

August 3, 2006

TO: CWA Executive Board

FROM: Bob Patrician
Research Economist

RE: Pension Legislation

Secretary-Treasurer Easterling asked me to write a brief explanation of the recent pension legislation. That follows here. If you have any questions or comments, please advise. I am happy to respond.

Background

On Friday, July 28, the House passed H.R. 4, the Pension Protection Act of 2006 (PPA) - a package of changes to ERISA, the tax code and related law which has been described as the most significant pension legislation in 32 years. On Thursday, August 3, the Senate passed the same bill.

Funding

The most important provisions of the legislation relate to pension funding. These provisions will require employers to put more money into the pension plans they sponsor. Several proposals which would have been very disadvantageous for some employers were not included in the final bill. Both the UAW and their major employers, Ford and GM, have stated publicly that they support the legislation now that they will not face even more stringent funding requirements because of their credit rating. Other major employers (including Lucent) were also concerned about the prospects of these "at risk" provisions.

Our joint lobbying effort with the IBEW and Lucent was successful in garnering the inclusion of language that will help Lucent to fund retiree health care from excess pension assets.

While the impact of the new funding rules will not take effect until 2008 and it is hard to predict what may happen to plan assets over the next 18 months, most of the major employers of CWA members were far better funded than most of plan sponsors at the end of 2005 (see Table 1 in the attached spreadsheet).

In particular, there are some airlines – primarily Northwest and Delta, who are both in bankruptcy – that will benefit from an extended period of time over which to make up for the inadequate funding in their pension plans.

Calculation of Lump Sum Distributions

A specific issue of concern to CWA members relates to changes in the methodology for the calculation of lump sums received in lieu of monthly pension payments (annuities). Lump sum distributions are related to plan funding in that such a payment amounts to an immediate reduction in plan assets, as compared to the long string of payments with a monthly pension. For a plan which is in financial trouble such an immediate payout could have negative consequences for the ongoing health of the plan. The legislation would prevent plans which are severely under-funded from paying out lump sum distributions.

The proposal would also make some changes to the part of the law which governs the calculation of lump sums. Under current law, "a plan's lump sum payment to a participant or beneficiary must be *no less* than the present value of the annuity to which the participant or beneficiary would have been entitled. For this calculation, the plan must use specified interest and mortality assumptions. Currently the specified interest rate refers to the rate on 30-year Treasury bonds."¹ (Note: the 30-year Treasury bond rate is often referred to as the GATT Rate.)

Under the new legislation, the calculation of this minimum lump sum amount must use a "three-segment yield curve"² of corporate bond rates to determine the interest rate to be used. As a rule of thumb, corporate bond rates have generally run about one percentage point higher than the 30-year Treasury bond rate.

A "three-segment yield curve" is effectively a composite interest rate combining rates for the period of the retiring employee's projected years in retirement. Such an interest rate might be a combination of one rate for the first five years after retirement, another for the next 15 years and a third for the years beginning 20 years after retirement. Generally, interest rates rise as the time horizon reaches further into the future.

Under the new legislation, the application of this new interest rate formulation would not take place until 2008 and then would phase in over 5 years. During this phase-in period, the lump sum would be calculated using both interest rates. In 2008, the lump sum payable would be the sum of 80% of the amount calculated using the 30 year Treasury and 20% of the amount calculated with the corporate yield curve rate; in 2009, 60% of the old plus 40% of the new; and so on until 2012 when the calculation would be based only on the corporate yield curve rate.

¹ Pension Conference Report, Title III, Section 302, from BNA Daily Labor Report

² Ibid

Impact on Collective Bargaining and Lump Sums

Despite all these details, the most critical fact about the calculation of lump sum distributions is that the new law sets the methodology for calculating the minimum amount. It is perfectly acceptable for a pension plan to pay a larger amount, as long as that amount does not exceed the limitation established in Section 303³ of the proposal.

Several CWA collective bargaining agreements, including the Verizon and BellSouth contracts, as well as the AT&T Midwest, Southwest and West contracts, specifically refer to the 30-year Treasury or "GATT" rate for the calculation of lump sum pension distributions. This amount is likely to be somewhat greater than the amount payable using the corporate yield curve. These contractual formulas would not have to be changed as a result of the new legislation. The "GATT" rate will continue to be published by the Federal Reserve Board of Governors.

There are other methods for calculating lump sums which do not utilize the GATT rate. The lump sum calculated under such a method must equal or exceed the amount calculated under the law. Under the new legislation, the comparative calculation method would use the yield curve interest rate.

If, however, the collective bargaining agreement does not specify the use of the GATT rate or the 30 year treasury rate in reference to the calculation of lump sums, or if it only refers to the IRC Section 417(e) applicable interest rate, there may be a problem once the Internal Revenue Code is changed to reflect the new legislation. In that case the calculation of the lump sum refers to the section which defines the minimum lump sum, and so, that calculation will be modified by the new legislation.

Summary

For most prospective CWA retirees, the impact of the Pension Protection Act of 2006, will be relatively mild. For some, notably those whose airline pension plans may not survive without the assistance the legislation affords, it will be critical.

In particular, those members employed by ATT, BellSouth and Verizon worried about the impact of the legislation on the calculation of their lump sum pension distribution should not have any difficulties, particularly as long as those contracts remain in place. There have been rumblings from the

³ Section 303 sets interest rate assumptions for determining the maximum lump sum distributions allowed under the law. The maximum benefit is defined as an annual annuity of \$175,000 in 2006. This section of the law is not likely to be applicable to any CWA member (based on the size of the annuity on which it is based.)

employer community that their willingness to maintain defined benefit pension plans will drop if it becomes more expensive to do so under the proposed funding regime. More benefit freezes and even plan terminations have been predicted.

Table 1. CWA-Related Employers: Pension Funding 2005

Company	Funded/ Unfunded (\$mill)	Fair Value of Assets (\$mill)	Benefit Obligation (\$mill)	Assets/ Obligation (%)	Net Pension Income (\$mill)	Employer Contribution (\$mill)
Delta Airlines	(6,372.0)	6,521.0	12,893.0	50.6%	(1,281.5)	390.0
Northwest Airlines	(3,678.0)	5,794.0	9,278.0	62.4%	(995.0)	308.0
Walt Disney United Technologies	(1,541.0) (2,334.0)	3,410.0 18,131.0	4,951.0 20,937.0	68.9% 86.6%	(207.0) (417.0)	112.0 865.0
Sprint Nextel Northrup Grumman	(550.0) (1,825.0)	4,133.0 18,867.0	4,683.0 20,692.0	88.3% 91.2%	(200.0) (410.0)	300.0 415.0
TimeWarner	(223.0)	2,870.0	3,093.0	92.8%	(157.0)	181.0
Ford	(2,038.0)	41,857.0	43,895.0	95.4%	(452.0)	1,432.0
Qwest	391.0	9,348.0	8,957.0	104.4%	(28.0)	-
IBM	2,137.0	48,542.0	46,405.0	104.6%	381.0	1,715.0
AT&T	2,579.0	48,755.0	46,176.0	105.6%	(135.0)	-
Gen'l Motors	6,117.0	95,250.0	89,133.0	106.9%	(1,446.0)	125.0
Lucent	2,693.0	34,004.0	31,311.0	108.6%	973.0	60.0
Verizon	3,429.0	40,990.0	37,561.0	109.1%	(172.0)	852.0
Gen'l Electric	5,765.0	49,096.0	43,331.0	113.3%	(329.0)	106.0
BellSouth	4,415.0	16,315.0	11,900.0	137.1%	532.0	-

Data from report on Pension

