

# The Railway Pensions Commission

Final report

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# Contents

Acknowledgements .....	v
The Commissioners.....	vii
Executive summary .....	1
1 Affordable, sustainable and equitable pensions.....	7
Criterion 1 Affordable for both employees and employers.....	8
Criterion 2 Sustainable and appropriately structured for the industry .....	16
Criterion 3 Equitable and fair for existing scheme members .....	18
(actives, deferred members and pensioners) and new employees	
Defined benefit pension provision for the future .....	20
2 Proposals for reform .....	21
Shared cost .....	22
Legal framework .....	22
Retirement ages .....	23
Early retirement (normal health) .....	24
Early retirement of deferred members .....	24
Proposed changes for existing employees .....	25
Proposed changes for new employees .....	29
Affordable .....	32
Sustainable .....	33
Equitable .....	34
RPS governance .....	36

3	Transition arrangements .....	39
	Train operating companies.....	40
	Financial support .....	41
	Transfer timing .....	42
	Transfer values .....	43
	Investment strategy .....	43
	Network Rail.....	44
	Freight operating companies.....	45
	Companies with a small proportion of employees in the railway industry	46
	Infrastructure companies .....	47
4	Other pension provision in the railway industry .....	49
	A minimum standard of defined contribution pension provision.....	50
5	Conclusion .....	53
Annex 1	Changes in mortality experience of retired railway workers .....	55
	since 1987	
Annex 2	Issues in the design of RPS(acre).....	57
Annex 3	Comparison of benefits – final pay and average .....	63
	career revalued earnings	
	Glossary .....	67

## List of tables

Table 2.1	Reduction in RPS(sca) pension.....	29
Table 2.2	Summary of RPS(acre).....	30
Table 2.3	Projected benefits from RPS(acre) and State 40 years' service ..	31
Table A3.1	Final pay compared to average revalued earnings – examples..	64

## List of figures

Figure 2.1	Deferred members of RPS(sca) by length of qualifying service..	25
Figure 2.2	RPS(sca) members by BRASS membership and pensionable pay .....	26
Figure 2.3	Active voluntary retirees aged 55-65 in 2005.....	28
Figure A1.1	Changes in pensioners' mortality experience since 1987 .....	56
Figure A2.1	Comparison of revaluation rates .....	59
Figure A2.2	Contribution rate comparison .....	60
Figure A3.1	Comparison of revalued average earnings and final pay benefits.....	65
Figure A3.2	Members' active service at retirement .....	66

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# The Commissioners



Left to right: Bryn Davies, Jeannie Drake, Peter Thompson

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The Commissioners were supported by two representatives from the industry in the provision of information:

**Nick Cole** – Pensions Officer, RMT

**Nick Mitchell** – Retired HR Director for Go-Ahead Rail



# Executive summary

No one who reads the newspapers or watches television can be unaware of the major problems that have affected pension schemes in the UK during recent years. As a result many employers, in both the public and private sectors, have reviewed the structure of their pension schemes and have worked with unions and trustees to implement changes to ensure the sustainability of their schemes. The railway industry cannot be immune from what is happening in the wider pensions environment.

The Railway Pensions Commission was asked, against a background of rising costs of pension provision and the rail unions' pension campaign objectives, to identify:

- the strengths and weaknesses of the Railways Pension Scheme (shared cost arrangement), referred to in this report as the RPS(sca); and
- alternative means of long-term pension provision to be considered by stakeholders in the railway industry.

The Commission's first report dealt with the scheme's financial development and its current legal framework in the context of a competitive railway industry in the 21st century. It concluded that the RPS(sca) is not sustainable in its present form, because of the increasing cost of providing pension benefits and the consequential increase in both the employer and active member contribution rates due to the shared cost nature of the scheme.

The main factors contributing to the difficulties in funding the RPS(sca) were identified as:

- improvements to the level of benefits as a result of legislation, collective bargaining and regulatory intervention;
- significant and continuing improvement in the life expectancy of members of the scheme; and
- a reduction in the anticipated income from pension fund investments.

Any of these three factors – benefit improvements, longer life expectancy and lower investment income – on its own would have been a problem. Together they constituted a ‘perfect storm’ in terms of funding the pension promise that has to be addressed either through increased contributions or the adjustment of pension benefits, or both.

The Commission concluded that these difficulties reflected a fundamental change in the cost of providing defined benefit pensions in the RPS(sca) and that there are likely to be further increases in the cost of the current pension arrangements. It must be understood that there is no magic wand that will provide a solution to the scheme’s difficulties. All stakeholders have to face the reality of the situation.

The Commission’s first report concluded that there are three criteria that should be used to assess a sustainable defined benefit railway industry pension system over the long term and determine new affordable means of pension provision. The three criteria identified by the Commission are:

- affordable to both employees and employers
- sustainable and appropriately structured for the railway industry
- equitable and fair for existing scheme members (actives, deferreds and pensioners) and new employees.

## The way forward

This final report from the Railway Pensions Commission has been produced following a rigorous review of the current RPS(sca) and in the light of comments received following the first report. The Commission accepts that its recommendations will have a far-reaching impact for many, but if defined benefit pension provision is to be sustainable in the major part of the railway industry over the long term, then change is needed. There have already been many changes to other public sector and private sector pension schemes faced with similar difficulties. Had the railway industry not been privatised, the Railways Act and its associated protection order would not have been put in place and it is most likely that changes to the RPS(sca) would be under consideration or would have already been made.

If the response to the rising cost of pension provision in the railway industry is not planned and managed, the alternative is an ad hoc situation resulting in inequitable solutions as employers seek to contain their pension costs. Many changes to the way in which the RPS(sca) operates have already been made. These include:

- closure of some sections of the RPS(sca) to new entrants with no transition arrangements in place to protect existing active members;
- the introduction of lengthy waiting periods before new members can join the RPS(sca);
- adjustments to the pay upon which pension is calculated; and
- changes to early retirement factors.

This final report addresses the following two key areas:

1. Proposals for reform – What action is required to ensure that pension provision in the railway industry is affordable and sustainable for both employees and employers over the long term?
2. Transition arrangements – How is the transition to new affordable arrangements to be managed so that current active members of RPS(sca) do not face an increased burden of risk while allowing employers to reduce their pension costs?

## 1. Proposals for reform

In setting out its proposals for new affordable pension arrangements for new recruits, new entrants and existing employees who wish to opt in, the Commission relies on the three criteria identified in the first report: affordability, sustainability and equity.

**Affordability:** the Commission does not believe that a scheme that provides the current benefits of RPS(sca) can be afforded in the longer term, either by members or their employers. Preliminary indications are that, following the 2007 actuarial valuation, the joint future service contribution rate will be around 30 per cent of section pay. Deficit contributions will be payable in addition. The Commission recommends a new, more affordable shared cost arrangement for new recruits to the railway industry with a standard contribution rate of no more than 20 per cent, with the employers' share at 12 per cent and the members' share at 8 per cent.

**Sustainability:** the Commission believes that the sustainability of the new scheme depends on the continuation of a shared cost arrangement, but with protections for both employers and members against rising costs. This involves:

- a calibration mechanism to deal with demographic changes such as improvements in anticipated mortality; coupled with
- a cap on members' contributions of 10 per cent of section pay.

**Equity:** the need for equity means that the new arrangement should be established on a revalued average earnings basis, where benefits are calculated on the member's earnings over the whole of their pensionable service rather than earnings at or near retirement. The Commission is firmly of the view that the way in which a revalued average earnings scheme allocates available resources is more equitable than a final pay scheme with the same joint contribution rate.

The Commission recognises that under the RPS(sca), the contribution levels for both members and employers will continue to increase and may soon become unaffordable. The proposals for reform also identify changes to the current RPS(sca) which will make a contribution towards reducing costs.

In summary, the changes the Commission proposes for pension provision in the railway industry are as follows:

**For those members of the RPS(sca) employed in the railway industry immediately prior to privatisation and who have the indefeasible right:**

- cessation of British Railways Additional Superannuation Scheme (BRASS);
- contribution rate to be based on retention of current RPS(sca) benefits.

**For those members of the RPS(sca) who joined after privatisation and who do not have the indefeasible right:**

- cessation of British Railways Additional Superannuation Scheme (BRASS);
- retirement age to increase to 65 for benefits earned in the future;
- on retirement before 65, benefits earned in the future to be reduced on a cost-neutral basis;
- contribution rate to be based on the cost of provision of the amended benefit structure; and
- members with the indefeasible right to be able to elect to transfer to these arrangements.

**For new employees and others who wish to opt into it:**

- a new scheme which is referred to in the report as Railways Pension Scheme (average career revalued earnings) (RPS(acre));
- the key characteristics of the new scheme are:
  - a pension on retirement at 65 of one-fiftieth of the member's revalued average earnings for each year of pensionable service;
  - member's annual earnings are revalued in line with the Retail Prices Index (RPI);
  - benefits will be adjusted to allow for improvements in mortality;
  - retirement before 65 on a cost-neutral basis;
  - the ability to convert part of the pension to a lump sum, up to the limits set by the Government;
  - benefits on death and ill-health retirement.

## 2. Transition arrangements

Introducing new pension arrangements poses particular problems in the railway industry because of the shared cost nature of the RPS(sca). The Commission stated, in its first report, that it would be inequitable for active members of an alternative, affordable defined benefit scheme to share the cost of funding the RPS(sca). The new arrangements must be kept financially separate from the existing arrangements,

with the result that the RPS(sca) will be closed to new members, except for those with the indefeasible right.

While the introduction of more affordable arrangements will allow employers to reduce their pension costs, the remaining active members of the RPS(sca) will face an increase in the level of funding risk in relation to pensioner and deferred members' liabilities. The transition to more affordable pension arrangements must, therefore, provide for employers to take on greater responsibility for pensioner and deferred member risk in their closed RPS(sca) sections and for funding any deficit arising from those liabilities.

The Commission sets out in the report the transition arrangements that it considers necessary. It proposes structural change to the RPS(sca) in the train operating companies to allow for the creation of a single section for pensioners and deferred members, supported by the employers and related to the franchise agreements agreed with the Department for Transport (DfT).

## A minimum standard

A significant number of employees in the railway industry do not have access to the RPS(sca) and sometimes have no access to any pension scheme. These are often employees who work in the industry on commercial contracts secured by their employers. Applying the criteria it identified for future pension provision to this section of the industry, the Commission considers that there should be a minimum defined contribution standard (contributions of 5 per cent by employees and 7.5 per cent by employers), which would assist in creating a level playing field for those companies who seek to be good employers.

For this minimum standard to operate effectively, however, those who award contracts, together with the Office of Rail Regulation, the DfT and the Scottish Executive, will have to allow explicitly for this standard in competitive tendering exercises to ensure that the market is not tilted against the good employer.

## Final comment

The RPS(sca) needs to change. It is not immune from the circumstances affecting other pension schemes in the UK. The Commission's final report sets out clear options for RPS(sca) that will help to resolve many of the difficulties the Scheme faces. If a consensus on reforms is to be achieved and implemented early in 2009, there will be a demanding agenda to work through and detailed planning to be undertaken. If such a challenging timetable is to be met the Commission would strongly encourage all the stakeholders jointly to discuss the broad principles underlying the proposals.

The report provides a way forward that is affordable, sustainable and equitable for all stakeholders. And it is with this in mind that the report should be read in full.



# 1 Affordable, sustainable and equitable pensions

- 1.1 The fundamental problem confronting the participants in the Railways Pension Scheme (shared cost arrangement) in its current form is that the scheme has become significantly more expensive to provide than in the past. It is also clear, from the preparatory work that has been undertaken on the 2007 actuarial valuation, that these costs can be expected to continue to rise.
- 1.2 As a result, some scheme members find that they cannot afford to pay their share of the cost of the scheme, while many employers are becoming unable or unwilling to pay their share. The Commission is clear that maintaining the status quo in the face of this challenge is not an option, as the process of change is already taking place.
- 1.3 If the rising cost of the RPS(sca) is not addressed by making the changes proposed by the Commission, the result will be further increases in contribution rates, declining scheme membership, increasing inequity and arbitrary adjustments in benefits. The Commission firmly believes, however, that if the parties are willing to bring about change in a planned way this spiral of decline can be halted, and sustainable defined benefit pension provision for most of the railway industry can be secured.
- 1.4 In its first report, the Commission set out the following three criteria that should be used to assess the structure of pension provision for the railway industry over the long term:
  - Affordable for both employees and employers.
  - Sustainable and appropriately structured for the railway industry.
  - Equitable and fair for existing scheme members (actives, deferred members and pensioners) and new employees.

None of the responses to the first report seriously questioned these criteria. This chapter, therefore, explains why changes must be made to the RPS(sca), if these criteria are to be met. The remaining chapters describe what changes should be made for different groups of members.

## Criterion 1 Affordable for both employees and employers

### The 2007 valuation of the RPS

- 1.5 The actuarial valuation of the RPS(sca) is being undertaken as at 31 December 2007. The results, which are expected to be available in draft in June 2008, will show what progress is being made in dealing with the deficits shown by the 2004 valuation, as well as changes in the future cost of providing benefits. For each section of the RPS(sca) the result will be a future service contribution rate to cover ongoing benefits, plus a deficit contribution, where necessary, to cover any shortfall.
- 1.6 The Scheme Actuary and the Trustee are in the process of consulting with employers and pensions committees on the basis, methodology and assumptions they plan to use. Without anticipating the results of the valuation, some informed predictions can be made.
- 1.7 Equity markets had substantially recovered between the 2004 and 2007 valuation dates. However, it is unlikely that this improvement will have been sufficient to eliminate all of the past-service deficits that were found at the 2004 valuation.
- 1.8 The consultation material issued jointly by the Scheme Actuary and the Trustee makes it clear that improvements in mortality will assume an ever-greater importance in valuing the RPS(sca). The longer, on average, an RPS(sca) member lives after retirement, the higher the sum of total pension benefits that will have to be paid by the scheme. In setting the contribution rate the Actuary, therefore, needs to predict how long RPS(sca) members are going to live and receive pension. In other words, if members live for longer, pensions will be more expensive and, hence, the contribution rate will increase.
- 1.9 In looking at the actuarial basis to be used in the 2007 valuation, the Scheme Actuary is seeking to answer two questions:

**Current mortality experience:** what has actually happened to RPS(sca) members – did they live for longer or shorter periods than was predicted at previous valuations? The Actuary has reviewed data for all members during the period 2002-6 and found that they are living for significantly longer than was anticipated at the time of the 2004 valuation.

**Future mortality improvements:** how long are current and future RPS(sca) members now expected to live? The Actuary has indicated his preliminary view, which is that mortality will improve at an even faster rate than previously predicted. For example, whereas in 2004 he estimated that a 65 year old man in 2027 could on average expect to live another 20.3 years (i.e. to 85.3), he now estimates that the correct figure could be 24.6 years (i.e. to 89.6). This reflects trends in the British population as a whole, as confirmed in the Interim Life Tables published by the Office for National Statistics on 27 November 2007. The rate of improvement in the mortality of ex-railway workers is illustrated in the graph that is shown in Annex 1, based on the consultation material with the permission of the Scheme Actuary and the Trustee.

- 1.10 These revisions of the mortality assumptions must result in increases to the joint future service contribution rate. While these increases will vary from section to section, following the 2007 valuation they are likely to be, on average, of the order of 2 per cent of section pay. This is in addition to the net effect of other factors identified by the Scheme Actuary, such as the change in investment returns projected in 2007 as compared to 2004. The consultation material suggests that typically this effect might be a further increase in contributions of 3 per cent of section pay.
- 1.11 It should be noted that the Scheme Actuary has proposed some changes in the valuation method as well as the assumptions. First, he proposes that all sections, and not just those open to new members, should be valued using the projected unit method. Second, he proposes to use a "dual discount" approach, i.e. to use different discount rates in calculating liabilities before and after retirement – specifically, a lower discount rate for post-retirement liabilities. These changes need not, of themselves, affect the overall outcome of the actuarial valuation, but the use of a lower discount rate for post-retirement liabilities will have a particular impact on those sections which are closed to new entrants.
- 1.12 From the preliminary work by the Scheme Actuary, the indications are that the joint future service contribution rate will increase to around 30 per cent of section pay, although it must be stressed that there is still some uncertainty about this figure. This figure excludes any deficit contribution, which can be expected to increase the joint contribution rate by even more in most, if not all, sections.

1.13 Taking all this into account, the Commission draws two important conclusions:

- first, it is unlikely that the 2007 valuation will find that all of the deficits identified in 2004 have been cleared; indeed, it is possible that in some sections further deficits will have arisen in the past three years. Consequently, many sections will continue to require additional deficit contributions to make good the shortfall; and
- second, even if it were found that the deficits identified by the 2004 valuation had been eliminated in full, the cost of providing future benefits is rising and, as a result, the recommended future service contribution rates will be higher than those set following that valuation. Consequently, it is not sensible to proceed on the assumption that the problems that led to the establishment of the Commission have been resolved. What has been experienced over the past few years is not a temporary difficulty but, rather, a fundamental shift in the cost of pension provision.

### **The use of RPS(sca) surpluses**

1.14 The 1993 actuarial valuation of the RPS(sca) revealed a past-service surplus of £1.8 billion. This surplus, and further surpluses that were revealed in subsequent valuations, have been used over the past 13 years to reduce the contributions payable by employers and members and to meet the cost to the employers of BRASS matching. The use of surplus in these ways was a conscious decision carried forward from the British Railways Pension Scheme (BRPS). However, this surplus has been exhausted and both parties now have to meet the full cost of pension provision.

### **Long-term trends in pensions**

1.15 This section emphasises what the Commission said in its first report about long-term trends affecting pension provision. Over the last few decades, developments in the pensions environment and the interaction of demographic and economic factors have led to a significant increase in the cost of providing defined benefit pension schemes. Pension provision in the railway industry has inevitably been affected by many of these trends.

1.16 First, during the 1970s, 1980s and 1990s, the extent and the standards of benefit provision increased as a result of legislation, collective bargaining and regulatory intervention, leading to an overall increase in the value of the pension promise and, consequently, the cost of such provision. Examples of such provision include better treatment of members who left prior to retirement; requirements for index-linking both before and after retirement; and the provision of widowers' pensions.

- 1.17 Second, the cost of provision was increased by the continued improvement in life expectancy which, from the 1980s onwards, began to outstrip projections based on the experience of previous decades. Some argue that there must be some limit to this process, but there is no evidence as yet to suggest that we are approaching that stage. It must therefore be assumed that each succeeding generation of employees will live for longer than the generation that went before. As a result, the cost of providing a given pension will continue to increase with each cohort of members.
- 1.18 Third, and most recently, there has been a reduction in the rates of return that can be anticipated on pension fund investments. The reserves needed now to secure future pension fund liabilities are typically higher by around one half than ten years ago.
- 1.19 With the benefit of hindsight, these far-reaching changes were not sufficiently foreseen by Government, academics, professionals or other observers. This is especially true of the rate of improvement in life expectancy, which has continued to surprise actuaries, doctors, demographers, and other commentators. Throughout the pensions industry, funding assumptions regarded as reasonable in the late 1980s have proved too optimistic.
- 1.20 The Commission concludes that the inevitable result of all these changes is that a given level of defined benefit pension provision has become much more expensive to deliver over the last 15-20 years. The Commission also believes that this trend will continue and that there is certainly no realistic prospect that it will go into reverse.

### Changes in public sector pension provision

- 1.21 Evidence submitted to the Commission by RMT, TSSA and ASLEF all suggests that the problems faced by the RPS(sca) and concern among employers at the level of pension contributions stem, at least in part, from the privatisation of the railway industry.
- 1.22 RMT reported that prior to the privatisation process beginning, the then Pensions Director of the British Railways Board *“expressed the view that the Board would agree to keep [employee] contributions down”*. RMT went on to argue that *“there is little doubt that if the Railways had not been privatised members would not be expected to pay additional contributions in respect of Section deficits...RMT is of the opinion that deficits arising from the actuary’s changed assumptions would have been underwritten by the Board...”*. TSSA made the same point.
- 1.23 ASLEF noted that *“[we] were against the privatisation of the industry, which is one of the contributing factors that we are where we are today.”* and added in a response to the first report that *“[i]n practice, privatisation has had a significant negative impact on the pension provision of many employees within the industry.”*

- 1.24 The Commission understands members' expectations. The problem, not just in the railway industry, is that many decisions that were made about pension funding in the late 1980s and early 1990s have proved too optimistic. As such, assurances given in good faith at that time have had to be revisited. In any event, to make a proper comparison, it is necessary to look at recent changes in those pension schemes that have remained in the public sector.
- 1.25 Following the Public Service Forum agreement between the Government and public service unions in October 2005, the teachers, NHS and civil service pension schemes have been undergoing significant reforms. As well as increasing the normal pension age from 60 to 65 for new entrants, reforms to all three schemes include mechanisms designed to ensure the future sustainability and affordability of these schemes, such as cost sharing and a cap on taxpayer contributions. In other words, they all involve the prospect of further changes in benefits if future events (e.g. continuing improvements in life expectancy) mean that costs continue to rise.
- 1.26 Change is also underway, or has been completed, in other public service schemes: a new pension scheme for the Armed Forces was introduced in April 2005 and new schemes for police officers and fire-fighters apply from April 2006. Reforms to the funded Local Government Pension Scheme (LGPS) will be implemented in April 2008. The LGPS already has a normal pension age of 65. Changes to the Royal Mail scheme – including a normal pension age of 65, career average benefits for the future service of existing members and defined contribution provision for new entrants – are now under consultation.
- 1.27 These changes have been made to schemes which remain solely in the public sector. Had the railway industry not been privatised, the Railways Act and its associated protection order would not have been put in place and the Trustee of the BRPS would have retained its discretion to make appropriate adjustments to the scheme after 1993. For example, it seems unlikely that the favourable reduction factors currently applied on early retirement from the RPS(sca) would have been left unchanged for so long.
- 1.28 The Commission does not accept that had the railway industry remained in the public sector, all the cost increases would have been borne by the British Railways Board (and hence, by the fare paying passenger and the taxpayer). It is much more likely that changes to the scheme would be under consideration, or would have already been made, as is clearly demonstrated by the experience of the remaining public sector schemes.

## Changes in private sector pension provision

- 1.29 In any event, it is not open to the Commission to propose any change to the commercial structure of the railway industry. It is perhaps more relevant, therefore, to look at what has happened to pension provision in the private sector, where the landscape of occupational pension provision has changed significantly over the past few years. The scale of the change is illustrated in a recent report by the Pensions Policy Institute (PPI) based on recent Government data (*The changing landscape for private sector Defined Benefit pension schemes*, October 2007).
- 1.30 The PPI report shows that the majority of defined benefit pension schemes in the private sector are now closed to new members or, in some cases, to future accrual of benefits for existing members. As a result, there are fewer active members in defined benefit schemes in the private sector than there have been at any time in the last 40 years. This scale of change is continuing, as confirmed by the recent publication from the Association of Consulting Actuaries, *2007 Review and Pension Trends Survey Report*.
- 1.31 In almost all defined benefit pension schemes, the employee contribution rate is fixed (unless the scheme rules are changed), leaving the employer responsible for the balance of the cost; the RPS(sca) is a rare exception. This obligation on employers explains why employers' special contributions to such schemes have increased in recent years in order to reduce the shortfall of assets compared with liabilities. The rising costs for employers also explain why many 'balance of cost' defined benefit schemes have been closed to new members, and sometimes also to future accrual of benefits, as employers have sought to manage their costs.
- 1.32 Scheme sponsors in the private sector are moving away from providing defined benefit schemes and are instead offering defined contribution. Today there are between 3 and 4 million active members in private sector defined benefit schemes but there has been a steady decline in membership since 1991. At the same time there has been considerable growth in defined contribution pension arrangements. Most of this growth has been in contract-based personal or stakeholder pensions, rather than trust-based defined contribution occupational schemes: a recent (summer 2007) survey by the consultants, Mercer, found that 63 per cent of defined contribution plans set up since 2002 were contract-based.
- 1.33 As part of its report, PPI asked three expert commentators what they believe to be the future for DB schemes in the private sector. Although there was not a consensus, the authors of the PPI report conclude that "*DB provision, if it survives in the private sector, is likely to look very different in the future to the DB provision of the recent past...*". While it can be understood that members might wish it were otherwise, there seems no reason why the railway industry should be exempt from these developments.

### How the RPS is already changing

- 1.34 Employers in the railway industry are already taking action to control costs in a variety of ways. It should be understood that all the changes to provision that are detailed below are permissible under both legislation and the rules of the RPS(sca).
- 1.35 **Closure to new entrants:** A number of sections of the RPS(sca) are closed to new employees (excepting those with the indefeasible right). Most significantly, the infrastructure companies, which carry out engineering work under contract to Network Rail, have all closed their sections. Submissions of evidence from some of these companies to the Commission make clear that, given the competitive environment in which they operate, they see no prospect of reopening their RPS(sca) sections.
- 1.36 **Waiting period:** Network Rail, by far the largest employer in the railway industry, has introduced a waiting period before new staff may apply to join the RPS(sca). Agreed as part of a settlement negotiated with the trade unions, employees in the first five years of employment with Network Rail may join a defined contribution scheme with default contributions of 3 per cent from Network Rail and 0 per cent from the employee. Although employees can opt to make higher contributions, matched by Network Rail, the evidence is that approximately one-third of participating employees stay with the default contribution rates. At the end of the five years, employees are offered the choice between remaining in the defined contribution scheme and joining the RPS(sca).
- 1.37 Like many employers, Network Rail experiences relatively high turnover among its staff in the early years of employment. One result is that a high proportion of staff does not reach five years employment and as such will never become eligible for the RPS(sca). The waiting period was only introduced in 2004, so as yet only relatively small numbers of new entrants (those whose previous service elsewhere in the railway industry has been recognised through TUPE transfers and the like) have now completed it: of these, only around 50 per cent are choosing to join the RPS(sca). It is clear, however, that membership of the Network Rail section has declined sharply and that the employer has already made considerable savings.
- 1.38 **Adjustments to pay for pension purposes:** Some employers are negotiating settlements in which the full value of a pay award is not treated as pensionable. This results in lower contributions for both employer and employee and, ultimately, smaller pension benefits.
- 1.39 **Changes to early retirement factors:** As was discussed in some detail in the Commission's first report, the reduction factors that are applied to benefits when an RPS(sca) member retires before 65 are not actuarially neutral; in other words, they are favourable towards members who retire

early in the sense that their benefits are more valuable and, hence, cost more to provide than if they had retired later. For example, an RPS(sca) member retiring from railway work at age 55 and taking pension benefits would have their accrued pension reduced by 10 per cent. In comparison, it has been suggested to the Commission that a cost-neutral reduction of a pension taken at 55 based on a normal pension age of 60 would be around 16 per cent; and a cost-neutral reduction of a pension taken at 55 based on a normal pension age of 65 would be in the order of 35 per cent.

- 1.40 The Commission is aware of at least one employer that has, after negotiation with trade unions, changed these reduction factors for the future service of some members of the section, making them much closer to cost-neutral, in return for those members paying lower contributions. This change has been applied to all members of the section without the protected status; members with the protected status have been given a choice. It is understood that around 25 per cent of protected members have chosen to move to the new factors.
- 1.41 **Changes in the employer's share of contributions:** In a number of sections, the employer has agreed to pay more than its normal 60 per cent share of the contribution rate, but this has occurred only in exceptional circumstances. These few sections are predominantly small, closed or both and the increased employer contributions are for a clearly defined period. There does not appear to be any example of a major employer within the industry being prepared to pay more than its 60 per cent share of the cost in order to maintain the existing scheme.
- 1.42 The unions in their evidence are clearly concerned about ensuring the continuing affordability of the pension arrangements for members, with a suggestion that the member's contribution rate should be capped at 10.56 per cent. It will be noted that this is likely to be materially less than the members' 40 per cent share of the cost following the 2007 valuation and, in any event, the Commission is of the view that this would not solve the problem of affordability; it would simply pass the cost burden to the employer, while destroying the shared cost nature of the RPS(sca). The likely outcome would be a rapid retreat from defined benefit provision, other than for members with the indefeasible right.
- 1.43 The unions need to recognise that railway industry employers are also concerned about the cost of the RPS(sca). The employers have made it clear that they will not continue to accept pension costs of the order needed to retain the existing scheme. Shifting even more of the cost on to the employer will lead to the sort of uncoordinated cutbacks in pension provision, and the loss of defined benefit provision by individual employers, that the Commission is determined should be avoided.

1.44 The Commission emphasises that pension provision in the railway industry is already being altered, in a piecemeal, tactical way, in response to the changing pensions environment and pressure of increasing cost. The Commission believes that such changes will gather pace following the completion of its work, unless agreement is reached about a single lower-cost alternative pension arrangement. The issue is not whether lower-cost pensions will be introduced in the railway industry, as it is clear this will now happen in any event. The real issue is whether it is possible to introduce an alternative affordable defined benefit pension system that will be regarded as acceptable to all parties.

## Criterion 2 Sustainable and appropriately structured for the industry

- 1.45 A sustainable railway industry defined benefit pension scheme has to be appropriate for the existing commercial structure of the industry, and be capable of adapting to future changes in that structure. This section reiterates the Commission's findings on areas where the RPS(sca) does not currently meet this need.
- 1.46 The frequent changes to corporate structure, contractors, franchisees and franchise boundaries, which have characterised much of the industry since privatisation, have resulted in a changing pattern of employers and transfers of employees and, in turn, a significant incidence of employers opening, closing, or transferring employees to, or from, sections of the RPS(sca). This has contributed to increased complexity in the section structure; diversification in section benefits; and differences in funding levels and in contribution rates. It must be recognised that much of this is inevitable, given the current structure of the industry and the clear opposition of the DfT to any fundamental change. However, the Commission is of the view that the problems can be ameliorated.
- 1.47 In the Train Operating Companies (TOCs), the mix of active members, deferred members and pensioners in the RPS(sca) sections of each of the TOCs has frequently changed as a result of franchise remapping. A section which has a greater proportion of deferred and pensioner members has less time and flexibility to manage its liabilities and may need to rely more on higher contributions from the active members and the employer. The consequence of a franchise remapping exercise may therefore be that the contribution rate in a particular section increases for reasons which, from the active members' perspective, are arbitrary.

- 1.48 In the sectors participating in the industry since privatisation through contracts (infrastructure, engineering, catering, cleaning and others), employers compete for business with price as an important factor. As mentioned above, in many of these companies it is only employees with the indefeasible right who continue to have access to the RPS(sca). Unless employers choose to make additional contributions, these members face the prospect of escalating contribution rates as the number of active members in their section declines. At some point, active members will start to withdraw as employee contribution rates reach an unaffordable level.
- 1.49 Following the transition from Railtrack to Network Rail, some maintenance work, particularly from the infrastructure companies, was taken in-house by Network Rail. This resulted in some employees of the companies concerned, who were active members of their RPS(sca) section, transferring to Network Rail and its section of the RPS(sca). But the liabilities for pensioner and deferred members, many of whom would have accrued benefits as British Rail employees, remained with the infrastructure companies' sections. This has had a negative effect on the remaining active members of those sections as they are left to bear 40 per cent of the deficit funding requirement, with a consequential increase in active member contribution rates. This issue appears to have attracted little consideration when the decision to transfer work back to Network Rail was taken.
- 1.50 Some large employers participate in the industry as a relatively limited part of their business activities. These companies may already offer their own defined benefit pension provision but cannot discharge their obligation to meet the indefeasible rights of employees through any scheme other than the RPS(sca). This restriction introduces complexity by requiring such companies to operate a small RPS(sca) section in addition to their own defined benefit scheme. These sections are likely to be closed to all but those with the indefeasible right and are especially vulnerable to rising contribution rates.
- 1.51 Companies in the freight sector are operating in a growing but fiercely competitive market, facing increased pressure from road hauliers and other operators, with some contracts awarded for short periods such as a year. Issues of sustainability, in the face of rising pension costs, will manifest themselves sharply in companies facing intense competition. The case for more affordable pension arrangements is compelling in this sector.

- 1.52 For a defined benefit pension system to be sustainable across most of the railway industry it must be made affordable and remain affordable. To achieve this the Commission concludes that:
- first, the structure of pension provision within the industry must be fit for purpose; and
  - second, any new system will need to include mechanisms to ensure that it is sustainable and does not give rise to the difficulties that led to the establishment of the Commission.

### Criterion 3 Equitable and fair for existing scheme members (actives, deferred members and pensioners) and new employees

- 1.53 The Commission believes that problems of equity can only be addressed through planned changes to the RPS(sca). This section provides a reminder of those problems.
- 1.54 **General inequalities in final pay schemes:** An inherent characteristic of defined benefit pension provision where benefits are based on members' final pay is a degree of regressive distribution of benefits, in that it tends to favour members who are on average to high incomes, as compared to those on lower incomes. Such provision also tends to favour members with longer periods of active membership and those whose pay rises rapidly in real terms.
- 1.55 This characteristic is enhanced in the case of RPS(sca), because its shared cost nature means that the contribution rate paid by an active member depends on the cost of providing the benefits for the membership as a whole. For example, where the benefits payable to those retiring on higher incomes contribute disproportionately to rising costs, the result is that benefits for the better-paid are subsidised by the contributions of the less well-paid.
- 1.56 **The benefit formula:** In addition to the general inequities inherent in any final pay scheme, the benefit formula in the RPS(sca) provides higher benefits for members who have higher final earnings. This is the case even when allowance is made for the additional lump sum benefit. For example, a member who retires with pay of £50,000 per annum has a pension of 1/60th of that amount for each year of service; while a member who retires with pay of £10,000 per annum has a pension of only 1/96th of that amount for each year of service.

- 1.57 **Early retirement:** A fundamental source of inequity that is specific to the RPS(sca) is the favourable early retirement provision. As explained by the Commission in its first report and reiterated above, the early retirement factors in the RPS(sca) are not cost-neutral and, as a result, members who take early retirement will, on average, receive benefits that are significantly more valuable over their lifetime than if they had retired with an unreduced pension at age 60, and even more so than if they had retired at 65 (which many members of the RPS(sca) do). Evidence shows that while all members pay for the extra costs caused by the favourable early retirement terms, for the most part it is those on higher salaries who are in a financial position to (and in fact do) take early retirement. This is a further instance of benefits for the better-paid being subsidised by the contributions of the less well-paid.
- 1.58 **BRASS matching:** Until recently, member contributions to BRASS were matched by the employer up to a limit of 5 per cent of the member's pay. The great majority of sections have decided to stop any new BRASS matching arrangements being established but existing arrangements have been allowed to continue at current levels. When RPS(sca) sections were in surplus, any BRASS matching contributions by the employer were actually offset against that surplus rather than being paid in cash. However, the 60:40 shared-cost structure applies to surpluses in the RPS(sca) as well as to deficits. This means that 40 per cent of the cost of BRASS matching that was met using surplus was effectively paid by active members as it could have been used to reduce their future contributions .
- 1.59 This is inequitable because not all members are in a position to obtain equal value from BRASS matching. Employees on lower levels of pay are much less able to afford to pay extra contributions and even to the extent that they do, they are likely to contribute at lower rates. In addition, the annuitisation of BRASS within the RPS(sca) can create an extra strain on a section's finances.
- 1.60 The Commission's proposals for change set out in the remaining chapters address these issues of equity both in the RPS(sca) and in the arrangements for future new employees. The Commission is firmly of the view that it is inequitable for active members of an alternative new affordable defined benefit scheme to share the cost of the RPS(sca). It also believes the changes proposed to pension provision in the railway industry will produce outcomes that are more equitable in the distribution of costs and benefits between higher earners and those on lower incomes.

## Defined benefit pension provision for the future

1.61 The Commission believes that while the arguments set out in this chapter demand engagement and action by all parties, there is still good cause for optimism. There is a definite need to make pension provision in the railway industry more affordable for both employers and employees. Doing so in a planned way also provides the opportunity to address questions of sustainability and equity. If this is done, it will be possible to operate a fairer defined benefit, shared-cost, pension scheme across major parts of the railway industry, for the future. The alternative is not the retention of the existing scheme but a move to provision that is less favourable than the Commission's proposals across most, if not all, of the industry.

## 2 Proposals for reform

- 2.1 It has become clear to the Commission, throughout the process of collecting written and oral evidence, that certain key reforms will have to be adhered to if defined benefit pension provision is to be retained in most if not all of the railway industry in the medium to long term.
- 2.2 Equally, certain aspects of the current arrangements set up at the time of privatisation were repeatedly cited in evidence as giving rise to problems, and the Commission concludes that it will be necessary to address these issues by changing the current arrangements.
- 2.3 Given this need for change, the Commission sets out in this chapter the key principles behind its proposals for reform and then explains in more detail its proposals for each of the main categories of employees in the railway industry, as defined by their pension entitlements.
- 2.4 The importance, and the value to the workforce, of defined benefit pension provision have been made clear to the Commission by many of those who gave evidence. It is of course the case that over the last decade, a large number of defined benefit pension schemes in the private sector have been closed to new entrants and in some cases, to future accrual of benefits as well, for reasons associated with the increasing costs and risks of such arrangements.
- 2.5 The Commission believes that a number of the characteristics of the railway industry combine to make it possible and desirable to continue with defined benefit provision, provided that some of the issues which have been identified are addressed and that costs and risks can be controlled. For example, many people work in the railway industry throughout their career and as a result a pension model based on this career path can be expected to be appropriate. Also, the shared cost nature of the current arrangements serves to share risk; so, provided that risk can be shared on an equitable basis, this should serve as a suitable model for defined benefit pension provision over the long term.

## Shared cost

- 2.6 As mentioned already, the RPS(sca) was established on the basis that costs are shared between employers and contributing members in the ratio 60:40. This approach is unusual and has both advantages and disadvantages, which were described in the Commission's first report. However, none of the evidence received was in favour of changing the shared cost approach and the Commission therefore recommends that this approach should be kept in any new benefit structure.
- 2.7 A particular problem that arises from the shared cost nature of the RPS(sca) is that any deficits arising from improving life expectancy amongst deferred members and pensioners have to be met partly by contributions from the remaining active members of the relevant section. This is a significant and not fully anticipated reason for the rising contributions faced by contributing members of the RPS(sca).
- 2.8 The Commission is of the view that the shared cost nature of the RPS(sca), together with the Protection Order introduced as part of the privatisation process, have contributed to the survival of the RPS(sca) without significant amendment for the majority of railway industry employees. It is arguable that, had the RPS been a more conventional balance of cost arrangement, where employees' contributions are fixed and employers pay all of any increase in cost, these issues would have had to be faced some years ago. To that extent, the RPS(sca) appears to have been ahead of its time in terms of providing an example of the risk-sharing that the Government, as well as bodies like the Association of Consulting Actuaries, argue is needed to retain defined benefit provision.
- 2.9 The Commission concludes that limited modifications are needed in the 60:40 structure to protect contributing members from at least some of the impact of improving life expectancy among deferred members and pensioners. Such modifications are an essential and integral part of the proposals for reform.

## Legal framework

- 2.10 Chapter 2 of the Commission's first report described the legal framework applicable to the RPS, and in particular the **Railways Pension Scheme Order 1994** (SI1994/1433) and the **Railway Pensions (Protection and Designation of Schemes) Order 1994** (SI1994/1432). These Orders established the RPS(sca) and, importantly, include the entire Rules of the RPS, which therefore have the force of legislation for those members of the RPS who were members of the BRPS at the time of privatisation.

- 2.11 The Commission's first report showed that approximately 44 per cent of the active members of the RPS(sca) fell into this category but that the liabilities in respect of these members accounted for nearly 80 per cent of the liabilities of the RPS(sca) – not surprisingly, since these members will be, on average, older, longer-serving and better-paid than other members.
- 2.12 Some of the evidence received by the Commission proposed that the protection legislation should be totally rescinded. The Commission rejects this idea, on the grounds that there was a clear commitment made to serving employees at the time of privatisation. Nevertheless, as stated in the first report, the Commission identifies the factors applied to early retirement and the operation of BRASS as instances where the protection legislation has been too rigid and has inhibited fair and sensible adjustments.
- 2.13 For all the reasons described in this report and in the Commission's first report, those who retain rights enshrined in this legislation can expect employee contributions for these benefits to continue to increase in the future.
- 2.14 It is important to remember that employees who joined the industry in the 14 years since privatisation are not covered by the protection legislation. It is, therefore, possible to make changes to their benefits, subject to the normal provisions of Section 67 of the Pensions Act, which applies to all amendments to the rules of occupational pension schemes.

## Retirement ages

- 2.15 The RPS(sca) is one of a decreasing number of final pay pension schemes which offers all members the right to retire at age 60 and draw their full accrued pension. Most private sector employers, and many public sector employers, have moved away from this practice in recent years and future accrual of pension benefits is now typically based on a normal retirement age of 65.
- 2.16 In addition, improvements in general health (for example, the reduction in smoking and improved health and safety in the workplace) mean that a person aged 60 can often expect 25 or even 30 years of retirement, mostly spent in good health.
- 2.17 The Commission noted in its first report the pattern of retirements in normal health from the RPS(sca). This shows that a significant proportion of those retiring voluntarily do so at age 65 and also that those who do work until 65 tend to be lower-paid than those who retire earlier. This highlights one of the features of the RPS(sca), arising from its shared-cost nature, which is that those who retire at or near age 65 are in effect subsidising those who retire earlier, even though the latter group tends to be higher paid.

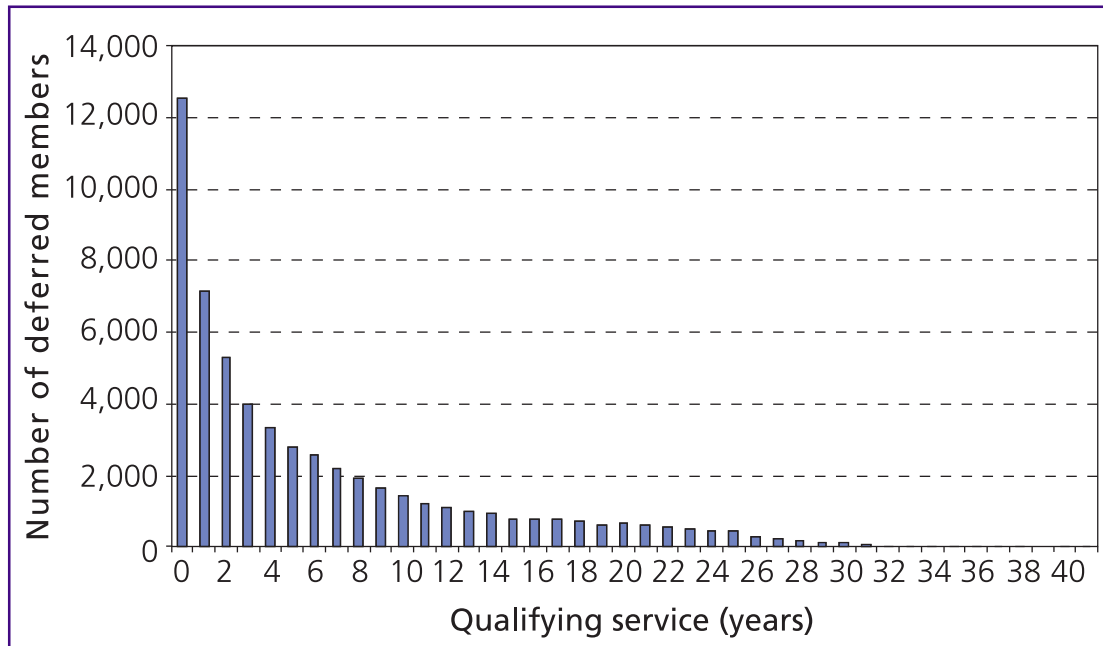
## Early retirement (normal health)

- 2.18 As well as the right to retire on full accrued pension at age 60, the RPS(sca) also offers favourable early retirement factors to those who choose to retire before age 60. So, for example, if an individual retires at age 55, their accrued pension will be reduced by 10 per cent if it is drawn immediately. This compares to a cost-neutral reduction which would be approximately 16 per cent based on a normal pension age of 60.
- 2.19 The legislation referred to above protects the early retirement rights of those who were in the industry at privatisation. However, those who joined since privatisation have no such protection. In an era of lengthening healthy life expectancy and other pressures that are increasing the cost of pension provision, the Commission thinks that it is neither sustainable, nor the best use of available resources, to continue to offer favourable early retirement terms to those as young as 55 or even 50.
- 2.20 An argument on “health and safety” grounds is sometimes advanced by those wishing to protect favourable early retirement terms. The Commission accepts that if someone is unfit to carry out their role, or a suitable alternative role, in the industry, then they should be entitled to early retirement on ill-health grounds. However, the need for such provision does not require every employee to be provided with early retirement on a full pension, particularly in a shared cost scheme and given its substantial cost.

## Early retirement of deferred members

- 2.21 Deferred members of the RPS(sca) – those who have left the industry, or at least left the RPS, but retain benefits in the scheme – have, in general received early retirement treatment as good as that given to those retiring from active service. This is relatively unusual and was recognised as such in evidence received by the Commission. Information provided to the Commission shows that the great majority of deferred members have left with relatively short periods of active service. This is illustrated by the graph shown in Figure 2.1.

Figure 2.1 Deferred members of RPS(sca) by length of qualifying service



2.22 The continuing availability of favourable early retirement factors for deferred members is subject to the agreement of the Trustee. The rules of the RPS(sca) give no guidance to the Trustee as to the circumstances in which agreement to favourable factors may be given or withheld. The Commission understands that the Trustee's practice has been to continue to allow use of the favourable factors unless the particular section of the RPS(sca) is in significant deficit.

2.23 The Commission urges the Trustee to look again at this subject. At a time when most, if not all, employers in the RPS(sca), and the contributing members, are facing the increasing cost pressures which the Commission has identified, it is neither equitable, nor the best use of the available resources, for favourable discretionary early retirement terms still to be on offer to former employees, many of whom are no longer connected with the railway industry.

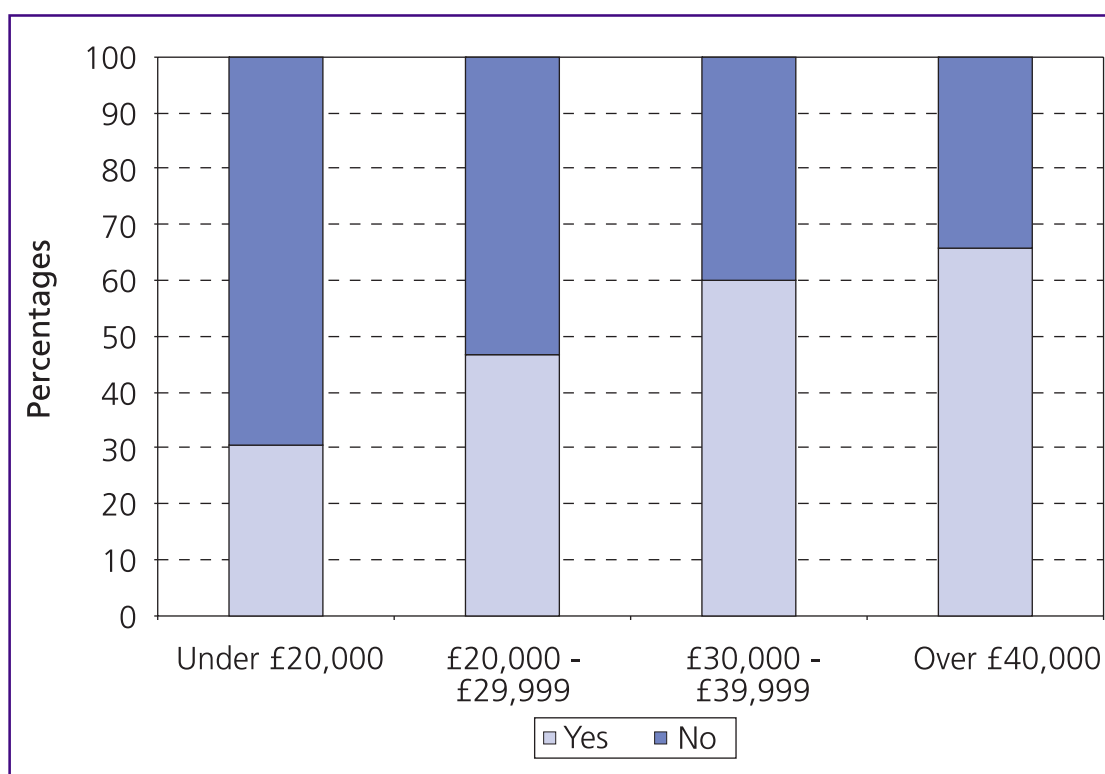
## Proposed changes for existing employees

### (i) Those with protected status

2.24 As mentioned earlier in this chapter, the Commission rejects the idea of a wholesale revision of the protection legislation. Specific commitments were made to employees who were members of the BRPS at the time of privatisation and these should continue. However, those members of the RPS(sca) who continue to benefit from these commitments need to understand that, for all the reasons described in this report and the Commission's first report, the cost of these commitments, which are much more favourable than those commonly found elsewhere, should be expected to continue to increase in future years.

2.25 The Commission concludes that the one element of the protection legislation which should be changed for active members with protected status is BRASS. At a time when the cost of pension provision is of increasing concern to both employers and members, it does not seem sensible for the company contributions to BRASS (£25 million in 2006) to be used to improve benefits that are already favourable by most standards. As pointed out elsewhere, BRASS contributions are often utilised by the better-paid in the industry to improve their early retirement position and this increases the inequities of treatment between higher and lower earners. This feature is illustrated by the graph shown in Figure 2.2.

Figure 2.2 RPS(sca) members by BRASS membership and pensionable pay



2.26 The inequity is compounded because the annuitisation of BRASS benefits within the RPS(sca), at the guaranteed rate of £12 of BRASS funds for £1 of pension, creates an additional strain on a section's finances.

2.27 The Commission proposes that because of the cost pressures of providing RPS(sca), all contributions for BRASS, by both employees and employers, should cease.

2.28 There would of course be nothing to stop any employer in the railway industry setting up an Additional Voluntary Contribution (AVC) arrangement for existing or new employees, but this should be done separately from the RPS(sca).

2.29 RPS(sca) members with protected status would be able to elect to transfer to either the arrangement for those without the protected status, or the arrangement for new employees, both of which are described below, without the loss of their indefeasible right. This would be a one-way transfer and there would be no option to rejoin the current RPS(sca), unless the member chose to exercise their indefeasible right on a change of employer.

## (ii) Those without protected status

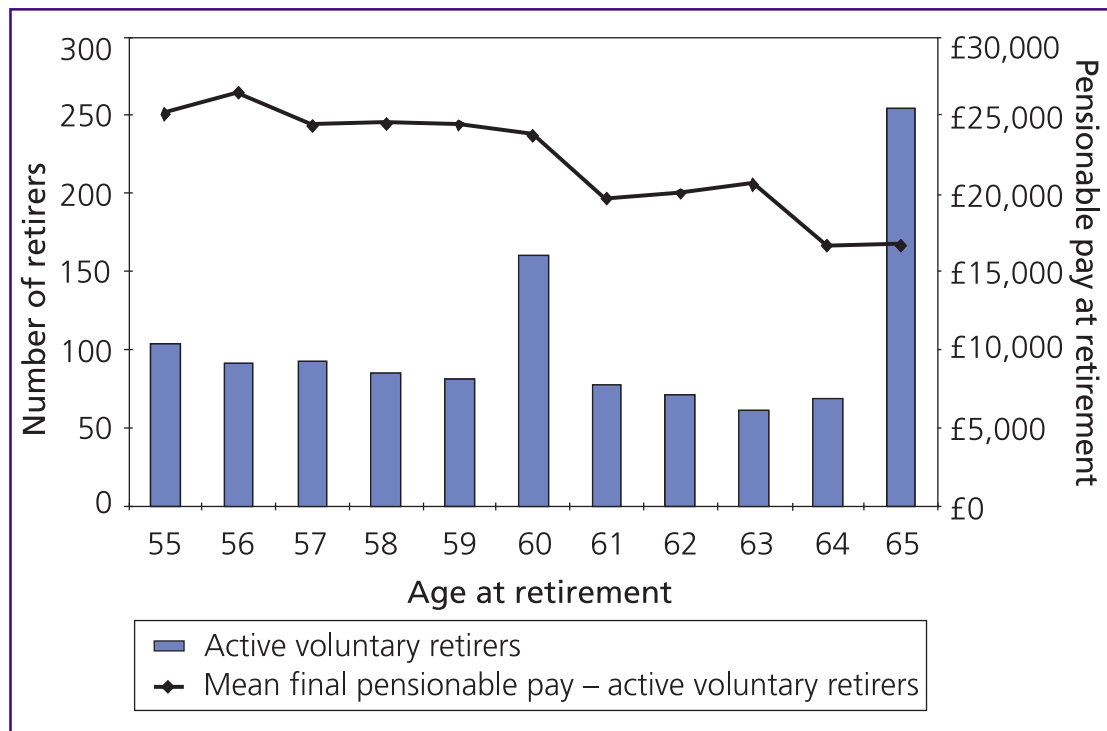
2.30 Over half of the active members of the RPS(sca) have joined the railway industry since privatisation. These members do not have either the indefeasible right or the protected status accorded to those who were members of the BRPS at the time of privatisation. Their position as regards changes to their benefits is the same as for other employees in the UK – namely that changes can be made to the benefits that will accrue in respect of their future service, subject to the normal consultation and negotiation procedures applicable to the industry concerned.

2.31 It must be made clear that the Commission does not, and indeed cannot, propose any changes which would affect members' benefits already accrued in the RPS(sca). Past service benefits are protected by Section 67 of the Pensions Act 1995, which requires that members' benefits already accrued cannot be changed without **either** members' consent **or** a certificate to be given by the Scheme Actuary to the effect that they are not reduced in value.

2.32 The principal change that the Commission proposes to benefits for those who are already members of the RPS(sca), but who do not have the indefeasible right, is that retirement should be based on a pivotal age of 65, rather than 60 as at present. Pensions on retirement before age 65 would be reduced on a basis that is, as far as possible, cost-neutral.

2.33 It became clear during the Commission's earlier work that many employees in the railway industry already work until age 65, as shown in Figure 2.3 (reproduced from the Commission's first report), and that these employees are, on average, less well-paid than those who retire earlier. There is no reason why these employees should pay higher contributions to an occupational pension arrangement in order to allow those, typically better-paid, employees who wish to retire at 60 or even 55 to do so.

Figure 2.3 Active voluntary retirees aged 55-65 in 2005



- 2.34 It is estimated that this reduction in the generosity of early retirement provisions, to be based on a pivotal age of 65, would lead to a joint contribution rate lower on average by about 6 percentage points (2.4 employee and 3.6 employer), i.e. contributions of around 24 per cent of section pay in total, rather than the 30 per cent or so that it is expected will be required to secure existing RPS(sca) benefits.
- 2.35 As the pivotal age of 65 can only apply to service after the date of change, the impact would only be felt gradually over a long period. For example, a long-service member who retires only a few months after the change will still have the bulk of their pension based on a retirement age of 60, with unchanged early retirement factors applied to that part of the pension. Some examples of how individual employees might be affected are set out in Table 2.1.

Table 2.1 Reduction in RPS(sca) pension

On retirement at age 55	Post-change service to retirement (years)			
	1	5	10	20
Pension under current rules	£11,087	£11,087	£11,087	£11,087
Pension under proposed rules	£11,002	£10,660	£10,232	£9,376
Reduction of pension	-£86	-£428	-£856	-£1,711
Percentage reduction	-0.8%	-3.9%	-7.7%	-15.4%
On retirement at age 60	Post-change service to retirement (years)			
	1	5	10	20
Pension under current rules	£12,319	£12,319	£12,319	£12,319
Pension under proposed rules	£12,264	£12,045	£11,772	£11,224
Reduction of pension	-£55	-£274	-£548	-£1,095
Percentage reduction	-0.4%	-2.2%	-4.4%	-8.9%
On retirement at age 65	Post-change service to retirement (years)			
	1	5	10	20
Pension under current rules	£12,319	£12,319	£12,319	£12,319
Pension under proposed rules	£12,319	£12,319	£12,319	£12,319
Reduction of pension	£0	£0	£0	£0
Percentage reduction	0.0%	0.0%	0.0%	0.0%

Notes:

1. Based on member with pensionable pay of £24,000 per annum
2. Member's total service assumed to be 36 years
3. It is assumed that member converts additional lump sum to pension

2.36 Provisions to allow early retirement for those whose health prohibits them from continuing to work exist at present in the RPS(sca) and the Commission proposes that these provisions should be modified to be based on service to age 65.

2.37 The Commission also proposes that, for the same reasons set out above in relation to members with protected status, all contributions for BRASS, by both employees and employers, should cease.

## Proposed changes for new employees

2.38 The Commission proposes that a new pension arrangement should be offered to new employees with those railway industry employers who currently offer RPS(sca) to new entrants. This should also be made available to those who are not already members of the RPS(sca). In preparing its proposals for what is referred to throughout this report as RPS(average career revalued earnings) or RPS(acre), the Commission has sought to satisfy the criteria of affordability, sustainability and equity. The key features of the proposal are set out in Table 2.2.

Table 2.2 Summary of RPS(acre)

Type of scheme	Revalued average earnings
Pensionable pay	Basic pay plus additions, as for RPS(sca)
Section pay	Pensionable pay less one times the single person's basic state pension
Accrual rate	1/50 (equal to 2 per cent)
Revaluation basis (in-service)	RPI
Calibration mechanism	Longevity adjustment in line with changes in mortality basis (see paragraphs 2.50 – 2.53)
Pension	Total revalued section pay times the accrual rate. This figure will be subject to the operation of the Calibration Mechanism.
Revaluation basis (in deferment and in payment)	RPI subject to a maximum of 5 per cent per annum
Normal retirement age	65
Early and late retirement	Accrued pension adjusted on cost-neutral basis
Ill-health retirement	Immediate pension, based on current section pay including projected service to age 65
Lump sum on retirement	Commutation of pension within HMRC limits
Death-in-service	Lump sum of 4 times pensionable pay plus dependant's pension of half the pension payable on ill-health retirement
Death-in-deferment	Dependant's pension of half the member's accrued pension
Death-in-retirement	Dependant's pension of half the member's pension, before allowing for commutation – with 5 year guarantee
Member contribution rate	40 per cent of ongoing cost of benefits – initially 8 per cent of section pay and subject to a cap of 10 per cent
Contracted-out status	Contracted-out (see paragraph 2.48)

2.39 It should be understood that because RPS(acre) is intended to be more affordable than RPS(sca), the joint future service contribution rate will be lower. It is inherent in the Commission's proposals, therefore, that the new arrangement will provide a lower level of benefits than is being accrued by members of RPS(sca) at present. However, the Commission is of the view that the new arrangement will still provide an attractive package of benefits, including a reasonable income in retirement when taken with State pension benefits.

2.40 Illustrations of potential outcomes in terms of the benefits payable to members in different circumstances are provided in Table 2.3. It will be seen that it is anticipated, in broad terms, that the replacement rate for the typical member with 40 years' service, including state benefits, will amount to 55 per cent of their income at retirement.

Table 2.3 Projected benefits from RPS(acre) and State 40 years' service

Pensionable Pay		Benefits		Total
Current pay	Projected final pay	Scheme pension	Basic State Pension	Replacement rate
£10,000	£13,308	£3,558	£4,314	59%
£15,000	£19,962	£6,895	£4,314	56%
£20,000	£26,616	£10,454	£4,314	55%
£25,000	£33,270	£14,012	£4,314	55%
£30,000	£39,924	£17,570	£4,314	55%
£35,000	£46,578	£21,128	£4,314	55%
£40,000	£53,232	£24,686	£4,314	54%
£45,000	£59,886	£28,245	£4,314	54%
£50,000	£66,540	£31,803	£4,314	54%

Note. The basic State Pension is assumed to increase in line with the RPI up to 2012 and average earnings thereafter.

2.41 Given the nature of labour relations across much of the railway industry, the Commission understands that details of any new scheme are bound to be subject to a process of consultation and negotiation between the employers and the independent recognised trade unions within the industry. However, what is set out in this section presents the Commission's settled view of the framework which will best accommodate the different objectives of all the parties involved, while retaining defined benefit pension provision within as much of the railway industry as is practical.

2.42 As well as being offered to new entrants to the industry, the Commission believes that RPS(acre) should be available to existing members of RPS(sca) who find that they cannot, or do not wish to, afford the contributions that will be required if they remain members of that arrangement. There may also be members of RPS(sca) who decide that they might benefit from the greater degree of equity that the new scheme will offer. Such members should not lose their indefeasible right, however, which means if and when they change their employment within the railway industry, they should be treated by their new employer in exactly the same way as any other new employee with the indefeasible right. Any other approach is bound to lead to excessive administrative difficulties.

2.43 The Commission considers, given the current commercial organisation of the railway industry and the attitude of the Government, that RPS(acre), like the RPS(sca), should be a shared cost scheme. For the same reasons the RPS(acre) will have to be a sectionalised scheme, with no cross-subsidies, where each employer and its employees will be responsible for meeting the cost of their own section. The Commission believes that both these features are essential in maintaining a defined benefit pension scheme within the railway industry.

- 2.44 The following sections explain why the Commission's proposals meet the agreed criteria of affordability, sustainability and equity. In addition, Annex 2 sets out more detail of the Commission's proposals in relation to three key elements of the new scheme: the revaluation basis; the calculation of section pay; and its contracted-out status.

## Affordable

- 2.45 As explained in Chapter 1, the Commission does not believe that a scheme that provides the current benefits of RPS(sca) can be afforded in the longer term, either by members or their employers. Preliminary indications are that the joint future service contribution rate will be around 30 per cent of section pay. Deficit contributions will be payable in addition. Part of the solution must be to provide an affordable alternative.
- 2.46 The issue of what is affordable is clearly a matter of judgement. The overall cost needs to be less than the rates identified above for RPS(sca) but worthwhile benefits must still be provided for members, while meeting the employers' need to balance cost against the objectives of attracting and retaining staff. In the light of the evidence that has been received, the Commission is of the view that the joint standard contribution rate, i.e. the cost of accruing benefits, for RPS(acre), when expressed as a percentage of section pay, should be no more than 20 per cent. It should be understood that this contribution rate is an average for the railway industry as a whole and that the figure will vary between sections, depending principally on the age structure of each workforce.
- 2.47 RPS(acre) will be a shared cost arrangement: the employers' share of this proposed contribution will be about 12 per cent of pensionable pay and the members' share about 8 per cent. It should be noted that for many members, the share of the contribution is not greatly in excess of the contribution rate of 5 per cent that will be payable by members to the personal accounts due to become available in 2012. The Commission's proposal also offers employers the prospect of a contribution rate significantly lower than that which would be payable to the RPS(sca).
- 2.48 This rate is set on the assumption that the new arrangement, like the RPS(sca), will be contracted-out of the State Second Pension; if it were not contracted-out, the target should be set at 20 per cent less the contracting-out rebate, i.e. no more than 14.3 per cent in current terms. The issue of whether the new arrangement should actually be contracted-out or not is discussed in Annex 2 but, either way, the impact on affordability should be neutral.

## Sustainable

- 2.49 The Commission considers that keeping the shared cost basis, with contributions generally paid in the proportion 60:40 by employers and members respectively, is essential if the scheme is to be sustainable. The fact that the existing scheme has lasted as long as it has over much of the industry, even for members without protected status, is testimony to the importance of the shared cost approach. The Government, as well as many pensions experts, has emphasised the importance of risk sharing as a factor in maintaining defined benefit pension provision in general, and the cost-sharing approach of the RPS(sca) is a simple means of achieving such an end.
- 2.50 The Commission recognises that deficits may still arise in RPS(acre), although the potential for a future mismatch between assets and liabilities should be minimised by the use of assumptions that are robust in the longer term and the adoption of investment policies that match assets as closely as possible to changes in accrued liabilities. The Commission proposes that, in addition, employers and members should have further protection against the risk of escalating contribution rates by having calibration mechanisms built into RPS(acre).
- 2.51 A calibration mechanism is an arrangement whereby future benefit accruals are adjusted to allow for changes in the underlying assumptions used to calculate the cost of the scheme. In essence, it is intended to maintain the value of benefits at retirement. So, if members are expected to live for longer, the prospective pension that is being accrued will be reduced in proportion to the consequent increase in the expected cost. The net result will be that members, on average, are no worse off, in terms of the value of benefits that are accrued on their behalf, although the income that this can provide will be lower as it has to be spread over a longer period.
- 2.52 There are a number of different mechanisms by which this objective can be achieved. One way is to increase normal retirement age. However, the Commission is of the view that it would be best and most straightforward to adjust the accrued pension at the existing retirement age. The most notable example of this sort of mechanism is that used in the BAE Systems Pension Scheme, following agreement between the company and the trade unions, where it is applied to pensions earned after 5 April 2006. This mechanism adjusts the pension calculated at retirement to reflect changes in life expectancy by what is described as a Longevity Adjustment Factor (LAF). This will be set by the Scheme Actuary, based on changes in expected mortality rates, compared to those implied by the mortality tables used at the time the LAF was introduced.

- 2.53 This sort of calibration mechanism offers employers an important protection against future cost increases. The Commission considers that at the same time, members should be offered protection against future increases in their contributions by providing for a cap on member contributions of 10 per cent of section pay.
- 2.54 The Commission concludes that the sustainability of the new scheme depends on a continuation of the shared cost basis. However, there should be protection for both employers and employees so that the difficulties which led to the establishment of the Commission can be avoided, as far as possible, in the future. This involves:
- calibration mechanisms to deal with demographic changes including, for example, improvements in anticipated mortality; coupled with
  - a cap on members' contributions of 10 per cent of section pay.

## Equitable

- 2.55 The Commission believes that the need for equity within the new arrangement means that the RPS(acre) must be established on a revalued average earnings basis, as opposed to the final pay basis that has traditionally been used in most defined benefit pension schemes including the RPS(sca). The final pay basis is where benefits are calculated on the member's earnings at, or near to, retirement; the revalued average earnings basis is where benefits are calculated on the member's earnings over the whole of their pensionable service, with the crucial proviso that the earnings for each year are increased or revalued up to retirement in line with an appropriate index.
- 2.56 The Commission is aware that the unions have expressed varying degrees of opposition to any move to a revalued average earnings basis. However, the Commission believes that this is based on the misapprehension that a revalued average earnings scheme is inevitably worse for all members than a final pay scheme. This simply does not have to be the case, as it depends on the particular benefit design. There will, of course, be differences between the arrangements, as explained below, but these have an impact only on how the scheme allocates benefits between members, not on its overall standard. While recognising these differences, the Commission is firmly of the view that the way in which a revalued average earnings scheme allocates the available resources is more equitable than a final pay scheme with the same cost.
- 2.57 The main argument in favour of a revalued average earnings pension scheme is in terms of equity between members. In particular, such schemes relate benefits more directly to the contribution that members have made to the scheme, which is particularly important in a shared-cost scheme like the RPS(sca). They also avoid the systematic bias in a final pay scheme in favour of members whose earnings increase by more than the average over their

working lives. This lack of fairness in a final pay scheme is compounded by the likelihood that those who gain most from such schemes will, in any event, tend to be on a higher income when they reach retirement. It is unfair for members on lower levels of pay, with little prospect of systematic pay increases in real terms through promotion or pay scales, to be contributing in part to the much more favourable terms currently enjoyed by higher-paid members of the RPS(sca).

- 2.58 Nevertheless, it is necessary to understand why revalued average earnings schemes have not achieved wider acceptance. Partly this is sheer convention: the final pay basis has been considered by employers and unions alike as the “gold standard” of pension provision and it can be difficult for anyone who has championed such provision to recognise its shortcomings. This is particularly the case at a time when standards of occupational pension provision are under pressure and there is a concern among members that any such move is simply a covert way of cutting standards of provision.
- 2.59 Members also tend to find final pay schemes easier to understand – a pension based on final pay has a compelling simplicity that is not enjoyed by a revalued average earnings scheme. In addition, a case can be made in favour of a final pay scheme in that it is designed to enable the member to maintain, in retirement, their standard of living immediately before retirement.
- 2.60 Despite these arguments, the Commission is firmly of the view, particularly in the circumstances of a shared cost arrangement, that benefits for future new entrants to the railway industry should be based on their revalued average earnings. This is on the clear understanding that the scheme will be established within the cost parameters specified above. Put simply, a revalued average earnings scheme that costs 20 per cent of members’ section pay offers a better deal to the majority of members than a final pay scheme that costs the same. The difference is in how the resources are distributed between the members in terms of the benefits they will receive, not in the overall quality of the scheme.
- 2.61 This means, of course, there will be those who gain and those who lose from having a revalued average earnings arrangement, as compared to how they would have fared under a final pay arrangement, and this will inevitably be unwelcome to those who anticipate that they will be worse off. However, none of this will affect existing members of the RPS(sca), unless they choose to join RPS(acre).

- 2.62 How well a member will do in a revalued average earnings scheme, compared with a final pay scheme, depends on two sets of factors. First, there are the provisions of the respective schemes including, crucially, the accrual rates and, in the case of the revalued average earnings scheme, the rate at which pay is revalued during service. Second, there are the individual circumstances of the member, where the key factors are how long they remain as an active member of the scheme and how their earnings increase in real terms over their period of active scheme membership.
- 2.63 Illustrations comparing a final pay scheme and an average earnings scheme within an overall cost of 20 per cent of pensionable pay are set out in Annex 3.

## RPS governance

- 2.64 In its first report, the Commission noted that:
- “The employer-nominated trustees represent employers with very different commercial interests. The current nomination procedure, however, based on electoral groups weighted by the size of sections, has led to some unintended consequences. In particular the Board is not fully representative of those different commercial interests. It would also appear that if the employment status of the employer-nominated trustee changes and he/she remains a trustee, the question of who they are representing can become ambiguous. It also occurs to the Commission that a trustee board of sixteen may be too big, and that a smaller group may be more conducive to dealing with the increasingly difficult and challenging issues which the Board has to address.”*
- 2.65 The Commission acknowledges the recent work of the Trustee Board to review and improve its working methods (for example, the changed committee structure). These changes are still bedding in but may well prove helpful. Nevertheless, the Commission considers that the issues raised in the first report remain relevant.
- 2.66 The Commission does not wish to make any detailed recommendations in relation to these issues, but recommends that they are a topic of further discussion for all parties. The Commission appreciates that any proposal to reduce the size of the Board might lead to difficult debates over the nomination arrangements. This should not be insurmountable; it is successfully dealt with in many other large schemes which accommodate a wide range of interests in a board of eight or twelve.

- 2.67 The Commission believes that Railpen, RPMI and the Trustee Board have the ability and capacity to facilitate alternatives to be considered by stakeholders. They could provide the trustee, investment and administration arrangements for a single TOC section for pensioner and deferred members of the RPS(sca) (described further in Chapter 3), and for any alternative schemes/sections set up as a result of the introduction of RPS(acre) consequent upon the publication of this report. There is clearly merit in maintaining economies of scale and a concentration of expertise in the delivery of pension provision throughout the railway industry. Managing the transition to new affordable arrangements could be seriously hindered if RPMI and the Trustee are not involved and engaged in the process.
- 2.68 The introduction of new arrangements will bring further pressure on the Trustee Board to address the issues on stakeholder engagement identified in the Commission's first report, and to discuss with the parties the most effective system of trusteeship for any new provision. If employers are to be discouraged from taking unilateral action to address their concerns and if the Trustee is to play an important and influential role in providing fair and equitable pensions to workers in the railway industry over the long term, then the Trustee must review its way of engaging with stakeholders.



## 3 Transition arrangements

- 3.1 Introducing new pension arrangements will always pose problems but these will be particularly acute in the railway industry. This is because of the nature of the shared cost arrangement, which is unlike a more typical balance of cost defined benefit pension scheme where all the investment and longevity risk is borne by the employer. This means the transition has to be managed in a way that ensures a fair sharing of the investment and longevity risks, without placing an unreasonable burden on the members. While the introduction of more affordable arrangements will allow employers to reduce their pension costs, it would be unfair, as well as unsustainable, if the transition arrangements were to place an increased burden of risk on a declining number of active members.
- 3.2 The Commission stated, in its first report, that it would be inequitable for active members of an alternative, affordable defined benefit scheme to share the cost of funding the RPS(sca). This means that the finances of the new arrangements must be kept separate from the existing arrangements, with the result that the RPS(sca) must be closed to new members, except for those with the indefeasible right. Over time the proportion of active members of the RPS(sca) at younger ages will reduce, with the result that the contribution rates will increase. In addition, active members will face an increase in the level of investment and longevity risk in relation to pensioner and deferred member liabilities.
- 3.3 An essential element, therefore, in the transition to more affordable arrangements must be for employers to take on a greater responsibility for pensioner and deferred member risks in the closed RPS(sca) sections. This would mean, in effect, that active members of the RPS(sca) sections would continue to pay their 40 per cent share of the joint standard contribution rate set by the Actuary but the employer would take responsibility for funding any deficit in respect of pensioner and deferred member liabilities.

3.4 The Commission emphasised in its first report that managing the costs and risks faced by active members in the RPS(sca) would need to form part of any transition to new, affordable pension arrangements within the railway industry. Although the transition path should reflect the different requirements in different parts of the railway industry, in each case it must lead to:

- affordable arrangements for new entrants;
- containment of the exposure of active members to the risks in respect of pensioner and deferred member liabilities; and
- a reduction in employers' rising pension costs over the medium to long term.

3.5 Given these general objectives the following paragraphs set out further details of the transition arrangements for particular sections of the industry.

### Train operating companies

3.6 In the TOC sections of the RPS(sca), the employer covenant is provided by holders of franchises, the length and boundaries of which are determined by the DfT and the Scottish Executive. The combination of the impact of changes to those franchises, the shared cost nature of the RPS(sca), and the long-term nature of pension funding, all require some structural reform that will facilitate the transition to more affordable pension arrangements. Any such structural reform will require the active support of the DfT and the Scottish Executive as well as the TOCs.

3.7 The Commission considers it essential that the introduction of affordable pension arrangements for new employees must not place an unfair burden of risk on the remaining active members in the existing TOC sections. It therefore proposes the creation of a single section of the RPS (referred to in this report as the RPS(pds)), for pensioners and deferred members of the TOCs who are currently covered by the RPS(sca).

3.8 The Commission believes that, unlike the creation of a single TOC section for all members including actives, it is possible to envisage the creation of a RPS(pds) for pensioners and deferred members of the TOC sections. This is because, when members cease to be active contributors, their pension liabilities are sufficiently crystallised for this to be viable.

- 3.9 The idea of having a single section for pensioners and deferred members is not entirely new and some work has already been undertaken on what form it should take. From this it is apparent that there are four major issues to be resolved:
- financial support – The identification of sources of financial support acceptable to the parties involved;
  - transfer timing – The timing of the transfer of pensioners and deferred members from any TOC RPS(sca) section to the RPS(pds);
  - transfer values – The methodology and assumptions to be adopted for determining the transfer values to be paid from the TOC sections to the RPS(pds);
  - investment strategy – The investment approach appropriate for the RPS(pds).

## Financial support

- 3.10 The needs of members' security and current pensions legislation require a strong financial support mechanism for the RPS(pds). However, it is doubtful whether Ministers would agree to the DfT being identified as the principal employer, although this would be the most straightforward approach. The DfT would not expect the TOCs to be exempt from responsibility for underwriting the RPS(pds). Nevertheless, the Commission stresses that the TOCs and the DfT have a mutual interest in securing the introduction of lower cost pension arrangements. The Commission also recognises that the detailed arrangements for creating and supporting the RPS(pds), and how this relates to the franchise agreements, would need to be agreed between the parties.
- 3.11 There would need to be consultation with the RPS Trustee on rule changes to provide for transfers to be made to the RPS(pds).
- 3.12 The way forward is to set up the RPS(pds) as a multi-employer section, with the financial responsibility assessed in proportion to the contribution of each TOC to the section's liabilities. To address the issue of employer covenant, the DfT should provide an assurance to the trustee of RPS(pds), in broadly the same terms as that already provided to the trustee of RPS(sca), to the effect that there will always be an employer in a TOC franchise to honour the employer covenant. This assurance should be built into the RPS(pds) structure.
- 3.13 Such an approach would address the concerns of the TOCs that there should be no cross-subsidies between employers in the funding of pension liabilities and no sharing in the risk of other employers defaulting.

- 3.14 The financial support mechanism discussed above would also need to deal with an issue identified in the Commission's first report – the allocation of pensioner and deferred member liabilities on boundary changes. The operation of the RPS(pds) should not require the identification of individual pensioners and deferred members for transfer in the event of boundary changes. Instead, the RPS(pds) should be set up so that the relevant share of the liabilities would be allocated to the relevant employers and a formula would need to be agreed for determining the appropriate share.
- 3.15 The Commission considered whether deficit contributions for the RPS (pds), if required, could be expressed as a percentage of the total payroll for active members in the TOC RPS(sca) sections. However, this is not possible; first, because it would not reflect an appropriate share of the liabilities that have been passed over to the RPS(pds); and second, because the TOCs would not be prepared to underwrite the liabilities of other employers who default on their obligations.
- 3.16 Modest surpluses in the RPS(pds) should be carried forward to meet future uncertainties. If a sizeable surplus were to emerge, one option would be to allow more favourable transfer terms in respect of future transfers for a period.
- 3.17 Access to RPS(pds) should be seen as part of the transition to more affordable pension arrangements. Where, as part of such a transition, a TOC had not closed its RPS(sca) section to new members other than those with the indefeasible right, it would not be permitted to participate in the RPS(pds).

### Transfer timing

- 3.18 The timing of the transfer of liabilities into the RPS(pds) could, in principle, take effect on the occasion of one or more of the following:
- at the date of an individual's retirement or leaving active membership;
  - at each actuarial valuation of the RPS(sca);
  - at the time of franchising.
- 3.19 While individual transfers at retirement or leaving service appear to be the right approach in theory, this is also the least practical option. It would be administratively burdensome; any problems or funding implications are more likely to appear following an actuarial valuation; and it could inhibit assessment of the contribution each TOC has made to the liabilities in the RPS(pds).

- 3.20 The Commission suggests, given that contribution rates are reassessed at each actuarial valuation, that making the transfer at that time would seem to be the most practical approach. It would also allow the actuary to assess the contribution of each TOC to the liabilities of the RPS(pds) on a basis consistent with the valuation and ensure a common date for making such transfers across all TOC RPS(sca) sections.
- 3.21 Transfers to RPS(pds) at the time of franchising would allow for the financial effect of the transfer to be taken into account when setting the terms of the franchise. However, this approach on its own would mean that the transfers would take place infrequently, particularly with the increasing length of franchises. This would delay the transition to new arrangements and would risk an increased burden on remaining active members in the interim.
- 3.22 The Commission urges the parties to seek to reach a comprehensive agreement on transition arrangements in the TOC sections prior to the completion of the 2007 actuarial valuation process. This would allow the introduction of the RPS(pds) immediately afterwards. The financial effect of the transfer of pensioner and deferred member liabilities, and the implications for the franchise agreement for each TOC, need to be identified and discussed between the Association of Train Operating Companies (ATOC), the DfT and the Scottish Executive, given their mutual interest in lower-cost pension arrangements. There should also be provision in the rules of the RPS(pds) to allow transfers at other times, for example on franchise renewal or remapping.

## Transfer values

- 3.23 Transfers should be the past service reserve, calculated on the scheme-specific funding basis (or technical provisions). If a TOC section is in deficit, the shortfall should be owed to the RPS(pds) with payments in line with the section's recovery plan (under the Pensions Act 2004). The debt should be against the franchise, or any part of that franchise, under the same terms as the existing 'letter of comfort' from the DfT.

## Investment strategy

- 3.24 The investment strategy for the RPS(pds) would be a matter for the Trustee or Pensions Committee in consultation with the employers, but a desirable principle must be to reduce the variability of future outcomes, which would indicate a predominantly bond-based approach. Consequent upon the introduction of the RPS(pds), the TOC RPS(sca) sections would have a much greater proportion of active members, with the possibility of a corresponding adjustment to the investment strategies of these sections and, in principle, the overall impact on fund returns should be neutral.

3.25 The Commission believes that the RPS(pds) is a crucial element in the process of change and stresses to the TOCs, the DfT and the Scottish Executive that they have a mutual interest in facilitating the transition to more affordable pension arrangements in the railway industry. However, for the RPS(pds) to be introduced, there are details that will need to be resolved, including rule changes to the RPS. There will also need to be discussions between the DfT, Scottish Executive and ATOC on the employer covenant structure for such a section and the relationship with the franchise arrangements. Access to RPS(pds) should be seen as part of the transition to more affordable pension arrangements. Where a TOC had not closed its RPS(sca) section to new members as part of such a transition, it would not be permitted to participate in RPS(pds).

## Network Rail

- 3.26 Network Rail is the largest employer within the industry, subject to regulatory control and under pressure to reduce costs and improve service levels. The company has already secured a significant reduction in its ongoing pension costs by introducing, in April 2004, a five-year waiting period for new employees before they become eligible to join the RPS(sca). The scheme available in those first five years is a defined contribution scheme, with employer contributions on a scale of 3 to 7 per cent and employee contributions on a scale of 0 to 4 per cent. The level of contribution made on behalf of any employee within this range is determined by individual choice. Approximately one-third of the members of the Network Rail defined contribution scheme, many of whom are on low to moderate earnings, have chosen the default contribution rate of 0 per cent employee and 3 per cent employer.
- 3.27 The manner in which Network Rail has made adjustments to contain the rising costs of pension provision has fallen heavily on new entrants and on those on low to moderate incomes. This change is inequitable and unfair for new employees in comparison to existing scheme members and is an example of the arbitrary adjustments that will be made if the challenge of rising pension costs is not effectively managed across the industry.
- 3.28 The Commission recommends that RPS(acre) should be introduced in Network Rail for those employees who, at the point of introduction, do not meet the current qualifying conditions for entry into the RPS(sca); for new employees; and for those existing members of RPS(sca) who choose to opt into the new arrangements. In introducing the new affordable arrangements, the Commission believes strongly that it would be equitable to revisit the requirement of a qualifying period for new entrants. It would be desirable if there were no qualifying period, but in any event it should be of no more than twelve months' duration.

- 3.29 The introduction of new affordable arrangements, which are kept financially separate from the existing arrangements, will have the effect of closing Network Rail's RPS(sca) section to new members, except for those with the indefeasible right. Over time the proportion of active members at younger ages in the section will reduce. The remaining members will face a potentially unsustainable increase in the level of investment and longevity risk in relation to pensioner and deferred member liabilities. The introduction of a five-year qualifying period for entry into the current RPS(sca) section is already reducing the number of active members, so to achieve fairness, risk sharing for pensioner and deferred member liabilities would need to be revisited at some stage under the current arrangements.
- 3.30 The Commission considers that Network Rail, as a large employer providing a strong long-term covenant, has the capacity to manage the transition issues that occur in a shared cost arrangement when moving to new affordable arrangements, and to take on responsibility for deficit funding for pensioner and deferred liabilities. To do so, however, the company will need the incentive of a sustained reduction in its pension costs over the medium to long term, particularly if it is to take on a greater responsibility for funding any deficit in respect of pensioner and deferred member liabilities. The unions and the employer will need to engage constructively on these issues in order to achieve the transition.
- 3.31 The other changes described in Chapter 2 of this report will also help Network Rail to carry greater responsibility for funding pensioner and deferred member liabilities.

### Freight operating companies

- 3.32 The Commission recognised, in its first report, that the freight companies are operating in a growing but fiercely competitive market, facing increased pressure from road hauliers and other operators, with some contracts awarded for short periods. However, the introduction of new affordable arrangements into these companies, which are kept financially separate from the existing shared cost pension sections, will similarly have the effect of reducing the number of active members in their existing RPS(sca) sections.
- 3.33 A transition to new affordable pension arrangements, which will allow employers to reduce their pension costs in the medium to long term, while being fair to active members, will require those employers to take on a greater responsibility for funding any deficit in respect of pensioner and deferred liabilities.
- 3.34 The Commission recognises that the freight companies, facing as they do a competitive marketplace, are bound to be concerned with minimising volatility in their short-term costs. It cannot be assumed that the freight companies will continue to provide access to the RPS(sca) for new recruits to

their companies. Managing the detail of the transition arrangements, therefore, will require detailed and constructive engagement between the stakeholders. The cessation of BRASS and the move to cost-neutral retirement before age 65 should assist these employers in managing their short-term pension costs.

## Companies with a small proportion of employees in the railway industry

3.35 In its first report, the Commission observed that:

*“The indefeasible right has been considered a hindrance, in particular to those engineering companies with large interests outside the railway industry and relatively small involvement within it. Some offer comparable benefits to the RPS in their own occupational schemes, but must nevertheless maintain an involvement in the RPS(sca) whenever individuals assert the indefeasible right.”*

3.36 The Commission proposes that in such instances, employers should be permitted to discharge their obligation to any employees with the indefeasible right through their own occupational schemes, where it can be demonstrated that these schemes provide benefits equivalent to, or better than, those of the RPS(sca). This might also act as an encouragement to such employers to continue with defined benefit pension provision.

3.37 A light-touch regulatory arrangement would be needed. For example, the scheme actuary could be asked to certify that the benefits of the scheme in question are indeed equivalent to, or better than, those of the RPS(sca).

3.38 An employee with the indefeasible right who joined such a defined benefit scheme would retain the indefeasible right, with no break in continuity. So, if the employee later left this company and moved to another employer in the railway industry, they would again be able to assert the indefeasible right. It would be necessary to put in place processes for capturing the names of individuals with the retained indefeasible right.

3.39 The Commission is aware that there may be legal difficulties in this approach but considers that these should not be permitted to rule out an option which could be helpful for both employers and employees.

3.40 As this question relates to the terms of the Protection Order and not to the rules of the RPS(sca), the Commission considers that it is a matter for the DfT, rather than the Trustee. The Commission, therefore, recommends that the DfT explore the matter carefully, considering both what is possible under the Protection Order and, if necessary, what options for change exist.

## Infrastructure companies

- 3.41 The Commission's first report identified, in some detail, the unfair treatment of many remaining active members, in infrastructure companies' closed sections of the RPS(sca), which was exacerbated by the decision by Network Rail to take maintenance work in-house.
- 3.42 There has been a significant increase in the ratio of pensioner and deferred members to active members in many of these closed RPS(sca) sections, with the latter left to bear 40 per cent of the deficit funding requirement.
- 3.43 The current level of risk faced by these active members cannot be wholly attributed to the factors set out in Chapter 1 of this report. The policy decisions and actions of the DfT, the Office of Rail Regulation (ORR) and Network Rail were intended to address problems with the railway network. However, they also had an inequitable and arbitrary effect on the active scheme members affected, who had no control or influence over the change in the nature of the liabilities in the RPS(sca) sections of which they were members.
- 3.44 The Commission believes that the ORR, Network Rail and the infrastructure companies should, under the auspices of the DfT, discuss measures to contain the exposure of the declining number of active members, in these closed sections of the RPS(sca), to risk in respect of pensioner and deferred member liabilities.



## 4 Other pension provision in the railway industry

- 4.1 Previous chapters have set out how shared cost defined benefit pension provision could be made both affordable and sustainable in much of the railway industry including, but not limited to, Network Rail, the TOCs and the freight operators. However, it must be recognised that the RPS(sca) is not offered in all parts of the industry, particularly in companies participating in the industry through contracts. The Commission suggests that the provision of an affordable defined benefit arrangement along the lines proposed in Chapter 2 might encourage some of these employers to offer the new scheme to their employees.
- 4.2 This chapter examines what other pension provision the Commission considers should be provided, in those few circumstances where an employer is only prepared to offer a defined contribution arrangement. Such an obligation should be seen in the context of the Government's proposed legislation, due to come into effect in 2012, which will require "personal accounts" to be established for such employees in any event.
- 4.3 A number of railway industry activities (maintenance, cleaning, catering and so on) are now carried out primarily by companies acting under contract – usually to either Network Rail or a TOC.
- 4.4 In most of these companies, existing RPS(sca) sections have been closed to new entrants, other than those with the indefeasible right. The Commission also understands that when companies with no previous history in the railway industry win a contract for the first time, they often seek to avoid having to participate in the RPS(sca), unless obliged to because they have employees who wish to exercise their indefeasible right. Submissions of evidence from a number of these companies made it clear that, given the competitive environment in which they operate, they see no prospect of opening RPS(sca) sections.

- 4.5 When closing existing RPS(sca) sections, companies have contained and reduced their ongoing pension costs, while placing an increasing burden of cost and risk on the remaining active members. The Commission repeats an observation made in the first report that while some employers have recognised this and have begun to address the problem, others have not. The need for equity dictates that they should.
- 4.6 The Commission considers that there should be a minimum standard of occupational pension provision offered to all employees without access to the RPS(sca) or RPS(acre). The Commission realises that all contractors and bidders are operating in a competitive environment. In order to ensure a level playing field, therefore, all contractors and bidders should be expected to meet this minimum standard. This would need to be implemented by the organisations letting contracts within the railway industry, primarily Network Rail and the TOCs.
- 4.7 Ultimately, this implies that Government (ORR, DfT and the Scottish Executive) should use its powers and influence to ensure that such a minimum standard is observed by all parties. In the context of the forthcoming legislation that will require workplace pension provision, this would seem to be an appropriate stance for the Government.

### A minimum standard of defined contribution pension provision

- 4.8 There are four issues to be resolved in creating a minimum standard of defined contribution pension provision:
- what the standard would be;
  - which companies and contractors it would apply to;
  - how it would be enforced; and
  - how it would be administered.
- 4.9 The Commission does not intend to go into detail about the characteristics of such a minimum standard as this will be for the parties to agree. However, the Commission believes it would be helpful to all parties to put forward an outline of the standard.
- 4.10 A useful starting point for setting a minimum standard might be the Government's proposals for "personal accounts" as outlined in the White Paper *Personal accounts: A new way to save*, published on 12 December 2006. The necessary legislation has been introduced in the current parliamentary session.

- 4.11 The Government's proposal is that from 2012 all employers will be obliged to enrol all employees automatically into either a personal account or an equivalent or better scheme. Employees would be free to opt out. The Government's proposed level of minimum contributions to personal accounts is 3 per cent from the employer and 5 per cent from the employee (4 per cent plus tax relief). These minimum contribution rates will also apply to any scheme deemed equivalent to, or better than, personal accounts.
- 4.12 The Commission believes that it will, of course, remain desirable for employers to sponsor schemes with better provision and help employees develop reasonable prospects for income in retirement.
- 4.13 Another useful comparison is current average contributions to this sort of arrangement. The Office for National Statistics' 'Pension Trends' reported that in 2005, the average employer contribution rate to defined contribution occupational pension schemes was 6.3 per cent, while the average employee contribution was 2.7 per cent. A recent (summer 2007) survey by the consultants, Mercer, found an average employer contribution rate of 6.8 per cent and an average employee contribution rate of 3.6 per cent.
- 4.14 The Commission suggests that it is reasonable to expect that in the railway industry (which, as discussed in Chapter 3 of the first report, is successful and has good prospects for future growth) employer contributions should be higher than the personal accounts minimum and current average contribution rates. The Commission also suggests that the 60:40 ratio of contributions that applies to the RPS(sca) and RPS(acre) is a useful model, easily understood by all parties, which could also be applied to a minimum defined contribution standard.
- 4.15 The total contribution rate will have to cover not only the contributions for members' pensions on retirement but also the cost of providing benefits on death in service and, if possible, on ill-health retirement. The costs of administration will also need to be covered. It is assumed that the members of this arrangement will not be contracted out of the State Second Pension.
- 4.16 The Commission recommends that the minimum level of contributions should be 5 per cent from the employee and, given that the 60:40 ratio should apply to this, 7.5 per cent from the employer. Contributions above the minimum, and any matching arrangements, would be for individual employers to agree with their workforces.
- 4.17 The Commission understands that the great majority of contractors in the railway industry are working (either directly or through sub-contracts) for Network Rail or a TOC. The Commission proposes that all contractors and sub-contractors in the railway industry, undertaking work carried out by British Rail before privatisation, should be subject to the minimum standard.

- 4.18 The ORR, the DfT and the Scottish Executive have authority, or at least influence, over Network Rail and the TOCs (both franchisees and open-access operators). The Commission recommends that these bodies put in place an arrangement whereby all bidders for contracts and sub-contracts put out to tender by Network Rail or a TOC, offer a pension which meets the minimum standard. The Commission recommends that other industry parties which let contracts put in place their own equivalent arrangement.
- 4.19 Defined contribution provision meeting the standard could be easily and efficiently delivered by RPMI, either as part of the RPS or as an entirely independent arrangement. The Commission recommends that this would be a sensible and cost-effective way forward. However, it may be that some contractors (particularly those where the railway industry forms only part of their operations) would wish to have their defined contribution pension provision delivered in a different way; the Commission acknowledges that this may be appropriate.

## 5 Conclusion

- 5.1 This final report of the Railway Pensions Commission sets out our recommendations for change and our view on the likely evolution of the railway pension system if current arrangements remain unchanged. As Commissioners, we were asked to propose alternative means of long term pension provision for the railway industry for consideration by industry stakeholders, and this we have done.
- 5.2 In our first report we addressed the financial development of the RPS(sca); its current legal framework; the commercial structure of the railway industry; the strengths and weaknesses of the scheme; and the rail unions' campaign objectives. We also identified the criteria we would use to assess the sustainability of a railway pension system over the long term. We invited stakeholders to comment on our findings before we proceeded to make our recommendations for change.
- 5.3 In their submissions, interested parties expressed differing views as to where the solutions lay to the current pension funding challenges but there was little dissent from our analysis of the situation, the problems and challenges. In our final report, we present the difficult but unavoidable choices which must be made if there is to be sustainable defined benefit pension provision for most of the railway industry over the long term.
- 5.4 The debate between the stakeholders now needs to commence. Our report sets out an agenda for change but it is for others to take it forward. We are clear in our view, however, that the problems will get worse unless reforms start soon. Avoiding change is not an option; pension provision in the industry is already being altered, in a piecemeal way, in response to the pressure of increasing cost. The real issue is whether it is possible to introduce an alternative defined benefit pension system by consensus.
- 5.5 The timetable for change is set by the publication of the actuarial valuation results later this year. The need to agree the new joint contribution rates for the individual sections of the scheme will provide the opportunity to introduce a package of reforms in 2009 that will be acceptable to all parties. We encourage all the parties to seize the moment.

- 5.6 If a consensus on reforms is to be achieved and implemented early in 2009, there will be a demanding agenda to work through and detailed planning to be undertaken. Notwithstanding that employers want to retain autonomy over their own employee relations agenda, if such a challenging timetable is to be met we would strongly encourage all the stakeholders jointly to discuss the broad principles underlying the Commission's proposals for new and affordable pension arrangements.
- 5.7 With the publication of our final report we have discharged our function and terms of reference and our task is finished. We would, however, be pleased to meet with stakeholders to present our proposals and the reasoning behind our recommendations if parties consider this helpful.
- 5.8 We take this opportunity to thank all those involved in the railway industry with whom we have engaged, all of whom have extended us great courtesy.

Jeannie Drake  
Bryn Davies  
Peter Thompson

January 2008

# Annex 1

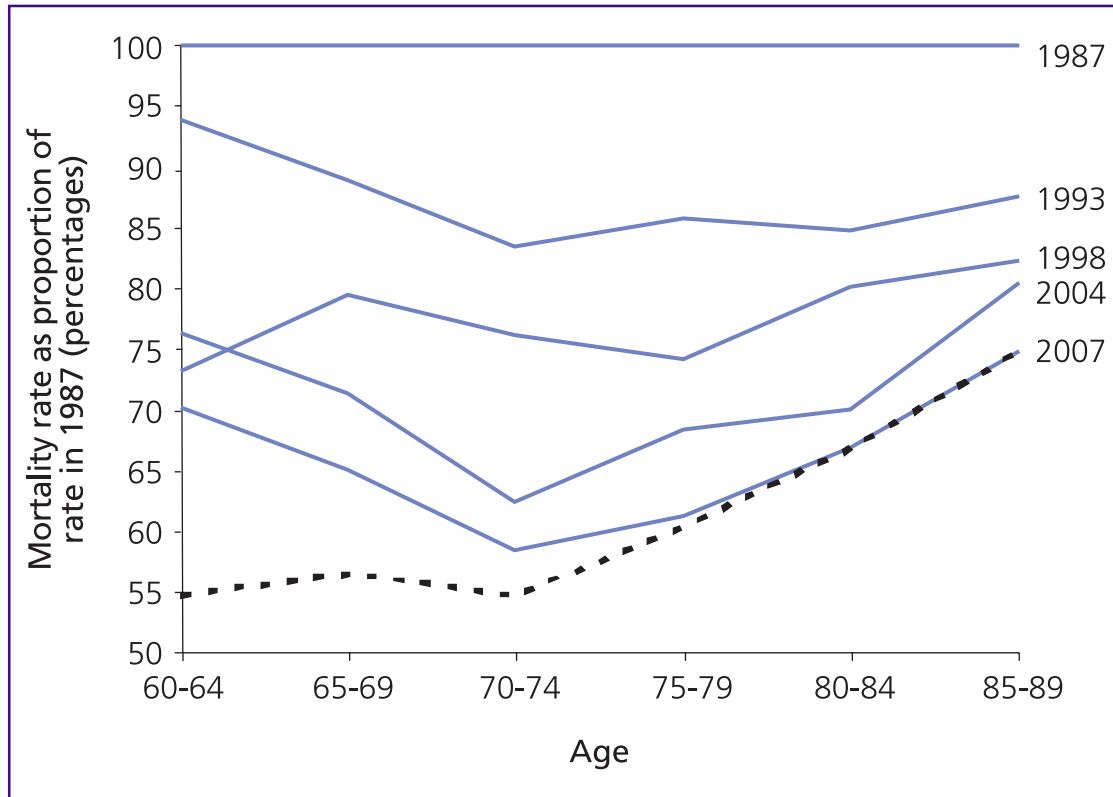
## Changes in mortality experience of retired railway workers since 1987

The graph in Figure A1.1 illustrates the significant improvement there has been in the mortality experience of retired railway workers since 1987. It uses data that was in the material circulated by the Scheme Actuary and the Trustee as part of the consultation process on the actuarial basis, methodology and assumptions to be used for the actuarial valuation of the RPS(sca) as at 31 December 2007.

The data is drawn from the experience of 1994 pensioners, except for the 2007 figures, because until now the number of retired members of RPS(sca) sections has not been sufficient to provide meaningful results. However, the data shown for 2007 illustrates the experience of both 1994 pensioners, shown by the solid line, and for 1994 and RPS(sca) pensioners combined, shown by the dotted line.

Each line shows the mortality rate for pensioners in the given age group that was found in the mortality investigation undertaken at the time of the relevant valuation, expressed as a percentage of the mortality rate for that age group that was found in the 1987 valuation. The graph shows that except on one occasion and then just for the youngest age group, there has been a consistent fall in the mortality rate experienced by pensioners in each age group over the last 20 years. The end result, looking at the combined results, is that over that period the number of deaths has declined in every age group by at least 25 per cent and, over the 60 to 74 age range, by around 45 per cent. It can also be seen that the rate of improvement in the mortality rate has been maintained, if not increased.

Figure A1.1 Changes in pensioners' mortality experience since 1987



The year shown for each line is that of the valuation and the mortality experience that will have been reported on each occasion which will, of necessity, have been that of an earlier year or years. For example, the mortality experience used for this purpose in the 2007 valuation is that which took place in 2005 and 2006.

# Annex 2

## Issues in the design of RPS(acre)

The Commission proposes that new employees in the railway industry should continue to be offered membership of a defined benefit occupational pension scheme. However, to make the scheme affordable, the Commission proposes that it should be established within a cost ceiling of 20 per cent of section pay and, to make it equitable, that it should be established on the basis of revalued average earnings. There is, however, some flexibility within these parameters in the detail of the scheme.

This Annex explains, in more detail, the Commission's view on three specific points of scheme design:

- the basis for revaluing earnings when calculating the average figure used to calculate the member's pension;
- the definition of earnings used for the purpose of calculating benefits and contributions, known in the RPS as "section pay"; and
- whether or not the scheme should be contracted-out of the State Second Pension.

These issues are dealt with in turn below.

### Revaluation basis

It is important to understand that, just like final pay schemes, it is possible to have good career average schemes and bad ones. The problem is that it is not as straightforward to judge a career average scheme, as it is to judge a final pay scheme. For example, it is easy to understand with a final pay scheme that a scheme with a 1/60ths accrual rate is better than one with 1/80ths. The position is not as straightforward with a revalued average earnings scheme, since the standard of benefits depends not only on the accrual rate but also on the revaluation basis. For example, it is not immediately obvious whether a 1/50ths scheme with revaluation of earnings in line with the RPI is better or worse than a scheme with a 1/70ths accrual rate and revaluation in line with National Average Earnings (NAE).

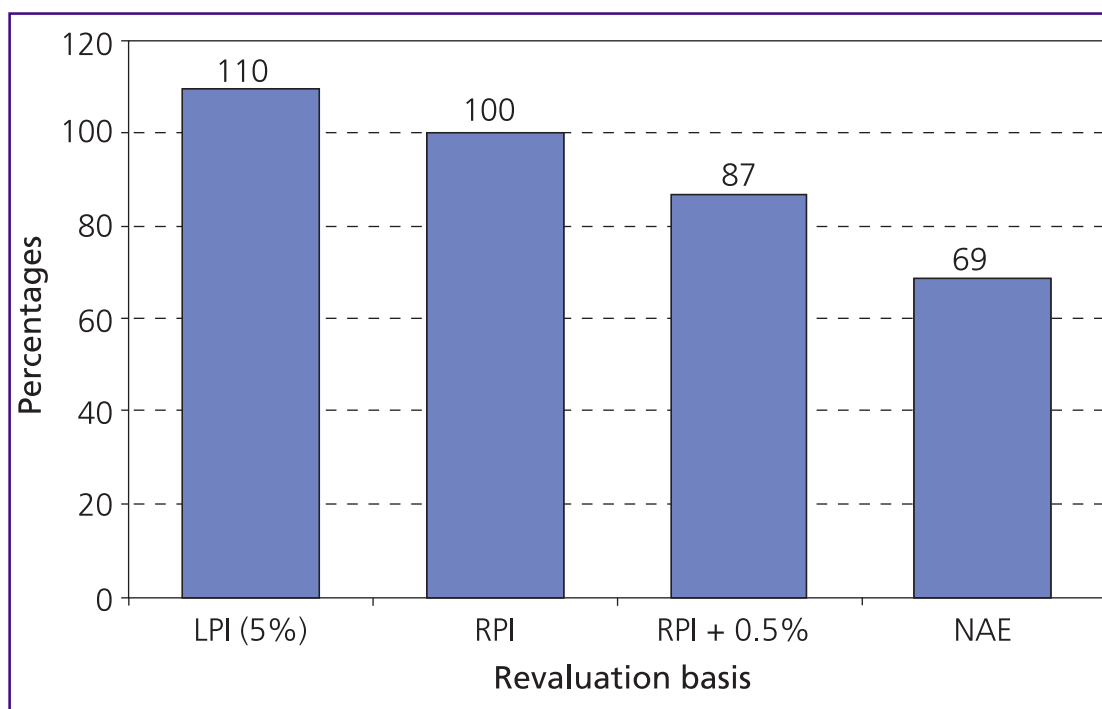
As far as the rate of revaluation is concerned, there is a range of practice among the career average schemes that are already in operation. At one extreme there is what, from a member's perspective, is the most favourable revaluation basis, which is revaluation in line with NAE; while the least favourable is Limited Price Indexation (LPI), where accrued pension is revalued in line with the RPI but subject to a maximum of 5 per cent in any single year. Other bases used in practice lie between these extremes, including RPI without a cap and RPI plus 1 per cent per annum.

It might be thought that it is always preferable, from the members' perspective, to look for the highest rate of revaluation. The problem, however, is that given a fixed level of resources as set by the contribution rate, the adoption of a higher rate of revaluation must be accompanied by a lower rate of accrual. In other words, the higher the rate of revaluation that is used, the lower the rate of accrual that must be set to keep within the given level of cost. It is important, therefore, to consider the accrual rate and the basis of revaluation together and choose the package that is considered to offer the best deal for members taken as a whole.

This obviously raises the question of what accrual rates produce schemes of equivalent value, given the range of possible rates of revaluation. This comparison requires assumptions to be made about the relationship between increases in the members' current pay and increases in the revaluation basis, so long as they remain in active service. For the purpose of illustration, it is assumed that these increases will be in line with those assumed in most sections of the RPS(sca) for the last valuation, i.e. 0.75 per cent in excess of increases in NAE and 2.25 per cent in excess of increases in the RPI. No final decision has yet been made about the equivalent assumptions at the forthcoming valuation but the joint discussion document that has been circulated envisages no change.

Figure A2.1 shows the relative size of the accrual rates that the Commission estimates will provide benefits within the same overall cost, compared to the accrual rate with RPI revaluation.

Figure A2.1 Comparison of revaluation rates



This shows, for example, that to achieve the same overall cost, the accrual rate in a scheme with NAE revaluation would be only 69 per cent of that in a scheme with LPI revaluation. So, for example, an accrual rate of 1/50ths in a revalued earnings scheme with RPI revaluation would cost the same as an accrual rate of 1/72nds (i.e. 69 per cent of 1/50th) in a revalued earnings scheme with NAE revaluation.

So, in the same way as explained in relation to the choice between final pay and revalued earnings schemes, the difference between such arrangements manifests itself in how the given level of resources is distributed between the members, in terms of their ultimate benefits. This distribution will depend on factors such as their age at entry, how long they remain in active service and the pay increases they receive over that period, compared to the average.

Here the general rule, given the same level of cost, is that the higher the rate of revaluation, the more weight will be given to earnings earlier in the working lifetime, rather than later earnings. Equally, the lower the rate of revaluation, the less weight will be given to earnings earlier in the working lifetime, rather than later earnings. What this means is that the lower the rate of revaluation and hence, the higher the rate of accrual, the less dramatic the change will be when compared with members' benefits calculated on a final pay basis.

Given this situation, the Commission is of the view that revaluation in line with the RPI offers the best balance between the interests of the different groups of members. Using this revaluation basis, the Commission proposes an accrual rate of 1/50th for each year of service. Were the basis of revaluation to be in line with NAE, the Commission calculates, as explained above, that the accrual rate required to keep within the cost ceiling would need to be 1/72nd.

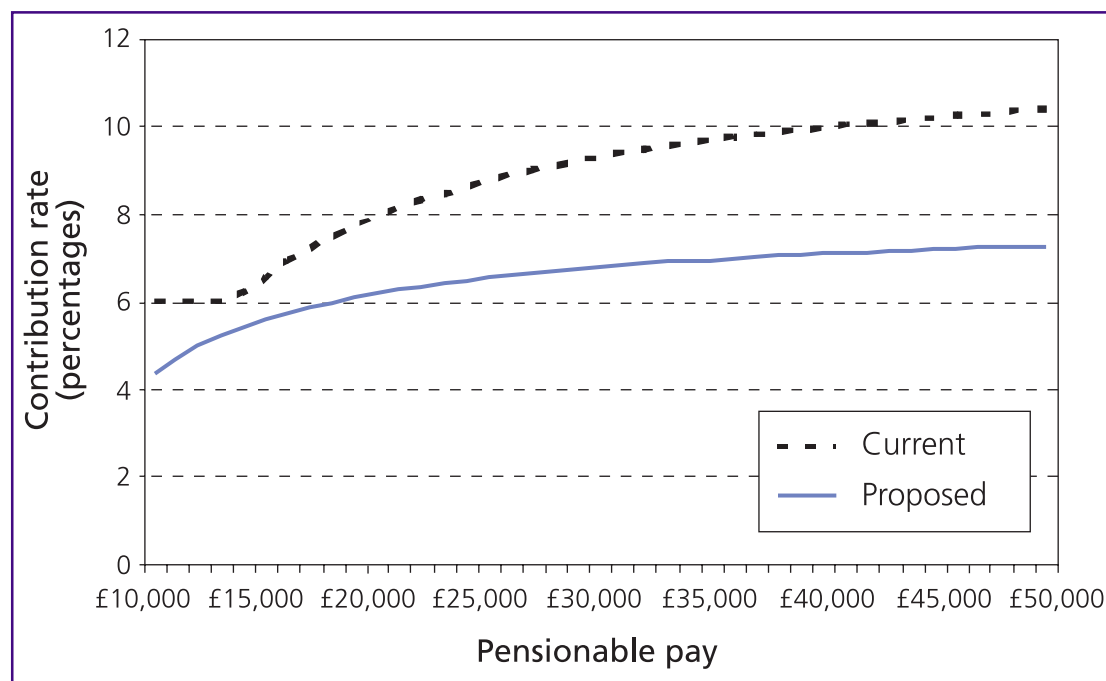
## Deduction from pensionable pay

An important factor that determines the affordability of the new arrangement, particularly as far as members are concerned, is the definition of pensionable pay, i.e. the figure that is used to calculate both benefits and contributions. Under the present RPS(sca) there is effectively a deduction made from pensionable pay for both these purposes, equal to one and a half times the single person's basic state pension, although this is offset, at least in part, by the lump sum addition.

This approach to the definition of pay that is used for the purposes of calculating pensions, commonly referred to as "integration", is often unpopular among members, since it results inevitably in a reduction in their benefits. On the other hand, it also reduces their contributions, which is particularly important in the RPS(sca), given its shared-cost nature and the high level of contributions that are payable. There is no doubt that if contributions at the rate envisaged for RPS(acre), let alone those prospectively payable to RPS(sca), were applied to the whole of members' pay, many members, particularly those on lower rates of pay, would find them unaffordable, with the result that they would be driven out of the scheme.

For this reason, the Commission considers that there does need to be an element of integration within RPS(acre), even with contributions of 8 per cent. However, given the lower overall cost of the new scheme, the Commission recommends that there should be a deduction of only one times the single person's basic state pension. As with RPS(sca), the deduction should be limited to no more than half the member's pensionable pay. The result is that the member's contributions to RPS(acre) will always be less than those that would have been payable to RPS(sca), as shown in Figure A2.2. For this purpose the member's contributions to RPS(sca) are assumed to be at 12 per cent, which is the rate that it appears will be required, as an absolute minimum, to secure current benefits, before allowing for any deficits.

Figure A2.2 Contribution rate comparison



## Contracting-out

The Commission has assumed, for the purposes of illustration, that the members of RPS(acre) will be contracted-out of the State Second Pension. This makes it more straightforward to compare the scheme with the existing arrangements. However, the Commission recognises that there are strong arguments in favour of the new scheme not being contracted-out, including the administrative burden and the terms of the current contracting-out rebate. In addition, for those employees with very low earnings it may not be appropriate to contract out of the State Second Pension, particularly given the anticipated reforms. It is open to discussion as to whether the scheme should be contracted-out and the Commission does not wish to pre-empt a decision on the matter.

If it were to be decided that RPS(acre) should not be contracted-out, the benefits and contributions outlined in the Commission's proposals would need to be adjusted to allow for the additional state benefits and contributions that would be payable, so as to keep the overall cost within the limit that has been laid down. It is estimated that this would mean an annual accrual rate of 1/70th instead of 1/50th and a reduction in members' contributions of 1.5 per cent, up to the Upper Earnings Limit (UEL).

The impact of such changes would be relatively complex, varying over time as the State Second Pension changes in line with the Government's announced intentions. However, it would be relatively limited, particularly in the short and medium term. In the longer term it would mean some shift of benefits in favour of the lower paid members. However, the Commission considers that an acceptable arrangement could be established on either basis and that this issue should, therefore, be the subject of more detailed study, as and when the arrangements for RPS(acre) are discussed in more detail.



# Annex 3

## Comparison of benefits – final pay and average career revalued earnings

This Annex looks at how well a member will do in the proposed RPS(acre), as compared with a final pay scheme that costs the same to provide. The results of the comparison depend on two sets of factors. First, there are the respective scheme provisions including, crucially, the respective accrual rates and, in the case of the revalued average earnings scheme, the rate at which pay is revalued during service. Second, there are the individual circumstances of the member, where the crucial factors are how long they remain as an active member of the scheme and how their pay increases in real terms over their period of active scheme membership.

A key factor here is the length of the member's active service as, in general terms, the shorter the member's period of active service, the better will be the revalued average earnings approach. This is shown by the examples in the box and this suggests that there is a dividing line, depending on the length of the member's service, between those that do better from a revalued average earnings scheme and those that do worse, compared to a final pay scheme of the same cost.

For the purposes of illustration, the examples compare a final pay scheme with an accrual rate of  $1/72^{\text{nd}}$ , with an average earnings scheme with an accrual rate of  $1/50^{\text{th}}$  and a revaluation rate equal to the RPI. It is estimated that these schemes will cost broadly the same to provide, using the assumptions from the actuarial consultation document, and be within the figure for overall cost that is proposed by the Commission in the main report, i.e. 20 per cent of pensionable pay. The issue, therefore, is not which is the better scheme overall – they are the same – but which future members will gain and which future members will lose.

Table A3.1 Final pay compared to average revalued earnings – examples

For the purposes of illustration the comparison is between the following two schemes that are of equivalent value:

Final pay: accrual rate of 1/72<sup>nd</sup> per year of active service

Average career revalued earnings: accrual rate of 1/50<sup>th</sup> of average pay, revalued in line with the RPI

It is assumed that the member's pensionable pay, on leaving active service, will be £24,000 (in current terms)

#### Financial assumptions

General pay increases are assumed to have been 1.50 per cent p.a. greater than the RPI

Age related earnings increases are assumed to have been 0.75 per cent p.a. greater than general pay increases

#### Example A. Benefit accrued after two years of active service (in current terms)

Final pay	£530
Average career revalued earnings	£760

The pension accrued on the revalued average earnings basis after two years of active service is 43 per cent greater than that on the final pay basis

#### Example B. Benefit accrued after 40 years of active service (in current terms)

Final pay	£15,120
Average career revalued earnings	£13,330

The pension accrued on the revalued average earnings basis after 40 years of active service is 12 per cent less than that on the final pay basis

Figure A3.1 provides the same comparison in graphical form, for all periods of active service, up to 40 years. Here the results are not presented in cash terms but as a percentage, where the red line shows what benefit is accrued in the proposed RPS(acre) expressed as a percentage of the benefit accrued in a final pay arrangement with an equivalent cost.

Figure A3.1 Comparison of revalued average earnings and final pay benefits

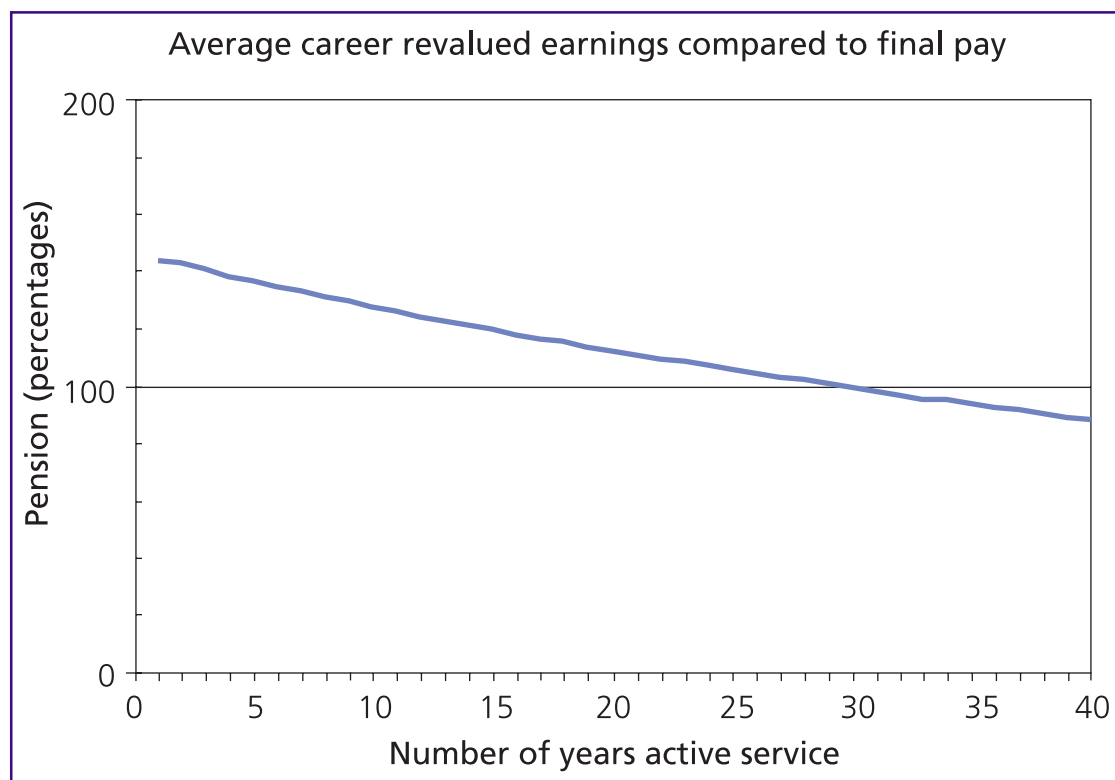
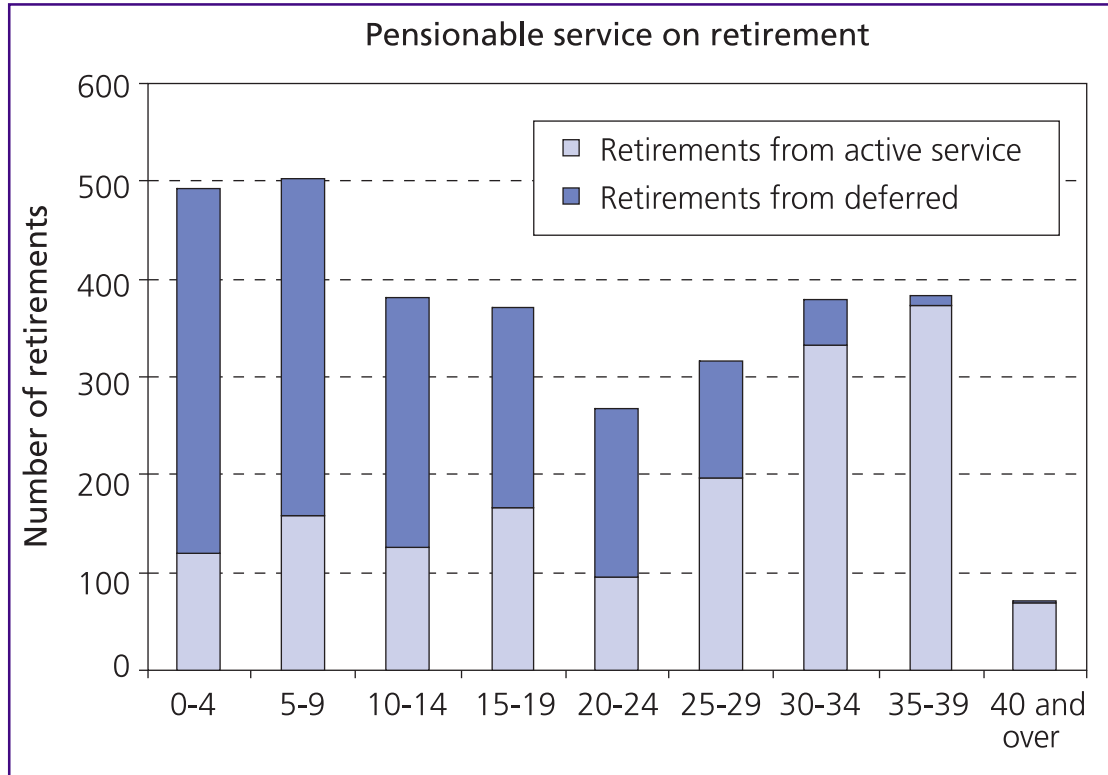


Figure A3.1 shows, as expected, that members with longer periods of active service are likely to receive less from a revalued average earnings scheme than they would from a final pay scheme of an equivalent value. On the other hand, members with less than 30 years' service do somewhat better. It should be understood that these particular results depend on the assumptions that have been made about pay increases, compared to the increase in the RPI. It is, nevertheless, clear that the benefits of the scheme are spread more widely in a revalued average earnings scheme, with the members who would receive the smallest benefits from a final pay scheme tending to gain the most.

While the graph identifies who gains and who loses, it does not tell you how many members who join the scheme in future will fall into each of those groups. The Commission has been provided with data for the active service of members of RPS(sca) who took a pension between 1 January 2007 and 30 September 2007, from both active service and from deferment. The results are set out in Figure A3.2 which shows that a clear majority of members who retired over that period have less than 30 years of active pensionable service, i.e. they would have received higher pensions from an equivalent revalued average earnings scheme.

Figure A3.2 Members' active service at retirement



It is worth pointing out that the first entrants to RPS(acre) will only enter the arrangement in 2009 at the earliest. All those who take a pension from the scheme over the first 30 years of its existence, whether they are entering employment or transferring from RPS(sca), are likely to end up being better off from being in the new scheme, particularly those who retire in its early years. In other words, it will be 2040 or after that it is likely that anyone will end up with anything less from the new scheme, than they would receive if it were established on a final pay basis.

# Glossary

<b>Active membership</b>	Active members are current employees who are contributing (or having contributions made on their behalf) to an organisation's occupational pension scheme.
<b>Additional Voluntary Contribution (AVC)</b>	These are pension contributions made voluntarily by an active member of an occupational scheme, in addition to any normal contributions, to secure additional benefits. The AVC arrangement in the RPS is called BRASS.
<b>ATOC</b>	Association of Train Operating Companies.
<b>Balance of cost arrangement</b>	A form of defined benefit pension scheme where the individual member makes a contribution at a fixed rate (or no contribution at all) and the employer pays the balance of cost.
<b>Basic State Pension (BSP)</b>	A flat rate pension based on an individual's National Insurance contribution record.
<b>BRASS</b>	British Railways Additional Superannuation Scheme. The railway industry AVC arrangement.
<b>BRASS Matching</b>	An agreement whereby employers match BRASS contributions made by individuals.
<b>BRPS</b>	British Railways Pension Scheme. The shared cost pension scheme which covered most employees of British Rail prior to privatisation.

<b>Career average scheme</b>	A defined benefit scheme that gives individuals a pension based on the number of years of pensionable service. Pension entitlement is calculated for each year of work, then uprated by an index – usually prices but sometimes average earnings. The final pension paid is the cumulative outcome of each year’s earned pension.
<b>Contracting-out</b>	The system by which individuals cease to participate in the State Second Pension and use a proportion of their National Insurance contributions to build up a funded pension.
<b>Deferred membership</b>	Deferred members are former active members of a pension scheme who retain an entitlement to a pension payable when they retire.
<b>Defined benefit (DB) pension scheme</b>	A pension scheme where the pension is related to the member’s pay or some other value fixed in advance.
<b>Defined contribution (DC) pension scheme</b>	A scheme where the individual receives a pension based on the contributions made and the investment return that these have produced. Sometimes referred to as a money purchase scheme.
<b>DfT</b>	Department for Transport.
<b>Employer covenant</b>	The ability and willingness of an employer to pay the contributions due to their occupational pension scheme.
<b>Final pay scheme</b>	A defined benefit scheme that gives individuals a pension based on the number of years of pensionable service, the accrual rate and final earnings as defined by the scheme.
<b>Indefeasible right</b>	A protection set out in Schedule 11 of the Railways Act 1993 which applies to any individual who at midnight on 4 November 1993 (i.e. immediately before privatisation) was an employee of the British Railways Board or one of its subsidiaries <b>and</b> was a member of the BRPS. It confers on individuals the right to continue to participate in the joint industry scheme (i.e. the RPS) for as long as they are employed in the railway industry.

<b>Joint contribution rate</b>	The total of contributions due from the employer and the employees.
<b>Life expectancy</b>	Life expectancy is the period of time from a given age that an individual is expected to live.
<b>Longevity</b>	Life expectancy.
<b>Mean</b>	The average value of a set of numbers, calculated as the total of all the values in the set divided by the number of values.
<b>Occupational pension</b>	A pension which is provided via the employer, but the pension scheme normally takes the form of a trust arrangement and is legally separate from the employer.
<b>ORR</b>	The Office of Rail Regulation. A statutory board which is the economic regulatory authority for Great Britain's railway network. It was established on 5 July 2004 by the Railways and Transport Safety Act 2003, replacing the Rail Regulator.
<b>Past service funding level</b>	The ratio of the assets of a defined benefit pension scheme to its past service liabilities.
<b>Pension accrual</b>	The build up of pension rights. In a defined benefit scheme this may be based on the number of years of membership of the scheme and rate of accruals, e.g. 1/60th.
<b>Protected status</b>	A protection set out in the Railways Act 1993 which applies to any individual who at midnight on 4 November 1993 (i.e. immediately before privatisation) was an employee of the British Railways Board or one of its subsidiaries <b>and</b> was a member of the BRPS or one of a small number of other schemes. Protected persons have a legal right to pension provision for their future employment which is no less favourable than the relevant pension rights which they had under the BRPS.

<b>Protection Order</b>	The Railway Pensions (Protection and Designation of Schemes) Order 1994 (SI1994/1432).
<b>Real terms</b>	Figures “in real terms” have been adjusted to remove the effect of increases in prices over time (i.e. inflation), usually measured by the RPI. Thus, if something shown in real terms increases, then it is rising faster than prices, whereas if it is constant, it rises at exactly the same pace as prices.
<b>RPS</b>	Railways Pension Scheme. The joint-industry pension scheme for the railway industry.
<b>RPS(sca)</b>	The shared cost arrangement of the RPS.
<b>Section pay</b>	Pay upon which an active member’s pension is calculated in a particular section of the RPS(sca).
<b>Shared cost arrangement</b>	A form of defined benefit pension scheme where the individual members pay a fixed proportion of the contributions due.
<b>Standard contribution rate</b>	The total of contributions due from the employer and the employees, excluding adjustment for any surplus or deficit in the scheme. It is normally expressed as a percentage of pensionable pay.
<b>State Second Pension</b>	The National Insurance pension which gives benefits additional to the Basic State Pension based on an individual’s earnings and contributions.
<b>TOC</b>	Train Operating Company.