# The Prepaid Pension Asset Puzzle

## NASUCA 2016 Mid-Year Meeting

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Independent Actuarial Services
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# The Magic of Pension Accounting

If you bring up the topic of pension accounting, most people will roll their eyes, some will run the other way as fast as they can, and a few people will even fall fast asleep right on the spot. The problem: The accounting in FAS No. 87, "Employers' Accounting for Pensions," is convoluted, complicated, misleading, and for many it just doesn't make any sense. The terminology alone is enough to make your head spin—unrecognized gains and losses, service cost, prior service cost, projected benefit obligation, minimum pension liability, curtailment, settlements, etc. What does it all mean? Add the enormously complicated rules from Section 412 of the tax code that determine when a company has to contribute to its pension plan (if you think that pension accounting is tough, try reading Section 412); mix in a pension obligation with unknown future cash flows; and you have a recipe for confusion.

David Zion, CFA, CPA

Bill Carcache, CPA

CSFB, September 2002

# Discussion Items

- What is a prepaid pension asset
- Why should I care
- Underlying economics
- How did we get here
- PNM example
- Colorado settlement

# What is a prepaid pension asset

- Company testimony
  - A prepaid pension asset represents the difference between: (1) the cumulative cash amounts contributed to the pension fund, and (2) the cumulative actuarially determined net periodic pension cost calculated in accordance with FAS 87.
- Translation
  - A prepaid pension asset is an obligation owed to the <u>Company</u>, often times *interest bearing* at above market rates
  - In addition to deficits owed to <u>plan trust</u>

# Why should I care

- Prepaid pension assets:
  - Have grown exponentially since 2007
  - Will persist for decades under current accounting and funding regimes
  - Locked in source of risk-free profits for company
  - Represents growing intergenerational inequity
- Pervasive and hotly contested
  - Recent “wins” in Colorado electric and gas jurisdictions (PSCo)

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# Underlying economics

- Company can earn spread on prepaid pension asset
  - Can borrow at cost-of-debt *, with tax deductible interest charges
  - And earn an after-tax return of WACC for the shareholder “investment”
- Ratepayers are captive borrowers
  - Forced to borrow at rates in the 11.5% range
  - Penalty rates compared to credit worthiness

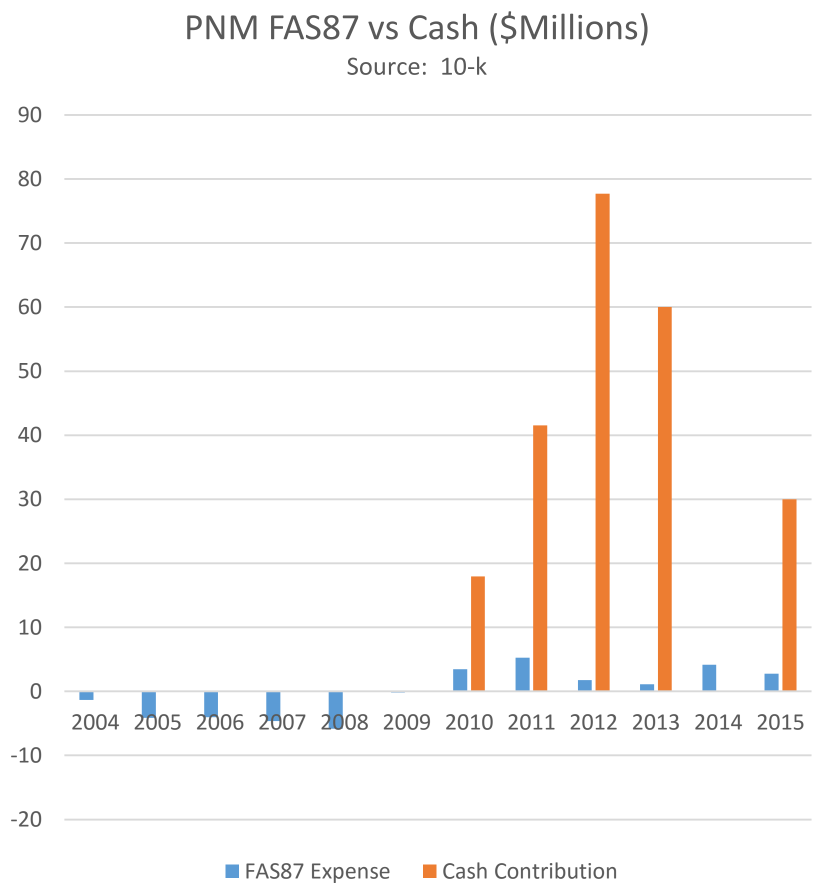


*Moody’s has stated “borrow-to-fund” strategies are generally credit neutral

# How did we get here

- Rise in overall pension debt
  - Asset/liability mismanagement
  - Increased longevity?
- Regulatory inertia
  - Complicated, lack of transparency
  - Arcane accounting and funding standards
- Agency problem
  - Hotly contested
  - Profit center for company

# Example: cash vs. expense




- FAS87 “income” in early years created prepaid pension assets
- FAS87 “cost” in later years nowhere near sufficient
  - Smoothing and deferral mechanisms inadequate for shocks
  - Cash contributions well in excess of FAS87

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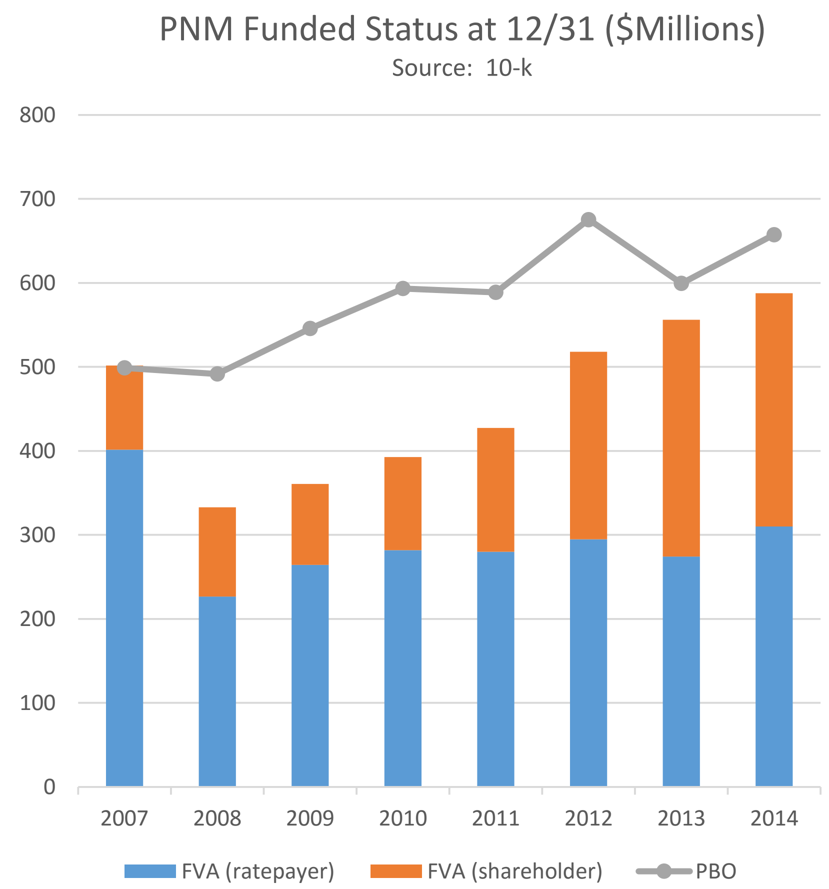
# Example: deficits and prepaids




- Inadequate FAS87 rates led to near tripling of prepaid pension assets
  - Represents a company claim on ratepayers, similar to credit card debt
  - Violates regulatory principal of intergenerational equity
  - Will remain for many, many years under current accounting policies

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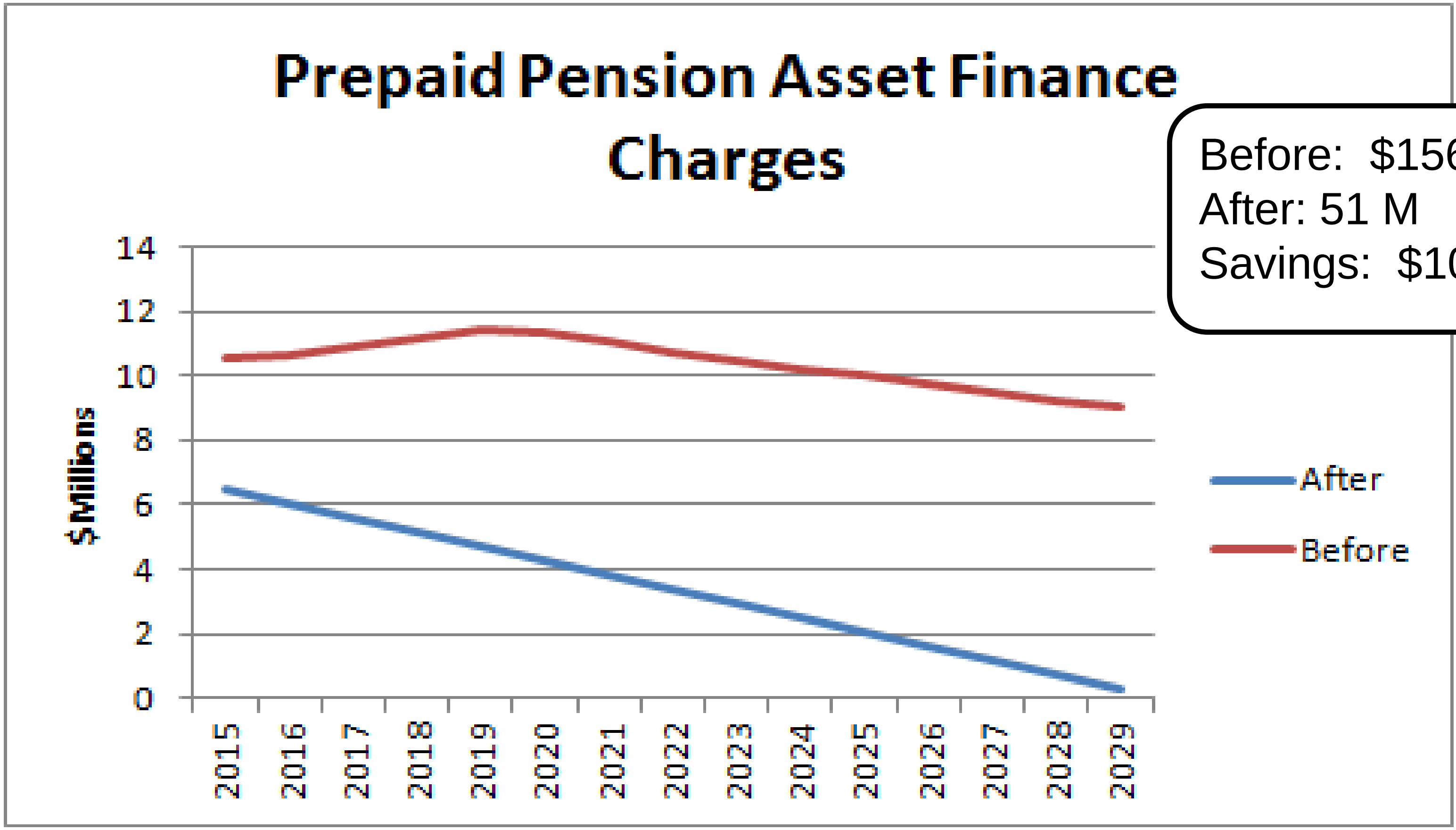
# Colorado Settlement

- Prepaid Pension Asset:  “Legacy” and “New”
- Legacy Prepaid
  - Equals Prepaid Pension Asset as of 12/31/2014
  - 15 year amortization (post-tax)
  - Cost of debt vs. WACC
  - Interest charge to be renegotiated in 2017

# Colorado Settlement




Before: $156 M
After: 51 M
Savings: $105 M

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# Colorado Settlement

- New Prepaid
  - Cash / FAS87 differences after 2014
  - Non-interest bearing
  - Interest and recovery subject to renegotiation in 2017
- Pension tracker in place
  - Deviations between actual FAS87 expense vs. test-year expense

# Colorado Settlement

- Pay cap for 2017
  - Recovery limited to pensions based on 15% AIP cap
- Enhanced disclosures on an annual basis
  - Asset and liability reconciliations ~ FAS158
  - Prepaid Legacy and New reconciliations
  - Cash, expense, Prepaid projections
  - Form 5500 with schedules

# David G. Pitts, FSA

David Pitts has provided actuarial consulting services to Fortune 500 companies for more than 25 years, assisting the Human Resource and Finance functions in the design, pricing, risk management, communication and administration of pension and other compensation programs.

In 2010, David launched Independent Actuarial Services, focusing primarily on the actuarial needs of the legal community. In this role, David has served as a consultant and expert witness representing utility ratepayers in both Colorado and New Mexico, and has served as a forensic economist in civil matters ranging from wrongful termination to personal injury claims.

David received his BS in Mathematics from Tufts University, and is a Fellow in the Society of Actuaries.

David is a regular speaker at actuarial conferences, and currently serves on the Pension Finance Task Force – a sponsored committee whose primary mission is to strengthen retirement systems, by incorporating the teachings of financial economics into traditional retirement actuarial practice.  David also serves as the retirement expert for the SOA curriculum committee on enterprise risk management.

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