

# Report under s89 of the Pensions Act 2004

Issued by The Pensions Regulator (the 'regulator') in relation to the Docklands Light Railway Pension Scheme (the 'Scheme')

## Executive summary

This report sets out how the regulator considered using its scheme funding powers under section 231 of the Pensions Act 2004 ('the Act') in relation to a failure to meet the statutory deadlines for the Scheme's 2009 and 2012 actuarial valuations.

The regulator had previously issued a warning notice in August 2012 with a view to asking its Determinations Panel ('the Panel') to require the trustees and statutory employer, Serco Limited ('Serco'), to obtain skilled persons' reports on the Scheme's funding position and the strength of Serco's covenant. These reports would then enable the Panel to make an informed decision as to how the regulator should (through the Panel) use its scheme funding powers under section 231 of the Act.

A decision was taken not to pursue regulatory action further before the matter was transferred to the Panel. It followed the submission of formal scheme funding documentation after a settlement agreement had been reached in November 2014 between the trustees, Serco and the principal employer under the Scheme documentation, Docklands Light Railways Limited ('DLR'). Under this agreement, the Scheme's funding deficit revealed by the 2012 valuation (£36.1m) will be cleared by January 2018 (with over £20m payable by January 2016).

During its investigation, the regulator had encouraged the trustees and DLR to consider the steps they considered were open to them to take under the Scheme's contribution rule. The trustees made a demand for contributions under the Scheme contribution rule in late 2013 and then brought Court proceedings seeking payment of the contributions demanded. The regulator's regulatory action remained suspended pending the outcome of those proceedings. The pursuit of those Court proceedings then led to the funding settlement described above.

## Background

The Scheme is a defined benefit occupational pension scheme. DLR is the Scheme's principal employer under the terms of the Scheme's governing documentation. During the period relevant to the regulator's investigation, the Docklands Light Railway franchise was operated by Serco, who was the only statutory employer of the Scheme for the purposes of Part 3 of the Act.

The trustees of the Scheme sought to prepare an actuarial valuation with an effective date of 1 April 2009 (the '2009 valuation'). They were unable to reach agreement with Serco in respect of the funding requirements of Part 3 of the Act prior to the statutory deadline of 30 June 2010. Whilst the parties provisionally agreed most of the 2009 valuation assumptions and agreed that the Scheme was in deficit, they were unable to reach agreement in respect of a recovery plan ('RP') to clear the deficit and a schedule of contributions ('SOC'). DLR was not an active party to the negotiations between the trustees and Serco concerning the 2009 valuation as it was not a statutory employer for the purposes of Part 3.

## Regulatory action

Initially, the regulator facilitated further discussions between the trustees and Serco to explore whether an appropriate outcome could be agreed. As these discussions were not successful, the regulator reached the view that it was appropriate to pursue exercising its powers under section 231 of the Act (to, amongst other things, give directions for the calculation of the technical provisions and detail the steps needed to be taken to clear the resultant deficit and impose a SOC).

On 31 August 2012, the regulator issued a warning notice with a view to exercise its funding powers under section 231 of the Act. As well as the trustees and Serco, DLR received a copy in its capacity as a directly affected party. Decisions as to whether to exercise these powers are reserved to the Panel, which is a separate committee of the regulator. The warning notice requested the Panel to direct the trustees to obtain (at the trustees' and Serco's cost) two skilled persons' reports under section 71 of the Act on matters which were relevant to the potential exercise of the regulator's functions. One skilled person's report was sought on the Scheme's funding position; another was sought on the strength of Serco's covenant.

The decision to issue a warning notice reflected the regulator's view that it is important for schemes to have appropriate funding plans in place which reflect an understanding of the schemes' funding objectives and the risks. The regulator, therefore, has a low tolerance for late actuarial valuations. In this instance the decision to issue the warning notice was taken reluctantly in view of what the regulator believed to be the trustees' powers to seek appropriate contributions under the Scheme contribution rule, without the need for regulatory intervention. There was not a common interpretation between the parties and the regulator of the scope of the trustees' power under the Scheme rules. In the warning notice, the regulator again raised the point about the ability to impose contributions outside the scheme funding framework under Part 3 under the rules of the Scheme.

Subsequently the regulator suspended its regulatory proceedings as the parties considered that there was potential for a consensual solution on the 2009 valuation. At this stage the warning notice had not been referred to the Panel. However, the further negotiations were unsuccessful.

The trustees subsequently made a demand under the Scheme contribution rule and issued court proceedings against Serco seeking to recover those contributions. Serco defended those proceedings and raised issues going into, amongst other things, the proper interpretation of the Scheme contribution rule. Pending the outcome of the court proceedings, the regulator continued to suspend its regulatory proceedings.

Due to the length of time taken to address the 2009 valuation, the 15 month statutory deadline for the actuarial valuation with an effective date of 1 April 2012 (the '2012 valuation') also passed. The regulator was also concerned about non-compliance with this deadline.

## Key elements of outcome

In November 2014 the trustees, Serco and DLR agreed a settlement in respect of the trustees' court proceedings. As part of the settlement, it was agreed that the Scheme will receive deficit repair contributions of £37m by 2 January 2018 (the Serco payments being underwritten by a parental guarantee from Serco Group PLC) broken down as follows:

From Serco:

- ▶ £8.25m payable on or before 2 January 2015
- ▶ £8.25m payable on or before 2 January 2016
- ▶ £8.25m payable on or before 2 January 2017
- ▶ £8.25m payable on or before 2 January 2018

From DLR:

- ▶ £4m payable on or before 2 January 2015

To facilitate the settlement the regulator confirmed to the trustees that it was unlikely to seek to exercise its powers under section 231 of the Act in respect of either the 2009 or 2012 valuations provided that the scheme funding documentation reflected the terms of the settlement. In reaching its view that it would be unlikely to take further regulatory action, a key consideration for the regulator was the period over which the deficit revealed by the 2012 valuation (£36.1m) would be cleared (by January 2018, and with over half the amount payable by January 2016).

This settlement has been reflected in the 2009 and 2012 valuations, including RPs and SOC's, which have been submitted to the regulator. In the light of those formal submissions the regulator has decided not to take regulatory action. All payments falling due to date under the settlement terms have been made on time.

## Regulatory comments

Putting in place an actuarial valuation is a statutory requirement. Late actuarial valuations can create uncertainty and could increase risks to both the scheme and the employer. The regulator's focus will be to help the trustees of a scheme in such a situation to reach an appropriate outcome as soon as possible.

Where compliance with Part 3 of the Act is outstanding and it appears to the regulator that the parties are not taking urgent positive steps to remedy this in a timely way, the regulator will consider whether to use its powers to address this non-compliance. In such situations, it may be appropriate to seek skilled persons' reports under section 71 of the Act to assist it in the potential exercise of its powers under section 231 of the Act. The regulator is likely to seek that the cost of any such reports will be met by the trustees and/or employers.

Where the trustees and employers have options available to them which are capable of addressing the funding issues associated with a failure to comply with the requirements of Part 3 of the Act (such as the exercise of powers under a scheme's governing documentation), the regulator will generally expect these options to have been pursued before the regulator will consider exercising its powers. This underlines the importance for trustees to pay close attention to the terms of contribution powers available under the governing documentation of a given scheme.

Where the relevant parties engage in settlement discussions which have the potential to avert the need for regulatory action, the regulator is open to working constructively with the parties. In doing so, one of the regulator's concerns will be to ensure that the scheme is put in the position that it would have been in had the valuation been agreed by the trustees and employers before the statutory deadline.

In this case, the statutory employer was a franchisee. In such a case, the franchise arrangement forms part of the circumstances surrounding the scheme to be taken into account in any funding decisions. Where there is a fixed term franchisee, it can be of particular importance that scheme valuations and funding plans are put in place in good time, to assist in orderly management and/or prevention of any deficit. As part of any covenant assessment or funding planning exercise, the trustees will want to take into account the fact of any upcoming end of franchise. However, unless there is good reason to do so, the regulator does not regard it as necessary to assume that the covenant support enjoyed by the scheme will fall away entirely at the end of that particular employer's franchise.

## General

More information on the regulator's current approach to the regulation of funding for defined benefit schemes can be found in the 'Defined benefit funding regulatory and enforcement policy' (2014): <http://www.thepensionsregulator.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf>.

The regulator's consideration and approach to individual cases is informed by the specific circumstances presented by a case, not all of which are referred to or set out in this summary report.

This summary report must be read in conjunction with the relevant legislation. It does not provide a definitive interpretation of the law. The exercise of the regulator's powers in any particular case will depend upon the relevant facts and the outcome set out in this report may not be appropriate in other cases. This statement should not be read as limiting the regulator's discretion in any particular case to take such action as is appropriate. Trustees and other parties should, where appropriate, seek legal and other advice on the facts of their particular case.

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Docklands Light Railway Pension Scheme

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