Reviewing the BT Pension Scheme (BTPS)

July 2017

We announced recently that we've started a review of the BT Pension Scheme (BTPS) – our defined benefit pension arrangement.

We've been asked by a number of BTPS members to explain why a review is necessary, so this guide explains the cost pressures facing the BTPS and BT itself.

In 2009, we changed both our main pension schemes to be competitive, sustainable and fair. Since then, the costs per member in the BTPS have gone up significantly, while they've remained stable in our other main pension scheme – the BT Retirement Savings Scheme (BTRSS).

This guide provides further details about the pressures we're facing.

Defined Benefit (DB) pension schemes across the UK have been under strain over recent years.

The BTPS is one of the largest private sector DB schemes in the UK, so it's not immune.

The changes we made to the BTPS in 2009 allowed us to continue providing benefits for members at that time. Despite these changes, we now face pressure from the rising cost of providing future service benefits, alongside an increased deficit.

As we've done in the past, we're discussing the issues with the unions and we are keeping the Trustee up to date.

As we progress this review, we'll let you know any proposals and how they could affect you.

Unless stated otherwise, the figures used in this guide have been independently calculated by KPMG using the approach adopted by the BTPS Trustee in the most recent annual funding update, but using March 2017 market conditions. Please note that market conditions vary over time.

The cost of future benefits

As an active member of the BTPS, you're building up new benefits every year. You pay contributions at a fixed rate to help meet the cost of those benefits and BT pays the balance.

When changes were made to BTPS benefits in 2009, the cost of providing £1 of annual pension was around £10.

This is now estimated to be £20. BT has to meet the entire increase while members' contributions stay the same, effectively meaning BT's costs are three times as much.

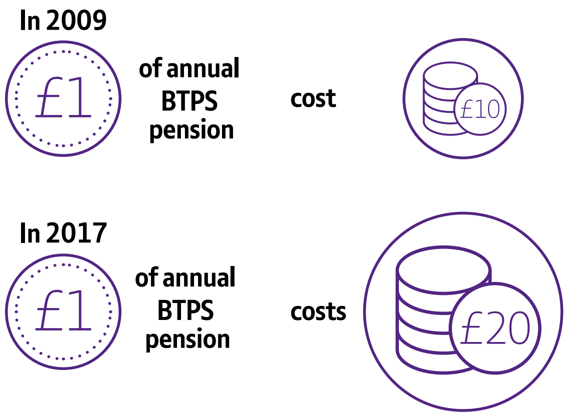
When you consider there are around 32,000 active members, this means we need to substantially increase the money we pay into the BTPS to cover the cost of future service benefits.

It's also important to note that the BTPS costs BT a lot more than our other primary scheme – the BTRSS – despite now having fewer members.

WHAT YOU NEED TO KNOW

THE COST TO BT OF PROVIDING FUTURE SERVICE BENEFITS IS THREE TIMES WHAT IT WAS IN 2009.

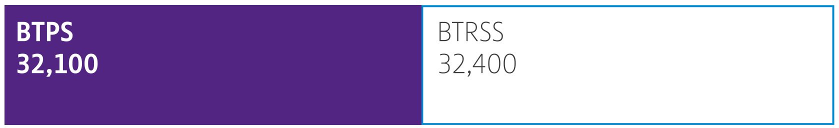
Average cost of building up £1 of annual BTPS pension



1. In 2009, member contributions met around half the costs.
2. Today, members still pay the same as they did in 2009.
3. But the cost to BT is now three times as much.

Source: KPMG. Figures quoted include allowances for 3 x lump sum and the State Pension offset.

Employee pension membership
(Approximate number of employees)



Source: BT headcount figures at 31 March 2017

Why have pension costs increased?

BTPS costs have increased largely due to:

- Fall in long-term interest rates
- Longer life expectancy

In addition, pay inflation and increased pensions regulation has added to the overall costs of the BTPS.

See page 4 for more details on interest rates and life expectancy.

Funding the deficit for benefits already built up

In addition to the cost of future benefits, BT has to meet the cost of any shortfall between the BTPS assets and the expected cost of providing benefits already promised to members – known as the deficit.

Like other UK defined benefit schemes, the BTPS has experienced sustained pressure from a number of external financial factors, each contributing to the rise in the deficit. This is despite billions of pounds of top-up contributions and other measures taken by BT and the BTPS Trustee to reduce the risk of the deficit rising.

The changes we made to the BTPS in 2009 allowed us to continue providing benefits for members at that time. Actions have been taken to reduce the deficit and risks since the 2009 changes, including:

- BT paying in £6.2bn in top-up payments. This is on top of BT's payments for future benefits.
- The BTPS assets being managed responsibly, and consistently achieving higher investment returns than expected.

As part of the 2014 valuation agreement, BT committed to pay a further £7.6 billion in deficit reduction contributions over the next 13 years.

But these measures have not been enough to fully offset the unexpected growth in the value of benefits already promised to members. Due predominantly to external factors beyond our control, the value of the benefits already promised rose from £40 billion at the end of 2008 to £60 billion by June 2016 – a 50% increase. The value of active members' benefits has increased substantially, which is good news for members. But it also means BT is faced with an increased deficit, estimated at £13.9 billion at the end of June 2016.

WHAT YOU NEED TO KNOW

WE'VE PAID OVER £6BN TOWARDS THE DEFICIT SINCE 2009. BUT THE DEFICIT HAS GROWN, REQUIRING EVEN MORE MONEY TO BE PAID BY BT.

Tackling the deficit

BT has made £6.2bn top up payments alone since the 2009 changes

2009-2017

£6.2bn

Despite what we've paid in, the latest Trustee estimate of the deficit is £13.9bn at the end of June 2016

£13.9bn

We have already committed £7.6bn in top-up payments to the BTPS over the next 13 years, but it won't cover the whole deficit.

Growth in the average pension built up in the BTPS

Team Member

The average BTPS pension in 2009 was... **£8,000 per year**

The average BTPS pension in 2017 is now... £13,400 per year

Current average value of all BTPS Team Member benefits (per member) £400,000

Manager

The average BTPS pension in 2009 was... **£13,500 per year**

The average BTPS pension in 2017 is now... £20,900 per year

Current average value of all BTPS Manager benefits (per member) £650,000

Source: KPMG. Average BTPS pensions are before allowance for the State Pension offset built up since 2009. Lump sum benefits are payable in addition.

Why have pension costs increased?

WHAT YOU NEED TO KNOW

LOWER LONG-TERM INTEREST RATES MEAN WE NEED TO SET ASIDE MORE MONEY TODAY TO PAY FOR THE SAME BENEFITS IN THE FUTURE

The BTPS has been managed responsibly, achieving good investment returns over the years compared with the market. But this hasn't been enough to make up for external factors out of our control increasing the costs.

Why is this happening?

A significant reason why pension costs have increased is a significant period of low long-term interest rates.

These rates drive the future investment returns expected on the money set aside to pay your pension. If they fall, BT needs to make up for this by setting aside more money today.

Similarly, this also increases BT's costs for future BTPS benefits that members continue to build up. As members pay a fixed contribution towards their benefits, it's BT that has to meet the full balance of any increase.

It's just like if your bank lowered the interest rate on your savings. You would need to put in more money today to take out the same amount of money in the future. The BTPS looks at long-term interest rate expectations, not just the current base rate set by the Bank of England.

The low interest rate conditions we find ourselves in have not been a short-term phenomenon, so the BTPS will continue to present significant cost and risk pressures to BT.

It's not just interest rates that have played a part in the increasing costs. Longer life expectancy means that pensions are paid out for longer too. BT has also made above inflation pay increases over recent years. As members' benefits are linked to pay, growth in pay also adds to pension costs.

Long-term interest rates have continued to fall and have reached record low levels

2009 interest rate

3.9%

2013 interest rate

2.7%

2017 interest rate

1.6%

Did you know?

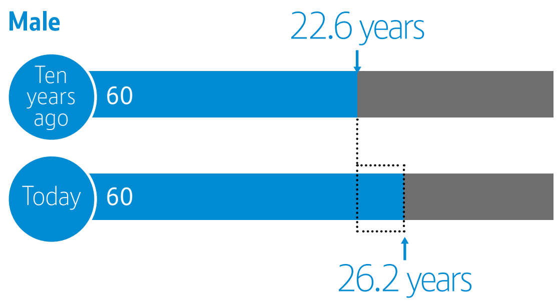
Each 1% fall adds £3bn to the deficit and increases the cost of future service benefits by a quarter.

Source: Bank of England 15 year nominal government bond yields at31 March of each year.

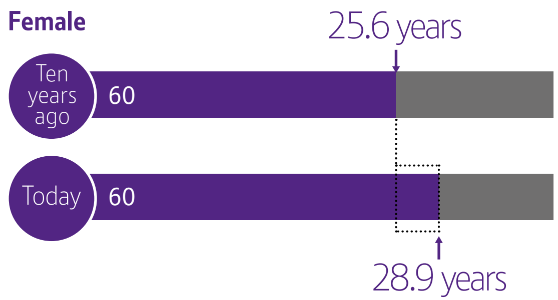
Life expectancy assumed in the BTPS

In the last ten years, the average life expectancy for BTPS members has increased by 3-4 years. That's longer than previously anticipated.

The graphs below show how life expectancy has changed for a typical male and female member in the BTPS from age 60:



Male members are expected to live 3.6 years longer than they were ten years ago.



Female members are expected to live 3.3 years longer than they were ten years ago.

Source: BT plc annual report 2007 and 2017

In summary

Key points

1. External factors have led to cost and risk pressures for all UK defined benefit schemes.
2. The cost of providing future benefits in the BTPS has significantly increased – the cost to BT is three times what it was in 2009.
3. We've seen an increase in the pension deficit, despite good investment returns and top up payments into the scheme by BT of over £6bn since 2009.
4. The BTPS needs to continue being managed responsibly. If we ignore the challenges we face, it will restrict our ability to invest in the future of the business. We can't just plug the gap with cash as we need to invest in our growth.

What happens next?

- Remember, no decisions have been made to date, and you don't have to take any action.
- Over the coming weeks, we'll keep you informed as the review of the BTPS progresses.
- As we've done in the past, we're discussing the issues with the unions and we're keeping the Trustee up to date with these discussions.
- If we decide to propose changes, we'll let you know what they are and how they could affect you.
- Any proposals will be subject to a full 60-day consultation where you'll get to ask questions and make comments.
- We'll then consider all feedback before deciding on any final outcomes and sharing these with you.
- There are legal protections in place which mean, generally speaking, pensions already built up cannot be reduced.

Where can I find out more?

We've set up a website at http://snip.bt.com/pensions

Here you'll find more information and FAQ.