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The Pension Woes of the U.S. Legacy Airlines

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Just a few years ago, the U.S. airlines were flying high. So high that the old-line traditional carriers, the "legacy airlines," negotiated significant wage and salary increases as well as major increases in benefits promised their employees under their defined benefit ("DB") pension plans. DB pension plans, as opposed to defined contribution (or "DC") plans, promise a benefit at retirement based upon a plan formula that typically provides a monthly benefit equal to years of service times a percentage of an individual's average pay over one or more of his highest-paid years with the company. The employer (the "plan sponsor") is responsible for contributing sufficient cash to the plan's trust to assure that the contributions plus earnings on the trust will be adequate to pay all benefits as they come due. The risk is borne by the employer. Participants' promised benefits are guaranteed, at least in part, by a U.S. government agency, the Pension Benefit Guaranty Corporation ("PBGC").

By contrast, in a DC plan the employer only commits to make specific payments into an account established for each individual plan participant. The benefit will be whatever the balance of the account will provide at retirement. The individual plan participant bears the risk that the account will grow sufficiently to provide a comfortable retirement income for his retired lifetime. As there is no promised benefit to guaranty, PBGC does not stand behind DC plans.

At the time, the legacy airlines' DB plans appeared to be well funded, some having more than 100% of the asset value needed to pay all promised benefits. The pension trusts were heavily invested in equities and the equity markets were performing well. But over a scant few years, events took place that caused the funded ratio of these airlines' pension plans to plummet, some to as low as 50-60%. Under U.S. pension law (the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986), plans having a funding ratio under 80% are required to greatly accelerate funding in order to bring the ratio back up quickly. This so-called "deficit reduction contribution" requirement (the "DRC") can cause required minimum funding payments to soar.

What happened? The actuaries called it the "perfect storm." The equity markets fell off significantly and have remained in decline for more than 3 years. This resulted in a great decline in the value of asserts in pension plan trusts.

At the same time, market interest rates fell to 40-year lows. Because these rates are used to determine the present value of benefits promised by pension plans, and because a drop in rates causes an increase in that measurement, plan liabilities increased shot up. The underfunding of DB plans (liabilities less assets) rose greatly and funded ratios plummeted. The deficit reduction contribution began to apply automatically to many DB plans.

The perfect storm hit all DB plan sponsors, but the legacy airlines had several other events befall them at the same time, exacerbating the problem. Fuel prices reached all time highs. The terrorist attacks of September 11, 2001, where the terrorists used commercial airliners hijacked from 2 of the legacy carriers, and the resulting public concern as well as new precautions, reduced the number of passengers. The war in Iraq did as well. And perhaps most significant, fierce competition from the so-called low-cost carriers steadily eroded their market share. The low-cost carriers, as new entrants to the industry, have no legacy costs to pay down, have lower labor costs, and perhaps most significantly, only DC pension plans.

Earlier this year the PBGC took over US Airways' pension plans[1]. Then a few weeks ago, a bankruptcy court approved the termination of United Airlines' pension plans. Combined these unfunded liabilities totaled $12.3 billion[2] according to PBGC.

Investors question how the remaining legacy carriers will deal with their unfunded pension liabilities. Significantly, the cash contributions required to fund these ongoing pension plans in the near term may push one or more of these carriers to the brink.

	2005 Required Cash[3]	2002-2004 Operating Loss
Delta Airlines	$285 million	($5.4 billion)
Northwest Airlines	$420 million	($1.6 billion)
Continental Airlines	$266 million	($338 million)
American Airlines	$310 million	($4.3 billion)

[1] *PBGC previously became trustee of the US Airway's pilots pension plan in 2003.*

[2] *All dollar amounts herein are USD.*

[3] *The companies expect 2006 required contributions to exceed 2005 amounts.*

The Pension Woes of the U.S. Legacy Airlines (continued)

If these carriers are unable to continue their pension plans, PBGC must step in and assume the plans. This is not a good solution for anyone:

- PBGC reported a $23.3 billion deficit as of September 30, 2004. The U.S. Congress has questioned how much more liability PBGC can absorb before it needs a taxpayer bailout.
- The airlines' employees and retirees lose because PBGC guarantee limits can reduce the amount of pension benefits participants can receive. For plans terminating in 2005, the maximum annual benefit PBGC will pay a plan participant retiring at age 65 is $45,614[4]. For employees who retire earlier, the maximum pension is reduced. This is particularly pronounced for pilots who, under U.S. law, must retire at age 60. That maximum guaranteeable pension benefit is $29,649 annually.
- Companies lose since the typical method for terminating a pension plan occurs in the bankruptcy arena, which is an expensive and time consuming endeavor. And they have to deal with PBGC's claim for the plan's underfunding. Resolution of the claim could involve costly and time-consuming litigation all the way to the Supreme Court.

Problems with the airline industry and their underfunded pension plans are not new. Congress previously enacted the Pension Funding Equity Act of 2004, which among other pension changes, provided DRC relief to the pension plans sponsored by commercial passenger airlines for up to two years[5]. However, this legislation is scheduled to expire[6].

What's to be done? Two proposals are currently being discussed, some hearings have been held by the Congress, and more will certainly be held. Both proposals are similar in many respects; for example, they would require a freeze of plan benefits and PBGC's guarantees as to those benefits. However, they differ in a fundamental respect.

The Administration has proposed that sponsors of grossly underfunded plans further accelerate the amortization of the underfunding. The proposal also would adopt a major increase in the premiums DB plan sponsors pay to PBGC for its insurance coverage. While acknowledging that the defined benefit pension system is broken and needs an overhaul, opponents of this proposal argue that it appears to exasperate the problem by requiring even more cash from companies now in dire need of relief and will actually force some if not all of the remaining legacy airlines to file for Chapter 11 reorganization and terminate their DB plans.

Against this backdrop, on April 20, 2005, Senators Johnny Isakson (R-GA) and John Rockefeller (D-WV) introduced the "Employee Pension Preservation Act of 2005" which would permit commercial passenger airlines to stretch out payment of certain pension liabilities over 25 years.

Some argue that special exemptions for industries are protectionism and interfere with the natural order of the capital markets. Others point to the long-term nature of pension promises and the stunning $13 billion of underfunding[7] and contend that some breathing room is necessary for an industry under siege. And because of the pension relief already afforded US Airways and United Airlines, something must be done to level the playing field for the remaining legacy carriers.

Given the overwhelming burden posed by existing contribution requirements, as demonstrated already by United Airlines and USAirways, it is likely that, absent legislative relief, a significant and immediate improvement in airline economics, or a combination of both, one or more legacy carriers will be unable to afford their pension liabilities and PBGC will assume them.

[4] *PBGC's guarantee covers basic pension benefits only. Additionally, PBGC does not pay lump sums in excess of $5,000.*

[5] *In addition to commercial passenger airlines, the relief is also applicable to certain companies in the steel/iron ore industries. Generally, the legislation provided companies with the option to fund just 20% of their deficit reduction contribution amounts in exchange for restrictions on benefit increases.*

[6] *The legislation is applicable for any plan year beginning after December 27, 2003 and before December 28, 2005.*

[7] *These amounts for American, Delta, Northwest, and Continental were calculated in accordance with generally accepted accounting principles. PBGC computes the funded status of a pension plan on a termination basis, which results in significantly greater underfunding amounts.*