I write in response to your letter of 24 April 2019 regarding the Railways Pension Scheme (the “RPS”) and Train Operating Companies (“TOCs”).

I was delighted to announce in the House on Wednesday 10 April that, in line with our specification, Abellio East Midlands is the successful bidder to operate the next East Midlands rail franchise. It will be responsible for delivering new trains, smart ticketing and more frequent services for passengers. Passengers in the East Midlands are to get reduced journey times, over £17 million of investment in stations facilities, including accessibility improvements, and free wi-fi throughout the franchise both on trains and at stations as Abellio takes over the franchise from August 2019.

Abellio will invest £600 million in the new franchise, while the Government continues with its £1.5 billion upgrade to the Midland Main Line—the biggest upgrade to the line since it was completed in 1870. This is part of the Government’s £48 billion investment to modernise our railways over the next five years.

As I informed the House in my written statement, Abellio was successful following a rigorous, fair and open competition. Abellio provided the best bid in which it demonstrated that it will not only meet but exceed the Department’s specifications. Stagecoach chose to put in a non-compliant bid,
which resulted in its disqualification in line with the terms of the published invitation to tender. Stagecoach has played an important role in our railways, and we hope it will continue to do so after the conclusion of the Rail Review. However, it is entirely for Stagecoach and its bidding partners to explain why it decided to ignore established rules by rejecting the commercial terms on offer.

In response to each of your specific questions (using your numbering and lettering):

1. 
   a. Since franchising arrangements were first introduced in 1994 TOCs, as the designated employer, have been, and continue to be, responsible for paying any employer pension contributions to their own Section(s) of the RPS during a franchise term, according to a schedule of contributions calculated by the Scheme Actuary following each triennial valuation. This includes any contributions payable to address a deficit. An employer’s obligations to pay contributions are set out in both the governing documents of the RPS and are a statutory requirement by virtue of Part 3 of the Pensions Act 2004. The Department anticipates that this will remain the case. The Department has not placed any new or additional pensions demands on new franchisees because the pensions terms of the franchise agreement have remained largely unchanged. The changes made to franchise agreement terms in the latest competitions actually improve on the terms for franchise bidders by sharing risk on changes to deficit recovery contributions following the next actuarial valuation, thereby reducing the financial risk to franchisees from the position they would otherwise have been in.

   b. Rail franchise Passport holders, and incumbent TOCs, were informed of The Pensions Regulator’s (TPR’s) investigation in October 2017. RDG, on behalf of owning groups, was also aware of the issue and are taking a lead on the development of a solution. The owning groups who were shortlisted, and bid for, the East Midlands franchise were therefore well aware of TPR’s concerns. At my officials’ request, the Scheme Actuary produced an illustration, applying TPR’s expectations, of the potential scale of the deficit in the East Midlands section of the RPS as at the effective date of the 2016 valuation, and this was first shared with bidders on the East Midlands franchise in July 2018.

   c. Shortlisted bidders for the East Midlands franchise were aware of the TPR’s concerns in advance of issue of the Invitation to Tender
(the “ITT”). In line with standard procurement practice, a number of items were discussed with bidders at various points during the procurement of the East Midlands franchise. In the East Midlands competition, the Department received feedback, some of which included concerns over the pensions issue, from all of the bidders ahead of the release of a set of focussed rebid instructions that covered pensions as well as other issues. Following the release of these instructions in October 2018, which included details of the risk sharing mechanism (the change to the Franchise Agreement described at 1 (a)) one bidder raised concerns to the East Midlands project team.

2.

a. The Stagecoach bid was non-compliant with subsection 4.1.2 of the East Midlands ITT which states that ‘The Department expects to receive Bids that contain no qualifications. Bidders shall not propose amendments to the Franchise Signature Documents (other than to fill gaps denoted by the drafting note 'Bidders to populate'), including by proposing their own Secretary of State Risk Assumptions or any other contractual amendments which seek to transfer risk from the Franchisee to the Secretary of State. For the avoidance of doubt, any failure by a Bidder to comply with the requirements of this subsection 4.1 shall mean that the Bid is deemed non-compliant, and the provisions of subsection 3.5 (Non-compliant Bids) of this ITT shall apply’.

Since the bid was non-compliant in proposing amendments to the Franchise Agreement terms, seeking to transfer risk from the Franchisee to the Secretary of State, it was dealt with in accordance with the process defined in subsection 3.5 of the ITT (which deals with the treatment of non-compliances in bids).

b. On 21 November 2018 Stagecoach submitted a bid which included a non-compliance statement in which Stagecoach admitted that the bid was non-compliant with the ITT. The Department then completed its evaluation process, confirming in writing on 9 April 2019 that Stagecoach was non-compliant and that, as a consequence, its bid was disqualified.

The Department did not take this decision lightly, but ultimately the Department has to treat all bidders in a competition fairly. A bid that complied with the Department’s clear instruction with respect to the allocation of pensions risk would have taken into account the bidder’s considered view of their risk exposure. In view of the Department’s duties of transparency and equal treatment, and since Stagecoach’s bid was inconsistent with government policy (i.e. on terms we were unable to accept) and
its tendered price could not be compared on a fair basis with other compliant bids, the Department considered it could not properly have come to any decision other than to reject a bid which was non-compliant with the terms in respect of allocation of pension risk, and had we not done so the Department would have run the possibility of being legally challenged by those bidders submitting a compliant bid.

c. Since the Department became aware of TPR’s concerns, it has been in regular contact with RDG and TPR, and has communicated with all TOCs and owning groups on a number of occasions.

As part of the standard franchising procurement process, the Department and the incumbent TOC shared a significant amount of information and data with bidders in order for them to develop their bids. This included recent actuarial valuations as performed by the Scheme Actuary. As explained in response to 1(b) above, the Department actively sourced and provided bidders with the Scheme Actuary’s illustration of the potential impact of applying TPR’s expectations to the draft 2016 valuation.

The Department will continue to engage with key industry stakeholders, and bidders for franchises. Bidders are also able to approach the Trustee to the RPS at any time.

3. The Department has to have regard to its contractual and statutory obligations in respect of the confidentiality of information received from bidders and competition processes that are still live, in accordance with section 145 of the Railways Act 1993 and the Franchise Letting Process Agreement. The South Eastern and West Coast Partnership competitions are both live. However, in an effort to assist the Committees I can confirm that:

a. On 2 March 2018, prior to the original bid submission date for the South Eastern rail franchise competition, the Department issued a letter to bidders clarifying certain expectations of TPR for addressing funding levels of RPS sections. In response to this letter, each of the three bidders set out their concerns, largely in relation to information levels around pensions at that time.

The Committees should note that a re-bid for the South Eastern franchise competition occurred in September 2018 when bidders were invited to re-submit the pensions-specific elements of their bid in the light of additional information. The Committees will note that in terms of non-compliance with pensions risk allocation
requirements Stagecoach’s is the only bid which has been disqualified.

This issue has been a contributing factor to the delay in awarding the new franchise which was scheduled to have occurred toward the end of 2018.

b. In the West Coast Partnership competition, ahead of the release of a set of focussed rebid instructions that covered pensions as well as other issues, the Department received feedback from all of the bidders, some of which included concerns over the pensions issue. Following the release of these instructions in October 2018, which included details of the risk sharing mechanism, two bidders raised queries on aspects of the approach taken. However, the Committees will note that the only bidder which has been disqualified in terms of non-compliance with pensions risk allocation requirements is the consortium of which Stagecoach is a member.

The ITT issued in March 2018 set out a planned franchise award date of ‘May to September 2019’. The current expected date of franchise award of June 2019 is within that window.

The November 2018 start date referred to in the West Coast Partnership Prospectus was extended to allow new ITT consultation and negotiation stages with bidders, reflecting the Shadow HS2 Operator requirements which are unique to the West Coast Partnership.

4.

a. On all previous franchise competitions, the Department has required TOCs to be fully liable for their share of pensions contributions, and for the risk of those contributions changing, during their franchise term (the RPS is a shared cost scheme by which 60% of costs are paid by employers and 40% by employees). This was also the case with franchises let by the Strategic Rail Authority. In practice, what this means is that a TOC (and its employees) needs to meet the contributions payable during the term of their franchise. This includes any increases to future service or deficit contributions that arise during the franchise term. At the end of the franchise term, this obligation passes to the TOC taking over the franchise and the outgoing franchisee is not responsible for any past service deficit that “built up” during the franchise term provided it had paid the contributions that it was required to pay by the Trustee (nor would it benefit from any surplus that had built up). The approach adopted on the East Midlands, South Eastern and West Coast
Partnership competitions means that the TOC will be exposed to no additional risks or demands when compared to current TOCs. Indeed, the risk sharing mechanism agreed across Government and offered on the 3 competitions reduces the financial risk being borne by franchises awarded through previous franchise competitions.

Contributions to the RPS are largely agreed between the Trustee and the Designated Employer (and to the extent this involves changes in employee contributions, employee and Trade Union consultation is carried out).

In developing the East Midlands, West Coast Partnership and South Eastern competitions, the Department had regard to the recommendation in the Brown Review of rail franchising that risk be allocated to the party best able to manage it.

In particular, therefore, the future TOC following these competitions will retain the risks around contributions which cover employees’ pension rights arising from future service.

However, the Department will share with the TOC some of the upside and downside risk of potential changes to total pensions deficit recovery contributions at the next valuation.

This means that a franchisee under a franchise agreement including the new risk share mechanism will be exposed to less risk than it would be exposed to under the contractual terms applying to most current franchises.

5.

a. A valuation of the RPS in 2004 showed it to have a deficit. Concern about rising costs led rail unions and employers to establish an independent Railway Pensions Commission. Its first report, published in 2007, concluded that defined pension provision across major parts of the railway industry was sustainable over the long term if it was made more affordable. Its final report, published in 2008, made recommendations for change.

TPR are the Government regulator of occupational work based pension schemes and operated by, but independent from, the Department for Work and Pensions. TPR first wrote to the Department in 2014 outlining concerns with the funding approach taken by the RPS Trustees for the 2013 valuation of the TOC sections of the RPS.
TPR reviews or investigates these valuations to ensure that they are adopting sufficiently prudent financial assumptions, paying off any deficits in a prompt fashion and not exposing the Pension Protection Fund to excessive risk.

b. The RPS is a large pension scheme with over 100 sections that are managed individually. Generally, there is a section per employer and the funding position of each section is assessed at a triennial valuation. There are 27 sections of the RPS where TOCs are the designated employers.

All of the relevant TOC sections of the RPS are shared cost sections, meaning that the designated employers and the employees both make pension contribution payments into the relevant section. If the contributions for a given RPS section need to increase following a valuation, then the designated employer and employees for that section would increase their contributions. TOCs pay 60% of pension contributions and employees pay the remaining 40%.

The funding position of each section is assessed individually. If there is a deficit in one section of the RPS, and higher contributions are required as a result, it is for the employer and employees of that section only to increase contributions accordingly.

c. All RPS sections are valued on a triennial basis, with the latest valuation having taken place in 2016 (effective date 31st December 2016). The funding position for each section is a matter for the RPS Trustee and the designated employer for that section. As Secretary of State, I am only the designated employer of the BR and 1994 Pensioners Sections), and therefore have no responsibility for the funding of other sections.

The Department does not assess the funding position of RPS sections. This is a matter for the designated employer and the RPS Trustee. TPR, as the government’s independent regulator of workplace pensions, is responsible for monitoring the funding position of schemes to protect members’ pension benefits, reduce the risk of claims being made on the PPF and promote good pension scheme administration.

d. In fulfilling my statutory duty to ensure the continuity of passenger rail services, the Department closely monitors the operational and financial performance of all TOCs.
The Department has considered the extent to which employer contributions may increase as a result of addressing TPR’s concerns, and has factored this in to its assessment of the financial performance of all TOCs.

Pensions costs are a relatively small percentage of a TOC’s revenues and operating costs, and the Department does therefore not consider an increase in pension costs, in isolation, will materially increase the risk of default. This view was informed by work conducted by specialist external financial advisers.

e. To the extent that LNER’s employer contributions are required to increase to address TPR’s expectations, the Department will receive less premium.

f. Pension contributions into TOC sections of the RPS are met by both employers and employees. Due to the shared cost nature of the TOC sections, TOCs cover 60% of pension contributions with employees covering the remaining 40%. Employees and their Trade Unions are consulted by the employers on any proposals that would affect their contributions or benefits.

6. The Department does not take a view on the funding positions of those sections of the RPS where I am not the designated employer as this is a matter for the RPS Trustee and the designated employer for that section.

Given that the Department does not make an assessment of section funding positions, and these figures are not in the public domain, it is not appropriate for me to comment on the size of any deficit associated with RPS sections. The Pensions Regulator has shared information with my officials under section 84(1) of the Pensions Act 2004, but section 82(1)(b) of that Act places constraints on onwardly disclosing that information to others including the Committees. The Trustee are best placed to provide this detail.

7. Any assessment of a shortfall in contributions to the TOC sections of the RPS is a matter for the designated employer and the RPS Trustee. As above, it is not appropriate for me to comment on this.

TPR expect that TOC sections of the RPS, like other defined benefit pension schemes, are managed in a way that meets funding requirements the Pensions Act 2004. The Rail Delivery Group (RDG) have been developing an industry-wide framework solution to meet TPR’s expectations and positive dialogue continues between TPR, RDG and the Trustee.
8. The Department is currently reviewing the rail franchise schedule. The Secretary of State has commissioned Keith Williams to undertake a root and branch review of the rail network, including franchising. Currently contracted franchises and ongoing franchise competitions are outside the scope of the Review (https://www.gov.uk/government/collections/the-williams-rail-review).

Information on each passenger rail franchise for bidders, passengers and stakeholders can be found on https://www.gov.uk/government/collections/rail-franchising

I trust that the above answers all of your questions.

Rt Hon Chris Grayling MP
SECRETARY OF STATE FOR TRANSPORT