

Letter from the Chairman of the NAPS Trustees, sent to NAPS members and pensioners – March 2011

Dear NAPS member

New Airways Pension Scheme (NAPS) - Pension Increase

We are writing to notify you of an important change made by the Government which will affect NAPS. Under the Scheme Rules, pension increases for deferred pensions and pensions in payment (pensioners) are made in accordance with Orders which are issued by the Government. The Government has decided that these Orders will now increase in line with the Consumer Prices Index (CPI) and not, as was previously the case, the Retail Prices Index (RPI).

The CPI figure which forms the basis for the April 2011 increases to pensions in payment and deferred pensions is 3.1%. Although the Government has changed the index on which the Order is based, at present the Order continues to provide an April increase figure based on the index changes in the twelve months to the previous September (e.g. the April 2011 increase reflects September 2010 CPI).

The purpose of this letter is to provide more information about the change and to report to you on what action the Trustees are taking.

NAPS increases

Under Rules 15 and 17 of the NAPS Rules, increases to deferred pensions and pensions in payment are made in accordance with the Pensions Increase (Review) Orders up to a maximum of 5% each year. The same Orders are used by pension schemes in the public sector, for example local government schemes and some private sector schemes which were formerly state owned. The Government has changed the basis of the increases under the Pensions Increase (Review) Orders. In past years the Order broadly reflected RPI increases but will now reflect CPI increases. The Government considers that CPI is a more appropriate measure of inflation for pension increases. RPI and CPI are discussed further in the enclosed Q & As.

Impact of the change

Over the longer term, based on past performance, increases in CPI are estimated to be on average 0.5%-1% a year less than RPI, although in some years CPI has been higher than RPI.

Valuing the NAPS liabilities to take account of the annual increases based on projected CPI (rather than RPI) improves the funding position of NAPS. You may recall that in our November 2010 'In Focus' we advised that NAPS assets covered 75% of the Scheme liabilities as at 31 March 2010. The position at the same date, but allowing for a prudent assessment of the CPI based increases, reduces the liabilities and improves the funding position to around 79%.

British Airways (BA) has confirmed that despite the funding improvement arising from the Government's change, they will continue to pay contributions in accordance with the schedule of contributions and recovery plan agreed in June 2010 as part of the 31 March 2009 valuation. Since the valuation date, from April 2009, BA has paid £290m in normal Scheme contributions for current employees in NAPS and £282m in NAPS deficit contributions.

The Trustees' response

The Trustees are aware that many members and pensioners will be disappointed that the basis of the increases will change from RPI to CPI. Ever since the Government first announced it intended to make this change, the Trustees have monitored developments. The Trustees have obtained extensive legal, actuarial and covenant advice and have devoted considerable resource and time to undertake a detailed

review of the options available to them under the Scheme Rules. The covenant review is concerned with assessing the strength of BA and its ability to pay contributions to the Scheme.

Whilst the Trustees understand that many members and pensioners do not want the basis on which their pension, or their future pension entitlement, will be increased to change, introducing an alternative provision for pension increases to that set out in the Order would require an amendment to the Scheme Rules. Amendments to the Rules can only be made jointly by BA and the Trustees so any amendment would require the agreement of BA.

A key impediment to amending the Rules is that whilst NAPS is in significant deficit (£2.7bn as at 31 March 2009), it is difficult to reconcile taking action which would be detrimental to the funding position with the primary duty of the Trustees to ensure that existing benefits are secured to the maximum extent possible.

The decision as to whether to introduce an amendment at a future date would also not be straightforward. Questions as to the funding level, the progress of NAPS to full funding, whether the level of risk in the investment policy should be further reduced and wider issues concerning the security of accrued benefits would need to be addressed. These questions would need to be considered in the context of the strength of BA's covenant, financial conditions and the circumstances at the time. The power to amend the Scheme Rules of NAPS can only be exercised with the agreement of BA.

Past Scheme communications

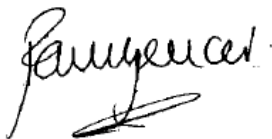
The NAPS Scheme Rules have always referred to the Pensions Increase (Review) Orders up to a maximum of 5%. However, the Trustees are aware that communications to members have varied over the years and they are therefore seeking the advice of Leading Counsel (a QC specialising in pensions law) as to whether these various documents might have informed member expectations that pension increases were specifically referenced to RPI. The meeting with Leading Counsel is scheduled for April and the outcome of this will determine what further action the Trustees take. Further information will be made available once this process, which is expected to take a number of months, is completed.

Next Steps

As part of the process of finalising the legislation the Government has issued a formal consultation document to which the Trustees have responded. The Trustees will be reviewing the reported outcome from the consultation, expected in June, and also monitoring any changes to the proposed legislation.

The Trustees will be writing to pensioners again in April to confirm the April pension increase and will send an update to the membership once further progress has been made to determine the options that are available to the Scheme in response to the Government changes.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Paul Spencer', with a stylized flourish at the end.

Paul Spencer
Chairman of Trustees

Q & A document

This question and answer document has been prepared to provide you with further information on the impact of the Government's decision to move to CPI as the measure of price inflation for pension increases and the actions that the Trustees are taking to respond. If you have a question which is not addressed here please contact us.

Has the Scheme been changed?

The Scheme Rules have not been changed. The Scheme Rules make provision for pensions to increase in line with the Pensions Increase (Review) Orders and it is the Government which has decided that from now on these Orders will be based on CPI rather than RPI which was previously the inflation measure on which the Orders were based.

I understand that the APS Trustees have decided to amend the APS Scheme Rules. Why has APS introduced a discretionary increase power but NAPS has not?

The terms of the governing documentation for APS and NAPS are different. The APS Trustees have the power under Clause 18 of the APS Deed, on the basis of a two thirds majority, to amend the APS Scheme Rules. The NAPS Deed also contains an amendment power at Clause 16 but this power must be exercised by both BA and the Trustees.

The APS Trustees have decided to amend the Rules to give the Trustees a discretionary power to consider on at least an annual basis whether to award an additional pension increase to that provided for in the Orders. However in most years, whether a discretionary increase should be awarded by APS, and if so at what level, will not be a straightforward decision. Questions as to the funding level, the progress of APS to full funding, whether the level of risk in the investment policy should be further reduced and wider issues concerning the security of accrued benefits will need to be addressed each time the matter is considered. These questions will need to be considered in the context of the strength of BA's covenant, financial conditions and the circumstances at the time.

In common with the APS Trustees, the NAPS Trustees have also given consideration to such an amendment. The NAPS Trustees recognise that even if an equivalent Rule change to that made by the APS Trustees were to be introduced in NAPS, the ability to exercise that power would be curtailed until the funding position of NAPS significantly improved. The NAPS Trustees have asked BA to consider such a Rule change but BA has suggested that the timing of any such change should be deferred.

The key issue in the context of NAPS is that, in the current circumstances, it is difficult to reconcile taking action which would be detrimental to the funding position with the primary duty of the Trustees to ensure that existing benefits are secured to the maximum extent possible.

How can the Government justify a change in policy the impact of which is to reduce the future value of member benefits?

The Government has stated that, "the objective is to adopt the most appropriate measure of inflation. Additionally, the use of CPI for uprating purposes will assist some defined benefit occupational schemes to maintain adequate funding levels to meet future liabilities."¹

In July 2010 the Pension Regulator issued a statement confirming that where the effect on the scheme was to result in lower estimated liabilities for schemes (meaning potentially lower future benefits for members than would have been the case if RPI had been retained) that the expectation would be that this would lead to shorter recovery plans resulting in greater security for members.

Why did the Government choose CPI instead of RPI?

The pension increase legislation effectively requires the Government to make a judgment each year on the increase in prices over the previous 12 months. At present the Order continues to provide an April increase figure which is based on changes in prices in the twelve months to the previous September. The Government has stated that RPI has proved volatile over recent years and the Secretary of State no longer considers it the foremost measure of inflation. After consideration, the Government concluded that rather than continuing to provide increases according to the RPI measure of inflation, it was more appropriate to, "use CPI as the best measure of movements in the general level of prices."¹ In reaching this conclusion the Government has said that it took into account that CPI is calculated in accordance with a common EU methodology to measure price levels and is the index used by the Government to set the Bank of England's inflation target.

What is the difference between RPI and CPI?

CPI is calculated differently from RPI, for example, it is based on a different basket of goods and services and excludes most housing costs. As well as a difference in the basket of goods and services covered there are also differences in the weightings assigned to the different elements of the basket and the formula used to calculate product inflation. It is the 'housing effect' and the 'formula effect' which are the main differences between the CPI and RPI indices.

In the past RPI inflation has typically been higher than CPI inflation, although there have been several periods when this has not been the case. The expectation is that CPI inflation will continue to average less than RPI in the long term, but it remains likely that there will be some periods where this is not the case. In the long term it is estimated that the average annual difference between RPI and CPI might lie in the range 0.5% - 1%, but in any individual year the difference could be larger, smaller or even negative.

How will the Government's change affect my pension?

Over the longer term, based on past performance, increases in CPI are estimated to be on average 0.5%-1% a year less than RPI, although in some years CPI has been higher than RPI. In the long term, therefore, it is expected that members' benefits will be lower if they are linked to Orders based on CPI rather than RPI.

By way of illustration, we have shown below the difference in the pension increase based on Orders linked to RPI and Orders linked to CPI. The example below uses a current pension of £100 p.a. It assumes RPI inflation of 3.5% p.a. and CPI inflation of 3% p.a. (i.e. 0.5% p.a. lower).

Orders based on RPI Orders based on CPI Pension after 10 years £141 p.a. £134 p.a.

The impact on the member's annual pension after 10 years is £7 p.a. In cumulative terms over the 10 year period, the member would be expected to have received around £35 less pension. The £35 represents the cumulative difference in the amounts that would have been received over the 10 year period. Orders based on RPI would have delivered total payments over the 10 year period of around £1,215 whilst Orders based on CPI would deliver payments of around £1,180.

Why is my pension entitlement governed by Government policy when other schemes are not affected?

Under Rules 15 and 17 of the NAPS Rules, increases to deferred pensions and pensions in payment are made in accordance with the Pensions Increase (Review) Orders up to a maximum of 5% each year. The reference to the Orders is a legacy of BA's history as a nationalised company until privatisation in 1987. Some other private sector schemes which were previously state owned will also be affected as well as public sector schemes, for example the civil service and local government schemes.

¹Extracted from DWP Impact Assessment (11 February 2011)

The impact on the members of other UK occupational schemes depends on how the rules of the scheme to which they belong have been drafted. For example, some schemes will specify RPI as the increase measure whereas others might provide for entirely discretionary increases (although subject to the statutory minimum). The Government issued a consultation document in December 2010 which invited respondents to identify the impact of the Government's changes on their schemes. In each case the impact will vary depending on the interaction between the legislation and the scheme rules of each scheme, in particular the pension increase and scheme amendment provisions.

The Government's consultation exercise closed on 2 March 2011. The Government's aim is to provide a summary of the outcome of the consultation within three months of this date. The Trustees will be reviewing the reported outcome from the consultation and also monitoring any changes to the proposed legislation.

I thought that NAPS pension increases were already directly linked to RPI?

The Scheme Rules have always referred to the Pensions Increase (Review) Orders (up to a maximum of 5% each year) issued under Section 59 of the Social Security Pensions Act 1975. However, the Trustees are aware that communications to members have varied over the years and they are therefore seeking the advice of Leading Counsel as to how these various documents might have informed member expectations that pension increases were specifically referenced to RPI.

I have read about the 'triple guarantee', what is the impact of this?

The triple guarantee applies to the Basic State Pension and not to amounts payable from public or private sector company pension schemes.

Issued April 2011 as an attachment to letter sent to NAPS membership.