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7 January 2019

Dear Richard

Regulatory Policy Statement on NERL's Pension Costs

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

At our recent meeting we discussed the possibility of the CAA issuing a Regulatory Policy Statement (RPS) along the lines of the draft included in Appendix O to NERL's Business Plan published on 26 October 2018. You asked the Trustee to place an estimated value on the existence of such an RPS in order to justify the resource commitment needed from the CAA to pursue this.

In my letter to you of 26 May 2017 I explained why confidence in the future treatment of pension costs within the CAA's economic regulation of NERL is so critical to the Trustee. A copy of that letter is enclosed for convenience. Although the arguments from my earlier letter are not repeated in full here, the key points can be summarised as follows:

- The size of the NATS Section of CAAPS is many times the size of NERL's 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, a position we understand is highly unusual amongst regulated industries*.
- To date, this framework has enabled the Trustee to regard the sponsor covenant supporting the Section as strong, both now and over the longer term, enabling a much less prudent approach to investment and funding than could be justified with a covenant comprising NERL's assets alone.
- This brings economic benefits to NERL (and, in turn, to airspace users) in the form of both lower expected ultimate pension costs and lower short-term cash funding requirements than would apply with a weaker sponsor covenant.
- At the 31 December 2015 valuation of the Section, the technical provisions deficit of £459m corresponded to a solvency deficit of some £4.7bn, so the economic benefit derived from the assumption of a continued strong covenant over the long term is very large indeed. (The corresponding figures at the 31 December 2017 valuation were £270m and £3.1bn, so this message is unchanged.)

*This point is illustrated very clearly in the attached charts prepared by the Trustee's covenant advisers, previously shared with you in May 2017.

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The proposal for an RPS has gained increased significance in light of the current political uncertainty, including in particular the potential longer-term implications of Brexit. For example, the Trustee now understands that the continued application of the EU's Single European Skies Regulations to NERL is unclear and that, even if these Regulations do continue to apply, the UK is likely to lose any influence in their future development. This undermines the Trustee's confidence in the continuation of a stable and predictable regulatory pricing framework with respect to pensions over the long term, and hence the Trustee's view of the sponsor covenant.

The Trustee's covenant advisers consider that such a weakening of the regulatory framework covering NERL's pension costs could readily result in a one-notch downgrade of the sponsor covenant, in the context of the Pensions Regulator's four-notch covenant scale. Whilst this is not an exact science, the Trustee's actuarial advisers consider that this could clearly justify a 25bps reduction in the Trustee's long-term return target for funding and investment strategy, given the relative sizes of the NATS Section (with a £3.1bn solvency deficit at the latest valuation) and NERL's own assets.

The RPS principles proposed in NERL's Business Plan would provide meaningful reassurance to the Trustee. An RPS in the form proposed would enable the Trustee to retain more confidence in the continued strength of the sponsor covenant in the face of the current political and regulatory uncertainty.

Our advisers have estimated that a 25bps variation in the return achieved over the long term would affect the present value of assets expected to be needed to pay the benefits of the Section by around £400m as at 31 December 2017 (with this differential reducing over time as the scheme matures). Notwithstanding the uncertainty inherent in projecting the covenant, investment and funding impacts of potential future events, this figure would therefore be a reasonable estimate from which to determine the "value" of the proposed RPS for NERL and airspace users.

Please contact either myself or CAAPS' Interim CIO, John Stannard, if you have any questions about this letter.

Yours sincerely



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

Encs: Joanna Matthews' letter of 26 May 2017 to Richard Moriarty
Penfida "NERL Covenant Benchmarking" presentation of May 2017
cc: Lynette Hilton, Scheme Secretary
Philip Kenley, Chief Operating Officer
John Stannard, Interim Chief Investment Officer