Appendix K: Cash pensions

NATS has three pension arrangements:

- **Defined benefit (DB) scheme:** Pensions are provided through the CAA Pension Scheme (CAAPS) defined benefit scheme. This has been closed to new members since 1 April 2009
- **Defined contribution (DC) scheme:** For new staff from 1 April 2009
- **Pension cash alternative (PCA):** This is offered as an option to members of both the DB and DC schemes in the event that they choose to defer membership or opt completely out of the schemes for tax or other reasons following independent financial advice. In reality, the vast majority of staff who opt for the PCA are from the DB scheme

Our NR23 cash pension costs and underlying percentage of pensionable pay assumption for total NERL are shown in the table below.

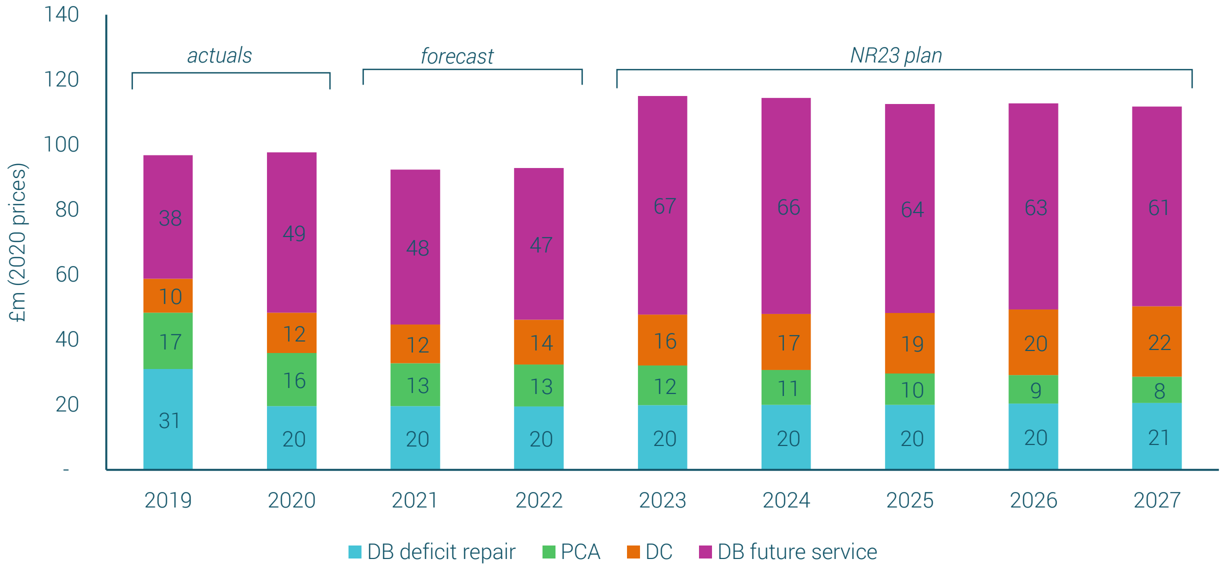
CY, 2020 prices, £m	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Actual	*Actual*	*Forecast*	*Forecast*	*NR23 plan*	*NR23 plan*	*NR23 plan*	*NR23 plan*	*NR23 plan*
Defined benefit									
Future service	*38*	*49*	*48*	*47*	*67*	*66*	*64*	*63*	*61*
Deficit repair	*31*	*20*	*20*	*20*	*20*	*20*	*20*	*20*	*21*
Sub total: defined benefit	69	69	67	66	87	86	84	84	82
Defined contribution	10	12	12	14	16	17	19	20	22
Pension cash alternative	17	16	13	13	12	11	10	9	8
Total cash pensions	97	98	92	93	115	114	113	113	112

Cash pension projections

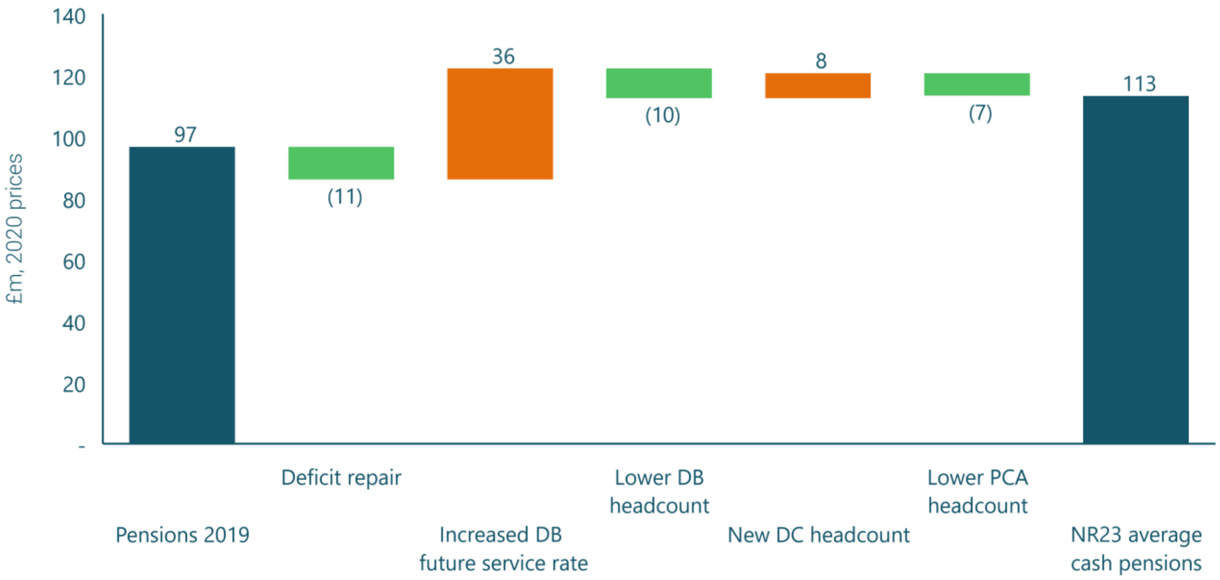
% of pensionable pay	2019	2020	2021	2022	2023	2024	2025	2026	2027
	Actual	*Actual*	*Forecast*	*Forecast*	*NR23 plan*	*NR23 plan*	*NR23 plan*	*NR23 plan*	*NR23 plan*
Defined benefit									
Future service	*32%*	*42%*	*42%*	*42%*	*66%*	*66%*	*64%*	*64%*	*63%*
Deficit repair	*26%*	*16%*	*17%*	*18%*	*20%*	*20%*	*20%*	*21%*	*21%*
Sub total: defined benefit	58%	58%	59%	60%	86%	86%	85%	85%	85%
Defined contribution	15%	16%	16%	16%	16%	16%	16%	16%	16%
Pension cash alternative	28%	28%	28%	28%	29%	29%	29%	29%	29%
Total cash pensions	39%	38%	39%	38%	47%	46%	44%	43%	42%

% pensionable pay contribution assumptions

The values in the table above reflect our latest actuals/forecasts for DC costs and the PCA for the three years of RP3 (2020-22) and the plan for NR23 (2023-27). The costs of the defined benefit scheme for 2020 to 2022 reflect the CMA determination. Savings in costs from the level assumed in the CMA determination are included in the regulatory pension pass through mechanism The voluntary redundancy programme has delivered around £15m of cash pensions savings in the 2020-22 period, relative to the RP3 plan, and has also resulted in lower DB scheme FTEs going forward. Despite this, cash pension costs are around £17m pa (17%) higher across NR23 than 2019 actuals. This is driven by material adverse changes to financial market conditions for the DB scheme, albeit this has been significantly mitigated via NATS negotiation and CAA's regulatory policy statement (RPS). The underlying net impact of those adverse changes is illustrated in the charts below, with further detail provided in the remainder of this appendix.



Evolution of cash pensions, 2019 - 2027



Average NR23 cash pensions vs 2019 actual cash pensions

Defined benefit scheme

NATS' final salary pension scheme was established prior to Public Private Partnership (PPP) and closed to new members on 1 April 2009. As outlined in previous price control reviews, members benefit from significant protections in the trust deed and rules, including a no decrement clause and HM Government's (HMG) Trust of a Promise (ToaP). We have taken several steps to mitigate the cost of the DB scheme; most recently in 2018, the company sought legal advice on the lawfulness of changes to this scheme to mitigate increasing costs. Counsel concluded that the 'no decrement' clause prevents any reduction in previously accrued or prospective benefits to members and prevents any increase in member contribution rates. These protections were further reinforced at PPP through the ToaP undertaking given by HMG. A summary of the actions taken since 2009 to mitigate the cost and risk of the DB pension scheme is set out below.

The scheme had 1,635 active members on 31 December 2020. During 2016/17, more than 900 members deferred their membership or transferred out to take advantage of the PCA. This reduced assets and liabilities by £1.7bn, significantly de-risking the scheme. The PCA is less costly and lower risk than the costs of ongoing future service accrual. Both benefit customers in the form of lower future prices.

Developments since the RP3 business plan

In its policy update CAP 2119[1], the CAA published an RPS to provide clarity to NERL and trustees on the future regulatory treatment of pensions. As a result, and following robust challenge by the company, in their latest triennial valuation (31 December 2020) trustees agreed to:

› change their approach to the discount rate which reduced scheme liabilities by £280m

› exend the deficit recovery by three years which defers payment of around £60m until 2028 and 2029

› use best estimate CPI inflation assumptions which, combined with the discount rate approach, reduces future service costs by around £23m over the NR23 period

The final outcome of the valuation was a deficit of £172m (a funding ratio of 97%) and an employer future service cost of 66% from 2023. The funding deficit represents a reduction of £98m from the 2017 valuation but, significantly, is £442m lower than the deficit would have been under the 2017 valuation assumptions. The future service cost is also some six percentage points lower than the 72% equivalent rate it would have been on 2017 valuation assumptions.

The final outcome also represented a very significant improvement on the trustees' initial proposal (a deficit of £455m and future service cost rate of 70%) and was secured following the company's robust commercial challenge to the trustees' level of prudence in the valuation assumptions and the extent of their regard to the RPS. Based on advice from *Mercer*, our actuarial advisor, we are satisfied that the assumptions underlying the 2020 valuation are in line with market practice and represent a very positive outcome for customers which reflects the benefit of the RPS within a broadly stable and well understood regulatory framework.

We have continued to discuss an appropriate long-term funding target and associated long-term investment strategy with trustees. The trustees agreed to the use of a term-dependent discount rate for the 2020 valuation, as opposed to the previous pre- and post-retirement discount rate structure (with the post-retirement discount rate set at gilts + 0.25%) which is consistent with our preferred approach to fund the scheme on a long-term lower-risk basis. This reduces the chance of deficits

[1] CAA, Economic regulation of NATS (En Route) plc: Update on approach to the next price control review, CAP2119, March 2021

emerging in the future, and is more cost effective than the alternative de-risking approach of a pension buy-out.

NR23 plan

Our projected contributions for NR23 represent NERL's portion of the NATS group scheme (c75% share). This uses our cost allocation model which was reviewed in February 2019 by CAA-appointed consultants for the RP3 price control review[2].

Deficit payments are spread over a nine year recovery plan ending 31 December 2029, which is the recovery period agreed following the 2020 valuation.

However, the significant reduction in real interest rates since the 2017 valuation, which are driven by external financial market conditions, has had the effect of increasing the cost of future benefit accrual for CPI-linked benefits. Overall, future service costs have increased to 66% of pensionable pay from 42% at the 2017 valuation.

Actions taken to mitigate the cost and risk of the defined benefit scheme

The legal protections, provided in the trust deeds and rules and the ToaP, prohibit many of the actions available to other companies to control the costs of defined benefit schemes (eg increasing employee contributions or closing the scheme to existing members). We have however taken all reasonable actions available to us to mitigate the cost and risk of NATS' scheme. In combination, these actions (listed below) have significantly reduced the adverse impact of current financial market conditions, thereby avoiding materially higher pension costs in NR23 and beyond:

- Scheme closure to new entrants: since 1 April 2009, some 1,406 new NERL staff have joined the defined contribution scheme (at 31 December 2020) following the closure of the defined benefit scheme
- Pensionable pay:
    - increases capped at RPI + 0.5% until 2013 and then CPI + 0.25% until January 2024
    - no negotiated pay awards during the Covid-19 pandemic to date, including suspension of the 2020 pay award
    - 153 NERL scheme members left the business as part of the redundancy programme in 2020 which avoids the accrual of future liabilities for these staff
- Indexation of liabilities: trustees agreed to index annual pension increases by CPI rather than by RPI for service earned after 1 November 2013
- Pensionable pay rise assumptions: trustees agreed to adopt annual pay increase assumptions for the calculation of future liabilities in the December 2020 valuation, based on CPI rather than CPI +

[2] CEPA 2019, *NERL's Cost Allocation and Non-Regulatory Income Forecasts*

0.25%. The same was done for the December 2015 valuation, alongside a reduction in the assumed rate of promotional increases, resulting in a £65m reduction in liabilities

The changes to indexation and the pensionable pay cap avoided cost increases in RP2 of around £200m. Further, we previously estimated that the changes made to the scheme in 2009 resulted in avoided cost increases of around £600m over the ten-year period from 2016

- Pension cash alternative: introducing a PCA for staff opting out of the DB scheme currently reduces pension costs to a fixed 28.5%[3] of pensionable payroll compared to 66% for future accrual in the scheme from 2023 (based on the 2020 valuation). The number of opt-outs in 2016/17 saves over £10m pa from 2020 and has de-risked the scheme by reducing assets and liabilities (see above). Future transfers out will depend on government pension policy and legislation, tax treatment and financial market conditions, but if more staff do take that step during NR23, customers, not NERL, will benefit through the pass-through mechanism

- Transfer values: ensuring that trustees' calculation of cash equivalent transfer values is based on best estimate assumptions

- Scheme governance: continuing to ensure good governance and stewardship of the scheme through the efforts of our nominated trustees, including input to the scheme's investment strategy which has helped reduced the exposure to return-seeking assets and increased hedging of the real interest rate exposure. The latter alone has resulted in a deficit that is £440m lower than it would have been

- Shareholder assurances: alongside the CAA's RPS, the NATS Board strengthened its employer covenant which enabled trustees to change to a term-dependent discount rate for the 2020 valuation

- Deficit repair plan: this has been extended by three years to 2029 to reflect the RPS and the improved funding position. As a result, deficit repair contributions over NR23 will be around £60m lower than they would have been had the end date of December 2026 been maintained. This proposal is more affordable to customers, and also reduces the risk of a trapped surplus (see below)

- Trapped surplus risk: we mitigate this risk by ensuring that the trustees' valuation assumptions are not overly prudent and deficit contributions are spread over a sufficiently long period to reduce the chance of this arising ahead of the next scheduled valuation. If a surplus on the scheme arises in future, we will work closely with trustees to ensure that an appropriate balance is struck between using this opportunity to de-risk the scheme towards an appropriate long term investment strategy and reducing the projected level of future pension contributions which in turn would reduce prices to customers. Having a measured and balanced approach to de-risking and contribution reduction minimises the likelihood of a trapped surplus and better reflects the interests of customers. With the company continuing to pay significant contributions to cover staff benefit accrual, there remains the opportunity for normal contributions to be paid at a rate less than the cost of benefits to reduce any surplus over time. NERL has a track record of reaching such agreements with trustees (for example, in years 2001 to 2010). The reduction in contributions payable over NR23 as

[3] The contribution will increase to around 29% from 2022, following UK government policy to increase employeers national insurance contributions by 1.25pp.

a result of lower deficit and longer recovery plan negotiated by the company also acts to reduce the risk of a trapped surplus arising, as does the increase hedging implemented by the Trustee and agreed by the company

We have also taken actions to engage other stakeholders on the following matters outside of our control:

- **Statutory override:** consulting the Secretary of State for Transport, in their capacity as a shareholder of NATS, on implementing the statutory override provisions introduced by HMG in RP2. These were intended to enable benefit or contribution changes to offset cost increases following the cessation of the contracted-out national insurance status of all UK defined benefit schemes. The circumstances under which a fair balance of cost and benefit between employer and employee was intended to be restored by the override applied fully to our scheme. However, protections introduced at PPP meant that the override could not be applied without shareholder consent. We were disappointed to be advised that consent was not granted, barring us from passing some of the employer national insurance costs to scheme members who stand to benefit from the introduction of the higher flat rate state pension. The benefit that this change would have obtained had we been permitted to apply the override has, however, since been reduced by the large number of active members who transferred out of the scheme, as explained above

- **Indexation of past service liabilities by CPI:** given the extensive mitigations of scheme costs described above, the potential for aligning the inflation index for all scheme liabilities by adopting CPI for past service (ie service accrued before 1 November 2013), not just for future service liabilities (which are already indexed by CPI), is the last realistic option for further long-term cost mitigation, given the protections from PPP by which we are constrained. Agreements negotiated in 2013 with staff that mitigated the cost and risk of the scheme preclude a formal request to the trustees by the company. Having said that, the trustees have a policy of reviewing indexation for the scheme and could choose to implement a change to CPI indexation. However, given the improved funding position since the 2017 valuation, and assuming no further material deterioration in market conditions, it is very unlikely that the Trustee would look to pursue this option or that there would be any grounds for the company to put forward a formal request to the Trustee to change indexation further before 2024. Furthermore, the HMG's proposal to reform and align RPI with CPIH (a measure of CPI which includes housing costs) from 2030 provides mitigation against the cost of RPI-linked benefits and the increase in the level of real interest rate hedging has reduced the inflation risk associated with these benefits

Regulatory considerations

Our prices for NR23 will include true-ups for pension pass-through adjustments relating to RP1 and RP2, which have already been approved by the CAA (and the European Commission while the UK was part of the European Union), with recovery expected over the same period as regulatory depreciation, ie 15 years.

Defined contributions

Since the closure of the DB scheme to new entrants in April 2009, we have provided a DC scheme to new employees which is significantly less costly than the scheme it replaced. We pay employer contributions that match employee contributions on a 2:1 basis up to a maximum employer cost of 18% of pensionable salary. We are not exposed to costs beyond this level. In practice, the average cost is 16% of pensionable salary, and this is the basis for our projections.

NERL's DC benefit should be viewed relative to the cost of the DB scheme it replaced and considered as part of the overall remuneration package, as well as against wider market practice. The closure of the DB scheme followed very difficult and protracted negotiations with trade unions over a three year period, and was agreed without industrial action or other service disruption that was of significant benefit to customers. Critically, the scheme provides a competitive benefit consistent with attracting and retaining NERL's technically skilled and professional workforce, while also enabling the significant investment made in training air traffic controllers to be recovered and efficiently incurred.

There were 1,406 company members of the scheme at 31 December 2020. The size of the scheme and its membership will continue to increase during NR23 as new joiners replace leavers and retirees who were members of the DB scheme.

Pension cash alternative

The PCA is offered as an option to members of both the DB and DC schemes in the event that they choose to defer membership or opt completely out of the schemes for tax or other reasons following independent financial advice. The alternative is 25% plus ERNIC for employees opting out of the DB scheme, and 15% plus Earnings Related National Insurance Contributions (ERNIC) for employees opting out of the DC scheme. In reality, the vast majority of staff who opt for the PCA are from the DB scheme.

Further details on the regulatory mechanisms associated with the PCA are provided in Appendix P.