Carillion (DB) Pension Trustee Limited
Carillion House
84 Salop Street
Wolverhampton WV3 0SR

T: 01902 422431
www.carillionplc.com

Rt Hon Frank Field MP
Chair
Work and Pensions Committee
House of Commons
London
SW1A 0AA
workpencom@parliament.uk

By email

26 January 2018

Dear Mr Field

Carillion (DB) Pension Trustee Limited

Many thanks for your letter of 17 January.

The Carillion Group of companies sponsored several pension schemes in the UK; both defined contribution and defined benefit. I am chairman of the trustee company, Carillion (DB) Pension Trustee Limited, which is the trustee of 6 of the defined benefit pension schemes, as listed at the end of this letter. I do not speak for the chairs of the other schemes.

By way of background, Carillion (DB) Pension Trustee limited became trustee of the 6 schemes on 1 April 2011. I have been chairman since that date.

I have set out responses to your questions below. These are given in respect of all 6 schemes, however, all the schemes are separate trusts, so for example the outcome of valuation discussions and investment decisions has in practice been tailored for each scheme.

1 *What assurances did you seek about the sponsor's business model during your tenure as trustee chairman?*

The Trustee board took advice from external covenant assessors in connection with triennial actuarial valuations.

In addition, the board (and/or its relevant committees) received regular updates from Carillion through quarterly reporting on: covenant metrics, information on events potentially notifiable to the Pensions Regulator (tPR) and brokers' reports. In addition, in recent years, Carillion's finance director has given an annual presentation to the Trustee.

Other than this, the information made available to the Trustee and its covenant assessor was, until 2017, largely that available in the public domain, and the Trustee had no legal power to require additional information to be provided. For the covenant assessment work done in May 2017, and subsequently, the

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Trustee was given greater access to personnel at the Company, and information from Company business plan cash flow forecasts and viability reviews.

The covenant reports obtained in connection with actuarial valuations focussed on an assessment of what Carillon could afford to pay in pension contributions, taking into account commitments to its other stakeholders, as well as the perceived strengths and weaknesses of the covenant, and how robust it was expected to be in withstanding shocks to the business.

The Trustee board understood that such an analysis would necessarily take into account Carillon's business model to the extent that might constrain funding to the pension schemes, and impact on the strength of Carillion's covenant. The last formal covenant report obtained in May 2017 in preparation for engagement with Carillion on the results of the 31 December 2016 valuation, did indicate potential weaknesses in Carillion's debt position, but still concluded that it had scope to increase the amount being paid in pension contributions.

Carillion made it clear, repeatedly, to the Trustee in valuation discussions (e.g. in correspondence shared with tPR for the 2011 and 2013 valuations) that it considered it was constrained in agreeing higher contributions due to constraints in cash flow connected with its business model.

However, in discussions for each of the 31 December 2008, 31 December 2011 and 31 December 2013 valuations, the Trustee sought to agree higher contributions for the schemes (taking into account the covenant advice they had received).

For both the 2008 and 2011 valuations, the Trustee and Company were not able to reach agreement on the valuations by the due date under the Pensions Act 2004. This was essentially due to the Trustee seeking to take a more prudent approach to funding than the Company considered it could afford. The Trustee (and the former trustees of the schemes in the case of the 2008 valuations) reported this to tPR and tPR became involved in the discussions.

Ultimately, for all three valuations, tPR decided not to exercise its powers.

In addition to the Trustee's conversations with tPR, the Trustee board understands that tPR has had regular meetings with Carillion since the discussions on the 2008 valuations.

2 *How did the trustees respond to the profit warning issued in July of last year?*

The Trustee engaged with Carillion (starting in earnest with a presentation from Carillion to the Trustee on 14 July 2017) to understand what the profit warning meant for the schemes, and also began regular and close dialogue with tPR.

The Trustee's initial understanding was that although this represented a correction to Carillion's expected results, and had led to a loss of confidence in the markets, Carillion's lenders were still supporting the Company and with the exception of certain contracts announced to the market, it was continuing to trade as normal across all business sectors. The announcement on 10 July 2017 referred to an expected contract provision of £845m at 30 June 2017, with £375m relating to the UK (mainly three PPP projects) and £470m to overseas markets (mainly relating to exiting markets in the Middle East and Canada). Carillion also referred to the associated future net cash outflows in respect of these contracts being £100m - £150m (primarily in 2017 and 2018), with the implication being that the contract issues that had been uncovered were manageable.

Discussions on the 2016 valuation were however halted while Carillion, with the assistance of EY, carried out a review of contracts and cash flow across the businesses.

In early August 2017 the Trustee was approached by Carillion with a request that the Trustee agree to defer payment of contributions to the schemes for a period, as part of discussions it was having with its lenders about providing additional facilities to assist with cash flow. Carillion also later asked the Trustee to agree to move to CPI increases to pensions rather than RPI, where this was possible under the rules of the schemes (no final decision had been taken on this by 15 January 2018 when Carillion plc was put into compulsory liquidation).

The Trustee then became involved in negotiations with Carillion and its lenders with regard to the contribution deferral request towards the end of September. It was clear to the Trustee from these negotiations that the banks saw the Trustee agreeing to the request as an integral part of them committing to providing new money to Carillion. In this context, where a failure to agree the deferral would, in the view of the Trustee, have led to the banks not lending the new money, and the Carillion Group becoming insolvent, the Trustee agreed (provided satisfactory protections were obtained in return) to defer eight months' of contributions due to the schemes. These were due to be repaid in full, with interest, by the end of January 2019 at the latest. The term sheet for this was agreed at the end of September 2017 and the final agreement was documented on 24 October 2017.

The Trustee was at the table with the Company and lenders throughout these negotiations, and as part of the negotiations secured terms in relation to information and consent requirements commensurate with equivalent stakeholders in the business. The Trustee also fully reserved its rights in relation to anticipated future events that it was considered may have a material detrimental impact on the schemes (e.g. certain disposals).

From the date of agreeing the contribution deferral until it was announced on 15 January 2018 that the Official Receiver (OR) had been appointed and Carillion plc (and other companies) put into compulsory liquidation, the Trustee and the Company continued a close dialogue about the Company's trading position and plans for restructuring. And the Trustee remained engaged in talks about the restructuring until the OR was appointed.

The Trustee worked closely with tPR throughout the negotiations in September and October 2017, and subsequent discussions between the Company and Trustee.

The contribution deferral agreement fell away with Carillion plc going into compulsory liquidation, and the deferred contributions (and ongoing contributions for the four of the schemes not currently in a Pension

Protection Fund (PPF) assessment period), are now due to the schemes. This has been brought to the attention of the OR's Special Managers.

3 *What has caused the upsurge in the pension deficit?*

In answering this question, it is worth noting that there are 4 different deficit calculations.

First, there is the Company accounting deficit produced for the purposes of the Company's year-end accounts. This is not a Trustee responsibility, but we expect the £587m figure you quote in your letter, refers to this deficit calculation. There are accounting rules as to how the accounting deficit is assessed. The deficit reported in the Company's accounts will relate to all of its defined benefit schemes.

Secondly, there is the deficit calculated using the Trustee's Technical Provisions basis, used by the Trustee and tPR for the purposes of the statutory triennial valuation on the basis of which the contributions and funding plan are negotiated and agreed between the Trustee and Company. The deficit on that basis (for the 5 largest schemes to which I am Chair of Trustees, this does not include the Bower Scheme which had a different valuation cycle) was calculated to be £508m as at the 31 December 2013 valuation.

The Trustee was in the course of carrying out the 31 December 2016 valuations at the time Carillion issued the profit warning, and had tabled to the Company a proposal that would lead to a circa £990m deficit (in aggregate across the 5 main single trustee schemes). The main reason for the increase in deficit between 31 December 2013 and 31 December 2016 was the significant reduction in interest rates over those 3 years. The Trustee did not consider the covenant of Carillion to be strong enough to warrant dis-regarding the lower interest rate effect in striking its Technical Provisions, and so higher deficits were disclosed (than would otherwise have been the case) reflecting the low interest rate fully in the valuation discount rate assumption.

Thirdly, there is a PPF valuation (valuing the reduced benefits payable by the PPF on a basis prescribed by the PPF). This valuation is intended to approximate the cost of buying out PPF benefits. On this measure, the deficit as at 31 December 2016 is circa £0.8bn (for the 6 schemes), as you indicate in your letter.

Fourthly, the financial position can be valued on a "buy-out basis", assessed by estimating the cost of buying out the accrued benefits with an insurance company. Currently, annuities are relatively expensive to purchase, reflecting the current low interest rate environment and margins that insurers build into their premiums for improved longevity and profit. On that basis, the aggregate deficit (for the 6 schemes) as at 31 December 2016 is nearer £2bn.

In setting the on-going contributions, the Trustee focusses on the Technical Provisions basis, which can be viewed as a "going-concern" basis, as against the "break-up" buy-out basis or the PPF basis.

The Technical Provisions funding level is monitored at least quarterly by the Trustee, and more frequently where concerns have arisen (such as over the Brexit voting period when gilt yields dropped significantly and assets under-performed).

The Trustee engaged very early with Carillion on the 31 December 2016 valuation (some 6 months or more in advance of the valuation effective date itself, i.e. in June/ July 2016). It did so partly in anticipation of an increased deficit following its monitoring and also in the light of its experience when negotiating Company contributions in previous years. TPR was involved throughout, and confirmed its proactive engagement in the valuations in March 2017.

The 31 December 2016 valuations had not been completed by 15 January 2018 when Carillion plc was put into compulsory liquidation. But prior to that the Trustee had carried out extensive scenario planning

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projections and iterations of different investment /funding strategies to equip itself in the negotiations with the Company and inform the dialogue with all parties, including tPR.

Since the 2017 profit warnings, the Trustee's focus had been on short-term funding issues and working to agree a long-term funding strategy with the Company as part of a solvent restructuring solution.

4 *Can you please explain the investment strategy and approach to de-risking adopted by the trustees (a) before the sponsor's profit warning and (b) after.*

The Trustee has a policy, for each scheme, of holding a diversified portfolio consisting of long term growth assets (predominantly shares listed on stock markets around the world), income generating assets (for example, property) and more defensive assets from a pension scheme perspective (UK government bonds for example). The Trustee tailored the split between these categories for each of the 6 schemes to fit with the specific circumstances of each scheme (reflecting their funding position and maturity).

As at 30 June 2017 (i.e. shortly before the profit warning in July) the aggregated assets of the 6 schemes were split approximately 44% to growth, 13% to income and 43% to defensive assets. At the end of 2017 the aggregated assets of the 6 schemes were split approximately 33% to growth, 18% to income and 49% to defensive assets. The changes between 30 June and 31 December were to move from growth to income (as part of the long term strategic shift in that direction) and defensive (partly in reaction to the weakening covenant).

The Trustee (and former trustees before the schemes had a common trustee) has in valuation discussions since the 2008 valuations made clear to Carillion its commitment to adopting investment return assumptions that would allow gradual de-risking of the schemes, and this was also made clear to tPR in discussions.

The Trustee regularly reviews the investment strategies for each Scheme with support from its advisers (Scheme Actuary and Investment Advisor) in light of the Trustee's view at the time of the employer covenant (as informed by the external covenant advisor). At each review, the Trustee considered a range of different options. The consideration of options included analysis of the various risk and return expectations with each potential strategy. The Trustee's policy was to balance the risks (the ability to meet member benefits as and when they fall due with the need to maintain sufficient long-term growth assets to generate the necessary returns) which alongside the available contributions would eliminate the Technical Provisions deficit. The Trustee maintained the objective of increasing the defensive asset allocation over time so that each scheme would be fully invested in defensive assets by the time that 95% of that scheme's members were pensioners.

Recently the process of reviewing the investment strategies of the schemes led the Trustee to take a number of actions to reduce risk while still maintaining the required rate of future growth. This reduced the schemes' reliance on stock markets (equities). More recently, the Trustee has been expanding its allocation to the income generating asset category in order to reflect the increasing cashflow demands as more members retired. This expansion was achieved through investments in property plus bond like instruments including investment grade corporate bonds. This expansion was being made gradually over a period of years; the process was ongoing and was intended to be complete before the next actuarial valuation cycle (2020).

After the Company announced its profit warning in July 2017, the Trustee undertook (with support from its advisers) a thorough review of the investment strategies of the schemes. This included detailed analysis of the various risks, and an ongoing dialogue with tPR. During this time the Trustee took steps to increase the allocations to defensive assets and to draw up a contingency plan. The objective of this contingency plan was to put in place the mechanics to allow the Trustee to materially and quickly reduce investment risk should it become appropriate.

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However, while credible discussions were ongoing between Carillion and the Trustee on a solvent restructuring, which remained the case until the Government and lenders announced their conclusions on going support for Carillion on 15 January, the Trustee did not implement a change in investment strategy that could have run counter to being able to achieve such a restructuring.

5 *What interactions have you had with the Pensions Regulator aside from usual routine meetings around scheme valuations*

I have covered this in the previous answers.

6 *Were you aware of the Pensions Ombudsman ruling against Mr Green, and did you have concerns about whether his stewardship of Carillion considered the interests of its pension schemes?*

This was not something that the Trustee was aware of.

If you need any further information, please come back to me. In the light of current changes at Carillion, it might be better were you to write to me care of the Trustee's lawyers, Sacker & Partners LLP, 20 Gresham Street, London EC2V 7JE rather than to the address on this letter.

Yours sincerely

Robin Ellison
Chairman
Carillion (DB) Pension Trustee Limited
Trustee for the Carillion Staff Pension Scheme, Carillion B Pension Scheme, Alfred McAlpine Pension Plan, Bower Group Retirement Benefits Scheme, Mowlem Staff Pension and Life Assurance Scheme, and Planned Maintenance Engineering Limited Staff Pension and Assurance Scheme