

Letter from the Chairman of the APS Trustees, sent to APS members & pensioners - March 2011

Dear APS member

Airways Pension Scheme (APS) - Pension Increase

We are writing to notify you of an important change made by the Government which will affect APS. 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 Price Index (CPI) and not, as was previously the case, the Retail Price Index (RPI).

The CPI figure which will form the basis for the April 2011 increases to pensions in payment and deferred pensions is 3.1%. Once the level of increase is confirmed, each pensioner will receive their usual annual update letter.

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.

APS increases

Under Rule 15 of the APS Rules pension increases are made in accordance with the Pensions Increase (Review) Orders. 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, CPI is estimated to be on average 0.5%-1% less than RPI, although in some years CPI has been higher than RPI.

Valuing the APS liabilities to take account of the annual increases based on projected CPI (rather than RPI) improves the funding position of APS. You may recall that in our November 2010 'In Focus' we advised that APS assets covered 92.1% 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 97%. British Airways (BA) has confirmed that they will continue to pay contributions for current employees and the deficit contributions payable in accordance with the schedule of contributions and recovery plan agreed as part of the 2009 valuation exercise.

Trustee response

The Trustees are aware that many employed members and pensioners are angry and 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, have obtained extensive advice and have devoted considerable resource and time to undertake a detailed review of the options available to them under the Scheme Rules.

The Trustees do have the power under Clause 18 of the APS Deed, on the basis of a two thirds majority, to amend the Scheme Rules. However the interaction between the CPI change, Rule 15 and the APS Clause 18 amendment power is legally complex and this is discussed further in the enclosed Q&As.

Introduction of a Discretionary Increase Rule

Following a detailed review and on the basis of advice they have received, the 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.

As a matter of course the Trustees monitor the funding position of the Scheme and the strength of the employer covenant. The decision as to whether to provide an additional increase in April 2011 will be formally made at the APS Main Board meeting at the end of March. 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 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. Taking these issues into account, the Trustees are not hopeful that they will be in a position to grant an additional discretionary increase this year.

Changing the Scheme to RPI based increases

The Trustees have also considered in detail with their advisers whether it would be appropriate to amend the Scheme to change the basis of the increases to RPI.

The same questions and issues that would arise in relation to an additional discretionary increase are relevant in the context of a decision to change the Scheme Rules to specify an RPI based increase.

This issue is made more complex because the legislation has yet to be finalised but also because of the operation of Clause 18 which concerns the Trustees' power of amendment. The main issue is that in some years CPI could be higher than RPI so that specifying RPI in the Rules could result, in those years where CPI exceeds RPI, in a lower annual increase than would have applied if the Rules had not been changed. The remedy would be to base increases on the 'higher of' either CPI or RPI but a 'best of' arrangement of this kind would increase the liabilities and reduce the overall funding position.

More importantly, whilst APS is not fully funded, 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.

Past Scheme communications

The APS Part VI Scheme Rules have always referred to the Orders issued under Section 59 of the Social Security Pensions Act 1975. Until 1979 the Orders made under this Act were the Annual Review Orders but since 1979 these Orders have been the Pensions Increase (Review) Orders. 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 whether these various documents might have informed member expectations that pension increases were specifically referenced to RPI.

Next Steps

As the issues are complex and because of their significance to the APS membership the Trustees will continue to use all legal channels to establish the options that are available to them. An application to Leading Counsel is scheduled for April and this will determine further action. Further information will be made available once this process, which is expected to take a number of months, is completed.

As part of the process of finalising the legislation the Government have 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.

In April employed members and those in receipt of a pension will also receive an invitation to attend a meeting that is being arranged in response to a formal request by a number of employed members and pensioners. The meeting will be held in May in the London region. Full details of the time (s), venue and attendance procedures will be included in the formal meeting notification.

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 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.

In response to this the 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.

In what circumstances might the Trustees award a discretionary increase?

Under the new discretionary increase rule, the Trustees will review the position at least annually. In most years, whether a discretionary increase should be awarded, 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.

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. 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."² 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.

¹ Extracted from DWP Impact Assessment (11 February 2011)

² Extracted from DWP Impact Assessment (11 February 2011)

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. 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.

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 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.

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

Under Rule 15 of the APS Rules pension increases are made in accordance with Orders issued under Section 59 of the Social Security Pensions Act 1975. Until 1979 the Orders made under this Act were the Annual Review Order but since 1979 these Orders have been the Pensions Increase (Review) Orders. This 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.

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 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.

Why don't the Trustees change the Scheme Rules so I can continue to receive RPI increases?

The Trustees have considered this and it is one of the issues that has been referred to Leading Counsel (a QC specialising in pensions law). The APS funding and recovery plan arrangements, which were agreed with the Company in June 2010, were based on the presumption that pensions would increase in line with RPI. Intuitively, therefore, it would seem entirely consistent with the funding arrangements to retain RPI and remove the impact of the Government's policy change for APS members.

When evaluating the appropriateness of making such a Rule change the Trustees will need to address 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. 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.

A further difficulty with reflecting the principle that APS benefits should not be affected by a change in Government policy by making a Rule change to specify RPI increases arises because in some years CPI exceeds RPI. Clause 18 of APS sets out the Trustees' amendment power and contains a specific member protection which prevents an amendment being made which would have the effect of diminishing or prejudicially affecting pension benefits. This Clause is sometimes referred to as the 'no worsening' provision.

Without a Rule change, the Orders and thereby APS pension increases will be based on CPI. If the Trustees were to amend the Rules to specify RPI then in a year where CPI is higher than RPI it could be argued that the Trustees amendment had delivered a lower increase than a pensioner would have received if the Trustees had not amended the Rules. The legal advice which the Trustees have received to date states that this would fall foul of the Clause 18 protection. To avoid breaching this protection, there would have to be included in any Rule change a provision such that members effectively receive the 'best of' CPI or RPI. However an amendment which gave the 'best of' CPI or RPI would be a benefit improvement and would increase the Scheme liabilities. The appropriateness of granting such a benefit improvement when the Scheme is not fully funded is a contentious issue.

Overall the Trustees must consider all of the issues in the context of their duty to secure the benefits under the Scheme rules that have been built up by Scheme members and ensure that the decisions they take are consistent with this duty.

The Trustees have participated in the Government's consultation exercise and expressed the view that schemes which offer, or are amended so as to offer, RPI increases should not be required to provide the 'best of' CPI or RPI. However, to date the legal advice received by the Trustees is clear that it would be inappropriate in current circumstances to amend the Scheme rules to an RPI basis should a CPI underpin be required.

How can a Clause designed to protect my benefits prevent me from receiving the same level of increases?

The Trustees are also concerned about this as the effect of the Clause 18 'protection' appears to be counter intuitive especially given that, in the longer term, average RPI is expected to exceed CPI.

The Trustees have decided that the complexity of these issues warrants further legal analysis and they have already begun the process of seeking this additional advice.

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

The Scheme Rules have always referred to the Orders issued under Section 59 of the Social Security Pensions Act 1975. Until 1979 the Orders made under this Act were the Annual Review Orders but since 1979 these Orders have been the Pensions Increase (Review) Orders. 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 March 2011 as an attachment to letter sent to APS membership.