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NATS/CAA Regulatory Appeal

CAAPS Trustee Ltd – Third Party Representation in relation to NATS En-route Limited (NERL) Price Determination

The purpose of this document is to set out the views of the Trustee of the NATS Section (the "Section") of the Civil Aviation Authority Pension Scheme ("CAAPS") in the context of the Civil Aviation Authority's ("CAA's") RP3 Decision as it relates to pension cost allowances, notably deficit repair payments, and the treatment of pension surpluses.

The Section is a defined benefit pension scheme with liabilities currently exceeding £5bn (on 2017 valuation assumptions), providing benefits to some 5,700 current and former NATS Limited ("NATS") employees and their dependants.

The Trustee's primary duty is to operate the Section in accordance with its trust deed and rules, UK pensions law and the Pensions Regulator's guidance. This includes managing the security and funding of the promised benefits, having appropriate regard to the covenant strength of the sponsor. The Trustee also has a responsibility to work with NATS to deliver the promised benefits cost effectively. The Trustee has no direct responsibility to the CAA, as NERL's economic regulator, in relation to the Section or to airspace users.

The substantial majority of NATS' business relates to NERL so the economic regulation of NERL, in particular the treatment of NERL's pension costs, is directly relevant to the Trustee. The size of the Section is many times the size of NERL's regulated asset base ("RAB"). The strength of the sponsor covenant supporting the Section is therefore derived predominantly from NERL's regulatory pricing framework, including both the full recovery of efficiently incurred pension costs under the regulatory settlement and the ability under the pass-through mechanism to recover variations in such costs as a result of unforeseeable financial market conditions, rather than having to rely on recovery from the assets of NERL itself.

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To date, as a result of the Trustee's current assessment of the regulatory framework, the Trustee has been able to regard the sponsor covenant supporting the Section as strong, both now and over the longer term. The economic benefits which this brings to NERL and, in turn, to airspace users are that:

- The Trustee can invest in assets which carry a greater level of risk but are expected to deliver real growth over the long term, resulting in lower expected ultimate pension costs.
- The Trustee can finance the Section having regard to the expected returns on these growth assets, resulting in lower cash funding requirements in the shorter term.
- The Trustee can allow funding deficits to be repaired over a longer time period (9 years at the 2017 valuation), again resulting in lower cash funding requirements in the shorter term.

At the most recent (31 December 2017) valuation of the Section, the technical provisions deficit of £270m (of which c.£205m related to NERL) corresponded to a solvency deficit of some £3.1bn (of which c.£2.3bn related to NERL), so the economic benefit derived from the assumption of a continued strong covenant over the long term is very substantial. We have been kept closely informed on the substantial steps that NATS has taken to mitigate further increases in this exposure which are very limited due to strong benefit protection mechanisms for members of the Section.

For these reasons, there is a clear economic benefit to airspace users in the continuation of a stable and predictable regulatory pricing framework with respect to pensions over the long term. To this end, the Trustee, NERL and the CAA have held discussions regarding the potential for a Regulatory Policy Statement ("RPS") which would provide the Trustee with the longer-term assurance it requires in order to support the strategic approach outlined above.

The proposal to reduce NERL's pension cost allowances in respect of its share of committed deficit payments is of concern to Trustees and follows a similar approach to the RP2 allowances. As for the reductions CAA made in RP2, it is unclear how the amount by which these allowances will be reduced has been derived and is substantiated, introducing the risk that there could be further reductions in the future and that these could be substantially greater. The introduction of this uncertainty could require the Trustee to take a more cautious approach to:

- investment strategy, resulting in an increase in the expected ultimate cost of delivering the promised benefits, and
- funding strategy, resulting in an increase in the degree of prudence assumed in its assessment of the liabilities and/or a reduction in the period of time over which deficit payments are made with associated higher cash costs for NERL.

The CAA's proposal would also be in conflict with the proposed RPS which the Trustee has previously indicated to the CAA could, based on certain assumptions, have a present value in the order of £400m as at 31 December 2017. Any such uncertainty is compounded by the risk that such deficit payments (being entirely "foreseeable", or to the extent not foreseeable, might still not be found to be "significant changes" under the relevant EC legislation) may not be recoverable under the pass-through mechanism and would therefore put pressure on NERL's overall financial position.

The CAA has indicated that the reason for the proposed reduction in deficit contributions is the lack of information as to how a scheme surplus might be used for the benefit of customers. Since the 2017 valuation, the deficit of the Section has increased to approximately £590m as at 30 September

2019 as a result of financial market conditions. Although this remains subject to market conditions, investment performance and demographic changes over the coming year, it currently appears unlikely that the 2020 valuation position will be such that the Trustee could consider releasing NATS from its committed deficit contributions in 2023 and beyond.

Nonetheless, should a surplus arise, the Trustee would, in accordance with the statutory funding framework, enter into negotiations with NATS at the time as to how that surplus should be managed. The Trustee would, consistent with its responsibilities to members and NATS, take into account all relevant factors at the time in determining the most appropriate course of action. This could include de-risking the scheme, thereby reducing volatility and the risk of additional funding being required, as well as the potential to reduce ongoing contributions below the underlying future service rate, resulting in reduced costs for NERL and airspace users. However, any such decision would in large part be influenced by the Trustee's perception of the strength and duration of the covenant.

[redacted]

Joanna Matthews
For and on behalf of the Civil Aviation Authority Pension Scheme (NATS Section)