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4 August 2023

By e-mail:economicregulation@caa.co.uk

Mr Stewart Carter
Civil Aviation Authority
Programme Director, NR23

Economic regulation of NATS (En Route) plc: Provisional Decision for the next price control review ("NR23") (CAP 2553)

I am writing in my capacity as independent chair of the Trustee of the Civil Aviation Authority Pension Scheme (CAAPS).

My letter of 12 December 2022 set out in full the Trustee's response to the proposed treatment of pension costs in the CAA's consultation on its Initial Proposals (CAP 2394). The detailed arguments from my previous letter are not repeated here but, in summary, those arguments demonstrated why:

- The Trustee remained confident that CAAPS' current pension costs were both reasonable and efficient
- By contrast, the arbitrary assumptions and resulting pension costs illustrated by the Government Actuary's Department (GAD) and adopted by the CAA did not appear to have appropriate regard either to the specific circumstances of the NATS Section or to the requirements of pensions law and regulation from the Pensions Regulator (TPR) by which the Trustee was governed
- The covenant of NERL, and hence the perceived long-term reliability of the regulatory pricing framework in relation to pension costs, remained the key factor in keeping those costs to a minimum

I concluded my previous letter by strongly urging the CAA to reconsider its Initial Proposals on the treatment of NERL's defined benefit pension costs, not only for the benefit of CAAPS members but more importantly (from the CAA's perspective) for the benefit of airspace users.

Trustee reaction to Provisional Decision

The Trustee is disappointed that, with one exception, neither the CAA's Provisional Decision nor the GAD supplementary note on pension costs appear to have recognised any of the points made in my previous letter. The one exception is the acknowledgement in the GAD supplementary note of the flaw in previous comments regarding assumed outperformance in the recovery plan, given the structural changes made to the discount rate at the 2020 valuation.

The GAD supplementary note updates the previous GAD report to reflect data from TPR's latest "Scheme funding analysis 2022 annex" covering valuations with effective dates between September 2019 and September 2020 (known as "Tranche 15" valuations). This data still does not cover the NATS Section's actual valuation date, which was captured in Aon's September 2022 In Depth analysis of 124 Tranche 16 scheme valuations, as attached to my previous letter.

The Trustee continues to regard as arbitrary the suggestion that the “reasonable and efficient” range for the discount rate should be the 70th to 95th percentile amongst schemes from a historic survey. Nonetheless, the GAD supplementary note concludes that the NATS Section’s 2020 valuation assumptions continue to lie within this particular definition of the “reasonable and efficient” range.

The Trustee and NERL have therefore continued to comply with all of the relevant obligations set out in Principle 2, paragraphs 5-8 of the CAA’s Regulatory Policy Statement (RPS) (CAP 2119). Hence the Trustee would have expected the CAA to follow Principle 6, paragraph 22, which states: “*Subject to NERL and/or the Trustee fulfilling their obligations and complying with the principles set out in this RPS, we commit to the continued full funding of reasonable and efficient future service costs and reasonable and efficient deficit repair contributions associated with NERL’s Pension Costs by way of revenue allowances in relevant control periods.*”

Instead, the CAA has specified in its Provisional Decision that the appropriate allowance for the discount rate should be the mid-point of GAD’s “reasonable and efficient” range, which it has set at the 85th percentile. The CAA’s decision effectively overrides the valuation assumptions and specifies this exact figure, rather than accepting that the actual 2020 valuation discount rate lies within a justifiable range of outcomes. The Trustee is still firmly of the view that this decision is arbitrary and does not properly take into account the circumstances of the NATS Section or the separate and overriding duties incumbent on the Trustee in agreeing an actuarial valuation of the Section with NATS.

The Provisional Decision therefore implies that the commitment given by the CAA in the RPS to the continued full funding of reasonable and efficient pension contributions can no longer be relied upon, fundamentally undermining the value of the RPS. This will inevitably have an adverse impact on the Trustee’s confidence in the strength of NERL’s covenant, which in turn will need to be reflected in the NATS Section’s future funding and investment strategies.

Impact of gilts crisis

The GAD supplementary note refers to the very significant rise in gilt yields over the two years since the 2020 valuation date, and correctly notes that this will have led to a substantial reduction in the cost of future service accrual. However, the supplementary note fails to mention any of the other impacts of the new economic environment associated with that rise in gilt yields, in particular the impacts on pensions schemes’ asset allocations and on expected investment returns.

As I suggested was likely in my previous letter, the gilt yield spikes of September/October 2022 and the associated pension scheme liquidity crisis have now led to fundamental changes for schemes (such as the NATS Section) which employ liability driven investment (LDI) strategies.

In April 2023, TPR issued new guidance on the minimum allocation to LDI to reduce leverage and increase schemes’ resilience to future yield spikes. Aon have suggested, based on anecdotal evidence, that schemes seeking to maintain moderate to high hedge levels have typically had to increase LDI allocations by 10% to 20% of assets compared with their allocations prior to the gilts crisis. This alone will typically have reduced expected portfolio returns by 0.3% p.a. to 0.6% p.a., even assuming no change in best-estimate returns for the various asset classes. In practice, the higher yield environment has also led to lower expected excess returns from most growth assets relative to gilt returns, further compounding the direct effect of the reduced allocations to those growth assets.

GAD's focus on particular percentiles from a historic survey of discount rates is essentially irrelevant in this context, and it would seem unrealistic at this stage to assume that the 2023 valuation will be carried out using more optimistic assumptions than were used for the 2020 valuation.

Conclusion

As previously explained, CAAPS and the Trustee are governed by pensions law and subject to regulation by TPR. They are not themselves subject to economic regulation by the CAA. The Trustee therefore must, and will, continue to operate CAAPS' funding and investment strategies in line with pensions law, regulatory guidance and best practice, irrespective of the CAA's final decisions on the treatment of pension costs in NR23. The Trustee will of course have careful regard to the implications of the CAA's final decisions on NR23 as those decisions are of fundamental importance to the strength of NERL's covenant. Indeed, to the extent that the CAA's final decisions and the Trustee's obligations diverge despite the commitment given in the RPS, this will impact the Trustee's assessment of the strength of NERL's covenant in both the short term and the longer term, beyond NR23. However, I need to state clearly for the record that the Trustee's funding and investment strategies cannot be bound in any way by the CAA's arbitrary choice of discount rate underlying the allowable pension costs for NERL.

As offered previously, if it would help the CAA to meet with Trustee representatives and relevant CAAPS advisers in order to clarify any points from this letter then please let me know.

Yours sincerely

DocuSigned by:

Joanna Matthews

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Joanna Matthews
Chair of CAAPS Trustee