Rt. Hon. Chris Grayling MP
Secretary of State for Transport

24 April 2019

Dear Chris,

Railways Pension Scheme (RPS) and Train Operating Companies

Further to your announcement of the award of the East Midlands franchise to Abellio on 10 April (HCWS1502), the Urgent Question from Clive Betts MP on 11 April, the letter from the Work and Pensions Select Committee of 15 April to The Pensions Regulator (TPR), and the letter from Stagecoach to the Work and Pensions Committee, enclosed, our Committees have the following questions.

1. We understand from Stagecoach that the rail industry (through the Rail Delivery Group, RDG) has been in correspondence with the Department to make clear its “very significant concerns” about the current pensions settlement. The context of this is given in a number of press reports, which suggest that TPR wrote in June 2018 to RDG’s lawyers to indicate that the RPS’s deficit had increased from £4.8bn to £7.5bn in three years. Given this:
   (a) Is it your position that bidders for new franchises should take responsibility for the RPS deficit highlighted by TPR in June 2018? If so, do you anticipate that this will remain the Government’s position for any future deficit that might come to light?
   (b) On what date were the bidders for the East Midlands franchise made aware of the deficit? Were the implications of it made clear to them at that time?
   (c) The East Midlands franchise ITT was issued on 7 June 2018. At what point did you receive representations from the bidders for this franchise of their concerns about the RPS liability? How many bidders raised concerns?

2. As regards the disqualification of Stagecoach from the East Midlands and other bids, in response to the UQ on 11 April the Parliamentary Under-Secretary of State for Transport, Andrew Jones, said that: “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”.
   (a) Can you point us to the relevant portions of the ITT with which Stagecoach was non-compliant?
   (b) Mr Jones stated that bidders were invited to bid on the basis of a pension deficit recovery mechanism and that “they knew that at the very start of the process. Stagecoach did not accept it and made some

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1 “Stagecoach rejection shines light on rail pensions funding gap”, Financial Times, 12 April
amendments as it submitted the bid”. Can you explain at what point in the bidding process you decided that Stagecoach was, as far as you were concerned, non-compliant and at what point you notified the company of that fact?

(c) Given the experiences with Stagecoach and the East Midlands franchise, does the Department plan to change how it communicates issues around pensions liabilities to potential bidders for current and future franchises?

3. Given that Stagecoach has also been disqualified from bidding for the new South Eastern and West Coast franchises for due to their position on the pensions issue:
   (a) The South Eastern franchise ITT was issued on 29 November 2017. At what point did you receive representations from the bidders for this franchise of their concerns about the RPS liability? How many bidders raised concerns? Has this issue contributed to the long delay in awarding the new franchise (originally intended to be August 2018)?
   (b) The West Coast franchise ITT was issued on 27 March 2018. At what point did you receive representations from the bidders for this franchise of their concerns about the RPS liability? How many bidders raised concerns? Has this issue contributed to the long delay in awarding the new franchise (originally intended to be November 2018)?

4. In correspondence to us, Stagecoach has said that the Department’s view on pensions is contrary to one of the key recommendations of the 2013 Brown Review into rail franchising, i.e. that the private sector should be asked to accept risk only on issues that it can control and manage. Stagecoach argues that no TOC can control long-term pensions risk given the short-term nature of their franchise contracts.
   (a) Do you agree that long-term pension liability is an exogenous risk that should sit entirely or largely with the public sector rather than the franchisee?
   (b) If you do not agree, why do you take that view?

5. As regards the significant increase in the RPS deficit highlighted by TPR and reported to RDG in June 2018, can you tell us:
   (a) How far back the issue with the deficit goes.
   (b) Whether all current contributors to the scheme – including existing TOCs – are liable to cover these increased costs and how the burden of covering the deficit is shared between the 170+ current contributors.
   (c) Given that sections are valued to different timetables, to what extent you are confident that that you understand the full extent of the problem.
   (d) What assessment the Department has made of whether this additional liability will cause franchises to fall into financial difficulties and whether it increases the risk of default.
   (e) If the taxpayer will have to cover the additional costs of this liability for LNER.

\(^2\) Dates taken from the July 2017 Rail Franchising Schedule
(f) Whether this will affect employee contributions or benefits as well as, or instead of, employer contributions.

6. How many of the current employers in the RPS are in deficit and how much is that deficit for each TOC currently operating a franchise?

7. In its letter to the Work and Pensions Committee, Stagecoach notes that the rail industry has developed a “sustainable and cost-effective solution, which incorporates risk-sharing”. This proposal would see “an additional £500m to £600m in total put into the various sections of the Railways Pension Scheme by train companies over a period of 10 to 12 years”. What is the extent of the shortfall between this proposal and the amount TPR estimates is needed to fund the deficit?

8. In researching the franchising background for this letter, we had difficulties in establishing the franchising schedule, as the last update of the schedule on the Gov.uk website is almost two years old (July 2017). Why has the schedule not been updated and republished? Will you commit to doing so before Parliament rises for the Summer recess?

We would be grateful if you could reply by Wednesday 1 May 2019.

Rt Hon Frank Field MP
Chair, Work and Pensions Committee

Lilian Greenwood MP
Chair, Transport Committee
16 April 2019

Rt Hon Frank Field MP
Chair, Work and Pensions Committee
House of Commons
London
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Dear Mr Field

RAILWAYS PENSION SCHEME

I am writing in connection with your letter to The Pensions Regulator on 15 April, where you rightly express concerns about the substantial deficit in the Railways Pensions Scheme and the need for an urgent solution.

Before discussing the wider issues in detail, I would firstly like to make the position of our own company very clear. We have a strong track-record of supporting the pensions of transport workers across all of our operations. We have met all of our commitments on employer contributions and we have also worked closely with pension fund trustees to make additional contributions to schemes where appropriate.

The issue you have rightly raised is separate. It is specifically because we believe that employees’ pensions are very important that in our recent bids for three new rail franchises we took a principled position on the specific issue of long-term funding risk.

Having been asked to do so by the Department for Transport (DfT), along with other rail operators we have been working since October 2017 to secure an industry-wide solution to the pensions issue. We have been pressing government to agree a sustainable solution which protects the future livelihoods of rail workers, delivers value for money to taxpayers, and ensures the future viability of government contracts.

However, the DfT has had a constantly changing position on this issue and its current reckless approach fails to deliver on any of these objectives.

In short, the DfT has sought to rip up the long-standing position that the government is the ultimate guarantor of the Railways Pension Scheme (RPS) and instead transfer full long-term funding risk to train companies through franchise contracts. This is separate to the normal employer pension payments which are made by train companies in agreement with the trustees of the relevant sections of the RPS.

It is also important to understand that the structure of the RPS was established to ensure that train companies, who operate services under contract to the DfT, could not access any pension surplus, with the corollary that these companies are not liable for any deficit. Indeed, since de-regulation the DfT has had and continues to have complete control and veto over all funding, benefit and contractual arrangements of the pension scheme.
There are a number of reasons why the Work and Pensions Committee should be concerned about the DfT’s approach:

1. **It breaks a key principle of a previous government review.** The DfT’s position on pensions is contrary to one of the key recommendations of a previous review of the rail system by Richard Brown six years ago. That review said that the private sector should be asked to accept risk only on issues that it can control and manage. No private train operator can control long-term pensions risk when it is responsible for running train services only for a short period of seven or eight years.

2. **DfT policy on the appropriate balance of pensions risk has changed on several occasions.** The DfT’s policy on pensions has been fluid and it has changed its instructions to rail contract bidders on the issue a number of times as it gradually accepted there was a pension problem. However, the final position of the DfT on the balance of risk still does not go far enough, leaving significant risk for both employers and employees.

3. **There are conflicting views between government departments on pension risk allocation.** It is clear that there has been a difference of opinion between the DfT and the Treasury on the level of risk that should be borne by the state and the private sector, with the latter particularly keen to offload the risk. This prompts a key question: if the Treasury believes that the pensions risk is too large for the country to bear, then how on earth does it think that train companies are better placed to carry that risk.

4. **Train companies are not structured or capitalised to assume full long-term pensions risk.** Private train companies operate franchises on relatively short contracts where they are contracted to use their expertise to operate train services to a particular specification, with an agreed level of investment in customer improvements. They are not investment fund managers with access to the significant capital required to manage pensions risk in the way demanded by the Government.

5. **Inappropriate risk allocation damages the return to the taxpayer from the letting of public service contracts.** There is significant taxpayer value in the rail contracting system from properly managed procurement which incorporates the right balance of risk and reward as well as aligned incentives. Attempts by the DfT to transfer inappropriate levels of risk to the private sector further damages the already fragile investor confidence in the UK rail market, reduces the competition for contracts, resulting in a lower return to the taxpayer.

6. **Mismanagement of the pensions issue by the DfT risks industrial relations conflict and the failure of contracts.** Unions have significant concerns about the misguided approach taken by the Government and have already raised the spectre of a potential national rail strike. In addition, if the significant risks involved were to crystallise during a rail franchise contract, then in an industry where average profit margins are less than 3% it could easily result in contract failures. Respected business commentators have shared our view that no sensible bidder would sign up to something over which it has no control. In this case, if pension liabilities rapidly escalate, a company would effectively have written a blank cheque to Government. Such an approach would be reckless in the extreme.

We are extremely surprised that the Government still expects private operators to take risks they are not best placed to manage, despite the recent difficulties experienced by a number of operators of outsourced public sector contracts. Operators across the rail industry made their significant concerns very clear in correspondence sent to the DfT by the industry umbrella body the Rail Delivery Group, most recently on 1 April 2019.
What makes this issue frustrating is that the rail industry has developed a solution which it has put to government and to which it is still awaiting a response. This sustainable and cost-effective solution, which incorporates risk-sharing, can meet the requirements of the key stakeholders in railway pensions: the regulator, railway pensions trustees, employees, train operators and the DfT. Consistent with the position previously where the Government accepted the position as ultimate guarantor, the industry has proposed a phased approach. It would see an additional £500m to £600m in total put into the various sections of the Railways Pension Scheme by train companies over a period of 10 to 12 years. This measured approach and stability contrasts with the instability caused by the position maintained by the DfT.

For our company specifically, having been disqualified from three franchise competitions over this issue, the reason is clear. We have been penalised for protecting the interests of pension fund members by supporting a sustainable approach on pensions which is consistent with industry guidance rather than the reckless and poor value approach followed by the DfT. We would urge the Committee to request a full independent value for money review is undertaken into this issue without delay.

Both myself and my pensions colleagues at Stagecoach would welcome the opportunity to meet you to discuss these important issues further in greater detail. We believe it is critical this issue is resolved and there is urgent agreement on a way forward.

Yours sincerely

[Signature]

Martin Griffiths
Chief Executive
Stagecoach Group Plc