

Pensions

Introduction

1. The CAA, in its March 2007 proposals to us, highlighted four questions with respect to evaluating BAA's projected pension costs for the Q5 period. These were:
 - What is the appropriate measure of pension costs when calculating BAA's revenue requirement?
 - Should an adjustment be made for changes in the pension fund investment strategy arising from the acquisition by ADI?
 - Should an adjustment be made for the effects of BAA's pension holiday in Q3?
 - How should pension costs be treated at future reviews?
2. This appendix provides background information to these questions and offers a recommendation on the treatment of pension costs for Heathrow and Gatwick in Q5.
3. Annex 1 summarizes the latest detailed assessment of BAA's pension scheme, which shows that as at 30 December 2006, using the then existing valuation approach, the fund had a surplus of £218.4 million. However, using the funding target outlined in the accounting standard IAS¹ 19, there is a deficit of £98.6 million (a variance of £317 million). BAA has set its future target contribution rate for Q5 assuming the approach adopted under IAS 19.
4. The figures presented in the tables below do not reflect the impact of any possible future changes that might be made to the availability of the pension scheme to new employees of BAA.

Definition of pension costs

5. The choice of measure of pension costs will have a material impact on the total operating cost allowance, and hence on the price control. The three measurement options are (a) ongoing service costs (b) the charge to the profit and loss account, or (c) cash pension contributions. The latter two measures take into account investment gains on fund assets and interest costs on fund liabilities.
6. Table 1 outlines the differences in value of the three alternative measures over Q5 for the whole BAA group, and a reconciliation of the three values.

¹International Accounting Standard 19: *Employee Benefits*.

TABLE 1 BAA pension scheme forecasts, Q5

£ million

	Year ended 31 March				
	2009	2010	2011	2012	2013
Service costs (a)	-96.5	-99.4	-103.7	-108.0	-112.6
Interest costs on fund liabilities	-127.9	-137.0	-146.7	-156.9	-167.8
Return on fund assets	147.9	159.3	171.3	184.0	197.5
Actuarial gains	12.1	14.6	16.7	17.9	19.1
Profit and loss charge (b)	-64.4	-62.5	-62.4	-63.0	-63.8
Pension fund deficit—open	97.7	92.1	84.6	77.0	70.0
Cash contribution (c)	-70.0	-70.0	-70.0	-70.0	-70.0
Profit and loss	64.4	62.5	62.4	63.0	63.8
Pension fund deficit—closed	92.1	84.6	77.0	70.0	63.8

Source: BAA submission.

7. IAS 19 requires that at the start of each year an employer company estimates the amount by which the discounted pension scheme liabilities will increase over the year by reason of the additional year's service of the pension scheme. This is known as the service costs (a), and represents the costs of additional benefits earned by employees for their service in each relevant period. This cost depends on variables such as salary levels, employee turnover and mortality. The ultimate cost is usually uncertain and in order to measure the present value of the post-employment benefit obligations and the related service costs, firms obtain valuations of their future pension obligations (using actuarial assumptions) and attribute these obligations to periods of service to derive an annual service cost.
8. The employer company must also estimate at the start of the year the amount by which the net present value of pension scheme liabilities will increase during the year as a result of the discounted period being one year less. This figure is called the interest cost, and is computed with reference to an assumed discount rate. According to IAS 19, the discount rate used shall be determined by reference to market yields at the balance sheet date on high quality corporate bonds.
9. The expected return on fund assets is based on assumptions on equity market performance, and reflects changes in the fair value of fund assets held during each period as a result of expected contributions paid into the fund and expected benefits paid out of the fund.
10. Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets. These may arise, for example, from an unexpectedly high or low rate of employee turnover, the effect of changes in the discount rate; and differences between the actual and the expected return on plan assets.²
11. The pension cost charge to the profit and loss account (b) is the sum of the service and interest costs, the return on fund assets and actuarial gains.
12. The level of cash contributions (c) required depends on the expected profit and loss charge and the level of the pension deficit, which is projected to be £97.7 million as at the 31 March 2008. The higher the return assumption (and thus the lower the profit

²Discounted pension scheme liabilities as at the end of the year are likely to be different from the figure used to calculate the service costs, due to a more up to date actuarial valuation becoming available and/or a change in the assumptions (eg financial, demographic) underlying the liabilities.

and loss charge), the lower the level of cash contributions required to provide the same pension benefit to employees. Subject to the need to reduce the pension deficit, the profit and loss charge and the cash contribution should be more or less equal over time.

13. The figures in Table 1 include BAA's pension costs for businesses not subject to regulation such as its Scottish and Southampton airports. Annual service costs for the group are projected to increase from £97 million to £113 million over the Q5 period (3.9 per cent CAGR³), reflecting projected increases in nominal salaries. Despite this increase, the pension charge to the profit and loss account is projected to remain at about £63 million a year, due to increasing returns on pension fund assets and actuarial gains.
14. BAA has allocated a portion of the above projected service costs to the Heathrow and Gatwick airport operating companies. These costs are included within staff costs in the price control business plans of the airports and there are no separate forecasts of pension cost within these business plans. However, BAA has provided an estimate of its pension costs contained with staff costs for the regulated businesses, and these are shown in Table 2:

TABLE 2 BAA's estimate of its pension costs for Q5

£ million (2006/07 prices)

	<i>Year ended 31 March</i>				
	<i>2008/09</i>	<i>2009/10</i>	<i>2010/11</i>	<i>2011/12</i>	<i>2012/13</i>
Heathrow	39.4	37.2	36.9	36.2	36.7
Gatwick	15.8	15.9	16.0	16.1	16.1

Source: BAA submission.

15. In previous quinquennial reviews, we and the CAA have used the cash measure of pension costs when determining airport prices. For Q5, the CAA considered that it would be appropriate to continue with this approach. It cited the following reasons for its decision:
 - It results in a consistent approach over successive quinquennia, as this was the measure used in previous price reviews.
 - Cash payments to the pension fund represent the best measure of economic cost borne by shareholders each year.
 - Setting airport prices on the basis of cash contributions enables airport users and BAA to share the risk of unforeseeable and uncontrollable movements in financial markets on a timely basis as cash contributions will be lower when markets are performing well and higher when returns are low.
 - Using service costs would require the CAA to follow the relatively conservative IAS 19 rules for discounting future pension liabilities, creating a risk that users will systematically over-compensate BAA for providing benefits to its staff.

³Compounded annual growth rate.

16. The CAA acknowledged that the cash measure could be volatile since the cash contributions to the pension fund could fluctuate as a result of changes in the investment strategy and the performance of pension assets.
17. For this reason BAA argued that the service costs is the most appropriate basis for setting the allowance on operating costs, as it represents a smoother recognition of the cost of the pension obligations, whereas the cash contributions can be impacted by a number of events outside the control of BAA, and therefore represents a more volatile recognition of the pension obligation.

Other regulatory decisions

18. The issue of whether airport charges should reflect the pension charge through the profit and loss or cash contributions to a pension fund has featured prominently in several recent price control reviews. The CAA argued in its March proposals that other regulators have tended to use the cash measure when setting price caps on the basis that the cash contribution is a more tangible measure of economic costs to the regulated entity.
19. Ofgem has an established policy on pensions, and this issue was first covered in the Developing Networks Price Controls Initial Conclusions paper in 2003, further developed in the various Distribution Price Control Review documents in 2003 and 2004, and also applied in the transmission price control review. It is also being applied in the current Gas Distribution Price Control review. Ofgem's policy is to make explicit allowance for expected actual cash contributions both for ongoing (future service) contributions and deficit repair contributions, and to make retrospective adjustments for variances between expected and outturn contribution rates, including the investment return.
20. In its recent NATS price control review, the CAA stated that it would continue to allow pension costs to be recovered on a cash payment basis, rather than by reference to a particular accounting measure. It argued that it is desirable to maintain a consistent approach to regulatory policies across price control periods unless there were good arguments to the contrary.

Implications from ADI acquisition

21. As part of the acquisition, agreement was reached between ADI and the pension scheme trustees on the changes to the funding basis, level of investment risk and the amount of cash contributions each year. It was agreed to increase the contribution from £46 million to £70 million a year, from 1 July 2006, which is broadly equal to a 25 per cent contribution rate. It also agreed that the scheme's investment strategy would switch to give a higher weight to investment in bonds and less to equities. Both these arrangements came into effect when ADI's acquisition was completed.
22. BAA's proposed cash contributions of £70 million a year has been set to fund its ongoing pension obligations as well as to eliminate the pension scheme's deficit of £98 million at the start of Q5, as calculated under the requirement of the IAS 19 accounting standard (see Annex 1).
23. The impact of these new arrangements on Q5 pension costs depends on whether an allowance is made for BAA's service cost or cash contributions, since only the latter will be affected by the increase in contributions or the change in investment strategy. The CAA argued, as a matter of principle, that it would be inappropriate for BAA to pass on to airport users the costs which ADI incurred in making its acquisition, unless

these charges would have occurred anyway. Accordingly, the question with regard to the new arrangements is whether these are in line with good pension fund management practice, or an unreasonable cost pass-through to airport users.

24. BAA argued that if the CAA insisted on using the cash measurement approach, it should be based on the post-acquisition investment strategy as to do otherwise would mean that at future reviews, pension allowances would need to be based on a set of subjective and hypothetical circumstances (ie the regulator would have to determine the appropriate investment strategy when calculating the cost allowance) and result in regulatory uncertainty between reviews. BAA added that the investment strategy was a matter for the fund trustees, who were independent from BAA, and not for the CAA.
25. One airline argued that ADI should not be reimbursed for the costs of acquiring BAA but did not comment directly on the investment strategy. BA said that it did not consider it appropriate for a change in investment strategy automatically to trigger an increase in airport charges, and therefore argued that the costs related to the de-risking of the scheme should not be passed on to airport users. BA explained that allowing BAA to de-risk its investment policy without also putting into place a more conservative employee benefits proposal consistent with market reality would put an additional cost of £25 million per annum on the airlines at Heathrow and Gatwick. BA also considered that to set such a precedent might encourage the trustees of BAA's pension scheme to de-risk further the investment policy in future as the costs of such a strategy would be underwritten by the airline community. BA did not consider that this was equitable.
26. BA said that it did not consider it appropriate that a change in investment strategy should automatically trigger an increase in airport charges, and therefore argued that the costs related to the de-risking of the scheme should not be passed on to airport users.
27. The CAA, in its March 2007 proposals, proposed that the price caps should not be adjusted for the new investment strategy because it recognized that more conservative approaches to pension liability management have become market practice. It added that there are likely to be practical constraints to basing the pension allowance on BAA's former investment strategy. This would require the CAA to calculate a 'shadow' cash charge based on an investment strategy no longer used by the company.

Q3 pensions holiday and recovery in Q4

28. The treatment of pension costs was a major issue in the Q4 price review. Q3 charges were set assuming that projected pension costs would be paid at 14 per cent of eligible payroll costs. In practice, a pension holiday applied throughout Q3 and BAA made no contributions to the defined benefit scheme because it wanted to eliminate the pension fund surplus, which at 1 April 1997 was running at 50 per cent of fund liabilities. Accordingly, in July 1996 BAA reduced its group funding rate from 14 to 8 per cent and contributions ceased from 1 April 1997. This meant that during Q3, airport users paid charges based on expenditure that did not occur.
29. In the Q4 review BAA told us that adverse falls in the stock market meant that it had needed to resume contributions, as the fund surplus had reduced to about 3 per cent of fund liabilities by the end of 2002. It told us that the long-term contribution rate was estimated to be 22 per cent of eligible payroll costs and its projected Q4 contribution rate, taking account of the reduced surplus of the scheme, would be about 19 per

cent. This rate was assumed in the Q4 operating expenditure projections made by BAA.

30. We made a downward adjustment to these projections to reflect the pension holiday that BAA had benefited from during Q3. We argued that airport users had already paid BAA during the control period for contributions that were not made and that to ask users to accept the 19.3 per cent funding rate in BAA's Q4 operating expenditure projections would effectively have forced users to pay twice. We calculated that the benefit equated to 3.9 per cent of eligible payroll costs a year. In setting charges for Q4, we recommended that only two-thirds of this benefit should be passed to airport users, and allow BAA to keep one-third. This was consistent with the modelling of other aspects of operating expenditure projections, where we chose estimates above the lowest estimate.
31. The CAA accepted these recommendations and adjusted BAA's pension forecasts accordingly. Annex 2 shows the calculation of the pension holiday benefit to BAA in Q3, and the amount recovered in Q4.⁴
32. The effect on the Q3 pension holiday on the pension allowance for Q5 depends on which measure of pension cost is chosen. If the service costs measure is adopted then the Q3 holiday becomes irrelevant because the service cost estimates should not (theoretically) include an allowance for under-payments into the scheme in previous periods. However, if the cash contribution measure is adopted then there is the possibility that airport users will be asked to pay again for contributions that were expected to be paid in Q3, as the cash contribution includes an allowance to reduce the current pension deficit.
33. BAA has told the CAA that the assets held by its pension scheme would be about £175 million higher had contributions in Q3 been made as originally anticipated. This can be seen as the amount airport users 'overpaid' BAA in Q3, and an adjustment may be required to BAA's proposed cash contribution estimate to reflect this. (However, see paragraph 44.) The CAA has proposed an adjustment to the RAB at each airport to offset the shortfall in BAA's pension fund assets, which aim to ensure that airport users are no better and no worse off as a result of cash underpayment in Q3. The calculation of this adjustment is not reflected in the CAA's March proposals because it was unsure as to how the CC adjusted for this in the Q4 recommendations.

How should pension costs be treated for Q5 and beyond?

34. Setting the pension allowance for Heathrow and Gatwick in Q5 and beyond involves making decisions on the above issues, that is, what pension measure to use and what adjustments (if any) are required for the new investment strategy implemented by ADI and for the underpayment of contributions in Q3.
35. With regard to the appropriate pension measure, the difference between the projected service cost and the cash contributions is considerable, as shown in Table 1. The difference is accounted for by the projected investment returns on scheme assets (net of interest on pension liabilities) and projected actuarial gains. There is some credibility in BAA's arguments for the use of the service costs

⁴These calculations were made at the Q4 review. BAA argued that this was not the only way the 'benefit' could be calculated.

measure, including it being a less volatile measure which is not affected by the investment returns on pension assets, which are outside the control of BAA.

36. However, it is important to note that the service charge projections shown in Table 1 have been inflated by the adoption of IAS 19, ie the discounting future pension obligations by the yield on highly rated corporate bonds. Also, given that airport users have effectively paid for past pension contributions, which have contributed to the build up of pension assets, it is reasonable for users to benefit from the projected returns of these assets. Additionally, it is standard practice for companies offering final salary schemes to offset the gross cost of this benefit with the investment returns on pension assets. Accordingly, there are good arguments for adopting the cash contribution measure, as this is what the airport operator is more likely to 'pay' over the long term, rather than the service costs measure.
37. With regard to the change in investment strategy, this has the effect of increasing the cash contributions, as the projected investment returns are lower, ie, a greater proportion of investment assets will be diverted to bonds. There is some merit in allowing the extra contribution arising from the change in strategy, as this would prevent us from making judgements on the appropriate investment strategy for BAA's pension assets. However, it would be unreasonable to pass on all of the extra costs of 'de-risking' the pension scheme to airport users.
38. We commissioned the Government Actuary's Department (GAD) to review the BAA pension scheme, including the current funding position, investments strategy and the proposed cash contribution rate (25 per cent) over Q5. Specifically, we asked GAD to consider what would be an appropriate cash contribution rate for BAA assuming (a) the pension scheme was in balance, (b) average investment returns assumed by private sector pension schemes and (c) pension benefits that were in line with average private sector defined benefit schemes.
39. GAD carried out some illustrative calculations based on the assumption that members of the open section of pension scheme (for future service) were deriving benefits at an average accrual rate of 60ths rather than BAA's accrual rate of 54ths, and that unreduced benefits were payable from age 65 (average) instead of age 60 (as in BAA's scheme). It adjusted the results of the interim funding assessment of the BAA scheme as at 31 December 2006 to reflect the average level of benefits. GAD's calculations implied an employer cash contribution rate of between 16 to 20 per cent.
40. GAD stressed that the results were approximations and that it did not have full membership information available which would enable more accurate calculations to be carried out. It added that there is a wide range of potentially reasonable cash contribution rates, given the sensitivity of the results to the assumed rate of return. However, the above calculations assume that pension scheme would continue to be open to new members, and that the Office for National Statistics survey information suggests that the above range is within the typical range of employer contributions in the private sector. Accordingly, we currently believe that the upper range of the GAD calculations (20 per cent) provides a reasonable cap on BAA's pension cash contribution costs to be included in the price control, and would better reflect the pension costs of an entity facing greater commercial and competitive constraints. Table 3 shows the effect on Heathrow's and Gatwick's pension costs from capping at a rate of 20 per cent.
41. BAA argued that such a cap on pension costs effectively penalised BAA's pension trustees for excellent management of the scheme, and introduces an element of asymmetry. Our recommended cap is not targeted at BAA's pension scheme trustees. It seeks to limit the degree to which BAA can pass on all of the costs of a

relatively generous pension scheme to airport users. Also, by applying the high end of the range provided by GAD, we see our cap as being a generous estimate rather than asymmetric.

TABLE 3 Calculation of HAL and GAL pension allowance

£m (2006/07 prices)

	Year ended 31 March				
	2008/09	2009/10	2010/11	2011/12	2012/13
<i>BAA proposals (service cost)</i>					
Heathrow	39.4	37.2	36.9	36.2	36.7
Gatwick	<u>15.8</u>	<u>15.9</u>	<u>16.0</u>	<u>16.1</u>	<u>16.1</u>
	55.1	53.2	53.0	52.3	52.8
<i>CAA proposals (25% cash rate)</i>					
Heathrow	26.5	26.0	25.6	25.2	25.0
Gatwick	<u>11.4</u>	<u>11.4</u>	<u>11.3</u>	<u>11.2</u>	<u>11.1</u>
	38.0	37.4	36.9	36.4	36.1
<i>CC proposals (20% cash rate)</i>					
Heathrow	21.2	20.8	20.5	20.2	20.0
Gatwick	<u>9.2</u>	<u>9.2</u>	<u>9.1</u>	<u>9.0</u>	<u>8.9</u>
	30.4	29.9	29.6	29.1	28.9

Source: CC calculations from BAA and CAA data.

42. Table 3 shows that capping pension costs at 20 per cent of payroll reduces the costs included in the price control by about £25 million a year (collectively for Heathrow and Gatwick) from BAA's original proposals, and by about £7 million a year from CAA recommendations.
43. The under-payment in Q3 pension contributions is still a factor that needs to be addressed in this price review. BAA argued that revisiting past decisions in this way undermined any incentive for airports to strive for efficiency and out-performance. However, had BAA contributed according to the pension cost included in the revenue requirement in Q3, BAA pension schemes assets would have been greater, and thus projected investment returns would also be greater. Because we are choosing to adopt the cash contribution measure, the shortfall in investment assets becomes relevant.
44. BAA has initially estimated that the shortfall in scheme assets arising from the Q3 pension holiday was about £175 million (see paragraph 33), but later provided us with an estimate of about £151 million. However, it argued that instead of calculating the impact of the Q3 holiday on the current scheme position, we should calculate the difference between the aircraft charges received in Q3 compared with the aircraft charges revenue that would have been received in Q3 if the contributions holiday had been anticipated when the revenue requirement was calculated. We believe that this latter approach is likely to derive a smaller figure, given that it would exclude the investment returns that would have accumulated if the contributions allowed for in Q3 had been invested. We currently believe that, in order to deal with this Q3 under-payment issue once and for all, a proportionate share of the shortfall in pension fund assets should be deducted from the RAB of Heathrow and Gatwick. We note, however, that the approach taken in Q4 was to deduct only two-thirds of the shortfall from each RAB, with BAA retaining the balance of the benefit.

Actuarial assessment of BAA's pension scheme

1. This annex sets out the outcome of the interim actuarial assessment of the BAA pension scheme as at 30 September 2006. Under the scheme's rules, the actuary is required to undertake a full evaluation and report on the financial condition of the scheme once every three years. The last such assessment was as at 30 September 2004. In the intervening period, the trustees of the scheme require the actuary to produce annual interim assessments in order to monitor developments within the fund. Such an assessment was undertaken as at 30 September 2006 and the outcome is shown below.
2. The scheme's past service position, in terms of funding level, has improved since the full evaluation in 2004, when the scheme's surplus was £78.2 million (equating to a funding level of 105.2 per cent). The 30 September 2006 position is a surplus of £161.5 million (a funding level of 108.4 per cent), which is equivalent to a contribution rate of 6.5 per cent.
3. According to the scheme's actuary, the required service funding rate has increased due to the higher implied level of inflation and consequent pay increases. The required rate has increased from 20.5 to 24.4 per cent in the two years to 30 September 2006. This would suggest that the ongoing contributions from 2007 could be at the rate of 17.9 per cent (24.4 per cent less 6.5 per cent equivalent to the surplus). Rolling forward the results to 31 December 2006 would produce a surplus of £218.4 million.
4. From 1 July 2006, the company's cash contribution was increased to a flat rate of £70 million a year in line with an agreement between ADI and the trustees, which broadly equate to a contribution rate of 25 per cent. Also, the funding target would change to comply with IAS 19. The major impact of applying this accounting standard is that instead of the actuary (in discussion with the trustees) determining the appropriate investment return assumption, the return on AA rate corporate bonds is adopted. This return measure is used as the discount factor to calculate the present value of the cost of fund liabilities. The return on AA-rated corporate bonds is lower than the assumption used in the previous valuation approach, which has the effect of increasing the present value of those liabilities, while the value of fund assets (valued at market to market) remain unchanged.
5. Using IAS 19 as the funding target, the outturn at 30 September 2006 would be a deficit of £146.5 million (a funding level of 93.4 per cent) and a future service contribution requirement of 33.9 per cent. Rolling forward the results to 31 December 2006 would produce a deficit of £98.6 million (a funding level of 95.6 per cent) and a future service contribution requirement of 33 per cent.
6. The above suggests a significant variance in the assessments of the scheme; a surplus of £218.4 million (using the previous approach) versus a deficit of £98.6 million (using the IAS 19 approach). Although the change in methodology appears to have cost BAA £317 million and a significant increase in the future service requirement, the difference is accounted for by the rate adopted for discounting the fund liabilities.
7. The actuary, in its 2006 interim assessment, has built back a more realistic assumption of the expected return over and above that available on AA-rated

corporate bonds in order to assess the real impact of the change in the approach. The actuary has assessed what impact the annual £70 million of contributions will have on the IAS 19 deficit of £98 million over 5-, 10- and 15-year time horizons. This is summarized in Table 1 below.

TABLE 1 BAA Actuary estimate of pension IAS 19 deficit

	<i>£ million</i>		
	<i>5 years</i>	<i>10 years</i>	<i>15 years</i>
No outperformance	23	13	10
1 per cent outperformance	11	–	–
2 per cent outperformance	–	–	–

Source: Interim actuarial assessment as at 30 September 2006

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8. Table 1 shows that the deficit could be eliminated within five years with only a 1 per cent out-performance in asset returns. To eliminate the deficit over five years, the actuary estimated that the annual cash contributions required would be about £108 million, assuming no out-performance over AA corporate bonds, but this to £89 million assuming a 1 per cent out-performance, and drops further to £68 million assuming a 2 per cent out-performance.
 9. There had been ongoing discussions between BAA and the fund trustees in relation to investment strategy. The actuary's modelling work shows that a 50:50 equity to bond split carries an out-performance expectation of 3 per cent whilst a 40:60 split would be 2.6 per cent. As explained above, a 2 per cent out-performance would produce a cash contribution requirement of £68 million, which is slightly below the current agreed level of £70 million. There would be a built in margin of prudence adopting a 40:60 bond to equity split.
 10. The scheme's trustees believe that given the agreed a cash contribution of £70 million and the expected investment return over and above AA rated corporate bonds, the scheme is 'nicely in balance' at this time, and it reasonable to assume that this cash contribution is appropriate over the five-year period (from 1 July 2006) to fund BAA's ongoing pension obligations and to eliminate the IAS 19 deficit.

Calculation of benefit of BAA pension holiday

Staff costs (statutory accounts)

	<i>£ million</i>				
	1997/98	1998/99	1999/2000	2000/01	2001/02
HAL	104.0	106.6	100.3	101.2	101.7
GAL	49.6	51.2	50.3	50.2	48.5
STAL	15.4	17.4	18.8	20.0	20.5
HEOC	<u>2.5</u>	<u>5.5</u>	<u>6.3</u>	<u>7.9</u>	<u>8.0</u>
Total	171.5	180.7	175.7	179.3	178.7

Pension cost 2001/02 (statutory accounts)

	<i>HAL</i>	<i>GAL</i>	<i>STAL</i>	<i>HEOC</i>	<i>Total</i>
Charge for pensions in accounts (£ million)	19.0	8.7	3.3	0.4	31.4
Charge as percentage of staff costs in year (%)	18.7	17.9	16.1	5.0	17.6

If the actual charge for the year is based on the full 22 per cent funding rate, then the funding rate of 14 per cent projected in 1996 for Q3 would represent $14/22 \times$ actual sum charged of 17.6 per cent: this is approximately 11.2 per cent. The effect of the pension holiday would then be 11.2 per cent of the staff costs in each year.

Assumptions on returns

Assume the additional contribution was invested half way through each year. Assume a return in line with the annual averages shown in the UBS Pension Fund Indicators 2002. In the absence of fiscal year data, apply the return in calendar year 1997 to fiscal year 1997/98.

	<i>per cent</i>				
	1997/98	1998/99	1999/2000	2000/01	2001/02
Average return on pension funds:					
UBS pension fund indicators 2001/02	16.8	14.9	20.4	-2.7	-8.8
Accumulation of additional investment					
Accumulated fund b/f	-	20.8	45.7	76.7	94.4
Invested in year—11.2% x total staff cost	19.2	20.2	19.7	20.1	20.0
Return at average level:					
New investment—6 months	1.6	1.5	2.0	-0.3	-0.9
Accumulated fund b/f—full year	<u>-</u>	<u>3.1</u>	<u>9.3</u>	<u>-2.1</u>	<u>-8.3</u>
Accumulated fund c/f	20.8	45.7	76.7	94.4	105.2

A surplus of £40 million generated a reduction in the contribution rate of 1.5 per cent in BAA/377, so a notional surplus £105 million, if applied pro rata, would be equivalent to a reduction of 3.9 per cent in the projected funding rate required.

	%
Projected future funding rate	
Projected future funding rate per BAA/377	19.0
Uplift for fire service members (additional 2 per cent)	0.3
Abatement for accumulated additional investment	<u>-3.9</u>
Amended projected future funding rate	15.4

Source: CC 2002 report.

Note: The calculation has been made for the years from 1997/98 to 2001/02, but without reflecting the position in 2002/03, which now forms part of Q3.