GMCA GREATER MANCHESTER COMBINED AUTHORITY

Bus Franchising in Greater Manchester Assessment

September 2019

Pension Impacts Supporting Paper

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1.1 Introduction

PENSIONS

1.1.1 Another consideration for operators (both existing small and large operators and those new to the market) is the potential impact that franchising could have on operators' pension schemes; an award of a franchise contract to a new operator would mean that some employees of the incumbent operator would likely transfer over to the new operator in compliance with *Transfer of Undertakings (Protection of Employment) Regulations 2006 (*"TUPE"*)*.

1.1.2 In order to safeguard the interests of such transferring employees, the new operator will be required to offer pension protection, so as to satisfy the requirements of *The Franchising Schemes and Enhanced Partnership Schemes (Pension Protection) (England) Regulations 2017* ("Pension Regulations") in ensuring that any transferring employee is provided with the required level of pension protection, which includes providing them either the same or "broadly comparable" pension accrual compared to the employee's entitlement at the point of transfer.

1.1.3 The requirement to offer this additional pension protection applies equally to franchising and Enhanced Partnership Schemes ("EPS"). Whilst this section is focused on what potential impacts franchising could have on operators' pension arrangements, it is understood that in principle the same issues would likely apply to an EPS, although the number of any TUPE transfers would be unlikely to be as extensive compared to franchising.

1.1.4 The analyses set out in this paper principally relates to defined benefit ("DB") schemes; such schemes are inherently more complex to provide compared to defined contribution ("DC") schemes and TfGM understands there could be potential impacts in relation to existing DB pension liabilities as a consequence of any TUPE transfers. However whilst the analyses mainly relates to DB schemes for these reasons, TfGM's understanding is the vast majority of pension accrual in the Greater Manchester bus industry is now through DC schemes.

1.2 Impact on incumbent operators

1.2.1 Franchising does not introduce a new retrospective requirement that an incumbent operator should be liable for any of its past service pension liabilities. This intention is made clear in the *Bus Services Act 2017: Response to the Consultation on Draft Regulations and Guidance* (DfT, 2017), which states that "it is for current employers to put in place the necessary arrangements to address any shortfalls that exist and to manage the pension funds that relate to the past service of their employees – franchising authorities will not be expected to make arrangements to address shortfalls that have arisen before franchising is introduced".

1.2.2 Instead and depending on the terms of its pension arrangements, there is a risk that incumbent operators may lose flexibility as to how and when they may be required to fund any past service pension liabilities and associated deficits.

1.2.3 The degree of any potential pension related impacts attributable to franchising will depend on a number of factors including the terms of the operator's existing schemes, the funding position and scale of liabilities in those schemes, the extent to which employees would TUPE transfer to another operator, what steps operators could take to mitigate any pension liabilities and deficit repayments and the extent to which any pension related factors are issues operators would already need to address under the Do Minimum option.

1.2.4 In assessing these impacts, TfGM does not attempt to measure or forecast values related to incumbent operators' existing pension liabilities other than to contextualise the current position and such potential impacts. This is because the valuation of pension liabilities is highly dependent on prevailing circumstances including, but not limited to, the value of scheme assets, detailed membership data such as the value of benefits accrued and age profile, changes in regulations and legislation, and the actuarial assumptions influenced by current and future market conditions.

1.2.5 The impacts analysis refers to scenarios where incumbent operators' existing pension related liabilities could be measured on a different or more conservative basis and such impacts, if they were to arise as a consequence of franchising, could potentially result in changes to the valuation of existing liabilities. The focus of the impacts analysis is to assess the likelihood of such an impact arising as a consequence of franchising from the information available to TfGM.

1.2.6 The principal DB pension schemes are operator own defined benefit schemes, typically national multi-employer schemes, and the Local Government Pension Scheme ("LGPS") where some incumbent operators are admitted bodies and are therefore able to participate in the scheme. The subsequent analysis considers in more detail TfGM's understanding of the potential impacts that could arise on these different categories of DB schemes and the likelihood of these potential impacts arising as a consequence of franchising for different groupings of operators.

1.3 Operator own defined benefit schemes

1.3.1 For these schemes, impacts on incumbent operators could include:

i. the possibility of an employer cessation event triggering a debt pursuant to Section 75 of the Pensions Act 1995 ("a Section 75 debt"). This is a complex area however TfGM understands the essential concern would be if an incumbent operator ceased to employ at least one active member in a DB scheme (when another group employer in the same pension scheme continues to employ at least one active DB member) as a consequence of a TUPE transfer then this could constitute an employer cessation event, potentially triggering a crystallised lump sum liability on the incumbent operator. This debt calculation could result in the operator becoming liable to contribute a share of the total 'buy-out' deficit of the whole scheme, which could be significant and payable as a capital lump sum in the immediate term; and

ii. where the incumbent operator still continues to employ at least one active member, there is the possibility that the trustees of the scheme may seek more prudent funding arrangements if it is considered an operator's financial position and security has weakened (and this is deemed to impact the overall strength of covenant provided to the scheme).

1.3.2 The Greater Manchester ("GM") operating subsidiaries of FirstGroup and Stagecoach Group (trading as First Manchester Limited and Greater Manchester Buses South Limited respectively) are the two largest operators in GM by revenue and employees and TfGM's understanding from the information available is the circumstances in relation to their DB pension schemes are similar. The information available, and subsequent analysis, pre dates the announced agreement of terms between FirstGroup and Go-Ahead Group for the sale of some of First Manchester's operations and it has also been reported that FirstGroup are considering the sale of other parts of their GM bus business.

1.3.3 Both FirstGroup and Stagecoach Group have recently reported reforming their own multi-employer DB schemes in their *Annual Reports* (Stagecoach Group, 2018 and FirstGroup plc, 2018); the Stagecoach Group Pension scheme is now closed to new members and closed to future accrual in April 2017, similarly the First UK Bus Pension scheme and First Group Pension scheme are now closed to new members and closed to future accrual in April 2018.

1.3.4 TfGM's understanding is the consequence of these reforms means that there are no active members in these schemes and they are effectively already 'frozen'. This means that a Section 75 Debt would not arise for these operators as a consequence of any TUPE transfers to franchised operators.

1.3.5 As noted, trustees of DB schemes are required to assess the employer covenant (the legal obligation and financial ability of the employer to support the pension scheme) on a forward looking basis and could seek more prudent funding arrangements as a result of changes in the GM bus market.

1.3.6 However this is considered to have less of a direct potential impact compared to a cessation event as covenant is typically assessed at a group level and in general would be dependent on a broad range of factors, including group wide business performance and plans, market sector outlook, scheme specific circumstances and potentially any contingent funding or security arrangements already entered into (for example any funding arrangements already entered into particularly by the First and Stagecoach groups in closing their respective schemes to future accrual).

1.3.7 Considering other incumbent operators, TfGM understands the vast majority of other operators do not have any corporate DB arrangements that are open to future accrual and consequently the identified cessation impacts should not be a consideration for these operators.

1.3.8 TfGM is aware of one operator that has active members in a corporate DB arrangement that is open to future accrual; therefore it is possible in principle that a Section 75 Debt could arise for this operator as a result of TUPE transfers to franchised operators. TfGM understands this operator delivers some cross boundary services and consequently the output of any TUPE arrangements would need to result in all active DB members transferring to franchised services and franchised operators before a cessation debt could be triggered.

1.4 Local Government Pension Scheme

1.4.1 For incumbent operators participating in the LGPS, the potential impacts of franchising could include:

i. if the operator ceases to employ active members they could become liable for a cessation debt under the terms of their admission agreement to the LGPS. This is similar to a Section 75 Debt with the default position being liabilities are valued on a 'gilts cessation basis' with no allowance for potential future investment outperformance; although there may be more discretion as to the terms and timing of any cessation debt under LGPS but the terms would be dictated by the actual admission agreement in place between the relevant incumbent operator and the administering authority; and

ii. if the operator employs a substantially reduced number of active members, it is possible that the LGPS could seek increased contributions from the operator to address any funding shortfall in respect of the accrued benefits of the departing members.

1.4.2 In considering such potential impacts for the larger incumbent operators, the First and Stagecoach Manchester operating subsidiaries participate in the LGPS through the Greater Manchester Pension Fund (“GMPF”). In both cases TfGM assumes participation in the GMPF is closed to new entrants[1] and that the membership profile is likely to be characterised by a low proportion of active members and high proportion of pensioner and deferred members[2].

1.4.3 First Group have also consolidated the administration of their LGPS arrangements with a single administering authority, the GMPF. The information in GMPF’s *Annual Report* (GMPF, 2018) sets out the transfer of the assets and liabilities in relation to First West Yorkshire Limited and First South Yorkshire Limited with effect from 1 November 2017.

1.4.4 TfGM does not have any further specific information in relation to the transfer, however it does not appear from the publicly available information that the transfer arrangements would materially impact franchising arrangements.

1.4.5 The GMPF assets and liabilities disclosed in the *Annual Reports* (First Manchester Ltd, 2018 and Greater Manchester Buses South Ltd, 2019) on an accounting basis are:

GMPF Assets / (Liabilities) [3]	**First Manchester as at March 2018**	**Greater Manchester Buses South as at April 2018**
	£millions	**£millions**
Market / fair value of assets	**237.9**	**178.5**
Present value of liabilities / obligations	**(229.0)**	**(150.4)**
Irrecoverable surplus / asset ceiling	**(5.9)**	**(31.9)**
Asset / (Liability)	**3.0**	**(3.8)**

1.4.6 It is possible in principle that a cessation debt could arise from ceasing to employ at least one active member as a result of TUPE transfers to

[1] Stagecoach Group’s Annual Report (Stagecoach Group, 2018) indicates LGPS schemes are closed to new members from the Group and TfGM assumes the position is the same for First Manchester’s LGPS scheme.

[2] GMPF’s *Actuarial Valuation* (GMPF, 2014) report provides active, deferred and pensioner members by employer

[3] These figures are for context and represent current estimates from financial statements which are different to a cessation type basis

franchised operators. However if an employer has a scheme which is closed to new entrants, the GMPF's *Funding Strategy Statement* (GMPF, 2017a – "Funding Strategy") states:

"For admission agreements that have no guarantor[4] and are closed to new entrants, liabilities may be valued on a more prudent basis (i.e. using a discount rate that has a lower allowance for potential investment outperformance relative to UK Government bonds). The target in setting contributions for any employer in these circumstances is to achieve full funding on an appropriate basis by the time the agreement terminates or the last active member leaves in order to protect other GMPF employers. This policy will increase regular contributions and reduce, but not entirely eliminate, the possibility of a final deficit payment being required when a cessation valuation is carried out".

1.4.7 GMPF's Funding Strategy acknowledges there will necessarily be a cessation point if a scheme is closed to new entrants. As the First and Stagecoach GMPF sections are considered likely to have relatively few active members, it is possible that there could be a cessation point in the near future. In acknowledging that there will necessarily be a cessation point in these circumstances, the Funding Strategy also sets out steps to plan for and mitigate the risk of a final deficit arising through adopting more conservative valuations of liabilities and increasing employer contributions.

1.4.8 In the context of planning for such a cessation, and seeking to mitigate any final deficit payment through increased employer contributions, both these employers are currently characterised as paying amongst the highest contribution rates across the GMPF. The primary employer contribution rates disclosed in GMPF's triennial *Actuarial Valuation* (GMPF, 2017b) for the period from 1 April 2017 to 31 March 2020 are 30.4% of pensionable pay for Greater Manchester Buses South Limited and 31.4% of pensionable pay for First Manchester Limited.

1.4.9 These primary rates compare to GMPF's whole fund weighted average primary rate of 16.7% over the same period. Whilst the primary rate is set to fund the cost of new benefits, such high primary contribution rates may typically be indicative of a closed employer and a membership profile where there is a limited time horizon to allow for future investment returns.

1.4.10 Both employers also currently pay secondary contributions in addition to the primary rates. First Manchester's secondary contribution is £5.17

[4] TfGM assumes the most likely position is these operators have admission agreements without guarantees reflecting admittance and historic entry requirements after de-regulation.

million per annum and Greater Manchester Buses South's secondary contribution is £2.4 million per annum, both over the period from 1 April 2017 to 31st March 2020.

1.4.11 GMPF's Funding Strategy describes the secondary rate as "if required, a Secondary Rate has also been calculated to meet the twin aims of maintaining the consistency of contributions over time while targeting a fully funded position within the employer's set time horizon". Both employer's secondary contributions are significant relative to the primary rate and are specified as periodic lump sums rather than rates. The Funding Strategy notes with regard to secondary lump sums that "this approach is generally applied for employers where the workforce/payroll is expected to decline in order to ensure sufficient contributions are made towards repaying any deficit."

1.4.12 The secondary contributions are therefore again likely reflective of the stated policy in GMPF's Funding Strategy and the target of achieving a fully funded position in anticipation of the last active member departing.

1.4.13 The assessment of impacts related to GMPF for the two largest operators is therefore that under a Do Minimum option there will necessarily be a point when the last active member ceases if the schemes are closed to new members.

1.4.14 The information available to TfGM in the form of the analysis of primary and secondary contributions relative to the Fund's average, and the stated policies in the Funding Strategy, indicate there is already a significant ongoing cost for both operators in planning to achieve a fully funded position and mitigate the risk of a cessation debt arising.

1.4.15 In setting contributions in the current triennial valuation to meet the employers' funding target the scheme actuary would have considered the appropriate time horizon, and probability, to achieve the target. For an employer with an open admission agreement and appropriate covenant such as a statutory body, the Funding Strategy states the maximum time horizon is a period not exceeding 20 years.

1.4.16 For operators such as First and Stagecoach it is considered likely the time horizon could be considerably shorter and the Funding Strategy refers to the expected future working lifetime of the average employee as a default position. The expected future working lifetime would also typically allow for the possibility of members leaving or retiring early. Under the Do Minimum option, it is reasonable to expect the ongoing funding strategy (and associated contribution costs) will tend towards a gilt type cessation basis over the future working lifetime of active members.

1.4.17 It is possible the introduction of franchising could bring forward the last active member leaving these schemes and thus shorten to some degree the effective time horizon to make good existing liabilities relative to the Do Minimum option. This is a pace of funding matter, the impact of which would depend on the timing of the last active member leaving the scheme under the introduction of franchising versus the Do Minimum option.

1.4.18 TfGM is aware of other operators who participate in the LGPS through different administering authorities. TfGM's understanding of the circumstances is these are likely similar to the analysis provided for the two largest operators; the following table sets out these employers and summary information from the *Actuarial Valuations* (Cheshire Pension Fund, 2017; Merseyside Pension Fund, 2017; Lancashire County Pension Fund, 2017) in relation to participation in the respective LGPS schemes:

Operator entity	Administering Authority	Contribution Rate% / £ 2017 to 2020
Warrington Borough Transport[5]	Cheshire Pension Fund	27.5%
Arriva	Merseyside Pension Fund	26.0% plus £1.0 million
Rossendale Transport Limited[6]	Lancashire County Pension Fund	25.6%

1.4.19 From the information available to TfGM the total number of LGPS active members across these employers is very low. The assessment of the potential impacts for these operators is again that if the schemes are closed, and collectively have a very low number of active members, there will necessarily be a cessation point under the Do Minimum option. Therefore it is possible that the introduction of franchising could bring forward the last active member leaving, however this is considered even less likely given that these operators are generally characterised by a greater proportion of cross boundary operations.

1.5 Impact on prospective operators

1.5.1 The requirement to offer transferring employees the same or "broadly comparable" pension accrual is a more onerous requirement than is required under TUPE or the Pensions Act 2004*,* so it may have an impact on prospective operators in terms of their ability to meet such requirements and, particularly for any DB arrangements, the associated funding and contribution risks during a franchise term.

1.5.2 The 2000 Act and the associated Pension Regulations do not precisely define what constitutes a "broadly comparable" arrangement but state that the transferring employee's future accrual of pension benefits as an

[5] Warrington Borough Council described as responsible for past service in the *Actuarial Valuation*.
[6] A *Treasury Management* report (Rossendale Borough Council, 2016) indicates the pension deficit transferred to the council.

employee of the new operator should not suffer any "material detriment" compared to their previous pension entitlement.

1.5.3 Under franchising, the GMCA would be under a duty to ensure that any franchise contract it enters into with an operator includes terms that require the operator to secure the necessary pension protection for employees. Operators are also required to obtain a written pension statement from a Fellow of the Institute and Faculty of Actuaries certifying the new pension arrangements offer the transferred employees the required pension protection. In this regard existing HM Treasury guidance is referred to in assessing broad comparability between two sets of pension benefits.

1.5.4 Whilst it is for prospective operators to determine in the first instance their own preferred approaches to comply with the Pension Regulations, TfGM has assessed, from the information available, the types of pension arrangements currently offered by GM operators (as these current arrangements are relevant, on the assumption they remain similar up to the point of any franchising implementation, in considering how broadly comparable future accrual could be provided) and the approaches prospective operators could take to comply with the requirements.

1.5.5 The types of pension arrangement currently provided by operators includes:

i. operator provided defined contribution scheme;
ii. membership of the LGPS administered through GMPF or in a small number of cases another administering authority; and
iii. operator provided defined benefit scheme.

1.5.6 TfGM understands that the vast majority of current pension provision is now through DC schemes; from the information available to TfGM it is estimated in the order of 95% of employees currently accrue benefits in DC schemes with the balance through LGPS and operator provided DB schemes. Whilst the terms of provision and contribution rates may vary between operators, in principle it is common practice for nearly all employers to provide, or be familiar with, DC arrangements especially since the advent of automatic enrolment.

1.5.7 Consequently for the majority of transferring employees, a prospective operator could offer the required pension protection by replicating future pension accrual through DC scheme structures, therefore providing equivalent benefits to their existing schemes.

DB options – GMPF

1.5.8 Whilst the Pension Regulations do not define what "broadly comparable" means, for the purposes of assessing the options to provide DB arrangements TfGM's assumption is that in practice it will be necessary for a new employer to provide the same or another comparable DB arrangement.

1.5.9 DB arrangements are inherently more complex to provide compared to DC arrangements; a minority of employees overall currently accrue benefits through DB arrangements, principally through the LGPS, where a number of large and small operators currently participate in the scheme as admitted bodies, as summarised in the impact on incumbents section.

1.5.10 The most practicable means for an operator to provide benefits that are the same as, or at least broadly comparable to the LGPS, is likely to be by replicating benefits through continued access to the LGPS. GMCA and TfGM are Scheme Employers within the GMPF and in the event that franchising was introduced, TfGM's understanding is there would be a legal basis for new operators to be eligible to become admitted bodies under *the Local Government Pension Scheme Regulations 2013.*

1.5.11 In order to become an admitted body, the operator would need to enter into an admission agreement with the LGPS administering authority which the GMCA (or TfGM on its behalf) would also be a party to. An admission agreement will typically include a number of standard requirements and obligations upon the operator including, amongst others:

i. rights to terminate admission if the franchisee failed to pay any sums due to the administering authority;
ii. rights to off-set against any money owed to the franchisee any overdue pension contributions;
iii. rights to terminate admission if there were a material breach or the franchisee ceased to be an admitted body;
iv. notifying the administering authority of any change in the status of the franchisee (such as takeover or restructuring);
v. a requirement that only employees of the franchisee with a connection to the relevant service can become members of the LGPS;
vi. details of the contract between the franchisee and Scheme Employer; and
vii. a continuing assessment of risk of insolvency or winding up.

1.5.12 The above requirements and terms of a typical admission agreement are not considered to be onerous upon operators, regardless of their size or experience, and eligibility to become an admitted body provides a practicable route for operators to replicate LGPS benefits. The most significant aspect of the admission process is likely to be the actuary's assessment of the funding costs of participation, taking into account the risk of the franchise contract terminating through insolvency, winding up or liquidation of the franchise operator.

1.5.13 The actuary's assessment may result in the administering authority requiring security from the new franchise operator or alternatively require the GMCA or TfGM to act as a guarantor. If the administering authority does require security, it is considered that providing a guarantee would be the preferred approach as this would mitigate the direct costs for a franchised operator in providing security, would reduce barriers to entry and would be more likely to achieve the most efficient long term funding cost.

1.5.14 As noted the terms and process to become an admitted body are largely prescribed in statute and subject to the terms and conditions of the administering authority's requirements, however it is also common practice in similar scenarios for separate risk allocation and risk sharing arrangements to be developed which in this case would be through a contract between a franchised operator and TfGM, in conjunction with the GMPF.

1.5.15 Therefore in consideration of the financial risks inherent in the provision of DB arrangements, a risk sharing arrangement would be included in the franchise contract. The risk sharing allocation would set out, amongst other factors, arrangements in relation to:

i. responsibility for variations in contributions arising over the franchise term;
ii. security and guarantee arrangements;
iii. exit arrangements and succession at the end of the franchise term;
iv. responsibility for funding any variation in past service liabilities; and
v. if relevant any 'pooling' arrangements with other bodies the GMCA wishes to put in place.

1.5.16 The overarching principle in developing risk allocation arrangements is set out in the Commercial Case and would be based on achieving an equitable bidding process with risk being allocated to whichever party is best able to manage the risk or where risks relate to exogenous factors whichever party is best able to achieve the most efficient cost.

1.5.17 At this stage the QRA includes provision for a risk cost in a scenario where risk is transferred to the GMCA acting as a guarantor in order to mitigate any cost impact upon franchisees from additional security requirements.

DB options – Other LGPS Administering Authorities

1.5.18 GMCA and TfGM are scheme employers with the GMPF and the vast majority of bus employees with current service in the LGPS also participate through the GMPF. However as noted in the incumbent impacts section there are a small number of employees who participate in the LGPS through other administering authorities.

1.5.19 The operators in these cases typically have cross boundary operations and therefore the extent to which such employees would transfer to a franchised operator would be less likely and would be dependent on a number of factors, including the outcome of TUPE arrangements, however in principle similar arrangements for admittance to the LGPS could apply.

DB options – Operator own DB schemes

1.5.20 As noted the principal DB arrangement currently offered by GM operators is through the LGPS. The incumbents section notes TfGM is aware of one operator which has its own corporate DB schemes. There would be a number of options to provide the required pension protection under franchising, including;

i. an operator provided comparable DB scheme;
ii. a comparable DB scheme provided through a master trust type arrangement; and
iii. if the benefit structures were deemed broadly comparable, the possibility to provide benefits through the LGPS as described above.

1.5.21 Each of these identified options would involve different considerations with a comparable master trust type defined benefit scheme more likely to replicate existing benefits, whilst admittance to an existing scheme such as the LGPS would be more practicable in terms of establishment and ongoing administration, particularly for any smaller operators who are less likely to have their own DB schemes.

1.5.22 In the event of any TUPE transfers for employees accruing benefits in operator own DB schemes, further information could be sought to provide more detailed consideration of these options; at this stage the QRA includes allowance for an estimate of active employee numbers in operator own DB schemes and additional contribution costs if it were necessary to provide pensions benefits through an existing higher cost rather than broadly comparable scheme.

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