ANNEX 2

NATS Defined Benefit Pension Scheme
NATS operates a group Defined Benefit Pension Scheme which covers NERL, and its affiliate NATS (Services) Limited. This Scheme was closed to new members on 1 April 2009. For legal reasons the scheme cannot be closed to staff who were members prior to that date.

The attribution of pension costs between NERL and NSL is based on staff membership. Further allocations were made by NERL to the UK Air Traffic Services and Oceanic charge controls. References in this paper to NATS are to the group Defined Benefit Pension Scheme, while references to NERL are its economic share which is subject to the European Commission Charging regulation.

Assumptions made to establish RP1 Determined Costs for UKATS
The projections of pension cash contributions for RP1 were developed for NERL by its actuarial advisors and are expressed in the table below as a percentage of staff pensionable pay relating to UKATS.

	2012	**2013**	**2014**
% of pensionable pay			
Future service contributions	36.7%	36.7%	37.6%
Deficit repair contributions	9.4%	9.7%	0.0%
Total	**46.1%**	**46.4%**	**37.6%**
Assumed pensionable pay - £m (outturn)	**200.7**	**199.0**	**197.2**
Determined costs - £m (outturn)	**92.6**	**92.4**	**74.2**

The principal assumptions made in developing these projections were:

a. Trustee triennial valuation:

RP1 projections were based on the Trustees valuation performed as at 31 December 2009 and the Schedule of Contributions and Deficit Recovery Plan.

The valuation reported a deficit on the NATS scheme of £351.1m (the economic share of this deficit of NERL's UK air traffic services was c. 75%) and meant Trustees put in place an 11-year deficit recovery plan which required deficit repair contributions to be paid by the company. The Schedule of Contributions required future service contributions to be paid at 36.7% of pensionable pay and for deficit repair payments to be made by the NATS scheme of £24.0m per annum from 1 January 2011, increasing by 3.5% annually.

This valuation took account of the 2009 pension reforms made by NATS (see ex ante mitigations described below) to manage costs risks, which provided a significant mitigation to pension cost. The cap introduced by NATS on annual increases in pensionable pay enabled the Trustees to reduce their salary growth assumption. The Scheme Actuary reported that this reduced the value of liabilities by £312m (see 2009 valuation report), and therefore reduced the level of cash contributions required.

b. NATS assumptions
Taking account of the Trustees valuation, NATS advisers developed projections for RP1 with the following assumptions:

i. Future service contributions: NATS advisers also assumed that after the 2012 triennial valuation the Scheme Actuary would report a small increase in future service costs from 36.7% to 37.6% to reflect the maturity of the membership of the scheme (because the scheme is closed to new joiners). In turn it was assumed that the Trustees would increase future service contributions to 37.6% from January 2014.

ii. Deficit repair contributions: assets would perform better than the growth assumptions made by the Trustees. The advisers assumed that this would result in the deficit being repaired at, or shortly after, the Trustees next triennial valuation at 31 December 2012. In turn, NATS advisers then assumed that Trustees would no longer require deficit repair payments which would cease from January 2014 onwards.

    Note that these projections represented the company's best case estimates at the time, rather than prudent Trustee assumptions, and so enabled users to benefit from lower charges if market conditions performed as assumed.

    The Schedule of Contributions sets out the value of deficit repair contributions required by Trustees. These are an annual sum which is increased annually by a pre-determined rate of inflation (explained above). These contributions are set for the NATS Group as a whole. In preparing its RP1 projections the company allocated these to NERL's UK air traffic services based on the size of its pensionable payroll relative to that of the NATS Group.

iii The company's projections also assumes the proportion of own pensionable payroll relating to members of the defined benefit scheme. This was forecast to reduce from 92% at the start of RP1 to 84% by the end.

Actual performance during RP1

	2012	2013	2014
% of pensionable pay			
Future service contributions	36.8%	36.7%	36.7%
Deficit repair contributions	9.1%	9.3%	9.9%
Total	**45.9%**	**46.0%**	**46.6%**
Actual pensionable pay - £m	**198.5**	**200.6**	**196.0**
Actual costs - £m (outturn)	**91.1**	**92.2**	**91.2**

The company's defined benefit pension scheme's funding position, along with the majority of similar UK defined benefit schemes, deteriorated significantly during 2011 due to the reduction in long term real interest rates (as derived from gilt yields) to historical low levels. This was caused by a combination of unforeseen financial market factors including the Bank of England's programme of Quantitative Easing to stimulate economic recovery and the financial crisis in the Eurozone. The effect of lower real interest rates is to increase pension liabilities and in turn create an additional funding deficit which, without mitigating action, would be materially higher than the deficit applying in 2009. These financial market conditions are outside the company's control.

Based on the Trustees' 2009 valuation assumptions but updated for 2012 market conditions, the Scheme Actuary determined that the funding deficit would increase to £949m. As this is a NATS group scheme, NERL's economic share of this would have been c.£740m.

The company recognised that funding a deficit of this magnitude was unaffordable as it would increase the company's cash pension contributions from c. 46% of pensionable pay today to around 81% at the start of RP2. The company therefore took action during 2012, before the Trustee valuation was performed, to address this deficit increase through a further ‘pension mitigation plan’ to help reduce the cost of pensions in RP2. These measures are described below under mitigating actions during RP1.

These reforms were reflected in the Trustees valuation performed at 31 December 2012. The impact of unforeseen financial market conditions and the benefit of the company’s mitigating actions was explained to members of the pension scheme in a letter provided by the Chairman of CAAPS. This letter shows how market conditions increased the funding deficit to £949m and the benefit of changes in Trustee assumptions, which followed consultation with the company, and reforms (see reference to SMoU) reduced the deficit to £383m. This letter has been provided separately as evidence for both unforeseen financial market conditions and mitigating actions taken in RP1.

Determined Costs for RP1 assumed that the funding position of the scheme would improve during RP1 enabling the Trustees to stop deficit repair payments. In practice this was not the case and the Trustees maintained an 11-year deficit recovery plan following the 2012 valuation and set a Schedule of Contributions which required deficit repair contributions to continue.

The Schedule of Contributions also required future service contributions for 2014 to continue at 36.7% of pensionable pay before reducing to 29.4% in January 2015, to reflect the benefit of future service indexation at CPI (see 2013 reforms). The 2014 future service contribution rate was lower than the assumption for RP1 Determined Costs of 37.6%. The company is passing this benefit back to users through costs exempt from cost sharing.

Costs exempt from risk sharing - UKATS
The impact of the unforeseen market conditions described above resulted in higher deficit repair contributions than assumed of £19.5m. This was partly offset by the benefit of the company’s mitigating actions which enabled future service contributions to be maintained at 36.7% during 2014 (£1.8m), and which are passed on to users. In summary, costs exempt from cost sharing for UKATS amounted to £17.7m in 2014.

The summary of differences between actual and Determined Costs for RP1 is as follows:

	RP1 2012 £m	RP1 2013 £m	RP1 2014 £m	Total £m
Cost differences subject to cost-sharing				
Reduction in pensionable pay (e.g. driven by headcount reductions)	(0.8)	0.4	(0.2)	**(0.6)**
Mix of NATS payrolls across NERL & NSL	(0.2)	0.3	(0.4)	**(0.3)**
Impact of NERL DB/DC split	(0.3)	(0.4)	0.0	**(0.7)**
Other controllable differences	(0.2)	(0.5)	0.0	**(0.7)**
Costs exempt from cost-sharing				
Market conditions requiring deficit repair contributions beyond 1 January 2014	0.0	0.0	17.7	**17.7**
Total of all differences	**(1.5)**	**(0.1)**	**17.1**	**15.4**

The analysis of costs exempt is presented below in the format requested by CAA:

All figures in £'000 except where stated	**2012**	**2013**	**2014**	**Total**
Actual payroll	198,520	200,568	195,967	
Wage (increase)/decrease (controllable)	2,165	(1,589)	1,247	
Payroll used in the Performance Plan (excluding costs resulting from controllable factors)	200,685	198,980	197,215	
Contribution rate excluding parameters resulting from controllable factors (%)	46.1%	46.4%	46.6%	
Actual pension costs resulting from uncontrollable factors	92,591	92,378	91,813	
Determined costs	92,591	92,378	74,153	
Uncontrollable costs	-	-	17,660	17,660

EC Charging Regulations provide the mechanism by which costs exempt from cost sharing are recovered from/rebated to Eurocontrol customers. NERL has calculated that of the UKATS amount of £17.7m, £16.1m is recoverable from Eurocontrol customers. The other activities in UKATS, e.g. providing infrastructure to MoD etc bears some 17%.

NERL's RP2 settlement assumed no recovery or rebate of cost exempt from cost sharing relating to the Eurocontrol revenue stream (pending guidance from the SSC Working Group on Economic Aspects) but did include £1.6m relating to non-Eurocontrol revenue streams. This has been discussed previously with CAA and is set out in the proposed RP2 RAB Rules (see pages 8, 24 (5d), 54 & 55).
The £16.1m of costs exempt from cost sharing is assumed to be recovered through the RAB over a 15-year period. An adjustment of £2.6m is to be reflected in the 2016 Eurocontrol charging tables accordingly.