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Hot Topic – Liability-Driven Investments for Pension Plans; Implications for Regulated Utilities

With recently adopted funding and accounting rules, such as the Pension Protection Act (PPA) and FAS 158, the focus of pension plan cost measurement is shifting towards marking to market a plan's assets and liabilities. These changes are highlighting the financial volatility resulting from a mismatch between assets and liabilities. In response to these changes, many organizations are looking into various investment alternatives which would result in a better match between changes in a plan's assets and liabilities and therefore less volatility. In addition to the risk/reward trade-offs usually associated with these liability-driven investment (LDI) strategies, regulated utilities face industry-specific issues such as their impact on the amount of pension cost that can successfully be negotiated into a rate case.

Pension Financial Risks – Changing Environment

The inherent risks of pension plans have not changed, but the consequences are being passed along more quickly to plan sponsors. Government and regulators are changing the rules of funding and accounting for pension plans to immediately recognize market value movements of assets and liabilities in financial statements. In a move towards greater transparency, various smoothing techniques that were historically available are being retracted.

While conventional wisdom has always held that the financial risk of a pension plan is associated with the volatility of the rate of return on its investment portfolio, this trend towards transparency is beginning to shift the focus to the volatility of the plan's funded status. In other words, the true financial risk isn't simply measured by the fluctuation in the plan's assets, but rather by the fluctuation in the plan's funded status caused by the mismatch between a plan's assets and liabilities.

Regulated utilities face an additional challenge. For many utilities, the amount of pension cost built into their rates is fixed until rates are re-negotiated, and as a result, volatility of pension costs will result in either a windfall or a loss for the utility. Depending on the length of time between the rate cases and the utility's ability to obtain rate adjustments, this mismatch risk may be very real. Additionally, utilities need to consider whether the

risks are symmetric. For example, a windfall gain may result in pressure to reduce customer prices, but the regulators may be more reluctant to allow price increases resulting from losses, instead expecting shareholders to absorb such losses.

In response to the changing rules, many sponsors are beginning to look at ways to reduce pension plan cost volatility. Although several organizations have decided to move away from pension plans in favor of defined contribution replacements, many are taking another look at the plan's investments to help control the increased financial risks. Even organizations that froze their pension plan find that the mere plan freeze did not significantly reduce short-term financial risks as they must still manage assets and liabilities for previously accrued benefits.

Liability Driven Investments (LDI) – What It Is? What It Is Not?

The term “LDI” is being used a lot these days, and sometimes with very different meanings. We like to think about LDI as *an investment strategy that is set with explicit reference to plan liabilities, where return objectives are carefully weighed against the plan funded status (i.e., surplus or deficit) risk implications*. It does not necessarily mean an investment strategy that perfectly matches liabilities, but rather a strategy that measures the interaction between changes, expected or unexpected, in assets and liabilities to support an ongoing risk management strategy appropriate to the specific circumstances of the plan sponsor.

LDI does not always mean reducing risk. Eliminating the risk in a plan is one extreme, whereas plan sponsors will most likely end up adopting a more balanced approach. LDI does mean a policy that measures the appropriate risk in the new world of pension finance, which looks at the change in funded status and not just assets in isolation. LDI also implies a strategy of seeking the proper balance of eliminating risk that may not be wholly compensated and accepting risks that carry a greater likelihood of higher returns. LDI comes in a variety of different flavors and risk management strategies. While LDI outcomes are different, there is commonality in the strategy development process. By definition, an effective LDI program incorporates the characteristics of the plan liabilities and tailors any resulting strategy to the circumstances of the plan and sponsor.

The Utility Perspective

In situations where an organization's revenues are fixed for an extended period of time, it goes without saying that cost predictability is extremely desirable. In these circumstances, LDI strategies may effectively be used to control cost volatility and produce a more predictable cost pattern.

Although some reduction in volatility may be achieved without an increase in costs, the potential downside increases as a more material amount of risk is mitigated. This downside is that the plan sponsor may need to accept lower expected asset returns as a trade-off for lower cost volatility, especially if there is a reduction in equity allocation. In other words, materially lower volatility comes with a price: higher cost. As long as these costs can be built into a utility's rates, this can be a very attractive proposition. In addition, certain strategies using derivative instruments such as swap overlays can reduce

or significantly mitigate the funded status volatility caused by changes in interest rates while maintaining the existing equity allocation and higher expected returns of equity investments. However, under this type of strategy, the plan continues to experience the volatility from the equity markets which can be significant.

LDI is not always synonymous with reducing risk, but rather LDI implies a new measurement of risk that recognizes both assets and liabilities, and also a framework for managing this risk. In some cases, an LDI strategy will involve reducing risk, or “de-risking” the plan. De-risking a defined benefit plan by matching assets and liabilities can have tremendous advantages for the sponsor and its shareholders if the resulting cost can be built into the rates, as it minimizes the risk that the actual cost will exceed the amount recovered in the rates.

It may also prove beneficial to plan participants as it may result in increased benefit security, at least where the plan is well funded.

From the ratepayers’ perspective, the benefits of an LDI strategy may not be as obvious. In order to successfully incorporate the increased cost into the rates, the utility will have to convince the Public Utility Commission (PUC) of the benefits of employing such a strategy. The main selling points include:

- Better cost predictability is in the customers’ best interest as may minimize the risks of significant rate variations.
- Better alignment between the cost and the “generation of ratepayer”. With a very risky allocation, current costs often include amortization of experience losses that occurred in the past. A good LDI strategy may reduce the likelihood of these losses and therefore, this cost transfer.
- Locking in a well funded position to avoid future contribution requirements resulting from potential losses.

Another potential issue for regulated utilities in a transition to an investment strategy that increases cost as a price for lower volatility is the lag between when costs are incurred and when they are built into rates. This can lower earnings per share (EPS) for a few years. In order to implement such a de-risking strategy, a utility may have to absorb the cost increase for one or two years before the new (higher), less volatile costs can be built into rates. One approach to address this problem would be to time the implementation of a de-risking strategy when costs would otherwise decrease (either after a year of favorable returns or increasing interest rates which would decrease a plan’s liabilities). In this situation, the utility would basically “spend” the difference between the lower cost and the amount built into the rates to reduce the volatility. Another alternative is to stagger the implementation over a number of years.

Volatility of costs is not as much concern to a utility where most of its business is regulated and their rate-making process includes a tracking or true-up mechanism. This tracks the difference between the cost included in rates and the actual cost incurred and uses this difference in determining the costs to be included in future rates. One of the real

benefits to the utility of such a tracking mechanism is that it allows the utility to establish a regulatory asset or liability under FAS 71 for the difference between the actual FAS 87 expense incurred and the amount collected in its rates. As a result, volatility in FAS 87 expense does not impact EPS the same way it would for a non-regulated entity, at least for the regulated portion of the business.

Conclusion

As rule makers change funding and accounting rules, the cost of defined benefit plans are expected to become more sensitive to changes in a plan's funded status. For regulated utilities, this additional cost volatility exacerbates the age-old problem of matching actual costs with the amount recovered into rates. A plan's investment strategy is a powerful tool to assist a plan sponsor in managing this volatility. Although the benefits of de-risking for the plan sponsor, its shareholders and its employees are quite apparent, the case may be more difficult to make to the various PUCs. However, some strong arguments can be made to advocate its benefits, and we believe such strategies are worth exploring.

Who We Are

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