ANNEX 3

Mitigating actions taken to manage cost risk

a. Ex ante mitigations

A number of actions were taken by the company before RP1 to mitigate the impact of pension costs to users as follows:

Pension reforms undertaken in 2009

NERL was proactive in mitigating the rising cost and risk of the scheme through the following actions:

- The defined benefit pension scheme was closed to new joiners with effect from 31 March 2009 (for legal reasons the scheme cannot be closed to staff who were members prior to that date).
- From 1 January 2009, annual increases in pensionable salaries were limited to a maximum increase in the retail price index (RPI) plus 0.5%.
- A lower cost defined contribution scheme was also introduced for new joiners;
- Pension salary sacrifice arrangements were introduced with effect from 1 April 2009 in order to save employer national insurance taxes, which reduces the overall cost of providing pension benefits.

The financial benefits of the changes to the pension arrangements introduced in 2009 arise over time due to both the lower cost of pension provision for new employees (under defined contribution arrangements) and lower contribution requirements for the existing pension scheme due to a direct improvement in the funding position. This improvement in funding position was reflected in the Trustees' 2009 valuation and directly impacted on the assumptions made for RP1. The financial benefits of the reforms to customers compared to the position beforehand were estimated by NERL to be worth c. £200m over the 5 years 2011 to 2015 and a further c. £600m in the ten year period beyond from 2016, although these figures will vary depending on market conditions.

These very difficult and sensitive reforms without a significant cost and with no disruption to the airline industry from major industrial action through NATS policy of Working Together with the staff and unions.

Influencing Trustees 2009 valuation assumptions and its investment strategy

- The company held four consultation meetings with Trustees and /or their advisors during which all assumptions have been exhaustively reviewed from first principles.

- The company's aim has been to ensure that whilst Trustees' legal responsibilities are met, the package of assumptions agreed are not more prudent than is required.

- Encouraging Trustees to introduce an investment policy and strategy to progressively de-risk the defined benefit pension scheme;

Operating cost efficiencies to mitigate pension costs

Notwithstanding the reforms, the company also recognised that the costs of the defined benefit pension scheme in RP1 would continue to be significant and subject to volatility due to external factors. For this reason, and to help mitigate the impact of rising pension costs on the unit rate, in 2006 to 2010 the company reduced its underlying operating cost base by £45m from previously planned levels and also put forward further operating cost efficiencies in CP3/RP1.

Pension entitlements

- NERL has made no benefit improvements since 2001 (the year of the PPP) which would increase the cost of pensions, and nor does it intend so to do in future. Benefit improvements are completely incompatible with NERL's long term strategy. This is evidenced by the closure to new joiners of the defined benefit pension scheme.

b. Mitigating actions during RP1

During RP1 the company responded to the unforeseen change in financial market conditions with the following mitigations:

Pension reforms undertaken in 2013

In response to the deterioration in financial market conditions in 2011, a mitigation plan was developed in 2012 to ensure that the burden would not fall on any single group of stakeholders and that any residual impact on customer charges represents only those unavoidable increases after all other mitigations are applied to the extent practicable.

The main actions included:

- A re-negotiation with trades unions of a reduction to the cap on the increase in pensionable pay introduced in 2009. This limits the increase in pensionable pay to CPI + 0.25% (compared with RPI + 0.5% previously). This had the benefit of reducing the size of the funding deficit when the Trustees performed their 2012 valuation;
- A recommendation from the company, supported by its trades unions, to the pension scheme's Trustees that the indexation of future service benefits be linked to CPI instead of RPI. This reduced the future service cost from 36.7% to 29.4%; and
- Consultation with Trustees to establish funding assumptions for the 2012 valuation which ensure affordable contributions through the remainder of RP1 and RP2 taking account of the strength of the employer's covenant, the long-term nature of pension provision and the unusual market conditions today. These contributed to both a reduction in the funding deficit and to lower cash contributions during the RP2 period.

Following the actions taken above, the company has been able to limit the impact of the deterioration in market conditions and so avoid higher pension costs and real increases in customer charges during RP2. The reduction of the cap on pensionable pay increases and future service indexation avoids cost increases in RP2 of £200m.

Influencing Trustees 2012 valuation assumptions and its investment strategy

NATS and Trustees implemented a liability driven investment (LDI) programme in 2012 in order to hedge the impact of changes in inflation and interest rates on the value of the scheme's obligations, which are sensitive to inflation and movements in yields in the gilt market. The strategy includes establishing trigger levels which define the rates of interest and inflation rates at which hedging transactions will be executed. In addition, and as an acceleration of the existing strategy, NATS and the Trustees agreed during 2014 to increase the level of hedging of interest rates and inflation to 50%, as measured on the Trustee funding basis. Swap transactions are executed with carefully scrutinised banks and collateral is provided in the form of index-linked gilts to protect against the unlikely event of default by a counterparty bank.

At NATS' request, Trustees have also considered further de-risking over time to protect the scheme from the impact of volatility in the value of return-seeking assets. This would involve progressively converting from return-seeking assets into hedging assets to increase the level of matching of the scheme's liabilities. As changing the mix of assets changes the returns achieved, this would impact on contributions payable. The strategy will aim to maintain an appropriate balance between the potential impact on contributions and the reduction in volatility of return-seeking assets, and therefore reduced investment risk.