Report under s89 of the Pensions Act 2004

Issued by The Pensions Regulator ('the regulator') in relation to the UK Coal Operations Limited sections of the Industry Wide Coal Staff Superannuation Scheme and the Industry Wide Mineworkers Pension Scheme

Background

This report should be read in conjunction with the section 89 report published on 7 January 2013 regarding the UK Coal Mining sections of the Industry Wide Coal Staff Superannuation Scheme and the Industry Wide Mineworkers Pension Scheme (the Former Sections). The report can be found at **www.tpr.gov.uk/section-89**.

UK Coal Operations Limited (UKCOL) was formed in 2012 as part of the restructuring of the UK Coal Group (as detailed in the January 2013 report and summarised below). UKCOL is the sole statutory employer in relation to the UK Coal Operations Limited sections of the Industry Wide Coal Staff Superannuation Scheme (IWCSSS) and the Industry Wide Mineworkers Pension Scheme (IWMPS) (together, the UKCOL Sections). The UKCOL Sections replaced the Former Sections in the respective schemes (and received a bulk transfer of all assets and liabilities) as part of the 2012 restructuring.

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The Pensions Regulator

In early 2013, a fire at one of UKCOL's deep mines (Daw Mill) put the group's mining business at risk of insolvency. The relevant stakeholders were able to agree a further restructuring plan that has resulted in the UKCOL Sections passing to the Pension Protection Fund (PPF).

In summary: the December 2012 restructuring

During the course of 2012, the board of UK Coal Plc concluded that it was necessary to restructure the group in order to mitigate the operating risks inherent in the mining business and to facilitate the raising of funds required by the group.

These risks were highly relevant to the trustees of the IWCSSS and the IWMPS for two reasons. Firstly, the trustees were reliant on the group continuing to trade to enable deficit repair contributions to be made to the Former Sections. Secondly, as unsecured creditors, the trustees stood to lose access to all (or almost all) of the potential value in the group's property portfolio in the event of failure of the mining business.

Following extensive discussions, a plan was agreed to restructure the business. The headline elements of that restructuring were:

- The business was split into two ring-fenced businesses: mining, incorporating the group's three deep mines and its surface mines (Mineco) and property (Propco).
- Substantially all of the economic interest in the group passed from the existing shareholders to the trustees, via the trustees' acquisition of a 75.1% stake in Propco and their entitlement to substantially all the cash generated by Mineco (which would be free of bank debt).

The trustees' view (shared by the regulator) was that the plan represented the best outcome available for the Former Sections.

Events occurring in 2013

Daw Mill was the largest of three deep mines operated by UKCOL's Mineco business. It generated (and was forecast to continue to generate) around a third of UKCOL's revenues.

In February 2013, a fire broke out underground at Daw Mill. Despite efforts to control the fire, it quickly became apparent that the severity of the incident meant that the costs required to reopen the mine in future would be prohibitive. Therefore in March 2013, UKCOL announced that Daw Mill would not re-open.

The fire at Daw Mill had two serious effects on the prospects for the Mineco business:

- The costs of closing the mine (including the costs of making the mine safe and providing redundancy payments) would cause cash flow problems in the short term, risking insolvency; and
- Even if insolvency in the short term could be avoided, the Mineco business would face a significant loss of revenue and profits. As a result, the funding that Mineco would be able to provide to the Former Sections would be significantly reduced.

The Propco business was not at risk of insolvency due to the ring-fencing introduced by the 2012 restructuring. However, due to some limited ongoing arrangements between Propco and Mineco, the value of the trustees' shareholding might have been affected by an insolvency of the mining business.

UKCOL's management immediately began discussions with relevant stakeholders, including creditors, generators, banks and Government.

Initial proposal

Management engaged in a constructive dialogue with the regulator, the PPF and the trustees in relation to the options available for the UKCOL Sections.

A restructuring was proposed under which the Mineco business, excluding Daw Mill, would be hived down to a new group. By leaving Daw Mill in Mineco, the new group would avoid the closure costs which would otherwise be unaffordable and so would be able to continue to trade.

The parties also proposed that the UKCOL Sections would be attached to the hived down group. However, given the loss of future revenue generation and profits from Daw Mill, the pension liabilities would be supported by a weaker employer covenant which would not be able to provide the same level of deficit repair contributions as previously expected.

In order to reach full funding, the trustees would therefore need to seek increased investment return, requiring them to maintain a significant proportion of their investment portfolio in return-seeking assets for a material length of time (in excess of that envisaged under the 2012 restructuring). The UKCOL Sections would be exposed to investment volatility associated with such a strategy.

Having considered the proposal, the regulator concluded that, given the level of investment risk to which the members would be exposed (which in practice would fall on the PPF for the foreseeable future), the inability of the weakened covenant to underwrite that risk and the limited potential for deficit repair contributions, it could not support the proposal.

The regulator encouraged UKCOL's management to continue discussions with the trustees so that alternative options could be explored, which did not carry the same risk to the UKCOL Sections or PPF levy payers.

Revised proposal

A revised proposal was put forward by UKCOL. Under this arrangement the assets of the Mineco business would be hived down to a new group (broadly as previously proposed), but there would be a controlled entry of the UKCOL Sections into the PPF (following an assessment period triggered by an insolvency of UKCOL).

In order to facilitate the restructuring, the trustees would release part of their claim against UKCOL as an unsecured creditor. In return, the PPF would secure significantly all of the economic interest and value in the new group through a series of debt instruments held in the new group's operating company. As noted below, the interests in the new group are expected to be more valuable than the portion of the claim which was given up.

The risks inherent in the mining business would be mitigated by ring-fencing the two remaining deep mines and the surface mines from each other. This would provide greater protection to the wider group (and so the value of the PPF's interest) against future catastrophic events in any single mine.

Outcome

As some of the steps in the restructuring process (including the release of part of the trustees' claim against UKCOL) could be detrimental to the UKCOL Sections, various entities within the UKCOL group sought clearance from the regulator in respect of the revised restructuring plan.

Having considered the proposal, the regulator determined that it would provide the requested clearances, as:

- the proposed restructuring protected the PPF's position (by not leaving it exposed to excessive investment risk)
- the interest in the new group was forecast to provide the PPF with a substantially larger return than would have been obtained if UKCOL had entered insolvency proceedings, and was fair value for the UKCOL Sections' creditor interest
- there were no other parties that could reasonably be expected to provide covenant support
- the shareholding in Propco was protected against potential decline in its value that could have been caused in an uncontrolled insolvency.

Whilst other creditors would receive a higher return compared with an uncontrolled insolvency (due to the trustees of the UKCOL Sections releasing part of their claims against UKCOL), this was considered to be reasonable given the expected improvement to the PPF's position under the restructuring. The PPF had obtained its own advice on the expected outcomes and structure of the group going forward and supported the proposal.

The restructuring was announced in July 2013. The restructuring has, in the regulator's view, provided the best available outcome for the PPF and has also preserved the remaining business as a going concern, enabling the retention of around 2,000 jobs.

General

The best outcome for members and the PPF is generally an ongoing sponsoring employer that is able to provide appropriate long-term funding to support a viable recovery plan.

In some circumstances this will not be possible. Where appropriate, the regulator will work constructively with all parties to obtain the greatest value for the scheme. This optimal outcome may (but will not always) be achieved where the employer is able to avoid insolvency.

However an optimal restructuring will not necessarily mean that the continuation of a scheme is appropriate, as members and/or PPF levy payers may be exposed to excessive risk relative to the future value available to the scheme from the restructured business. In those situations, the regulator will seek a controlled entry of the scheme into the PPF, or a winding up outside the PPF where the scheme is sufficiently funded.

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 advice on the facts of their particular case.

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UK Coal