Letter from the Chairman of the APS Trustees, sent to APS members and pensioners - September 2013.

Dear APS member/APS pensioner

31 March 2012 Funding Valuation – Trustee report to the APS membership

We are pleased to confirm that the 31 March 2012 Scheme valuation has been completed. Whilst it is important that we communicate the outcomes of the valuation to you we recognise that for many of you the prospect of an additional increase is of more pressing interest. When we wrote to pensioners in April we said that once the funding valuation was completed, the Rules provided for the Trustees to conduct a further review as to whether an additional increase could be paid. We said that at that point we would have the most current and detailed information on which we could base a judgement as to the affordability of a potential additional increase.

So what have we done and what is the outcome? A substantial amount of preparatory work had been undertaken prior to the finalisation of the valuation with the intention that we would be able to confirm our position on the move from CPI to RPI increases, including a decision for 2013, at the same time as reporting to you on the valuation outcomes. However we have been held up because BA has raised further concerns, with us and the Pensions Regulator, that we must first discuss with them. We are fully aware that the discretionary increase power gives us the ability, without the need for third party agreement, to award additional increases when it is prudent to do so. However, we do have an obligation to consider the views of the Company, particularly in a context where BA's financial commitments to the Scheme (as set out below) are significant and long term. It is our intention to maintain a constructive relationship with BA by ensuring that it is understood that our approach to additional increases is prudent, affordable and does not jeopardise the security of members' accrued benefits. Under this approach additional increases may be modest and could be only a portion of the gap between CPI and RPI in any given year. The position will be assessed annually and, even where an additional increase has been awarded in a prior year, there may be circumstances (for example if investment returns are below expectations) where we have to conclude that no additional increase over the level in that year's Pensions Increase (Review) Order can be paid.

We consider that the current discussions with BA build on previous engagement on this topic and that our approach has been prudently constructed on the very extensive legal, actuarial and covenant advice we have considered over the last few years. Our approach to the current consultation with BA will therefore continue to be robust.

This process is ongoing and we will write again to you in the autumn. Please be assured that the Trustees' aspiration to return to paying RPI increases when it is prudent to do so is unchanged.

APS valuation headlines:

- The funding level as at 31 March 2012 has increased since the last formal valuation to 91.5% (2009: 85.2%)
- The deficit has decreased to £680 million (2009: £1,030 million)
- The recovery plan implemented to address the deficit is expected to achieve full funding relative to the technical provisions by 31 March 2023, which is 11 years from the valuation date (2009: 14 years)
- The discount rate has been strengthened and the pension increase assumption targets a return over time to RPI increases

- BA will continue to pay the same level of deficit contributions that were due under the 2009/10 Recovery Plan
- The restriction on BA providing funds for dividends falls away but such payments are linked to retention of a cash sweep arrangement (which delivered over £55 million in additional contributions to APS during 2011 and 2012)
- Retention of the £230 million guarantee (agreed in 2006) and the £250 million security (agreed in 2009/10)

Before looking at the detail behind these headlines, we thought it would be helpful to set out the background and the objectives that underpinned our approach to the 2012 funding valuation.

Background and Trustees' objectives

The Pensions Regulator expects the Company and the Trustees to negotiate and to agree the level of technical provisions (this is essentially the value placed on past service liabilities) and the plan for repairing any deficit. The negotiations are framed by the requirements of the Pensions Act 2004 but also by the objectives we set ourselves. These can be summarised as follows:

- Our funding approach is to produce a prudent budget for future contributions which recognises the long term nature of pension funding.
- We are committed to, and have unanimously agreed, to return to paying RPI pension increases when doing so will not jeopardise the ability to pay the pensions, to which you are entitled under the Scheme Rules, in full.
- By law, we are required to start from the position as at the last valuation (31 March 2009) and any changes need to be justified by a change in legal, demographic or economic circumstances. With this in mind we wanted to maintain a strong position for the 31 March 2012 valuation as this will form the basis for the equivalent 2015 exercise.
- APS remains reliant on the covenant i.e. BA's ability and willingness to support the Scheme. This is key as the Trustees need to balance ensuring that the Company is paying the most that it can afford to pay without damaging the longer term viability of the covenant.
- We consider that there needs to be a package of measures to protect and benefit the Schemes in a range of scenarios.

The recovery plan to repair the £680 million deficit

The Trustees and the Company have agreed a recovery plan to repair the deficit such that:

- the Company will pay additional contributions to the Scheme at a rate of £4,583,333 per month until 31 March 2023; and

- if the assumptions in the recovery plan are borne out in practice, the deficit will be removed by 31 March 2023. This includes an allowance for investment returns at 0.3% a year in excess of the discount rate.

The expected investment return (also referred to as the discount rate) used to calculate the value of the liabilities as at 31 March 2012 for the purposes of agreeing a recovery plan with BA was 0.4% a year above the returns available on gilts (bonds issued by the Government). By assuming that assets will perform 0.3% a year above this level the Trustees therefore assumed total investment returns over the course of the recovery plan of 0.7% a year above gilts. The continued suitability of the allowance for investment outperformance will be reviewed at future valuations, and considered alongside our future plans for investment de-risking, with an aspiration to reduce or eliminate the reliance on outperformance in future recovery plans.

PwC are engaged by the Trustees to carry out extensive and ongoing reviews of BA's financial position and future cash flows. PwC have advised the Trustees that the contributions that BA has committed to pay to the Schemes are the maximum that BA can reasonably afford in current circumstances. The airline industry is volatile and the Trustees have agreed protections in the event that BA's position were to deteriorate but have also agreed a cash sweep mechanism which means that the Scheme will receive additional contributions in the event that BA's 31 March cash balance exceeds prescribed thresholds.

The calculation of the past service deficit

The reduction in the deficit, relative to the 31 March 2009 position, is the net effect of a number of factors, many of which worked in opposite directions. In isolation the strengthening of the discount rate (from 0.5% a year above gilt yields (in the 2009 valuation) to 0.4% a year above gilt yields) would have led to a significant increase in the deficit, but this was offset by factors that reduced the deficit. These were the deficit and cash sweep contributions that were paid to the Scheme under the 2009/10 Recovery Plan and better than expected investment performance.

As the assumptions used in the 31 March 2012 valuation effectively set a precedent for the 2015 exercise, we are pleased to have strengthened the discount rate to recognise that as the Scheme matures the investment strategy will transition to assets which deliver returns with the same characteristics as the liabilities.

Pension increase assumption

To allow for possible additional increases, pension increases are assumed to transition linearly from CPI in April 2013 to RPI from April 2023 onwards. The Trustees will consider at least annually whether an additional increase may be awarded, and the size (if any) could be higher or lower than the allowance in the technical provisions.

A copy of the full actuarial report is available on the member website. Further information on the funding level on a solvency and Pension Protection Fund (PPF) basis can be found in the attached Q&A document.

Active members – Pay for Contribution Purposes

The level of contributions paid by the Company in respect of continuing accrual of benefits for active members will vary as active members leave the Scheme but initially are expected to be approximately £9.5 million a year.

The valuation assumptions acknowledge that increases to pensionable pay are currently frozen (other than for increments and promotions) but that this will be reviewed by BA. This is a matter for BA to determine (as the Company defines 'Pay' for pension purposes) but it is understood that in due course there may be a mechanism to allow staff to opt to take a voluntary salary deduction in order to retain annual pensionable pay awards up to the level of inflation (RPI). We will administer the Scheme on the current basis until further notice from BA.

Other features

The following arrangements are carried forward from previous funding agreements:

- The security in the form of a charge over Company assets to the value of £250 million which would become available to the Scheme in the event of the insolvency of BA. If this charge is still in place in 2019 and the Scheme remains underfunded the charge is expected to be replaced by a cash payment of £250 million to the Scheme.

- The Guarantee of £230 million available in the event of BA insolvency, provided as part of the 2006 valuation remains in place. We reported in July 2009 that we had agreed to release this existing Guarantee should appropriate alternative security be provided by BA. We have not however received any request from the Company to replace this Guarantee.

In addition, the cash sweep mechanism has been retained but has been modified. The Trustees of APS and NAPS were determined to retain an effective cash sweep mechanism as the combined proceeds to the Schemes have been £220 million during 2011 and 2012. Under the new arrangements, in the event that BA's cash balance at 31 March each year exceeds £2 billion then 25% of the cash balance above £2 billion will be paid to the Schemes, with an equivalent amount being available to BA to fund dividends payable by IAG. The remaining 50% will be retained within BA to further strengthen the covenant position. If BA's cash balance is between £1.6 billion - £2 billion and amounts are applied to make a dividend payment then an equivalent payment must be made to the Schemes.

The cash sweep mechanism sits within a package of measures designed to protect and benefit the Scheme in a range of scenarios. These include significant enhancements to the existing information sharing provision between the Company and the Trustees. In constructing this package, and negotiating its terms with BA, we have carefully considered all elements of the funding arrangements including the technical provisions and the investment strategy. We consider that, in current circumstances, the outcome is the best that could be achieved and establishes a platform to further strengthen the security of APS as part of the 2015 funding valuation exercise.

In closing I would like to extend my thanks to all Trustees but particularly those involved in the negotiating group and the development of the discretionary increase framework. Once engagement with BA and the Regulator on the framework has concluded we will write to you again in the autumn.

Yours sincerely

Paul Spencer
For and on behalf of the APS Trustees

APS Q&As : Your questions answered.

How has the funding position evolved since the last formal valuation?

	31st March 2009 (£m)	31st March 2010 (£m)	31st March 2011 (£m)	31st March 2012 (£m)
Liabilities	(6,995)	(6,996)	(7,211)	(7,995)
Assets	5,925	6,442	6,672	7,315
Deficit	(1,030)	(554)	(539)	(680)
Funding Level	85.2%	92.1%	92.5%	91.50%

How has the funding position changed over the year to 31 March 2012?

The funding level is slightly lower than at 31 March 2011, corresponding to an increase in the deficit of £141 million. This is due to lower gilt yields increasing the value placed on the liabilities by more than the increase in the value of the assets, and the strengthening of the assumed discount rate by assuming a lower margin over gilt yields and making a higher allowance for future mortality improvements. This has been partly offset by the additional contributions paid by BA in accordance with the recovery plan.

The existing recovery plan was based on a deficit of £554 million, the deficit is now £680 million but there are no extra contributions. Why?

The APS deficit as at 31 March 2009 was £1,030 million. Having identified a deficit it was necessary to establish a recovery plan to bring the Scheme back into balance as quickly as possible. When setting a recovery plan it is possible for changes in investment conditions and asset values to be considered. In the period between March 2009 and March 2010 there were significant changes in investment conditions and market performance generally and the recovery plan was based on a reduced deficit amount of £552 million (subsequently amended to £554 million once final audited accounts became available).

Under the terms of the current recovery plan:

- the Company will pay additional contributions to the Scheme at a rate of £4,583,333 per month until 31 March 2023; and
- if the assumptions documented in the recovery plan are borne out in practice, the deficit will be removed by 31 March 2023. This includes an allowance for investment returns at 0.3% a year in excess of the discount rate (i.e. outperformance).

Is it prudent to rely on outperformance in the recovery plan?

The expected investment return (also referred to as the discount rate) used to calculate the value of the liabilities as at 31 March 2012 for the purposes of agreeing a recovery plan with BA was 0.4% a year above yields available on gilts (bonds issued by the Government). By assuming that assets will perform 0.3% a year above this level the Trustees therefore assumed total investment returns over the course of the recovery plan of 0.7% a year above gilts. This assumption is still prudent, as the current best estimate of the investment returns expected on the Scheme's assets is higher than this (approximately 1.3% a year above gilt yields). In other words the Trustees have assumed in the recovery plan that a small part of the deficit will be met by future investment returns, with the balance (the majority) being met by deficit contributions paid by BA. If, as expected, actual investment returns are better than the 0.7% a year above gilts that has been assumed in the recovery plan then the deficit would be expected to be paid off before 2023. The deficit would also be expected to be paid off earlier if the £250 million contingent payment is paid in January 2019.

PwC are engaged by the Trustees to carry out extensive and ongoing reviews of BA's financial position and future cash flows. The Trustees are advised by PwC that the contributions that BA has committed to pay to the Schemes are the maximum that BA can reasonably afford in current circumstances.

What impact did the change to pension increases have on the deficit?

The CPI based Pension Increase (Review) Order increases paid in April 2011 (3.1%), April 2012 (5.2%) and April 2013 (2.2%) reduced the deficit but this reduction was nearly fully offset by inflation itself being higher than the 2009 assumption so that the net effect on the deficit was a reduction of £13 million.

The more substantive impact is in relation to the 2012 pension increase assumption which assumes a linear transition to full RPI increases in April 2023.

The construction of RPI and CPI assumptions is described in more detail in the full valuation report but in essence the RPI assumption for this valuation is 3.35% p.a. compared to 3.06% p.a. as at 31 March 2009. The CPI assumption is based on the expected long term gap (0.75%) between RPI and CPI.

Additional funding information

What is the estimated solvency position?

As part of every formal valuation, the Actuary is also required to provide an estimate of whether there is enough money within the Scheme to buy out benefits built up to date, with an insurance company. This is known as the solvency level. This does not mean that consideration is being given to winding up the Scheme, it's just another piece of financial information that helps with understanding its financial position. The APS Solvency level as at 31 March 2012 was 82.6%. As at 31 March 2009 it was 78.2%.

How are my benefits protected?

The Government introduced the Pension Protection Fund (PPF) in April 2005. The PPF is intended to ensure that pension scheme members receive a minimum proportion of their accrued benefits should their employer's business fail. Upon the insolvency of a company the trustees can apply for admission to the PPF and, if it meets the criteria for entry, the PPF will absorb the assets of the scheme and provide benefits up to certain prescribed levels. The pension an individual would receive from the PPF might well be less than the full benefit earned in the Scheme, depending on their age and when the benefits were earned.

On a PPF basis, as at 31 March 2012, APS was 125% funded. This means that if the Scheme had ceased as at 31 March 2012 it is unlikely that it would have been accepted into the PPF. The Scheme would therefore either have been run on as a closed fund or the possibility of buying out the benefits with an insurance company would have been investigated. Whichever the actual route chosen, the level of benefits you would receive would have been above the minimum PPF level but only just over, on average, 82% of your full APS benefit entitlement.

Further information and guidance is available on the PFF website at www.pensionprotectionfund.org.uk. Or you can write to the PPF at Knollys House, 17 Addiscombe Lane, Croydon, Surrey, CRO 6SR.

Pensions Regulator – additional required reporting

The Pensions Regulator acts as a watchdog, ensuring employees and trustees are fulfilling their responsibilities and schemes are being run effectively. The Pensions Regulator has the powers to intervene in the running of a scheme if necessary and can also issue directions to trustees and companies operating pension schemes. We are required to report to you that the Pensions Regulator has not issued any such directions to the APS Trustees, and that the Scheme has not made any payments to the employer in the year to 31 March 2012.

Why will BA be allowed to pay money to fund dividends when the Scheme is still in deficit?

The Schemes continue to be reliant on a strong covenant which can support the Schemes. The advice that the Trustees have received is that the ability to pay dividends will contribute to the ongoing viability of the covenant.

You mention a discretionary increase framework. How will this work in practice?

The basic principle underlying the framework, which is based on actuarial analysis, is that discretionary increases are derived from the level of pension increase that could be supported from the current assets, the value of the recovery plan and the funding arrangements if the agreed assumptions are borne out in practice.

Once an additional payment is made in any given year it becomes part of your total pension benefit to which, as a minimum, future guaranteed (i.e. Pensions Increase (Review) Order) increases will be applied in future years.

However, in subsequent years we will need to balance the cost of any further additional increase against the many factors that could affect the ability of APS to pay pensions in full: the value of the assets relative to the value of the pensions we need to pay (the funding level); our confidence in the Company being able to support APS in the future; the risk that people will live longer and draw their pension for longer than is presently assumed; the risk that investment returns will be lower than expected and the risk that inflation will be higher than expected. On each occasion we will need to be satisfied that the cost of any award will not jeopardise our ability, over the life of the Scheme, to pay everyone's pension in full.

What is the investment profile of the Scheme?

More information on the Scheme's investment strategy can be found on page 23 of the APS valuation report but the investment profile as at 31 March 2012 (excluding the buy in policy executed in 2010) can be summarised as follows: