How Lucent's Retiree Programs Cost It Zero, Even Yielded Profit

Trusts Paid the Tab -- Till Now; Facing Need to Use Cash, Company Imposes Cuts A Handy Tool for Downsizing

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Henry Schacht, **Lucent Technologies** Inc.'s former chief executive and still a director, met with retirees in 10 states last fall to explain why Lucent was cutting their medical and life-insurance benefits.

In Buckhead, Ga., the retirees, some propped on canes and walkers, tottered into a meeting at the Sheraton hotel. Then, according to a handout from Mr. Schacht's presentation, he explained the burden Lucent faced from growing medical costs and rising numbers of retirees. There are now five retirees for every U.S. worker, the handout said. "Unfortunately, the numbers just don't work."

Many retirees say they resigned themselves to that conclusion. A high ratio of retirees and older workers, they figured, must be a burden that forced the company to cut benefits if it hoped to be competitive.

But an examination of Lucent's government filings shows that having a disproportionately high number of retirees hasn't been a problem for Lucent. In the first place, thanks to three benefit and pension funds that Lucent was born with when spun off from AT&T Corp. eight years ago, the big provider of telecom gear never had to dig into its own pocket to pay benefits for U.S. retirees. The funds paid every cent, both of pensions and of retirees' health care.

In addition, Lucent has been able to use assets in these funds to help it pay for repeated rounds of downsizing.

Moreover, the benefit plans -- thanks to accounting rules -- have fed Lucent hundreds of millions of dollars of income. And through a separate accounting maneuver, the cuts that Lucent made in the benefit plans last fall will contribute hundreds of millions of dollars more in income over future years.

In short, in most years the pension and retiree benefit plans have enhanced Lucent's earnings, not burdened them. But now that the surplus in the biggest fund is essentially gone, Lucent is faced with using some of its own cash to pay retiree benefits, and it is cutting those benefits.

The Lucent story is a case study of the often-bewildering world of retiree benefits. Contrary to a common perception, having a high ratio of retirees to employees doesn't necessarily raise a company's benefits burden. Lucent also shows the sundry ways companies can actually profit from their retiree plans, both to relieve demands on their cash and to produce new income that burnishes the bottom line.

For many retirees, the impact is painful. "This is like getting an enormous pay cut -- in retirement," says Howard O'Neil, 90 years old, who began work in 1939 for Lucent predecessor Western Electric in the radar group, and then was a pricing specialist for AT&T Technologies. "We're going to have a really tough time this year," says the Wall, N.J., resident, now faced with paying for Medicare "part B" coverage and dental benefits that Lucent used to cover for him and his wife, Mabel, 79. Their total increase is $183 a month.

Lucent also eliminated a death benefit it had told Mr. O'Neil he would have. The benefit was to equal his $16,600 pay in his last year, 1973, and he intended it for his burial costs. "They punish you for being old," Mr. O'Neil says.

Lucent says it adopted many techniques that other big companies also use to manage pension and benefit plans. But it makes a distinction. Most companies imposing cuts "are doing it to improve their performances or to better insulate themselves" from health-care inflation, Mr. Schacht says in an interview. "We're in an entirely different position. We can't generate the cash." Lucent's revenue is down radically from four years ago after two spinoffs and a brutal slump in demand for telecom equipment and services.

Lucent says that until now, it has never spent any cash from operations on benefits for U.S. retirees, because the trusts always paid for this. Now that Lucent can't rely on the trusts to pay all the benefits, Mr. Schacht says the company has no choice but to cut them. He says the company must commit its resources to improving the business and describes the cuts as necessary to keep Lucent strong enough to pay any benefits at all.

Cutting retiree benefits was "the least-worst of bad alternatives," he says. "We spent eight months trying to figure out how not to do" what the company ended up doing.

Lucent began life in 1996 when AT&T put together several divisions, including Western Electric and Network Systems, and spun them off as a new company. It made and sold telecom equipment, including many of the computers and switches that undergird the Internet and the U.S. telephone system. It also housed the storied Bell Laboratories, the research center that developed technologies as diverse as transistors, lasers and fax machines. Based in Murray Hill, N.J., Lucent started off with 100,000 retirees, ex-employees of these AT&T divisions.

They came with a dowry. AT&T transferred to the new company a $29.8 billion pension fund plus two special trusts to pay retiree benefits, containing $3.7 billion. Counting the estimated cost of paying all the retiree benefits to everybody entitled to them, the new company had retiree liabilities of $28.7 billion. And it had $33.5 billion in assets to pay them.

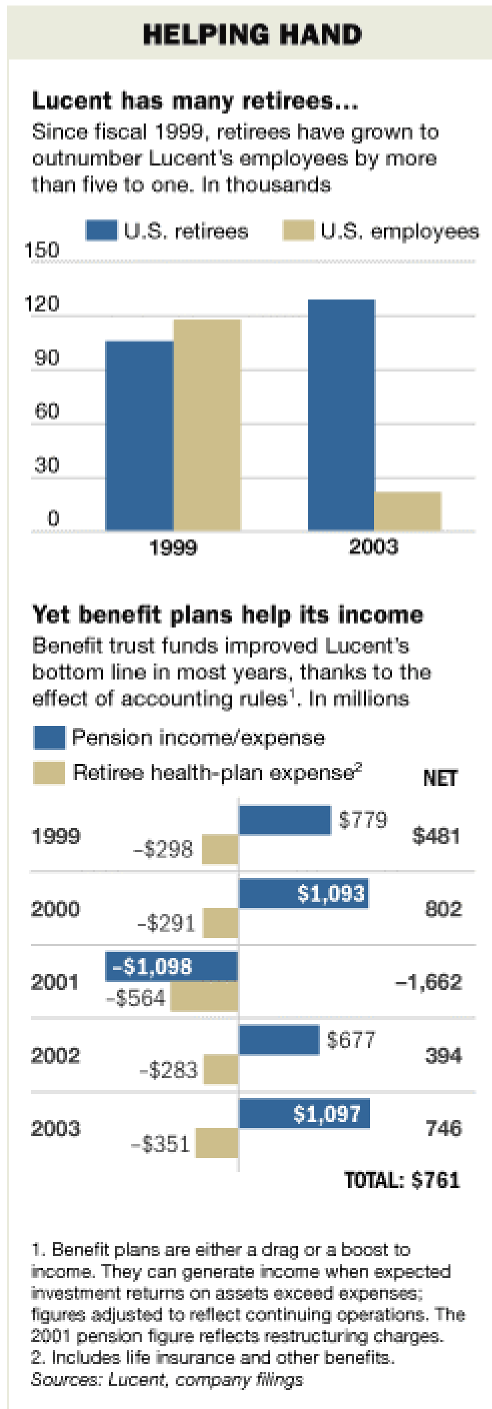
Lucent focused on growth: acquiring companies, hiring people, borrowing heavily and generally operating as if the roaring telecom market of the time would continue. It didn't. When the bubble burst in 2000, Lucent deflated too. Demand for telecom products and services went into a steep fall, exacerbated in Lucent's case by its habit of financing customers' purchases.

Accounting issues accompanied the financial troubles. Lucent disclosed in late 2000 it had improperly recognized $679 million in revenue. As recently as early this month, a federal grand jury was continuing to look into Lucent's business practices. Also this month, Lucent said the Securities and Exchange Commission will fine it $25 million for lack of cooperation after a 2003 preliminary SEC settlement, which didn't require penalties or further restatements.

Retirees Multiply

After the telecom bust, Lucent began downsizing through spinoffs of business units, layoffs and early-retirement offers. A U.S. labor force that had been 118,000 in 1999 stands at 22,000 today.

As its work force shrank, its retiree population grew. In the U.S. by last fall, retirees numbered 127,000.



One might think this would increase Lucent's pension obligation. Not so. The company had the same pension obligation to employees while they were still on the payroll as it did after they left. Having a higher ratio of retirees to active workers doesn't make a company's pension obligation worse.

That's because companies that offer pensions must fund them. They're expected to set aside enough money in a pension plan to meet all obligations to current and future retirees. As employees retire, the liability the company carries for those employees actually begins to decline, because the people are no longer building up new pension benefits.

Before the telecom bubble burst and stock market turned down, Lucent's pension plan was more than well-funded: It had a giant surplus. Its assets reached $45.3 billion at the peak, with a surplus of about $19 billion.

Pension Income

Besides the effortless payment of pensions, that rich pension plan provided a valuable resource for the company itself. First, it generated pension income. When expected returns on the assets in a pension fund exceed current costs, the difference counts as company income. While this isn't spendable money, it fattens the reported profits that drive stock prices.

In Lucent's first full year, ended Sept. 30, 1997, its earnings included $329 million of pension income. The figure more than tripled in fiscal 2000. After that, Lucent ran huge annual net losses, but most were narrowed by hundreds of millions of dollars in pension-fund income.

An exception was fiscal 2001, when the pension fund generated a billion-dollar accounting loss, thanks in part to the company's restructuring. In addition, accounting expense for other retiree programs, particularly health care, has lowered corporate income. But even after subtracting those factors, the net result was $929 million added to Lucent's bottom line over its eight-year history as a result of its benefit plans.

The pension plan also served the company as a kind of piggy bank. From 1999 to 2001, Lucent withdrew about $1 billion from pension-plan assets to pay for retirees' health care. This is perfectly legal, although companies that do it face certain restrictions if they later try to cut those health benefits.

Severance Aid

Lucent also used its pension fund for severance. For example, in 2001, to induce older employees to take early retirement, Lucent offered them beefed-up pensions. Doing so raised Lucent's pension liability by $1.95 billion, which was a big part of the reason the plan hurt rather than helped earnings that year. But offering bigger pensions let Lucent shed workers at minimum cash cost. It "was a better way to finance because we didn't have the cash," Mr. Schacht says. "It is still far better ... than if we would have just had to fire" people.

In its medical trust funds for retirees, Lucent found another useful downsizing tool. The company encouraged older employees to leave by offering them accelerated health coverage in retirement.

In 2001, Lucent offered retiree health coverage to a pool of managers who weren't yet eligible for the benefit. About 8,500 managers accepted the deal and left. "We were encouraged to take it to get the medical benefits," says Mark McGill, 48, a former sales director in Denver. Together, the pension plan and the retiree health plan limited the cost to Lucent of a radical downsizing.

But wouldn't the resulting higher number of retirees boost Lucent's health-care burden? Actually, the total bill for medical benefits didn't grow appreciably. Rather, Lucent had shifted a chunk of medical costs from the employee side of the ledger to the retiree side.

In fiscal 2003, Lucent spent about $1.11 billion on health care. This was in the same neighborhood as the $1.06 billion it spent in 1999, when its payroll was at its peak. Between the two years, the sums Lucent spent on health care for employees shrank (because there were fewer), while the amounts spent for retirees grew (because there were more).

The figures: In fiscal 1999, $517 million for employees and $539 million for retirees. In fiscal 2003, $850 million for retirees and $264 million for employees.

In terms of health care, moving a population from active to retired even has some advantages. Once employees became retirees, Lucent no longer had to pay for their health-care benefits with cash earned in its business. Now, it could pay the benefits out of assets in the pension plan and special trusts.

Cost Limits

What's more, although Lucent was exposed to health-care inflation for employees, it faced far less such exposure for retirees. For 28,000 of its managers, Lucent has ceilings on what it will ever pay toward their retirement health benefits in a year: $7,850 for a family, and $1,700 for single retirees over 65.

A spokesman for Lucent confirms that it spends roughly the same overall for medical coverage as in 1999 -- but more for retirees now and less for employees. He says that switch wasn't a strategy but

just a byproduct of restructuring. In any case, Mr. Schacht says, the bill is much tougher on a company with only $8 billion-plus of annual revenue, versus the $38 billion-plus Lucent had in 1999.

Meanwhile, any cuts Lucent makes in its retirees' benefits bring it accounting gains. The cuts lower a liability recorded earlier. That generates an accounting gain, which adds to the company's income.

For example, in 1999, Lucent eliminated -- for people who had retired after 1983 -- a longstanding benefit: discounted long-distance phone rates. In lieu of this, Lucent raised their pensions $25 a month. The move, combined with other changes, lessened the retiree-benefit obligation on Lucent's books by $359 million. That produced an accounting gain, which helped Lucent's bottom line in subsequent years.

The new Medicare prescription-drug law also lets companies' retiree plans throw off still more corporate income. Under the law, those that provide drug coverage for retirees will get federal subsidies for preserving coverage instead of dumping their retirees on the Medicare program. Lucent estimates its eventual total amount of subsidies at roughly $500 million in today's dollars. This will reduce the company's liability and generate an accounting gain of that size. It will be gradually parceled out into income over about a decade.

A New Situation

Although Lucent's retirees long cost the company zero cash from its operations, Lucent says this is changing. Companies must have 25% surpluses in their pension funds to use fund assets to pay retirees' health benefits. Lucent's pension plan remains in good shape but the former huge surplus is gone. Stock-market losses are the main reason. Lucent says about 10% of the pension-fund decline is due to transferring money out to pay for retiree health care.

Lucent's two trusts for U.S. retirees' health care are also less flush. They total $2.3 billion, down 37% since Lucent's founding, after payment of benefits and losses during the bear market. Lucent says the trust for management retirees' health care is tapped out. The company expects the one for union employees to run out within two years. Lucent confirms it never put any cash into the trusts while it was prospering in the late 1990s.

The fiscal year that began Oct. 1 will be the first time Lucent must dip into its own cash from operations to pay part of the retiree-health-care tab. It estimates it will have to use $240 million of its cash for this purpose this year -- equal to about 2.7% of revenue -- and $300 million annually in 2005 and 2006.

Lucent says it can't afford this. The company has been profitable for the past two quarters and projects a profitable year. Still, executives say Lucent remains cash-flow negative -- using cash faster than taking it in.

Lucent had $4.3 billion in cash as of Dec. 31. But it says it must commit its cash to securing its future, by spending on such things as sales efforts and research and development. It also must pay competitive compensation, Mr. Schacht adds, "because that's what it's going to take to continue to attract and retain the talent required to build this company back to where we want to go."

Walt Ehmer, 67, retired chief executive of Lucent Technologies Denmark, argues that Lucent "can accomplish both goals: to take care of Lucent and the retirees. They talk about the cost of retiree

benefits, but they continue to pay all these executive bonuses." Lucent paid $300 million in bonuses at the end of 2003. Mr. Schacht says that bonuses, too, are important to retaining top people.

Early-Retirement Offer

Last September, as Lucent faced the need to spend cash on retiree health benefits for the first time, the company chose to cut them. It eliminated Medicare "part B" and dental coverage, death benefits, and spousal benefits for management retirees who made more than $87,700 a year. The effect was to rescind some of the health coverage Lucent had offered people in 2001 to get them to retire early.

Jon Wallace was one who took Lucent's offer that year and left. The offer meant that Mr. Wallace, an engineer, stood to receive $6,700 a year in retiree medical coverage. Changes Lucent made in September cut this to $3,532.

His share of premiums, formerly about $1,800 a year, is now more than $6,900. With a daughter just finishing college, Mr. Wallace, 56, figures he has traded tuition payments for a higher insurance bill. Mr. Wallace says he doubts Lucent's "simplistic story" about why it had to cut benefits but also says that "I don't want Lucent to go out of business," noting that he holds 15,000 shares of Lucent and its spinoffs "in my poor, beat-up 401(k)."

Mr. Schacht says employees who took the early-retirement option in 2001 had been warned that the company could change those benefits at any time.

Cutting the retiree coverage gave Lucent a tidy financial payoff, even though it hadn't been using its own cash for the benefits. The cuts reduced its balance-sheet liability for retiree benefits by $1.1 billion, or 11.7%. This generated a $1 billion-plus pool of accounting gains that will bolster income over several years.

The benefit cut was a last resort, Mr. Schacht says. "It's not for any other reason than we don't have the cash, and won't have the cash." He discourages any thought of restoring the cuts later, saying, "We're not going to be able to grow our way out of it."

Mr. Wallace asked about that as well, at a retiree meeting last fall in Naperville, Ill. He says Mr. Schacht demurred, saying only that the company would "review" conditions in the future.

"I just looked around the room -- a lot of folks there were in their 70s and 80s -- and I thought, 'In 10 years, they're going to be gone,' " Mr. Wallace says. He says he had gone to the meeting sympathetic to Lucent, willing to hear more and understand its decisions. "But I lost the illusion that they would do the right thing. The handwriting was on the wall: that we should expect more cuts. I came away from the meeting tightening my belt."

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