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A Bumpy Road for Delphi, GM and U.S. Auto Workers

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Following the October 8 announcement that Delphi, the nation's largest auto parts manufacturer, is filing for reorganization under Chapter 11 of the U.S. Bankruptcy Code, one thing became clear: the road ahead is going to be bumpy not only for Delphi, but also for General Motors, the United Auto Workers and the federal Pension Benefit Guaranty Corp., the government-run entity that stands behind defined-benefit plans when they are terminated.

Experts at Wharton and elsewhere who follow the auto industry say Delphi's decision to file for bankruptcy was hardly surprising but nonetheless significant. Also important was GM's subsequent announcement, on October 17, that it had reached a tentative agreement with the UAW to cut the healthcare benefits of unionized retirees, reducing by about $15 billion the company's $77.5 billion in healthcare obligations to retirees. On the same day, GM announced a loss of $1.63 billion for the third quarter, its largest quarterly loss in more than 10 years. GM also said it was considering selling a controlling interest in General Motors Acceptance Corp., its highly profitable finance subsidiary, as part of an overall effort to strengthen the parent company.

The Delphi filing and the tentative GM-UAW accord set in motion a chain of events that may forever alter the relationship between America's Big Three carmakers and the UAW, and they underscore the degree to which globalization is exerting downward pressure on the wages and benefits paid to U.S. workers. The fates of GM, Delphi, and their workers and retirees are inextricably linked because GM has some level of responsibility -- it is not yet clear exactly how much -- for the billions in benefits owed to retirees at Delphi, which was spun off from GM in 1999. Ford and Daimler-Chrysler, adhering to a tradition of pattern bargaining, are expected to follow GM's lead and seek their own concessions from the UAW.

The news from Delphi and GM also drives home the point that the days of defined-benefit pension plans -- where retirees get a monthly check for a fixed amount in return for years of corporate service -- are under increasingly intense pressure, at least at firms like auto companies and airlines that are struggling to turn a profit. This is an especially key takeaway for workers of all ages who may not have yet come to terms with the seismic shifts in the pension and healthcare landscape as many major companies struggle to figure out ways to reduce both current healthcare expenses and the so-called "legacy" liabilities of pension payments and related retirement costs.

Susan Helper, an economics professor at the Weatherhead School of Management at Case Western University in Cleveland who specializes in studying auto parts companies, calls the Delphi bankruptcy "a watershed event." "There have been many instances in which the auto industry has been the bellwether for the economy as a whole," she says. "Henry Ford was the first [industrialist] to raise wages to $5 day, and the industry was at the forefront of adopting new technologies. Now it's at the forefront of what we as a nation are going to do about wages and benefits and how we are going to compete in an era of high healthcare costs and low-wage competitors."

After Delphi filed for bankruptcy, its chairman and CEO, Robert "Steve" Miller, said that the company needs to get rid of a "substantial" number of its North American operations and reduce its 51,000-member workforce. He wants the UAW to agree to concessions that would reduce members' average wage-and-benefit packages from about $65 an hour to about $20 or $25 an hour. Of that total compensation package, the hourly wage alone would drop from $27 to $10 if Miller has his way. In an interview with *The Wall Street Journal*, Miller said Delphi cannot stand up to non-union competitors if it has to pay such high wages and the kind of blue-ribbon benefits UAW members now enjoy. He called the traditional defined-benefit pension plan that Americans have come to expect in the last 50 or 60 years an "anachronism."

Wharton management professor John Paul MacDuffie says Delphi's problems -- and GM's for that matter -- do not stem directly or entirely from the legacy costs or high wages paid to current workers. A major part of Delphi's difficulty is that it remains too dependent on a weakened GM as a customer for its parts. "One of the main questions about Delphi was whether changes could have been made earlier that would have started an adjustment process sooner," he says. "It often seems to take a crisis to get movement on difficult problems."

Since the spin-off from GM, Delphi has made many positive changes of the kind that auto parts manufacturers need to make to stay competitive in global markets, according to MacDuffie, who is also co-director of the International Motor Vehicle Program (IMVP), which has a network of researchers at universities worldwide and is funded by major automakers and suppliers. Delphi adopted new production methods to streamline the way in which it deals with its suppliers. It hired talented executives from Toyota in Japan and the head of purchasing for Honda in America. Moreover, Delphi was early and aggressive about globalizing its manufacturing footprint, opening technical centers in Mexico, Poland and China.

But there were tough problems, too -- inefficient businesses and pressure to sell some parts to GM at less than cost. "Delphi has older businesses where labor costs are high," MacDuffie says. "The question is why there wasn't pressure to deal with that issue sooner. There wasn't much of an inclination to invest in [improving] those businesses, maybe because labor costs were seen as insurmountable barriers."

One of Delphi's key goals after it was spun off was to increase sales to companies other than GM. When Delphi became independent, fully 70% of its sales were to its former parent. Today, that figure is lower but still higher than Delphi would like -- around 50%.

"Delphi had hoped to make further progress in that area," says MacDuffie. "They were excited about Toyota as a customer because Toyota is known for working with suppliers to help them improve cost performance. Delphi was not able to shift away from this GM-dependent business as quickly as it had hoped. And for those GM-dependent businesses in the last few years, GM was putting extreme pressure on them to cut costs. I think Delphi was selling to GM at less than cost in some cases. If, in fact, that situation hadn't developed, both Delphi and GM would have felt pressure sooner to deal with the lagging parts of their business. The hope had been that GM would get healthier and that car sales would increase, bringing in revenue to less competitive parts of Delphi's businesses. But, as we know, GM's sales have declined."

John Moavenzadeh, executive director of IMVP, agrees with MacDuffie's diagnosis of Delphi's problems. "In some business lines, Delphi was quite innovative, like diesel systems. They had a great product, great technology, and they were doing well. But unfortunately, their sales to GM were low-margin to negative-margin sales. So they kept GM as a customer but they weren't necessarily making money -- and in some cases were losing money. As a result, Delphi found itself in the same dilemma that a lot of the auto industry finds itself in: labor becomes a fixed cost. You have to pay workers whether they are working or not, and for that you need a lot of volume. Delphi in many ways faced some of the same strategic decisions as GM has faced in recent years: they had to keep the volume of their sales up because of the high cost of their unionized workforce."

Intertwined Companies

GM's future is intertwined with Delphi's because GM became responsible for Delphi's legacy costs once Delphi filed for bankruptcy -- a move that Miller, the Delphi CEO, had hoped would focus heightened attention on the looming national issue of healthcare and legacy costs. "When Delphi was spun off, there were agreements with GM about certain aspects of labor contracts," MacDuffie explains. "In the case of bankruptcy, GM agreed to pay benefits to about 12,000 Delphi retirees. Delphi is now going to ask GM to do that as part of the bankruptcy filing. The bankruptcy reflects the view of the leadership at Delphi that they needed to be willing to do something dramatic that would force GM, as well as Delphi, to confront this issue."

Moavenzadeh and MacDuffie agree that Delphi could very well emerge from Chapter 11 as a stronger, more competitive company. "I think they probably will get back to being a competitive supplier," says MacDuffie. But, he adds, "It's hard to see any outcome that doesn't involve wage cuts."

MacDuffie says it is too soon to tell whether, and how much, the October 17 tentative agreement between GM and the UAW to trim healthcare benefits for retirees will serve as a model for Delphi and its unionized employees and retirees. Relatively deep cuts in medical costs by Delphi, along with the sale of certain assets, might allow the company and the union to reach agreement on wage cuts that would not be as deep as currently envisioned by Miller.

"There are unionized parts suppliers that pay more than $10 an hour and are quite competitive in doing so, and I guess the UAW will ask Delphi why wages would have to be cut below what other workers at other companies are getting," MacDuffie notes. "We may also see Delphi sell its least-competitive businesses. In Delphi's other businesses, where wage-cost reductions would have to occur, the union may negotiate to have Delphi spend more in capital improvements to restore those businesses to competitiveness."

Many Uncertainties

Olivia S. Mitchell, professor of insurance and risk management and executive director of Wharton's Pension Research Council, and Wharton accounting professor Wayne Guay say that many questions remain unresolved as the Delphi filing begins to wend its way through the bankruptcy court and as Delphi and GM hold their separate discussions with the UAW over reducing wages and benefits for current and retired workers.

"In the near term the workers and retirees at Delphi are facing great challenges to their compensation and benefits packages," says Mitchell. "It's not completely clear whether the Delphi bankruptcy will trigger termination of the pensions. Also, Delphi had received some guarantees from GM to help cover or subsidize pensions and other benefits in the event of a Delphi bankruptcy. But there is a lot of uncertainty around that issue, too. There are huge uncertainties about what the Delphi workers and retirees will get, what GM will have to shoulder, and what the PBGC might be responsible for down the road. There will be a morass of claims and counter-claims by GM and Delphi, and it will take a long time to sort out."

Just how much money is involved? As of Dec. 31, 2004, Delphi had a total of $22.5 billion in obligations to retirees -- $12.8 billion in the form of pensions and $9.6 billion in health insurance, life insurance and other retirement benefits. How well funded are Delphi's obligations? Delphi has set aside assets of just $8.5 billion to cover the total that it owes retirees.

"That's a severely underfunded pension plan," Guay says. "In all likelihood, Delphi doesn't have the cash flow to satisfy that obligation. The question [during the bankruptcy process] then becomes whether Delphi will turn its obligation over to the PBGC. And GM may be on the hook for some of this."

The Role of the PBGC

Mitchell calls the PBGC, which itself has a $23 billion deficit, the insurer of "last resort," and notes that if the PBGC is left with the responsibility for Delphi's obligations taxpayers could be on the hook. "The PBCG has enough cash today to pay retirees but it's still looking at red ink. Higher taxes at the moment are not required to bail out the PBCG. But one could surmise there will be a workout arrangement like the savings-and-loan bailout in the 1980s. So I suspect taxpayers will end up bearing part of the burden."

Many people in the baby-boom generation, Mitchell adds, "didn't factor the decline of defined-benefit plans into their calculations in planning for the future. They assumed defined-benefit plans would always be there. They always assumed the upside and discounted the downside. Now we have to go back and remember that there's always risk. The chickens have come home to roost."

Mitchell notes that Congress has been working on legislation to strengthen the PBCG. "As of a few weeks ago it looked like there was an impasse and that they would stop for this year. But I hope this bankruptcy spurs legislators to restart the process and get some reforms at the PBGC. Every year they wait they're digging a hole, and it's quite dangerous to do nothing."

Helper, the economics professor at Case Western Reserve, hopes that the Delphi bankruptcy also starts a national debate over the immense changes that globalization has brought to blue-collar union families that worked for decades to earn middle-class wages and rock-solid benefits.

"Some of Delphi's problems are of its own making and some are the result of implicit policy choices that we made as a society," Helper says. "One of those policies was the decision [in the 1990s] not to have national healthcare. Another issue is the way we write trade agreements so that there is no standard at all as to the wages we pay. This is an opportunity to reexamine the policies that make it hard for Delphi and GM to compete the way they used to. Workers being able to live the American dream -- to own a house and send kids to college -- is a good thing."