Pension Derisking in Regulated Industries

Wesley Smyth, Vice President – Senior Accounting Analyst

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Agenda

- Analytical Approach for Defined Benefit Pension Plans
- Recent history of volatility
- Credit Impact of Derisking Strategies
Analytical Approach to Defined Benefit Pension Plans

- Because of the contractual nature of pension obligations, we view underfunded pension liabilities as “debt-like”
- We adjust three primary financial statements to show pension underfunding as debt
- Artificial smoothing distorts the measurement of pension expense
- Adjust Income Statement to remove “Accounting Noise”
- Pensions only one of many factors in rating process
  - Unlikely to drive a downgrade/upgrade in isolation
  - Can constrain a rating
**Defined Benefit Pensions – Balance Sheet**

- Reclassify pension liability from long term liability to senior debt
- Imputed debt equal to the gross underfunding of all trusts

<table>
<thead>
<tr>
<th>Amounts recognized in balance sheet</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncurrent asset</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Current liability</td>
<td>(76)</td>
<td>(50)</td>
</tr>
<tr>
<td>Noncurrent liability</td>
<td>(3.25)</td>
<td>(3.5)</td>
</tr>
<tr>
<td>Total</td>
<td>(1.30)</td>
<td>(5.0)</td>
</tr>
</tbody>
</table>

The accumulated benefit obligations and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets were $5,567 million and $4,374 million, respectively, at October 31, 2009 and $767 million and $423 million, respectively, at October 31, 2008. The projected benefit obligations and fair value of plan assets for pension plans with projected benefit obligations in excess of plan assets were $1,570 million and $4,973 million, respectively, at October 31, 2009 and $135 million and $458 million, respectively, at October 31, 2008.

**Defined Benefit Pensions – Income Statement**

- Service cost the operating cost to providing a pension
- Remove “Accounting Noise”
- Service cost is only cost reflected in adjusted Pretax Income
- If plan is underfunded add implied interest
- Interest is calculated as follows
  
  Underfunded Pension Debt  XXXX
  
  x Marginal Borrowing rate  x%
  
  =Implied interest cost  XXXX
**Defined Benefit Pensions – Cash Flow Statement**

- Any contributions in excess of service cost to be reclassified to financing activities
- Service cost $20
- Cash contribution $100
- CFO ↑ $80
- Cash from financing activities ↓ $80

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**Defined Benefit Pension Plans - Summary**

<table>
<thead>
<tr>
<th>THE REPORTING PROBLEM</th>
<th>HOW MOODY’S ADJUSTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>» Because of the contractual nature of pension obligations, we view underfunded pension liabilities as “debt-like”</td>
<td><strong>Balance sheet</strong>&lt;br&gt;We adjust to record the underfunded pension obligations (i.e. PBO less FMV of pension trust assets) as debt</td>
</tr>
<tr>
<td>» Artificial smoothing distorts the measurement of pension expense</td>
<td><strong>Income statement</strong>&lt;br&gt;We adjust pension expense to eliminate smoothing, and to exclude net periodic pension income if any</td>
</tr>
<tr>
<td></td>
<td>Add implied interest expense on pension debt</td>
</tr>
<tr>
<td></td>
<td><strong>Cash flow statement</strong>&lt;br&gt;We change the classification of cash contributed to the pension trust on the cash flow statement under certain circumstances</td>
</tr>
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</table>
Recent History of Volatility

Funding Status

» Regulated utilities went from 98% to 72% - back to 92% at end of 2013
  » Went to 82% in 2010

» Local natural-gas distributions companies (LDC) funding levels fell from 96% in 2007 to 70% in 2008 – Recovered to 88% by end of 2013
  » Never went above 73% in intervening years

» Other corporates fell from 102% to 77% with subsequent recovery to 91%
  » Also recovered to 82% in 2010

» Utilities exhibited greater volatility than LDC’s or other corporate issuers

» Slump was deeper and lasted longer for LDC’s
Pension funding status

![Graph showing pension funding status for different sectors over years 2007 to 2013.]

Imputed Pension Debt

- Pensions as % of reported debt lower than corporates
  - 3.9% for LDC's
  - 3% Utilities
  - 6.8% other corporates
  - Similar trends for prior 6 years
Pensions larger drain on regulated entities

- LDC’s contribute highest % of CFO to service pension debt
  - LDC pension contributions averaged 8.5% 2008-2013 period
  - Utilities 7.9%
  - All others 6.9%

Regulated entities’ pensions more expensive

- Electric utilities most expensive plans
- Utilities not addressing benefits
- LDC’s historically had most generous packages
- LDC’s started freezing plans just as financial crisis hit
- This trend is similar to other corporates, but are still expensive
Regulated entities slow to change asset allocations

- 2008 most companies had traditional 60% equity, 30% fixed income, 10% other
- This is a recipe for volatility
- 2008-2012 time frame LDC’s asset returns similar to utilities but diverging for corporates
- Corporates gradually moved over to fixed income during this period
- Utilities started moving to fixed income in 2013 – still remain higher than corporates

![Asset returns graph](image)

Diverging de-risking strategies

- LDC’s reducing service costs but not changing asset allocations strategy
  - Leads to less expensive plan but leaves door open to volatility
- Utilities starting to shift asset allocation but not reducing benefits
  - Less volatility but more expensive
- All other corporates reducing service cost and shifting asset allocations
  - Less volatility cost neutral*

* Overall cost may be higher or lower dependent on the amounts of assets reallocation and benefit cuts
Credit Implications of Pension De-Risking

- De-risking long term strategy
- Observing more companies implementing de-risking strategies
  - Pace of de-risking slower for regulated entities
- Expect to see more
  - Regulatory support will be major determinant in derisking trajectory for regulatory entities
- De-risking generally positive – however ultimately a cost benefit analysis
- Regulatory support will ultimately determine credit impact for regulated entities
- Pensions only one of many factors in rating process
  - Unlikely to drive a downgrade/upgrade in isolation
  - Can constrain a rating

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<tr>
<td>Voluntary Contributions</td>
<td>Contributions in excess of required</td>
<td>Positive</td>
</tr>
<tr>
<td>Liability Driven Investing</td>
<td>Switching asset allocation to more effectively match durations</td>
<td>Neutral</td>
</tr>
<tr>
<td>Plan Freeze</td>
<td>Ceasing some or all benefit accruals going forward</td>
<td>Positive</td>
</tr>
<tr>
<td>Defeasance of Plan Obligation</td>
<td>Annuities</td>
<td>Neutral</td>
</tr>
<tr>
<td></td>
<td>Lump sum settlements</td>
<td>Positive</td>
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Pension De-Risking – Voluntary Contributions

- Pension contributions in excess of required
- Akin to pay down of debt
- Credit impact dependent on source of cash
  - Debt – Neutral
  - Excess FCF – Positive
  - Own Stock – Positive
- Tax deduction – If used to reduce leverage - positive

Pension De-Risking – MAP – 21

- MAP – 21 substantially reduced required contributions
  - Benefit extended by Highway and Transportation Funding Act
- We continue to use GAAP funded number for imputing debt
- We are observing differing approaches to the relief offered
  - “We will put in the lowest required amount to the dollar”
  - “MAP – 21 will not impact how we fund our plan”
- We view MAP – 21 to be credit positive from a liquidity perspective
- Main benefit is for liquidity constrained companies
- Is betting on interest rates and equity markets good risk management?
- Underfundings will need to be addressed
- Potential for MAP-21 to turn credit negative if underfundings are higher than would otherwise have been when relief expires
Pension De-Risking – Liability Driven Investing

- Offsetting interest rate and asset performance risk
- Achieved through direct or synthetic means
- Theoretical sacrifice of higher returns for lower volatility/risk
- Generally neutral for solidly positioned companies with well funded plan
- Demonstrates pro active approach to risk management
- If helps improve metrics on a lagging basis then naturally positive
- Regulatory support will be key determinant of credit implication for regulated industries

Pension De-Risking – Plan Freezes

- Reduce or eliminate service cost going forward
- Generally positive
- Asset and interest rate risk still retained for benefits earned to date
- Any benefits earned going forward must still be funded
- Levels of risk retained will determine how positive
- Cost of providing alternative will also factor in equation
Pension Annuitzations

- Credit impact generally neutral – Benefit of lower volatility versus sacrifice of liquidity

Lump Sum Settlements

- Arbitrage in Interest rates allows lump sum settlement at less than GAAP liability
- Akin to getting a discount on paying down debt
- Source of cash to achieve funding level may offset any benefit
- Potentially credit positive
Pension De-Risking – Other Considerations

Labor Relations

- Any change in pension strategy will impact labor relations
- Could be negative from a credit perspective

Mark to Market Accounting

- Mark to Market accounting no impact on credit
- Mark to Market accounting precursor to LDI?

Regulatory scrutiny expected

- Pensions benefits higher
- Contributions higher
- Natural area for regulators to focus on
- Will a regulator prefer utility approach or LDC approach?
- Will they dislike both?
- Dependent on regulatory recovery, potential for credit positive outcome
- If full recovery of higher cost while volatility lower then positive (utility model)
- Could be neutral – recovery lowered by same amount of cost savings (LDC model)
- Negative outcome also possible
  - Utilities not given full recovery as not attacking benefit packages
  - LDC’s recovery cut by more than cost savings due to retained volatility
- Ultimately all comes down to the regulator
Wesley Smyth, Vice President – Senior Accounting Analyst
7 World Trade Center
New York, NY 10007
212 553 2733
Wesley.smyth@moodys.com

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