and the guaranteed liabilities, leaving it with a loss of $6.4 billion.

Figure 1 shows our estimates of the cumulative effect on PBGC's total cash and investments ("cash") by year. We truncated the projection at 2024, for ease of illustration. The effect worsens every year, since there are no additions of cash from the UAL terminations after the first few years, but there are continuing pension payments and other cash outflows.

Figure 1

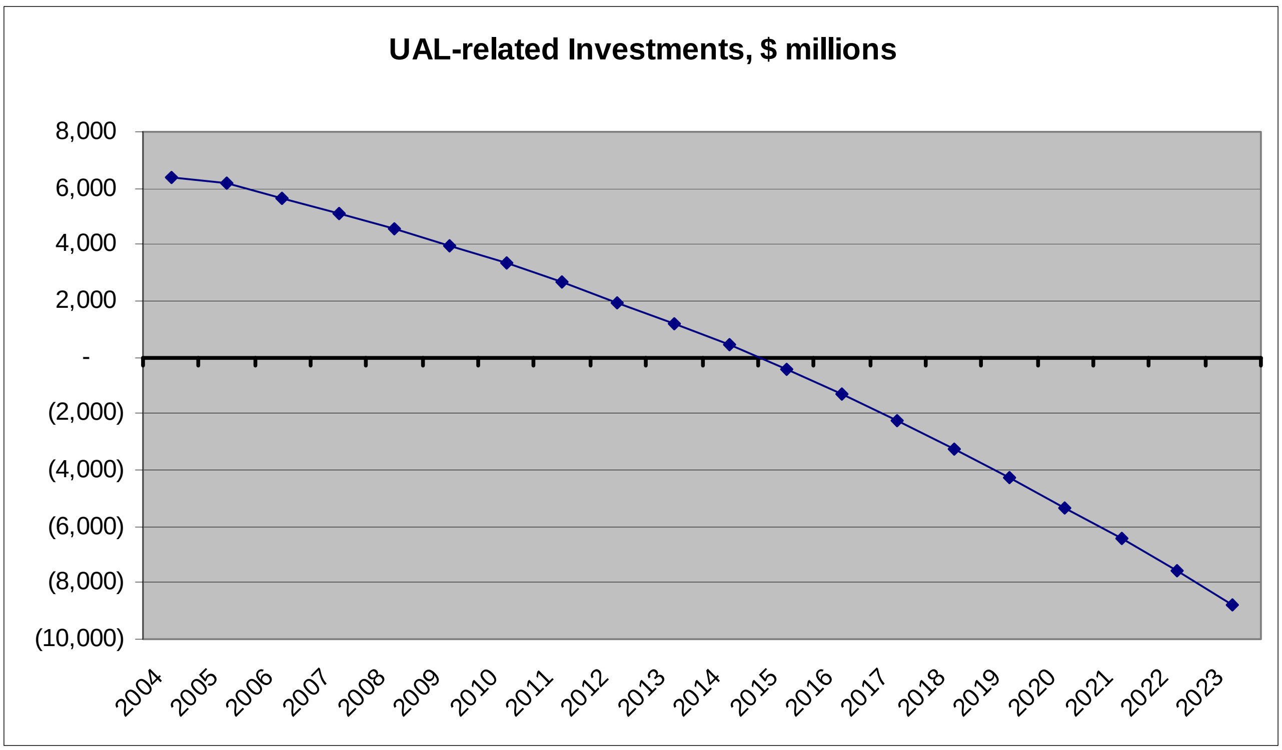

Table 1 shows the details of the cash flows that lead to these deficits.

Table 1. UAL-related cash flows. All figures in $ millions

Fiscal Year	Pension Payments	Pension-related Expense	Net Other Expense	PBGC Premiums	Investment Income	Assets Taken Over	Bankruptcy Recoveries	Total Cash Flow
2005	(699)	(52)	(64)	(5)	325	6,900		6,045
2006	(707)	(38)	(63)	(5)	307		290	(216)
2007	(717)	(30)	(63)	(5)	289			(526)
2008	(718)	(21)	(63)	(5)	263			(543)
2009	(720)	(13)	(62)	(5)	236			(565)
2010	(723)	(14)	(63)	(5)	208			(597)
2011	(726)	(14)	(63)	(5)	178			(630)
2012	(729)	(14)	(63)	(5)	146			(665)
2013	(732)	(14)	(63)	(5)	113			(702)
2014	(739)	(15)	(64)	(5)	77			(746)
2015	(747)	(15)	(65)	(5)	40			(792)
2016	(755)	(15)	(65)	(5)	0			(840)
2017	(759)	(16)	(66)	(5)	(42)			(887)
2018	(763)	(16)	(66)	(5)	(87)			(937)
2019	(763)	(16)	(66)	(5)	(133)			(984)
2020	(756)	(16)	(66)	(5)	(182)			(1,025)
2021	(749)	(16)	(65)	(5)	(233)			(1,069)
2022	(742)	(16)	(64)	(5)	(287)			(1,114)
2023	(728)	(16)	(63)	(5)	(342)			(1,154)
2024	(714)	(16)	(62)	(5)	(399)			(1,196)

Cash is initially boosted by $6.9 billion in pension assets assumed from UAL's plans. PBGC will also recover a modest amount from UAL's bankruptcy estate in partial payment of its claim for the pension underfunding. The other source of cash is investment earnings.

By far the largest cash outflow is for pension payments. Other outflows include expenses directly related to the pension payments, as well as an increase in "net other expenses", representing a higher level of overhead at PBGC as a result of the substantial increase in activity of all kinds caused by UAL's terminations. A minor effect is the cessation of PBGC premiums coming in from UAL's plans.

The initial pension assets, combined with investment income and bankruptcy recoveries, are sufficient to cover about 11 years of pension payments and other expenses. After that, the net effect of UAL's terminations worsens every year. Once the net effect on investments turns negative, PBGC will face a drain on its investment income from the rest of its assets, as it has to draw assets down to fund payments that are no longer covered by UAL-related assets.

Again, it is important to note that, for ease of illustration, we only show 20 years. The situation continues to deteriorate for the rest of our 75-year projection period.

What are the financial implications for PBGC of US Airways' terminations?

PBGC expects to take a loss of $2.1 billion from US Airways' plans. This is based on $4.0 billion in pension obligations, in today's dollars, of which $0.2 billion falls outside the guarantee limits and will be absorbed by retirees and employees. There is approximately $1.7 billion of pension assets available to cover the remaining $3.8 billion. PBGC takes over both the assets and the guaranteed liabilities, leaving it with a loss of $2.1 billion.

Figure 2 shows our estimates of the cumulative effect on PBGC's total cash and investments ("cash") by year. We truncated the projection at 2024, for ease of illustration. As with UAL, the effect worsens every year, since there are no additions of cash after the first few years, but there are continuing pension payments and other cash outflows.

Figure 2

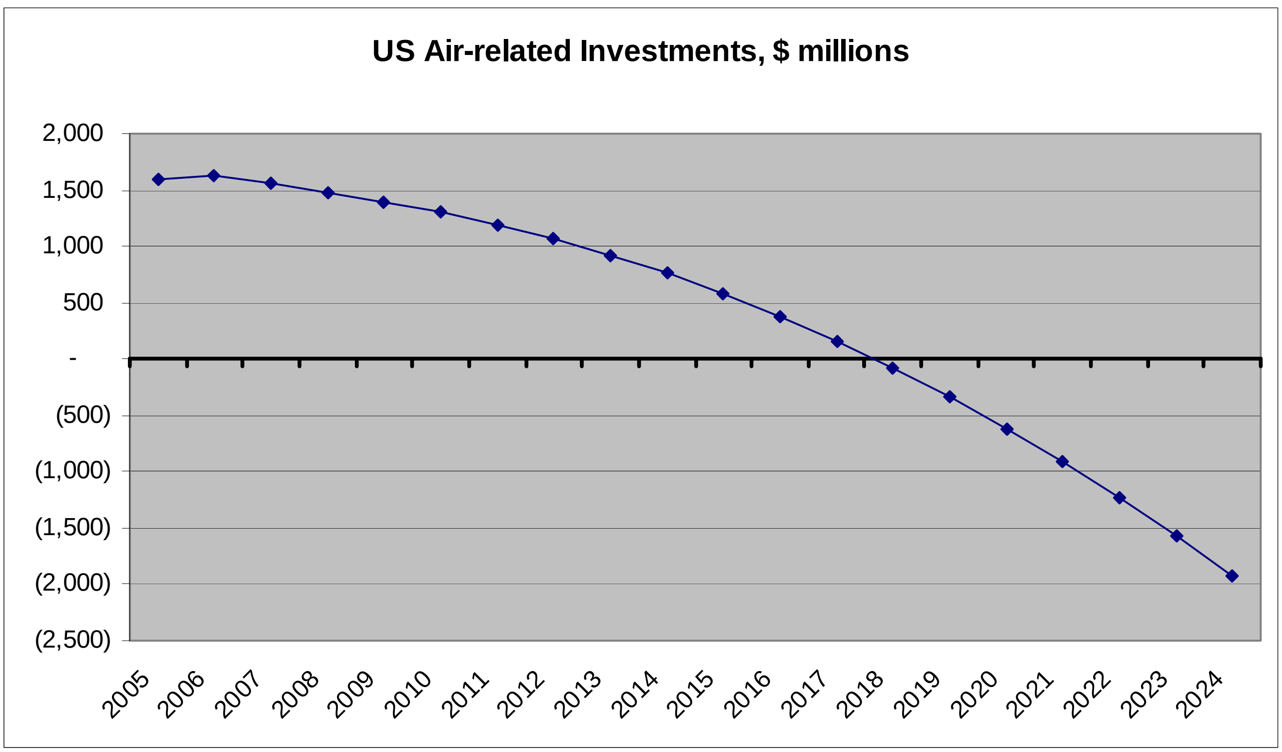

Table 2 shows the details of the cash flows that lead to these deficits.

Table 2. US Airways-related cash flows. All figures in $ millions

Fiscal Year	Pension Payments	Pension-related Expense	Net Other Expense	PBGC Premiums	Investment Income	Assets Taken Over	Bankruptcy Recoveries	Total Cash Flow
2005	(112)	(20)	(11)	(5)	80	1,667		1,598
2006	(115)	(14)	(11)	(5)	78		89	22
2007	(119)	(10)	(11)	(5)	77			(68)
2008	(123)	(7)	(11)	(5)	74			(72)
2009	(131)	(4)	(11)	(5)	70			(81)
2010	(140)	(4)	(12)	(5)	66			(95)
2011	(148)	(4)	(13)	(5)	61			(110)
2012	(158)	(5)	(14)	(5)	55			(126)
2013	(168)	(5)	(15)	(5)	49			(144)
2014	(177)	(5)	(16)	(5)	41			(162)
2015	(186)	(6)	(16)	(5)	33			(180)
2016	(195)	(6)	(17)	(5)	23			(200)
2017	(203)	(7)	(18)	(5)	13			(219)
2018	(211)	(7)	(19)	(5)	2			(240)
2019	(217)	(7)	(19)	(5)	(10)			(259)
2020	(224)	(8)	(20)	(5)	(23)			(279)
2021	(228)	(8)	(20)	(5)	(37)			(298)
2022	(233)	(8)	(20)	(5)	(52)			(319)
2023	(235)	(8)	(21)	(5)	(68)			(337)
2024	(237)	(9)	(21)	(5)	(85)			(357)

Appendix: Technical Details of Cash Flow Modeling

The specific financial projections are based on COFFI's cash flow model for PBGC. The model is explained in great detail in a paper available on our website, www.coffi.org, called "PBGC: When Will the Cash Run Out?" This appendix lays out the methodology for the key UAL-specific estimates.

Pension payments. Under recently revised GAAP accounting rules, UAL and US Airways provided estimates of their total pension payments for each of the next five years and for the following five years in aggregate when they filed their Form 10-K with the Securities and Exchange Commission in the Spring. The payments after 2013 were projected by COFFI, using three guidelines. First, that the total net present value of the payments should match that provided by the airlines in their 10-Ks, based on their assumed discount rates (6% for US Airways and 6.25% for UAL.) Second, that the calculated duration (a technical measure of the point when half the payments will be completed) should be reasonable for a company with their demographics. For example, our calculated duration for UAL was 13 years, which is reasonable for a long-established airline. Third, the details were filled in by providing a smooth pattern of growth and then decline in pension payments. (The increase due to retirements is greater in the early years than the decrease due to deaths, but this reverses over time.)

These estimated payments were then adjusted to back out the effect of projected salary increases, since termination of the plans eliminates any such increase in benefits. Only 3.5% of UAL's estimated net present value of pension payments came from this source, and less than 1% of US Airways, according to their 10-Ks, so this did not produce a major adjustment. A larger impact came from reducing the benefits to reflect PBGC guarantee limits. Here we used PBGC's publicly reported estimates of the aggregate effect ($1.9 billion out of their estimated $15.3 billion of net present value falls outside the guarantee for UAL and $0.2 billion out of $4.0 billion for US Airways.) We assumed that the percentage effect was the same for all years.

Related expenses. PBGC faces a number of expenses in connection with calculation and payment of pension benefits. We estimated these expenses based on PBGC's 2003 Actuarial Report, which provides a detailed methodology to calculate the costs.

Net other expenses. As noted, these terminations will add roughly a quarter to the size of PBGC, with a resulting increase in overhead expenses. We used a linear regression on past expense levels to estimate the effect of a change in the volume of pension payments on overhead expenses. This yielded the intuitive result that there are relatively fixed costs of approximately $84 million and variable costs of roughly 8.5% of pension payment levels. Therefore we assume that every dollar of additional pension payments due to the assumption of these airline liabilities brings an additional 8.5 cents of PBGC costs.

Loss of PBGC premiums. UAL has paid premiums to PBGC every year, which ceases upon termination. The fixed, per-participant charge, has produced $2-3 million per year. The large underfunding would add substantial variable premiums, which we very conservatively estimated at another $2-3 million, for a total of $5 million in foregone premiums. A similar calculation was used for US Airways.

Investment income. As explained in our paper on the full model, we assumed a 5% investment return, based on PBGC's current investment strategy and existing market conditions. Pension assets were assumed to be taken over on the first day of Fiscal 2005, while all other flows were assumed to occur evenly over the relevant year.

Pension assets taken over. We based this on PBGC's public statements and the last 10-K filings for the two airlines.

Bankruptcy recoveries. We assumed that 3% of total PBGC-guaranteed pension liabilities would be recovered in the bankruptcy proceedings. Over PBGC's 30-year life, the average has been about 4%, but it has been significantly lower of late.