Cheshire East Council

Cabinet Member for Finance and Assets

Date of Meeting: 10 June 2016

Report of: Chief Operating Officer (Section 151 Officer)

Subject/Title: Pensions Settlement with Cheshire East's wholly owned and controlled companies

Portfolio Holder: Peter Groves, Finance and Assets Portfolio Holder

1. Report Summary

1.1. This report proposes that the Council revises the pensions' arrangement with its wholly owned and controlled companies. The proposal is that ANSA, Orbitas, Civicance and Transport Service Solutions move to a pensions 'pass through' arrangement, back dated to 1st April 2015, whereby all the pensions' assets and liabilities that have nominally been allocated to each company are transferred back to the Council. The new arrangement is often implemented when a Council awards a contract to a private sector company. This approach will also ensure that the financial position of the companies is improved via a stronger balance sheet and higher operating profits. The potential risks of this proposed course of action are considered with mitigating actions identified.

2. Recommendation

2.1. That the Portfolio Holder for Finance and Assets approves the set up of a pensions 'pass through' arrangement with ANSA, Orbitas, Civicance and TSS backdated to 1st April 2015 with all pensions' assets and liabilities currently allocated to these companies transferring back to the Council.

2.2. That the Portfolio Holder for Finance and Assets approves the 'pass through' arrangement as the default settlement for all future controlled companies (to include the Skills and Growth Company) that the Council may set up.

2.3. That the Portfolio Holder for Finance and Assets authorises the Chief Operating Officer to enter into agreements with the companies and the Cheshire Pension Fund to deliver the pensions' 'pass through' arrangement.

2.4. That the financial benefits released from company balance sheets of the 'pass through' arrangement are retained in the ring fenced fund reserved for use by the Council's companies and controlled by Cheshire East Residents First Ltd.

3. Other Options Considered

3.1. Do nothing – the continuation of the existing pensions arrangement will result in the continuation of the current accounting anomaly whereby our companies have a past service pensions deficit on their balance sheets but funding in relation to the deficit rests with the Council. This, when combined with the likelihood of continuing low discount rates, will mean that our companies will struggle to deliver a net operating profit in the next few years. This is because the accounting entries required under the current arrangements will significantly reduce reported operating profits. In addition the continued existence of large pension deficits on the balance sheets of our companies may hamper their ability to successfully trade with other companies and win new business in the future.

3.2. Ameliorate the worst impact of the low discount rate used by the actuary to value liabilities. Our companies could ask for revised actuarial reports that show a lower net pensions liability; this would result in a relatively small improvement in the reported financial position of the companies. However, this option could result in the accounts of both the company and the Council being qualified by the Auditor if they disagree with the assumptions made that underpin the revised figures. This option has therefore been discounted as it is considered to be a high risk and it will only reduce rather than solve the current problem.

4. Reasons for Recommendation

4.1. The current pensions settlement between the Council and the companies was intended to ensure that pensions' risks were shared equitably between the parties in such a way that the companies would not be penalised financially for past pension funding decisions and the companies would be able to operate effectively in the market place. This sharing of risks was buttressed by the Council through the provision of an overarching guarantee to the Cheshire Pension Fund that the Council would meet any pensions obligations that our owned and controlled companies were unable to meet.

4.2. The dual impact of changes in accounting standards and a huge downturn in corporate bond yields have meant that the existing pensions settlement is no longer fit for purpose and needs to be recast. The companies do now have significant pensions liabilities relating to past service deficits on their balance sheets and even though these are unrealistic and artificial, they are having a real impact on the finacial viability of our companies. Put simply, it was never the intention that our companies would carry large past service pensions deficits on their balance sheets and the proposed 'pass through' arrangement removes these deficits from their accounts.

4.3. The pass through solution enables all pensions assets and liabilities to be transferred back to the Council where different accounting rules apply. These accounting rules mean that the existence of a large pensions deficit does not impact on the broader financial position of the Council – its impact is contained to a ring fenced pensions reserve and there is therefore no impact on the revenue account of the Council and hence Council Tax payers are protected from the immediate impact of funding the deficit.

4.4. On the company side the revised arrangement means that the companies effectively account for the pensions scheme as though they were contributing to a defined contribution scheme; the company will just show its annual employer contributions to the scheme in its Profit and Loss account and no further accounting entries are required. This has the advantage of ensuring that all deficits are consolidated on the Council's balance sheet and correctly aligned with the funding of this deficit.

4.5. The proposed treatment has been shared with both sets of external auditors – the private arm of Grant Thornton, who audit the Council's companies and the public sector arm, who audit the Council. Discussions are ongoing with both teams but neither have raised any concerns to date and no objections are expected. The private sector arm of Grant Thornton have indicated that the proposal should improve the accuracy of our financial reporting by ensuring that the accounting and funding of past service liabilities is undertaken in a more consistent manner.

4.6. Table 1 below shows the position of the companies before and after the pass through agreement.

Company position before Pass Through agreement

	Balance Sheet 31.03.2016	Profit & Loss Account - 2015-16			
	Pension Liability (Deficit) £'000	Draft Net Operating Profit £'000	IAS19 Current Service Adj £'000	IAS 19 Net Interest Cost £'000	Net Profit / (Loss) £'000
Ansa Environmental Services Ltd	(4,956)	250	(771)	(308)	**(829)**
Orbitas Bereavement Services Ltd	(535)	54	(74)	(28)	**(48)**
Transport Service Solutions Ltd	(162)	40	(106)	(27)	**(93)**
Civicance Ltd	(96)	195	(40)	(28)	**127**
Net Liability	**(5,749)**	**539**	**(991)**	**(391)**	**(843)**

Company position after Pass Through agreement

	Balance Sheet 31.03.2016	Profit & Loss Account - 2015-16			
	Pension Liability (Deficit) £'000	Draft Net Operating Profit £'000	IAS19 Current Service Adj £'000	IAS 19 Net Interest Cost £'000	Net Profit /(Loss) £'000
Ansa Environmental Services Ltd	0	250	0	0	**250**
Orbitas Bereavement Services Ltd	0	54	0	0	**54**
Transport Service Solutions Ltd	0	40	0	0	**40**
Civicance Ltd	0	195	0	0	**195**
Net Liability	**0**	**539**	**0**	**0**	**539**

Net Improvement in Company Financial position	**5,749**	**Net Improvement on reported Profits**	**1,382**

5. Background/Chronology

5.1. When the first wave of Council owned and controlled companies were set up in April 2014 a pensions settlement was negotiated between the Council and the companies. The most important principle underpinning this settlement was that the companies would not be responsible on an ongoing basis for a share of the Councils' past service deficit. The Council currently has a net pension's deficit of £267m and insisting that our companies take an appropriate share of this libility would have meant that the companies would have been financially unstable from day 1. Therefore, Cabinet agreed on 24th March 2014 that all companies would be 'fully funded' in respect of their share of the past service deficit. For example, on the formation of ANSA staff TUPE transferred from the Council to the company and the actuary calculated that the cost of the pensions benefits earned by staff up to the point of transfer was £19.854m. Had the new company taken its 'share' of the Council's overall deficit the company would have been allocated insufficient assets to cover its liabilities, resulting in a company pensions deficit of either £3.8m or £12.4m (depending on treatment of deferred pensioners). The Council and company agreed to avoid this scenario by allocating assets from the Council to the company sufficient to cover all past service liablities at the point of formation.

5.2. The above settlement ensured that all Council owned companies could function effectively on day 1 and were not hampered by significant deficits. However, this picture started to change when the first year end accounts at the end of 2014-15 were produced. These accounts showed that all our companies now had a large opening deficit which was subject to volatility and which was unrelated to their ongoing pension contributions to the Fund. Furthermore, the deficits would hamper their ongoing financial performance. The reasons why such significant deficits arose at the end of 2014-15 is explained by a combination of a change in accounting standards and actuarial assumptions. Appendix 1 contains a fuller explanation.

5.3. The net impact of these two factors has had a detrimental impact on the accounts of our companies over the past two years and has impacted on both the balance sheet and the proft and loss accounts of the companies. The net impact means that between 2014-15 and 2016-17, our companies take a real hit of £2m on their profit and loss accounts and this cost flows through to impact on the Council through the proft/loss share agreement that is in place. As a result over £2m of revenue funding would be tied up on the companies balance sheet. The proposed solution removes this impact, and thereby frees up this £2m to be applied more constructively by the Council/companies.

6. Wards Affected and Local Ward Members

6.1. Not applicable.

7. Risk Management & Implications of Recommendation

7.1. There are several potential risks that have to be considered as a consequence of the pensions pass through arrangement. The Council will now be reporting a higher net pensions liability than prior to the pass through arrangement. However, this does not represent a real material increase in the risk taken on by the Council as the Council is already the guarantor of all pension liabilities both for itself and for all controlled companies. In addition, the incorporation of a higher net pension's liability on the balance sheet of the Council does not have any broader impact on the financial standing or performance of the Council.

7.2. Further details of the confidential legal advice received are attached at Appendix 2.

8. Access to Information

8.1. *IAS19 reports produced by Hymans Actuary for ANSA, Orbitas, TSS and the Council.*

9. Contact Information

Contact details for this report are as follows:-

Name: Peter Bates
Designation:Chief Operating Officer
Tel. No.: 01270 686013
Email: peter.bates@cheshireeast.gov.uk

Appendix 1

Explanation of why pensions deficits arose in Cheshire East's controlled Company's Accounts

The reasons why our companies moved from a net nil pensions deficit on formation to significant deficits reported in their accounts at the end of 2014-15 and 2015-16 can be summarised over two main headings:

i) <u>The change in the valuation bases used by the Actuary</u>

The initial actuarial assessment on the formation of each company was done on what is called a 'valuation' basis. This approach looks at the costs of future liabilities i.e. the cost of paying a pensioner for the next 30 years and discounts this back to a current day value so that a valid comparison can be made against assets held (assets can easily be valued by reference to current market prices). Critically, the discount rate used by the actuary here takes account of the mix of assets held by the pension fund and assumes a realistic rate of return on these assets informed by past performance. Unfortunately, when the actuary moves to value liabilities for accounts purposes this realistic assumption is disposed of and instead the actuary discounts future liabilities in line with the return on high quality corporate bonds. This unrealistic assumption of future returns is specified by the International Accounting Standard 19 which seeks to show pensions liabilities with all risk filtered out.

The net result of this is that the pensions liabilities shown in the accounts are artificially inflated and bear no relation to the real level of liabilities as used by the actuary in assessing real cash contributions. The full extent of this mismatch between the real level of pensions liabilities and those shown in the accounts has been hugely exacerbated by the massive decline in discount rates (as determined by yields on high quality corporate bonds) over the past 2 years.This decline is linked to the continuing after effects of the 2008 financial crash and the ongoing high level of quantitative easing undertaken by many major economies. This has made the market in high quality corporate bonds relatively illiquid and driven down corporate bond prices and yields. This was not foreseen when the original pensions settlement was reached with the Council's owned companies.

ii) <u>The change in accounting standards</u>

In 2014-15 most private sector companies, including those owned by Cheshire East Council, moved from the previous Financial Reporting Standard 17 to the new International Accounting Standard 19. Adoption of the new standard is now compulsory as part of the move to harmonise accounting standards worldwide. This move meant that the accounts of companies could no longer show any benefit from the fact that the return on real assets held to meet pensions liabilities have and would continue to be considerably above the yields of corporate bonds. This exacerbated the impact on net profits of most companies with defined benefit pension schemes.