Pensions Review

Stage 1 Call for Evidence

August 2021

Table of Contents

Introduction by Sir Brendan Barber

Under the terms of the Transport for London (TfL) Funding Agreement dated June 1 2021 HM Government required that TfL conduct a review (the Review) of the TfL Pension Fund (the Scheme) and reform options with the explicit aim of ensuring that the TfL's pension arrangements are sustainable and affordable in the long term, fair to employees, farepayers and taxpayers, and consistent with TFL's financial challenges ahead, while protecting members' benefits built up to date. These objectives are reflected in the Terms of Reference for the review attached as Appendix 1. I have asked TfL to set out a summary of their financial challenges and information in relation to its pension arrangements and this is attached at Appendix 2 and 3, respectively.

In considering how the Review should be taken forward TfL decided that, rather than simply conducting an internal review of the Scheme, it would be appropriate for the Review to be conducted by an independent person. I accepted TfL's invitation to lead the Review and also secured the participation of Joanne Segars whose expertise in the pensions world is unparalleled and highly respected. I also secured the support of George Boyce, a Senior Adviser at ACAS. Detailed TfL involvement with the Review will of course be essential but this Review will be independently conducted and any recommendations emerging will be the responsibility of Joanne and me.

In accepting TfL's invitation, I made it clear that I would intend to involve stakeholders throughout the Review process. I recognise how hugely important the sustainability, security and quality of pensions provision is to working people. I have formed a Contact Group with nominated union representatives with whom I will meet regularly during the Review process. Similarly, I will seek to arrange to meet with the Trustee and the Fund Office.

I am also now inviting written submissions of representations and evidence from:

- The Contact Group;
- The Trustee;
- The Fund Office;
- The Pensions Working Group;
- The Pensioners' Forum;
- Company Councils; and
- The Pensions Consultative Council.

I may approach various relevant external organisations with experience of managing similar pensions arrangements, and/or pensions reform, who may be able to offer lessons learned to the review as well as relevant authorities, such as The Pensions Regulator, who will have an interest in the outcome of the Review.

In due course it will be appropriate to examine all aspects of the Scheme, but, in the first instance, I intend to conduct this first round of engagement with all the relevant stakeholders about the core challenges to be considered.

Attached as Appendix 4 is my Stage 1 Call for Evidence, on which written responses are invited.

Appendix 1: Terms of Reference

Transport for London Pensions Review (the Review)

Terms of Reference

1. **Purpose of the Review**

Under the terms of the TfL funding agreement dated 1 June 2021, HM Government required that TfL conduct a review of the TfL Pension Fund (the **Scheme**) and reform options, with the explicit aim of moving TfL's pension arrangements into a financially sustainable position.

The purpose of the Review, therefore, is to conduct an assessment of the Scheme and to make recommendations in relation to TfL's pension arrangements generally that are sustainable and affordable in the long term, fair to employees, farepayers and taxpayers and consistent with TfL’s financial challenges ahead, while protecting members' benefits built up to date (the **Purpose**).

2. **Scheme Coverage**

The Review shall relate to all sections of the Scheme.

3. **Scope of the Review**

The Review shall have regard to and consider the following matters (the **Scope**):

A. the need to ensure that future pension provision is fair across TfL's employees, including protecting members' benefits built up to date;

B. the needs of TfL in ensuring generally that TfL's future pensions provision is affordable and sustainable in the long term for TfL, farepayers and taxpayers (including taking into account the volatility and risk associated with TfL’s contributions to the Scheme);

C. the circumstances of the Scheme in terms of its employer covenant, member contributions, benefits, funding position on the bases required under Part 3 of the Pensions Act 2004, section 179 of the Pensions Act 2004 and section 75 of the Pensions Act 1995, investment strategy, legal status and legal constraints on making changes under its trust documentation and how this compares to other public and private sector schemes; and based on these circumstances, produce an analysis of the funding and legal issues faced by TfL in relation to the Scheme;

D. how risk should be shared between farepayers, taxpayers, employees and members;

E. wider policy considerations such as provision of choices for, and promoting adequate saving for, retirement and longer working lives;

F. the needs of TfL as an employer in terms of recruitment and retention including matters such as the overall reward package being offered; and

G. potential implementation and transitional arrangements for any recommendations.

Based on the Purpose and Scope set out above, the Review shall consider all options for reforming TfL's pension arrangements, with nothing ruled in and nothing ruled out (the **Options**).

4. Review Scope Exclusions

It is recognised that TfL will be required by law to inform and consult with affected members and their union representatives about any proposals for reform which may arise as a consequence of the Review and to follow any required legislative processes. These matters are therefore excluded from the Scope.

5. Review Independent Lead

The Review shall be independently led and facilitated by Sir Brendan Barber (the **Independent Lead**) who will be joined by Joanne Segars OBE, who will provide independent expert pensions advice.

The Independent Lead will have access to the knowledge and full co-operation of TfL, including the provision of a secretariat function.

The Independent Lead shall also have access to professional external advice in relation to legal, actuarial and technical modelling matters.

The Independent Lead will conduct the Review in accordance with these terms of reference, including the matters set out in section 6 below.

6. Reporting Deliverables

The Review will:

- identify and clearly set out the potential pros and cons of Options that would meet the Purpose and Scope; and
- set out a recommended approach (including an explanation of why the other Options considered are not being recommended) that would meet the Purpose and Scope.

These matters shall be reported as follows (the **Deliverables**):

- by 31 October 2021, the Independent Lead shall provide a final list of Options under consideration; setting out high level, general assessments on how they could meet the matters set out in the Purpose and the Scope;
- by 11 December 2021, the Independent Lead shall provide an Interim Report which shall explain the Options that are being considered in further detail and

clearly describe in further detail how they meet the matters set out in the Purpose and the Scope; and

- by 31 March 2022, having considered all of the evidence and representations received, the Independent Lead shall provide a Final Report, setting out a full analysis of the Options and a recommended approach along with an implementation plan.

The Independent Lead shall meet regularly with TfL during the course of the Review period in order to discuss and report on progress and other matters pertaining to the completion of the Deliverables set out above.

7. Engagement, Evidence Gathering and Representations

The Independent Lead of the Review shall offer interested parties (including but not limited to trade unions, the Trustee of the Scheme, HM Government, other public and private sector organisations with relevant pension arrangements) a reasonable period of time to engage with and submit evidence and representations to the Review. This will be taken account of at all stages of the Review.

The Independent Lead shall decide how this engagement shall be organised considering the period of time available to conduct the Review; for example, via written correspondence and/or meetings.

The Independent Lead shall decide upon the general views and/or specific questions to be posed in the engagement, in consideration of the matters set out in the Purpose and Scope.

Appendix 2: TfL's Financial Context

1. Executive Summary

1.1. TfL's finances have been decimated by the pandemic, with significant reductions to revenue and other existing funding streams resulting in emergency financial support being provided by HM Government and requirements to deliver significant additional savings on top of existing ambitious efficiency plans.

1.2. TfL is currently facing a substantial average annual funding shortfall of around £1.6bn even after assumed savings are delivered and an additional source of revenue of at least £500m net has been found. This is exacerbated by the uncertainty that exists in the future in relation to the recovery of passenger demand for TfL's services.

1.3. As a result of the ongoing financial challenges, TfL must review every aspect of its organisation to see how it can work differently, save money and increase income, while continuing to maintain the safety of colleagues and customers. This includes, but is not limited to, the affordability of TfL's current pensions provision.

2. Background

2.1. TfL's finances have developed in the 20 years since it was created as an integrated transport authority.

2.2. TfL's financial position was relatively strong in its first decade with low debt, strong revenue growth and affordable long-term plans. From 2007-2009 TfL received:

2.2.1. A 10-year funding settlement covering the 2012 Olympic Games, investment in London Overground and Crossrail 1 construction;

2.2.2. Significant borrowing programme for TfL and Greater London Authority (GLA), with proceeds funding its investment programme;

2.2.3. Agreement on two hypothecated taxes, Business Rates Supplement and Mayoral Community Infrastructure Levy.

2.3. From 2010 onwards, several factors have led to changes in TfL's financial position. These include:

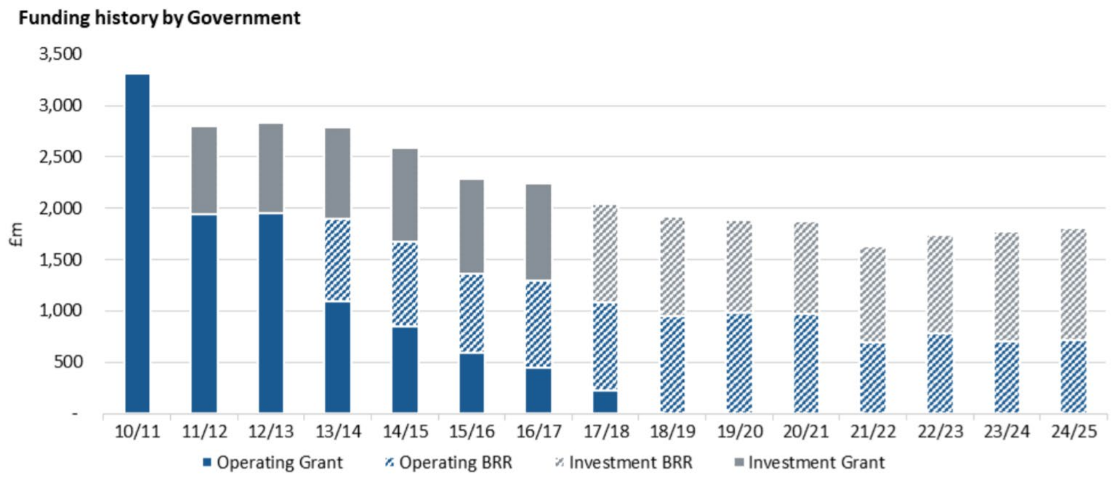
2.3.1. Reductions in Operating Grant of £1bn per annum since 2015;

2.3.2. Delays in opening Crossrail 1 leading to lower than anticipated revenues and TfL and the GLA bearing a significant portion of additional capital costs;

2.3.3. Growing levels of debt reducing TfL's fiscal headroom.

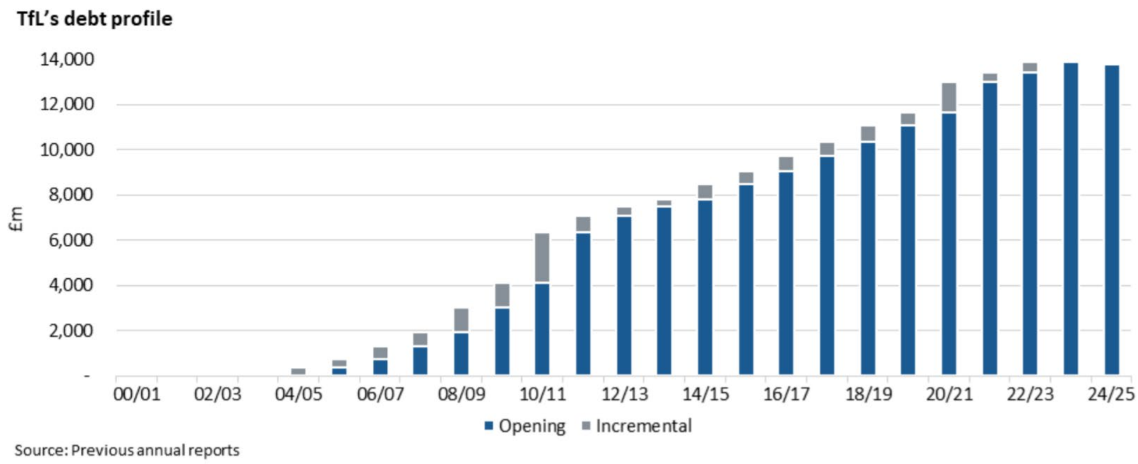
2.4. TfL's operating and capital grants from Central Government were swapped in three stages for allocations of London's rates under the Business Rates Retention scheme. This is demonstrated in Chart 1.

Appendix 2 Chart 1 – Government Funding History



2.5. Chart 2 shows how TfL's debt grew to around £13bn by financial year 2020/21, reaching the limit of affordability against its revenue base. This means that TfL can no longer borrow significantly into the future without increases in revenue or other recurring funding streams.

Appendix 2 Chart 2 – TfL's Debt Profile



2.6. Recognising the importance of managing costs, TfL's financial plans include a wide ranging and ambitious efficiency programme. From financial year 2016/17 to 2019/20 TfL made almost £1bn of annualised recurring savings across the organisation. A significant proportion of these savings were achieved in reducing back office costs and reducing like-for-like costs by £170m compared with financial year 2015/16. In addition to the savings already delivered, an additional £730m of efficiencies are planned to be delivered over financial years 2019/20 to 2024/25.

Pre-pandemic TfL were on track to deliver an operating surplus

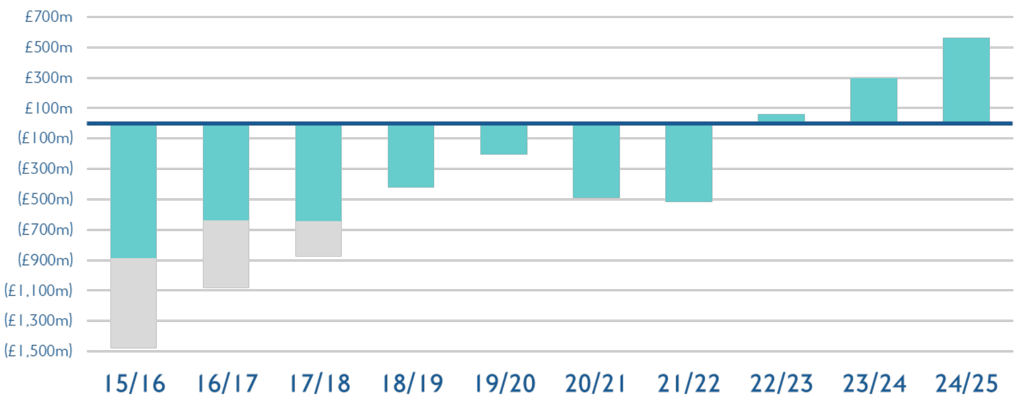
2.7. TfL's efficiency programme meant it was on a path to breakeven the cost of operations, maintenance, financing costs and core renewals, with TfL having taken almost £1bn out of its net operating costs over the past four years. London Underground alone were forecast to achieve a £1bn surplus. Despite this, TfL still required external support for capital investment. Grant levels prior to 2012 demonstrate that the capital's transport has always needed national support.

2.8. In addition, TfL has also made significant progress in the generation of new commercial income streams. TfL has in recent years increased the income it raises from property development, management of its media and advertising estate, and leveraging its expertise and intellectual property in markets in the UK and overseas.

2.9. Finally, the opening of stage 3 of Crossrail (now forecast to take place in the first half of calendar year 2022) is also expected to contribute significantly to financial sustainability as the line is expected to generate a net operating surplus.

2.10. As recently as March 2020, TfL was on track to reduce its like-for-like operating deficit for the fourth consecutive year, with a firm plan to turn this into an operating surplus during financial year 2022/23. This is illustrated in Chart 3 below.

Appendix 2 Chart 3 – TfL's Net Cost of Operations – 2019 Business Plan



But there was a requirement for additional funding for the capital programme

2.11. Despite the operating account approaching break even, and before the coronavirus pandemic, the funding challenge on the capital account was forcing the deferral of some asset renewals and threatening TfL's ability to achieve its future objectives. TfL was showing a projected shortfall in affording the 2019 capital plan of around £1bn per annum.

3. Impact of the COVID-19 pandemic

The pandemic has decimated TfL's finances

3.1. At the peak of the COVID-19 pandemic TfL's overall passenger demand was reduced by more than 90 per cent, with Tube journeys falling by over 95 per cent. This resulted in TfL's income falling by 90 per cent in the first six weeks of the pandemic, while TfL's cash balances dropped by £200m in the final two weeks of financial year 2019/20. Although passenger demand has recovered since, total passenger journeys are still only at 54 per cent of pre-pandemic levels.

3.2. Passenger income for the financial year 2020/21 dropped to £3bn, a decrease of 66 per cent compared with financial year 2019/20, while TfL spent £144m in operating costs directly related to the pandemic. TfL also spent 35 per cent less on capital investment during 2020/21. As restrictions lifted, car use rebounded more rapidly than the use of public transport.

Overreliance on fares revenue exposed TfL to financial shocks

3.3. The pandemic exposed the current funding model (in place since 2015, following the withdrawal of the operating grant for the delivery of transport services) to be overly reliant on fare revenues (this dependence being much higher than other major public transport operators internationally). Due to the high fixed cost nature of transport infrastructure, reducing operating costs in line with reductions in demand has proved impossible in the short to medium term. TfL's significant exposure to changes in demand due to its high fixed costs and dependence on fares revenue mean that it is particularly susceptible to potential future recessions. Running fewer services would not have delivered significant savings and it was right that TfL played a vital role in keeping London moving for key workers.

Emergency Government support was required to keep London moving

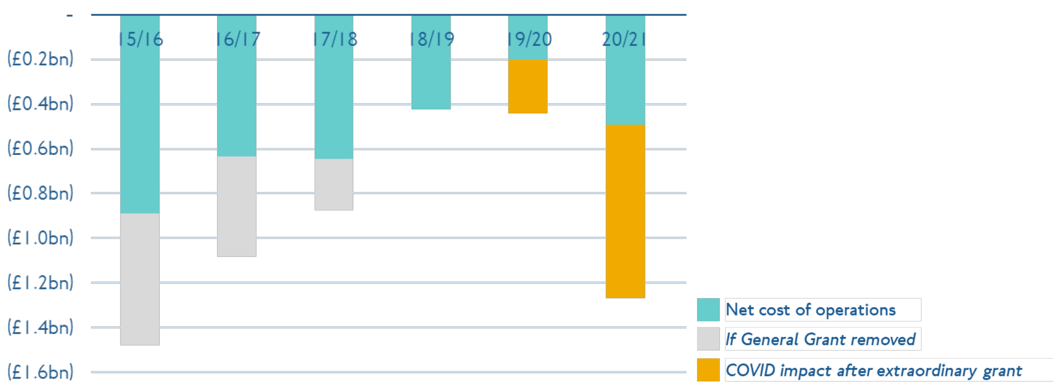
3.4. This meant that emergency financial support from Government was and continues to be required in the short term. TfL has entered into three substantive funding agreements with Government. On 14 May 2020, the Secretary of State for Transport confirmed that £1.6bn of funding would be made available to TfL over the period from 1 April to 17 October 2020. This included around £1.1 bn of grant funding and a further £505m of additional borrowing from the Public Works Loan Board (PWLB). On the 31 October 2020, the Secretary of State for Transport agreed further funding of 18 October 2020 until the 31 March 2021 including £905m of grant and additional borrowing by TfL from the PWLB of £95m. On the 1 June 2021, the Secretary of State for Transport provided further funding of £1.08bn until 11 December 2021. Since the 18 October 2020 funding agreement, Government has provided a revenue top up mechanism under which TfL's revenues are supplemented by further grant payments if revenue is lower than the Government forecast or repaid if higher. Total support provided to TfL by Government amounts to around £5bn.

3.5. The pandemic has had significant impacts on TfL's overall operating deficit, demonstrated in Chart 4. The impacts are significant across TfL's divisional businesses. The net cost of operations for London Underground in financial year 2019/20 (the year before the pandemic) was at a deficit of £148m, very close London Underground being financially sustainable. However, in financial year 2020/21, this deficit plummeted to over £2bn. Similarly, in the surface businesses, comparing the net cost of operations from financial year 2019/20

[1] https://content.tfl.gov.uk/tfl-extraordinary-funding-and-financing-settlement-letter-1-june-2021.pdf

to financial year 2020/21, the deficit position grew from around £1.1bn to around £1.8bn, a significant deterioration of £700m.

Appendix 2 Chart 4 – TfL's Net Cost of Operations – Impact of the pandemic



Uncertainty in passenger demand poses challenges for the future

3.6. It is not yet clear how travel patterns will change in the medium to long term or how quickly demand will return to pre-pandemic levels. This is because the pandemic has resulted in more people working from home, shopping locally or online and making shorter journeys on foot or by bike.

4. Financial Sustainability Plan

4.1. Under the terms of its funding agreements, Government required TfL to *"produce a single, comprehensive management plan with options as to how a trajectory to financial sustainability could be achieved by as soon as possible with a target date of financial year 2022/23".* On 11 January 2021 TfL published its Financial Sustainability Plan (FSP)[2]. The FSP noted that the pandemic led to a crisis in TfL's immediate financial position; but with its effect on longer term travel demand in London, it could also impact the organisation's long-term finances and funding gap.

The Financial Sustainability Plan forecasts an ongoing funding gap

4.2. The FSP modelled various demand scenarios, which highlighted the trajectory towards sustainability pre-pandemic, the impact of the pandemic and that there is likely to remain a very significant gap towards TfL achieving financial sustainability going forwards without a long-term funding arrangement with Government. By financial year 2023/24, it is estimated that TfL could cover the costs of operations, maintenance and financing costs, by financial year 2024/25 it could also start to cover the cost of its core renewals. To deliver this, £500m per annum of additional income is required which may be from revenue such as Vehicle Excise Duty, a possible Greater London Boundary Charge (subject to consultation, impact assessment and decision making) or other sources of income. The funding gap to cover the remaining renewals, enhancements & to

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[2] https://content.tfl.gov.uk/financial-sustainability-plan-11-january-2021.pdf

decarbonise by 2030, is estimated to be on average £1.6bn per annum from 2023 to 2030, even after TfL's ambitious savings programmes are delivered.

5. Annual Report and Statement of Accounts 31 March 2021 and the financial year 2021/22 Revised Budget

5.1. The impact of the pandemic was set out in more detail in TfL's Annual Report and Statement of Accounts for year ending 31 March 2021[3].

5.2. Following the latest funding agreement on 1 June, TfL produced a Revised Budget[4] covering the reminder of financial year 2021/22 and the full financial year 2022/23. This was approved by the TfL Board on 28 July 2021.

5.3. The Revised Budget includes updated assumptions based on the conditions set out in the Funding Agreement with the Government of 1 June 2021, including the requirement to find a further £300m of savings on top existing efficiency and savings programmes. The Revised Budget also includes the latest cost estimates and income profiles including passenger revenue scenarios based on the updated Government Roadmap.

TfL's financial performance is improving compared to previous budgets

5.4. By the end of the first quarter of financial year 2021/22 (quarter ending June 2021), TfL's net cost of operations, that is the day-to-day operating deficit including capital renewals and financing costs – before Government funding – was £636m. This is £370m, or 37 per cent, better than TfL's March 2021/22 Budget. This is driven by higher than expected passenger revenue, which was £175m better than TfL's March 2021/22 Budget, as journeys increased at a faster rate than expected after steps 1 to 3 of the Government's Roadmap. Operating costs were also £71m lower than TfL's March 2021/22 Budget due to tight spend controls and deferrals to spend due to funding uncertainty.

5.5. While performing better than the March 2021/22 Budget and against last year, the day-to-day deficit remains significantly worse than pre-pandemic levels. Compared to the first quarter of 2019/20, the net cost of operations (excluding extraordinary funding from Government) is £600m worse, driven by almost £530m lower passenger income.

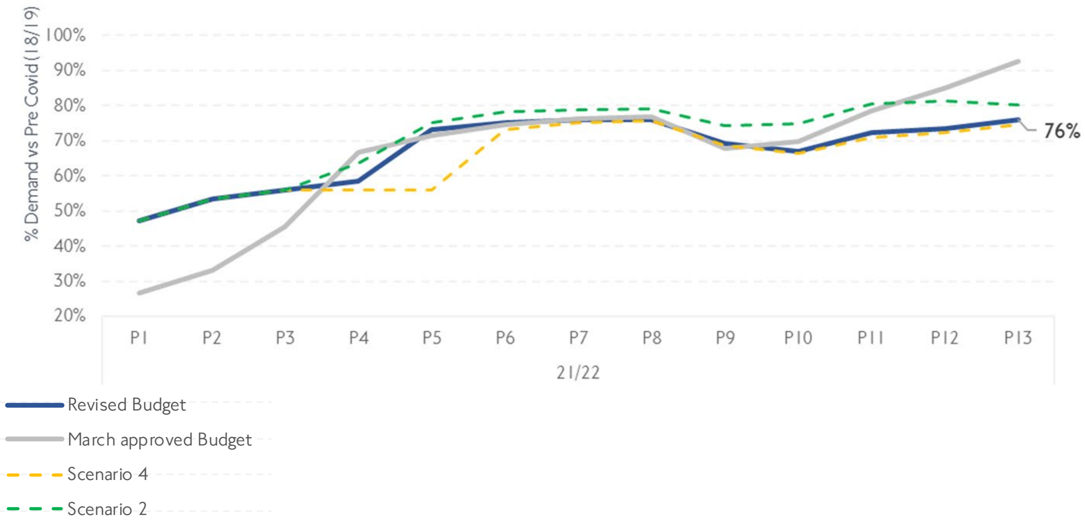
But the Revised Budget demonstrates that financial challenges remain…

5.6. The Revised Budget highlights the continued financial challenges that TfL faces. The Revised Budget reflects the latest modelling which predicts (in the central case) that passenger demand by the end of financial year 2021/22 will only recover to 76 per cent of the pre-pandemic levels of financial year 2018/19. There is still a great deal of uncertainty around passenger demand and revenue, and scenario modelling indicates a range of +/- £200m for this financial year. This is illustrated in Chart 5 below. TfL continues to discuss the need for additional funding, including the continuation of the revenue mechanism, with Government. As a result of the ongoing financial challenges, TfL will need to review every aspect of its organisation to see how it can work

[3] https://content.tfl.gov.uk/board-20210728-agenda-papers-item07-annual-report-accounts.pdf
[4] https://content.tfl.gov.uk/board-20210728-supplementary-agenda.pdf

differently, save money and increase income, while continuing to maintain the safety of colleagues and customers.

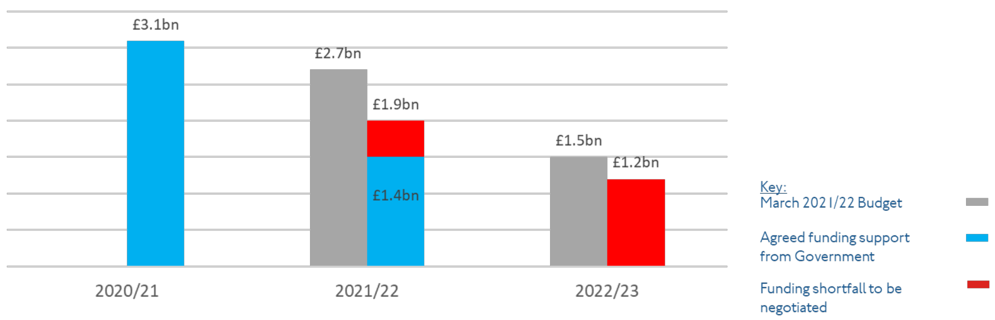
Appendix 2 Chart 5 – Demand Recovery Scenarios



5.7. The Revised Budget sets divisional targets to help achieve financial sustainability across TfL and fund long-term investment needs. The target for Rail (including London Underground) is to cover renewals from its operating surplus after financing and indirect costs and to start contributing towards the cost of replacing its life expired assets. This means moving from the current FSP forecast for 2023/24 of an £800m deficit, to a £300m surplus. The target for the combined bus and streets network is for the net cost of operations (including renewals) to break even without the need for ongoing operating subsidy. This means moving from a pre-pandemic deficit of £1.1bn to a net zero.

5.8. TfL is legally required to produce a balanced budget. The Revised Budget sets out the total TfL funding requirement for financial year 2021/22 of £1.9bn and for financial year 2022/23 of £1.2bn. Taking into account agreed funding for the year, an additional £500m grant funding is required for the remainder of financial year 2021/22 once the funding agreed in the June 2021 Funding Agreement ends on 11 December 2021 in order to maintain a balanced budget. This is illustrated in Chart 6 below.

Appendix 2 Chart 6 – TfL Total Funding Gap (excluding Government Grant)



Appendix 3: TfL's Pension Arrangements

1. Introduction

1.1. The TfL Pension Fund (the Scheme)[5] is a funded occupational "final salary" multi-employer defined benefit pension scheme set up under trust, regulated under UK pensions legislation. The Scheme is separate and distinct from Transport for London (TfL) and its subsidiaries.

1.2. TfL is the principal sponsoring employer of the Scheme and TfL Trustee Company Limited is the trustee of the Scheme (the Trustee).

1.3. The Scheme has two sections – the Public Sector Section (in which TfL and its subsidiaries participate) and the Composite Section (in which Thales Transport and Security Limited and Cubic Transportation Systems Limited participate). The Public Sector Section holds over 99% of the Scheme's liabilities.

1.4. The Scheme is a "balance of cost" arrangement, where members currently pay a fixed contribution of 5% of their pensionable salary (or pro-rated pensionable salary if the member works part time) and TfL pays the balance of cost required to meet the Scheme's liabilities.

1.5. The Scheme has around 85,000 members, of whom over 25,000 are active contributing members.

1.6. The Scheme is open to new members and the future accrual of benefits.

2. History of the Scheme

2.1. The provision of transport in London was first centralised by the London Passenger Transport Act 1933 when the London Passenger Transport Board (LPTB) was formed to operate the underground, buses and trams in the capital. The activities of LPTB were overseen by the London County Council. The LPTB was responsible for transport in London from 1933 to 1947.

2.2. When the railways were nationalised by the Transport Act 1947, the British Transport Commission (BTC) was formed and the London Transport Executive (LTE) was established and was responsible for transport in London from 1948 to 1962.

2.3. The BTC was broken up by the Transport Act 1962 and its assets were distributed to various bodies including to the London Transport Board (LTB). The LTB was responsible for transport in London from 1963 to 1969. The activities of the LTB were overseen by the Minister of Transport. The LTB established and operated a final salary pension scheme known as the London Transport Pension Fund (the Wages Fund).

2.4. When the Greater London Council (GLC) took over responsibility for transport in London, a transport executive was formed under the London Transport Act 1969 and was again called the London Transport Executive (LTE). The LTE

[5] https://tfl.gov.uk/pensions/

was responsible for transport in London from 1970 to 1984. The LTE established and operated a final salary pension scheme known as the London Transport 1970 Superannuation Fund (the Staff Fund).

2.5. The GLC was abolished in 1984 and responsibility for public transport in London was transferred from the GLC to the Secretary of State for Transport. The LTE was renamed and reorganised by the London Regional Transport Act 1984 and became known as London Regional Transport (LRT). LRT was responsible for transport in London from 1984 to 2000. The Scheme was established by LRT in its current form on 1 April 1989 and is, in effect, an amalgamation of the both the Wages Fund and the Staff Fund which was achieved by a private Act of Parliament (section 16 London Regional Transport Act 1989).

2.6. TfL was formed in 2000 and took over the operation of public transport in London when responsibility for transport was transferred from the Secretary of State for Transport to the Mayor of London. TfL substituted LRT as the principal sponsoring employer of the Scheme on 3 July 2000.

2.7. When Metronet (the contracting organisation for two of the three London Underground PPPs) went into administration in 2007, TfL guaranteed the pension liabilities and obligations of Metronet to the Scheme and subsequently, when the Metronet employees were transferred to London Underground Limited, these liabilities became part of the Scheme.

2.8. Tube Lines Limited (the third contracting organisation for the London Underground PPPs) was acquired as a wholly owned subsidiary of TfL in 2010 and employees of Tube Lines Limited were later also provided with the opportunity to become members of the Scheme.

2.9. The Scheme is the pension arrangement used by TfL for “auto-enrolment” purposes. Permanent employees of TfL are automatically included as a member of the Scheme when they begin employment with TfL. Membership is not compulsory, and employees can opt out if they wish.

3. Summary of the Scheme benefit design

3.1. Benefits payable[6] to or in respect of members are calculated by reference to their final salary when they retire, leave service or die (whichever happens first).

3.2. In summary, the benefit calculation formula for most TfL employees (payable unreduced from age 60, provided the member has more than three months' pensionable service) is:

1/60 × Pensionable Service × Pensionable Salary

3.3. Pensionable Salary is a member’s basic or contractual salary and may include permanent allowances where agreed with the employer and the Trustees but excludes overtime earnings, less the lower earnings limit. Pensionable salary is restricted to a level known as the scheme earnings cap, currently £170,400.

[6] https://tfl.gov.uk/pensions/your-pension/retirement; https://tfl.gov.uk/pensions/your-pension/ill-health-retirement

3.4. Pensionable Service is the period of time a member earns benefits from the Scheme as a contributing member. Pensionable service begins when a member joins the Scheme and builds to when a member retires or stops paying contributions, whichever is earlier. Part-time service is pro-rated.

3.5. Members may also exchange part of their pension for a tax-free cash lump sum. The maximum lump sum that can be paid is broadly 25% of the value of a member's pension at retirement.

3.6. On the death of a member, their adult dependants and eligible children may be entitled to receive benefits[7]. This could be in the form of a cash lump sum or a pension, or both, and depends on the member's and their survivors' circumstances at the time. If a member dies whilst still in service, then a lump sum of four times the member's pensionable salary is payable at the discretion of the Trustee.

3.7. Members' pensions revalue in deferment and increase in payment broadly in line with inflation each year, subject to certain caps[8]. The primary measure of inflation used for this purpose is the Retail Prices Index (RPI).

3.8. The Scheme also provides a facility for members to pay Additional Voluntary Contributions[9]. These are credited to individual member accounts, which are kept separate from the other assets of the Scheme and used to either fund the tax-free cash lump sum referred to above or provide additional defined contribution pension benefits on retirement.

4. The Trustee and Scheme administration

4.1. The Scheme is currently governed by a Consolidated Trust Deed and Rules entered into between TfL and the Trustee dated 19 December 2008 (as amended) (the Scheme Rules)[10].

4.2. The Trustee is the sole trustee of the Scheme.

4.3. The Scheme Rules require there to be 18 directors of the Trustee (Trustee Directors)[11]:

4.3.1. nine Trustee Directors must be nominated by TfL as the principal employer (of whom at least five must be members of the Scheme);

4.3.2. one Trustee Director each must be nominated by five specified trade unions and other representative bodies; and

4.3.3. four Trustee Directors must be nominated by members, through the TfL Pension Consultative Council (of whom two must be either pensioner or deferred and the other two must be active; one employed within the

[7] https://tfl.gov.uk/pensions/your-pension/benefits-on-death
[8] https://tfl.gov.uk/pensions/your-pension/pension-payments-and-deductions
[9] https://tfl.gov.uk/pensions/your-pension/your-contributions/additional-voluntary-contributions?intcmp=23579
[10] https://content.tfl.gov.uk/trust-deed-and-rules.pdf
[11] https://tfl.gov.uk/pensions/fund-management/trustee-board

London Underground Limited group of companies or subcontractors and the other not employed within that group).

4.4. The Trustee holds a general board meeting, which meets five times a year. There are also six specific committees: Operations, Audit, Investment, Actuarial Valuation, Appeals, and the Alternatives and Liability Hedging committee. In summary, the role of the Trustee is to administer the Scheme according to the Scheme Rules and overriding law and regulations and, when exercising its powers, to act in the best financial interests of the Scheme's members and other beneficiaries, to act impartially, prudently and honestly, to invest the Scheme's assets to obtain the best long-term return without putting the Scheme at undue risk.

4.5. The day to day administration of the Scheme is carried out by a specialist team, in-house. Independent specialist investment managers carry out day-to-day investment matters on the Trustee's behalf[12]. The Trustee also receives independent professional advice on actuarial, legal and audit matters from reputable third-party specialists.

5. Current Scheme funding position

5.1. Every three years the Trustee is required by law to carry out an actuarial valuation of the Scheme. As the last triennial valuation was carried out as at 31 March 2018 (the 2018 valuation)[13], the Trustee is currently carrying out its latest triennial valuation, in discussion with TfL, with a calculation date of 31 March 2021 (the 2021 valuation). The law requires these valuations to be agreed within 15 months, meaning that the 2021 valuation must be agreed between TfL and the Trustee by 30 June 2022.

5.2. The purpose of the valuation is to assess the value of the Scheme’s assets and liabilities as at the assessment date (known as the effective valuation date) and to review and, if necessary, revise the level of contributions paid by TfL; both in respect of any deficit arising in the Scheme in respect of past service benefits and those contributions required to meet the cost of new benefits that will be earned by active members in future.

5.3. The method and assumptions used in the valuation to calculate the value of the Scheme’s liabilities (the Technical Provisions), as well as the required level of contributions, must be agreed between TfL and the Trustee and set out in a number of key compliance documents which are ultimately submitted to the Pensions Regulator (the Regulator). The contributions agreed between TfL and the Trustee must be set out in a Schedule of Contributions, with the deficit recovery contributions also set out in a separate Recovery Plan.

5.4. The Technical Provisions are calculated by discounting the expected future cash flows from the Scheme. The discount rate and cash flows take into account current financial market conditions and expected future trends in respect of several key factors, such as:

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[12] https://tfl.gov.uk/pensions/fund-management/investment-management-and-principles
[13] https://tfl.gov.uk/pensions/fund-management/actuarial-valuation

5.4.1. the level of investment returns expected to be generated by the Scheme's assets and an associated level of confidence in these expectations being realised in practice, in light of the current and future investment strategy of the Scheme;

5.4.2. the level of salary growth expected for the Scheme's active members;

5.4.3. the degree to which TfL's covenant can support a range of likely adverse outcomes;

5.4.4. the expected level of future price inflation (set with reference to the RPI) which dictates the rate at which benefits are expected to grow when in payment and, for deferred members, before their retirement date; and

5.4.5. demographic assumptions such as how long Scheme members are expected to live and what spouses, civil partners or other dependants the members are expected to leave behind.

5.5. On the basis of the key assumptions agreed as part of the 2018 valuation, there was a deficit in the assets (which totalled £10,321m) versus the Technical Provisions (of £10,924m) in the Public Sector Section of £603m as at 31 March 2018[14]. In order to make up this deficit under a new Recovery Plan[15], it was agreed that TfL would pay contributions of at least £70m per annum (indexed) per annum until 31 May 2026. These contributions are paid as 6.4% of active members' pensionable salaries per annum.

5.6. In addition, TfL agreed to pay 26.9% per annum of active members' pensionable salaries to meet the cost of new benefits accruing for active members (with active members continuing to pay a fixed contribution of 5% of their pensionable salaries). This currently equates to around £295m per annum.

5.7. Therefore, TfL's total current pensions contributions equate to around £370m per annum, or 33.3% of pensionable salaries[16].

6. Scheme investment strategy

6.1. The Trustee sets the Scheme's investment strategy, in consultation with TfL[17]. The primary objective of the Trustee's investment strategy is that the Scheme's existing assets, together with future contributions from members and TfL, will be sufficient to meet the cost of the past and future service benefits to be provided from the Scheme.

6.2. Whilst the Trustee is required to act prudently when setting the Scheme's investment strategy, it has recognised that the current level of funding and strength of TfL's covenant permits some risk being taken in pursuit of growth (i.e. a deviation from a liability-matched portfolio).

6.3. In summary, the investment policy therefore pays regard to the following:

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[14] https://content.tfl.gov.uk/public-sector-section-actuarial-valuation-report-2019-01.pdf
[15] https://content.tfl.gov.uk/public-sector-section-recovery-plan-2019-01.pdf
[16] https://content.tfl.gov.uk/public-sector-section-schedule-of-contributions-2019-01.pdf
[17] https://content.tfl.gov.uk/statement-of-investment-principles-march-2021-1.pdf

6.3.1. the security of members' benefits;

6.3.2. the need to comply with scheme-specific funding requirements set out under Part 3 of the Pensions Act 2004;

6.3.3. a desire to control the cost of benefits by preserving the Scheme's wealth;

6.3.4. a desire to limit instability in contribution rates as a result of any failure of the investment strategy;

6.3.5. notwithstanding the above, a willingness to embrace risk in a controlled fashion in order to achieve incremental excess return.

7. Regulatory Context

7.1. As explained above, the Scheme is a private sector scheme established under trust. Whilst a matter of historical accident rather than design, this anomaly causes the Scheme to be subject to an increasingly challenging funding environment. This is because the Regulator is required, by legislation, to treat the Scheme like other private sector schemes despite TfL being a public sector body.

7.2. The law which sets out the funding requirements for private sector schemes is contained in Part 3 of the Pensions Act 2004[18]. In summary, to secure accrued benefits, the Regulator focusses on requiring increased levels of prudence and contributions, in order to reduce risk over time. The Regulator's Annual Funding Statement 2021[19] suggests that, for this purpose, all private sector scheme employers and trustees should be seeking to agree a long-term funding target. This typically means aiming for their scheme to achieve a level of assets, by the time it has reached significant maturity, such that it has a substantially reduced dependency on the scheme employer.

7.3. The Pension Schemes Act 2021[20], once fully implemented, will make it a requirement for all private sector schemes to put in place a legally binding long-term strategy, designed to achieve an agreed long-term funding target. The Regulator is developing updated guidance to sit alongside this new requirement, which is currently being revised and is expected to be ready for consultation towards the end of 2021. Broadly speaking, this new requirement is likely to mean that employers of private sector schemes, such as TfL, are put under increased pressure to pay more money into their schemes more quickly.

7.4. Where the Regulator considers that a private sector scheme is not being funded in accordance with Part 3 of the Pensions Act 2004 and its associated guidance, it has significant powers available to it, including an ability to impose its own measure of the scheme's liabilities and to set the level of contributions required to be paid by the scheme employer.

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[18] https://www.legislation.gov.uk/ukpga/2004/35/part/3

[19] https://www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2021

[20] https://www.legislation.gov.uk/ukpga/2021/1/contents/enacted

7.5. The new requirements and associated Regulator guidance being introduced with the Pension Schemes Act 2021 increase the uncertainty and potential significance attached to this regulatory risk for TfL.

7.6. As stated above, TfL as a public sector body (which does not pay dividends to shareholders) is required by legislation to operate a balanced budget and has its own statutory objectives in relation to the development and maintenance of London's transport infrastructure.

7.7. For comparison, whilst the Regulator oversees the governance of public sector schemes, it has no role in their financial management nor the security of members' benefits, which is a matter solely for Government to determine. It is the case that public sector schemes have different funding arrangements and are permitted to have longer recovery periods when deficits arise.

8. Scheme Specific Issues

8.1. As noted above, the Scheme currently provides a benefit which is linked to each member's "final salary" when they retire, leave service or die (whichever happens first). The link to final salary means that benefits provided to members can potentially significantly increase beyond that funded for if members receive a large salary increase towards the end of their career.

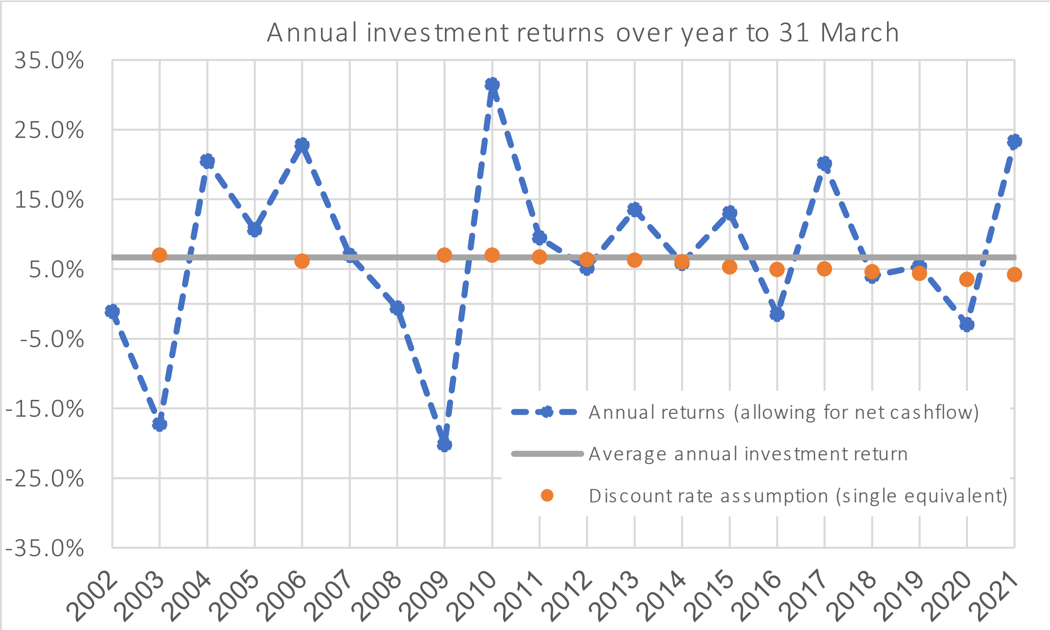
8.2. The Scheme is "balance of cost" in nature, such that members pay a fixed contribution rate equal to 5% of their pensionable salary and TfL meets any required contributions over and above this to meet the Scheme's liabilities. This means that TfL is exposed to all the risk that providing the promised benefits turn out to cost more than expected.

8.3. TfL is exposed to a number of different risks in relation to the Scheme. These are explained in further detail below.

<u>Investment risks</u>

8.4. One of the key assumptions made in an actuarial valuation is the discount rate. This is the level of investment returns expected to be generated by the Scheme's assets, with an associated level of confidence in these expectations being realised in practice. A high proportion of the Scheme's assets are invested in return-seeking classes (such as equities and alternatives) which are intended to maximise returns and, in turn, reduce the expected contributions from TfL. However, a higher risk investment strategy also means that investment returns are expected to be more volatile from one year to the next. This is illustrated by Chart below, which shows the annual returns actually received by the Scheme's assets over the last 20 years:

Appendix 3 Chart 1 – The Scheme's investment returns and discount rate assumptions over the last 20 years

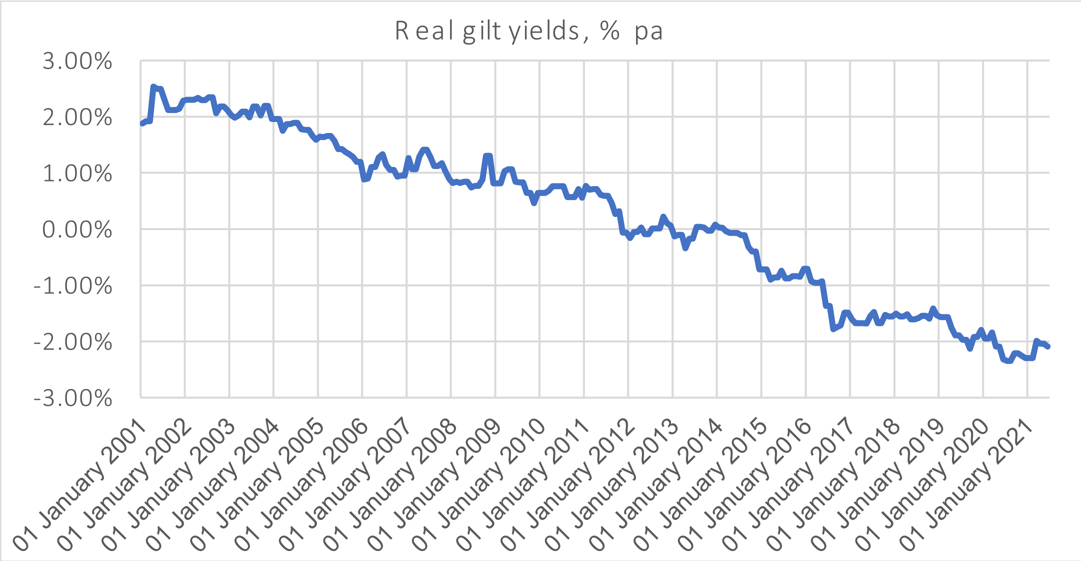


8.5. As the private sector funding regime requires the Scheme's assets (when compared to the Technical Provisions) to be assessed at a particular date, the Scheme, and hence TfL, carry a risk that a valuation falls due when the Scheme's assets have fallen in value (with no corresponding fall in the Technical Provisions). If this occurs, then there is the possibility that substantial deficits can result which can, in turn, lead to the need for TfL to pay substantial additional contributions. The significant size of the Scheme also means that a relatively small change in investment performance can lead to a relatively large increase in contributions needed from TfL.

8.6. Chart 1 also shows the discount rates (i.e. the allowance for the annual returns expected to be generated by the Scheme's assets, in future) that have been used by the Scheme actuary in the Scheme's funding assessments at each actuarial valuation and interim funding updates since 2003. This shows that the discount rate, and hence expected future investment returns, has fallen over the years, from 7.0 per cent per annum in 2003 to around an estimated 4.2 per cent per annum based on the 2018 valuation basis (updated for market conditions at 31 March 2021).

8.7. There are a number of reasons as to why discount rates have fallen over the years, but a key determinant is the very significant fall in real gilt yields over recent decades, as shown in Chart 2 below. In summary, this is because gilt yields are often considered to be a useful indicator of future investment returns. Notably, if future investment return expectations fall, then liabilities increase, as less reliance can be placed on investment income to meet the cost of the future benefit commitments. As such, unless the value of a pension scheme's assets rises in a similar way, falling gilt yields and investment return expectations give rise to larger shortfalls, all else being equal.

Appendix 3 Chart 2 – Real gilt yields over the last 20 years



Source: FTSE Actuaries Government Securities Index Linked over 15 years index – 3 per cent inflation

8.8. Falling interest and discount rates put further pressure on pension scheme funding, as lower expected future investment returns mean higher Technical Provisions and, in turn, that pension scheme sponsors, such as TfL, need to find cash to meet the inevitable 'funding gap' that arises.

Mortality risk

8.9. Another risk is the risk that members live longer than expected.

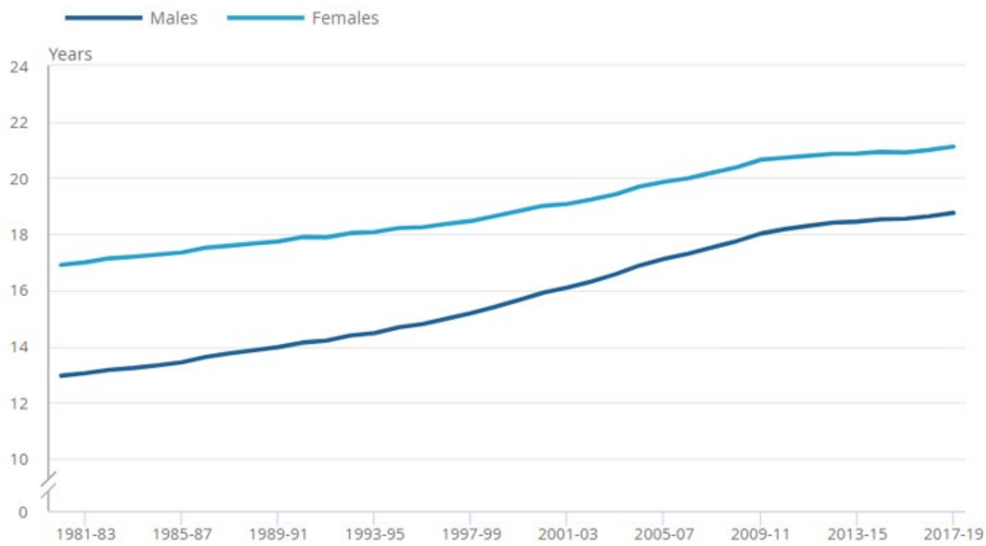
8.10. Higher life expectancy means that pensions are likely to be paid for longer, which increases the cost of providing the pension entitlement in the Scheme.

8.11. The impact of rising life expectancy is exacerbated when investment returns are lower. This is because an additional year of life expectancy leads to a greater increase in the Scheme's liabilities when the cash flows are discounted at a lower discount rate.

8.12. Life expectancies have increased substantially over the last few decades. This is illustrated in Chart 3 below, taken from the Office for National Statistics (ONS).

8.13. Chart 3 shows that over the period between 1980 and 2019, life expectancy increased by 5.8 years for males and 4.2 years for females. This has had a very significant impact on the Scheme's Technical Provisions, all else being equal.

Appendix 3 Chart 3 – Life expectancy at age 65 for males and females, UK: 1980 to 1982 and 2017 to 2019



Source: Office for National Statistics – National life tables – life expectancy in the UK: 2017 to 2019

<u>Covenant risk</u>

8.14. Another risk affecting the contributions required to fund a defined benefit pension scheme, such as the Scheme, is the strength of the sponsor covenant supporting it. In general, the Regulator expects funding assumptions to be set consistently with the strength of the sponsor covenant, such that if the sponsor is viewed to be "strong" then it is more likely to be able to support the pension scheme for the longer term, allowing the trustees to invest in higher risk assets and fund with relatively less prudence, in the expectation that the sponsor would reasonably be able to make up any funding shortfalls, should this be required. If the sponsor covenant is assessed as being "weak" then the converse is true, which would normally give rise to a higher value being placed on a pension scheme's Technical Provisions.

8.15. As explained in Appendix 2, the Covid-19 pandemic has had a significant impact on TfL's finances. In line with standard practice, the Trustee will formally assess the strength of the covenant provided to the Scheme as part of the 2021 valuation. However, if the covenant is deemed to have weakened, then this is could mean that the Trustee may aim to be more prudent in its funding assumptions, which will result in higher contributions than would otherwise have been the case.

<u>Other risks</u>

8.16. It is necessary to make a large number of assumptions in a formal actuarial valuation and there is a risk that these are not borne out in practice, giving rise to higher contributions than anticipated. These include:

8.16.1. the level of future salary growth for contributing members, in particular the risk that members receive a large salary increase towards the end of their career given the final salary nature of the Scheme.

8.16.2. how RPI inflation will increase in future, which affects the rate at which deferred and pensioner members' benefits increase.

8.16.3. the chance a member has an eligible dependant (spouse, civil partner or child) in the event of their death, and the age of the dependant.

9. Cost and volatility of the Scheme for TfL

9.1. Driven by many of the risks explained above, the costs for TfL of providing benefits in the Scheme have increased significantly over the last 30 years, both in monetary terms and as a multiple of employee contributions. This is illustrated by charts 4 and 5 below.

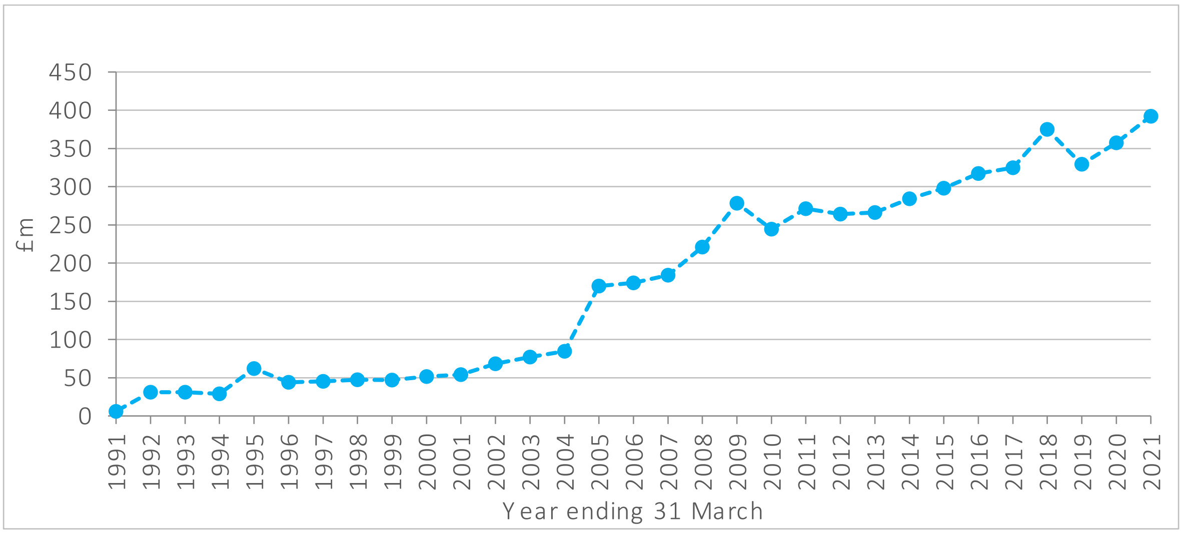
9.2. The Scheme has also grown significantly over the years, as illustrated below:

9.2.1. *Membership progression:* The total number of members in the Scheme has increased since 2003 from around 75,000 to around 85,000, with the contributing population increasing from around 15,000 to almost 26,000 over the same time period. The total membership, split by member type, is summarised in Chart 6 below at each valuation date since 2003.

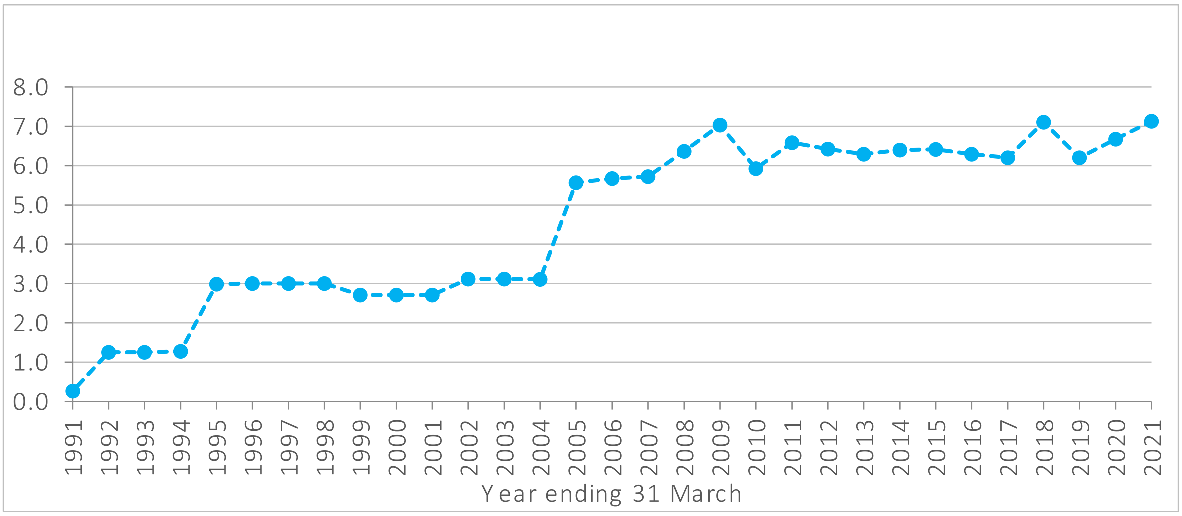
9.2.2. *Asset / Technical Provisions growth:* Chart 7 below shows that, since 2006, the Scheme has more than tripled in size, with the assets having grown from around £4bn to over £13bn as at 31 March 2021.

9.2.3. *Deficit progression:* The difference between the Scheme assets and Technical Provisions determines whether there is a surplus or deficit at each valuation date. The funding level is described by the assets as a proportion of the Technical Provisions; both these measures for the Scheme are shown below in Chart 8.

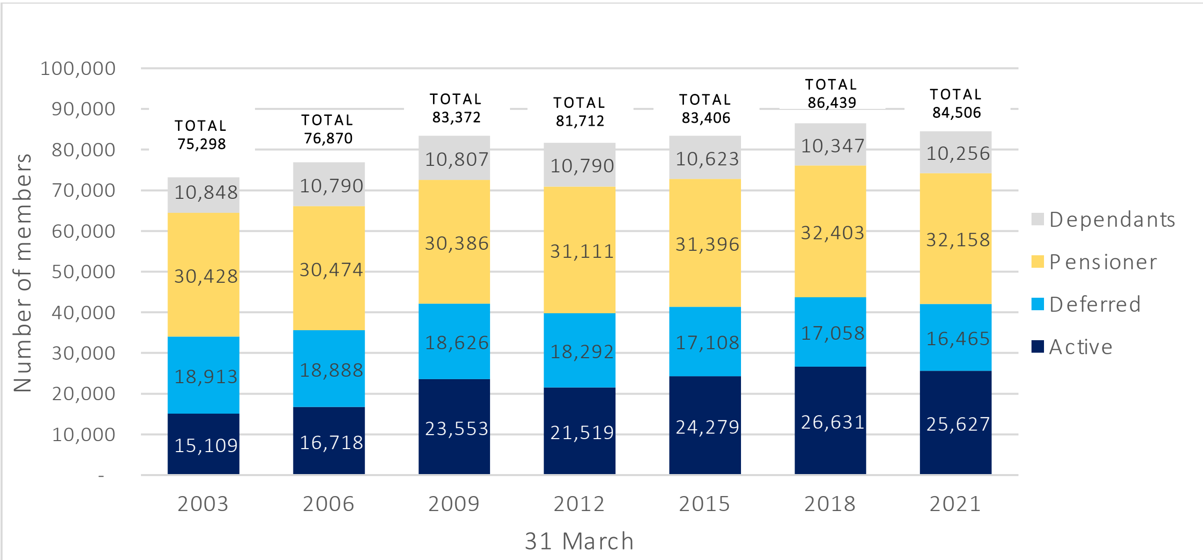
Appendix 3 Chart 4 – Total TfL contributions paid to the Scheme over the last 30 years



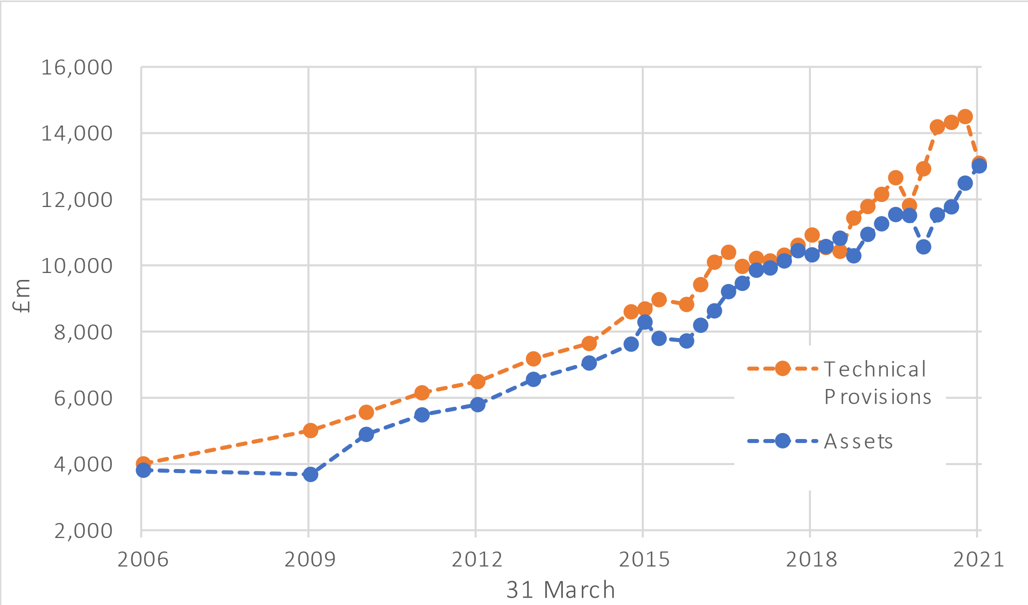
Appendix 3 Chart 5 – Total TfL contributions paid to the Scheme over the last 30 years, as a multiple of member contributions



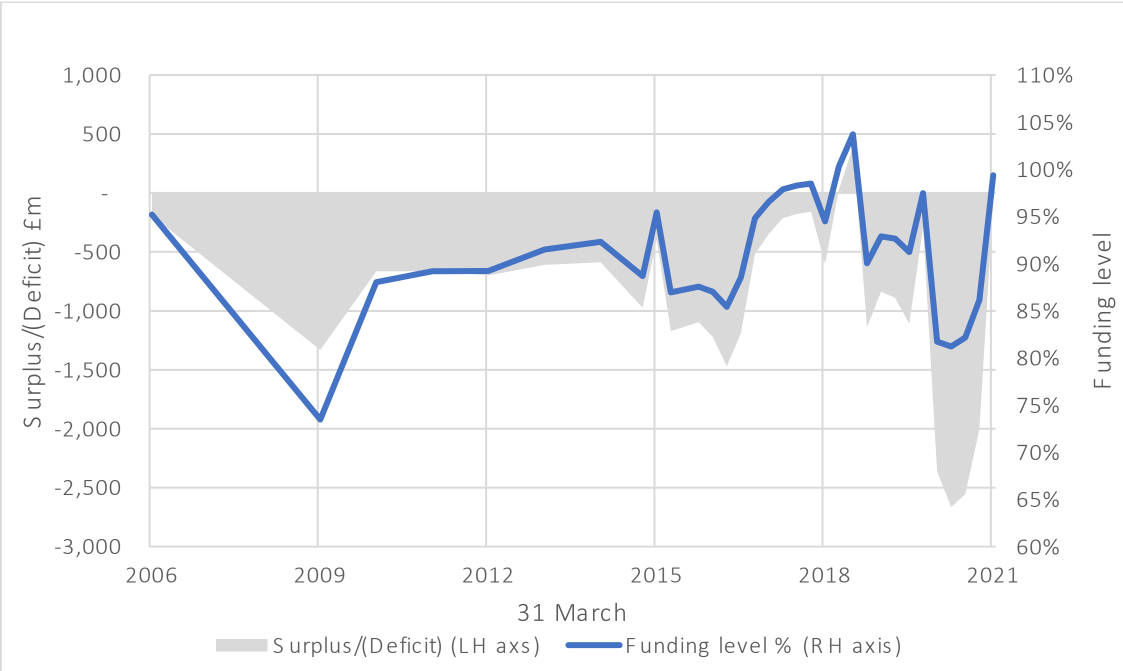
Appendix 3 Chart 6 – Membership progression since 2003, split by member type



Appendix 3 Chart 7 – Growth in Scheme assets and Technical Provisions since 2006



Appendix 3 Chart 8 – Progression of surplus/deficit and funding level in the Scheme since 2006



9.3. All the charts above demonstrate how the Scheme has grown over recent years. This growth brings some significant challenges for TfL. In particular, Chart 7 illustrates that the Scheme has grown substantially in terms of both its assets and liabilities over the years and, with that, the potential volatility of any deficits that can arise at a formal actuarial valuation.

9.4. Chart 8 shows how large the surplus / deficit swings can be and indeed in the two-year period ending 30 June 2020, the Scheme surplus / deficit swung by more than £3bn.

Appendix 4: Stage 1 Call for Evidence: questions and how to respond

For this first stage Call for Evidence the Review is keen to understand stakeholders' views on the challenges (if any) currently facing the Scheme in light of the continuing funding pressures on TfL as well as any Scheme-specific challenges arising from, for example, the increasing longevity of members.

Stakeholders are therefore invited to provide written responses to the following questions:

1. How should long term sustainability be viewed and how does this look from the perspectives of members; the employer; taxpayers; farepayers; the Trustee and others? What are the key features of long-term sustainability for the pension arrangements of TfL?

2. How should long term affordability be viewed, and how does this look from the perspective of members, the employer; taxpayers, farepayers, the Trustee and others? What are the key features of long-term affordability for the pension arrangements of TfL?

3. What do you consider to be the key risks and challenges in the short-, medium- and long-term in relation to the Scheme (for example, investment risk, salary risk, longevity risk) and how could these risks and challenges be mitigated?

4. How should TfL's pension arrangements compare with other pension arrangements available elsewhere in the public sector?

5. What are your views on how TfL's pension arrangements can be fair to all going forward, including different cohorts of members and the sharing of risk between the employer and the employee?

6. How are the current pension arrangements valued by TfL's staff? How important are the current pension arrangements in recruiting new staff and retaining existing staff?

7. Are there other considerations or criteria the Review should consider?

8. Is there anything else you would like to add?

It would be helpful if written responses could have particular (although not exclusive) regard to the questions set out above and provide evidence in the form of annexes to support answers.

Written responses should be submitted by midday on 17 September 2021 to pensionreviewsubmissions@tfl.gov.uk

It is the intention of the Review to be as transparent as practicable. Engagement responses (whether obtained in writing or in meetings) will be summarised and published as part of Interim and Final reports to be produced by the Review. Respondents may, by written request to the Independent Lead at the time of their submission, ask that their views and/or written responses remain anonymous and/or confidential.