

22. Retirement benefit obligations

Pension plans

BAE Systems plc operates pension plans for the Group's qualifying employees in the UK, US and other countries. The principal plans in the UK and US are funded defined benefit plans and the assets are held in separate trustee administered funds. The plans in other countries are unfunded or defined contribution plans. Pension plan valuations are regularly carried out by independent actuaries to determine pension costs for pension funding and to calculate the IAS 19 deficit.

The disclosures below relate to post-retirement benefit plans in the UK, US and other countries which are accounted for as defined benefit plans in accordance with IAS 19. The valuations used for the IAS 19 disclosures are based on the most recent actuarial valuation undertaken by independent qualified actuaries and updated to take account of the requirements of IAS 19 in order to assess the deficit of the plans at 31 December each year. Plan assets are shown at the bid value at 31 December each year.

Post-retirement benefits other than pensions

The Group also operates a number of non-pension post-retirement benefit plans, under which certain employees are eligible to receive benefits after retirement, the majority of which relate to the provision of medical benefits to retired employees of the Group's subsidiaries in the US. The latest valuations of the principal plans, covering retiree medical and life insurance plans in certain US subsidiaries, were performed by independent actuaries as at 1 January 2007. The method of accounting for these is similar to that used for defined benefit pension plans.

The financial assumptions used to calculate liabilities for the principal plans were:

	UK			US		
	2007 %	2006 %	2005 %	2007 %	2006 %	2005 %
Inflation rate	3.3	3.0	2.8	3.0	3.0	3.0
Rate of increase in salaries	4.3	4.0	3.8	5.8	5.8	5.8
Rate of increase for pensions in payment	2.3 – 3.3	2.9 – 3.0	2.6 – 2.8	–	–	–
Rate of increase for deferred pensions	3.3	3.0	2.8	n/a	n/a	n/a
Discount rate	5.8	5.2	4.8	6.5	5.9	5.8
Long-term healthcare cost increases	n/a	n/a	n/a	5.4	5.5	5.6

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. The bid value of plan assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of plan liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, as at 31 December are shown in the tables below.

For its UK pension arrangements the Group has, for the purpose of calculating its liabilities as at 31 December 2007, used PA 00 (2006 PA 92) medium cohort tables based on year of birth (as published by the Institute of Actuaries) for both pensioner and non-pensioner members in conjunction with the results of an investigation into the actual mortality experience of plan members. For its US pension arrangements the mortality tables used for pensioners and non-pensioners are RP 2000 projected to 2010. The current life expectancies underlying the value of the accrued liabilities for the main UK and US plans range from 18 to 22 years for current male pensioners at age 65 and 21 to 25 years for current female pensioners at age 65.

The Group has a number of healthcare arrangements in the US. The long-term healthcare cost increases shown in the table above are based on the assumptions that the increases are 10% in 2007 reducing to 5% by 2015 for pre-retirement and 10% in 2007 reducing to 5% for post-retirement.

A summary of the movements in the retirement benefit obligations is shown below. The full disclosures, as required by IAS 19, are provided in the subsequent information.

Additional disclosure – summary of movements of the retirement benefit obligations

	UK £m	US and other £m	Total £m
Deficit in defined benefit pension plans at 1 January 2007	(2,866)	(301)	(3,167)
Transfers arising on acquisitions	–	(22)	(22)
Actual return on assets (below)/above expected return	(171)	15	(156)
Decrease in liabilities due to changes in assumptions	817	135	952
One-off contributions	76	–	76
Recurring contributions over service cost	166	48	214
Other movements	70	34	104
Deficit in defined benefit pension plans at 31 December 2007	(1,908)	(91)	(1,999)
US healthcare plans	–	(21)	(21)
Total IAS 19 deficit	(1,908)	(112)	(2,020)
Allocated to equity accounted investments and other participating employers	450	–	450
Group's share of IAS 19 deficit excluding Group's share of amounts allocated to equity accounted investments and other participating employers	(1,458)	(112)	(1,570)

Notes to the Group accounts (continued)

22. Retirement benefit obligations (continued)

Amounts recognised on the balance sheet

	2007				2006			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Present value of unfunded obligations	(1)	(97)	(13)	(111)	–	(80)	(15)	(95)
Present value of funded obligations	(15,099)	(1,912)	(103)	(17,114)	(15,445)	(1,931)	(111)	(17,487)
Fair value of plan assets	13,192	1,918	95	15,205	12,579	1,710	91	14,380
Total IAS 19 deficit, net	(1,908)	(91)	(21)	(2,020)	(2,866)	(301)	(35)	(3,202)
Allocated to equity accounted investments and other participating employers ¹	450	–	–	450	774	–	–	774
Group's share of IAS 19 deficit, net	(1,458)	(91)	(21)	(1,570)	(2,092)	(301)	(35)	(2,428)
Group's share of IAS 19 deficit of equity accounted investments	(49)	–	–	(49)	(83)	–	–	(83)
Represented by:								
Pension prepayments (within trade and other receivables)	14	32	13	59	35	25	11	71
Retirement benefit obligations	(1,472)	(123)	(34)	(1,629)	(2,127)	(326)	(46)	(2,499)
Group's share of IAS 19 deficit, net	(1,458)	(91)	(21)	(1,570)	(2,092)	(301)	(35)	(2,428)

1 Certain of the Group's equity accounted investments participate in the Group's defined benefit plans as well as Airbus SAS, the Group's share of which was disposed of during the year ended 31 December 2006. As these plans are multi-employer plans the Group has allocated an appropriate share of the IAS 19 pension deficit to the equity accounted investments and to Airbus SAS based upon a reasonable and consistent allocation method intended to reflect a reasonable approximation of their share of the deficit. The Group's share of the IAS 19 pension deficit allocated to the equity accounted investments is included in the balance sheet within equity accounted investments.

Amounts for the current and previous four years are as follows:

Defined benefit pension plans	2007 £m	2006 £m	2005 £m	2004 £m	2003 £m
Defined benefit obligations	(17,109)	(17,456)	(17,767)	(14,482)	(12,386)
Plan assets ²	15,110	14,289	12,461	10,143	9,305
Total deficit before tax and allocation to equity accounted investments and other participating employers	(1,999)	(3,167)	(5,306)	(4,339)	(3,081)
Actuarial gain/(loss) on plan liabilities	952	473	(2,100)	(1,221)	(788)
Actuarial (loss)/gain on plan assets	(156)	521	1,138	265	827

2 at bid value

22. Retirement benefit obligations (continued)

Assets of defined benefit pension plans

	2007							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,296	63	8.0	1,384	72	9.25	9,680	64
Bonds	3,331	25	4.9	305	16	6.0	3,636	24
Property	1,142	9	6.0	115	6	7.0	1,257	8
Other	423	3	5.5	114	6	5.0	537	4
Total	13,192	100	7.0	1,918	100	8.25	15,110	100

	2006							
	UK			US			Total	
	£m	%	Expected return %	£m	%	Expected return %	£m	%
Equities	8,232	65	8.0	1,324	77	8.75	9,556	67
Bonds	2,735	22	4.8	260	15	5.5	2,995	21
Property	1,255	10	6.25	–	–	n/a	1,255	9
Other	357	3	5.0	126	8	7.0	483	3
Total	12,579	100	7.0	1,710	100	8.5	14,289	100

When setting the overall expected rate of return on plan assets, historical markets are studied and long-term historical relationships between equities and bonds are preserved. This is consistent with the widely accepted capital market principle that assets with higher volatility generate a greater return over time. Current market factors such as inflation and interest rates are evaluated before expected return assumptions are determined for each asset class. The overall expected return is established with proper consideration of diversification and rebalancing. Peer data and historical returns are reviewed to check for reasonableness and appropriateness.

Changes in the fair value of plan assets are as follows:

	UK defined pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Value of plan assets at 1 January 2006	10,833	1,628	92	12,553
Assets acquired on acquisitions	–	4	–	4
<i>Expected return on assets</i>	779	132	6	917
<i>Actuarial gain</i>	421	100	3	524
Actual return on assets	1,200	232	9	1,441
<i>Contributions by employer</i>	960	137	10	1,107
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	86	–	–	86
Total contributions by employer	1,046	137	10	1,193
Members' contributions (including DWP ³ rebates)	42	11	–	53
Currency loss	–	(214)	(12)	(226)
Benefits paid	(542)	(88)	(8)	(638)
Value of plan assets at 31 December 2006	12,579	1,710	91	14,380
Assets acquired on acquisitions ⁴	–	55	–	55
<i>Expected return on assets</i>	879	144	7	1,030
<i>Actuarial (loss)/gain</i>	(171)	15	(3)	(159)
Actual return on assets	708	159	4	871
<i>Contributions by employer</i>	384	103	8	495
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	107	–	–	107
Total contributions by employer	491	103	8	602
Members' contributions (including DWP ³ rebates)	29	10	–	39
Currency loss	–	(25)	(1)	(26)
Benefits paid	(615)	(94)	(7)	(716)
Value of plan assets at 31 December 2007	13,192	1,918	95	15,205

³ Department for Work and Pensions

⁴ on 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31)

Notes to the Group accounts (continued)

22. Retirement benefit obligations (continued)

Changes in the present value of the defined benefit obligations before allocation to equity accounted investments and other participating employers are as follows:

	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Defined benefit obligations at 1 January 2006	(15,492)	(2,275)	(144)	(17,911)
Net liabilities transferred on acquisitions/disposals ⁵	-	62	-	62
<i>Current service cost</i>	(173)	(60)	(2)	(235)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(86)	-	-	(86)
Total current service cost	(259)	(60)	(2)	(321)
Members' contributions (including DWP ³ rebates)	(42)	(11)	-	(53)
Past service cost	(7)	(2)	-	(9)
Actuarial gain/(loss) on liabilities	499	(26)	2	475
Curtailement gains	52	61	-	113
Interest expense	(738)	(118)	(8)	(864)
Currency gain	-	270	18	288
Benefits paid	542	88	8	638
Defined benefit obligations at 31 December 2006	(15,445)	(2,011)	(126)	(17,582)
Net liabilities assumed on acquisitions ⁴	-	(77)	-	(77)
<i>Current service cost</i>	(142)	(55)	(2)	(199)
<i>Contributions by employer in respect of employee salary sacrifice arrangements</i>	(107)	-	-	(107)
Total current service cost	(249)	(55)	(2)	(306)
Members' contributions (including DWP ³ rebates)	(29)	(10)	-	(39)
Past service cost	(14)	-	(2)	(16)
Actuarial gain on liabilities	817	135	12	964
Interest expense	(795)	(115)	(7)	(917)
Currency gain	-	30	2	32
Benefits paid	615	94	7	716
Defined benefit obligations at 31 December 2007	(15,100)	(2,009)	(116)	(17,225)

3 Department for Work and Pensions

4 on 31 July 2007, the Group acquired Armor Holdings, Inc. and its associated pension plans (note 31)

5 includes liabilities of £67m transferred on the disposal of Atlas Elektronik GmbH

Contributions

The Group contributions made to the defined benefit plans in the year ended 31 December 2007 were £403m (2006 £1,020m). In 2008, the Group expects to make regular contributions at a similar level to those made in 2007. The Group also incurred a charge in respect of the cash contributions of £62m (2006 £57m) paid to defined contribution plans for employees. It expects to make a contribution of £63m to these plans in 2008.

The amounts recognised in the income statement after allocation to equity accounted investments and other participating employers are as follows:

	2007				2006			
	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m	UK defined benefit pension plans £m	US and other pension plans £m	US healthcare plans £m	Total £m
Included in operating costs:								
Current service cost	(113)	(55)	(2)	(170)	(129)	(60)	(2)	(191)
Past service cost	(10)	-	(2)	(12)	(5)	(2)	-	(7)
	(123)	(55)	(4)	(182)	(134)	(62)	(2)	(198)
Included in other income:								
Curtailements and settlements	-	-	-	-	49	61	-	110
Included in finance costs:								
Expected return on plan assets	694	144	7	845	601	132	6	739
Interest on obligations	(631)	(115)	(7)	(753)	(568)	(118)	(8)	(694)
	63	29	-	92	33	14	(2)	45
Included in share of results of equity accounted investments:								
Group's share of equity accounted investments' operating costs	(6)	-	-	(6)	(7)	-	-	(7)
Group's share of equity accounted investments' finance costs	2	-	-	2	-	-	-	-

22. Retirement benefit obligations (continued)

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
Effect on the aggregate of service cost and interest cost	0.2	0.2
Effect on defined benefit obligations	2	2

A 0.5 percentage point change in net discount rates used to value liabilities would have the following effect:

	0.5 percentage point increase £bn	0.5 percentage point decrease £bn
Effect on defined benefit obligations	1.2	1.4