UK Pensions Briefing: Covenant strength and deficit funding: The curious case of the Railways Pension Scheme

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Introduction

The impact of a good overall covenant on the funding requirements of a defined benefit pension scheme and the ability for a deterioration in the covenant to result in a sharp spike in funding liabilities cannot be underestimated. This briefing looks at the case study of the Railways Pension Scheme to illustrate this.

For those not familiar with rail franchises...

The UK passenger rail network is split into long-term franchises for defined areas, which must be retendered from time to time through a complex public procurement process.

As part of winning the franchise, the train operating company (TOC) must take responsibility for the pension liabilities of the employees of that franchise, via participation in a section of the Railways Pension Scheme.

For those not familiar with the Railways Pension Scheme...

The Railways Pension Scheme has its origins in the rail privatisation legislation and is an industry-wide scheme providing defined benefit pensions and defined contribution accounts. The defined benefit part is sub-divided into standalone sections for different TOCs, plus an omnibus section which has many different sponsoring employers. This case study focuses on the standalone sections which effectively operate as individual pension schemes.

One unusual feature of the RPS standalone sections is that they are "shared cost sections". In other words the total cost of contributions to fund the section is shared with employees. As a general rule contributions are payable 60:40 by the TOC and the employees, although an individual employer could choose to pay more. As a result, if the funding requirements for a section dictate an increase in contributions, employee contributions have to increase too.

Playing musical chairs with pension liabilities

Pre-privatisation railway employees were given special pension protection on privatisation. As a result, franchise agreements require the TOC to become a "Designated Employer" (i.e. sponsoring employer) for the relevant section of the RPS. That means paying the employer's share of pension contributions. If the TOC's payments are up to date at the end of the franchise period, the franchise agreement releases the TOC from any further liability to the RPS.

As a result, the burden of funding any deficit falls on whichever TOC has the franchise when the deficit is identified. So it's a game of musical chairs, but with a twist. The importance of the rail network to the UK means that the government is expected to step in to take on the liabilities of any TOC which goes under (the "operator of last resort"). So the government could find itself sitting in the last chair for pension liabilities instead.

This led to an assumption by the RPS trustee that, despite the absence of a formal Crown Guarantee, the government would be standing behind the TOCs and the RPS. That allowed the trustee to take a rosy view of the wider employer covenant backing each section, and to be much more relaxed about the rate at which individual TOCs were required to make up the funding deficit in their sections.

Where did it all go wrong?

In 2014 the Pensions Regulator wrote to the Department for Transport questioning whether it was reasonable to fund the RPS on the assumption of "very long-term Government support which will cover all downsides". The DfT confirmed that there wasn't a Crown guarantee and that the DfT did not underwrite the TOCs' pension liabilities. That left the Pensions Regulator looking at the TOCs in their own right.

TOCs are typically relatively thinly capitalised special purpose vehicles established either by individual parent companies or consortiums. TOCs therefore represent a much lower level of financial backing to the pension scheme than a Crown guarantee.

Since then, the Pensions Regulator has been engaging with TOCs and the RPS trustee over its mounting concerns over covenant strength (weaker without the government guarantee), investment (overly risky and optimistic), funding (insufficiently prudent given the last two), and recovery periods (way too long). The Regulator has estimated that the weakening of the overall covenant strength leaves the overall funding deficit as at December 2016 at around £7.5 billion, although the spread across the individual sections is not uniform.

So far, the RPS's 2016 actuarial valuation has still not been approved and the Pensions Regulator has not accepted the only formal funding proposal put forward by the Rail Delivery Group.

Commercial effect

The effect of the Pensions Regulator's intervention has been to transform what had previously been thought to be stable sections operating with a sufficiency of assets into sections that would be in deficit and would require significant additional funding over a much shorter timeframe.

The DfT recognised the issue, and, for the three franchises which came up for tender in 2019, offered a pensions risk-sharing mechanism in the pensions section of the proforma franchise agreement. In essence it provides defined but limited protection against deficit recovery contributions (DRCs) arising from any recovery plan which may be agreed in connection with the 2019 valuation. There is no protection for any pension costs arising out of the 2016 valuation, and no protection against future service contributions. Finally, it doesn't offer any protection against additional DRCs (over and above the levels arising out of the 2019 valuation) which might arise out of the 2022 or subsequent valuations.

To cut a long story short, Arriva, Stagecoach and WCTP (a consortium of Stagecoach, Virgin and the French group SNCF) each chose not to commit to the new pension terms in their bid documents, and to try to open up discussions around alternative risk sharing arrangements. After careful consideration the DfT decided to disqualify those bidders who did not accept the pensions terms, and that decision was upheld by a High Court judgment on June 17, 2020.

So where are we now?

As far as anyone can tell, discussions with the Pensions Regulator have not ended. However, there are also other moving parts including emergency measures agreements (EMAs) initiated in response to COVID-19 which may have put regulatory action on the back burner temporarily. The press is rife with discussion about potential continuation of the EMAs well into 2021 and speculation that the government will have to extend them indefinitely, or renationalise the franchises. It is a case of "watch this space" for now regarding how the pensions problem will be resolved.

Comment

The Railways Pension Scheme case study demonstrates the significant increase in the funding deficit which can occur due to a change in covenant strength. It also demonstrates the dangers of incorrectly estimating a sponsoring employer's covenant strength and the intervention from the Pensions Regulator which is likely to result.

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