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CAPTAIN DUANE E. WOERTH, PRESIDENT

AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

BEFORE

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

WASHINGTON, DC

June 7, 2005

Preventing the Next Pension Collapse: Lessons from the United Airlines Case

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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.

Summary

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.