

Report under s89 of the Pensions Act 2004

Issued by The Pensions Regulator in relation to the UK Coal Mining Sections of the Industry-wide Coal Staff Superannuation Scheme and Industry-wide Mineworkers Pension Scheme

Background

UK Coal is Britain's largest producer of coal, supplying around 5% of the country's energy needs for electricity generation. The Group has three operating deep mines located in central and northern England, together with surface mines. The Group is also one of Britain's largest brownfield property developers, owning a substantial land portfolio.

UK Coal Mining Limited (UKCML) was the sole statutory employer in relation to the UK Coal Mining sections of the Industry-wide Coal Staff Superannuation Scheme (IWCSSS) and the Industry-wide Mineworkers Pension Scheme (IWMPS) (together, the 'UK Coal Sections'). The UK Coal Sections are segregated defined benefit sections of the IWCSSS and IWMPS and have, in aggregate, approximately 6,800 members.

The UK Coal Sections are subject to the Coal Industry (Protected Persons) Pensions Regulations 1994 (the 'Protected Persons Regulations'). As a result, various entities within the UK Coal group, including UKCML's parent, UK Coal Plc, were guarantors in relation to the UK Coal Sections.

At the time of the restructuring described in this report, each of the UK Coal Sections had a funding deficit. Deficits can be measured on a number of bases, however the most recent figures available showed an estimated aggregate deficit on a 'buy-out' basis (ie the amount it would cost to secure members' benefits by purchasing annuities) of £900m and an estimated aggregate deficit on the Pension Protection Fund (PPF)'s section 179 measure of £543m based on assets of £451m.

Position prior to restructuring

During the course of 2012, UK Coal Plc's board concluded that the Group's operating structure and balance sheet were not appropriate for the level of operating risk in the business. In particular:

- Due to the Group's structure, the failure of a single mine could put the entire business at risk of failure
- Despite support from stakeholders, the business had limited 'headroom' within its borrowing facilities which put continuing operations at risk.

As a result, the board concluded that it was necessary to restructure the Group in order to mitigate the operating risk and facilitate the raising of funds required by the Group.

The board also concluded that without a restructuring there was no possibility of shareholders receiving any return on their equity, given the Group's debts to its customers and bankers and the deficits in the UK Coal Sections.

Prior to the restructuring, the UK Coal Sections were reliant on the Group continuing to trade and being able to make substantial deficit repair contributions. The operational risks identified by UK Coal Plc's board were therefore also highly relevant to the trustees. In particular, without a restructuring, given the level of secured debt, in the event of failure of the mining business, as unsecured creditors the trustees stood to lose all or almost all of any potential value to them in the Group's property.

The initial proposal made by UK Coal to the regulator was for the liabilities in the UK Coal Sections to wholly or partially transfer to the PPF via a regulated apportionment arrangement (RAA), at the same time as a corporate restructuring. This would have severed the Group's liability to fund the UK Coal Sections in full or in part and meant that members would have received PPF compensation rather than scheme benefits. However, following detailed discussions and consideration of analysis prepared by the trustees' advisors, the regulator concluded that an RAA would not be appropriate or reasonable¹. As such, the regulator indicated to the parties that it would not approve an RAA and encouraged the parties to explore possible funding solutions.

¹ Where an RAA is proposed, the regulator will consider the relevant circumstances which may include whether insolvency of the sponsoring employer would be otherwise inevitable, or whether there could be other solutions (including funding options for the scheme) which would avoid insolvency. See the regulator's statement of August 2010 for further details.

Scheme funding negotiations

There was recognition by all parties that, as matters stood, the trustees of the UK Coal Sections were the largest unsecured creditors of the Group. The parties also recognised that value to all stakeholders was likely to be maximised if UK Coal was able to continue as a going concern.

Following extensive discussions over several months, the relevant stakeholders (including the Group, the trustees and the Group's bankers) agreed a plan to restructure the business. The key points of that plan were as follows²:

- As originally proposed, the Group would be split into two separate, ring-fenced businesses; mining and property
- Only the mining business, which would be largely free of any bank debt or security, would be liable to fund the UK Coal Sections. Payments of £30m pa (in aggregate) would be made to the UK Coal Sections, commencing in 2014. Any additional cash held by the business above an agreed ceiling would also be paid to the trustees. This initial contribution holiday would enable headroom to build up in the business to offset future operational risks
- No dividends would be payable from the mining business to its shareholders (ie the existing shareholders of UK Coal plc) until such time as the UK Coal Sections became fully funded in accordance with Part 3 of the Pensions Act 2004. Therefore substantially all of the cash which could be expected to be generated by the coal business would go to the UK Coal Sections
- The trustees would lose creditor rights over the property portfolio (as the entities holding the property would cease to be directly or indirectly liable to fund the UK Coal Sections or cease to be guarantors under the Protected Persons Regulations); however, the trustees would be granted a 75.1% equity stake in the holding company of the property business ('Propco')³
- The remaining 24.9% of Propco's shares would be owned by UK Coal Plc. The agreement to shareholders retaining a stake of this size was largely guided by the specific expertise in brownfield property development which could be offered by shareholders
- The trustees would make a £30m investment in Propco, in order to acquire the equity and provide the property operation with adequate funding to enable the release of the latent undeveloped value in the property portfolio. The trustees obtained specific advice in relation to this proposed investment, including advice on the expected value of the shareholding. This confirmed that the stake in Propco could be expected to have substantially more value to the Scheme than the monies invested
- Active members would continue to accrue benefits in the IWCS or IWMPS in accordance with the Protected Persons Regulations, albeit on a reduced basis with benefits capped to limit the cost of accrual.

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² Please note that, as with the entirety of this report, this list is not intended to be exhaustive.

³ Due to the ownership structure of the Group under this plan, Propco would not be an associate of, or connected with, the sponsoring employer of the UK Coal Sections. Therefore the trustees received legal advice that this investment could be made without contravening the restrictions in section 40 of the Pensions Act 1995 in relation to employer-related investment.

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- The effect of this restructuring plan would be to transfer substantially all of the economic interest in the Group from the existing shareholders to the trustees, via the majority shareholding in Propco and the restriction on the payment of dividends from the mining business until the UK Coal Sections become fully funded
- The separation of the ring-fenced businesses would preserve the value of the trustees' interest in Propco should the mining business fail. This would mitigate the risk present in the previous structure that the failure of the mining business would prevent the trustees from realising the potential value in the Group's property
- The trustees' view was that this plan represented the best outcome available for the UK Coal Sections.

Regulatory action

Various entities within the UK Coal group sought clearance from the regulator in respect of the restructuring plan, in relation to the regulator's power to issue contribution notices and (in respect of some of the applicants) in relation to the regulator's power to issue financial support directions.

The regulator considered the proposal and determined that it was appropriate to grant the requested clearances. In making this determination, the regulator had due regard to the following:

- As noted above, substantially all of the economic interest in the Group transferred from the existing shareholders to the UK Coal Sections
- In the particular circumstances of the Group, the retention of a significant stake in Propco by the existing shareholders was acceptable given the expertise which some of those shareholders could bring to the property business
- The trustees had sought investment, covenant and legal advice regarding the investment in Propco and had considered the size of the investment relative to the UK Coal Sections. The trustees had no conflicts affecting their decision to make this investment
- The restructuring would allow the Group to continue to trade, potentially allowing significant value to be generated for the UK Coal Sections. Whilst the UK Coal Sections will be subject to ongoing funding risks in the event of a future failure of the business, on balance these risks were acceptable in the particular circumstances of the case
- Whilst future accrual would not normally be appropriate in these situations, the particular circumstances of this case (including the provisions of the Protected Persons Regulations and the capped expense of accrual) meant that the continuation of accrual was acceptable.

Outcome

An extraordinary general meeting of UK Coal plc was held on 5 November 2012 in which the shareholders voted in favour of the restructuring.

In the regulator's view, the restructuring has improved the outlook for the business and will enable continued support to be provided to the UK Coal Sections from an ongoing sponsoring employer. This provides the best available opportunity to maximise the value which can be provided by the Group to the UK Coal Sections and so improve the chances of benefits being paid to the members.

However, all parties recognise that the UK Coal Sections have retained various risks, such as investment risk and the possibility that the restructured business will not be able to provide the expected funding/return to the trustees. Given these risks, the trustees and Group have agreed to establish a suitable monitoring plan to identify and, where appropriate, take steps to address ongoing risks to the UK Coal Sections. The Group has agreed to provide ongoing financial and management information to the trustees to facilitate this monitoring plan. The regulator continues to engage with the trustees in relation to the monitoring of these ongoing risks.

General

It remains the regulator's view that, where an employer is able to provide appropriate long-term funding to support a viable recovery plan, this is the best outcome for members and the PPF.

However where such long-term support is dependent on the restructuring or reorganisation of the sponsoring business, the regulator is prepared to work creatively with trustees and sponsoring employers to achieve optimal outcomes.

This statement must be read in conjunction with the relevant legislation. It does not override the legislation or provide a definitive interpretation of the law. The appropriate use of the regulator's powers in any case will depend upon its facts – 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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