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8 November 2017

Dear Richard

Guidance for NERL in preparing its business plan for Reference Period 3: consultation document (CAP 1593)

I am writing in my capacity as independent chair of the Trustee of the Civil Aviation Authority Pension Scheme (CAAPS). As you are aware, I have previously responded on behalf of the Trustee to the "Strategic outcomes for the economic regulation of NERL 2020-2024: Discussion document" (CAP 1511) in my letter of 25 May 2017.

My previous letter explained the critical link between the economic regulation of NERL, in particular the treatment of NERL's pension costs, and the NATS Section of CAAPS (the Section). The various points made in my earlier letter are not repeated here, but I explained why 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. In particular, if the principles of NERL's expected pension costs being fully reflected in its pricing, and of the inevitable variations in actual pension costs being passed through to airspace users over an appropriate period, were compromised then this would substantially impact the sponsor covenant supporting the Section. In turn, the Trustee would then be required to adopt a much more risk-averse approach to funding and investment strategy, which would drive up both short-term and long-term cash contribution requirements. The Trustee therefore welcomes the explicit acknowledgement of this point in paragraph 3.16 of the consultation document.

Deficit repair costs relate to existing obligations in respect of past service. In common with most UK pension schemes, the risk associated with those obligations is currently retained in the Section in the expectation that they can thereby be settled at a lower ultimate cost than would have arisen from the purchase of deferred or immediate annuities at the time each obligation was accrued. In so doing, there is an implicit understanding that the risk taken by the Trustee in relation to such existing obligations is effectively underwritten by the employer and, ultimately, airspace users. Inevitably, deficits will arise if outcomes are adverse relative to expectations, and deficit repair costs will be required on a temporary basis to address this. The willingness and ability of the employer to fund those past service obligations is crucial to the Trustee's assessment of the covenant and the Trustee's continuing ability to take risk and hence deliver lower expected costs to airspace users.

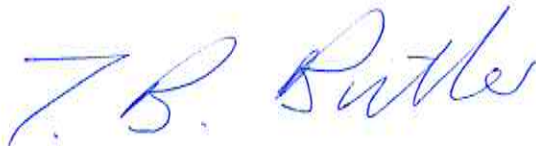
By contrast, ongoing costs reflect the expected long-term cost of benefits being accrued by employees in respect of current service, and those benefits and costs can be significantly impacted

by actions taken by NERL, such as the remuneration uplift offer referenced in paragraph 3.19 of the consultation document.

There is often an unhelpful tendency to conflate deficit repair costs and ongoing costs as one and the same "pension cost". The Trustee therefore welcomes the acknowledgement of this distinction between deficit repair costs and ongoing costs, for example in paragraphs 3.20 and 3.21 of the consultation document. Understanding that there are two forms of pension cost of different origin and different nature will, in the Trustee's view, facilitate the development of a truly efficient pricing model in RP3.

Please contact either myself or the Pensions Director, Jeff Butler, if you have any questions about this letter.

Yours sincerely



Joanna Matthews
For and on behalf of CAAPS Trustee Limited, as Trustee of CAAPS

cc: Lynette Hilton, Scheme Secretary
Jeff Butler, Pensions Director