Government Actuary's Department

Heathrow Airlines Limited H7 price control review

Review of deficit repair costs for the Civil Aviation Authority

Scott Madden, FIA

16 November 2023

GAD have not seen compelling evidence to support HAL's request for £20m a year costs and their claim that such costs are appropriate and necessary throughout H7

Executive summary

The CAA has asked GAD to perform a review of the deficit repair costs of HAL. This report sets out the results of our analysis. This report should support CAA in understanding the factors affecting HAL's pension costs.

In June 2022, the CAA published its final proposals for HAL's price controls for H7, requesting compelling evidence that HAL's pension costs requests of £99m is appropriate and necessary. Otherwise, CAA will remove the allowance. In March 2023, the CAA published its Final Decision, stating its intention that a review of pension deficit repair costs would follow in the second half of 2023. This paper is addressed to the CAA to support their policy decisions as a part of this 2023 review.

In August 2022, HAL published their response stating that while the scheme is in surplus at the 2021 actuarial valuation, the Heathrow section of the scheme is experiencing a deficit. They have also provided indicative funding updates as at 30 September 2022 and 30 April 2023, estimating deficits, supporting their requested pension costs. GAD's view is that reasonably and efficient costs would be those required under DB funding regulation; where the BAA Pension Scheme is in surplus, no contributions are required.

This report covers the defined benefit (DB) costs arising from the BAA pension scheme as a result of a requirement to remedy a past service deficit, and includes analysis of the factors which determine the financial position of the scheme at actuarial valuations.

The results of this review should assist the CAA in determining whether to adjust the H7 pension costs allowance requested by HAL.

GAD's review has considered the appropriateness and necessity of deficit repair costs incurred as a part of a robustly negotiated formal valuation settlement.

H7 covers the outcomes of three actuarial valuations, those at 30 September 2018, 2021 and 2024. Our recommendations are based on a view of the appropriate and necessary costs for HAL from actuarial valuations at these dates.

Possible H7 OpEx allowances based on GAD's recommendation

- **January 2022 – September 2022: £15m**
  GAD concluded that the 2018 valuation and the outcomes were not unreasonable, and that allowance for the recovery plan was appropriate.
- **October 2022 – December 2025: nil (flexibility if needed)**
  GAD considered that allowance for deficit repair costs would not be an efficient outcome for HAL's customers from an actuarial valuation placing the Scheme in surplus.
- **January 2026 – December 2026: flexibility**
  GAD recognise the uncertainty of the position as at 30 September 2022, and would encourage CAA to use regulatory mechanisms to facilitate an ad-hoc request for costs that are unavoidable, appropriate and necessary

In this report GAD have used a Red/Amber/Green colour coding to help highlight key areas for CAA's attention

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GAD's review has focused on costs over the H7 price control period from 1 January 2022 to 31 December 2026

Introduction

This report has been prepared by the Government Actuary's Department ('GAD') at the request of the Civil Aviation Authority ('CAA').

The CAA is the economic regulator of Heathrow Airport Limited ('HAL'). Every five years the CAA sets price controls which limit the maximum revenue HAL is permitted to earn from its regulated businesses. The CAA is currently reviewing the price controls for period H7, 1 January 2022 to 31 December 2026.

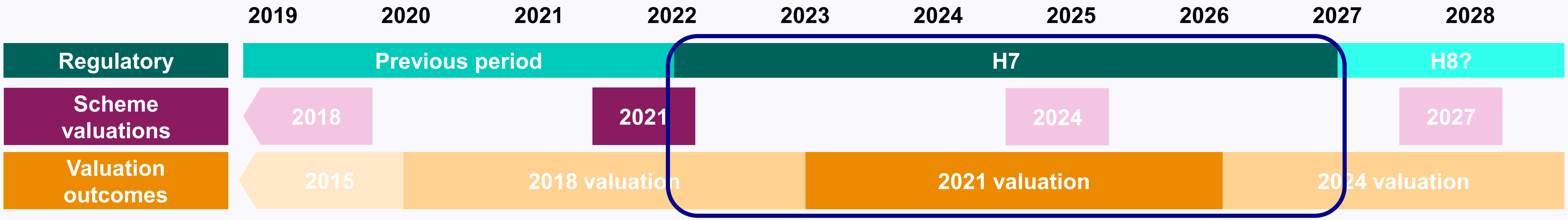
As part of this review, the CAA considers pension costs projected to be incurred. HAL's pension costs are with respect to a defined benefit pension scheme for employees joining before 2008, the BAA Pension Scheme (the 'Scheme').

The CAA has asked GAD to perform a review of the deficit repair costs of HAL. This report sets out the results of our analysis. This report should support CAA in understanding the factors affecting HAL's pension costs.

Pension costs have historically been requested in line with the agreed contribution plan between the HAL and the Trustee of the Scheme at actuarial valuations.

Actuarial funding valuations are a robustly negotiated settlement between employer and Trustee (acting on behalf of the members); these valuations are required to take place at intervals no longer than three years. The roles, varying objectives and responsibilities of the parties involved (Trustee, sponsor, Pensions Regulator) are summarised in Appendix C.

The BAA pension scheme's actuarial valuations overlap with the H7 control period and will cover HAL's requested pension cost allowance from 2022 to 2026. The timeline below illustrates the overlap of the 2018, 2021 and 2024 valuations with H7. The timings of H7 will cover the tail end of the 2018 valuation outcomes; the outcomes from the 2021 valuation, and some (about a year) of the outcomes from the 2024 valuation.



Introduction

The Final Proposals for H7's price control review included an allowance for costs to repair a deficit within the BAA Pension Scheme of £99m or equivalently £20m a year over the H7 price control period. The CAA's allowance for these costs was contingent on compelling evidence being provided that these costs were appropriate and necessary.

The price control period covers the valuation outcomes from three actuarial valuations, those as at 30 September 2018, 2021 and no later than 30 September 2024.

GAD's report covers the evidence provided by HAL to support the request for £99m of pension deficit repair costs as a part of H7, considering the outcomes of the 2018 and 2021 valuations and possible outcomes from the 2024 actuarial valuation, with due consideration of interim indicative funding updates.

GAD are supportive of the principal that the allowance of pension costs are set consistently with the outcomes of actuarial valuation outcomes provided the outcomes are a reasonable compromise between affordability and member security resulting from a robust discussion between the parties. Actuarial valuations are an opportunity for stakeholders to reach a settlement based on such robust negotiations, and one which takes into account factors including the long-term strategy of the scheme, the strength of the sponsor's commitment to continue to meet their commitment, the external environment (including market conditions and the regulatory framework).

Heathrow Airport Limited: H7 Final Proposals Section 2
CAA Final Proposals
June 2022
Paragraph 4.72
In total, the allowance in these Final proposals for PDRCs is £99m. If HAL provides **compelling evidence** that this allowance is **appropriate and necessary** in response to these Final Proposals then we will retain the allowance in our Final Decision. Otherwise, we will remove the allowance and make a compensating downward adjustment to the level of airport charges to reflect this change.

Heathrow Airport Limited: H7 Final Proposals
Heathrow's response
9 August 2022
Paragraph: 5.11.4
As part of the process of finalising the Triennial Valuation, we have received an initial assessment of the pension scheme value as at March 2022. This valuation shows that on a technical provision basis, the **Heathrow section of the scheme had a deficit of £260m at 30 September 2021** which was recently re-estimated at £340m as of 30 June 2022. This means that deficit repair payments for the Heathrow section of the scheme are **appropriate** and need to be increased throughout H7.

Introduction – appropriate and necessary

It is CAA's view that appropriate deficit repair costs would be:

- the result of a robustly negotiated valuation agreement between the Trustee and sponsor
- and that the result of this negotiation represented an efficient assessment of the liabilities, with due regard to the covenant, investment strategy and appropriate prudence margins
- efficiently and fairly consider the burden of costs between different generations of customers

CAA believe that necessary deficit repair costs would be:

- required to be made as a result of prevailing pensions regulation

CAA's view is that the following would not be appropriate deficit repair costs:

- costs as a part of a plan to remedy a shortfall in the funding of ex-employees' benefits of the legacy airports

The objectives of GAD's review are summarised in Appendix D, with details of the information that has been relied upon to produce this report summarised in Appendix E.

Features of the BAA Pension Scheme

The BAA Pension Scheme is a contributory, final salary, defined benefit pension scheme, established in 1966. The Scheme was established under trust and is administered by the Trustee, BAA Pension Trust Company Limited, in accordance with the provisions of the Trust Deed and Rules. The Scheme is sponsored by LHR Airports Limited.

The Scheme closed to new members on 15 June 2008, a DC Scheme was opened for new employees after this date. The Scheme remains open to accrual of benefits for members joining the Scheme prior to 2008. As at 30 September 2021 such members numbered 1,582 [redacted]

Historically the BAA Pension Scheme covered employees at other BAA-owned airports. As these airports were sold, the pension rights of former members (pensioners and deferred pensioners) were transferred to the new owner's scheme, and the Trustee paid a transfer from the Scheme's assets to transfer this liability. A separate lump sum was paid by the exiting business to sever its obligations to the Scheme in respect of deferred and pensioner members.

Employees of the legacy airports were offered the option to transfer their accrued service benefits to their new Scheme or to become deferred pensioner members of the BAA Pension Scheme. Further detail on the apportionment of past service liabilities is covered in Appendix A on sectionalisation.

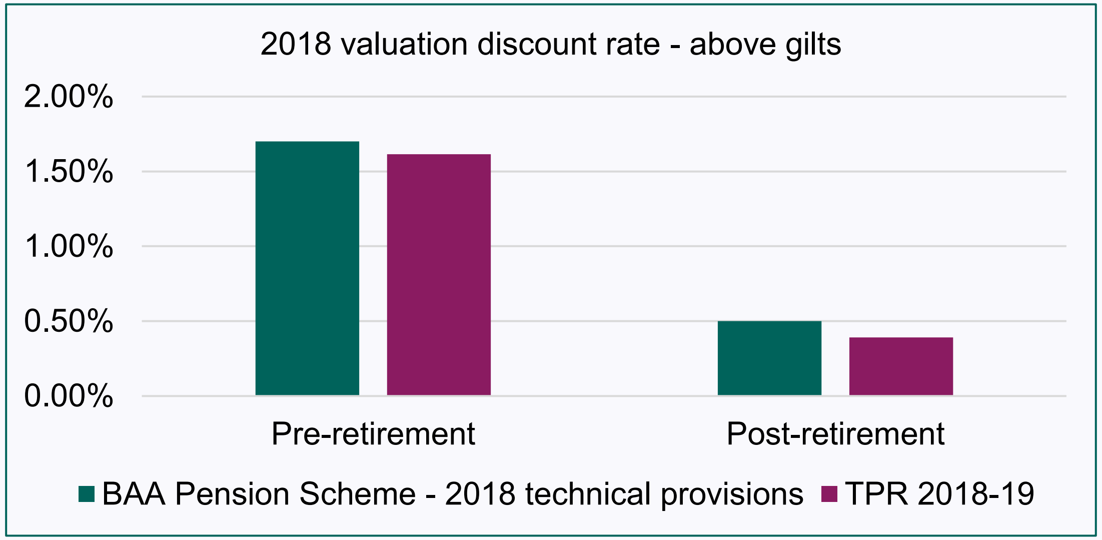
2018 actuarial valuation - assumptions

Assessing the financial position of a scheme (whether it's in surplus or deficit) is driven by a range of factors, principally the benefits being offered and the assumptions that made about the future. GAD's review has focused on the assumptions about the future, both financial and demographic.

HAL and the Trustee of the BAA Pension Scheme agreed the results of the actuarial valuation as at 30 September 2018, which identified a £123m deficit assessed on the technical provisions basis.

The discount rate is the rate at which a scheme's expected future benefit outgo is discounted back to provide a current capitalised value. It can be thought of as corresponding to an assumed rate of return on the scheme's assets. The assumed discount rate is usually the most important valuation assumption in determining contribution requirements because valuation outcomes are very sensitive to changes in the discount rate.

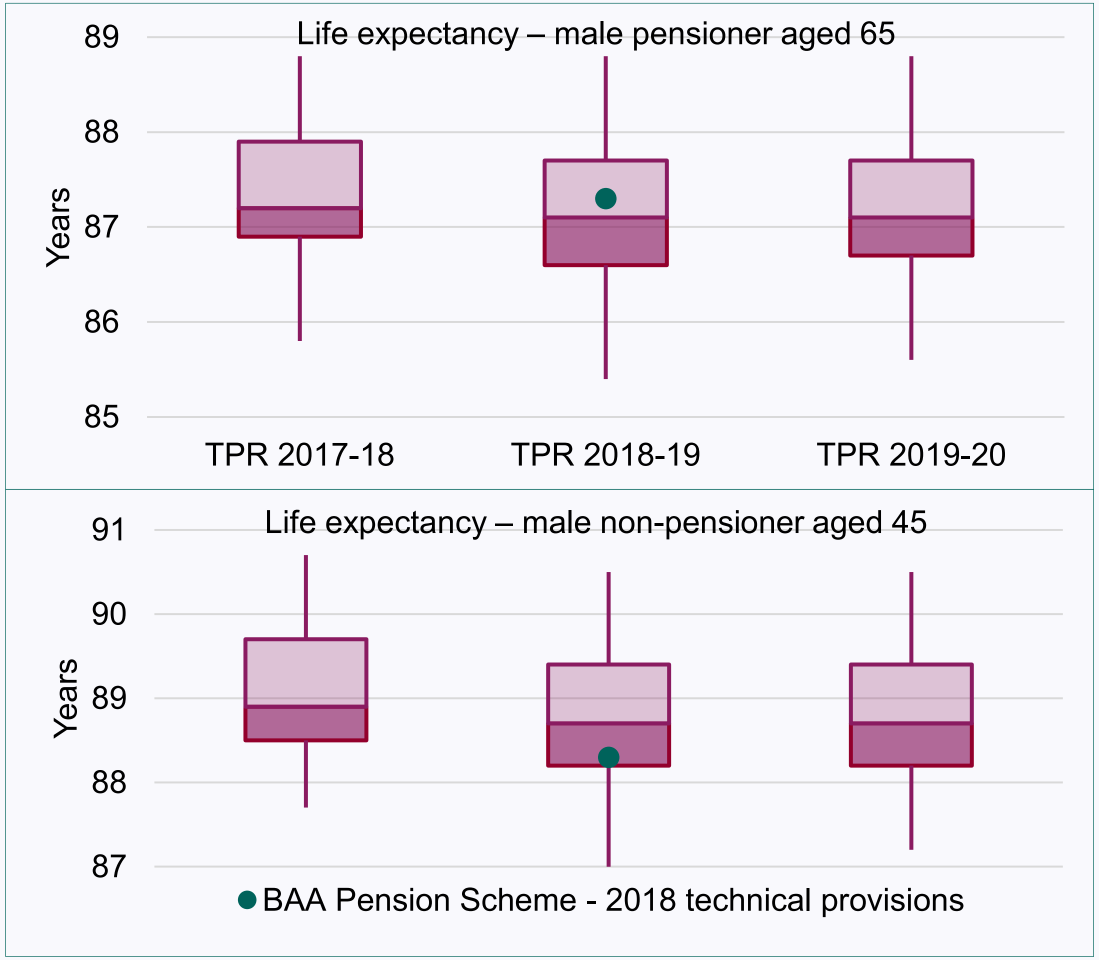
The discount rate adopted by the Trustee for the 2018 valuation assumes different rates for members pre-retirement and post-retirement. This is a traditional way of allowing for de-risking, with pre-retirement members supported by a greater risk tolerance. Relative to a risk-free government bond yield return, the discount rate was set at 1.7% pre-retirement and 0.5% post retirement.



We have benchmarked these assumptions against the average rates used by UK DB pension schemes with valuations in the same year using the same dual discount rate approach, and published by the Pensions Regulator; HAL's assumptions are slightly higher both pre- and post-retirement, which may reflect relative maturity or allocation to growth assets. All else being equal this would result in a slightly lower assessment of the Scheme's liabilities.

The discount rate assumptions is indicative of a more **efficient** basis from the perspective of the sponsor, and appears broadly **reasonable**.

2018 actuarial valuation - assumptions



The longer a pensioner lives after retirement, the greater the cost of providing a pension. Funding valuations require an assumption regarding the assumed longevity of members and their dependants.

The charts on the left show the expected age at death for a 65-year-old male pensioner and for an active member aged currently 45. The box and whisker charts show the distribution of life expectancies seen by the Pensions Regulator in the same year and the years either side.

The assumptions about life expectancies of the current pensioners at the 2018 valuation are typically more for longer life expectancy relative to the median assumed by comparable schemes in the same year; however members in the longer term are assumed to have shorter life expectancies relative to the median. In practice, assumptions about life expectancy are typically tweaked to reflect the experience of a scheme's membership; BAA fit standard industry tables to their own membership, and we expect that this produces robust estimates of their pensioner population.

The demographic assumptions are **within a reasonable range** based on the life expectancies provided at the 2018 valuation.

In summary, we believe the assumptions used to assess the BAA Pension Scheme liability at 2018 was **not unreasonable**.

GAD believe that the deficit repair costs agreed as a part of the 2018 valuation were relatively efficient, and would be reasonable to pass on to the customer under the Price Control; contributions were calculated based on the deficit of the scheme as a whole

2018 actuarial valuation – repair costs

At the 2018 valuation, the pension scheme reported a deficit of £123m. In the event of a deficit, there is a requirement for the Trustee and Sponsor to agree a plan to remedy this deficit: a recovery plan.

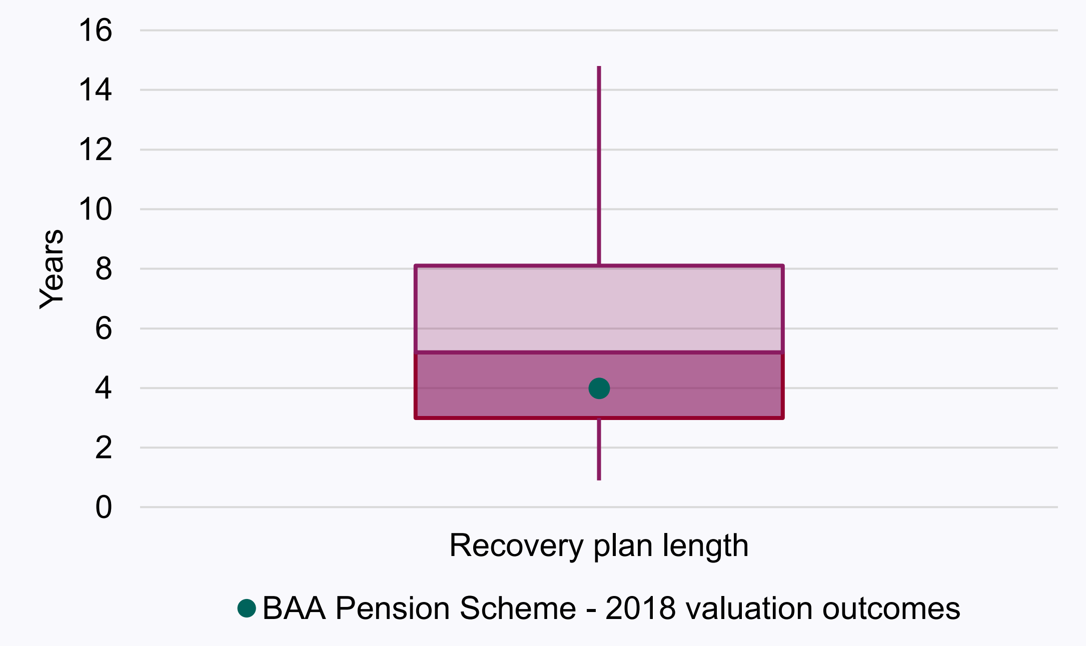
The Trustee and the sponsor agreed a plan of £20m a year up until 30 September 2022, in addition to £23m in the year immediately following on from the effective date of the valuation (a leftover from the 2015 deficit) would be sufficient. In addition, the Trustee and HAL agreed a level of prudence to be removed from the assumptions in calculating the recovery plan, agreeing to allow for an additional 0.4% a year of return on the assets.

This approach of allowance of outperformance is not uncommon, and is explicitly allowed in the Pension Regulator's guidance. GAD's view is that this reflects evidence of sponsor engagement with Trustees to reduce future costs, and ensure more predictable costs can be passed on to airspace users.

Benchmarking of these deficit repair contributions against information published by the Pensions Regulator for comparable schemes implies costs managed at a lower level. As a proportion of the liabilities, the annual costs (0.5% of total technical provisions) were much lower than the average (mean) for schemes with similar features (typically varies between 1.2% to 2.8% of total technical provisions).

The box and whisker plot on the left shows that the recovery plan length was also slightly below average; in principle, we would expect to see longer recovery plans, with an objective for future experience to negate the requirement for these to be paid in practice, and to also ensure fairness between different generations of customers.

On balance, given the lower than average contributions, we do not consider the agreed recovery plan to be unreasonable.

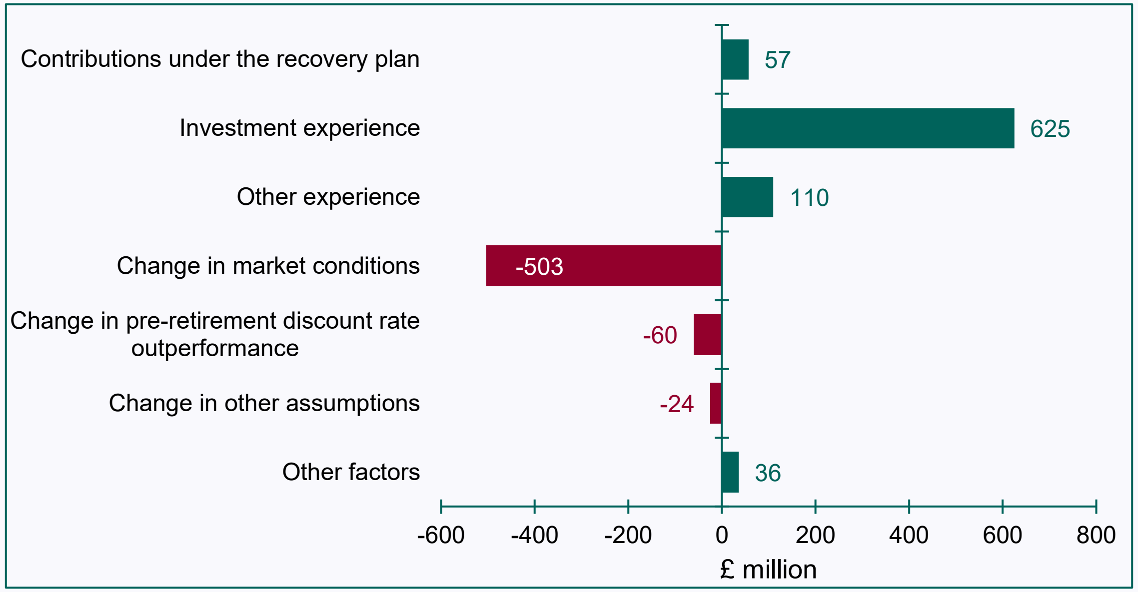


2021 actuarial valuation - results

We have been provided with the final results of the 2021 actuarial valuation, and we have based our analysis and recommendations on these results. The final results disclose surplus of £119m at 30 September 2021 on a technical provisions basis. This is an improvement of £242m from the 2018 valuation position. The chart on the right sets out the key drivers of this increase.

Most notably, the higher than expected returns on assets improved the position by £625m in isolation, while the changes in market conditions have had a significant negative impact, in isolation worsening the position by £500m. We expect that the opposite movements are in part driven by the leveraged Liability Driven Investment strategy deployed, which immunises the Scheme (partially) from movements in market pricing of government bond yields and inflation expectations. Leveraged LDI is common practice and is deployed as a part of a risk management approach to reduce the volatility and uncertainty of costs.

Sources of improvement in the position have principally come from favourable experience (investment returns net of changes in market conditions plus the other factors which would include pension increase ultimately being lower than assumed). In the long-term experience may be expected to prove favourable, given the prudent mandate for setting technical provisions assumptions. The contributions paid under the agreed recovery plan have also improved the funding position.



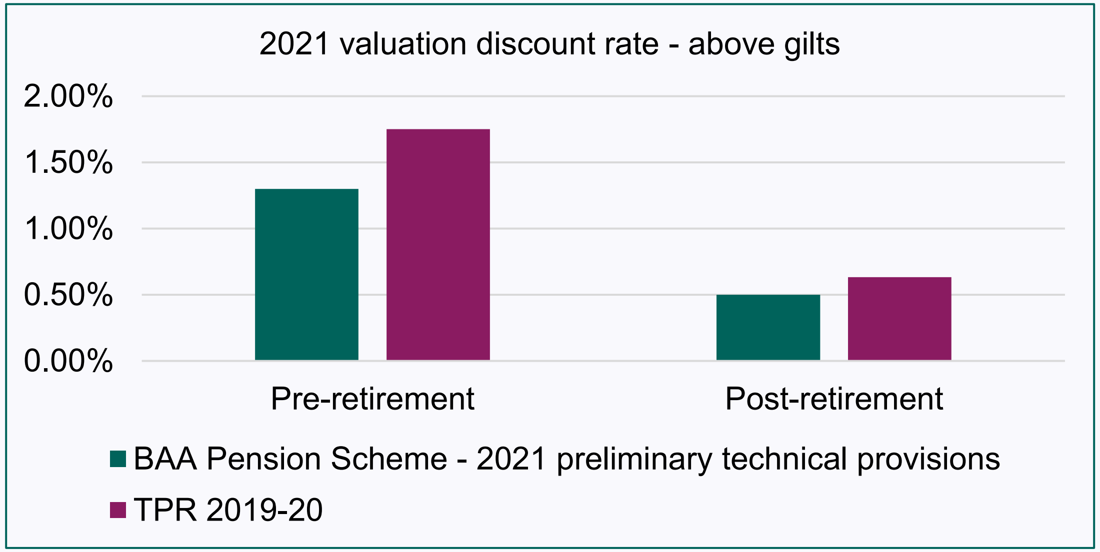
The Trustee's technical provisions basis has proposed a strengthening of the actuarial basis. The Trustee's independent assessment of the covenant, produced by PwC, suggested a slight weakening of the sponsor's ability to make contributions when necessary, within the same band of "tending to strong"*. As a result, the Trustee proposed a strengthening of their assumption for returns pre-retirement, in isolation resulting in a worsening of position by £60m.

The combination of other changes to actuarial assumptions have (in isolation) resulted in a worsening of the fund's position by £24m.

* Covenant bands are typically assessed in four bands: strong, tending to strong, tending to weak and weak. Notionally a fifth band exists: insolvent.

CAA may wish to consider whether appropriate steps were taken by HAL to provide reassurance of the ongoing ability and willingness to meet the Scheme's benefit obligation – GAD have not seen evidence of this.

2021 actuarial valuation – assumptions



Discount rate assumptions both pre- and post-retirement are slightly lower than the average from universe of comparable schemes submitted to TPR in the year before the effective date.

We note that the Trustee remarked that the change to the pre-retirement discount rate approach was driven by a perceived weakening in the strength of the HAL's covenant.

The impact of the change in methodology pre-retirement is an worsening of the funding position by **£60m**.

Using a consistent approach to our analysis of the assumption used for the 2018 actuarial valuation, we have benchmarked the assumptions used against the average rates used by UK DB pension schemes, and published by the Pensions Regulator. Submissions from the appropriate year is not currently available, we have therefore used the reporting period from September 2019 to 2020, the most recent data is currently available.

This benchmarking illustrates that the discount rate used in the preliminary results was lower both pre- and post-retirement than average schemes, which would result in higher estimated liabilities, all else being equal.

A part of this is change is the methodological change that has driven the reduction in the pre-retirement discount rate from 1.7% to 1.3% above gilts, and this is now significantly below the rate used by the average scheme within the TPR dataset.

Whilst, we have no reason to believe that this is an unreasonable conclusion for the Trustee to have reached, we would have expected HAL to negotiate robustly to reassure the Trustee as to their ongoing willingness and ability to meet the pensions costs. In particular there are avenues to explore such as contingent assets. We acknowledge that HAL recognised a pre-tax loss of £1.3bn and £1.5bn in the 2021 and 2020 calendar years respectively.

GAD have not seen evidence to suggest that further deficit repair costs would be appropriate and necessary as a part of the 2021 valuation outcomes.

2021 actuarial valuation – requested costs

Since the 2021 valuation, there are a few developments for the Scheme. These therefore are not included in the chart shown on page 10. Some important developments have been:

- A **bulk annuity purchase** of pension liabilities (~£370m), at terms more prudent than preliminary technical provisions creates a **£19m** reduction to the surplus. GAD do not consider it unreasonable for the securing of annuities, especially when achieved at competitive cost and considering the balance of risk reduction and the reduction in volatility of future contributions.

- **Rule-amendment** to not penalise furloughed employees in their final-salary definition. The impact of this on the surplus is likely **negligible**.

- **Market volatility**, which will have had a **significant impact** in measuring the liabilities and to the Scheme's invested assets. There have been various "shocks" since the actuarial valuation: principally much higher inflation in the short term due to the conflict in Ukraine and wider global economic pressures, rising interest rates (after 10+ years of historically low rates) driven, in part, by central bank monetary policy actions to manage inflationary pressures.

In general we would not expect post-valuation experience to be allowed for when finalising an actuarial valuation, and in our experience this would be unusual. Furthermore, we would expect consistency in the way that allowance is made for post-valuation experience.

Given the BAA Pension Scheme has been assessed as in surplus at the 2021 valuation, there would be no regulatory requirement the Trustee and HAL to agree a recovery plan, and therefore for HAL to pay deficit repair costs.

In the absence of a regulatory requirement for HAL to agree to pay deficit repair costs, we would view any proposal to do so as an inefficient cost incurred, and therefore we would advise that this would be an inappropriate cost to pass on to the customer.

It is GAD's view that efficiently incurred costs would be consistent with those required by regulation, and the result of a robust negotiation at an actuarial valuation between the Trustee and HAL.

The Trustee have commented that should their monitoring of the technical provisions funding level fall below 95% a consecutive quarter ends they will engage with HAL to agree a plan of contributions, or call an early valuation.

The CAA may wish to ensure that HAL have sufficient flexibility to negotiate a plan should the Trustee's threshold be met. It should be noted that an ad-hoc recovery plan may not always be in the best interests of the consumer, and that a new actuarial valuation may result in lower deficit repair contributions.

2024 actuarial valuation

The Trustee would be required to undertake an actuarial valuation at an effective date no later than the 30 September 2024. The outcomes of the 2024 valuation would be expected to fall within the H7 price control period. It is likely that any agreed outcomes will impact HAL's pension costs for at least the last year of the price control period (2026 calendar year), although early agreement could result in the outcomes being agreed sooner, and therefore taking up a large proportion of the price control period.

The outcomes of the 2024 valuation are impossible to predict at this stage, and would be based on the position of the Scheme at this point in time and would be the end-product from a robust negotiation.

An estimate of the Scheme's funding position as at 30 September 2022 identified a deficit of [redacted], a worsening of the position since the effective date of the 2021 valuation the year prior. It should be recognised that 30 September 2022 was a particularly stressed time for markets, which will have impacted the valuation of the Scheme's assets as well as an assessment of the liabilities at that date. However, a worsened funding position has been sustained since, with a funding estimate at 30 April 2023 suggesting a deficit of [redacted], equivalent to a funding position of 93%.

Were a deficit of [redacted] to persist to the 2024 valuation, this would need to be remedied through a recovery plan, with HAL incurring deficit repair costs.

By this time, the Pensions Regulator is likely to have published it's new DB funding code (summarised in Appendix F). It is expected that the new funding code will make specific allowance of current challenges and could potentially impose more stringent requirements on deficit repair contributions.

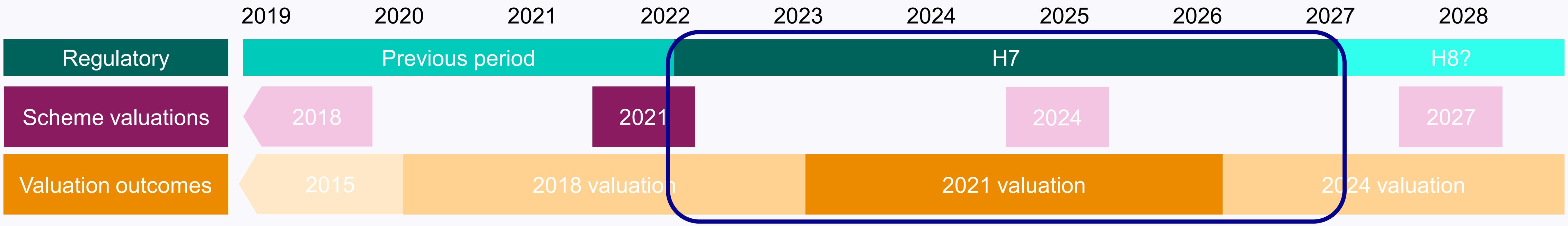
We would therefore expect that any recovery plan agreed would take into account the new funding code, and the principals and priorities outlined earlier. The CAA may wish to consider whether, ahead of the 2024 actuarial valuation, HAL could benefit from further guidance on expected behaviours.

We recommend that CAA consider whether flexibility could be incorporated within the Final Decision to allow HAL to recognise efficiently incurred costs that may emerge as a part of the uncertain 2024 valuation outcomes, or as a part of any pension deficit repair costs agreed to under an interim agreement with the Trustee.

To help illustrate possible valuation outcomes we have set out the possible implications for pension deficit repair costs at future valuations under plausible (adverse) scenarios and sensitivities from the 2021 results. These are illustrated in Appendix B.

GAD have not seen compelling evidence that £20m pa costs are appropriate and necessary throughout H7

GAD’s recommendations



Summary remarks

GAD do not believe that the £20m pa costs allowed for within the Final Proposals remain appropriate and necessary, and that HAL have not provided compelling evidence to support such an allowance with the operating expenses remains appropriate.

HAL have stated their view that the notional Heathrow ‘regulatory fraction’ would remain in deficit following the conclusion of the current recovery plan. Without formal sectionalisation there is no requirement for any deficit repair costs to be paid to remedy this notional deficit. It is GAD’s view that it would be inefficient to incur costs that were not the output of robustly negotiated funding agreement – further details on Sectionalisation are included in Appendix A.

GAD have based their conclusions on the CAA’s expectations of appropriate and necessary costs outlined on page 6.

GAD’s recommendations for operating expense allowances are included on the right hand side, alongside other areas that we have highlighted for CAA’s attention within this report.

Possible H7 OpEx allowances based on GAD’s recommendation

- **January 2022 – September 2022: £15m**
  GAD concluded that the 2018 valuation and the outcomes were not unreasonable, and that allowance for the recovery plan was appropriate.
- **October 2022 – December 2025: nil (flexibility if needed)**
  GAD considered that allowance for deficit repair costs would not be an efficient outcome for HAL’s customers from an actuarial valuation placing the Scheme in surplus.
- **January 2026 – December 2026: flexibility**
  GAD recognise the uncertainty of the future position as at 30 September 2024, and would encourage CAA to use regulatory mechanisms to facilitate ad-hoc requests for costs that are unavoidable, appropriate and necessary

Limitations and compliance

This review considers HAL's pension arrangements only. It is recognised that pension arrangements are only part of overall remuneration packages.

Part of the analysis included within this report compares the BAA Pension Scheme with publicly available information on other UK private sector defined benefit pension schemes. Such comparisons do not consider factors which affect specific industries, sponsoring employers or pension schemes in isolation, and are provided as a guide only.

Defined benefit pension schemes' benefits, investment strategies and funding approaches should reflect each scheme's particular circumstances. It is beyond the scope of this report to consider all such factors. It is recognised that a "one-size fits all" approach is not appropriate. This review must not be interpreted as advising that a particular approach is necessarily inappropriate.

The purpose of this report is to assist the CAA in considering its price controls for the period 1 January 2022 to 31 December 2026. This report does not represent advice on the appropriate funding of the BAA Pension Scheme, or other pension schemes.

Distribution and publication of this report

This report is addressed to the CAA. We are aware that the CAA may make BAA Pension Scheme and their advisers. We are aware that the CAA intend to publish this report in its entirety, or to quote this report in part, subject to confidentiality requirements. GAD reserves the right to review and comment on any documents in which the CAA quotes or refers to this report in part.

Advice provided by GAD to the CAA is intended solely for the use of CAA. GAD does not accept any responsibility to third parties who may read this report or extracts from it.

Compliance

This work has been carried out in accordance with the applicable Technical Actuarial Standard: TAS 100 issued by the Financial Reporting Council (FRC). The FRC sets technical standards for actuarial work in the UK.

The Government Actuary's Department is proud to be accredited under the Institute and Faculty of Actuaries' Quality Assurance Scheme. Our website describes the standards we apply.

The information in this presentation is not intended to provide specific advice. Please see our full disclaimer for details.

There is no formal sectionalisation of Heathrow and Legacy Airport members within the BAA Pension Scheme

Appendix A – sectionalisation

Historically the BAA Pension Scheme covered employees at Heathrow and other BAA-owned airports. In recent years these airports have been sold, and current employees had their pension rights transferred to the new owners. Liabilities for past employees were retained in the BAA Pension Scheme.

As a part of the sale proceeds, a lump sum payment to the Scheme was negotiated for payment into the Scheme, with the intention that this would compensate for the loss of recourse to future profits from those legacy airports.

Such an arrangement is common amongst multi-employer schemes. Employers exiting a scheme is an area of substantial risk, as the true cost of a providing benefits will not be known. Therefore exiting employers are normally required to pay a special contribution, this is covered by the Section 75 Debt legislation.

As a part of the H7 discussions, CAA have stated that the appropriate portion of the Scheme for regulation discussions is that covering current and former employees of Heathrow, excluding the legacy airports, a so-called 'regulatory fraction'.

This report considers the evidence submitted by HAL to support the allowance for deficit repair costs within OpEx during H7. As a part of this evidence GAD have considered HAL's proposal that a notional sectionalisation of the Scheme's assets and liabilities are considered for this purpose.

GAD believe that efficiently incurred costs would be no greater than those required under the prevailing pensions regulation, and therefore (based on the preliminary results) no costs should be considered as a part of the 2021 valuation outcomes.

The BAA Pension Scheme is not explicitly sectionalised. Therefore the valuation of the scheme, where appropriate deficit repair costs would be assessed, treats the assets and liabilities as a whole. For instance, at the 2018 valuation a deficit of £123m was identified across the whole scheme; this was remedied through a recovery plan to make good this shortfall rather than a potentially greater shortfall for the regulated fraction.

The 2021 valuation results present the total liabilities of the BAA Pension Scheme. [redacted]

There is **no explicit sectionalisation** arrangement within the BAA Pension Scheme.

GAD agree that this is a reasonable approach to providing a notional split of the liabilities, however, we would suggest that a more recent split would be more appropriate for any calculations underlying material decisions.

GAD do not believe that the approach taken towards notionally separating the Scheme's assets is appropriate for the H7 price control and OpEx allowance.

Appendix A – sectionalisation

Isio's paper dated November 2022 proposes an approach for notionally separating the assets of the BAA Pension Scheme between the Heathrow regulatory fraction and the ex-employees of the legacy airports. [redacted]

- [redacted]
- [redacted]

GAD have not seen any documentation or agreement between Heathrow and the Trustee as to the purpose of the special contributions. Legally, and in practice, the Scheme's assets are invested as a whole and are therefore comingled. In the absence of such agreement, GAD would question the appropriateness of this approach.

Isio's approach effectively ring-fences the special contributions paid into the Scheme at the dates of the various legacy airport sales. GAD's view is that such an approach would be not entirely inappropriate, and would in effect result in the regulated fraction cross-subsidising de-risking initiatives for the legacy airport members, for instance:

Without an explicit purpose for the special contributions, for instance as a part of integrated de-risking plans, GAD do not believe that the approach for notionally sectionalising the Scheme's assets are appropriate.

- The regulatory intention for Section 75 Debt payments when employers exit a multi-employer scheme is to provide additional security that the Scheme's benefit obligations would continue to be met given the departure of one of the employer's jointly backing up the Scheme. GAD's expectation is that any special contribution reserve would be drawn down to fund wider initiatives to provide additional security to the legacy airports ex-employee benefits. Such initiatives are:
  - The implicit de-risking within the current technical provisions approach, with post-retirement pension discounted at a lower discount rate (2021 preliminary results (pre-retirement: Gilts + 1.3% pa reducing to Gilts + 0.5% pa post-retirement) – see page 7 and 11 for more detail.
  - The £325m and £370m pensioner buy-in arrangement with insurer L&G in 2018 and 2022 respectively, where a premium is paid to take on an exactly-matching annuity arrangement for ultimate member security.
- As a last-man standing scheme, Isio's approach would see a refund to Heathrow equal to the total special contributions plus investment returns on the death of the last member. This would not appear to be consistent with the desired outcome of efficient management of pension costs and fairness between different generations of customers.

HAL may benefit from additional guidance setting out CAA's expectations for an approach taken to notionally sectionalise the Scheme's assets.

Appendix B - scenario analysis (sensitivities)

To help support CAA's considerations, we have illustrated the implications of plausible (adverse) scenarios, based on sensitivities from the 2021 valuation results, to help illustrate a changed position at 2024, and how that might feed into any agreed recovery plan. Please note, these sensitivities are for indicative purposes only, and should not be relied upon for any decisions. Analysis produced the Scheme Actuary may differ, with different approaches adopted and assumptions made.

The table on the right sets out the results of our various sensitivities to provide a flavour of how the Scheme's funding picture may change by 2024.

Discount rate – 0.5% pa: the approach to calculating the Scheme's discount rate is 0.5% a year more prudent, placing a high value on the Scheme's liabilities.

Inflation + 0.5% pa: the assumption of future inflation, and therefore the inflationary pension increases provided to Scheme members is 0.5% a year higher

Members typically live one year longer: the assumption about the life expectancy of members receiving benefits is one year longer

In all three sensitivities, we would expect the scheme's funding position to worsen (ie the scheme would be in deficit), creating a requirement for deficit repair contributions to become payable.

The 2018 recovery plan was agreed with an allowance for an additional 0.4% a year of outperformance on the Scheme's assets. Both recovery plan scenarios use a consistent approach with the recovery plan agreed following the 2018 valuation.

Sensitivity	Approximate surplus / deficit	Recovery Plan length with £20m p.a. contributions	Contributions pa: 4-year Recovery Plan
Discount rate – 0.5% pa	(£300m) ↓	8 years	£60m
Inflation + 0.5% pa*	(£180m) ↓	5 years	£30m
Members typically live one year longer	(£50m) ↓	1 ¼ years	Nil*

*0.4% pa outperformance sufficient to meet £50m deficit over a 4-year period

Appendix C – roles and responsibilities

Stakeholder	Roles	Objectives	Responsibilities
Trustees	✓ Act in line with the Trust Deed and Rules governing the Scheme ✓ Comply with duties and requirements under legislation and regulation	✓ Operate the scheme in line with legislation ✓ Ensure employer contributions are appropriate ✓ Maintain the security of benefits to ensure members needs continue to be met i.e. by ensuring sufficient assets are available to meet payments as they fall due	✓ **Perform three-yearly funding valuations** ✓ **Set assumptions for funding valuations prudently** ✓ Comply with all other duties and requirements under legislation and regulation
Sponsor / Employer	✓ Comply with duties and requirements under legislation and regulation	Objectives may vary depending on a range of factors, these objectives may include: ✓ prioritising a low and affordable costs ✓ funding the scheme efficiently ✓ reducing strain on company resources ✓ minimising disruption to operations	✓ **Agree contribution plans with Trustee when appropriate** ✓ Comply with all other duties and requirements under legislation and regulation
The Pensions Regulator	✓ Provide education and guidance ✓ Gather information ✓ Take enforcement action and act against avoidance	✓ Set clear expectations of practice ✓ Identify risks ✓ Drive compliance through supervision and enforcement ✓ Work effectively with stakeholders	✓ Supervise the management of the pension scheme ✓ Take enforcement action where appropriate ✓ Enforce regulations and investigate any breaches

Appendix D – objectives of the review

A high level summary of the requirements for this review, based on the specification contained within the invitation to provide a proposal, is set out below.

To consider and advise the CAA on

1. HAL's approach to estimating their current, and expected future, deficit of DB pension scheme and the level and timing of pension deficit repair contributions, and whether this is consistent with good practice from a reasonable and efficient employer.

    - Where GAD believe any elements are not consistent with good practice, GAD should suggest potential alternatives to the approach.

    - GAD should consider the relationship between changes in assumptions at actuarial valuations and the equivalent change in funding position and it's impact on PDRCs.

2. HAL's approach to producing robust estimates of PDRCs under a range of various financial and demographic scenarios. Specifically, GAD should consider the impact of varying actuarial assumptions, for example, expected asset returns.

    - GAD should comment on any elements which could be more robust and suggest potential changes.

GAD's review is limited to the information provided by HAL in support of their request for a £99m allowance for deficit repair costs.

Appendix E – information used for this review

Information provided by HAL (or sourced publicly)

1. The Scheme Actuary's actuarial valuation reports as at 30 September 2018 and 30 September 2021
2. The Scheme Actuary's life expectancy paper as at 30 September 2018
3. The Scheme Actuary's preliminary results (extract for company) as at 30 September 2021
4. The Trustee's annual report & accounts 2015-2021
5. Heathrow Airport Limited annual report & accounts 2020 and 2021
6. Isio's paper estimating the split of funding position between Heathrow and legacy airports
7. Heathrow Airport Limited response to CAA query, email dated 30 May 2023

Publicly available reference information

1. "The Purple Book", Pension Protection Fund, 2021
2. "Scheme funding analysis, annex", The Pensions Regulator, 2022.

Appendix F – DB funding code of practice

Funding and Investment strategy

- Setting out long-term objective, funding and investments at significant maturity

Significant maturity

- Low dependency on the sponsor (low risk asset allocation)
- Assessed at duration of around 12 years

"Statement of strategy"

- To be submitted to the TPR alongside triennial valuations

Sponsor agreement

- Sponsor agreement as a part of the FI strategy and the Statement of strategy

Recovery plan

- Any deficit "must be recovered as soon as the employer can reasonably afford"

2018 **2019** **2020** **2021** **2022** **March 2023** **Winter 2023/24** **April 2024**

HMG white paper → 1st consultation → Pensions Act 2021 → 2nd consultation → Laid before parliament →