caaps

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12/12/2022 | 9:07:56 AM PST

Dear Stewart

Economic regulation of NATS (En Route) plc: Initial Proposals for the next price control review ("NR23") (CAP 2394)

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

As you are aware, CAAPS and the Trustee are governed by pensions law and subject to regulation by the Pensions Regulator (TPR). They are not themselves subject to economic regulation by the CAA. However, the CAA's approach to the economic regulation of NERL is of fundamental importance to the Trustee as it is the strength of NERL's covenant which underpins the funding and investment strategy of the NATS Section of CAAPS (the Section). This interdependency was reflected in the preparation in 2020/2021 of the Regulatory Policy Statement (RPS) [CAP2119]. The RPS was intended to provide clarity on the regulatory treatment of pensions which would lead to benefits to consumers in the long term as well as specifically in relation to the triennial valuation as at 31 December 2020.

After brief comments on the context for the Trustee's response, the remainder of this letter focuses on specific areas of concern with the Initial Proposals insofar as they relate to the treatment of NERL's defined benefit pension costs. This includes concerns with some of the analysis in the accompanying report from the Government Actuary's Department (GAD) and the conclusions which the CAA has drawn from this.

Context for CAAPS Trustee's response

The Section had solvency liabilities of around £8.5Bn at its latest formal valuation on 31 December 2020. The size of the Section is therefore many times the size of NERL's Regulatory Asset Base (RAB), so the strength of the sponsor covenant supporting the Section is derived predominantly from NERL's regulatory pricing framework rather than from the assets of NERL itself. Confidence in the long-term stability of that framework, through the RPS, enables the Trustee to take a less prudent approach to investment and funding than would otherwise be required, leading to very substantial savings in both expected ultimate pension costs and short-term cash demands.

At the Section's 31 December 2020 valuation, the technical provisions deficit of £172M corresponded to a solvency deficit of some £3.0Bn, so the economic benefit to airspace users derived from the assumption of a strong covenant over the long term is very large indeed.

The Trustee welcomes the CAA's statement that the "*overall approach has not changed from RP3 and we propose to continue to allow NERL to recover reasonable and efficient pension costs*" [paragraph C66].

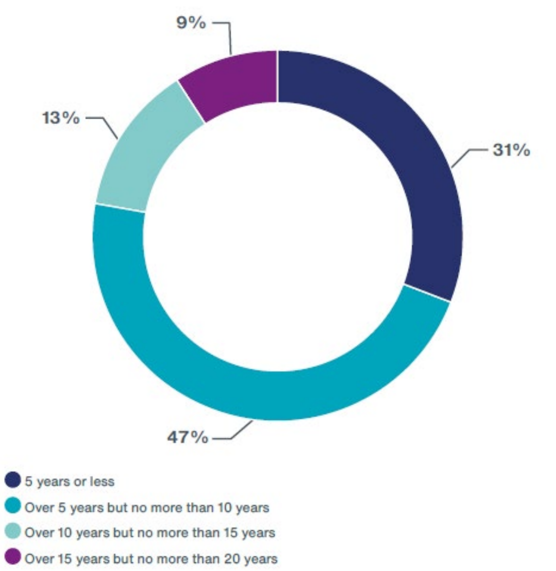
Long-Term Funding Target and associated timescale

The Trustee and NATS have agreed a Long-Term Funding Target (LTFT) to achieve 100% funding on a gilts plus 0.5% p.a. discount rate basis within a target window of 31 December 2033 to 31 December 2038, as formally documented in the Section's statement of funding principles. This LTFT is embedded in the current technical provisions discount rate, which reaches the gilts plus 0.5% p.a. level just over halfway through the agreed window, at 31 December 2036.

This LTFT discount rate is at the higher (i.e. less prudent) end of the gilts plus 0.25%-0.5% p.a. range considered by TPR as the maximum permitted long-term discount rate for the purposes of its "Fast Track" approval of scheme funding plans in the 2020 consultation on the new DB Funding Code. The Trustee was able to agree to this less prudent LTFT (compared with the long-term funding target of gilts plus 0.25% p.a. which was implicit in the previous technical provisions discount rate) having regard to the perceived strength of NERL's covenant, including the new RPS in particular.

Aon's September 2022 In Depth analysis covering 124 "Tranche 16" scheme valuations (TPR's term for valuations with effective dates between September 2020 and September 2021) showed the following data on expected timescales for schemes with long-term funding targets:

Chart 1.2.2 Expected timescale for reaching long-term funding target – tranche 16



This shows that 91% of these schemes expected to reach their long-term funding target within 15 years, suggesting that the NATS Section's target window of 13-18 years from the valuation date lies at the long end, again consistent with the perceived strength of NERL's covenant in light of the new RPS. Moreover, for around 60% of these schemes, these timescales relate to reaching long-term funding targets which are actually more prudent than the NATS Section's LTFT (e.g. gilts plus 0.25% p.a., gilts plus 0% p.a., or even buyout).

The GAD report refers to the concept of a scheme reaching "significant maturity", introduced by TPR in its March 2020 consultation on a new code of practice on DB funding. TPR proposed that a scheme would be deemed to have reached significant maturity once the duration of its remaining projected cashflows reached 12-14 years.

Paragraph 6.20 of the GAD report suggests that the NATS Section might be expected to reach significant maturity in 2045-2050 allowing for accrued benefits only, or by 2048-2053 if allowance is made for future accrual. However, Aon's latest projections as at 30 September 2022 suggest that the duration of the Section's cashflows in respect of currently accrued benefits will reach 14 years by around the end of 2038. This is broadly consistent with the LTFT target window, despite the fact that the latter was agreed before TPR introduced the concept of significant maturity.

TPR intends significant maturity to be the *latest* point by which a scheme must expect to reach its long-term funding target, not a target date to aim for. Furthermore, the timescale to significant maturity can itself be influenced by changing market conditions, making it unsuitable as a target date. For example, the peak level of gilt yields reached on 28 September 2022 would have brought the above significant maturity date closer by roughly three years (to around the end of 2035).

Appropriate single equivalent discount rate

Table 6.1 in paragraph 6.12 of the GAD report shows that the single equivalent discount rate (SEDR) of gilts plus 1.1% p.a. used in the NATS Section's 2020 valuation was materially higher (i.e. less prudent) than both:

- The average for schemes with a strong employer covenant (gilts plus 0.77% p.a.), and
- The average for schemes of similar maturity to the NATS Section (gilts plus 0.84% p.a.)

The same TPR analysis from which GAD extracted these figures also shows the following SEDR statistics which are pertinent to the NATS Section but which did not feature in the GAD report:

- The average for schemes with more than 5,000 members (gilts plus 0.51% p.a.), and
- The average for schemes with more than £300M of assets (gilts plus 0.53% p.a.)

Again, these statistics show that the NATS Section's 2020 valuation SEDR was materially less prudent than the averages for schemes with which it shares these characteristics.

To put these figures in context, had the NATS Section's 2020 valuation been carried out using the average SEDR for schemes with more than 5,000 members as shown above, rather than the SEDR actually used of gilts plus 1.1% p.a., this would have increased the technical provisions deficit by around £900M.

Given these observations, the suggestion in paragraph 9.2 that the discount rate should lie broadly in the range of the 70th to 95th percentile amongst schemes appears arbitrary and is stated without justification. Similarly, the CAA's adoption of GAD's "Mid (85th percentile)" illustration as in some way representing the single "correct" answer is also arbitrary and without justification. This percentile approach has no regard to the multitude of different circumstances which apply to schemes (employer covenant strength, size, maturity, investment strategy, level of prudence contained in assumptions other than the discount rate, etc).

GAD's conclusions were based on the Pensions Regulator's "Scheme funding analysis 2021 annex" published in June 2021 and covering valuations with effective dates between September 2018 and September 2019 (known as "Tranche 14" valuations).

As an aside, Aon's September 2022 In Depth analysis of 124 Tranche 16 scheme valuations (the tranche which covers the NATS Section's actual valuation date) showed a lower average SEDR of gilts plus 0.60% p.a. TPR's analysis covering Tranche 16 valuations will be published in mid-2023.

Allowance for outperformance in recovery plan

The GAD report refers to the removal of the outperformance margin previously allowed for in the recovery plan [Paragraphs 1.36, 8.14-8.21]. This is a misunderstanding resulting from changes in both the discount rate structure and the best-estimate investment return on the NATS Section's assets at the 2020 valuation relative to the 2017 valuation.

It is correct that the 2017 valuation recovery plan included an allowance for an additional 0.3% p.a. of investment return over the technical provisions discount rate. However, this allowance at the 2017 valuation was made in the context at that time of (i) a lower technical provisions discount rate and (ii) a substantially higher best-estimate investment return, than applied at the 2020 valuation. This enabled the Trustee to make the allowance (and so reduce NERL's contributions) whilst still maintaining a degree of prudence in the funding package, as it is required to do.

The new discount rate structure adopted at the 2020 valuation effectively incorporated the previous additional return allowance within the technical provisions themselves, by using a higher discount rate resulting in less prudent technical provisions.

The best-estimate return on the NATS' Section's assets also varies over time with market conditions. At the time when NERL and the Trustee were negotiating on NATS' proposed new discount rate structure for the 2020 valuation, the latest best-estimate return on the Section's assets was gilts plus 2.1% p.a., as set out in the scheme actuary's advice paper "Allowance for Outperformance in the Discount Rate" which was shared with the CAA and GAD for the purposes of NR23.

In the context of a best-estimate return of gilts plus 2.1% p.a., the increased technical provisions discount rate of gilts plus 1.8% p.a. until 31 December 2030 left only small margin of prudence and no scope for any further de-risking for at least 10 years.

Given the increased discount rate of gilts plus 1.8% p.a. and the reduced best-estimate return of gilts plus 2.1% p.a., any continuation of the previous allowance for outperformance of 0.3% p.a. in the recovery plan would have been demonstrably inappropriate – removing *all* of the prudence from the financial assumptions for the next 10 years.

The best-estimate return at 31 December 2021 (i.e. one year after the valuation date) was gilts plus 2.4% p.a., as referenced in the GAD report and as set out in the Trustee's investment adviser's paper "Investment Strategy as at 31 December 2021" which was also shared with the CAA and GAD for the purposes of NR23. However, this figure had reduced again to gilts plus 2.0% p.a. at 30 June 2022 and further to gilts plus 1.3% p.a. at 30 September 2022 based on the current asset allocation. This variation illustrates why it is always necessary in a valuation to leave a margin for prudence between the best-estimate return and the level of return being relied upon within the technical provisions and any recovery plan. Indeed, based on the position as at 30 September 2022, the margin allowed for in the 2020 valuation appears to have been insufficiently prudent.

The widely-publicised gilt yield spikes of September/October 2022 and the associated pension scheme liquidity crisis are expected to result in fundamental changes for schemes (such as the NATS Section) which employ liability driven investment (LDI) strategies. Whilst the NATS Section's investment process proved resilient throughout this period of crisis, there will inevitably be an impact from the need for an increased allocation to LDI to reduce leverage, and potentially reduced return expectations at the portfolio level. In this context, it would seem particularly 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.

Regulatory Policy Statement

At the 31 December 2020 valuation, following robust and extensive engagement with NATS, the Trustee agreed to an immediate and significant weakening of the technical provisions (by around £440M) as well as a less prudent long-term funding target of gilts plus 0.5% p.a. compared with the long-term funding target of gilts plus 0.25% p.a. which was inherent in the previous technical provisions discount rate.

These significant changes reflected the Trustee's confidence in NERL's covenant following the RPS – specifically 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.*"

The relevant obligations for this purpose are set out in Principle 2, paragraphs 5-8, the key components of which are:

5. "*reasonable and prudent assumptions in line with national law and current best practice, taking into account the strength of the employer's covenant and reflecting our commitment to fund reasonable and efficiently incurred Pension Costs*"
6. "*forward-looking prudent assumptions regarding long-run investment returns and other key variables by appropriately appointed actuaries*"
7. "*deficit should be funded over a reasonable period thereafter, taking into account the strength of the employer's covenant, our commitment to fund reasonable and efficiently incurred Pension Costs and prevailing guidance from tPR*"
8. "*NERL to provide evidence of benchmarking of the Trustee valuation assumptions against those adopted by trustees operating schemes in sectors of the economy open to normal commercial and competitive pressures*"

In terms of compliance with these obligations:

- Paragraph 6.1 of the GAD report clearly states "*the assumptions adopted for the 2020 funding valuation are within a reasonable range given the investment strategy adopted by the NATS Section and the assessed employer covenant strength*"
- The Trustee took advice from appropriately appointed actuaries throughout the course of the valuation
- The Trustee agreed to a deficit repair period of nine years, compared with an average recovery period of just 3.6 years for schemes with a strong employer covenant, which is clearly beneficial to airspace users *[Source: Aon In Depth September 2022 covering Tranche 16 valuations]*

Hence the 2020 valuation of the NATS Section complied with the requirements of paragraphs 5, 6 and 7 of the RPS.

The Trustee has not had sight of NERL's benchmarking under paragraph 8 (and would not expect to have done so), but the subsequent benchmarking by GAD has demonstrated the reasonableness of the assumptions by reference to the wider universe of schemes operating in commercial and competitive environments.

By contrast, as explained above, neither GAD nor the CAA has demonstrated how it could be considered reasonable to use a discount rate at the 85th percentile of all schemes in TPR's analysis, taking into account the specific circumstances of the Section (investment strategy, employer covenant strength, size, maturity, etc).

If the commitment given by the CAA in paragraph 22 of the RPS can no longer be relied upon this damages the Trustee's confidence in the covenant of NERL. A consequence of this will be the need to revert to more prudent technical provisions assumptions and to repair any future deficits over shorter periods, leading to materially higher costs to airspace users. This is what the publication of the RPS was intended to avoid.

NERL financial flexibility

The Trustee's primary duty is to the Section's members. In responding to this duty, as noted above, the Trustee is governed by the Trust Deed and Rules of CAAPS as well as by pensions law and guidance. As such, there is a range of factors the Trustee is required to take into account in agreeing with NATS the appropriate level of contributions to be paid to the Section, whilst being mindful of the impact on the sponsor. As set out above, the Trustee believes that the 2020 valuation assumptions and the resulting contributions are within the "*reasonable and efficient*" range targeted by the CAA in the RPS, a view endorsed by the GAD in paragraph 6.1 of its report. The Trustee is concerned that the practical implication of the CAA's proposed approach is to seek to impose an arbitrary valuation outcome on the Trustee, thus reaching beyond its regulatory remit.

Furthermore, the Trustee is concerned by the additional strain that the CAA's approach could put on the financial flexibility of NERL and its ability to respond to downside traffic volume scenarios and more extreme events such as another pandemic.

By way of example, to the extent that the current valuation assumptions were maintained at the next valuation, the CAA's base case proposal would require NERL to fund an expected additional £95M of ongoing and deficit contribution costs. The additional contributions would add an estimated 2%-3% each year to gearing levels (measured on a net debt/RAB basis), or 7%-8% over the 2025–2027 period.

Based on the CAA's low case, which itself undermines the outcome of the 31 December 2020 valuation which the RPS was intended to support, if the contributions to be funded by NERL were funded entirely by debt, the addition to gearing over the period would be an estimated 12%-13%. If the valuation assumptions were to be set more prudently at any future valuation, and/or if traffic outcomes were worse than envisaged, the impact on NERL's financial flexibility would be even greater. This could in turn have implications for NERL's longer term financeability as envisaged under the Transport Act 2000.

We note that if gearing levels were to be maintained to ensure financial flexibility, the CAA's Base Case and Low Case would absorb most or all of the proposed dividend. If this were perceived to be a risk over the longer term, it may also affect the ability of NATS to raise equity to support NERL over the longer term.

In summary, and as demonstrated by the points made in this letter:

- The Trustee remains confident that CAAPS' current pension costs are both reasonable and efficient
- By contrast, the arbitrary assumptions and resulting pension costs illustrated by GAD and adopted by the CAA do not appear to have appropriate regard either to the specific circumstances of the Section or to the requirements of pensions law and TPR regulation by which the Trustee is governed
- The covenant of NERL, and hence the perceived long-term reliability of the regulatory pricing framework in relation to pension costs, remains the key factor in keeping those costs to a minimum

I therefore strongly urge 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.

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