JOHN RALFE CONSULTING

BT Group pensions

A Report for The TalkTalk Group

6th October 2015

This Report was produced by John Ralfe Consulting Limited for The TalkTalk Group, as part of their response to the Ofcom Strategic Review of Digital Communications. Any matters of judgment or opinion are the sole responsibility of John Ralfe Consulting.

John Ralfe is an independent consultant advising companies and trustees on pensions. Until 2002 he was Head of Corporate Finance at Boots and instrumental in moving the £2.4bn Boots Pension Fund to 100% AAA long dated sterling bonds.

He was a consultant to the Accounting Standards Board on FRS17 and the International Accounting Standards Board on share options and worked with Harvard Business School to develop Boots Pensions as a Case Study.

In 2012 he acted as an expert witness for the Competition Commission's investigation into BT's pensions.

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1 Introduction

1.1 Ofcom has suggested that competition in digital communications might be better served if Openreach were separated from BT's other non-regulated businesses, to operate as an independent, stand-alone company. [1]

1.2 BT's Defined Benefit pension scheme – BTPS – is the largest DB pension scheme of any UK company, with £50bn of IAS19 liabilities, [2] and a £7.3bn deficit at March 2015. It has over 300,000 members, including almost 200,000 pensioners, and has three separate sections, depending on the date members joined. [3]

1.3 A Crown guarantee was also issued when BT was privatised in 1984, so if BT were to become insolvent, the government would guarantee BT's obligations to BTPS. The High Court has ruled that this guarantee applied to all BTPS members, including those who joined after privatisation, except for the 2 per cent of members employed by BT group companies other than BT itself. [4]

1.4 This Report considers how the issues around BTPS could be addressed if Openreach were to be separated from BT. In particular, it discusses whether the suggestion by the Financial Times Lex blog that *"BT's mountainous pension liabilities make [a separation of Openreach] effectively impossible"* [5], is supported by the evidence.

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[1] http://stakeholders.ofcom.org.uk/consultations/dcr-discussion/

[2] USS, the multi-employer scheme for the "old" UK universities, is bigger than BTPS in terms of assets & liabilities http://www.uss.co.uk/Annual%20Reports/reportaccounts2015.pdf p111

[3] http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/2015_BT_Annual_Report_smart.pdf See p172-179 of BT's 2015 Report for details of BTPS

[4] http://www.bailii.org/ew/cases/EWHC/Ch/2010/2642.html High Court Judgement July 2014

[5] See appendix http://blogs.ft.com/lex-live/2015/03/12/the-7bn-problem-with-a-bt-breakup/

1.5 The Report concludes that BTPS is not an impediment to Openreach being separated from BT. If Openreach were spun-off, the most straightforward approach is for the pension liabilities for former and current Openreach employees to remain with BTPS. This is the approach taken in 2002 when Cellnet (now O2) was spun-off from BT.

1.6 To compensate for the increased credit risk, as Openreach would no longer be making annual deficit contributions, there would be a one-off cash injection into BTPS. This cash injection would effectively be re-financing of BT's overall liabilities and should not affect BT's credit rating.

The Crown guarantee of BTPS would remain in place unchanged.

2 Summary

2.1 Most DB pension schemes, like BTPS, operate across a group, with only one pension scheme open to employees of all UK businesses. Usually when a business is sold the pension liabilities to its current and former employees remain with the vendor, as part of its groupwide scheme.

2.2 It is also possible to split a pension scheme, with the liabilities of the business's former and current employees and a share of assets transferring to a new scheme, supported by the business being sold, or its purchaser.

2.3 A subsidiary may have its own self-contained pension scheme, usually for historical reasons. If so, it may transfer with any sale, with a reduction in the purchase price to reflect any deficit, or may stay with the vendor.

2.4 The approach of pension liabilities remaining with the vendor, combined with a cash payment, has been used frequently:

- As part of its £884m disposal of the Financial Times to Nikkei, pensions will remain with Pearson, which is making a £90m pension contribution.
- It has also been used where the businesses being sold represents a large part of group operating profit. For example, in 2013 Invensys sold its Rail Division, representing half of its operating profit, for £1.7bn and made a pension contribution of £625m.
- In 2006 Smiths Group sold its Aerospace business, representing 30 per cent of total operating profit, for £2.45bn, paid £2.1bn to shareholders and made a £21m pension contribution.
- In 2012 Cookson Group split into two separate businesses, around one-third, two-thirds of group EBITDA, and also made a pension contribution of £32m. (See appendix II for full details of these and other examples).

2.5 When Cellnet was spun-out of BT in 2001, pension liabilities for former and current employees remained with BTPS, rather than transferring to the new Cellnet scheme. Current employees were given the choice of transferring to the new Cellnet scheme. [6]

2.6 An alternative would be for pension liabilities for former and current Openreach employees to be transferred to a "New Openreach" pension scheme, which would take its pro-rata share of BTPS assets. In this way the £7bn deficit would be split between New Openreach and "New BT".

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[6] http://www.btplc.com/Sharesandperformance/Financialandotherinformation/Listinginformation/DemergerCircular.pdf See p69 BT Shareholder Circular

2.7 Allocating liabilities could, for simplicity, be on the basis of those who currently work in Openreach, or did so when they retired or left BT, even if they had earned some of their pension working in other parts of BT. This approach was used by Cable & Wireless in 2010.

2.8 It may also be possible to split BTPS into two separate sections, supported by New Openreach and New BT, with no liability for the other section, each section having a pro-rata share of BTPS assets. This approach was used by WH Smith in 2006 (see appendix III for full details)

2.9 However, based on the complex legal position on the precise nature of the Crown guarantee, a transfer of liabilities, or splitting BTPS into two sections, is almost certain to require the government to extend the Crown guarantee to cover these liabilities, which may prove to be difficult.

2.10 If all BTPS's pension liabilities were to remain with BTPS, an Openreach spin-off would increase BTPS's credit risk on New BT, as Openreach's operating cash flows and assets would no longer be available to meet pension liabilities. As protection, the BTPS Trustees would require BT, prior to the spin-off, to make a cash contribution, to reduce the deficit.

2.11 As BTPS's deficit is a form of BT debt – recognised by the credit rating agencies, Moody's and Standard & Poors – BT would be expected to fund this pension contribution via borrowing to maintain its existing capital structure. This would be a refinancing - higher borrowing offset by a lower pension deficit - and should be neutral for the overall credit rating.

Following the spin-off, the new pension borrowing, along with BT's existing borrowings, would be allocated between New Openreach and New BT, based on various factors, particularly the relative ability to pay.

2.12 It is not possible to estimate the size of the cash contribution which BT and the BTPS Trustees would agree to reduce the £7bn deficit.

For illustration, one starting point could be to use the same formula which would have been agreed to split BT's existing £10bn debt between New Openreach and New BT. If it was agreed to pro-rate this to the split of EBITDA, this would be 40 per cent New Openreach, 60 per cent New BT.

40 per cent of the £7bn deficit is about £3bn, which would effectively be a pre-payment of Openreach's share of the BTPS deficit.

2.13 The BTPS Trust Deed does not give the Trustees any powers to prevent or slow an Openreach spin-off. In particular, unlike some pension schemes, the BTPS Trustees do not have the power to set employer contributions.

2.14 The Crown guarantee means BTPS is not subject to the Pension Regulator's jurisdiction, which arguably puts the Trustees in a weaker position, because they cannot appeal to the Regulator over the size of BT's contribution, and the Regulator cannot impose a contribution.

2.15 Although the BTPS Trustees have no legal powers to stop an Openreach spin-off, BT would negotiate with them in good faith, to agree the size of cash contribution. As part of the latest actuarial valuation, BT agreed various measures with the Trustees, over corporate events, such as agreeing to inject one-third of net disposal proceeds over £1bn [7].

2.16 New Openreach would have to provide future pensions for the 19,000 or so of its employees in BTPS. This could be either DC or a new Openreach DB scheme. It may be possible for New Openreach to be a participating employer in BTPS, so employees could remain as BTPS members.

[7] BT Annual Report 2015 Report p178

3 What might happen to BTPS if Openreach were spun-off?

3.1 The Pensions Regulator set up by the Pensions Act 2004 to protect pension scheme members and reduce the likelihood of a scheme entering the Pension Protection Fund, has issued guidance on corporate events, such as restructuring, disposals and distribution to shareholders. [8]

3.2 Although the Crown guarantee means BTPS is not subject to the Pensions Act 2004, or the Pensions Regulator, [9] its guidelines are a starting point for how BT might deal with BTPS. BT has also said that decisions on actuarial valuations are made without reference to the Crown guarantee.

3.3 A disposal does not, per se, reduce the remaining group’s ability to meet its pension obligations. If the disposal proceeds are re-invested, or used to pay down debt, there are, broadly speaking, no credit implications for the scheme’s security or action required by the Pensions Regulator.

3.4 If the vendor wishes to distribute some of the proceeds, through a share buyback or special dividend, the group’s ability to meet its pension obligations is reduced. Where the pension scheme is in deficit, and the employer covenant is “materially” weakened, the Regulator requires some “mitigation”, especially a cash contribution into the scheme.

3.5 The Pensions Regulator has a “pre-clearance” mechanism, which gives employers reassurance that it will not use its “anti-avoidance” powers, which include issuing a “Contribution Notice”, requiring payment to be made into a scheme, or a “Financial Support Direction”, requiring financial support to be put in place for a scheme.

[8] http://www.thepensionsregulator.gov.uk/guidance/guidance-clearance.aspx para 26 onwards

[9] http://www.bailii.org/ew/cases/EWHC/Ch/2010/2642.html High Court Judgement 2014 para 8

Because of the Crown guarantee this mechanism does not apply to BT.

3.6 Separating Openreach would be a disposal and distribution to shareholders, or an in-specie distribution. Given its relative size, it would be a "material" reduction in the employer covenant, requiring "mitigation" under the Regulator's guidelines through a cash payment into BTPS.

3.7 As well as the Pensions Regulator's guidelines, the Pensions Act 1995 contains a legal requirement to make cash payments into a pension scheme when a UK employer is sold, known as a "Section 75" payment. Although the prescribed formula calculates a high payment, in practice, it seems that this can reduced; for example, Cookson Group made a cash payment of only 25 per cent of the Section 75 amount.

Again, the Crown guarantee means Section 75 does not apply to BT.

3.8 As discussed above, if Openreach were to be spun-off, it may be possible to transfer or split BTPS's liabilities and assets. The remainder of this report discusses the practicalities of BTPS's liabilities remaining with BT.

4 How much cash might BT have to inject into BTPS?

4.1 The latest BTPS actuarial valuation, as of June 2014, calculated a £7bn deficit, which is being made good by deficit contributions until 2030.

One starting point for estimating the required cash contribution is to pre-pay Openreach's share of the total deficit, which could be calculated pro-rata to its share of BT's total £10bn debt. In turn, one way to apportion debt is pro-rata to Openreach's share of £6.1bn EBITDA, at 2015. (We also note that following the acquisition of EE, Openreach's share of EBITDA will fall).

4.2

2015	Total	Openreach		Other BT	
EBITDA	£6.1bn	£2.6bn	40%	£3.5bn	60%
Existing debt	£10bn	£4bn	40%	£6bn	60%
Pension deficit	£7bn	£3bn	40%	£4bn	60%

4.3 Using this approach, Openreach, with 40 per cent of BT Group EBITDA, would be responsible for 40 per cent of BT's £10bn debt (£4bn), and 40 per cent of BTPS's £7bn deficit (£3bn). This would require BT to borrow £3bn, or rather less taking into account the tax deductibility of pension contributions, which would be injected into BTPS, before the Openreach spin-off. This is purely for illustration and there are other ways of assessing the cash contribution.

4.4 Borrowing to pay down the BTPS deficit, with higher borrowings offset by a lower pension deficit, is effectively an exercise in refinancing. As the credit rating agencies look at the total debt and pension deficit, this should be neutral, with no impact on the formal credit rating.

4.5 When Marks & Spencer issued a £400m bond in 2004 to reduce its pension deficit, Standard & Poor's commented that it, *"considers unfunded pension obligations as debt-like, the additional contribution is considered to be essentially neutral, as an increase in the company's financial debt is matched by a similar decrease in its pension deficit".*

4.6

Before pension contribution	Total	Openreach	Other BT
Debt	£10bn	£4bn	£6bn
Pension deficit	£7bn	£3bn	£4bn
Debt + pension deficit	£17bn	£7bn	£10bn
After pension contribution			
Debt	£13bn	£7bn	£6bn
Pension deficit	£4bn	0	£4bn
Debt + pension deficit	£17bn	£7bn	£10bn

4.7 IF BTPS's liabilities and assets were to be split between New Openreach and New BT, there would be no cash contribution or borrowing as the combined £7bn deficit, and the ability to make deficit contributions, would be unchanged.

5 Could the BTPS Trustees prevent a spin-off?

5.1 The relative powers of employer and trustees for any DB scheme, especially power to fix employer contributions, are set by the Pensions Act 2004 and the precise terms of the individual trust deed and rules.

5.2 Under the Pensions Act 2004 trustees must obtain the employer's agreement to the assumptions for calculating the value of liabilities, statement of funding principles, recovery plan to make good any deficit and the schedule of annual and deficit contributions. [10]

[10] Pensions Act 2004, Part http://www.legislation.gov.uk/ukpga/2004/35/contents

5.3 The trustees and employer must agree these points within 15 months of the valuation date and if agreement cannot be reached, the Pensions Regulator can impose a "tie-break".

5.4 The trust rules of a minority of pension schemes give the trustees power to fix employer contributions after taking advice from the actuary (ie Cookson Group and British Vita [11]), and "consulting" the employer, but there is no requirement for the employer's agreement.

5.5 The Pensions Act 2004 does not override any trustee power to set employer contributions, although exactly how they interact has not been tested in court. Where trustees set employer contributions, they are required only to "consult" with the employer rather than "agree".

Even where trustees have this power the Regulator says: "*trustees are required to consult the employer and should seek to obtain agreement if at all possible on relevant scheme funding matters*" [12]

5.6 The "strong" power to set employer contributions, without employer agreement, may act as a potential block to a company being acquired, disposal of a major subsidiary, or large distribution to shareholders, without the trustee agreement to an acceptable cash contribution.

5.7 In 2004 talks over a possible acquisition of WH Smith by the private equity firm, Permira, which would have seen WH Smith becoming a highly geared company, broke down after the *"pension fund trustees demanded a substantial cash injection to help cover a fund deficit".* [13]

[11] http://www.bailii.org/ew/cases/EWHC/Ch/2007/953.html High Court Judgement 27/4/2007

[12] http://www.thepensionsregulator.gov.uk/docs/code-03-funding.pdf para 56

[13] http://www.ft.com/cms/s/0/ef05a27e-c644-11d8-b016-00000e2511c8.html#axzz3lzNidqNA

5.8 The Financial Times reported that the WH Smith Trustees were able to demand a "substantial cash injection" because the Trust Deed gave unusual powers to the Trustees to fix employer contributions.

5.9 The BTPS Rules do not give the Trustees power to fix the employer contributions. Rather BTPS employer contributions are set by the Scheme Actuary based on the regular three-yearly Valuation, including any deficit repair contributions. (BTPS Rules 2009. Rules 5.1 & 29.2)

5.10 The trust deeds of other former state-owned companies, including ICI, National Grid, AstraZeneca, British Airways and Corus, also give the power to fix employer contributions to the Scheme Actuary.

5.11 Under the Pensions Act 2004, schemes in this position are required to reach agreement with the employer in the normal way.

However, the scheme actuary must also certify that the rates of employer contributions are not lower than the rates he would have set, if he were responsible for setting them.[14]

5.12 Because the BTPS Trust Deed does not give the Trustees the power to fix employer contributions, it is difficult to see the Trustees acting as a potential block to an Openreach spin-off, by demanding a "substantial cash injection".

5.13 Where a Crown guarantee is in place, the Pensions Act 2004, including the power of the Pensions Regulator to impose a "tie-break" if the trustees and employer cannot agree, does not apply.

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[14] http://www.legislation.gov.uk/uksi/2005/3377/schedule/2/made para 9.5 "*I also certify that the rates of contributions shown in this schedule are not lower than I would have provided for had I had responsibility for preparing or revising the schedule, the statement of funding principles and any recovery plan*".

5.14 This means in practice that if the Trustees disagreed with the level of cash contribution proposed by BT, it could not appeal to the Regulator. It is difficult to see any legal case the Trustees might have under the Trust Deed as long as BT agreed to make good the deficit within 20 years, as required by the Trust Deed (Rule 29.2).

6 What would happen to the future pensions of New Openreach employees?

6.1 Around a third-of BT's 89,000 employees were employed in Openreach at March 2015. Given its history, it is reasonable to assume that a higher proportion, say, half of the 38,000 active members of BTPS [15], or 19,000, were employed by Openreach.

6.2 Pensions earned to the date of spin-off would remain with BTPS, as deferred pensions. New Openreach would then have to provide new pension arrangements for all employees, including those in BTPS, subject to any TUPE considerations

6.3 Employees who joined BT after BTPS was closed to new members in 2001 are in a DC scheme, BT Retirement Savings Scheme, run by Standard Life. New Openreach could easily set up its own scheme, on similar terms to the BT DC scheme – employer contributions between 6 and 9 per cent, depending on employee contributions.

[15] BT 2015 Annual Report p175

6.4 Future pensions for the 19,000 or so New Openreach employees currently in BTPS could involve:

6.5 **1 A DC scheme**, which might be considered inferior to BTPS, and may cause employee objections.

6.6 **2 A New Openreach DB scheme**, on similar terms to BTPS – 1/80th pension and 3/80th cash lump sum, with a normal retirement age of 65. (Royal Mail opened a new DB pension scheme in 2012, following flotation).

BTPS pensions earned up to 2009 increase in line with salary not inflation, so the link between future salary increases and deferred pensions in BTPS would be lost. This could be addressed by increasing the New Openreach pension in line with what the salary related increase would have been had they remained in BTPS**.**

A New Openreach DB scheme would not have the benefit of the Crown Guarantee, unless the government chose to extend it, which may prove to be difficult.

6.7 **3 New Openreach remaining as a participating employer in BTPS**. The BTPS rules allow a BT subsidiary being sold to remain in BTPS, for a period of 12 months or longer. (Rule 31.2)

It is not clear if the BTPS rules if this would make New Openreach and BT jointly and severally liable for all BTPS liabilities, which would make it impractical. (If BTPS was subject to Section 75 of the Pensions Act New Openreach and BT would be jointly and severally liable).

It is also not clear if the Crown guarantee would continue to apply if New Openreach remained as a participating employer.

Appendix I

http://blogs.ft.com/lex-live/2015/03/12/the-7bn-problem-with-a-bt-breakup/

FT Lex live blog 12/3/2015 Robert Armstrong *"The £7bn problem with a BT breakup"*

Last week Lex kicked around the possibility that BT would spin off or otherwise separate its network division, Openreach. BT's competitors, such as TalkTalk and Sky, depend on Openreach's wires. They suggest that BT is (to exaggerate their view slightly) under-investing in the Openreach network and using the monopoly profits from it to subsidize its other businesses. It's not very clear to Lex that a spin-off would lead to better service. But whether it would or not, Claire Enders of Enders Analysis has pointed out another little problem with the spin-off idea: that BT's mountainous pension liabilities make it effectively impossible. She writes:

In any spinoff of Openreach, the government would have to consider whether to keep the pension fund obligations with BT, spin them off with Openreach, or split them between the two. The pension fund trustees might have to approve the plan, or at least set conditions for it. Crucially, the Crown Guarantee would also have to be considered.

BT is responsible for the UK's largest private sector pension scheme. As of June 2014, it had a £7 billion deficit, with approximately £40 billion in assets and £47 billion in liabilities. It was closed to new members in 2001; around 85% of its members are retired or no longer work for BT. It is subject to a Crown Guarantee that backs BT's obligations in the unlikely event BT becomes insolvent.

Openreach's main asset is the 'last mile' copper and fibre infrastructure, and it requires very significant engineering staff to maintain, renew and extend this, with a current workforce of around 32,000 – a third of the BT Group total. It is likely that more than half of the pension fund members work or worked for Openreach or its predecessor businesses, given that the copper network is the oldest part of BT's business.

The financial viability of an independent Openreach can only be determined once the pension issues are worked out. It must make more sense to redouble regulatory oversight and set more enforceable targets for customer service (among other things) with the setting of long term price controls the ultimate sanction.

You know what? Let's go back to breaking up the UK, instead. Telecoms is too complicated.

Appendix II Examples of pension liabilities remaining with the vendor

1 Pearson 2015

https://www.pearson.com/news/announcements/2015/july/pearson-to-sell-ft-group-to-nikkei-inc-.html

Pearson to sell FT Group to Nikkei Inc. July 23, 2015

Pearson is today announcing that it has agreed the sale of FT Group to Nikkei Inc. for a gross consideration of £844 million, payable in cash. ....

A contribution will be made to the Pearson group pension plan following closing of the transaction, expected to be around £90m. *In addition, Pearson has committed to fund the pension plan to self-sufficiency in the near term.*

2 Invensys 2013

In 2013 Invensys sold its Rail Division, representing half of operating profit, to Siemens for £1.7bn and made a pension contribution of £625m.

http://www.invensyspensions.co.uk/docs/pdf/20130502-sale-of-invensys-rail.pdf

2 May 2013

Dear Invensys Pension Scheme Member

Further to our communication of 28 November, we are pleased to inform you of the completion by Invensys plc of the sale of its Rail division to Siemens which has led to the following benefits, ***worth £625 million, flowing to the Scheme****:---*

• ***A cash payment of £400 million to the Scheme***

• ***A new trust has been established with £225 million of funding from the Company, which will be available to fund the Scheme in the future, should it be required.***

There are no changes to members' existing entitlements and the Trustee believes that the security of your benefits has been significantly enhanced as a result of this transaction.

Further details of the transaction and the implications for the Scheme, together with some Additional Questions, are set out in the attached document.

3 DMGT 2012

In 2012 DMGT sold its local newspaper titles for £52.5m, plus a 38.7 per cent share in the new company, and made an undisclosed pension contribution.

http://www.ft.com/cms/s/0/c2f68244-33b3-11e2-9ce7-00144feabdc0.html#axzz3mq7oR5e2

DMGT agrees Northcliffe newspaper arm sale November 21st 2012

By Mark Wembridge and Robert Cookson

A consortium led by a former chief executive of Mecom has agreed a deal to buy Northcliffe Media, the regional newspaper arm of Daily Mail and General Trust, in a move that fires the starting gun on the long-awaited consolidation of the UK's local press.

DMGT, Trinity Mirror and Yattendon on Wednesday signed a deal to create a media venture called Local World, comprising more than 100 newspapers including the Hertfordshire Mercury and the Derby Telegraph. The publisher of the Daily Mail, Mail on Sunday and Metro newspapers will receive £52.5m cash for the sale of Northcliffe, as well as a 38.7 per cent stake in the new group....

Local World will not have pension liabilities – an issue that has dogged many local newspaper groups – and DMGT said it would contribute an undisclosed proportion of the £52.5m cash towards Northcliffe's pension fund.

Copyright Financial Times

4 Cookson Group 2012

In 2012 Cookson Group split into two separate businesses - Alent and Vesuvius, representing around one-third, two-thirds of group EBITDA – and made a pension contribution of £32m.

http://investors.vesuvius.com/sites/default/files/attachments/Cookson%20Shareholder%20Circular.pdf page 40-41

10.1 Cookson is the principal employer of the UK Plan, a multi-employer pension scheme that provides defined benefits for certain current and former Cookson Group employees. The UK Plan has been closed to the future accrual of new benefits since 31 July 2010.

Following the Demerger, the UK Plan will remain with Vesuvius and all pension liabilities of the Alent employers who participated in the UK Plan immediately prior to the Demerger will be discharged in full. Cookson has agreed, with the Trustee of the UK Plan, a mitigation package in light of the loss of support from the Alent participating employers. The mitigation payment will be calculated as approximately 25 per cent. of the UK Plan's Section 75 deficit calculated as at completion of the Demerger. This is estimated at approximately equivalent to a £32 million payment to the UK Plan.*...*

The pension liabilities of Alent participating employers will be apportioned to Cookson (which will be part of Vesuvius following completion of the Demerger) as part of this arrangement.

Clearance from the Pensions Regulator has been obtained in respect of the impact of the Demerger on the UK Plan. The purpose of seeking clearance from the Pensions Regulator is to obtain confirmation that it would not be reasonable in the circumstances for the Regulator to impose any liability on the applicants (which includes the Alent participating employers who will cease to participate in the UK Plan as a result of the Demerger) under a contribution notice or financial support direction in respect of the UK Plan. The clearance therefore confirms that the Alent participating employers have no further liability in relation to the UK Plan in respect of the matters covered by the clearance application.

5 Smiths Group 2006

In 2006, Smiths Group sold its Aerospace business for £2.45bn, and paid out £2.1bn to shareholders and made a £21m pension contribution.

http://www.smiths.com/ar07/siteFiles/resources/pdf/Smiths_AR2007-Business_Review.pdf page 15

Company contributions to the funded pension plans were £103m (2006: £110m). ***In 2007 special contributions were made totalling £56m, including £21m in respect of the aerospace disposal****. In 2006 a £61m special payment was made to facilitate UK scheme mergers.*

6 BT 2001

In 2001 BT spun off Cellnet.

http://www.btplc.com/Sharesandperformance/Financialandotherinformation/Listinginformation/DemergerCircular.pdf page 69 to70

The pensions schedule provides for participation by mmO2 plc and its subsidiaries in the BT Pension Scheme and other BT pensions arrangements to continue in respect of their employees for a maximum period of twelve months after the Demerger Effective Date.

During the participation period, mmO2 plc will contribute in respect of employees who are members of the BT Pension Scheme at the rate of 11.6 per cent. of such employees' pensionable salaries and employees will continue to contribute 6 per cent. of pensionable salary.

The pensions schedule to the Separation Agreement also provides for the making of a transfer payment, subject to certain conditions, following the end of the participation period in respect of those members of the BT Pension Scheme who consent to the transfer of their past service benefits from the BT Pension Scheme to a new pension arrangement to be established by mmO2 plc. mmO2 plc intends that those arrangements will provide benefits which are broadly equivalent in actuarial value to those accruing under the BT Pension Scheme.

Appendix III Examples of pension schemes being split

1 **Cable & Wireless 2010**

In 2010 Cable & Wireless split into two separate companies, Cable & Wireless Communications Group and Cable & Wireless Worldwide

Cable & Wireless Worldwide annual report 2011 p 89

Prior to demerger, a number of the Group's current and former employees participated in the defined benefit portion of the Cable & Wireless Superannuation Fund (CWSF), operated by the Cable & Wireless Group (now Cable & Wireless Communications Group)....

As a result of the demerger (see note 4), a portion of the assets and pension obligations of the CWSF were transferred to the Cable & Wireless Worldwide Retirement Plan (CWWRP), a new plan operated by the Cable&Wireless Worldwide Group. ***The obligations transferred to the Cable&Wireless Worldwide Group were determined based on members' last known employer.*** *The plan assets transferred to the Cable&Wireless Worldwide Group were determined by reference to the obligations transferred. Under IAS 19, this resulted in defined benefit plan assets of £1.2 billion and defined benefit pension obligations of £1.3 billion being transferred to the Group on 26 March 2010.*

2 Severn Trent 2006

In 2006 Severn Trent de-merged its waste management company, Biffa.

https://s3-eu-west-1.amazonaws.com/media.aws.stwater.co.uk/upload/pdf/full_report.pdf p77

On the demerger of Biffa Plc the company entered into an agreement with that company and the trustees of the STPS, the SSPS and the UK Waste Pension Scheme ("UKWPS") whereby the assets and liabilities relating to Biffa Plc employees in the STPS and the SSPS would be transferred to the UKWPS with effect from 31 March 2007. The group has no continuing responsibility for the UKWPS following this agreement.

The net deficit relating to Biffa Plc employees at the demerger date was £39 million. This has been included in the net assets that formed the dividend in specie on demerger. The reduction in the deficit between the demerger date and 31 March 2007 has been treated as an exceptional loss on settlement of £7.8 million.

3 WH Smith 2006

In 2006 WH Smith split into two separate businesses, WH Smith Retail and Smiths News

http://www.whsmithplc.co.uk/docs/reports/WHSPLC-IR-AR061.pdf page 54

On the date of the demerger, the assets and liabilities of the defined benefit scheme have been split between the WHSmith Retail business (owned by WH Smith PLC) and the News business (owned by Smiths News PLC) by way of a 'sectionalisation' of the defined benefit scheme into two different sections (i.e. the WHSmith Retail business section and the News business section). The two sections will remain within the defined benefit scheme. Similarly, the assets and liabilities of the defined contribution scheme will be separated (or 'sectionalised') into two different sections, a WHSmith Retail business section and a News business section, with each section only containing the accounts of members who are or were employed by the relevant business. The two sections will remain within the WH Smith Retirement Savings Plan.

Upon sectionalisation of the defined benefit scheme, the assets and liabilities of the defined benefit scheme have been allocated to the WHSmith Retail business section and the News business section in proportions that reflect the number of active, deferred, pensioner and orphan members belonging to the respective businesses. Orphan members are members (or spouses of members) whose employer had left the Group prior to the split but were classified as either News or Retail for the purpose of the sectionalisation. These proportions are currently estimated to be 65 per cent for the WHSmith Retail business and 35 per cent for the News business...

Assets apportioned to one section of the Pension Trust will not be able to be used for the purposes of the other section. There will be no cross-subsidy or cross-guarantee between the sections of the Pension Trust. However, for administration and investment purposes the Pension Trust will operate generally on a unified basis.