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Mr Iain Osborne
Civil Aviation Authority
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4 April 2014

Dear Mr Osborne

Draft UK-Ireland RP2 performance plan consultation document

On behalf of the Trustee of CAAPS I would like to make the following comments on the draft consultation document.

Change to the pension pass through

The Trustee is extremely concerned by the proposal in Appendix D paragraph 17 to limit the pension pass through to 80% of any difference between actual and assumed contributions in a "down side" scenario. This must lead to a weakening of the Trustee's assessment of the strength of the NERL covenant that would inevitably require the Trustee to increase the level of prudence within the scheme which would in turn feed directly through to higher contribution levels. Such an outcome is obviously the direct opposite of what the CAA intends. The Trustee therefore wishes to explain very clearly the nature of the pension regulatory regime and why, should the 100% pension pass through not be retained, the Trustee would be driven to take certain actions resulting in higher contributions.

The Trustee is bound by the guidance issued by the Pensions Regulator. The Pension Regulator's Code of Practice on Funding published in December 2013 requires the Trustee to take an integrated approach to risk management and to put an assessment of the covenant strength of the sponsor at the heart of that approach. Therefore the Trustee welcomes the statement in Appendix D, paragraph 16 "*The CAA as regulator stands behind the NERL's covenant to honour its eventual pension commitments*". This statement goes some way to mitigating the uncertainty that the CAA has introduced into the Trustee's mind on whether the regulated arrangements around pensions can be regarded by the Trustee as a constant going forward.

The 100% pension pass through under the current regulatory arrangements allows the Trustee to largely discount the effects on NERL of a "down side" scenario (i.e. it is not NERL that has to bear the consequences of the "down side" scenario). Without the 100% pension pass through the Trustee will need, for the first time, to consider the effects of "down side" scenarios on NERL. These effects, even with the retention of an 80% pension pass through, are likely to be significant in the context of the size of the NERL balance sheet and profit and loss account. The Trustee will therefore have no option but to conclude that the covenant strength of NERL has weakened.

The guidance issued by the Pensions Regulator makes it clear that a higher level of prudence within a scheme is required when there is a weaker covenant assessment. On assessing the NERL covenant as weaker, the Trustee will have to ensure that there is a higher level of prudence within the scheme. The Trustee can only do this either by reducing the amount of investment risk within the scheme or by strengthening the actuarial assumptions (in practice the Trustee is likely to do both in proportions it deems most efficient). Reducing the amount of investment risk will lead to a lowering of the investment return expectation of the scheme whilst strengthening the actuarial assumptions will increase the value of the liabilities. Both courses of action will obviously lead to an increase in the level of contributions.

The Trustee understands the desire of the CAA as regulator to incentivise NERL to further control pension costs. Whilst the Trustee will always need to consider any such control measures carefully given its primary duty to act in the best interests of members, the Trustee is very firmly of the opinion that moving away from a 100% pension pass through will not achieve the CAA's aim for the reasons given but will instead lead inevitably to higher contributions.

Ongoing control of pension costs and risk

The Trustee would like to inform the CAA that from its perspective, NERL has already taken significant actions to control pension costs and that the burden of doing so has fallen almost exclusively on the active membership of the scheme (deferred members and pensioners being subject to various protections). Caps on pensionable pay and the replacement of RPI with CPI for future indexation have significantly reduced the value of benefits that members can expect in the future. It is clear that the transfer of economic benefit is from the members of the pension scheme through the NERL charge payers into the hands of charge payer stakeholders and customers. Based on this experience, the Trustee believes that the evidence strongly indicates that NERL needs no further incentive to control pension costs.

In addition to the risk attaching to the employer's covenant and the investment risk, the assessment of two further sources of risk both arising out of the liabilities are key in the Trustee's approach to risk management. The first of these is the risk associated with changes in demographic factors particularly longevity risk and the second is the exposure to rate risk through the discount rate but even more importantly through inflation which is an integral component of the liability structure. The Trustee would wish to see the exposure to both these types of risk reduced and would like to think that this objective is shared by NERL, the CAA as regulator and charge payers. Adverse variations such as that experienced on interest rates between the 2009 and 2012 valuations are ultimately paid for by the stakeholders of charge payers and their customers. The Trustee intends to work with NERL within the consultation framework envisaged by the Pensions Regulator to mitigate these risks and control these unexpected costs. The Trustee would be more than happy to engage with the CAA as regulator in relation to these matters, including the investment strategy, as suggested in the report of the Government Actuary dated 14 March 2014.

Please contact me if you have any queries in relation to these comments

For and on behalf of CAAPS Trustee Limited
As trustee of CAAPS

Jeff Butler
Pensions Director