Pensions – the elephant in the corner?

Bart Huby, Partner and Head of Public Sector Outsourcing at consulting actuaries Lane Clark & Peacock, explains how companies in the PFI/PPP market are facing up to the challenges of the Government's Fair Deal rules on pensions…

The large majority of companies no longer offer new employees a final salary pension scheme (the norm is now a money purchase pension). 10 years ago, however, most reasonably sized companies did – so why the change? Essentially, companies now recognise the financial risks in providing final salary pensions. Having been bitten once in recent years by a variety of factors that combined to produce substantial funding deficits, many now no longer want to take those risks.

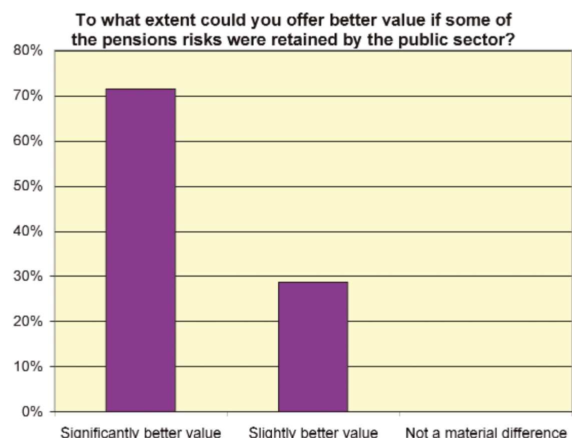
The Fair Deal

Yet the public sector continues to offer its employees high quality final salary pensions (even if the latest proposed changes to retirement ages are ever made). And if those employees transfer under TUPE to a private sector employer on a PFI/PPP contract, the new employer is required, by what are known as the Government's Fair Deal rules, to provide a final salary pension of similar value.

The Government set up the Fair Deal in the late 1990s to ensure that the pension expectations of public sector employees are protected when they transfer to a new private sector employer. Over the years, these standards, together with more general legislative developments affecting occupational pensions, have gradually become more and more onerous.

> *'The Treasury's aim is to pass on to outsourcing companies the whole of the pensions risks, and believes the private sector is at least as well placed to manage these risks as the public sector.'*

So how are companies in the PFI/PPP market responding to this issue? Are they properly allowing for the additional pensions risks that come with the Fair Deal rules when pricing their contract bids, or is it the elephant in the corner? – 'if we don't look at it, it may just go away'. To find out, Lane



Clark & Peacock have carried out a major study, the first of its kind in the UK.

Our study involved a 20 question survey that was issued to a wide range of organisations operating in this area. We followed this up with in-depth interviews with a sample of 12 of the respondent firms to obtain a fuller understanding of their attitudes and experiences. Finally, we met with senior civil servants from both the Treasury and the Government Actuary's Department (GAD), who have been heavily involved in setting up and applying Government policy in this area, to discuss the results of the survey. Our report, 'PFI/PPP Pensions Study 2006',[1] contains the full survey results with our analysis. We are also very pleased that

continued to p.14…

…continued from p.12

the Treasury allowed us to include their viewpoint on many of the key issues.

Main findings

For the large majority of companies participating in the study, public sector outsourcing work is a key part of their business, and they expect this to remain so in the future. All the companies we spoke to recognised that there are major pensions' issues to be considered when tendering for a contract that involves a material number of employees transferring under TUPE. However, the way in which they address these issues varies considerably. Some have a centralised and structured approach, which assesses pensions risk separately and quantitatively for each contract, and allow for this explicitly in their tender pricing. Most, however, take a more broad brush approach, adding a general risk margin into their pricing based on a view taken across all their contracts.

Although the large majority of respondents had a final salary pension scheme, only two still allowed new employees to join, except where required to do so for employees transferring from the public sector. This illustrates the growing divide between public sector employees with access to final salary schemes and their private sector counterparts, for whom final salary pensions are becoming increasingly rare.

> *'The Government set up the Fair Deal in the late 1990s to ensure that the pension expectations of public sector employees are protected when they transfer to a new private sector employer.'*

But our key finding is that there is a substantial and important difference in the view between the Treasury and the large majority of companies in this market with respect to pensions risk. The Treasury's aim is to pass on to outsourcing companies the whole of the pensions risks, and believes the private sector is at least as well placed to manage these risks as the public sector. In contrast, companies generally regard these risks as highly problematic, particularly on short to medium-term contracts as they are qualitatively different from the other risks they face.

We found that over 70% of these companies regard the financial risks from pensions as a material disincentive to tendering for PFI/PPP contracts, and all feel they could offer better value to the public sector if some or all of the pensions risks were retained in the public sector. We also suspect that the Government's Fair Deal requirements form a significant barrier to entry to new entrants to the pool of companies tendering for these contracts, which is unlikely to be in the public's interest.

Contrary to the Treasury's view, we believe there is little logic in requiring these risks to be transferred to the private sector. Managing pensions risk is not an area of specific expertise for outsourcing companies. Furthermore, there is a major disparity between the term of a typical PFI/PPP contract and the effective term of the pensions contract, which is likely to extend for up to 70 or 80 years into the future.

Local authority contracts

On local authority contracts the new employer can keep the employees in the Local Government Pension Scheme (LGPS) as an alternative to providing them with a pension under its own scheme. This option is not available for central government and NHS contracts.

Generally, this route still results in the new employer taking on substantial pensions risks – though these are somewhat different in nature. However, there is evidence from our study that some local authorities are increasingly prepared to retain some or all of this risk in order to simplify the contract negotiations.

We believe this is generally beneficial for all parties involved, as it creates a level playing field for potential contractors and means that they can remove some of the contingency margins in their pricing. However, the Treasury views such arrangements with suspicion and is generally opposed to risk retention by the public sector. The lack of co-ordination and agreement between central and local government on this important issue is a problem, as it prevents a considered and streamlined approach from being developed.

Who's ignoring the elephant?

Our study showed that in general, companies tendering for PFI/PPP contracts are highly aware of the pensions risks they are being asked to take on for transferring employees. While there are varying degrees of sophistication in the way in which they allow for them in contract pricing, it is clear that material additional risk margins are usually included.

Local authorities are also becoming more aware of the impact of pensions on contracts being outsourced, and are increasingly willing to take a pragmatic view in order to facilitate effective contract negotiations and pricing.

In our view, the main party that may be ignoring the pensions' 'elephant in the corner' is the Treasury, in taking a view that fails to recognise the fundamental difference between pensions risks and those operational and financing risks that private sector companies can and do specialise in.

We therefore believe that the Government should investigate putting in place alternative structures where most or all of the pensions risks are retained by the public sector. This should result in greater competition on contracts, keener pricing, and substantially better overall value for the public sector.

[1] LCP's PFI/PPP Pensions Study 2006 report is available to download from www.lcp.uk.com/psog - alternatively contact enquiries@lcp.uk.com or 020 7432 6601 for a hard copy of the report.

Bart Huby
Partner and Head of Public Sector Outsourcing
Lane Clark & Peacock LLP
Tel: 01962 870060
bart.huby@lcp.uk.com
www.lcp.uk.com