PFI/PPP Pensions Study 2006
The impact of the Government’s Fair Deal requirements for public sector outsourcing contracts
This study has been carried out by LCP’s specialist Public Sector Outsourcing Group, which focuses on advising companies taking on employees from the public sector on PFI/PPP contracts.

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Overview

Our study shows that there is a substantial and important difference in view between the Treasury and the large majority of companies in the public sector outsourcing market. The Treasury's aim is to pass on to outsourcing companies the whole of the financial risks of providing final salary pensions for transferred employees, and believes the private sector is at least as well placed to manage these risks as the public sector. In contrast, the private sector generally regards these risks as highly problematic, particularly on short to medium-term contracts.

On central government and NHS contracts (where there is generally no alternative and the private sector contractor must take on board the full pensions risk), this results in less competition, greater contingency margins and, we believe as a consequence, substantially poorer overall value to the public sector.

On local authority contracts the position is more complicated, as there are more options and there is evidence that local authorities are increasingly being prepared to retain some or all of the pensions risks. However, because there is no structured approach to this (not least because it is contrary to Treasury policy), there is a large amount of uncertainty for potential contractors.

There are also major problems in terms of the quality of the pensions information provided to companies by public sector organisations when carrying out outsourcing exercises.

Our conclusion is that the way pensions are currently handled in public sector outsourcing is a major source of inefficiency and, ultimately, extra cost to the public sector. This is both through inappropriate transfer of financial risks, and a lack of coordination and structured approach to the practicalities of providing information on contract tenders.

As a result, we believe that the Government should:

- undertake a fundamental review of the principles of pensions risk transfer on outsourcing contracts; and
- put in place adequate procedures and controls to ensure that companies are provided with good quality information when tendering for public sector contracts.
1. Introduction

Since the early 1990s, the employment of well over 100,000 public sector employees has transferred under TUPE* to the private sector on Public Private Partnership (PPP) outsourcing contracts, such as the Private Finance Initiative (PFI) and “Best Value” local authority contracts.

In order to protect the pensions expectations of these employees, the Government sets standards (known as the “Fair Deal”**) for the pension benefits which the new employer must provide. Over the years, these standards, together with more general legislative developments affecting occupational pensions, have gradually become more and more onerous, so that now the new employer must take on substantial financial obligations and risks.

LCP advises many companies on these issues when tendering for contracts which involve taking on employees from the public sector. During the second half of 2005, we carried out a major study into how companies take into account the financial risks relating to pensions when tendering for such contracts. We also looked at how in practice the pensions aspects of these contracts are handled both by the public sector organisations involved in putting contracts out to tender, and by the private sector.

From a pensions perspective, there are three main types of public sector outsourcing contract:

- Central government contracts (including Ministry of Defence), where employees generally transfer from the Principal Civil Service Pension Scheme (PCSPS);
- NHS contracts, where employees transfer from the NHS Pension Scheme (though in many cases certain types of employee can remain in NHS employment and as a result remain in the NHSPS, under the “retention of employment” model); and
- Local authority contracts, where employees either transfer from the Local Government Pension Scheme (LGPS), or alternatively are able to remain in the LGPS provided the new employer participates in the LGPS fund under an “admission agreement”.

Our study analyses each of these three types of outsourcing contract separately, to reflect the different pensions issues arising.

Both the PCSPS and the NHSPS are unfunded schemes where the liabilities are met on a “pay-as-you-go” basis by the Government – ie by the tax payer. While the LGPS is funded through a range of funds administered by various local authorities, responsibility for meeting shortfalls still rests with the taxpayer. In contrast, following the transfer of employment to the private sector, the liability for pensions falls on the new employing company and its shareholders.

*Transfer of Undertakings (Protection of Employment) regulations

**“Staff transfers from central government: a fair deal for staff pensions” issued by HM Treasury in June 1998
2. Main findings and conclusions

Future pension provision

For the large majority of companies responding to our survey, public sector outsourcing work is a key part of their business, and they expect this to remain so in future. Most have a defined benefit pension scheme open for employees joining from the public sector on outsourcing contracts (as required by Government’s Fair Deal rules), but fewer than 1 in 10 offer defined benefit pensions to other new employees.

This illustrates the growing divide between public sector employees (including those transferred to the private sector on this kind of contract), and those employed directly into the private sector – the former continue to be entitled to join a high quality final salary pension scheme, while the latter rarely do so now.

Financial risk issues

Around 70% of these companies regard the financial risks resulting from the Fair Deal requirements as a disincentive to tendering for public sector contracts, and all feel they could offer better value if some of these risks were retained in the public sector.

We suspect these requirements form a significant barrier to entry to new entrants to the pool of companies tendering for these contracts.

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 the PFI/PPP contract (usually no longer than 25 years and typically less than 10) and the effective term of the pensions contract. This is based on longevity and so is unknown but likely to extend for up to 70 or 80 years into the future.

Bulk transfer terms

Nearly 60% of respondents view the bulk transfer terms from the public sector as less than adequate.

The bulk transfer terms currently available from the public sector schemes are likely in many cases to result in the contractor’s scheme taking on a shortfall against the amount required for full funding on the new Pension Protection Fund (PPF) levy basis, so requiring the contractor to pay additional PPF levy payments.

Public sector pension scheme reform

Several companies expressed strong concern about the Government’s continuing failure to make progress in its public sector pension scheme reform programme.

This relates to both the high cost of the benefits they are required to provide under the Fair Deal, and the resulting substantial discrepancies between the pension benefits they provide to different employees doing the same job, depending on whether they came from the public sector or as direct entrants to the workforce.

We recommend that the Government 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.

We believe the Government should provide an underpin to the bulk transfer terms, based on the value of the transferring benefits on the PPF levy basis.

It is important that the Government grasps the nettle firmly and quickly on public sector pension reform.
Quality of information

The large majority of companies had regularly experienced significant problems with the quality of the contract tender information, and the employee pension data they were provided with both at the tender stage and at contract commencement.

This results in significant extra costs to the private sector which are inevitably, in the long-term, factored into contract pricing, so resulting in higher costs to the public sector.

Participation in the LGPS

In local authority contracts, there is clear evidence that many local authorities are, contrary to Government guidance, insisting that contractors participate in the LGPS rather than offering employees their own passport scheme.

For those companies wishing to use their own pension schemes, this can restrict their ability to manage risk effectively.

Risk retention by local authorities

In local authority contracts, there appears to be an increasing trend for local authorities to be prepared to retain some or all of the pensions risks.

We believe this is generally beneficial for all parties involved, as it creates a level playing field for potential contractors and removes the need for them to include additional 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 coordination 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.
3. Study methodology

The study is based on research during the second half of 2005, which was carried out as follows.

Survey

We issued a 20-question survey to a wide range of organisations which have had an involvement in taking on employees from the public sector. The survey questions focused on eight specific areas, as presented in this report.

We had identified 70 firms as being “major players” in this market, and were very pleased to receive a substantial 40% survey response rate from these firms. As a result, we believe this is the most representative and authoritative survey on this subject carried out in the UK. Of the 28 respondent firms, 17 indicated that they were happy to be included in a list of survey participants, as follows:

Alfred McAlpine  Lorne Stewart  
BAE Systems  Morrison  
Capita Group  Northgate Information Solutions  
Carillion  Taylor Woodrow  
Cleanaway  Unisys  
Colas  Vinci  
CSC Computer Sciences  VT Group  
Electronic Data Systems (EDS)  WS Atkins  
Interserve

We would like to express our thanks to all the survey respondents for their contributions, in particular those who provided additional comments (some of which are quoted within this report).

In-depth interviews

We followed up the survey by carrying out interviews with a sample of 12 of the respondent firms, in order to obtain a more in-depth understanding of their experiences and attitudes to these issues.

Again, we would like to thank those who took part in these interviews, which were very helpful in providing us with a greater understanding of how a wide range of companies deal with these issues.
Treasury/GAD meeting

The final stage of the study was a meeting at the Treasury with two senior civil servants heavily involved in setting and applying Government policy in this area: Bill Guy, Head of Policy, Public Service Pensions at the Treasury, and Andrew Johnston, Head of Pensions at the Government Actuary’s Department (GAD). At this meeting, we presented the results of the LCP survey, and discussed the Government’s viewpoint on many of the issues. Our thanks are due to Bill and Andrew, both for their time and for their willingness to take part in open discussion and to express their views clearly and candidly.

Presentation of results

The results of the study are presented in nine sections, in the same format as for the survey questionnaire. In each section, the questionnaire responses are analysed and, where appropriate, additional comments made by respondents in the questionnaire response or in the follow-up interviews are described. Also included are the views of the Treasury where relevant.
4. Background information

We started our survey by asking companies about the importance of public sector outsourcing work to their business, the public sector schemes from which they expected to take on employees, and their own pension arrangements.

These responses show that these companies consider public sector outsourcing work to be a key part of their business, and that within this part of the business staffing costs are either significant or very significant. Many of those we spoke to were very pleased that we were taking up these important issues with the Treasury in a way that is difficult for individual companies to do.

Public sector outsourcing is key to the respondents’ business, and staffing costs have a very significant impact on pricing of contracts.
Most companies had taken on a diverse range of employees from each of the three main public sector schemes – PCSPS, NHSPS and LGPS – and expected to continue to do so in future.

There is a growing divide between transferred public sector employees with access to defined benefit schemes and their private sector counterparts, for whom defined benefit schemes are becoming increasingly scarce.

Most companies had their own public sector “passport” scheme (a scheme providing benefits which had been certified by the Government Actuary’s Department as providing benefits satisfying the “broad comparability” requirements of the Fair Deal). The large majority also had a defined benefit pension scheme for other employees – however only two companies continue to offer membership of this to new employees, except where required to for employees transferring from the public sector. This illustrates and emphasises the growing divide between public sector employees (including those transferred to the private sector on this kind of contract), and those employed directly into the private sector – the former continue to be entitled to join a high quality final salary pension scheme, while the latter rarely do so now.
5. Financial risk issues

We then asked about what are clearly the most important set of issues for companies (and for the Treasury) - the financial risks resulting from taking on the pensions and redundancy benefit obligations for transferring employees.

A recurring theme among the respondents was the unwanted financial risks from pensions that they are forced to take on as part of the outsourcing contract; risks that they feel are wholly unrelated to their main business. Some of the organisations we spoke to saw this as a major barrier to tendering for these contracts, for example one company has been barred by its parent from taking on any defined benefit pension risk. We are also aware from discussions outside of the survey that many companies who would otherwise be interested in tendering for public sector contracts are not doing so because of the complexities of the pensions issues and the financial risks involved.

With most private sector schemes already in deficit due to falling bond yields and increasing longevity, and the Pension Protection Fund (PPF) levy a new burden to meet, many companies have little appetite for taking on further pension liabilities under PFI/PPP contracts.

In contrast, however, several of the larger organisations we spoke to accepted this as a necessary, though not particularly welcome, aspect of competing for these contracts. Generally, they recognised that they are better able than smaller companies to manage these risks, because of their size and prior experience, which therefore effectively places them at a competitive advantage. In effect, the Government’s Fair Deal pension requirements are acting as a barrier to entry to new companies (particularly smaller ones) wishing to tender for such contracts.
The majority of respondents felt that they could provide better value to the public sector if they did not have to take on the pension risks. Indeed, many companies we spoke to confirmed that they include specific additional margins in their pricing to compensate for this risk. Effectively the public sector is paying a risk premium to companies to take on these extra financial risks, when those risks could, we believe, be better managed on a long-term basis if they remained in the public sector, so ultimately saving public money.

Concern was expressed by some respondents that, where they are competing for a contract with an in-house public sector team, they will be at a disadvantage because of the additional margins they have to include to cover the pensions risks. As a result, they feel there is not a level playing field between the private and public sector bidders.
The revised Fair Deal requirements*, put in place in June 2004 to provide further protection to employees on “second generation” employment transfers, have also, according to the survey respondents, increased further the financial risks being taken on by the private sector. Contractors now have to guarantee to pay a full bulk transfer at the end of a contract, on a basis at least as strong as that used for the incoming bulk transfer at the start of the contract.

As a result of these new requirements, contractors are faced with a dilemma, particularly on short-term contracts. In order to have a chance of the incoming bulk transfer being adequate to provide for the benefits, there has to be a mixed-investment policy, including a material proportion invested in equities. But if equities fall in value over the term of the contract, they could be left with a substantial funding shortfall to make up at the end (though equally there is scope for investment gain should equities outperform).

There is a further bias here towards large firms with a significant number of this type of contract, as they are more likely to be able to take a long-term view, accepting that investment losses on some contracts should in the long run be balanced by gains on others. As a result, this is in effect another barrier to entry to new entrants to this market.

The Treasury viewpoint

When we spoke to the Treasury about these issues, they acknowledged that the public sector is paying a premium for the Fair Deal requirement that contractors provide defined benefit pension scheme membership, with a bulk transfer option for past service, for transferred staff. There was no doubt in their mind that the public sector could achieve lower contract prices if this requirement were waived and contractors were bound only to deliver the level of protection required by statutory regulations in all TUPE transfers.

However, the Government has a clear policy on protection of pension arrangements for staff compulsorily transferred to private sector contractors, and the issue is therefore how most efficiently to achieve this level of protection. The observation that contract prices should be lower if defined benefit pension risks were somehow retained by the public sector in these contracts was not seen as persuasive by the Treasury; they felt that it was necessary to look at the contracts in context, recognising that risks not transferred to the private sector were retained by the public sector instead of being avoided.

As a general principle, risks in service delivery should be allocated in contracts according to where they could best be managed, and the Treasury did not recognise pension and redundancy cost risks as inherently different and more difficult to manage than other business risks. They were extremely reluctant to engage in what they saw as an extrapolation from basic principles about the scale economies in public sector operation to conclusions about the micro-structure of particular out-sourcing contracts, as it was too easy to be drawn in that way to the conclusion that almost all economic activity should be financed and conducted by the State, whereas experience taught different lessons.

* “Fair deal for staff pensions: procurement of bulk transfer agreements and related issues” issued by HM Treasury in June 2004
Given that private sector partnership can deliver overall benefits when contractors are carrying risks, the question was why pension and redundancy costs should be given special treatment, and the Treasury did not feel that a strong enough case had been made for this. In their view, within a transferred workforce the private sector employer was in the best position to manage these employment costs and, if these costs and risks were to be retained by the public sector, it would be necessary to impose controls on the private employer which could negate the value of transferring the workforce in the first place.

The Government recognises that some firms may be deterred by their strong aversion to pension risks from tendering for contracts, but their view is that, provided there are sufficient numbers of firms willing to do so to make it a competitive process, and that the additional margins put into their pricing by these firms are not excessively large, then the process is working. At present they are satisfied that this is generally the case.

Nevertheless, they acknowledged that it is important for them to understand and monitor the size of the premium they are paying for the imposition of the Fair Deal pension requirements - if this were to become too high, this could make them reconsider how the standard of staff protection is best assured.

In contrast to the Treasury’s view, we continue to believe that pensions risks are fundamentally different from the other risks on such contracts.

This is for two main reasons:

- Firstly, very few (if any) companies involved in outsourcing regard pensions as an area of specific expertise or competitive advantage, so it is not an area where they would be attempting to provide added value on the contract. In our view, the most convincing argument in principle for public sector outsourcing is the transfer of operational and financial management to commercially-minded organisations which are specialists in their areas of expertise (be it facilities management, IT, catering, construction, etc) - this simply does not apply to pensions.

- Secondly, and perhaps even more importantly, pensions risks are extremely long-term, running for perhaps 70 or 80 years after the contract commences. This is generally a substantially longer period than the contract term (which is usually no longer than 25 years, and typically less than 10) so resulting in a significant timing mismatch against the other risks involved.

We therefore believe there are strong arguments for the Government, while maintaining the Fair Deal principles, to investigate the possibility of putting in place alternative structures under which much or all of the pensions risks would be retained by the public sector.

This should result in greater competition for contracts, keener pricing, and overall better value for the public sector. It would also be likely to give substantially greater security to the pensions entitlements of transferring employees.
6. Bulk transfer terms

Our next questions concerned the requirement in the Government’s Fair Deal rules that successful contractors offer to accept a transfer of the past service pension entitlements of transferring employees into their own pension scheme.

The bulk transfer terms offered by the public sector terms are, to a very large extent, non-negotiable. Just over 40% of respondents felt that the bulk transfer terms on offer are at least acceptable. Another 40% felt they are “less than adequate”, while just over 15% see them as a significant problem.

An issue which has arisen recently in this regard is the Pension Protection Fund (PPF) levy which has to be paid by all private sector pension schemes offering defined benefits. In many cases, the bulk transfer terms offered will mean that the contractor will have to pay an additional PPF levy in future in respect of any benefits transferred in from the public sector, unless he pays an immediate sum into his pension scheme to cover the difference.

We therefore believe that it would be appropriate for the Government to provide an underpin to the bulk transfer terms, based on the value on the PPF levy basis of the transferring benefits.

A further issue on bulk transfers is that, at the tender stage, bidding contractors do not know how many employees will in practice opt to transfer their past service benefits (employees have three months after transferring employment to decide whether to transfer). This leads to considerable uncertainty for potential contractors in assessing the level of financial risk that will transfer to them in respect of past service benefits. Over 90% of survey respondents regard this as a problem, with over half of these seeing it as a significant issue for them.

“The major issue on pensions in outsourcing is the unrealistic basis adopted by the GAD for bulk transfers, especially in comparison to guidance from the Pensions Regulator. The Treasury is at odds (again) with presumably the DWP. Underfunding on transfers increases bid prices and undermines financial security for members.”

Respondent’s name withheld
The Government has suggested in its guidance that a possible route round this problem would be for potential contractors to submit tender bids which include a contingent element dependent on the proportion of employees ultimately electing to take up the transfer option. There was, however, no evidence from our survey or subsequent interviews that this has been workable in practice.
7. Public sector pension scheme reform

While there were no specific questions on this in the survey, a theme that was raised several times during the follow-up interviews was that of public sector pension scheme reform.

Both the PCSPS and the NHSPS have normal pension ages of 60, while the LGPS has the “rule of 85” under which employees can retire on a full pension from age 60 provided they have at least 25 years membership. The Government has recognised that, in light of the substantial improvement in life expectancy experienced over recent decades, the cost of the pension promises being made under these schemes has increased to a level which is not sustainable in the long-term. As a consequence, it has published proposals to reform public sector pensions to make them “affordable and sustainable”. For each of the schemes, these proposals have included raising the normal pension age to 65. However, there has been fierce opposition from the trades unions and, on a number of occasions (most notably in March 2005 just prior to the general election), the Government backed down, at least temporarily.

Several respondents expressed strong concern about the Government’s continuing failure to make progress in this reform programme. The cost of these benefits is one issue, as a pension payable from age 60 is worth around 30% more than one payable from age 65. While this extra cost can (at least in theory) be factored into the contract pricing (so resulting in higher costs to the public sector outsourcing body but no immediate “hit” for the contractor), there are other issues also of concern to contractors:

- Where contractors want to integrate the transferring employees into their main workforce (on some contracts this is an important element of achieving the efficiency gains fundamental to a successful outsourcing programme), the substantial discrepancy between the pensions benefits for colleagues working together can cause significant workplace difficulties. This discrepancy is emphasised if employees transferred from the public sector can retire at 60, while those recruited direct cannot retire until 65 (or even later).

- The continuing uncertainty over the progress of public sector pension reform makes it difficult for contractors to plan effectively for the future.

It is important that the government grasps the nettle firmly and quickly on this, and makes progress well ahead of the lead-up to the next election, when it will again be particularly vulnerable to union pressure.
8. Contract information

An issue which in our experience regularly frustrates companies tendering for public sector contracts is the quality (or lack thereof) of the information they are provided with by the public sector body carrying out the tender. In many cases, the personnel at the public sector body who are involved in putting the contract out to tender do not properly understand the Government’s Fair Deal pensions requirements, so that there is a lack of clarity in the initial tender information over what the contractor will need to do. As a result, addressing the pensions issues can often be left to the last minute just prior to contract award, which is clearly not a satisfactory way of dealing with this important subject.

In terms of the clarity of contract information provided to companies, NHS employers were the clear winners, but even for them, less than 50% of respondents reported that they usually receive clear information at an early stage. This proportion fell to a third for central government contracts, and only a quarter for local authority contracts. Furthermore, over 30% of respondents reported that they often did not receive clear information at an early stage from local authorities. This differential is perhaps not surprising as local authority contracts tend to be smaller and more diverse, so the public sector bid team is more likely to be less experienced.

Some public sector bodies show a significant lack of understanding of the Government’s Fair Deal scheme, leading to frustration and costly last-minute negotiations for tendering companies.
A further issue for contractors is the quality of the employee data they are provided with at both the tender and take-on stages. Poor quality data causes problems to contractors at the bid stage because it means they are unable to properly assess the financial risks involved. At the take-on stage it can cause substantial additional administration costs to contractors in reconciling the information provided with the “position on the ground”. It can also result in significant concern to the employees involved, through not being sure that their pensions are being dealt with properly at a time of considerable uncertainty regarding their employment position in general.

Our survey showed that contractors often experienced significant problems, both at the tender and take-on stages. While none scored well in this regard, local authorities were the clear winners here, with around 40% of respondents reporting good quality data at the tender stage (compared to around 25% for central government and NHS contracts).

Lack of information makes assessment of risk - and therefore contract pricing - problematic.
The Fair Deal recognises the crucial issue of timely data provision, and anticipates that membership data should be provided promptly so that pension transfers can be processed, at least to the stage of a substantial interim payment, within six months of the staff transfer. Responses to our survey show that this remains an aspiration of Government that is nowhere near being fulfilled – in some cases it has taken three or four years to complete the bulk transfer process. This is problematic both for the contractor and for the transferring employees, for whom this can result in a lengthy period of uncertainty concerning how their pensions are being dealt with.

The Treasury viewpoint

The Treasury acknowledged that there are real problems concerning the way in which the public sector bid teams putting contracts out to tender work, including ensuring that adequate data is made available to bidders. Often there is no-one on the bid team with prior experience of handling the pensions issues, which are instead felt to be the responsibility of another department. We suggested that for all significant contract tenders the public sector bid team should include someone with experience of, and responsibility for, the pensions issues, including for following up implementation following contract completion. Andrew Johnston of GAD indicated that in some cases this does in fact happen, and the experience is that it has improved efficiency considerably.

In conclusion, we believe that contract clarity and data quality are serious issues which need to be addressed with urgency by both central and local government. The poor quality of the information often provided results in:

- significant extra administration costs to the private sector (which will inevitably be factored into contract pricing);
- uncertainty, which is likely to lead to additional margins in contracts pricing; and
- frustration, which may lead some companies to decide not to bid for further contracts.

Lack of clarity and poor data quality can often increase costs for the private sector - which will inevitably, in the longer term, be passed back to the public sector.
An alternative available only under local authority “Best Value” contracts is for the contractor, instead of providing its own pension scheme with broadly comparable benefits to those under the LGPS, to participate as an “admission body” within the LGPS. This option is possible because the LGPS is a funded arrangement, operated as just under 100 separate funds across England and Wales (with similar arrangements in Scotland and Northern Ireland as well). In contrast, largely because they are not locally funded arrangements, but instead provide benefits directly from the Exchequer, there is no similar option under either the PCSPS or the NHSPS.

There are a range of advantages and disadvantages for the contractor to this option, compared with provision of its own broadly comparable scheme. It is, however, very popular with employees and unions as it enables the employees to retain continuity and security of their pension arrangements.

In our survey, only 20% of companies indicated that they prefer to use the admission body option for their contracts. Just under 50% said they would prefer to use their own scheme, with the remainder indicating it would depend on the circumstances.
The government’s guidelines indicate that on local authority contracts contractors should be given a free choice between the options (ie between provision of a broadly comparable scheme of their own, and participation as an admission body in the LGPS). However, our survey showed that under 10% of respondents were generally offered a free choice on local authority contracts, and over 60% were generally expected to follow the admission body route.

This practice is in clear contravention of Government policy, and is a major source of frustration to a significant number of companies who would prefer to use their own schemes. When we raised this point with the Treasury, their response was that, while they acknowledged that many local authorities were alleged to be acting in a way that did not comply with stated Government guidance, investigations could not be made in the absence of formal complaints from contractors and potential contractors supported by evidence.

In our view it is unreasonable to expect the private sector to comply with Government policy and guidelines, while accepting that local authorities are able to pick and choose when to comply. Furthermore, it is unrealistic to expect contractors to make formal complaints about the behaviour of local authorities when they may wish to compete for further contracts in the future. We therefore believe that the Government should be more proactive in ensuring that their stated policy is carried out at local authority level.

In contrast to these frustrations, a positive development in recent years has been that a growing number of local authorities appear to be recognising that they can get better value by retaining some or all of the pensions risks on outsourcing contracts. This can be done in a number of different ways, for example by the local authority retaining the past service investment risk or, in more extreme cases, simply charging an agreed fixed contribution rate to the contractor and meeting any excess costs that arise.

“The most recent LGPS tenders have specifically detailed that in order to proceed we must state that we will use an admission agreement - even though this is not permitted under the regulations/guidance. This is after we have undertaken the expense of a GAD approved passport scheme (which is our preferred route). Following the recent round of LGPS valuations, all three schemes require deficit payments and, due to the short term to contract end, the payments are calculated over a short term, eg 12 months. This is unacceptable.”

Tina Keeling, Group Pension Manager, Alfred McAlpine plc.
By retaining risk, the local authority can effectively create a level playing field between bidding contractors in the pensions arena, and remove the need for contractors to include risk and contingency margins in their pricing.

Our survey indicates a wide range of experience of contractors in this regard, with the majority reporting that they are sometimes able to negotiate this kind of risk reduction provision on local authority contracts.

We believe this kind of agreement is generally beneficial for all parties involved, ie the local authorities, the contractors and the transferring employees. However, when we discussed this with the Treasury, their view was considerably less positive.

**The Treasury viewpoint**

The Treasury pointed to the mixed opinions of contractors about LGPS admission arrangements, with a sizeable proportion having major reservations - a view supported by our survey. They felt there was no evidence that introducing similar arrangements to the PCSPS and NHS schemes would result in lower bid prices, unless the terms for admission constituted a subsidy to the employers benefiting, which would not necessarily represent good value overall.

Furthermore, they were suspicious of any special deals which might be made to reduce contractor risk in some contracts. They felt there was a danger from a public interest viewpoint that local authorities acting in this way might be failing to assess properly the risks to the local LGPS fund of the protections which they were offering to the contractor, and that this could result in poor value for the public sector.

“There is an urgent need for the LGPS Admission Body route to be open but with the risk related for example to past service benefits and future changes in actuarial assumptions shared more realistically between the local authority, which participates indefinitely, and the contractor, whose involvement may be just for a few years.”

James Churcher, Pensions Manager, Cleanaway Limited.
In our view, this lack of coordination and agreement between central and local government bodies is itself problematic. In particular, we believe it results in the missed opportunity of developing a considered and streamlined approach to risk retention by local authorities. Without this, there is generally uncertainty for contractors looking at potential contract opportunities as to whether it will be possible to negotiate an element of risk retention. Furthermore, each case needs separate negotiation, so increasing significantly the time spent reaching agreement and the negotiation costs, for both parties.

We therefore believe the Government should work with local authorities to develop an agreed framework to enable them to retain risk, where they believe it appropriate to do so, in a structured and streamlined way.

Finally, our survey asked companies whether, if it were to be possible for them to participate as an admission body in the PCSPS or the NHSPS, they would find this an attractive option. 20% said “yes”, slightly more said “no”, while the majority, perhaps not surprisingly, said that it would depend on the terms available.
The Treasury viewpoint

When we spoke to the Treasury about this, they indicated that the Government does not have a closed mind on the issue. In principle, the technical issues about protecting the Exchequer should be capable of resolution, although this might not be by replicating the approaches taken in the LGPS. However, this might entail some interference in the operation of contractors which they would not welcome and, obversely, contractors seemed generally very wary of committing to paying the full costs of arrangements which they were not controlling.

It was therefore not at all clear that moving from the current arrangements to something more akin to LGPS admission would represent a better outcome in the round. However, this was an idea that the Government was not rejecting out of hand and it was likely to be the subject of further work. This would not just be to explore trade unions’ concerns, but also to scope possible policy responses if, for instance, pension compliance premiums in bid prices were to rise substantially, reflecting contractors’ perceptions of an increasing regulatory burden on sponsors of private sector defined benefit pension schemes.

We believe this would be a practical route to enabling the pensions of transferring employees to be provided on a more secure and efficient basis, with flexibility for the public sector to retain some or all of the financial risks where appropriate. We therefore encourage the Government to look more closely at the feasibility of enabling the PCSPS and the NHSPS to admit private sector companies as participating employers.
10. Multi-employer schemes

A recent development in this area has been the setting up by the Prudential of a multi-employer sectionalised scheme, Platinum, which has various benefit structures which satisfy the Government’s requirements for broad comparability to the PCSPS, the NHSPS and the LGPS. This scheme is available to companies to establish their own sections, and in particular offers a quick and cost-effective entry route for companies entering the public sector outsourcing arena for the first time.

Its main advantages are:

- Administrative simplicity, in that the Platinum scheme is already established, and has a structure which will be update on a centralised basis for any changes in the public sector schemes and in Government policy.
- If, at the end of a contract, the existing contractor and the new contractor both have sections in Platinum, a streamlined approach to transferring employees’ pensions rights.

Against that, there are potential disadvantages in that the benefit structure and investment and funding strategies are to a large extent pre-determined, so there is little flexibility for the contractor to adopt an approach customised to its own needs.

In general, the survey respondents showed little enthusiasm for multi-employer schemes such as Platinum. This is probably because the large majority of respondents already have their own pension schemes satisfying the Government’s requirements.

However, we are aware that the Platinum scheme has proved popular with new entrants to this market, and appears to have proved successful at enabling several companies, who would otherwise be deterred by the high entry costs of establishing their own arrangements, to take on public sector contracts.

While not popular with respondents, Platinum has helped to open up the market to new entrants.
11. Two-tier workforce issues

For several years, it has been a best practice requirement on local authority contracts that any new employees, hired by the private sector contractor to work on the contract after commencement, be employed on terms and conditions with a value benchmarked against those applying to the workforce who originally transferred from local authority employment. However, there is a limited exemption in terms of the pensions provided for new employees - the contractor is allowed to offer them one of:

- the same “passport” scheme as offered to transferring employees;
- an alternative “good quality” defined benefit pension scheme; and
- a defined contribution (ie money purchase) pension arrangement with the employer matching employee contributions up to a ceiling of 6% of pay.

In March 2005, the Government announced that these “two-tier workforce” provisions would be extended to cover central government and NHS contracts too.

Given that very few of these companies offer defined benefit pensions to their normal new employees, we were not surprised that the large majority expect to offer the defined contribution option.

Several contractors expressed the view that these rules are quite helpful, in that they set a benchmark for what is acceptable pension provision for new employees, and result in a reasonably level playing field for contract tenders in this regard.

The Treasury viewpoint

The Treasury acknowledged that the rules do not fully eliminate a two-tier effect in pension provision, but felt that they should have the effect desired by the Government of preventing the blatant erosion of terms and conditions in outsourced workforces by replacement of transferred staff with new entrants recruited on materially poorer contracts of employment.
12. Redundancy provisions

All of the main public sector pension schemes provide generous benefit enhancements to employees who are made redundant over the age of 50. Such employees are allowed to retire early on a full accrued pension without reduction for early payment and in addition, under both the PCSPS and the NHSPS, an allowance is made for unearned future years of service. The capital value of these enhancements can be up to 7 or 8 times salary where redundancy is just after age 50 - this is very substantially more generous than in the vast majority of private sector redundancy arrangements.

For employees transferring to the private sector, their basic pension entitlement is covered by the new employer’s pension scheme, while the redundancy enhancement “top-up” benefits are generally deemed to transfer under TUPE as a contractual entitlement (though there remains an element of uncertainty on the correct treatment under law).

Under the public sector, these redundancy provisions are expensive, but relatively straightforward to calculate and pay, as the total enhanced pension benefits all come from once source - the relevant public sector pension scheme. In contrast, after an employee transfers to the private sector, while the benefits remain just as expensive, they also become administratively very complex. This is because the employee then gets his benefits package from up to three sources: the new employer’s pension scheme; the new employer for the “top-up” element; and his former public sector pension scheme if he elected not to transfer his past service benefits across.

A company taking on employees on a contract where there are likely to be redundancies therefore needs to understand the potential costs in order to avoid the risk of being hit by high extra costs at the time the redundancies are made. It also needs to be provided with adequate information at the time of tendering to enable it to assess the potential redundancy cost exposure.

Q1: When tendering for contracts where post-transfer redundancies are anticipated, has the employee redundancy cost information provided to you generally been adequate to enable you to make proper allowance for redundancy costs in your tender pricing?

A full understanding of generous inherited redundancy benefits is key to contract pricing.
Our survey responses indicated that around 30% of respondents often experienced problems with obtaining adequate data for this purpose, with a further 50% on central government and NHS contracts sometimes experiencing problems. The position was slightly better on local authority contracts, though this may to an extent reflect the fact that the redundancy enhancements are generally not so valuable under the LGPS as under the PCSPS or the NHSPS.

With regards to the process of determining and calculating the redundancy benefits for transferred employees, most companies had problems at least some of the time. In our experience, the difficulties in determining employees’ redundancy entitlements, caused by the complexity of the arrangements following transfer to the public sector, can be problematic. This is both for the new employer (who has to make the calculations and explain them to its employees) and for the employee, for whom the array of benefits and options from different sources can be confusing and daunting.

We also wonder whether all of the relatively high proportion of respondents that find these calculations straightforward actually fully understand and apply the provisions in their full complexity.

The Government Actuary’s Department recently published a guide* which explains how they interpret that redundancy benefits should be determined for employees transferring from the PCSPS. This is a helpful development, as (while not a legally tested interpretation) it provides greater clarity and is likely to lead to more consistent treatment of employees. We would therefore encourage the GAD to produce a similar document in respect of the NHSPS redundancy arrangements.

* “Civil Service redundancy benefits: Note by the Government Actuary’s Department” dated March 2005
Next steps

LCP’s specialist multi-disciplinary Public Sector Outsourcing Group has over 15 years’ experience advising on all aspects of the pensions and redundancy benefits of employees transferring from the public sector.

We have developed a range of modelling tools to help our clients understand and manage the specific risks that arise on public sector outsourcing contracts. Further information on these tools is available on our website at www.lcp.uk.com/pso.

We can provide advice on:

- The best route for meeting the Fair Deal broad comparability requirements, including the benefit design for GAD passport sections
- Liaison with GAD over obtaining and maintaining GAD passports
- The cost allowance to be included in contract bids for pensions and redundancies
- Negotiations on bulk transfer terms
- Reviewing contract and/or admission agreement wording from an actuarial perspective
- Liaison/negotiation with pension scheme trustees over implementing the agreed arrangements.

About LCP

Lane Clark & Peacock is a limited liability partnership (LLP) and offers a full range of actuarial and benefit consultancy services to clients in the UK and internationally through LCP Corporate Consulting and LCP Trustee Consulting.

The LCP Corporate Consulting practice specialises in advising companies how best to manage the impact of their pension schemes on company finances, how to represent pension schemes in company accounts, how to help UK and international benefit plans attract and retain employees effectively, and how to manage benefit issues in mergers & acquisitions.

The LCP Trustee Consulting practice focuses on providing advice on pensions issues that are of concern to trustees, such as assessing the adequacy of contribution plans, advising on investment issues, and advising on the issues surrounding insolvency and the winding up of pension schemes.

With 57 partners and over 300 staff, we serve a wide range of clients in the UK and internationally, including many FTSE 100 companies, as well as a number of charities and unions.

We are part of the Alexander Forbes Group, the eighth largest risk and financial services organisation in the world.

To find out more about any of these services please contact Bart Huby, Matthew Pearlman or Tim Sharples on 020 7439 2266, or contact us through your usual LCP contact.

Further information about all our services is available on our website at www.lcp.uk.com.