PENSIONS OPTIONS PAPER

Transport for London

14 October 2022

Contents

Executive Summary

Following the submission to HM Government (the Government) of Transport for London's (TfL) response to the Independent Pension Review's Final Report on 27 September 2022, this paper now responds to Government's requirement for TfL to set out two broad categories of options, each with no more than two sub-options, in relation to future service benefit design. In accordance with the Government's requirements, this paper also sets out how past service liabilities will be managed. These requirements, from the 30 August Funding Agreement (the Funding Agreement), are set out in more detail in **Section 1 (Purpose)**.

Critical to the consideration of these options is the requirement by the Government that TfL should aim to reduce the cost of providing future service benefits by around £100m per annum. **Section 2 (The Government's Requirement for £100m Cost Saving in relation to Future Service)** sets out the background to this cost saving target, with its origins in suggestions made in relation to pensions by the TfL Independent Panel Review in its report, published in December 2020. However, this paper now shows that aiming to achieve the Government's £100m cost saving target creates a disproportionate focus on affordability (cost savings) at the expense of fairness (member impacts). This is particularly relevant when the target set by the Government is now based on information that is out of date and which is not properly defined. For example, the Government's £100m cost saving target does not take into account the cost of managing past service (despite this being included by the TfL Independent Panel Review in their report); instead, focusing on future service alone. Since the £100m savings figure was first suggested, TfL has already made savings of around £70m per annum (as a result of the 2021 valuation, completed after the TfL Independent Panel Review published their report). It is also the case that subsequent changes to the way indexation will apply to the current arrangements going forward following the announcement of the alignment of RPI to CPIH from 2030, should have the effect of reducing the target cost saving of £100m, based on a reduction in the extent of indexation change that could now be considered.

The analysis contained throughout the paper will support the fact that the consideration of reform on the basis of aiming to achieve the Government's £100m cost saving target, will lead to an unacceptable level of detriment to members' benefits and result in options that are significantly less generous than those available in comparable public sector schemes. This is neither reasonable nor fair and does not reflect the balance that is necessary between key criteria the Government themselves reference in the Funding Agreement, in relation to affordability, sustainability and fairness. The consideration of reform should instead examine how the potential risk of large cost increases in the future can be mitigated, while also aiming to minimise any resulting impacts on members' benefits. This could help to ensure that TfL's pension arrangements are sustainable and fair for both members and TfL (and by extension fare payers and taxpayers) going forwards.

With this in mind, **Section 3 (Classification of the Scheme and Management of Past Service Liabilities)** sets out the potentially significant risks that TfL currently faces in relation to the management of past service liabilities and the fact these risks are compounded by the anomalous classification of the TfL Pension Fund (the Scheme) as a private sector scheme (subject to regulation by the Pensions Regulator (tPR)), despite the fact that TfL is a public sector body. This private sector status leads to the level of risk and cost in the current arrangements being substantially higher than if the Scheme to be treated as a public sector scheme, and also means there are requirements to repair any deficits arising over a relatively short time period. This is because tPR requires the Trustee to use more prudent assumptions to fund the Scheme, than would be the case in the public sector, which in turn leads to higher required contributions from TfL. Reasons for this additional prudence reflect the fact that tPR, seeks to ensure private sector sponsors place sufficient focus on properly funding their pension schemes by prioritising pension contributions before shareholder dividends. TfL does not pay dividends (as it does not have shareholders) and therefore, as a public sector body, this additional prudence is neither required nor appropriate. TfL is also required to pay levies as a result of this private sector classification at a cost of £16m per annum. This is considered to be extremely poor value for money.

On the basis of the current arrangements there is a risk that in the future significant past service deficits could arise, resulting in unaffordable levels of contributions for TfL. There is a 1 in 20 risk of a £4bn deficit by 2024 and a 1 in 4 risk of a £2bn deficit by 2024. On a public sector basis, however, the funding position would improve significantly, to a surplus of around £2bn, reflecting a more appropriate funding basis for a public sector employer like TfL.

Reform of future service benefits would lead to similar significant risk issues. A closure of the Scheme to future accrual could crystalise a deficit of around £6bn. The level of contributions required from TfL in this circumstance would, in reality, preclude any potential future service reform unless past service liabilities were addressed at the same time.

It is clear, therefore, that the management of past service liabilities poses the principal threat to the sustainability of TfL's pension arrangements going forwards. TfL cannot manage these risks alone - Government support is necessary. There are only two options that TfL regards as practically capable of mitigating the risks associated with past service liabilities (aside from further Government financial support were these risks to crystalise). **Section 4 (Government Support for the Management of Past Service Liabilities)** sets these options out in detail. They are:

A. Government support for legislation to enable a transfer of past service assets and liabilities to a new or existing funded or unfunded public sector arrangement in order to reclassify the Scheme as a public sector scheme; or

B. Government provision of a Crown Guarantee, as has been the case with other organisations.

Both options would continue to ensure members' benefits built up to date are protected (as required by the Government in the Funding Agreement and in law) and members would benefit from a stronger Government covenant. Both options would also mean TfL would no longer be required to pay costly levies associated with the Scheme's private sector classification.

Legislation to enable a transfer past service assets and liabilities to an unfunded arrangement may have most benefit. This option would enable the risk to TfL of past service deficits arising in the future to be removed entirely and would provide the Government with around £12bn of assets that would no longer need to be matched to liabilities. Any surplus of assets over the value of liabilities transferred on a public sector valuation basis could be retained by TfL for vital investment in transport infrastructure. Any transfer of risk issues that the Government may perceive in relation to these options are capable of being mitigated through negotiated contractual mechanisms.

While the options outlined above relate to the management of past service liabilities, the Government also requires TfL to look at options for reform of future service benefits. The 27 September paper made clear that defined benefit (DB) pensions arrangements are the most appropriate arrangements for TfL going forward and that defined contribution (DC) and collective money purchase arrangements will be ruled out, primarily due to concerns that they would not meet assessment criteria in relation to fairness – leading to a material deterioration in benefits and issues of adequacy of pensions in retirement.

Section 5 (Future Service Reform) provides further rationale for this approach by looking at the risk allocation in different types of pension arrangements, along with other advantages and disadvantages. This rationale demonstrates that DB arrangements better reflect a fair and reasonable allocation of risks, such as investment risk, between the employer and member. They also better provide for adequacy and certainty of pensions in retirement than would be the case in DC arrangements. There are, therefore, only two broad categories of options available for TfL to consider further. These are the two established forms of DB arrangement - a final salary design and a Career Average Revalued Earnings (CARE) design.

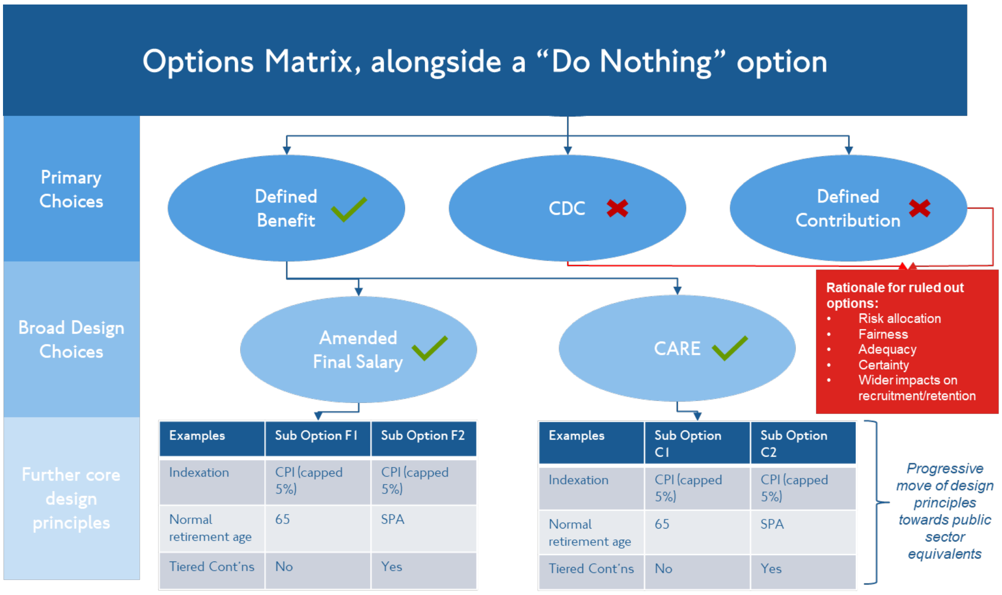
Public sector pension arrangements have been subject to reform and, broadly speaking, now all adopt a common DB pensions framework based on a CARE benefit design (although there are some variations between public sector schemes in more detailed design characteristics such as retirement age, accrual rates and member contribution rates).

However, a comparison to pension arrangements available in the public sector illustrates that it is not the case that final salary arrangements (including TfL's final salary arrangements) are always more generous or costly than CARE schemes available elsewhere – in some cases TfL's arrangements are comparable overall, in some cases less generous.

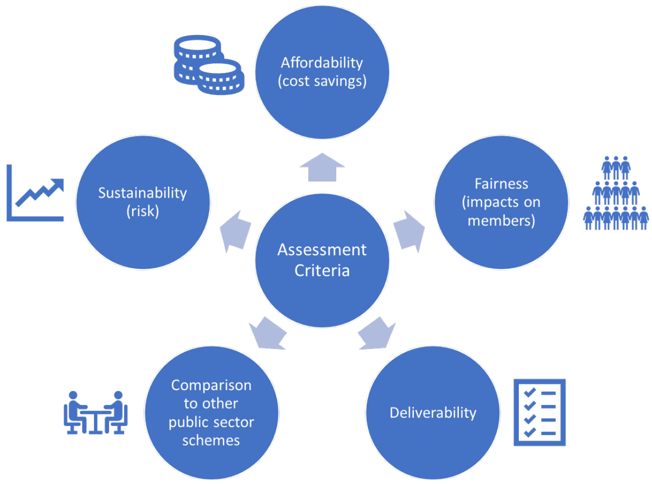
If TfL were, for example, to consider providing future benefits by adopting the Civil Service Pension Scheme (CSPS) design – this would actually lead to an increase to TfL's current pensions costs (of around £14m, although this may be higher in practice due to wider pensionable salary definitions used in the CSPS but not included here due to lack of available data) and would provide more generous benefits to members than TfL's current arrangements, on average. Another CARE arrangement available in the public sector is the Local Government Pension Scheme (LGPS). The application of the LGPS scheme design for future service could potentially generate some marginal cost savings but would lead to a reduction in members' benefits, on average, of around five per cent. The analysis is clear that the application of both of these comparable public sector future service benefit designs would not meet the Government's requirement for a £100m cost saving.

Despite TfL's view that considering reform on the basis of Government's cost saving target of £100m is neither reasonable nor fair, in order to meet the Funding Agreement requirements it has been necessary for TfL to develop two sub-options that, therefore, go further to reduce members' benefits compared to the benefits that are available in comparable public sector schemes.

These sub-options have been developed for each of the two broad categories of DB options and look at several key design features including indexation levels (moving from RPI to CPI with a cap), retirement age (moving from being able to take an unreduced pension at age 60 to age 65 or the State Pension Age (SPA)), member contribution levels (including a tiered contribution structure where those with higher salaries pay more for pension benefits than those with lower salaries) and a range of possible accrual rates. These sub-options have been examined alongside the current arrangements (a "Do Nothing" option). It is assumed these sub-options would be provided in a public sector arrangement, in order to avoid the unnecessary cost and risk that would come with a private sector classification. The sub-options are summarised in the diagram below.



TfL has assessed these options against the criteria specified by Government in the Funding Agreement, as set out in the diagram below, related to deliverability; affordability (assessment of cost savings); sustainability (risk); fairness; and how it compares to other equivalent pension schemes.



Section 6 (Affordability: Impacts on TfL's Costs of Future Service Benefit Design Options) sets out the modelling conducted to examine whether these options would result in cost savings to TfL. Compared to TfL's current costs of around £300m of providing future service benefits, this modelling shows that annual cost savings of up to around £126m are possible in relation to future service benefits, which rise to around £142m assuming future service is provided in the public sector and TfL no longer has to pay associated levies. These annual savings increase dramatically, to over £500m in some cases, when including risk adjustments for potential 1 in 20 downside risk events that could occur, which could require TfL to pay significant additional deficit reduction contributions under the current arrangements.

However, as set out above, options which aim to generate the £100m cost saving stipulated by the Government in relation to future service, lead to unacceptable detrimental impacts on members' benefits that have not been required as part of the reform of similar public sector pension schemes. These impacts would need to be managed, given any reform should be considered in a way that is fair. Offering more generous accrual rates is one way of minimising impacts on members (as has been done in comparable public sector schemes), where reduced benefits are allowed to accrue at a faster rate. The modelling therefore also analyses the cost savings that could be possible if higher accrual rates comparable to those in the public sector are used. The modelling demonstrates that the effect of higher accrual rates would be to reduce potential cost savings, to a level that is below the Government's target cost saving of £100m.

Section 7 (Sustainability: Impacts on Risk of Future Service Benefit Design Options) examines how each of the options would impact TfL's exposure to risk. Significant reductions in overall risk are possible through public sector treatment of the Scheme (with or without reform) and regulatory risk would reduce materially under this approach. Treatment as an unfunded public sector arrangement reduces risk most significantly for TfL, as the risk of future deficits would be eliminated entirely; however, treatment as a funded public sector arrangement would still also lead to a more appropriate overall exposure to risk compared to current arrangements, even though it would still be possible for deficits to arise in the future.

Specific reform design characteristics (such as CARE, tiered member contributions, changes to indexation and retirement age) help to reduce risk further and would reduce the likelihood of large cost increases building further in the future as benefits continue to be accrued. Salary risk is reduced significantly through a CARE design and through the introduction of tiered contributions. Changing the way indexation is applied to benefits would also reduce risk exposure further, particularly if a cap on indexation is introduced to protect the employer in times of high inflation. Increasing the retirement age helps to protect against the risk of members living longer, with a retirement age set as the SPA, providing a dynamic link should there be increases in longevity in the future.

Section 8 (Fairness: Impacts on Members' Benefits of Future Service Benefit Design Options) includes modelling of the options on a sample of "personas", which reflect a variety of roles throughout TfL. As set out above, the modelling clearly demonstrates that, in order to aim to meet the Government's cost saving target of £100m, the requisite changes to retirement age, indexation, member contribution rates and the way salary risk is shared with members would individually (and collectively) lead to significant detrimental impacts on member benefits. These changes would result in a reduction in members' pensions to be built up in the future, on average, by around one third (although this would not be equally felt, with younger members and more recent joiners suffering the most significant impact). This would result in far less generous benefit provision than is available in other comparable public sector schemes. TfL views this level of impact as unacceptable.

These impacts would need to be minimised. As set out above, one approach would be to offer more generous accrual rates (or broader definitions of pensionable pay). This would bring options further in line with the benefits that are offered in pensions provided in the public sector. Application of specific public sector scheme designs, such as the CSPS and the LGPS, may actually have a positive impact on benefits for certain employees, depending on their individual circumstances. On an overall basis, the CSPS is likely to benefit a more significant proportion of members compared to the LGPS.

Section 9 (Summary of Future Service Benefit Design Options Analysis) summarises the analysis conducted in the paper. Overall, as discussed above, this section firmly concludes that the unacceptable detrimental impact on members' benefits of aiming to achieve Government's out of date saving target of £100m against the cost of providing future service alone, is not a fair nor reasonable balance of the assessment criteria. While such impacts would need to be minimised (resulting in reductions to the potential cost savings available) it may still be possible to achieve an overall reduction to the risk of future cost increases.

The main outputs of the assessments discussed above are summarised in the diagram below.

	Do Nothing	LGPS	CSPS	F1 and F2	C1 and C2
Affordability	Current costs of around £300m per annum, including saving of £70m already made at 2021 valuation	Potential cost savings of around £60m per annum*	Increase in costs of around £14m per annum*	F1: Cost increase £28m to cost saving £86m (subject to accrual rate**) F2: Cost saving between £32m to £97m (subject to accrual rate**)	C1: Cost saving between £11m to £113m (subject to accrual rate**) C2: Cost saving between £67m to £126m (subject to accrual rate**)
Sustainability	Private sector classification creates unnecessary cost and risk 1 in 20 downside risk of £4bn	Funded public sector classification creates more appropriate level of risk, but some remaining risk of future deficits	Unfunded public sector classification significantly reduces risk, no risk of future deficits	Public sector classification reduces overall risk Some reduction in indexation and longevity risk High levels of salary risk but slightly lower in F2 due to tiered member contributions	Per F1 and F2, but salary risk greatly reduced compared to F1 and F2 options, especially in C2 due to tiered member contributions
Fairness	No impact on fairness to members – arrangements already exist	Certain members may be better off, although overall reduction to benefits of around 5 per cent, on average	A reasonable proportion of members may be better off	Unacceptable impact on members, reduction in benefits of one third, on average Impact would need to be mitigated, reducing cost savings	Unacceptable impact on members, reduction in benefits of one third, on average Impact would need to be mitigated, reducing cost savings
Comparisons	CSPS would cost more and is more generous Some savings may be possible in LGPS	Directly comparable to public sector	Directly comparable to public sector	Significantly less generous than public sector schemes at lower accrual rates required to meet Government's target cost savings, despite maintaining final salary link	Significantly less generous than public sector schemes when using lower accrual rates required to meet Government's target cost savings
Deliverability	No deliverability issues – arrangements already exist	Requires primary legislation and agreement of LPFA, cannot be delivered without Government support	Requires primary legislation, cannot be delivered without Government support	Requires primary legislation, cannot be delivered without Government support	Requires primary legislation, cannot be delivered without Government support

All cost savings exclude levies payable as a result of private sector classification. If these options were to be provided in the public sector, then a further saving of £16m per annum could be made against all options.

** It is expected that LGPS saving will be lower and CSPS cost will be higher, in practice, owing to wider pensionable salary definitions (including overtime, for example) available in these arrangements, but not included in this analysis due to available data*

***A range of accrual rates have been used. Lower accrual rates at the upper end of the cost saving range (1/70 for options F1 and C1, 1/60 for options F2 and C2) have been used to demonstrate what would be required to aim to meet Government's £100m target saving for future service. Higher accrual rates at the lower end of the cost saving range (1/49 for all options) have been used to demonstrate the mitigation of detrimental impacts on members, in line with accrual rates provided in the public sector.*

In order to deliver any future service reform, Government sponsored legislation would be required. **Section 10 (Deliverability: Government Support for Future Service Benefit Reform)** explains this view further. Restrictive Scheme rules mean that, in practice, it is not possible to pursue any reform of future service benefits that would have any adverse impact on members' benefits without Government support, because legislation would be required to enact any changes that might be considered. The Government could make use of existing legislation for this purpose, such as the powers available to it under section 31 of the Public Service Pensions Act 2013. Alternatively, it would be in the Government's power to introduce new primary legislation. If future benefits were to be offered in an existing public sector arrangement, then the design of that arrangement (based on CARE) would, broadly speaking, need to be adopted. Furthermore, if the LGPS were to be used, then this would also need the agreement of the London Pension Fund Authority (the LPFA). There would be more flexibility in the way arrangements might be designed, in theory, in a new funded or unfunded public sector arrangement.

It is also the case that, should any changes to the current arrangements be pursued, then this would require considerable, widespread engagement with stakeholders – including, for example, with the Trustee, members and their representatives. **Section 11 (Employee Considerations)** notes that the current pension arrangements are highly valued by employees and that any changes, should they be proposed, would need to be considered concurrently with TfL's wider reward and remuneration policies.

Pensions and employment law places significant obligations on employers to inform and consult with affected members and their representatives when making changes to future service benefits or contribution levels. Any options that impact employees' future service benefits will require a minimum 60-day statutory information and consultation process; although, in practice, given the complexity of pensions, this is likely to take much longer and will require individual impact assessments alongside a full equality impact assessment. It may also necessitate TfL paying for members to receive independent financial advice. Any options for reform will need to further consider how "Protected Persons" are treated (those members that have statutory protection to receive a materially at least as good level of benefits) and would need to avoid issues in relation to intergenerational fairness (as has been the case in the transitional arrangements put in place for public sector pensions reforms).

Section 12 (Next Steps) sets out the requirements that TfL must meet following the submission of this paper, including the requirement for TfL and the Mayor to agree with the Government a final detailed proposal for any recommended changes to both future service benefits and past service liabilities, with an implementation plan by no later than 31 January 2023.

It will now be vital that the Government consider, discuss and agree with TfL whether or not the support from the Government that is necessary in order to address both past service and any potential future service benefit reform will be made available. Without such support, TfL will, in practice, be precluded from further consideration of future service benefit reform.

To reiterate, **the options outlined in this paper are not proposals for reform** and continue to include a comparison to the current arrangements. The implementation of anything else will remain subject to further detailed work, the availability of appropriate legislation, relevant consultation with affected members and their representatives and TfL's decision-making processes.

1. Purpose

1.1. The Funding Agreement set out the requirements of the Government in relation to pensions. The dates of the first two submission requirements were amended by the Government to provide an extension of two weeks, following the death of Her Majesty Queen Elizabeth II.

1.2. On 27 September 2022, TfL met the first submission requirement, providing the Government with background on the Scheme, TfL's views on the Independent Pensions Review and a workplan setting out the steps that would be necessary for moving the Scheme into a long-term, financially sustainable position. A link to the 27 September submission is included at Appendix 1.

1.3. This paper addresses the second submission requirement set out in the Agreement. In accordance with the Government's requirements, this paper sets out:

A. **Two categories of options for future service benefit reform** with no more than **two sub-options** under each, all of which will **aim to reduce the cost of future service benefits by circa £100m per annum**.

B. Rationale as to why other potential options for reform have been ruled out.

C. And:

- core design principles for each sub-option (including but not limited to salary risk, retirement age, indexation and possible accrual rates);
- an assessment of how each sub-option meets key criteria required by the Government (consistent with the assessment principles outlined by the Independent Pensions Review) related to deliverability; affordability (assessment of cost savings); sustainability (risk); fairness; and how it compares to other equivalent pension schemes;
- a view on **what Government support is needed** to progress the shortlisted options alongside proposals for **how past service benefit liabilities will be managed** under these proposals.

1.4. For the avoidance of doubt, **this paper does not contain proposals for reform**. The paper continues to include comparison to TfL's current pension arrangements and the implementation of anything else will remain subject to further detailed work, the availability of appropriate legislation, relevant consultation with affected members and their representatives and TfL's decision-making processes.

2. The Government's Requirement for a Cost Saving of £100m in relation to Future Service

Section Summary

- **The Government's target cost saving of £100m is based on information that is now out of date and not properly defined**
- **This target, with its origins in suggestions made in the TfL Independent Panel Review's Final Report (December 2020), should relate to both future service and the cost of managing past service liabilities – not just future service alone**
- **The completion of the 2021 valuation has subsequently already resulted in a £70m reduction in TfL's costs; therefore, the majority of savings, on a comparable basis, have already been made**
- **The target cost saving should also now be lower, to take account of changes to the way indexation now applies to the Scheme funding assumptions since the TfL Independent Panel Review's Final Report was written**
- **Options for future service benefit provision that are required to aim to meet the Government's £100m cost savings target will result in unacceptable detriments to members' benefits**
- **It is also the case that, to meet the target cost saving, such options would need to be less generous than comparable public sector schemes**
- **The focus should instead be on creating a sustainable arrangement going forwards based on risk in a way consistent with pensions available elsewhere in the public sector, while minimising potential impacts on member benefits**

2.1. TfL's 27 September paper set out the background to the Government's requirement for TfL to aim to reduce the cost of future service benefits by around £100m. This target had its origins in the TfL Independent Panel Review which, in its report published in December 2020, suggested that around £100m of savings might be achieved in TfL's pensions costs through both a modernisation of scheme design and by introducing support for the scheme's liabilities (the report referenced a Crown guarantee, but this could be achieved in other ways with the Government's support).

2.2. The TfL Independent Panel Review proposed that a combination of these **two** actions could reduce TfL's funding gap by a total £100m per annum. For that reason, it was clear that the potential savings identified by the TfL Independent Review were related to both the costs of future service and the cost of managing past service liabilities.

2.3. However, despite being based on the TfL Independent Panel Review's findings, the cost saving target of £100m that the Government set out in the Funding Agreement is limited to future service alone. In TfL's view, therefore, the target saving in the Funding Agreement has not been properly defined.

2.4. This is particularly important when also taking into account that the TfL Independent Panel Review's comments on pensions were written based on the 2018 Valuation, when the Scheme was in deficit. As a result of this deficit, TfL was, at the time, making deficit recovery contributions in relation to past service of approximately £75m per annum. Since then, the 2021 valuation has been completed and TfL is no longer paying these deficit recovery contributions, owing to a surplus in the Scheme funding position. TfL's payments have already reduced by around £70m per annum as a result, on a basis that is comparable to values quoted by the TfL Independent Review.

2.5. In addition, the potential savings mentioned by the TfL Independent Panel Review did not take account of changes which have been subsequently announced in relation to the alignment of RPI with CPIH from the early 2030's . Had this been known, the value of potential savings cited by the TfL Independent Panel Review would have inevitably been lower (by up to an estimated £55m), reflecting the reduced scope for potential savings in the way indexation applies to the Scheme (a move from RPI to CPI, as has been the case in the delivery of public sector pensions reform). Subsequent to the TfL Independent Panel Review's findings, the alignment of RPI with CPIH has already been built into Scheme funding assumptions.

2.6. Therefore, the £100m savings target that the Government has set out in the Funding Agreement is now also out of date. Not only have the majority of the savings identified by the TfL Independent Panel Review already been realised through the improved funding position of the Scheme at the 2021 valuation (given that costs have reduced by around £70m due to deficit reduction contributions no longer being paid), but the target level of savings itself should now be lower, reflecting changes which have already been taken into account in the way indexation will apply going forwards.

2.7. In this paper, TfL will produce the assessment of options required by the Government in order to meet the requirements of the Funding Agreement. However, it is TfL's view that considering reform on the basis of out of date information on potential savings will lead to an unacceptable level of detriment to members' benefits and result in much less generous benefits that are available in the public sector elsewhere – this is neither reasonable nor fair. This paper will also show that the consideration of reform should instead focus on examining how the risk of large costs increases in the future can be mitigated in a way that is consistent with pensions available elsewhere in the public sector, while also aiming to minimise any resulting impacts on members' benefits. This would help to ensure that TfL's pension arrangements are sustainable and fair for both members and TfL (and by extension fare payers and tax payers) going forwards.

3. Classification of the Scheme and the Management of Past Service Liabilities

Section Summary

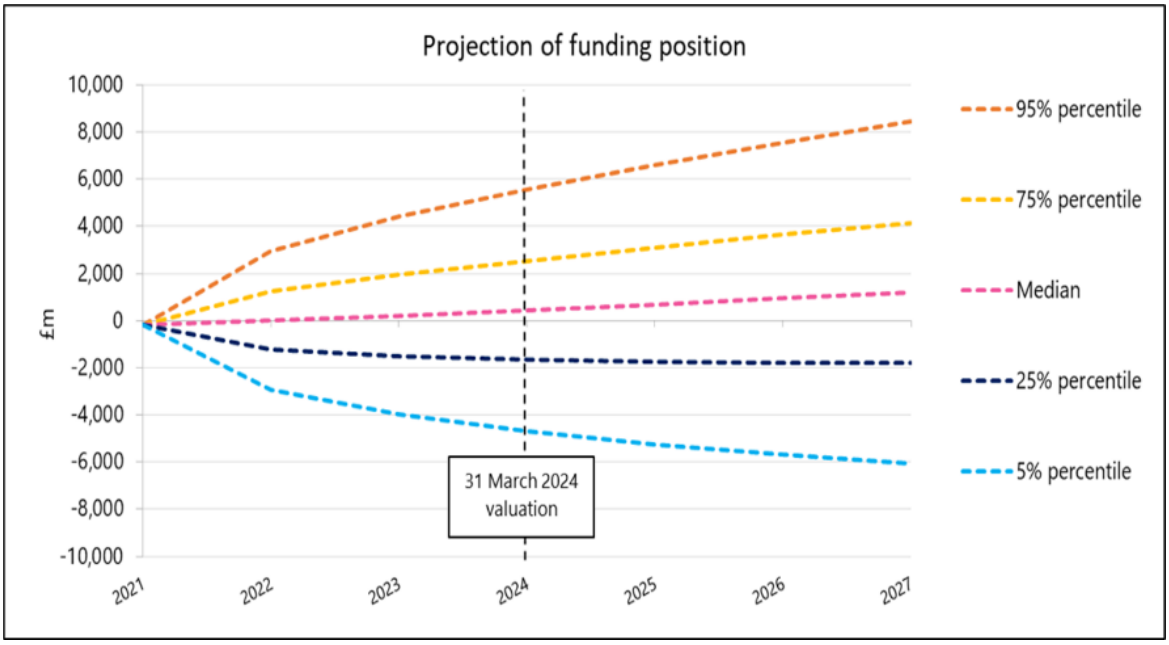
- **Risks related to past service liabilities pose the principal threat to the financial sustainability of the Scheme in the future**
- **Significant past service deficits could arise, resulting in unaffordable levels of contributions for TfL. There is a 1 in 20 risk of a £4bn deficit by 2024 and a 1 in 4 risk of a £2bn deficit by 2024**
- **These risks are exacerbated by the anomalous private sector status of the Scheme**
- **On a public sector basis, the funding position would improve significantly – reflecting a more appropriate funding basis for a public sector employer like TfL**
- **Reform of future service would lead to similar risk issues; a closure of the Scheme to future accrual could crystalise a deficit of around £6bn**
- **The level of contributions required from TfL in this circumstance would preclude any potential future service reform, unless past service liabilities are addressed at the same time**
- **TfL cannot manage these risks alone - Government support is necessary**

3.1. As set out in the 27 September paper, the management of past service liabilities poses the principal risk to the financial sustainability of the Scheme, with the potential for significant deficits arising in the future – with or without reform. Should such deficits arise, this would result in unaffordable increases in TfL's required pension contributions, creating a risk to TfL's own financial sustainability.

3.2. In its current form, there is a 1 in 20 risk that the Scheme could be in a £4bn deficit position by 2024 which could require contributions of around £700m a year for 6 years to pay off and a 1 in 4 risk that the Scheme could be in a £2bn deficit by 2024 which could require around £300m a year for 6 years to pay off. This is illustrated in Graph 1 below.

3.3. In addition, the underlying funding position of the Scheme is subject to change over time, as the value of the underlying assets move and other risks such as inflation and rising longevity impact the Scheme's funding position. Over the last twenty years, this has resulted in a material increase in TfL's costs. This is demonstrated in Graph 2 below.

Graph 1: Risk to the Future Funding Position of the Scheme



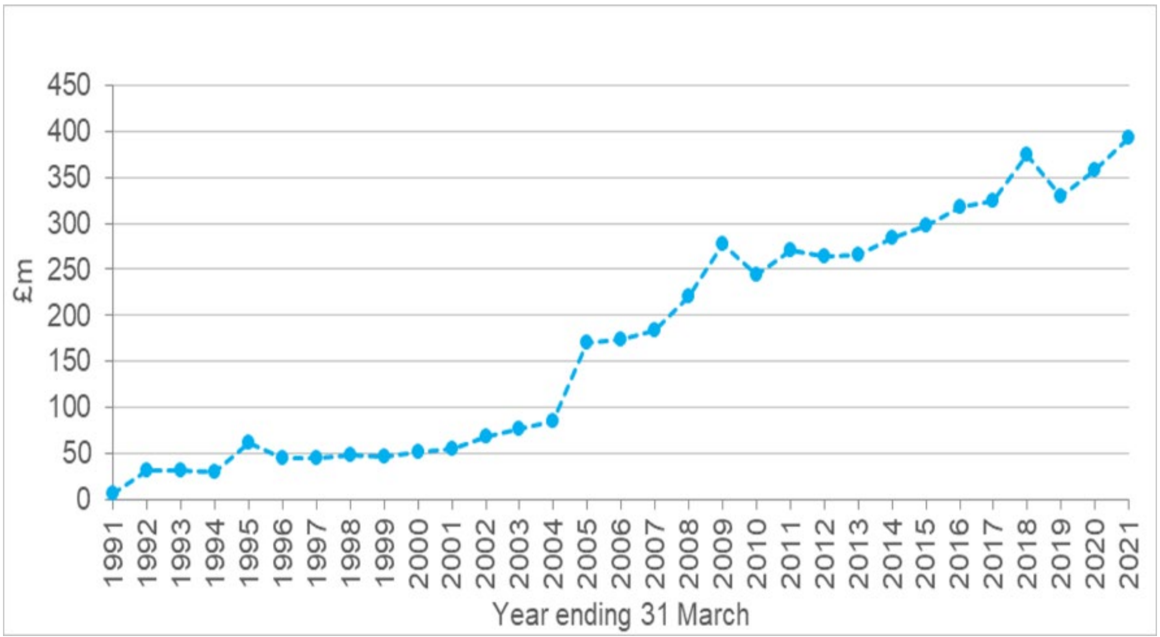
3.4. While the Scheme is currently in a surplus position as a result of the 2021 valuation, this may not always be the case. Over the period 2006 to 2021, the Scheme has only been in surplus for two financial quarters. In 2020, market volatility as a result of the pandemic significantly impacted the Scheme funding position – if the valuation had been conducted at that point, rather than in March 2021, there would have been a very different valuation result with a requirement for significantly higher contributions from TfL at a time when it was already facing significant financial challenges. These points are demonstrated in Graph 3 below.

3.5. It should be noted that the analysis within this paper is based on market conditions as at 31 March 2021, which was the most recent full actuarial valuation of the Scheme. Market conditions have been volatile over 2022, with significant changes in gilt yields seen over August and September, as well as increases in short-term inflation. Such rises in gilt yields, all else being equal, are likely to lead to an increase in the expected return on the Scheme's assets, which in turn would lead to an increase in the discount rate at the next valuation in 2024 and consequently a reduction in the past liabilities of the Scheme and the future cost of providing benefits within the Scheme. However, whilst such events are likely to be beneficial to the Scheme, falls in gilt yields will generally have the opposite effect. The Scheme's funding position and future contribution requirements remain very sensitive to such changes in market conditions.

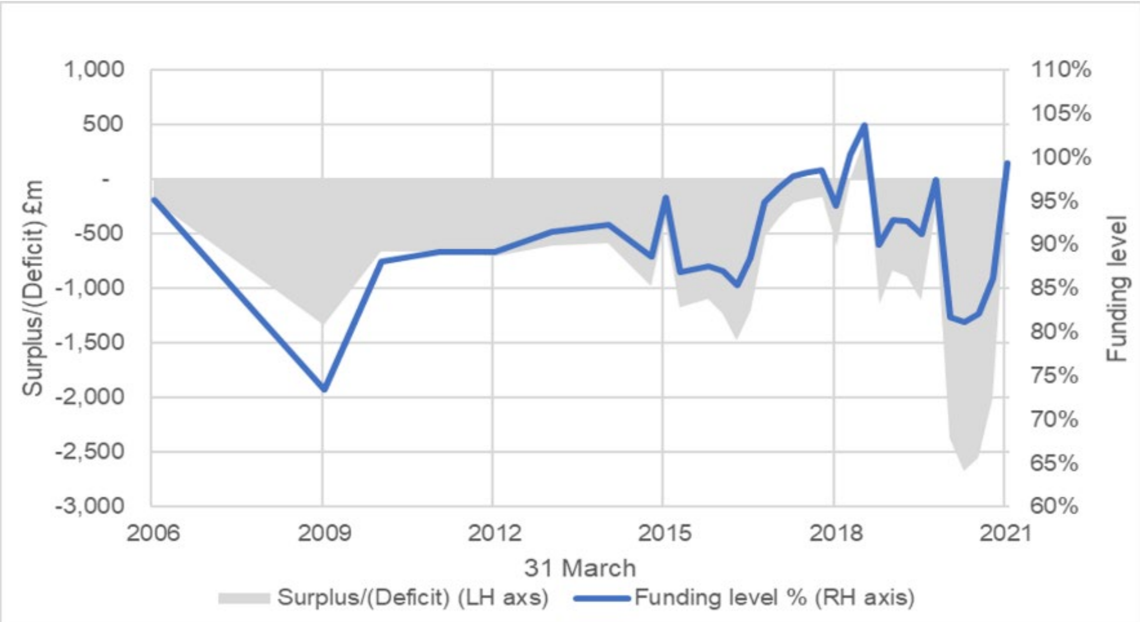
3.6. The anomalous private sector classification of the Scheme means it falls under the full remit of tPR. The Scheme is one of only a few private sector schemes operated by a public sector body. This private sector status means that the risks and costs set out above are substantially higher than they would otherwise be if the Scheme were to be treated as a public sector scheme, and also means there are requirements to repair any deficits arising over a relatively short time period. This is because tPR requires the Trustee to use more prudent assumptions to fund the Scheme, than would be the case in the public sector, which would in turn leads to higher contributions from TfL.

3.7. However, on a public sector basis, the Scheme's projected funding position would improve dramatically to a material surplus position, estimated to be around £2bn, with longer recovery periods available should a deficit arise in the future. This is due to more appropriate assumptions being used reflecting TfL's status as a public sector body. Further information on this assessment can be found in Appendix 2. As set out in the 27 September paper, depending on how a re-classification to a public sector scheme were delivered, this would provide significant resilience against, or eliminate entirely, the future risks of substantial deficits and would provide significant value on a whole of public sector basis compared to the current arrangements. Further information on how the Scheme could become a public sector scheme is contained in paragraph 3.14 below.

Graph 2: TfL's pension costs over the last twenty years



Graph 3: Progression of the Scheme Funding position



3.8. A private sector classification also means that TfL is required to pay Pension Protection Fund (PPF) levies, currently around £16m per annum. The PPF is set up to protect people with a DB pension when an employer becomes insolvent. However, there is an extremely remote possibility of TfL becoming insolvent. TfL is subject to statutory requirements to produce a balanced budget and, even in the most challenging financial circumstances, TfL, the Mayor and the Government have agreed the necessary financial support to prevent the possibility of a TfL insolvency and the devastating consequential impacts that would have on the provision of vital transport services to support London and the national economy as a whole. These levies are, therefore, effectively being paid to manage the risks to the pensions of members of other private sector pension schemes with insolvent employers, rather than TfL's own Scheme members.

3.9. These matters have been raised by TfL with the Government in the past and are becoming increasingly critical to the sustainability of TfL's pension provision going forwards. This is particularly the case in the context of the new funding regime due to come into force before the 2024 actuarial valuation, which will bring in the requirements of the Pension Schemes Act 2021 for trustees to set a long-term funding objective to reduce reliance on the employer over time (where a scheme is closed to accrual), along with a consistent low-risk investment strategy. The Department for Work and Pensions (DWP) is currently consulting on the draft regulations to implement this regime and while these have been drafted to be more flexible for open schemes, the new regime may still lead to further increased costs for TfL.

3.10. This treatment (including the payment of PPF levies) means the Scheme is carrying unnecessary cost and risk and it is TfL's strong view that this is not appropriate for a public sector organisation, and represents exceptionally poor value for money, which could be much better used investing in the future of London's transport.

3.11. It is also the case that any reform of future service would exacerbate the risk of past service deficits arising unless these liabilities were addressed at the same time. For example, a closure of the Scheme to future accrual for both existing members and new entrants is expected to result in the crystallisation of a significant past service deficit of around £6bn. The substantial additional contributions that would be required by TfL in this circumstance for past service would again not be consistent with ensuring a financially sustainable pensions arrangement, or a sustainable TfL, going forwards. The scale of the financial challenge that TfL would face as a result would inevitably mean that the Government would need to provide further financial support to TfL. These risks would, therefore, practically preclude any reform being considered further unless Government support were to be made available – either to prevent the risk from occurring or through further funding to accommodate the resultant financial impacts.

3.12. For the avoidance of doubt, there are virtually no approaches that TfL alone can adopt to address the risks of potential future volatility in the funding position resulting in increased costs. TfL and TfL Trustee Company Limited acting as the trustee of the Scheme (the Trustee) have agreed to make some allowance in the funding position of the Scheme, as a result of the 2021 valuation, to gradually begin to de-risk the Scheme investment strategy over time, which may help to gradually mitigate some risk. However, de-risking will ultimately result in increased costs. This is because a lower risk investment strategy would be expected to result in lower returns in the future and TfL will need to provide the balance of cost. Therefore, there is a limit to the extent of de-risking possible while keeping contributions affordable for TfL.

3.13. The risks associated with the management of past service liabilities could technically also be avoided by securing all past service liabilities with an insurance company. However, as the Independent Pensions Review noted, this is not feasible in practice, given that this would be expected to require a cash injection of around £14bn, based on the Scheme Actuary's solvency estimate as at the 2021 valuation date.

3.14. There are only two main options, therefore, that TfL regards as practically capable of mitigating the risks associated with past service liabilities. These options both require Government support and can be summarised as follows:

A. Reclassify the Scheme as a public sector scheme by transferring the Scheme's past service assets and liabilities to either an existing or new funded or unfunded public sector pension scheme:

- This would remove the Scheme from tPR's purview in relation to how it regulates the funding of private sector schemes and therefore eliminate the unnecessary contributions required to fund the Scheme up to an overly cautious funding threshold.
- This would reduce the risk of unaffordable past service deficits arising (if a funded public sector scheme were used, and in which case any deficit that did arise could be met over a longer time-period) or entirely (if an unfunded public sector scheme were used).
- However, this could not be achieved without legislative intervention, as there is a no existing statutory or other provisions for a transfer of this kind to occur.

B. A Crown guarantee being provided to the Scheme:

- While technically this would leave the Scheme within tPR's purview, as a private sector scheme, members would no longer be eligible for compensation from the PPF, as the Government would step in to cover pensions obligations should TfL cease to continue as a going concern. Therefore, tPR would not regulate the Scheme in the same way as a typical private sector scheme.
- There is precedent for this type of approach, most recently in July 2022 where a Crown Guarantee was provided by the Government in relation to the Atomic Weapons Establishment Pension Scheme. A list of other schemes who benefit from a Crown guarantee is included in Appendix 3.
- This would not require legislative intervention, as it would be within the Government's existing powers to provide a Crown guarantee.

3.15. In either option, the Scheme would no longer be required to pay the PPF levy, currently around £16m a year.

4. Government Support for the Management of Past Service Liabilities

<u>Section Summary</u>

- **There are two main options for Government support of past service liabilities**
- **These are:**
  - **A. legislation to support a transfer of past service assets and liabilities to a new or existing funded or unfunded public sector arrangement in order to reclassify the Scheme as a public sector scheme; or**
  - **B. the provision of a Crown guarantee**
- **Both options would continue to ensure members' benefits built up to date would be protected and members' would benefit from a stronger Government covenant, leading to better security of benefits in the future**
- **Legislation to transfer past service assets and liabilities to an unfunded arrangement may have the most benefit**
- **This option would enable the risk to TfL of past service deficits arising to be removed entirely and would provide the Government with the benefit of £12bn of assets that would no longer need to be matched to liabilities**

4.1. The options for Government support which were summarised in paragraph 3.14 are explained in further detail below:

A. Reclassifying the Scheme as a public sector scheme by transferring the Scheme's past service assets and liabilities to either an existing or new funded or unfunded public sector pension scheme

4.2. In relation to A) above, there are several sub-options. TfL would need to discuss with the Government its appetite for these, and what any Government preference might be. These include:

(I) Transfer of past service assets and liabilities to an <u>existing unfunded</u> public sector arrangement, such as the Civil Service Pension Scheme (CSPS).

(II) Transfer of past service assets and liabilities to an <u>existing funded</u> public sector arrangement, such as the Local Government Pension Scheme (LGPS).

(III) Transfer of past service assets and liabilities to a <u>new funded or unfunded</u> public sector arrangement.

4.3. Looking at each of these in turn:

(I) Transfer of past service liabilities to an existing unfunded public sector arrangement, such as the CSPS

4.4. In contrast to funded schemes, unfunded schemes, such as CSPS, do not use investment assets to generate return, as (broadly speaking) current income (contributions from employees and employers) is used to pay current liabilities (pension payments to current pensioners) on a Pay As You Go (PAYG) basis. As such, unfunded pension schemes such as the CSPS do not hold investment assets, only liabilities. The Government makes a promise to pay benefits as they fall due for payment – meaning members' benefits are secure. The Government recognises these liabilities as contingent in the National Accounts[1] (that is, they are not recorded on the public sector balance sheet in the core UK National Accounts publications) in accordance with relevant ESA[2] statistical standards.

4.5. The Scheme's assets and liabilities (as at a specified date) could be transferred to the Government, for example to the CSPS. This would require the Government to bring forward primary legislation as there are no existing statutory or other provisions which could currently achieve this. Secondary legislation may also be required to affect a bulk transfer of past service assets and liabilities to an existing public sector pension scheme, depending on how the primary legislation is framed. The Scheme's past service liabilities would be added to a new section of the CSPS. The Government would take the existing assets onto its balance sheet and continue to service liabilities on a PAYG basis (as an unfunded public sector arrangement) in relation to past service liabilities transferred.

4.6. This would relieve TfL of all risk related to existing past service liabilities transferred and remove the need for TfL to make deficit payments. TfL would also no longer fall under the purview of tPR in relation to this part of the Scheme and would, therefore, largely avoid the requirements of the new funding and investment strategy regime to be introduced by the Pension Schemes Act 2021. The benefits covered by this part of the Scheme would also no longer be eligible for compensation from the PPF, and as such, this would remove the PPF levy payments payable in respect of the Scheme.

4.7. As the assets would no longer be required to be held against the liabilities, the Government could deploy the assets elsewhere. The Scheme would be valued at the point of transfer, on a public sector basis. Currently, TfL's actuarial adviser considers that such a valuation on a public sector basis may result in a surplus value of around £2bn calculated using a valuation discount rate consistent with that used for the CSPS. Given this surplus will have arisen as a result of TfL employer and member contributions, this surplus value could be returned to TfL for investment in vital transport programmes to promote growth, subject to the structure of any arrangement that may be negotiated.

4.8. The Government may be concerned about the transfer of risks they do not directly control, for example salary risk, in this type of option. This could be addressed through the use of sufficiently prudent assumptions in any transfer valuation, or with some negotiated contractual requirement for TfL to "top up" pension payments to an agreed level where salary growth exceeded the assumptions set out in the transfer valuation. Equally, there would need to be a mechanism to accommodate any cumulative falls in the value of liabilities to offset any "top up" payments TfL may be required to make. It would be for TfL, therefore, not the Government, to manage salary risk under such a mechanism by considering the affordability of any "top up" payments that may arise when

[1] https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/methodologies/pensionsinthepublicsectorfinancesamethodologicalguide

[2] European System of Accounts (ESA) 2010

decisions on wider remuneration are made, after taking into account the wider value of the liabilities at the time.

4.9. If the CSPS were to be used for this option, in practice, new legislation would be needed to amend the regulations governing the benefits payable by the CSPS for former Scheme members and its ability to accept transfers-in on a bulk basis.

(II) Transfer of past service assets and liabilities to an <u>existing funded</u> public sector arrangement, such as the LGPS

4.10. It may be possible for TfL to undertake a bulk transfer of assets and liabilities to a funded public sector scheme, such as the LGPS.

4.11. This option would need primary legislation to amend the regulations governing the benefits payable by the LGPS and its ability to accept transfers-in on a bulk basis. Secondary legislation may also be required to affect a bulk transfer of past service assets and liabilities to an existing public sector pension scheme, depending on how the primary legislation is framed.

4.12. The LGPS is a funded scheme, and so unlike the option above, which would involve an unfunded arrangement, liabilities would not be paid on a PAYG basis but would instead continue to be paid from the assets of the scheme. The assets and liabilities would, therefore, remain subject to valuation and TfL would still be required to fund any deficits arising through ongoing deficit recovery contributions. However, as this option would also mean no longer falling under the purview of tPR in relation to how it regulates the funding of private sector schemes, a reduction in liabilities could be achieved through a less prudent funding approach (the Scheme would also have a surplus of around £2bn on an LGPS valuation basis). Should any deficit arise in future, deficit recovery contributions could be better managed through longer recovery periods. Finally, transfer to a funded public sector arrangement would remove the unnecessary risks of private sector treatment.

4.13. A transfer of assets and liabilities to the LGPS may impact the National Accounts as it is understood that the gross assets and liabilities of funded public sector arrangements are classified within fiscal debt statistics[3]. The impact may vary over time, given the value of the assets and liabilities will inevitably change over time.

4.14. This option would, therefore, mean TfL retaining some cost and risk compared to any unfunded public sector scheme option (existing or new), as the funded nature of the scheme would mean that TfL may be at continued risk of deficits arising in the future, albeit on a more appropriate funding basis (than the current private sector arrangements) for an employer like TfL. It is also the case that the Government would not gain access to around £12bn of assets that could be deployed elsewhere as the assets would still be required to be held against liabilities.

(III) Transfer of past service to a <u>new funded or unfunded</u> public sector scheme

4.15. Without amending Scheme benefits or transferring any obligations in relation to it, it would be within the Government's gift to introduce primary legislation to create a new funded or unfunded public sector arrangement for the Scheme to transfer to. Secondary legislation may also be required to affect a bulk transfer of past service assets and liabilities to an existing public sector pension scheme, depending on how the primary

[3] https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/methodologies/pensionsinthepublicsectorfinancesamethodologicalguide

legislation is framed. This new public sector arrangement could be run as it is today, with TfL as the employer sponsor potentially for both past and future service benefits.

4.16. This would have the benefit of removing the Scheme from tPR's purview in relation to how it regulates the funding of private sector schemes (if a funded public sector scheme were used) or entirely (if an unfunded public sector scheme were used).

4.17. Assuming a funded private sector scheme were used, more appropriate assumptions (that is, those appropriate for a public sector organisation) could be adopted relative to those currently being used for the Scheme. This would remove some of the risk and cost associated with the Scheme (noting that on a public sector basis the Scheme surplus would again be around £2bn).

4.18. Precedent for this type of arrangement exists. One well known example of the Government taking on a scheme’s pension liabilities in the past was in relation to the Royal Mail Pension Plan (the RMPP) in April 2012. In this case, around £37.5bn of pension liabilities were transferred to a new public sector scheme, with around £28bn of assets transferred to the Government. The Government agreed to provide the promised benefits on a PAYG basis, in line with other unfunded public sector arrangements such as the CSPS. The Government was able, therefore, to recognise a significant asset that no longer needed to be matched to the pension liabilities.

4.19. The Scheme currently has assets of around £14bn compared to liabilities, on a public sector basis, of around £12bn. Consequently, and as noted above, the Scheme currently has a surplus on a public sector funding basis of around £2bn. On this basis, the Government would not be in the same position as for the RMPP if all the Scheme’s assets were agreed to be transferred, as they could, potentially, have a significant buffer for any future changes in funding position in respect of the transferred liabilities.

4.20. In whichever option, to ensure past service benefits built up to date are protected, TfL will need to consider whether (i) a link to members' final salaries is retained, or (ii) a “leaving service basis” is adopted (or the better of both) in relation to the past service benefits transferred to the relevant public sector arrangement. Maintaining a final salary link would be consistent with wider public sector scheme reforms.

4.21. Under all of these options it is possible that, if future service benefits were to continue to accrue under the current arrangements, risks in relation to past service would build up again in the future. However, if future service were also to be provided in an unfunded public sector arrangement, then these risks would not arise again. If future service were provided through a funded public sector arrangement, then there would remain some risk, but on a more appropriate and reasonable basis. Therefore, for these options it will also be important to consider how risks can be managed in relation to the design of future service benefits going forward to avoid a repeat of the current issues TfL faces. This is discussed further in Section 5 below.

B. A Crown guarantee being provided to the Scheme

4.22. A Crown Guarantee was identified as an option in the report of the TfL Independent Panel Review (December 2020) and in the Independent Pensions Review’s Final Report (March 2022). A Crown guarantee provided by the Government could significantly reduce the cost of contributions and any further affordability pressures generated by the Scheme. In summary, this would be because the Trustee could effectively rely on the Government itself when assessing the covenant available to the Scheme and determining the prudence of the Scheme’s technical provisions and deciding its investment strategy. It would also reduce the impact of tPR involvement, as explained below. It is currently estimated that a Crown Guarantee would result in a valuation surplus of around £2bn and would also reduce the risk of tPR requiring the Trustee to use more prudent assumptions to fund the Scheme, which would in turn lead to higher contributions from TfL.

4.23. A Crown guarantee is an agreement whereby a "relevant public authority" gives a guarantee to the Trustee (not TfL or its subsidiaries) which will ensure the Scheme has sufficient assets to meet its liabilities. "Relevant public authority" is a Minister of the Crown or a government department so could, for example, be the Secretary of State for Transport or the Minister for London. The Crown guarantee would only be called upon in the event of: (i) a failure by TfL and / or its subsidiaries to make a payment to the Scheme on an ongoing basis under its schedule of contributions; (ii) TfL insolvency; or (iii) the Scheme entering wind up.

4.24. If a Crown guarantee were provided to the Scheme, it would remain a private sector scheme, but its members would not be eligible for compensation from the PPF in the event of TfL’s or TfL’s subsidiaries' insolvency (which, in itself, is in any event considered to be an extremely remote risk). The Scheme would also not be subject to section 75 of the Pensions Act 1995. As two of tPR's key statutory objectives are to protect people's pension savings and the PPF from claims, the provision of a Crown guarantee should significantly reduce tPR's desire to become involved in reviewing the Scheme's funding position and investment strategy from time to time, and no PPF levies would be payable, saving around £16m a year based on the most recent levy paid.

4.25. A Crown guarantee would be at no immediate cost to Government (unless it was called upon) and is a contingent liability only (not treated as debt). In practice, it is very unlikely that a Crown Guarantee would be called upon, given the extremely remote risk of a TfL insolvency. If TfL were to be faced with significant financial challenges (for example, as has been the case in the pandemic) then it is very likely that the Government would be required to step in and provide TfL with funding in any event – thus a Crown Guarantee does not, in practice, change the reality of the situation today.

4.26. As described in paragraph 3.14, precedent exists for other Crown Guarantees being provided to private transport schemes, including certain sections of the Railways Pension Scheme (the RPS). A Crown Guarantee was also recently granted to the Atomic Weapons Establishment Pension Scheme, in July 2022.

5. Future Service Benefit Reform

Section Summary

- **Defined benefit pensions are the most appropriate arrangements for TfL going forwards. Defined contribution and collective money purchase arrangements will be ruled out**
- **Defined benefit arrangements better reflect a fair and reasonable allocation of risk between the employer and member, and better provide for adequacy and certainty of pensions in retirement**
- **The two broad categories of defined benefit options TfL will consider are a final salary design and a CARE design**
- **Sub-options have been developed that look at indexation levels, retirement age, member contribution levels and a range of possible accrual rates**
- **It is assumed these sub-options would be provided in a public sector arrangement, to avoid the unnecessary cost and risk that would come with a private sector classification**
- **Being required to design these sub-options in order to aim to achieve the Government's £100m cost saving target is expected to result in an unacceptable impact on members' benefits (a reduction of around a third, on average, of pensions built up in the future) and would lead to scheme designs that are materially less generous than comparable public sector arrangements**
- **Any changes need to be considered in a way that is fair. It is not reasonable or fair for changes to be driven by a savings target required by Government for future service that is based on information which is out of date and not properly defined**
- **Any member impacts would need to be mitigated to an acceptable level. These impacts have been managed in public sector scheme reforms by offering more generous accrual rates and definitions of pensionable pay**
- **These mitigations would reduce cost savings to TfL in the near term; however, the types of changes contemplated in the sub-options would still significantly reduce the risks TfL faces in the future**
- **Focusing on risk in a way that is consistent with other schemes available in the public sector, while minimising the impact on members' benefits, is a more reasonable approach**

5.1. As set out in Section 3, the significant adverse impacts that future service benefit reform may have on the funding position of the Scheme would, in practice, preclude any future service benefit reform being pursued unless the Government support for the management of past service liabilities was provided at the same time. For the purposes of this paper, TfL has made the assumption that such support would be forthcoming. If, in reality, this support is not forthcoming, then it will not be possible for TfL to consider reform of future service benefits any further.

5.2. The arguments set out in this, and the 27 September paper, in relation to the unnecessary cost and risk caused by the Scheme's private sector status, apply equally to the consideration of the accrual of future service benefits and, as a consequence, to any past service that builds up in the future. Therefore, it is TfL's view that better value for money can be achieved if both future service benefit accrual and the management of past service benefits are provided via a public sector arrangement. The options discussed in this paper hence all assume that future service benefit will be provided in a public sector arrangement.

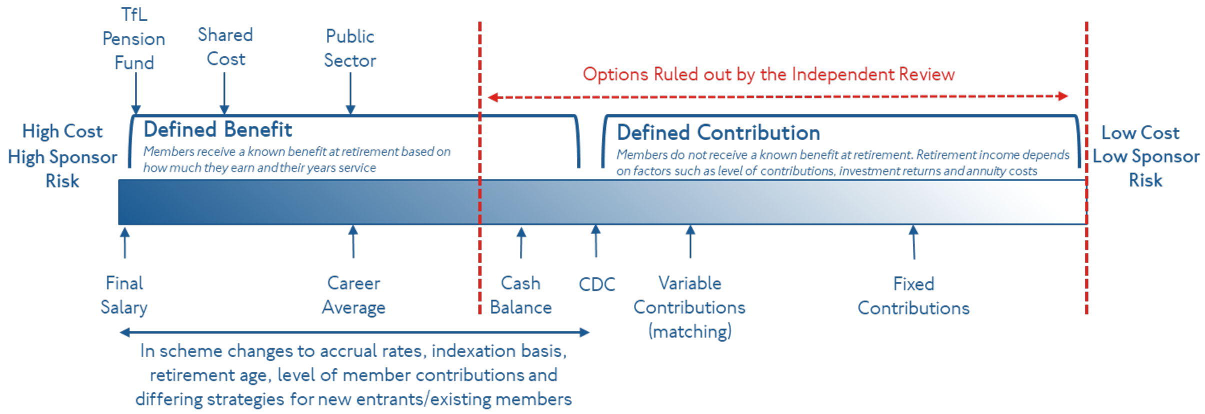
5.3. As set out in Section 2, it is also the case that the Government's target level of cost savings of around £100m per annum is based on information that is out of date and not properly defined. The target should include the costs of past service (not just future service), against which the majority of the savings identified by the TfL Independent Panel Review have now already been realised through the improved funding position of the Scheme at the 2021 valuation. Additionally, the value of £100m itself should now be lower, reflecting changes which have already been taken into account in the way indexation will apply going forwards and therefore the reduction in scope for savings to be generated in a way that is considered fair.

5.4. It would simply not be fair to members to pursue changes on the basis of a savings target that is based on information that is now out of date and not properly defined. This is particularly the case when, in order to aim to meet the Government's £100m cost saving target, the options would need to be far less generous than comparable public sector schemes. For this, and other reasons set out in the remainder of this paper, the focus should not be on short term cost savings, but instead looking at approaches which would limit the risk of large future cost increases in a way that is consistent with pensions available elsewhere in the public sector, while minimising any impact on members' benefits which change may bring.

Spectrum of Design Options

5.5. Generally speaking, there is a spectrum of potential design options for the provision of future service benefit which TfL could consider. This spectrum is illustrated in Figure 1 below. As noted in the 27 September paper, there are generally two broad categories of DB options, in particular, that TfL may consider further for the purposes of its substantive future service pensions provision, compared to the current pension arrangements. Consistent with the Review, these are: (i) some form of Final Salary arrangement; or (ii) a CARE arrangement.

Figure 1: Spectrum of Design Options



**CDC stands for Collective Defined Contribution, also known as Collective Money Purchase (CMP)*

Risk Allocation in Scheme Design

5.6. The choice between different categories of design options is further supported by looking at the allocation of risk in various types of arrangements and where these risks may be best placed (that is, with the employer, the member, or shared between the employer and member). Tables 1 and 2 set out a summary of the main risks inherent in the design of pensions arrangements and how they might be allocated, which helps to inform the consideration required for the selection of potential future service reform options from the spectrum above.

Table 1: Distribution of risks in categories of pension arrangements

Risk	Description	Defined Benefit: Final Salary	Defined Benefit: CARE	Collective Money Purchase (CMP)	Defined Contribution (DC)
Investment	The risk that lower than expected asset returns mean that there are insufficient assets to pay benefits when they come into payment or lower returns from which to buy an annuity at retirement	**EMPLOYER**	**EMPLOYER**	**EMPLOYER** up to a cap, then member	**MEMBER**
Inflation	Risk that higher than expected price inflation increases the cost of providing pensions or the cost of purchasing an annuity	**EMPLOYER** up to a cap depending on design	**EMPLOYER** up to a cap depending on design	**EMPLOYER** up to a cap, then member	**MEMBER**
Salary	Risk that higher than expected salary increases increase the cost of providing pensions or contributing to pensions	**EMPLOYER**	**SHARED** between employer and member	**SHARED** up to a cap, then member	**SHARED** between employer and member

Longevity	Risk that higher than projected life expectancy increases the cost of providing a defined level of benefit (ie benefits need to be provided for longer)	**EMPLOYER**	**EMPLOYER**	**EMPLOYER** up to a cap, then member	**MEMBER**
Annuity	Risk that market movements affect the purchasing power for an annuity (an ongoing income paid each year)	**N/A**	**N/A**	**N/A**	**MEMBER**

Table 2: Risk allocation considerations

Risk	Who?	Why?
Investment	**EMPLOYER**	As a large employer of critical public services, TfL is better placed to manage this risk over the long term and as part of its wider business plan, as compared to an individual member where the uncertainty of pension amounts is challenging to manage, particularly in times of market volatility, and will affect retirement planning
Inflation	**EMPLOYER** (but consider which index and any caps that would protect the employer in times of high inflation)	As a large employer of critical public services, TfL is better placed to manage this risk over the long term and as part of its wider business plan; however, there is a choice for the employer on what level of indexation risk should be taken (i.e. RPI vs. CPI, noting it is expected that RPI will be aligned with CPIH (which has historically been similar to CPI) anyway from early 2030's) and also level of cap in place (e.g. 5 per cent or 2.5 per cent a year)
Salary	**EMPLOYER OR SHARED** (but consider how, e.g. CARE and/or tiered contributions and/or shared cost)	This risk could be shared between TfL and members, to perhaps resolve inequities in Final Salary arrangements where higher earners who are promoted quickly receive a higher pension proportionate to contributions made than those who are lower paid. Due to their higher disposable incomes, higher earners theoretically have a greater capacity for managing the cost of pension benefits than lower earners
Longevity	**EMPLOYER** (but consider from what retirement age)	As with investment risk, this risk is likely to be more efficiently borne by the employer. But there is a question of at what level (i.e. from what retirement age)

Advantages and Disadvantages of Broad Design Options

5.7. The advantages and disadvantages of these broad categories of options can be found in Table 3 below.

Table 3: Advantages and Disadvantages of categories of pension arrangements

Scheme Type	Advantages	Disadvantages
Defined Benefit (DB) **Final Salary: benefits based on a member's service and salary in the last year(s) of service** **CARE: benefits based on a member's service and average earnings during that service (increased with inflation).**	Members receive a known and adequate benefit at retirement which can aid with retirement planning. Valuable for recruitment and retention of employees. All else being equal, CARE would be expected to be lower cost than Final Salary and lower risk as it reduces salary risk to the employer, subject to detailed design characteristics. CARE theoretically works better with flexible working patterns and resolves some of the potential inequities in Final Salary arrangements, where higher paid members who are promoted frequently and/or near the end of their careers do better relative to their contributions than those who are lower paid. Opportunities for amalgamation with other public sector DB schemes would reduce administration costs, as well as PPF levy costs, as previously noted.	The risks set out below are taken by the employer (meaning there is potential for the cost of these arrangements to vary over time), however these would be more affordable in a public sector arrangement: • Investment • Mortality • Salary inflation (in CARE this risk is shared) • Pensions inflation • Expenses • Regulatory risk (if private sector) Less flexibility for employees to choose how to draw their benefits at retirement. CARE is expected to result in lower benefits than Final Salary for some individuals, although for others may offer a higher level of benefits. Risk of past service deficits building up in the future as benefits accrue (unless in an unfunded public sector scheme).
Defined Contribution (DC) **Members receive a pension at retirement that depends upon the levels of contributions received, the investment returns achieved and the cost of purchasing benefits at retirement.** **The cost of providing these benefits is a defined percentage of pensionable salary (with varying options for contribution structures e.g. matching what members pay up to a cap) for the employer, with all other risks passed to the member.**	The cost of providing benefits is a defined percentage of pensionable salary and is therefore more predictable and generally provided at a lower cost (subject to the agreed employer contribution rate) than in a DB arrangement. Arguably, some employees may prefer the flexibility of DC benefits as they have more options on how to draw on them.	Almost all risks are passed to members. Therefore, members' benefits are not known in advance of retirement, and this can make it more difficult for employees to plan for their retirement. Most notably, there is a significant risk the benefits may ultimately be inadequate to meet members' needs in retirement. Compounds prevailing recruitment and retention risks and would be expected to require significant adjustments to other parts of the remuneration package (e.g. salary). The employer would retain some salary risk as the level of contributions are usually calculated as a percentage of overall salary.

Collective Money Purchase (CMP) **A CMP arrangement is a hybrid form of DC arrangement whereby the employer's cost is fixed and the employee is offered a target level of benefit at retirement rather than a guaranteed income as in a DB scheme.**	If a CMP scheme is under (or over) funded then the level of members' benefits can be adjusted so that the assets of the CMP arrangement are equal to the target liabilities relating to the target incomes in retirement. The cost to the employer of providing benefits is a defined percentage of pensionable salary, so more predictable than in a DB arrangement. For a given contribution rate, the CMP pension for an employee is expected to be higher than from buying an insured annuity with a pure DC pot.	Members are paid pensions which may change so suffer the same disadvantages as DC arrangements in this respect. The regulations under the Pension Schemes Act 2021 governing CMP arrangements have only just come into force, on 1 August 2022. Employers wanting to provide a CMP arrangement will need to do so through their own trust arrangement, which must be authorised and then will be supervised by tPR. Administratively burdensome, with potentially frequent changes being made to the level of member benefits.

Selecting Two Broad Categories of Options

5.8. Alongside the issues of fairness, adequacy and certainty of pension benefits in retirement and the wider impacts on recruitment and retention discussed by the Independent Pensions Review in its Final Report, the assessment of risk allocation and advantages and disadvantages of different scheme designs set out above also supports the view that DB arrangements are expected to be most appropriate going forwards.

5.9. DC arrangements, if they were to be provided as a default arrangement for all employees, would otherwise ignore the ability of TfL, as a large provider of critical public services, to manage certain types of risk (in the long term, despite near term financial challenges). They would also increase uncertainty and reduce the adequacy of post-retirement income for members (and their dependants), to an unacceptable level, which would be very difficult for individual members to manage. For example, recent financial market turbulence illustrates where members with DC benefits would have experienced material levels of uncertainty in their ultimate benefit provision.

5.10. This also applies to CMP arrangements (as a form of DC arrangement subject to similar issues), for which there is also the added issue of there being no practical history (with the first proposed such scheme in the UK, for Royal Mail, in the process of being implemented). As stated in the 27 September paper, this mirrors the conclusions drawn by Lord Hutton, in his review of public sector pensions provision[4].

5.11. Therefore, there are only two broad categories of options that TfL will consider further; these are a form of Final Salary arrangement or a CARE arrangement, both being types of DB arrangement.

Comparison to Public Sector Scheme Designs

5.12. Both Final Salary and CARE arrangements have their merits and disbenefits and could be designed in such a way so as to provide a similar level of benefit as each other at a similar level of cost.

[4] See Independent Public Service Pensions Commission: Interim Report dated 7 October 2010 and Final Report dated 10 March 2011

5.13. This is demonstrated in Table 4 where the Scheme has been compared to the LGPS and the CSPS (both CARE schemes) for the purposes of future service benefit provision.

5.14. While some cost savings are shown for the application of an LGPS scheme design, it is expected that these would reduce when taking into account the wider definition of pensionable salary available in the LGPS, for example where overtime and bonuses are included in the definition of pensionable salary for LGPS but not for the pensionable salary definition used by the Scheme. However, this potential impact has been excluded from this analysis due to available data.

5.15. It is also the case that a CARE arrangement may not always be more affordable than a Final Salary arrangement. Analysis demonstrates, for example, that were TfL to apply the same benefit design as the CSPS to its membership, then TfL's costs would be very likely to increase (again, these would be expected to increase further owing to overtime being included in the pensionable salary definition of the CSPS but noting that, again, this potential impact has been excluded from this analysis due to available data). This is also shown in Table 4 below. Despite the removal of the final salary link in the CSPS and the higher retirement age, other factors such as the preferential accrual rate and wider pensionable salary definition mean that the CSPS is more generous overall to members (and therefore, more costly for the purposes of future service) than the current Scheme design.

5.16. A broader comparison of the current Scheme design, to the design of other pension arrangements available in the public sector, is included at Appendix 4.

Table 4: Comparison to Public Sector Arrangements

Main Features	Scheme	LGPS	CSPS (ALPHA)
Design	Final Salary	CARE	CARE
Accrual Rate	1/60	1/49	1/43
Retirement Age	Unreduced from 60	SPA, Min 65	SPA
Indexation	RPI (capped at 5 per cent per annum for New Members post 1989)	CPI	CPI
Death in Service Lump Sum	4x salary	3x salary	Maximum of 2x salary or 5x pension
Employee Contribution Rate	5 per cent fixed	5.5-12.5 per cent, subject to salary	4.6-8.05 per cent, subject to salary
Employer Contribution Rate*	25.6 per cent	18.1 per cent	23.7 per cent
Est. Annual Saving (£m)	N/A	60	(14) An increase in cost due to higher pensionable salary definition

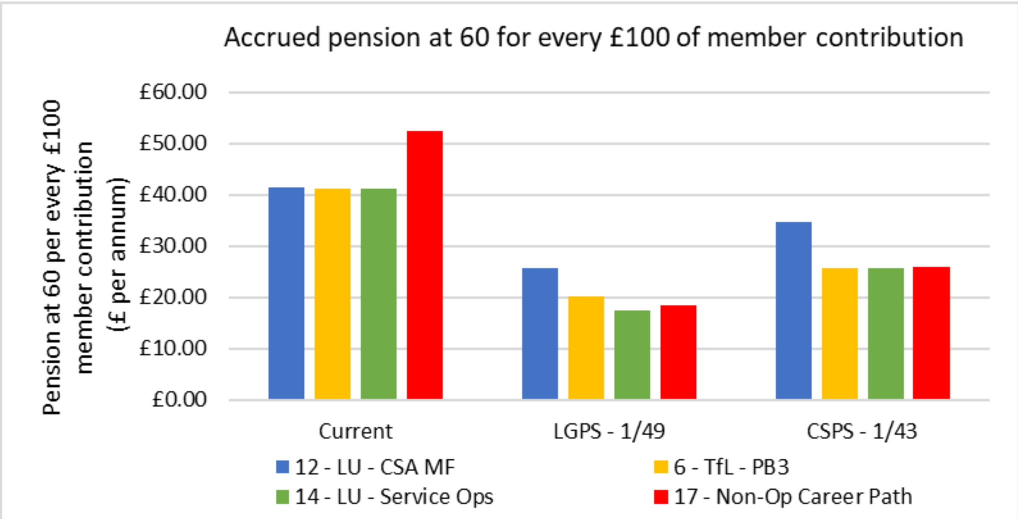
**Employer contribution rate is estimated based on the LGPS and CSPS benefit design but based on TfL Scheme membership data and funding assumptions at the 2021 valuation. These rates exclude any allowances for running costs / PPF levies. Also note that the employer contribution in £m shown reflects that the pensionable salary definition is more generous in LGPS/CSPS than the Scheme (as there is no deduction of the Lower Earnings Limit), even without any allowance for overtime or other additions.*

5.17. However, there are some important differences compared to the current Scheme design in the way these existing public sector scheme designs address key risks; salary related risks in particular. That is, there are differences between the current Scheme design and these public sector arrangements in the way in which salary increases impact both the benefits a member may receive and the risk that higher than expected salary increases result in higher costs of providing those pensions for the employer.

5.18. For example, a CARE arrangement may be helpful in resolving some of the potential inequities inherent in Final Salary arrangements, where higher paid members who are promoted quickly or promoted towards the end of their careers achieve higher pensions, as a proportion of contributions made, than those who are lower paid or have received fewer promotional increases. This is an important consideration when assessing fairness – both in relation to the fairness of the current arrangements and any future benefit design that may be considered.

5.19. To illustrate this, Graph 4 below demonstrates the difference in the pension per annum earned in the Scheme per £100 of contribution, to the LGPS and the CSPS, for a sample of employees (a description of these employees can be found in Tables 9 and 11). Graph 4 demonstrates that those who end their careers at a senior level (a high earner, illustrated by the red bar in the graph) have a significantly greater pension earned relative to their contributions with just over £50 pension per annum earned per £100 of member contribution, compared to a middle to lower earner (represented by the remaining bars in the graph) whose salary is subject only to general salary growth, these being relatively equal with just over £40 pension per annum earned per £100 of member contribution. In the CSPS and LGPS, Graph 4 demonstrates that the effect of CARE (and tiered contributions, where higher earners pay more for their pension benefits compared to middle or lower earners) is that this reverses, with the distribution leaning towards the lower and middle earners instead of the higher earners. It is important to note that this analysis is illustrative only, to demonstrate the distribution of benefits in different types of arrangement. Not all members will be impacted equally and the pension a member receives when they retire will be subject to a variety of factors, including their own individual service and salary history.

Graph 4: Accrued Pension at 60 per annum per £100 of member contribution



5.20. A final salary arrangement also has implications for employer costs, where, for example, promotions towards the end of the career can lead to higher benefits than expected (and hence create a larger balance of cost which the employer must fund); as benefits payable would be based on this (higher) final salary - as compared to a CARE arrangement, where this would be based on an average (that is, CARE avoids the employer having to pay for a “step change” in benefits).

More Detailed Design Choices

5.21. For each of these two broad categories of DB options, the Government has required that several design choices need to be considered in relation to key scheme design principles such as retirement age, indexation, tiered levels of member contributions and so on. Any amendments to each of these factors would have varying impacts on affordability (the cost to TfL of providing future service benefits going forward), sustainability (the way risk is shared between TfL and members (or between members)) and fairness (the impact on members’ benefits).

5.22. For the purposes of responding to the Government’s requirements for further information, TfL has considered two sub-options for each of these two broad DB options, which look at these factors as part of a wider scheme design, alongside a comparison to the current Scheme design (a “Do Nothing” option).

5.23. These sub-options include consideration of:

i. moving indexation away from RPI for future service benefits in the Scheme, to CPI (noting that public sector pensions are currently linked to CPI and that it is proposed that RPI will effectively be replaced by CPIH, an index which has historically been very similar to CPI, as an index from 2030 onwards in any event) and placing a cap on CPI to protect TfL in times of very high inflation (as has been the case recently);

ii. increasing the age at which a pension can be drawn on an unreduced basis from age 60 for future service benefits in the Scheme to age 65 or the SPA (although the appropriateness of this across the membership requires further consideration given a material number of TfL employees are engaged in physically demanding roles; for example, in engineering, on-street patrols, or require high levels of mental alertness for safety reasons); and

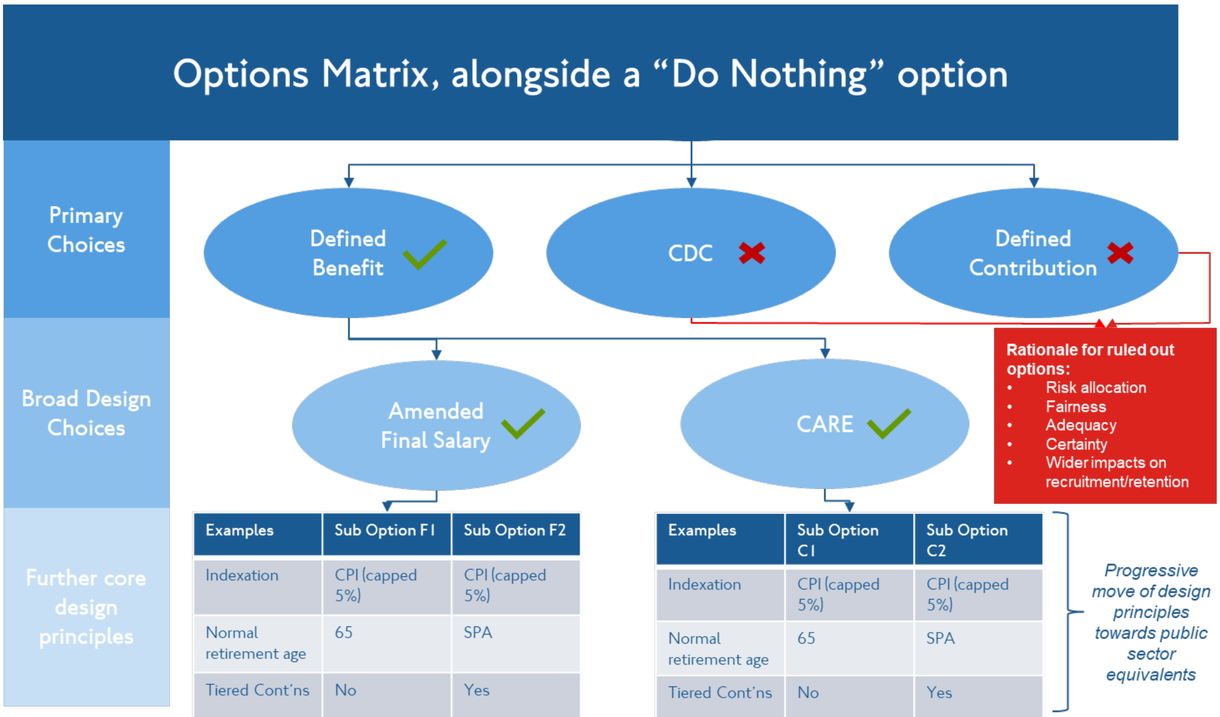
iii. creating a tiered member contribution structure where the level of contributions is based on how much a member earns as opposed to the fixed 5 per cent contribution for everyone that currently applies for the Scheme. The LGPS tiered structure has been used here for simplicity, but if this were to be considered further then TfL will need to assess whether this structure is appropriate taking into account the specifics of its own workforce.

5.24. Changing these core design principles for future service benefits in the Scheme would be expected to reduce risk and cost to TfL and align TfL’s pension arrangements better with other arrangements in the public sector.

5.25. A description of the two broad DB options, and their sub-options, are set out in Figure 2 below, with more detailed assumptions for the purposes of modelling set out in Appendix 5 and Appendix 6.

5.26. While the Government has required TfL to assess only two sub-options for each of the two broad categories of options being considered, it would, however, be possible to consider further variations to the core design principles set out above. For example, sub-option F1 and C1 could include an increase the member contribution rate from an assumed 5 per cent for all members, to say, 6 per cent or 7 per cent for all members. This approach would not be used to mitigate risk but would instead be used to reduce employer’s costs and pass some of these costs to members. Based on the current value of the pensionable payroll, every additional 1 per cent of member contribution would reduce TfL's cost by approximately £12m, with this cost being transferred to the active member population. Public sector reforms, however, did not apply a blanket increase, but instead targeted increases in contributions based on how much a member earns. This approach similarly reduces costs to the employer but also helps to mitigate some salary risk (as members are promoted to higher salaries they would pay more for their benefits) and is therefore what has been included in the sub-options here. This tiered approach has been included in option F2 and C2 – but could equally be applied to F1 and C1 also (that is, to options with a lower retirement age).

Figure 2: Options Matrix



5.27. Additionally, it would be possible to design future benefits without a cap on indexation in a similar way to the LGPS and CSPS, for example, which apply CPI on an uncapped basis. However, these schemes were designed when CPI inflation was low and expected to increase slowly as compared to RPI. Current market conditions demonstrate that increasing levels of CPI pose challenging risks for these pension schemes, and the absence of a cap could cause quite significant risks for the employer in times of high inflation. It is also the case that the current Scheme arrangements contain a cap on RPI.

5.28. Nevertheless, the extent to which TfL has flexibility to choose these design principles will be largely dependent on the delivery route. For example, if future service were to be provided within an existing public sector scheme, such as the LGPS or the CSPS, then TfL may be required to adopt those established scheme designs (as set out in Table 4). However, as Table 4 shows, these existing public sector scheme designs do not meet the £100m savings target for future service benefit costs set by the Government. To be clear, this does not mean that TfL have ruled out these existing public sector options (such as the LGPS and CSPS). It is simply the case that it is necessary for TfL, in order to meet the Government's requirements, set out in the Funding Agreement, to provide examples of options that would meet this savings target.

5.29. For the purposes of those options, presented in the remainder of this paper, it is assumed that these options are provided in a new unfunded public sector arrangement (that is, where there is the potential for greater design flexibility while also making sure that the risks in relation to past service are necessarily managed). Options could also be provided in a new funded public sector arrangement, although as stated in paragraph 4.12, this may still lead to a risk of deficits arising in the future, albeit on a more appropriate and reasonable basis when compared to the current private sector arrangements.

5.30. The Government requires that TfL make an assessment of how each of the sub-options set out in Figure 2 meets key criteria related to: deliverability; affordability (assessment of cost savings); sustainability (risk); fairness (impacts on members); and how it compares to other equivalent pension schemes. These assessments are contained in Sections 6 to 10 of this paper.

6. Affordability: Impacts on TfL's Costs of Future Service Benefit Design Options

Section Summary

- **Modelling has been conducted in order to produce a range of savings for each of the sub-options**
- **This modelling shows that annual cost savings of up to around £142m are possible in relation to future service benefits (including no longer having to pay the PPF levy) compared to TfL's future service benefit costs today**
- **These annual savings increase dramatically, to over £500m in some cases, when including risk adjustments for potential 1 in 20 downside events that could occur, which could require TfL to pay significant additional deficit reduction contributions under the current arrangements**
- **However, options which aim to generate the £100m cost saving target required by Government in relation to future service, lead to unacceptable detrimental impacts on member benefits and would result in much less generous arrangements than provided elsewhere in the public sector. These would need to be managed, given any reform would need to be done in a way that is fair**
- **Offering more generous accrual rates is one way of reducing impacts on members (as has been done in comparable public sector schemes), but this would have the effect of reducing potential cost savings**

6.1. An analysis of the range of potential cost savings that might be achieved from each of the sub-options is set out in Table 6. As stated in Section 5, these sub-options assume that both past and future service benefits would be provided through a new unfunded public sector scheme going forwards. Therefore, Table 7 also demonstrates the effects on risk and volatility in relation to past service benefits and the level of expenses payable which would be impacted by a public sector classification.

6.2. Were any of these options ultimately pursued, this would need to be done in a way that is fair. The future service design changes modelled could, in some cases, lead to significant detrimental impacts on member benefits (covered further in Section 7 below). Accrual rates have, in other examples of reform, been used to offset impacts on members – that is a reduction in benefits has, to some extent, been offset by allowing those reformed benefits to accrue at a faster rate. This has been the case in other public sector arrangements (for example, the LGPS has a 1/49 accrual rate and the CSPS has a 1/43 accrual rate, compared to the current Scheme of 1/60). Therefore, a range of accrual rates has been assumed here, broadly reflecting the accrual rates available in the current Scheme design and ranging to a more generous accrual rate provided in a comparable public sector scheme. In order to meet Government's requirements, it has been necessary in some options to reduce the accrual rate compared to the current Scheme accrual rate in order to demonstrate how the option would reach the Government's £100m target cost saving, despite TfL's view that this target is neither reasonable nor fair. These accrual rates used in the analysis are set out in Table 5.

Table 5: Accrual rate ranges used in each option

	Final Salary			CARE	
Option	**Current**	**F1**	**F2**	**C1**	**C2**
Higher	1/60	1/49	1/49	1/49	1/49
Lower	1/60	1/70	1/60	1/70	1/60

6.3. Detrimental impacts on members could, for example, also be managed by widening the definition of pensionable salary to include matters such as overtime (which is included within pensionable salary definition for the CSPS and LGPS but not the Scheme) or by otherwise considering an amendment to other aspects of the overall reward package for employees, such as salary and bonuses. These matters will need to be considered further as work progresses but for the purposes of this paper, accrual rates have been used to illustrate the point.

6.4. These mitigations, designed to address the impact on the value of members' benefits, would have the effect of reducing any cost savings to TfL in relation to future service benefits (reflected by the lower end of the savings range). However, the reduction in inflation and salary risk and mitigation of longevity risk that has crystalised in the past by increasing retirement age, which would be achieved through amending these design principles compared to the current Scheme design, should be expected to make the arrangements more affordable and sustainable going forwards by reducing the potential volatility in the funding position built up in the future. In some cases, a proportion of members (typically lower earners or those with lower promotional growth) may actually receive comparatively higher benefits, depending on their individual circumstances. Further information on member impacts is set out in Section 7 below.

6.5. This is also consistent with TfL's view that the focus of any potential reform should not be on short term financial savings, particularly where the Government's target cost saving is based on information which is out of date and not properly defined. It is also the case, as the 27 September paper set out, any such reform, if pursued, is likely to take years, not months, to deliver. There are, therefore, no options that can realistically reduce costs by a material amount in the short term. Instead, a more reasonable and fair approach would be to focus on the risk inherent in pensions arrangements, with the aim of reducing volatility and the potential for large and unaffordable cost increases in the future in a way that is consistent with pensions available elsewhere in the public sector, while aiming to minimise the impacts on members' benefits.

6.6. The analysis in Table 6 assesses savings against TfL's current pensions costs as a result of the 2021 valuation, consistent with the Independent Pension Review's Final Report. However, to reiterate, the Government's £100m cost saving target, is based in information for the 2018 valuation that covered both future service and past service liabilities. This is an important distinction, as TfL's costs have already decreased by around £70m per annum since 2018 as a result of the 2021 valuation. As set out in Section 2, TfL has, therefore, already met the majority of the target savings the

Government has asked TfL to aim to deliver. On the basis that TfL's past and future service benefits are transferred / provided in a public sector arrangement going forwards, then the risk of these cost savings being reversed would be substantially reduced, or even removed.

6.7. In both Table 6 and Table 7, the "Current – private" option is the Scheme as it currently stands, under private sector classification (the "Do Nothing" option). The "Current – public" option is the Scheme with the same benefit design as it is currently, but under a public sector classification.

6.8. Table 7 demonstrates the effects on risk and volatility on TfL's costs in relation to past service benefits and the level of expenses payable, and the savings that are therefore possible, and risks that are therefore avoided, with a public sector classification.

Table 6: Cost impacts to TfL of options

Type of scheme			**Final Salary**		**CARE**	
Option	**Current - private**	**Current - public**	**F1**	**F2**	**C1**	**C2**
Scheme design characteristics						
Retirement Age	60	60	65	SPA	65	SPA
Indexation	RPI	RPI	CPI (capped at 5 per cent)	CPI (capped at 5 per cent)	CPI (capped at 5 per cent)	CPI (capped at 5 per cent)
Member Contributions	Fixed 5 per cent	Fixed 5 per cent	Fixed 5 per cent	Tiered, subject to salary	Fixed 5 per cent	Tiered, subject to salary
Accrual rate range	1/60	1/60	1/70 to 1/49	1/60 to 1/49	1/70 to 1/49	1/60 to 1/49
TfL cost (as percentage of pensionable salaries) excluding expenses	**25.6 per cent**	**25.6 per cent**	**18.3 to 28.0 per cent**	**17.4 to 22.9 per cent**	**16.0 to 24.7 per cent**	**14.9 to 19.9 per cent**
TfL cost (£m per annum)	£300m	£300m	£214m to £328m	£203m to £268m	£187m to £289m	£174m to £233m
Difference vs "Current - private" design (£m per annum)	**£0m**	**£0m**	**-£86m to £28m**	**-£97m to -£32m**	**-£113m to -£11m**	**-£126m to -£67m**

6.9. As the analysis in Table 6 and Table 7 clearly demonstrates, the largest impact on the affordability of pensions costs in the future is derived from the application of a public sector classification. This is the case across all options assessed. The values demonstrate the extent to which risks in the funding position of the Scheme, as a private sector scheme, should they materialise, would have significant consequences for TfL's ongoing financial sustainability. These can only be avoided with Government support for past service liabilities.

6.10. It should be noted that current benefit design, were it to be provided in the public sector (the "Current-public" option in Table 6 and 7), is not currently expected to generate any savings against the cost of future service. This is because the assumptions currently used to value the cost of future service under the private sector classification (as per the 2021 valuation of the Scheme) do not contain the same level of prudence as used for determining the past service liabilities and are expected to be broadly similar to the assumptions used for providing benefits under a public sector classification.

6.11. In terms of future service benefit design, CARE options (C1 and C2) provide a greater level of saving than Final Salary options (F1 and F2), owing to the reduction in salary risk going forwards – with other design factors such as indexation and retirement age being otherwise broadly consistent across all of the reform options assessed. Option C2 is very similar to the LGPS scheme design, the only substantive difference being a cap on CPI of 5 per cent (whereas the LGPS applies CPI uncapped) – this accounts for the difference in the saving of £7m at a 1/49 accrual rate in Table 6 of £67m versus the £60m saving reported in Table 4. The values also demonstrate that, depending on the accrual rate used, Final Salary options may save more than CARE options (that is, there is a point at which Final Salary would be less costly than CARE).

Table 7: Impacts of public sector classification

Type of scheme			Final Salary		CARE	
Option	**Current - private**	**Current - public**	**F1**	**F2**	**C1**	**C2**
Difference vs "Current - private" design (£m per annum) – from Table 6 above	**£0m**	**£0m**	**-£86m to £28m**	**-£97m to -£32m**	**-£113m to -£11m**	**-£126m to -£67m**
Estimated PPF levy expense (£m per annum)	£16m	£0m	£0m	£0m	£0m	£0m
TfL cost including PPF levy expense (£m per annum)	£316m	£300m	£214m to £328m	£203m to £268m	£187m to £289m	£174m to £233m
Difference vs "Current - private" design allowing for PPF levy expense (£m per annum)	**£0m**	**-£16m**	**-£102m to £12m**	**-£113m to -£48m**	**-£129m to -£27m**	**-£142m to -£83m**
Additional deficit contributions potentially payable following a 1 in 20 downside scenario at the 2024 valuation (£m per annum)	£400m	£0m	£0m	£0m	£0m	£0m
TfL cost including PPF levy expense and additional deficit contributions (£m per annum)	£716m	£300m	£214m to £328m	£203m to £268m	£187m to £289m	£174m to £233m
Difference vs "Current - private" design allowing for PPF levy expense and additional deficit contributions (£m per annum)	**£0m**	**-£416m**	**-£502m to -£388m**	**-£513m to -£448m**	**-£529m to -£427m**	**-£542m to -£483m**

7. Sustainability: Impacts on Risk of Future Service Benefit Design Options

Section Summary

- **Significant reductions in overall risk are possible through public sector treatment of the Scheme (with or without reform)**
- **Public sector treatment would reduce regulatory risk materially**
- **Treatment as an unfunded public sector arrangement reduces risk most significantly for TfL; however, treatment as a funded public sector arrangement would also lead to a more appropriate overall exposure to risk compared to the current private sector arrangements**
- **Specific reform design characteristics help to reduce risk further, and would reduce the likelihood of large cost increases building further in the future as benefits continue to be accrued**
- **Salary risk is reduced significantly through a CARE design and through the introduction of tiered contributions**
- **Changing the way indexation is applied to benefits would reduce risk exposure further, particularly if a cap on indexation is introduced to protect the employer in times of high inflation**
- **Increasing the retirement age helps to protect against the risk of members living longer, with the SPA as a retirement age providing a dynamic link should there be increases in longevity in the future**

7.1. As set out in Section 6, the reduction in inflation and salary risk achieved through the amendments to the design principles in the sub-options compared to the current Scheme design, would be expected to reduce TfL's exposure to risk and thus reduce the potential for volatility in the funding position built up in the future and increases in ongoing future service costs.

7.2. Life expectancies have increased over recent years which increases the cost of providing each £1 of pension, all else being equal. Therefore, features of benefit designs that reduce the cost of providing pensions, such as a higher retirement age, help mitigate against this increase in longevity risk for the employer. Options with a retirement age linked to the SPA would help to create a more dynamic protection against these risks going forwards. CARE options would also reduce salary risk to a greater extent than Final Salary options.

7.3. Conversely, these design options would increase members' exposure to these risks compared to the current arrangements. For example, members would no longer receive higher levels of inflation based on RPI (albeit up to a cap under the current arrangements), members would need to work longer in order to not be subject to any early retirement reductions owing to a higher normal retirement age and, in CARE options, would no longer receive pensions based on their final salaries, instead being subject to an average (adjusted for inflation) across their period of service.

7.4. Options with tiered contribution levels share some of the risks inherent in scheme design with employees in a different way to the current arrangements – moving the member contribution away from a fixed 5 per cent for members to a greater share of cost being paid by higher earning members.

7.5. Table 8 sets out an assessment of TfL's exposure to typical risks in each of the sub-options. The "Current – private" column assumes the Scheme will stay under a private sector classification for both past and future service and therefore includes the risk that past service benefits cost more than expected. All other scenarios assume future benefits are provided via a form of public sector arrangement as noted, which means that there is an immediate reduction in risk as a result of not having to fund in advance any benefits accrued up to the point of any transfer.

Table 8: Impacts on TfL's risk exposure

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="8">Level of TfL exposure for each risk</th></tr>
<tr><th colspan="4">Final Salary</th><th colspan="4">CARE</th></tr>
<tr><th rowspan="2">Risk</th><th rowspan="2">Definition</th><th>Current – private</th><th>Current - public</th><th>F1</th><th>F2</th><th>C1</th><th>C2</th><th>CSPS</th><th>LGPS</th></tr>
<tr><th>Under private sector classification (funded scheme)</th><th colspan="6">Under public sector classification (unfunded scheme) – the risk of a past service deficit is removed</th><th>Under public sector classification (funded scheme)</th></tr>
<tr><td>Salary risk</td><td>Risk that higher than expected salary growth increases the cost of providing pensions</td><td>High</td><td>Medium</td><td colspan="2">Medium</td><td colspan="3">Low (salary risk reduced via CARE design)</td><td>Medium</td></tr>
<tr><td>Indexation risk</td><td>Risk that higher than expected price inflation increases the cost of providing pensions</td><td>High</td><td>Low (capped RPI)</td><td colspan="4">Low (capped CPI)</td><td>Medium (uncapped CPI)</td><td>High (uncapped CPI)</td></tr>
<tr><td>Longevity risk</td><td>Risk that higher than projected life expectancy increases the length of time benefits must be provided for</td><td>High</td><td colspan="6">Low (risk is reduced if no longer exposed to past service liabilities)</td><td>Medium</td></tr>
<tr><td>Financial market risk</td><td>Risk that the funding position of the Scheme will be impacted by volatile financial markets</td><td>High</td><td colspan="6">Low (unfunded public sector classification means being able to take a longer-term view on the cost of providing future service benefits)</td><td>Medium</td></tr>
<tr><td>Regulatory risk</td><td>Risk that new legislation/regulatory guidance will increase TfL's pension costs (e.g. through higher contributions)</td><td>High</td><td colspan="7">Low (public sector classification means not being under purview of tPR)</td></tr>
</table>

7.6. Table 8 assumes that for options F1, F2, C1 and C2, future service would be provided through an unfunded public sector arrangement and that there would be no past service deficit as a result of this treatment. Moving to an unfunded public sector arrangement materially reduces the exposure to both regulatory and financial market risk, and this is common across all the sub-options (albeit there is some residual risk which would still apply to public sector arrangements). There is also some further reduction to salary, indexation and longevity risks as a result of no longer having to fund past service liabilities.

7.7. If future benefits were provided through a funded public sector arrangement (and assuming the past service is also transferred to that arrangement), the reduction in regulatory risk would remain. There would be some reduction in financial market risk versus the current position, given the anticipated £2bn surplus when assessed using public sector funding assumptions and the greater flexibility for dealing with any deficits that might arise in future. Options C1 and C2 would reduce salary risk over time (whereas options F1 and F2 leave the salary risk unchanged versus the status quo). Indexation and longevity risks are reduced in a consistent way over the four sub-options being considered.

7.8. If provided via a funded public sector arrangement, Option C2 is very similar to the LGPS scheme design, the only substantive differences being no Lower Earning Limit deduction in the pensionable salary definition and a cap on CPI of 5 per cent (whereas the LGPS applies CPI on an uncapped basis).

8. Fairness: Impacts on Members' Benefits of Future Service Benefit Design Options

Section Summary

- **In order to aim to meet the Government's cost saving target of £100m, required changes to retirement age, indexation, member contribution rates and the way salary risk is shared with members would individually (and collectively) lead to adverse impacts on member benefits, with a reduction in members' pensions to be built up in the future, on average, by around one third (although this would not be equally felt)**
- **This would result in far less generous benefit provision than is available in other comparable public sector schemes**
- **TfL views this level of detrimental impact as unacceptable – any reform must be considered in a way that is fair**
- **As previously noted, such impacts could be mitigated, to some extent, by offering more generous accrual rates (or broader definitions of pensionable pay), for example, to bring options further in line with what is offered in comparable public sector organisations**
- **An application of LGPS or CSPS scheme design may mean certain employees may be better off, depending on their individual circumstances. However, there is still expected to be an overall reduction in benefits (albeit much reduced) of around 5 per cent, on average, for the LGPS**

8.1. An assessment has been conducted to show the range of potential impacts on members' benefits, for a small set of example "personas", for illustrative purposes only. These are based on the impact analysis conducted by the Independent Pensions Review but contain a smaller set of examples in order to make more manageable the amount of information contained within this paper. Should any of these options be pursued further, individual impact assessments would need to be conducted and a full equality impact assessment undertaken.

8.2. A description of the personas used, including assumptions regarding salary and length of service, can be found in Table 9 below. These personas include operational employees who work in London Underground (LU) and non-operational employees who work in TfL.

Table 9: Description of Personas taken from the Independent Pensions Review's Final Report

Persona	Area	Number of employees	Average Salary (£)	Average Tenure (years)
12 CSA(1)	LU	2749	35,926	13
9 Train Operator	LU	3368	58,949	13
14 Service Control Operations	LU	191	72,432	13
6 Pay Band 3	TfL	2869	56,513	13
7 Pay Band 4	TfL	775	77,595	13
8 Pay Band 5	TfL	135	102,399	13

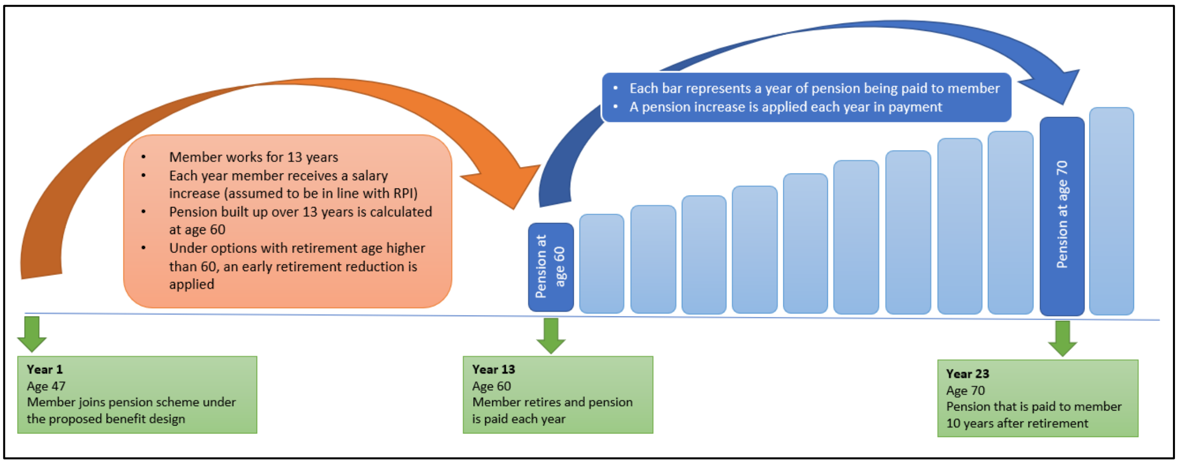
Methodology for Modelling Member Impacts

8.3. It is important to note, consistent with the approach in the Independent Pensions Review's Final Report, that the analysis of member impacts looks at the difference in expected pension benefits that would be built up after any change may be implemented, assuming:

- Members continue to be employed by TfL for a period of 13 years following any change (representing an average tenure);
- Members retire at age 60 (and so in options where the retirement age has increased would be subject to early retirement reduction factors); and
- Members receive a pension for at least 10 years (that is, the pension shown is the pension that would be taken in the 10th year after retirement, to show the impacts of inflation changes on pensions in payment).

8.4. This is illustrated in Figure 3 below.

Figure 3: Method for modelling Member Impacts



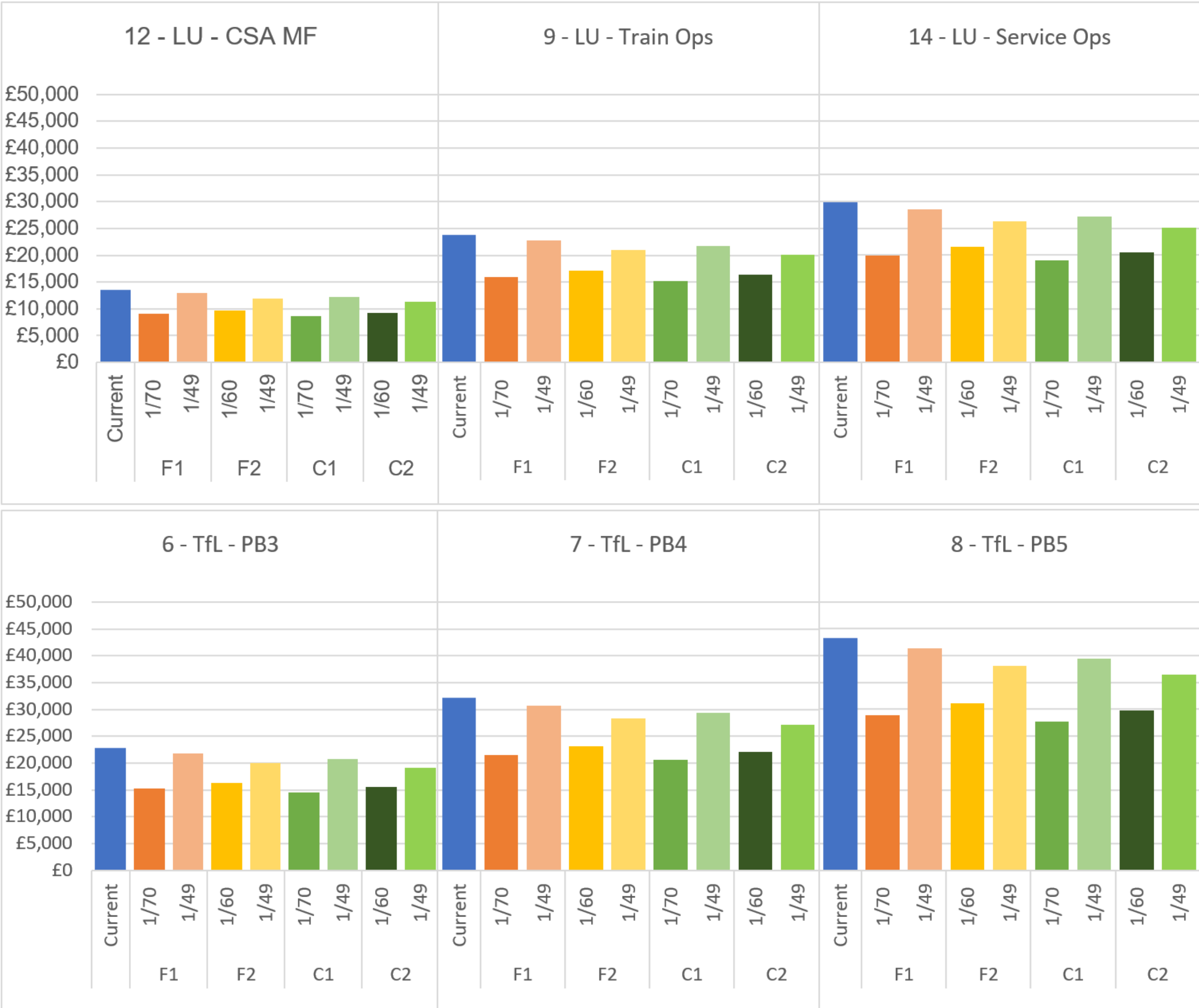
8.5. It should be noted that this analysis assumes that members' retire at age 60 in order to show the impact of changing retirement age in each of the options. This impact is demonstrated in the analysis by the application of early retirement reductions from age 65 and the SPA under the options assessed, which would not apply, or would be a smaller reduction, if a member retired at a later age. Therefore, were a member to retire later than age 60 the impacts of the options would be less pronounced (given early retirement reductions would reduce).

8.6. Members would continue to be entitled to and receive benefits based on what they have built up to date, as they would be protected. The benefits set out in the analysis below would therefore be paid in addition to benefits already built up to date. Modelling assumptions are set out further in Appendix 5 and Appendix 6.

Member Impact Analysis – Static Personas

8.7. Graphs 5 and 6 set out the results of this analysis for operational and non-operational personas, respectively. The dark shaded bar in each graph assumes 1/70 accrual (for F1 and C1) and 1/60 accrual (for F2 and C2); the lighter shaded bar to the right of this in each graph reflects the range of pension available for a higher accrual rate of 1/49.

Graphs 5 and 6: Impacts on Member Pension ten years after retirement



8.8. For example, under the current Scheme design, persona 12 (an LU CSA), having retired at age 60, will build up a pension in payment of £13,521 per annum by age 70. Under the F1 design with an accrual rate of 1/70, they will build up a pension in payment of £9,040 per annum by age 70, which is 33 per cent lower than the pension under the current

Scheme design. Under the F1 design with an accrual rate of 1/49, this individual would build up a pension in payment of £12,914 per annum by age 70 (4 per cent lower than the current Scheme design).

8.9. Graphs 7 and 8 reflect the proportionate change in the pension. Similar to the previous charts, the dark shaded bar reflects change using 1/70 accrual (for F1 and C1) and 1/60 accrual (for F2 and C2), while the lighter shaded bar reflects 1/49 accrual.

8.10. The graphs help to demonstrate that the impact of making changes to future service benefits based on the lower accrual rates, which would be required to aim to deliver the Government's target of around £100m per annum cost savings for future service benefits, would, on average, be to reduce the value of pension built up for future service by around one-third. When considering overall pension benefits (including benefits accrued to date), the impact of any reduction in future service benefits would not be equally felt, with greater impacts expected on those who are younger and/or have lower levels of accrued past service. This is illustrated in Table 10, which sets out the impact that differing amounts of past and future service have on overall impact of change, at the point of any change. The impact on members close to retirement is far less prominent than for those who have little past service benefits built up to date.

Graphs 7 and 8: Proportionate Change in Pension ten years after retirement

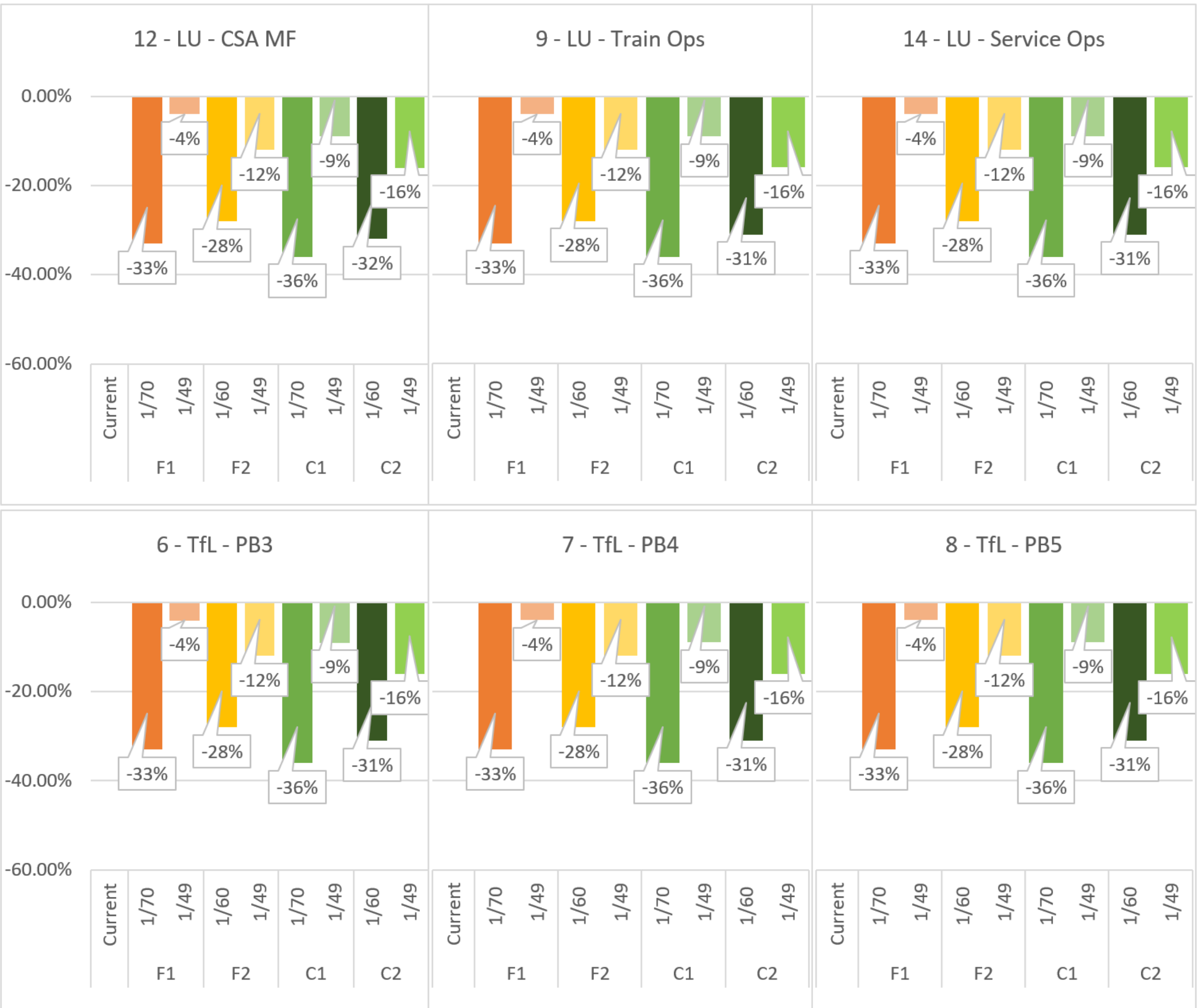


Table 10: Illustrative impact of level of service on pension benefits assuming example current pension entitlement of £10,000 per annum

	Pension at age 70 (10 years after retirement)		
Option	Current	F1 option	per cent difference
Age 25 now - no past service, 35 years future service	£10,000	£6,700	**-33 per cent**
Age 40 now - 15 years past service, 20 years future service	£10,000	£8,100	**-19 per cent**
Age 55 now - 30 years past service, 5 years future service	£10,000	£9,500	**-5 per cent**

Member Impact Analysis – Career Progression Scenarios

8.11. The assumption so far in this analysis is that the personas would remain on the same salary over their future service up to age 60 (subject only to general salary growth), with no promotional salary growth. Whether any individual member received a promotion would be down to individual circumstances, but, should promotional salary growth to be assumed, then the impacts could be even more detrimental than a one-third reduction under the CARE sub-options (as pensionable salary would be subject to an average rather than linked to any higher, final salary at retirement).

8.12. This is demonstrated in Graphs 9 and 10 below, which examine the impact on members' benefits in a career progression scenario. Two career progression scenarios have been used from the Final Report, as set out in Table 11 below.

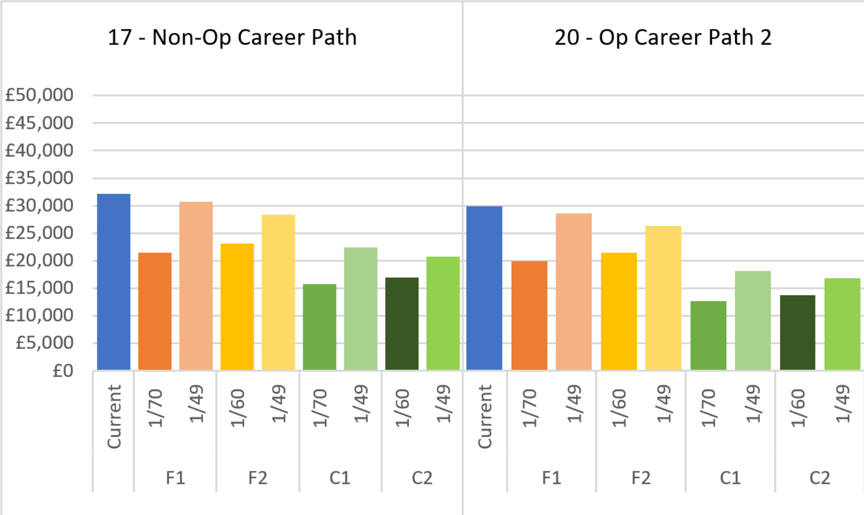
Table 11: Career Progression Personas taken from the Independent Pensions Review's Final Report

Persona	Description	Area	Average Tenure (years)
17 Non-Operational Career Path	Initial service as Pay Band 2, moving to Pay Band 3 after 3 years, moving to Pay Band 4 after 5 years	TfL	13
20 Operational Career Path	Initial service as a CSA, with final 5 years in Service Operations	LU	13

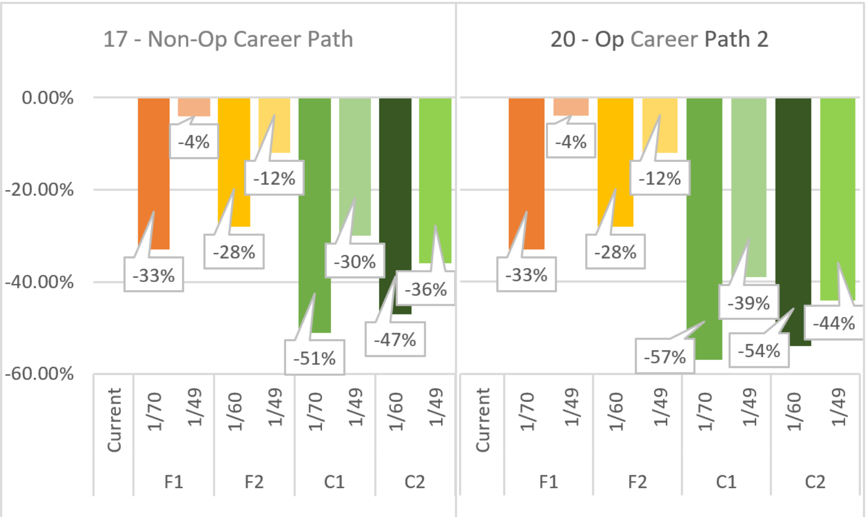
8.13. Again, these impacts reflect the difference in expected pension benefits that would be built up after any change may be implemented, assuming members continue to be employed by TfL for a period of 13 years following any change, then retire at age 60 and receive a pension for at least 10 years.

8.14. In a career progression scenario, the impacts of a CARE structure are clearly more pronounced, reflecting the fact that members' benefits would accrue based on their salary in each year of service, increased with inflation, rather than on their final salary. However, a CARE structure, particularly when coupled with tiered contributions would lead to a more equitable position between members in relation to the pension earned in proportion to contributions made. The analysis already presented in Graph 4 has been extended in Graph 11 to include the sub-options TfL has assessed.

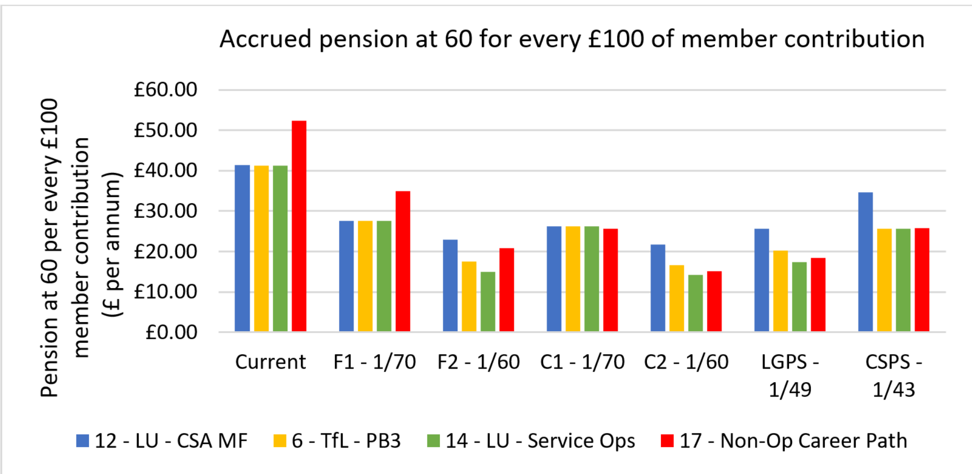
Graph 9: Impacts on Member Pension ten years after retirement



Graph 10: Proportionate Change in Pension ten years after retirement



Graph 11: Accrued pension for every £100 of member contribution



8.15. In the same way as set out in Graph 4, Graph 11 demonstrates that under the current Scheme, high earners do well, while everyone else is broadly equal. Under option F1 (which has fixed 5 per cent contributions), similar to the current Scheme, high earners do well and everyone else remains equal. Under option F2 with tiered contributions, the equitability starts to level out due to the introduction of tiered contributions. This is because lower earners are paying less contributions for the pension they are accruing compared to higher earners, who are paying more. Under option C1 with fixed 5 per cent contributions, everyone appears equal. Here you can see the effect that a CARE structure would have on a member who was a high earner towards the end of their career – the impact would be to prevent large step-change uplifts in pension benefits earned in comparison to other members who were not in the same position. Under option C2 it is evident that when combining CARE and tiered contributions together you see the distribution lean towards the lower earners instead of the higher earners. The LGPS and CSPS also show similar distributions to option C2, as they also have a CARE structure with tiered contributions.

8.16. Despite potential improvements in equitably in some of these options, as stated before, TfL considers the overall potential significant impacts, with an average reduction in benefits of one third (or greater in some career progression scenarios), to be an unacceptable level of detriment to member benefits.

Impacts on Members of providing an Existing Public Sector Scheme Design

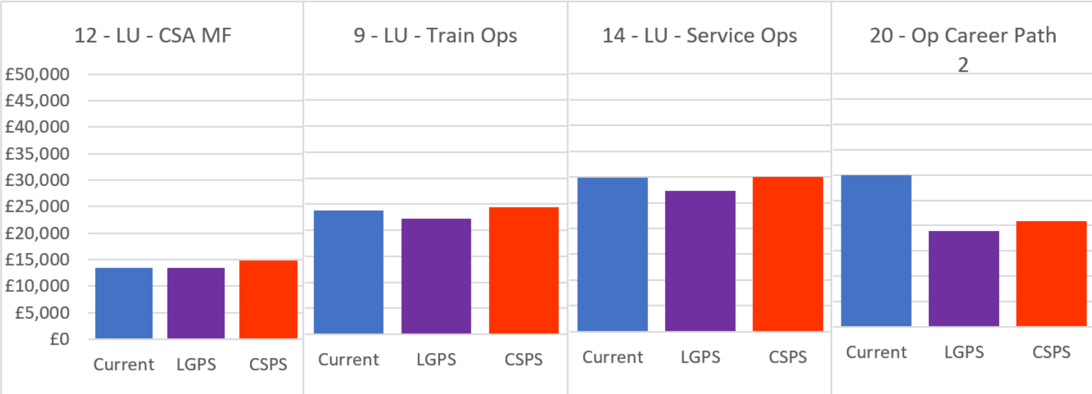
8.17. Providing a more generous accrual rate of, for example, 1/49 or 1/43 (as per the LGPS and CSPS), would mitigate some of this reduction (noting this could also be achieved through amendments to other elements such as the definition of pensionable pay or other parts of the overall benefits package). Mitigating the impact on members' benefits would, as set out in Section 6, have the effect of reducing savings compared to the Government's £100m cost savings target for future service benefits.

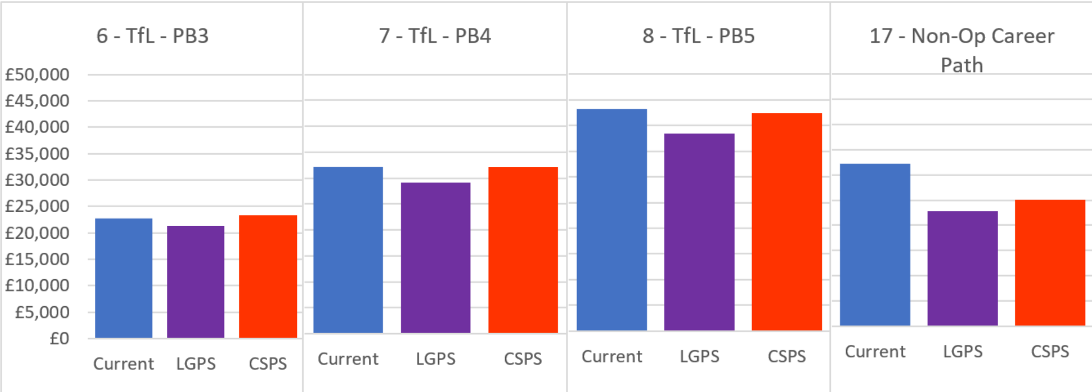
8.18. Comparability to pension benefits provided elsewhere in the public sector (such as the LGPS or the CSPS) might be considered more reasonable in terms of fairness to members in contrast to options that are required to save £100m from future service alone. It is also the case that if the Government do ultimately provide support for past service liabilities by making the Scheme a public sector scheme, then it may seem reasonable to expect that a public sector approach might also apply in respect of future service benefit provision.

8.19. Notwithstanding that these options would not meet the Government's £100m target for cost savings from future service, the member impacts of moving to an LGPS and CSPS design for future benefits have also been assessed. This is set out in Graphs 12, 13, 14 and 15 below. Again, these impacts reflect the difference in expected pension benefits that would be built up after any change may be implemented, assuming members continue to be employed by TfL for a period of 13 years following any change, then retire at age 60 and receive a pension for at least 10 years (as illustrated in Figure 3).

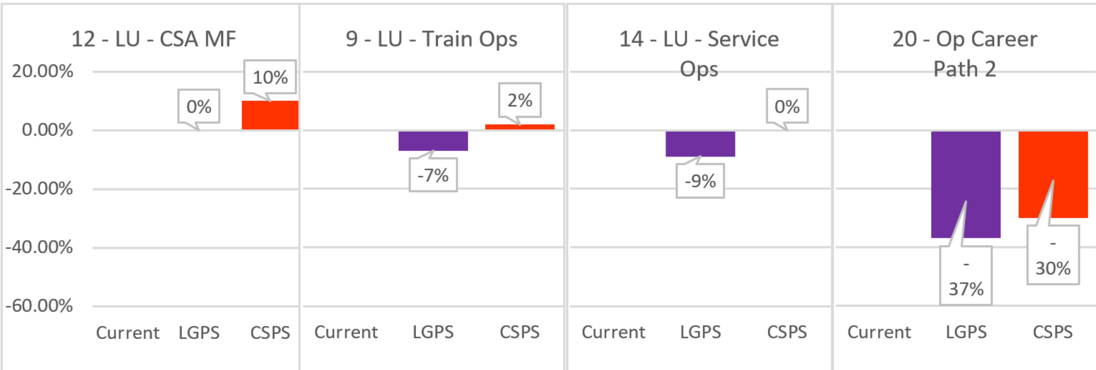
8.20. These graphs demonstrate that the member impacts of moving to comparable public sector scheme designs are far less pronounced, with materially lower average reductions to benefits (around a 5 per cent reduction, in the LGPS, on average) and in some cases, a proportion of members would be better off (as can be seen most prominantly in the CSPS). This means that the options TfL has been required to consider in order to achieve a £100m cost saving are far less generous to members than comparable public sector schemes.

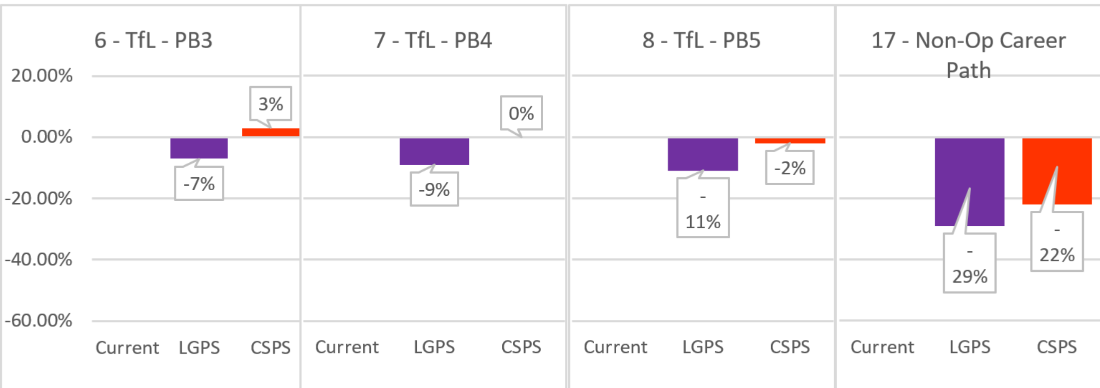
Graphs 12 and 13: Impacts on Member Pension ten years after retirement





Graphs 14 and 15: Proportionate Change in Pension ten years after retirement





8.21. It is important to note that Government's focus on a £100m cost saving target may have other implications. High levels of adverse impact on members' benefits as a result of pension reform options that aim to achieve the Government's £100m cost saving target may result in impacts on recruitment and retention of employees, particularly for those roles where there is the potential for outward labour mobility to other public sector organisations which offer more generous remuneration packages. This will need to be taken into consideration as further work is conducted and a comprehensive review of TfL's reward strategy will need to be undertaken to ensure that TfL is able to continue to attract and retain talent across the organisation. This may include looking at both fixed and variable pay elements, as well as ensuring robust market mapping analysis is undertaken.

8.22. For the avoidance of doubt, as set out in paragraph 8.15, it is TfL's view that conducting the consideration of reform, on the basis of the Government's out of date £100m cost saving target, will lead to an unacceptable level of detriment to members' benefits – this is neither reasonable nor fair. The consideration of reform should instead examine how the risk of large costs increases in the future can be mitigated in a way that is consistent with pensions available elsewhere in the public sector, while also aiming to minimise any resulting impacts on members' benefits. This would help to ensure, to the extent possible, that TfL's pension arrangements are sustainable and fair for both members and TfL going forwards.

9. Summary of Future Service Benefit Design Options Analysis

9.1. The heat maps set out in Figures 4, 5 and 6 illustrate a summarised comparison of the different benefit options modelled based on the following key criteria:

- **Affordability**: cost to TfL
- **Fairness**: impact on members' benefits and comparability to other public sector arrangements
- **Sustainability**: overall risk to TfL, as the sponsor

9.2. Consistent with the analysis presented in Sections 6, 7 and 8, this assessment compares the current position and design of the Scheme (as a private sector scheme) to the position if the alternative benefit designs were provided through an unfunded public sector pension arrangement.

9.3. As Figure 4 and Figure 6 below show, substantial reductions in risk and some savings in costs are possible through changes to the design of future service benefits, particularly when provided in an unfunded public sector scheme. Cost savings, however, reduce where there is a need to minimise the detrimental impact on members' benefits. This can be seen in Figure 4 where those options with higher accrual rates sit towards the middle of the heat map, compared to those options with lower accrual rates (noting those lower accrual rates would be required to meet the Government's £100m savings target), sitting at the right-hand side of the heat map.

9.4. Figure 5, particularly, illustrates the wholly unacceptable level of impact that would result from options that seek to meet the Government's £100m savings target against the cost of providing future service benefits; along with the fact that options which generate this level of saving, would be far less generous than comparable public sector schemes. Again, these options (with lower accrual rates) sit at the right-hand side of the heat map in Figure 5; with comparable public sector schemes, and options with higher accrual rates, sitting towards the middle and left-hand side of the heat map.

9.5. The position would be similar, but not identical, were benefits to be provided through a funded public sector arrangement. In a funded public sector scheme, the options at the lower risk end of the heat map in Figure 6 would move further towards the centre (close to the LGPS, a funded public sector scheme) – demonstrating that a step change in risk would still be possible.

9.6. The analysis set out in this paper, and the Independent Pensions Review's Final Report, highlights the complexity of the considerations in relation to reform and the careful balance that must be drawn between affordability, sustainability and fairness.

9.7. To reiterate, in TfL's view, the wholly unacceptable detrimental impact on members' benefits of seeking to achieve Government's cost saving target of £100m for future service alone, is not a fair or reasonable balance of these factors. The analysis has also demonstrated that the principal risk to the sustainability of the Scheme is the risk inherent in the management of past service liabilities. Accordingly, the consideration of reform should not be focused on short term cost savings - instead it should be focused on ensuring the arrangements are sustainable by minimising the risk of large cost increases in future, while mitigating the impact on members' benefits. Arrangements should also be fair, when compared to other public sector schemes.

Figure 4: Comparison of sponsor cost

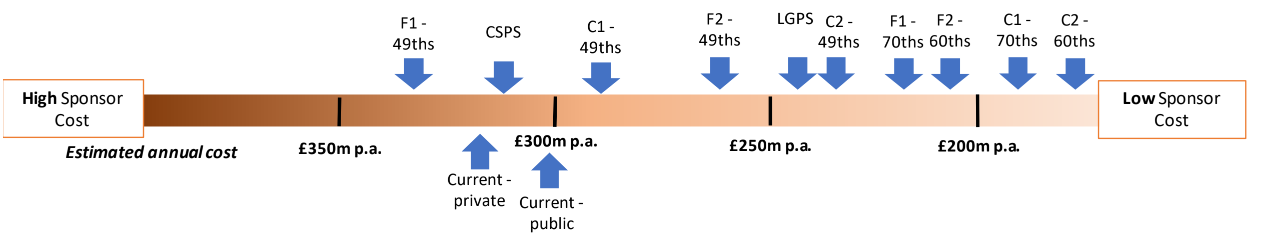


Figure 5: Comparison of member benefit

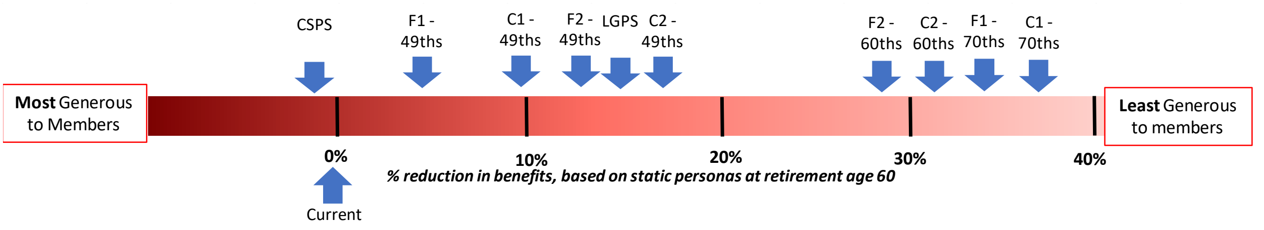
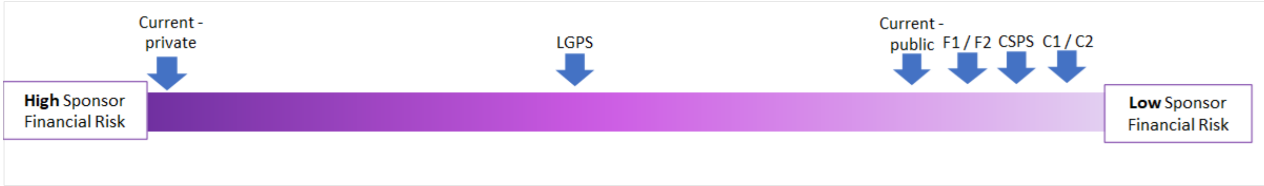


Figure 6: Comparison of sponsor risk



10. Deliverability: Government Support for Future Service Benefit Reform

Section Summary

- **Restrictive Scheme rules mean that, in practice, no reform of future service benefits, should such reform be pursued, can be delivered without Government support**
- **The Government could make use of existing legislation for this purpose, such as the powers available to it under section 31 of the Public Service Pensions Act 2013**
- **Alternatively, it would be in the Government's power to introduce new primary legislation**
- **If future benefits were to be offered in an existing public sector arrangement, then the design of that arrangement would, broadly speaking, need to be adopted**
- **If the LGPS were to be used, then this would also need the agreement of the London Pensions Scheme Authority (the LPFA)**

10.1. As set out in the 27 September paper, it is the case that, for the types of potential changes to future service benefits discussed in this paper, the Scheme rules require the agreement of Trustee, the Scheme Actuary and the majority agreement of all of the Scheme's members at a general meeting. This effectively acts as a "veto" right for members as in practice, member consent is certain to be unachievable where there would be any adverse impact on member benefits. Therefore, in virtually all future service benefit reform options, Government support will be necessary (for example, for required legislation) prior to implementation.

10.2. The 27 September paper also highlighted the difference between new joiners and existing members, where details were set out as to how the Scheme amendment power could potentially be used to change the benefits of new entrants only, after a specified date. However, there were a number of reasons why this option would not be optimal, primarily related to how changes to the way in which benefits are provided may change the maturity of the Scheme and compound the significant risk that already exists in relation to past service liabilities. The 27 September paper was clear that any reform that resulted in a closure of the Scheme to either new or existing members and therefore future accrual would have a material impact on the funding position for any past service benefits remaining in the Scheme, particularly in light of forthcoming regulatory changes. That paper set out that it is currently estimated that a closure of the Scheme to future accrual could, as a result of the need by the Trustee to de-risk the Scheme, result in a deficit of around £6bn being crystalised. This could require additional contributions (compared to today) of over £1bn per annum over 6 years (the maximum length of time tPR currently expects a scheme with a strong employer to remedy its deficit, albeit this may change in the new funding regime) or up to around an additional £700m per annum over 10 years (the maximum recovery period permitted under the Scheme rules). The additional contributions would therefore be expected to more than offset any potential savings that may be possible from the potential reform of future service, for at least the medium term, and would be so significant that they would pose a significant risk to TfL's ongoing financial sustainability.

10.3. As set out in Section 3 the impact this would have on TfL's required contributions would effectively preclude any future service benefit reform unless past service liabilities were addressed at the same time. Section 4 set out the Government support options required in relation to past service liabilities.

10.4. In terms of the deliverability of future service benefits only, there are two broad options for Government support – making use of existing legislation or introducing new legislation.

Making use of existing legislation

10.5. There are existing legislative options already in place for making changes to future service benefits under the Scheme, which would override the Scheme rules, such as the powers available to the Government under section 31 of the Public Service Pensions Act 2013 (the PSPA 2013). For example, the Government could add TfL (and its subsidiaries) to Schedule 10 of Section 31 of the PSPA 2013, which would give TfL a statutory override to any restrictions in the Scheme rules and enable TfL, at a date of its choice, to amend the Scheme to stop the future accrual of benefits. HM Treasury could deliver this by issuing an Order for TfL to be added to Schedule 10. The Order would be subject to the negative procedure (namely, the Order needs to be laid before both Houses of Parliament and will pass automatically into law without debate unless there is an objection from either House).

10.6. Section 31 of the PSPA 2013 anticipates that, if eligible for one of the existing public sector pension schemes, current employees would join that scheme for future pensions provision. If this is not the case, TfL could establish a new pension scheme, but this would require the agreement of the Government and would still need to be a CARE scheme. This route could not, therefore, be used to introduce any new Final Salary based benefit structure for future service.

10.7. In relation to paragraph 10.6, were the LGPS (a CARE scheme) to be used for future service benefits, an employee must be employed by a body listed in Schedule 2 of the Local Government Pension Scheme Regulations 2013 (the LGPS Regulations 2013) and be designated as being eligible for membership. TfL is already listed for this purpose and the relevant administering authority is the London Pensions Fund Authority (LPFA). TfL already has some current and former employees with benefits in the LGPS.

10.8. However, none of TfL's subsidiaries are listed in Schedule 2 of the LGPS Regulations 2013, so it would be necessary for them to come within the definition of an "admission body". There would be a number of routes available for TfL's subsidiaries to become an admission body, which would need to be considered and agreed with the LPFA. Further consideration of this option would be required but, in this scenario, it is likely that TfL or possibly the Government would be required to provide some form of bond, indemnity or guarantee to the LPFA in respect of TfL's subsidiaries' liabilities in the LGPS.

Introducing new legislation

10.9. The Government is, of course, free to develop an entirely new legislative mechanism to support any potential changes in respect of future and past service benefits under the Scheme or an entirely new pension arrangement.

10.10. In practice, this is the only route available to introduce a new (or amended) Final Salary benefit structure for future service.

10.11. Table 12 below sets out a comparison of different delivery routes for potential future pensions reform.

Table 12: Comparison of Different Delivery Vehicles for Potential Future Service Benefit Reform

Vehicle	Advantages	Disadvantages
New section of the Scheme	Structure already exists, so lower set up costs Providing CARE or Amended Final Salary benefits within a new section of the Scheme would reduce (but not remove) the risk the Trustee will immediately change their investment strategy to reflect maturing membership (if past service remains within the Scheme and does not transfer to Government or the LGPS). However, this does not address the unnecessary cost and risk TfL faces due to the private sector nature of the Scheme TfL could design the benefit structure in consultation with the Government	The Scheme rules are very restrictive and would need to be carved out of any new section. This may be difficult to achieve in practice. Would still require legislation in order to overcome restrictive Scheme rules for changes to the provision of future benefits The Trustee may seek to de-risk to some extent (even with a new section) due to the reduction in future accrual and this could cause an unaffordable increase in past service liabilities The Scheme would remain a private sector scheme under the purview of tPR and thus would be expected to fund pensions as if it were a normal private sector scheme with increasing levels of prudence and hence at a potentially substantial premium to the cost of providing the same or similar benefits in the public sector Continued substantial risk of significant past service deficits if past service is not addressed Continued separate administration costs of retaining a TfL arrangement Would require Government support to either use existing PSPA 2013 power or legislate for new statutory override
Existing Public Sector Arrangement	Structures already exist Effectively removes TfL from purview of tPR (if past service is also transferred) and removes/reduces risk in relation to past service if transferred at the same time Ensures alignment with majority of public sector - If an unfunded arrangement is used (e.g. the CSPS) then contributions would remain relatively low and predictable	TfL would have limited control over the benefits provided to employees and any changes to that over time TfL would have limited control over how contribution rates change over time The Trustee would seek to de-risk its investment strategy if past service benefits are not transferred or otherwise managed at the same time as future service benefits are transferred to a new arrangement, which would significantly increase past service costs, as described in paragraph 10.2 above Government legislative support would be required, in practice.

	Established governance requirements are likely to lead to efficiencies in administration costs TfL already has current and former employees in the LGPS	If the LGPS were used, some form of bond, indemnity or guarantee to the LPFA in respect of TfL's subsidiaries' liabilities may be required
New standalone Arrangement	Could be set up to be as flexible as TfL require, within reason Would ideally be set up to be classified as a public sector scheme, potentially on an unfunded basis, if legislative provision were made for this thus also removing/reducing past service benefit risk if this is transferred at the same time Separate from other Government schemes	More set up requirements than other options. The Trustee would seek to de-risk its investment strategy if past service is not transferred or otherwise managed at the same time as future service is transferred to a new arrangement, which would significantly increase past service costs, as described in paragraph 10.2 above If not possible to set up as a public sector scheme, it would remain a private sector scheme under the purview of tPR unless otherwise agreed with Government (e.g. by the provision of a Crown guarantee) and thus would be expected to fund pensions as if it were a normal private sector scheme with increasing levels of prudence and hence at a potentially substantial premium to the cost of providing the same or similar benefits in the public sector Government legislative support would be required

11. Employee Considerations

Section Summary

- **The current pension arrangements are highly valued by employees**
- **Any changes, should they be proposed, would need to be considered concurrently with TfL's wider reward and remuneration policies**
- **Pensions and employment law places significant obligations on employers to inform and consult with affected members and their representatives when making changes to future service benefits or contribution levels**
- **Any options that impact employees' future service benefits will require a minimum 60-day statutory information and consultation process; although, in practice, this is likely to take longer**
- **Any options for reform will need to further consider how "Protected Persons" are treated to ensure compliance with their statutory protections**
- **Any options for reform would need to avoid issues in relation to intergenerational fairness**

11.1. As the Final Report highlights, apart from salary, pensions provision currently represents one of the principal benefits offered to TfL employees. It will be important to consider how pensions provision is valued by different groups of employees; noting that the workforce is more transient than when the Scheme was first set up and tax rules on pensions can be prohibitive for high earners.

11.2. Reducing the value of the pensions benefit may impact recruitment and retention and, as this paper has already set out, any proposals that may be considered going forward will need to be assessed as part of TfL's wider remuneration policy and TfL's wider business planning process, and not in isolation of it.

11.3. It is also the case that distributional impacts of any proposals will need to be considered; to ensure that reforms are fair across the scheme membership (for example, in relation to age, gender and other characteristics). If proposals for reform are pursued, this will require extensive modelling and analysis of impacts on a detailed basis.

11.4. The impact of the consideration of any proposed changes to pension benefits from an employee relations perspective should not be underestimated. The pension benefit is highly valued by employees, and there is a risk of disruption to TfL's network if detrimental changes are proposed.

11.5. Pensions and employment law places significant obligations on employers to inform and consult with affected members and their representatives when making changes to future service benefits or contribution levels. There is also a more generally applicable, but very important, employment law obligation placed on TfL to deal with its employees in a manner which does not breach the implied duty of trust and confidence.

11.6. There are a number of significant interrelated employment law issues which must be considered, many of which are summarised in the Independent Pensions Review's Final Report. In particular:

a. the terms of employees' employment contracts;

b. the trade union recognition agreements – duties to consult collectively regarding pension arrangements;

c. any relevant employment law consultation obligations (depending on the method used to effect the pensions change); and

d. the implied mutual duty of trust and confidence

Employment contracts

11.7. Depending on how the proposed changes are implemented, consideration will need to be given as to whether there are any terms of individual employees' employment contracts which provide any specific contractual entitlement in respect of future service benefits (such that individual agreement would be required prior to any changes).

11.8. While many employees are subject to standard employment contracts, given the number of employees within TfL, and the fact that TfL has amalgamated several different entities during its history, this review could take a considerable length of time to ensure nothing has been missed.

Trade Union and Other Consultation Requirements

11.9. All options that impact employees' future service benefits will require a minimum 60-day statutory information and consultation process. Where there are impacts to the overall level of benefits an employee receives this is expected to take longer and industrial action is likely.

11.10. The options set out in this paper (excluding the comparison to the current arrangements) would be subject to these consultation requirements (including any necessary employment consultation). These may be summarised as follows:

a. TfL will need to inform affected members and their trade union representatives about the proposed changes to future service benefits;

b. TfL will need to consult with the affected members' trade union representatives and other representatives (for any who are non-unionised) about the proposed changes to future service benefits, using our existing union engagement arrangements, rather than individually with the affected members; and

c. Consultation will need to be meaningful and is likely to extend significantly past the statutory 60-day minimum period in order to consider and respond fully to any representations made.

11.11. Given the complexity of pensions and the potential impact on members' benefits, in TfL's view, it may need to provide the opportunity for affected members' to receive independent financial advice or guidance, which would need to be provided at TfL's expense.

Implied Mutual Duty of Trust and Confidence

11.12. TfL will need to ensure that it complies with the implied duty of trust and confidence that it owes to the affected members. In particular, TfL will need to consider whether any "reasonable expectations" may have been engendered for affected members, that certain changes will not be made to the Scheme, in which case any proposed changes to pensions benefits and consultation about them will need to be conducted carefully in this context. This will necessitate a substantial review of all past communications that have been made to employees on pensions related issues.

Protected Persons

11.13. Statutory protection is afforded to certain members of the Scheme (which we understand there are around 1,700 currently) who, having been employed by London Regional Transport or one of its subsidiaries, became employees of a private sector company as a result of certain private sector outsourcings which occurred between 20 March 1998 and 31 March 2002; these include employees who transferred to Metronet BCV Limited, Metronet SSL Limited and Tube Lines Limited under the Underground PPPs.

11.14. The relevant provisions are set out in Schedule 32 of the Greater London Authority Act 1999 and the London Transport Pension Arrangements Order 2000.

11.15. These individuals are referred to as "protected persons" and, in summary, they are each provided with the following statutory rights:

a. while they are employed in the London underground railway industry, they are entitled to remain as active members of the Scheme;

b. while their period of continuous employment remains unbroken, their employer must provide them with access to an occupational pension scheme which complies with the requirements described in paragraphs (c) or (d) below;

c. where the Scheme is used, the pension rights which accrue in respect of the protected person's service after transferring to the private sector must be "overall materially at least as good" as those which were accruing for them under the Scheme immediately before their transfer to the private sector; and

d. specific, equivalent provision is made for the position where another pension scheme is used.

11.16. Any options for reform of the Scheme will need to further consider how this group of members is treated to ensure compliance with the statutory protection.

Intergenerational Fairness

11.17. In addition, any reforms would need to avoid issues in relation to intergenerational fairness, particularly in any transitionary arrangements that may apply to any changes or to the way in which past service benefits are protected. This is an issue that the Government is now having to resolve itself in relation to public service pensions reform transitional arrangements following the McCloud and Sargeant litigation.

11.18. Intergenerational fairness may also potentially be an issue if pension arrangements for the purposes of future service benefits were amended only for new joiners. This would create “two-tier” pension arrangements which may, depending on the age distribution of new joiners, adversely impact younger members disproportionately.

11.19. If reform were to be pursued, individual impact assessments would need to be conducted alongside a full Equality Impact Assessment.

12. Next Steps

12.1. This paper has addressed the second of the deliverables required by the Government in accordance with paragraph 39 of the Agreement.

12.2. TfL will now need to work collaboratively with the Government to continue with the further work that is required to meet the requirements of paragraph 40 of the Agreement, which states that TfL and the Mayor will agree with the Government a final detailed proposal for any recommended changes to both future service benefits and past service liabilities, and an implementation plan by no later than 31 January 2023.

12.3. During the period between the submission of this paper and 31 January 2023, it will be vital that the Government consider, discuss and agree with TfL whether or not the support from the Government that is necessary in order to address both past service and any potential future service benefit reform will be made available. Without such support, TfL will, in practice, be precluded from further consideration of future service benefit reform.

Appendix 1: 27 September Submission

The 27 September paper, setting out TfL’s response to the Independent Pension Review’s Final Report, is available at the following link:

https://content.tfl.gov.uk/tfl-response-to-pension-review-final-report.pdf

Appendix 2: Analysis of moving to a public sector arrangement

This analysis shows the potential surplus if the Scheme were to be transferred to a public sector pensions arrangement, either funded (e.g. LGPS) or unfunded (e.g. CSPS).

This analysis reflects new information on the approach to the 31 March 2022 actuarial valuation of the London Pensions Fund Authority (LPFA) Pension Fund , which sets out the intended discount rates that will be used for the 2022 actuarial valuation depending on covenant grade, and the final results of the actuarial valuation of the Scheme as at 31 March 2021 (the “2021 valuation”).

The table below shows the impact on the surplus of the Scheme, if the proposed LPFA discount rates were adopted. No other assumptions have been changed from those used for the 2021 valuation.

TfL Pension Fund: Funding position at 31 March 2021	2021 valuation	LPFA – covenant grade A	LPFA – covenant grade B1
Assets (£m)	13,085	13,085	13,085
Liabilities (£m)	12,906	11,011	11,885
Surplus (£m)	**179**	**2,074**	**1,200**
Discount rate approach	RPI + 0.9 per cent per annum trending down to RPI + 0.6 per cent per annum over 7 years	CPI + 2.5 per cent per annum	CPI + 2.1 per cent
Equivalent discount rate approach relative to gilt yields	Gilts + 2.2 per cent	Gilts + 3.5 per cent	Gilts + 3.1 per cent

This suggests a surplus of £1.2bn - £2.1bn as at March 2021 would be revealed if the LPFA’s approach to setting the discount rate were adopted, with the range depending on the covenant grading given to TfL, as the Scheme’s sponsor. Covenant grading A could be justified given the nature of TfL’s covenant and hence it is likely that in this scenario the surplus would be at the top end of the range. We have therefore used a figure of £2bn for the commentary in this paper about the expected funding position on a public sector type funding basis.

At its 2016 actuarial valuation, the CSPS used a discount rate of CPI + 2.4 per cent per annum to value future pension payments. This would lead to a surplus towards the higher end of the £1.2bn - £2.1bn range quoted above. Please note that the CSPS is an unfunded arrangement and so does not have a formal surplus / deficit position like the LGPS.

Appendix 3: List of Pension Schemes with a Crown Guarantee

The following pension schemes benefit from a Crown Guarantee:

- The BT Pension Scheme
- The Mineworkers Pension Scheme
- The British Coal Staff Superannuation Scheme
- The 1994 Pensioners Section of the Railways Pension Scheme
- The BR Section of the Railways Pension Scheme
- The BR Superannuation Fund
- The BR (1974) Pension Fund
- The CAB International Superannuation Scheme
- The Local Enterprise and Development Unit (LEDU) Retirement and Death Benefit Plan
- The National Museum of Wales Pension Scheme
- The National Library of Wales Pension Scheme
- The BAE Systems Pension Scheme
- The Remploy Limited Pension and Assurance Scheme
- The Atomic Weapons Establishment Pension Scheme

Appendix 4: Comparison of the Scheme to Other Pension Arrangements Available in the Public Sector

COMPARATOR PENSION ARRANGEMENTS	Pension Arrangements within the GLA Group				Network Rail - CARE Scheme	TfL Pension Fund
	LGPS	CSPS	Police	Fire Fighters		
Provision	Defined Benefit	Defined Benefit	Defined Benefit	Defined Benefit	Defined Benefit (shared cost)	Defined Benefit
Reformed	Yes	Yes	Yes	Yes	Yes	No
Employee Contribution Rate	5.50 per cent - 12.50 per cent	4.60 per cent - 8.05 per cent	12.44 per cent - 13.78 per cent	11.00 per cent - 14.50 per cent	7.24 per cent	5.00 per cent
Employer Contribution Rate	15.20 per cent*	26.60 per cent - 30.3 per cent	31.0 per cent	28.80 per cent	10.86 per cent	27.3 per cent
Benefit Structure	CARE	CARE	CARE	CARE	CARE	Final Salary
Accrual Rate	$1/49^{th}$	$1/43.1^{th}$	$1/55.3^{th}$	$1/59.7^{th}$	$1/60^{th}$	$1/60^{th}$
Indexation Basis (pre-retirement)	CPI	CPI	CPI + 1.25 per cent	Average Weekly Earnings	CPI	RPI
Indexation Basis (post-retirement)	CPI	CPI	CPI	CPI	CPI (max 5 per cent)	RPI (max 5 per cent)
Normal Retirement Age (NRA)	SPA	SPA	60 (public sector pension reforms maintained a lower NRA for uniformed services) If member leaves service, NRA is deferred to SPA	60 (public sector pension reforms maintained a lower NRA for uniformed services) If member leaves service, NRA is deferred to SPA	65	65, unreduced from age 60

** LGPS employer contribution rate differs for each employer in practice. The 15.2 per cent in the table above reflects the LPFA's contribution rate as agreed for the 2019 valuation (the 2022 valuation is currently ongoing)*

Appendix 5: Modelling Assumptions

All calculations have been carried out by TfL's actuarial advisors, XPS Pensions Group

Modelling of different options for future service

Methodology

- All calculations are carried out with an effective date of 31 March 2021 and are in respect of future service only.
- Membership data has been used for the active members of the TfL Pension Fund as at 31 March 2021.
- Future service cost calculations have been carried out using XPS's valuation software, PFaroe, using the assumptions set out below or as otherwise stated.
- The Projected Unit method with a 1 year control period has been used.
- The future service costs shown make no allowance for expenses relating to administration.

Actuarial assumptions

- The assumptions used in the modelling are taken from the Statement of Funding Principles (dated 31 March 2022) for the 31 March 2021 actuarial valuation of the TfL Pension Fund, which can be found at the following link: https://content.tfl.gov.uk/tflpf-statement-of-funding-principles-public-sector-section-march-2022.pdf
- These assumptions include term-dependent rates for discount rate, RPI and CPI inflation, Pensionable Pay increases and increases to pensions in payment.
- For option designs where an NRA has been set to State Pension Age, each member's State Pension Age has been determined based on their date of birth and sex and allowing for current expectations for how and when the State Pension Age will increase in future. The estimated weighted average State Pension Age for the active membership is 67 years and 4 months. For these scenarios, we have not made any allowance for early retirement.

Notes on results

- The results shown are in terms of the balance of cost met by TfL after deducting the member contributions.
- Furthermore, these costs have been shown as annual £ amounts, based on the total Pensionable Salaries of the active membership as at 31 March 2021 which were approximately £1,170,000,000.

Example member outcomes modelling

Methodology and assumptions

- All calculations are in respect of future service only.
- The modelling is based on specific members from the personas detailed in the report titled "TfL Independent Pensions Review – Final Report" dated March 2022.
- The analysis looks at the pension that would be accrued over 13 years of future service, and allows for 10 years' worth of pension increases in retirement.
- Calculations have been carried out assuming a retirement age of 60 for each member, with early retirement factors as appropriate.

- Salaries provided have been used as the initial salary in the calculations. It has been assumed the first salary increase for each member applies at the start of year 2, and applies at the start of each year going forwards. For example, a member with 13 years future service is assumed to receive 12 salary increases up to retirement.
- Each tranche of CARE accrual has been calculated based on the salary at the start of each year.
- For scenarios modelled using a tiered contribution structure, the structure currently used by the LGPS has been applied. The contribution rate has been determined by "actual pensionable pay" in each year, not the full time equivalent salary. It has been assumed that the tiered pay bands increase in line with CPI each year. This tiered contribution structure is detailed below. Under the active membership of the Scheme as at 31 March 2021, this gives an average contribution rate of 7.97 per cent per annum

    - Up to £14,600 = 5.50 per cent
    - £14,601 to £22,900 = 5.80 per cent
    - £22,901 to £37,200 = 6.50 per cent
    - £37,201 to £47,100 = 6.80 per cent
    - £47,101 to £65,900 = 8.50 per cent
    - £65,901 to £93,400 = 9.90 per cent
    - £93,401 to £110,000 = 10.50 per cent
    - £110,101 to £165,000 = 11.40 per cent
    - £165,001 or more = 12.50 per cent

- If TfL consider tiered contribution structures further, the applicability of the LGPS structure would need to be calibrated against the specifics of TfL's workforce to ensure that it is appropriate.
- For scenarios using the SPA it has been assumed this will be 67 for all members. This is line with the average SPA for the Scheme membership and is the expected SPA for a member currently aged 47 and assumed to retire at age 60 with 13 years' service.
- For the purposes of simplicity, no allowance has been made for members to take cash at retirement.
- Under the calculations a retirement age of 60 is assumed, and so early retirement factors have been applied where applicable (5 year factor for NRA 65 and 7 year factor for SPA, assumed to be age 67 as set out above). These factors have been calculated using the assumptions set out in the Statement of Funding Principles (dated 31 March 2022) for the 31 March 2021 actuarial valuation of the TfL Pension Fund.
- The early retirement factor used in options F1 and C1 was 0.79 and the early retirement factor used in options F2 and C2 was 0.72. The value of any salary increases given up under F1 and F2, which some trustees reflect when setting factors (although currently the same early retirement factors are used in the Fund for both active and deferred members), have not been taken into account.
- The early retirement factors used in LGPS option is 0.71 and the early retirement factor used in CSPS option is 0.687. These are in line with current factors used by the public sector schemes.
- For the purposes of the member outcome calculations the following assumptions have been used:
    - RPI/Salary growth = 3.70 per cent per annum
    - RPI maximum 5 per cent per annum for increases in payment = 2.95 per cent per annum
    - CPI uncapped for revaluation / increases in payment = 3.00 per cent per annum

  - CPI maximum 5 per cent per annum for revaluation / increases in payment = 2.95 per cent per annum

- Salaries are assumed to increase in line with RPI inflation.
- It has been assumed that all members are currently 'New Members' as defined in the TfL Pension Fund Rules, i.e. a member who joined the Fund after 1 April 1989. This means that the member's increases in retirement are capped at 5 per cent a year. It also means that their pensionable salary is determined by their basic salary less a deduction equal to the Lower Earnings Limit (LEL).
- The LEL for the 2021/22 tax year is £6,240 and this is assumed to increase in line with CPI inflation each year.
- The Earnings cap for the 2021/22 tax year is £172,800. This has been assumed to increase in the same way as salaries. We have assumed that all members would be affected by the Earnings Cap, i.e. are "Class A" members as defined in the TfL Pension Fund rules.

Example member outcome modelling allowing for past service

- Each member has a total of 35 years' service
- The benefits under each example are in line with Option F1, with an accrual rate of 1/70th
- Each member is assumed to remain within the same Payband throughout their career.
- In the examples, past service benefits are assumed to increase in line with RPI up to retirement.
- For future service, salary has also been assumed to increase in line with RPI.
- The 'Percentage differences' in Table 10 have been assessed accurately in line with the assumptions above and these impacts have then been applied to an example pension of £10,000 per annum for all member scenarios.
- The £ figures within the table have been provided for illustration purposes only.

Appendix 6: Details of benefit design options

	Current	F1	F2	C1	C2
Type of scheme	Final Salary	Final Salary	Final Salary	CARE	CARE
Normal retirement age	65 (unreduced from 60)	65	SPA	65	SPA
Accrual rate	1/60	Ranging from 1/70 to 1/49	Ranging from 1/60 to 1/49	Ranging from 1/70 to 1/49	Ranging from 1/60 to 1/49
Pensionable salary definition	Basic Salary less LEL				
Pensionable salary cap	£172,800 per annum				
Revaluation of accrued pension pre-retirement (CARE revaluation)	N/A	N/A	N/A	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum
Revaluation of deferred pension pre-retirement	RPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum
Indexation of pensions in payment	RPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum	CPI capped at 5 per cent per annum
Member contribution rate structure	Fixed 5 per cent	Fixed 5 per cent	LGPS tiered structure	Fixed 5 per cent	LGPS tiered structure