Defined Benefits Pensions:
A Balancing Act of Financial, Regulatory, Fiduciary, and Public Trust Considerations

Framing the Issues
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Workshop Objectives
• Set out the financial challenges faced
• Discuss the various perspectives:
  – Competing interests
  – Accounting rules and guidance
  – Credit ratings implications
• Overview of some potential solutions
  – Description of some alternatives
  – Discussion of any merits and disadvantages
• Regulatory considerations and implications
Rules of Engagement

• This is intended to be a clinical discussion of facts and issues of interest to the participants:
  – No hidden agendas
  – No promotion of particular services
  – Non-partisan, fair, and balanced expositions
• Chatham House Rules apply:
  – Check your six-shooters in at the door
  – No attribution of comments that are made here

Objective Functions

• Rank order the competing financial objectives
• Optimize the funding status
• Ensure compliance with federal and state law and regulation
• Minimize uncompensated plan management risks
• Align plan sponsor obligations with operating public utility obligations
• Protect public utility’s financial integrity
• Mitigate disincentives to achieve the above
Interested Parties

- Retirees and employees
- Plan sponsor / public utility
- Customers
- Shareowners and creditors
- Wisconsin residents (the general public)
- Regulators
- Legislators

Retirees and Employees

- Retirees:
  - Primarily benefitting from defined benefit plans
  - Mostly or wholly reliant on defined contribution plans (e.g., 401-K plans)
- Employees (current and former):
  - Vested in defined benefit plans
  - Mostly or wholly reliant on defined contribution plans
Plan Sponsor

• The public utility in its capacity as a defined benefit plan sponsor
  – Fiduciary obligations to plan’s beneficiaries
  – Reporting requirements and disclosures
    • ERISA-driven
    • SEC-driven (including accounting standards and rules)
• The subtle demarcations on fiduciary duties
• Separate capacity from the regulated public utility’s operating duties and obligations

Public Utility

• Recognize its separate capacity as an operating public utility:
  – Duties and obligations under its regulatory compact
  – Relationship with its customers
  – Relationship with its providers of capital
  – Relationship with the broader public
• Aligning the two separate capacities
• Reconciling any potential misalignments
Customers

• Authorized rates to include fair and reasonable costs required to provide services
• Strong aversion to volatile rate changes (rate spikes)
  – Budgeting energy costs
  – Decisions to relocate cannot be based on short-term energy cost spikes
• Wisconsin’s preference to moderate changes in authorized rates over time (gradualism)

Shareowners

• Recognize different styles of equity investment
• Traditional public utility equity investors value
  – Steady cash flow and earnings generation
  – Relatively high dividend pay-out ratios
• Appreciate a predictable and enlightened state regulatory environment
• Averse to:
  – Surprises (event, regulatory and business risks)
  – Earnings and cash flow volatility
Creditors

• In many aspects, public utility creditors reflect shareowner preferences and aversions

• Strong preferences:
  – Predictable and steady cash flow generation
  – Predictable and enlightened regulatory environment

• Strong aversions:
  – No sudden subordination surprises
  – Cash flow volatility

Wisconsin Residents

The public interest is well served by:

– Financially sound public utilities
– Capital availability on best terms in the amounts and at the time required to build needed facilities
– Competitive energy prices
– Employers that are unlikely to relocate as a result of energy price spikes and volatility
– Retirees and employees who enjoy sound retirement plans
Regulators

- Knowledgeable and independent regulators are valued by those committing capital
- Can act as an independent party that helps to optimize and balance competing concerns
- Protects the public interest
- Looks at the long-term implications
  - Appointed, not elected
  - Not subject to short-term demands and interests

Legislators

- Sensitive to the public interest
- Responsive to Wisconsin interested parties
  - Retirees and employees
  - Customers
  - Plan sponsors and public utilities
- Responsive to the longer-term implications, both good and bad, of resolving these challenges
  *(when the legislator acts as a statesman)*
Plan Management Issues

- Nature and volatility of the defined benefit plan obligations imposed on public utilities
- Funding status
- Minimization of funding costs
- Pension fund asset risks and returns
- Mitigation of the funding risks
- Penalties associated with:
  - Under-funding
  - Over-funding

Heat Map of Issues

<table>
<thead>
<tr>
<th>Retirees</th>
<th>Employees</th>
<th>Plan sponsor</th>
<th>Public utility</th>
<th>Customers</th>
<th>Shareowners</th>
<th>Creditors</th>
<th>Wisconsin residents</th>
<th>Regulators</th>
<th>Legislators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funded status</td>
<td>Volatility</td>
<td>Cost</td>
<td>Compensating risks</td>
<td>Asset Mix</td>
<td>Fiduciary Liability</td>
<td>Aligning capacities</td>
<td>Financial integrity</td>
<td>Funded status</td>
<td>Volatility</td>
</tr>
<tr>
<td>= Important</td>
<td>= Of interest</td>
<td>= Indifferent</td>
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Color key:  
- = Important  
- = Of interest  
- = Indifferent
Issues and Retirees

- Retirees seek predictable and reliable income
- Their main hedge would be to assume direct management (*not an easy option for most*)
- Most sensitive to ensuring the plan manager:
  - Avoids volatility
  - Does not under-fund the plan
  - Maintains the most appropriate asset mix
- Less sensitive to the utility company’s welfare

Issues and Employees

- There is a split among those vested and those not vested in the defined benefit plan
- Younger employees have a higher risk tolerance:
  - They want to ensure the plan sponsor is able to honor their benefits in due course
  - They want to ensure that the public utility remains viable and retains them on the payroll
  - Funded status is gradually becoming an emerging issue for them
Issues and Plan Sponsor

• All of the issues are direct and immediate concerns for the plan sponsor
• Alignment of interests between the two capacities (plan sponsor and public utility operating company) is critical
• The fiduciary nature of some of the sponsor’s duties and obligations, and the subtle demarcations that can emerge, intensify the efforts to achieve optimal alignment

Issues and Public Utility

• All of the issues are direct and immediate concerns for the plan sponsor
• Alignment of interests between the two capacities (plan sponsor and public utility operating company) is also critical
• Additional key considerations facing the public utility:
  – Honoring the regulatory compact
  – Maintaining access to the capital markets
Issues and Customers

The most critical issues for customers are:
• Maintaining competitive and reasonable rates
• Ensuring predictability of rate changes
• Promoting their public utility’s:
  – Financial integrity
  – Lowest cost of operations, and
  – Reliable access to capital markets to fund required public utility investments

Issues and Shareowners

• Avoid:
  – Straying from the public utility’s core competence
  – Volatility in reported financial results
  – Impairment of future earnings prospects
  – Any reorganization in which the plan sponsor obligations impair a public utility’s emergence from bankruptcy

• Protect:
  – An appropriate risk compensation
  – Financial integrity of the public utility
Issues and Creditors

• Avoid:
  – Straying from the public utility’s core competence
  – Volatility in reported financial results
  – Impairing future cash flow generation potential
  – Impairing seniority of outstanding debt

• Protect:
  – An appropriate risk compensation
  – Financial integrity of the public utility
  – Funded status stability

Issues and Wisconsin Residents

• Avoid impairing:
  – The financial viability of public utilities
  – The cost competitiveness of the public utilities
  – Appropriate access to the capital markets

• Retain and attract energy-consuming businesses

• Protect retirees and employees from financial distress
Issues and Regulators

• Evaluating and balancing the competing duties and obligations faced by public utilities that sponsor defined benefit pension plans
• Considering regulatory alternatives that encourage optimal decisions in this area
• Overseeing the potential impacts on:
  – Their financial integrity and viability
  – Their ability to meet service quality and reliability standards

Issues and Legislators

• Understanding and evaluating the financial challenges faced by public utilities in this area
• Facilitating any alternative solutions that best serve the various interested parties
• Ensuring that the longer term implications and risks are adequately identified, reported, and acted on
• Sponsoring helpful legislation, if needed
Heat Map of Issues

Framing the Issues

- Balancing competing interests
- Optimizing outcomes for each interested party
- Maximizing the optimal outcomes when trade-offs are involved
- Near-term solutions
- Long-term solutions
- How much time do we have available?
Shifting to my Role as Moderator

• We will now have presentations on:
  – The accounting perspective;
  – The credit rating agency’s perspective;
  – The alternative solutions available; and
  – A public utility’s perspective on these issues.

• Deliberate overlaps among these presentations

• Our comments and your questions should:
  – Stimulate thoughtful discussion
  – Engender muscular debate