Managing pension and redundancy risks in public sector outsourcing contracts.
Public sector outsourcing

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.

In order to protect the pensions expectations of these employees, the Government has set standards (known as the “Fair Deal”) for the pension benefits which the new employer must provide. These standards mean the new employer must take on substantial financial obligations and risks. Public sector employees are also generally entitled to substantial redundancy benefits, and these transfer under TUPE to the new employer as contractual entitlements separately to pensions.

The Fair Deal

The Fair Deal is the Government’s guidance on pensions for transfers from central government schemes (such as the PCSPS or the NHSPS). The main features of the guidance are:

- Future service benefits must be “broadly comparable” to the benefits under the public sector scheme.
- Staff must be able to transfer their past service benefits in exchange for like-for-like credits in the new employer’s scheme.
- The new employer’s scheme must include several non-standard protections - eg a guarantee that transfer values will not be reduced for underfunding.
- Similar provisions should apply on a subsequent “2nd generation” transfer to a new employer.

In 2007, the Department for Communities and Local Government asked local authorities to adopt the same principles for transfers from local government.

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1 “Fair Deal for staff pensions: procurement of bulk transfer agreements and related issues” HM Treasury, June 2004
Meeting the Fair Deal
There are three main options open to contractors for providing broadly comparable pensions for transferring employees: set up your own scheme; participate in a centralised multi-employer scheme or participate in the public sector scheme as an “admitted body” (generally only for Local Authority contracts). Further details of these options follow.

- **Own scheme.** Set up a new pension scheme, or a new section in an existing scheme, which provides benefits broadly comparable to those under the public sector scheme.

  Under the Fair Deal, the Government Actuary’s Department (“GAD”) assesses the benefits provided by the new employer’s scheme for “broad comparability”.

  If satisfied, the GAD will issue a “certificate of broad comparability” (also known as a “GAD passport”). This passport can then be used on contract bids to demonstrate that the contractor has satisfactory pension arrangements.

- **Multi-employer scheme.** Participate in a centralised multi-employer scheme, which already provides benefits broadly comparable to those under the public sector scheme.

  A number of commercial providers offer centralised multi-employer schemes that the contractor can join. These can reduce the administration involved in running a pension scheme, and will already have a GAD passport in place.

- **Admitted body.** As an admitted body the employer participates in the LGPS and so can provide continuity of pension benefits simply.

  This route is generally very popular with employees and unions. However the contractor must usually take on the full liability, with associated funding risks, for all the employees’ past service benefits as well as for pensions earned while employed by the contractor. The contractor also usually has to provide a “bond” to the LGPS which entails additional costs.

  While this approach appears straightforward, it is important for the contractor to understand the level of risks involved. Indeed, some contractors have faced large unexpected increases in pension costs at the end of the contract or following actuarial valuations of the LGPS, sometimes out of all proportion to the profit margins in the contract.

  It is often possible to negotiate with the local authority for it to retain a significant level of the pensions risk, providing valuable protection to the contractor.

How we can help
LCP has a specialist multi-disciplinary Public Sector Outsourcing Group, with over 20 years’ experience of 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 which arise on public sector outsourcing contracts. Some of these tools are illustrated in this brochure.
How do these pension options compare?
Each of the options has advantages and disadvantages, depending on the contractor’s position and the nature of the contract.

By using its own scheme, a contractor gains maximum flexibility and control over the benefit structure, investment policy and approach to funding. However, set-up, administration and maintenance costs are likely to be relatively high, particularly where only a small number of employees are involved.

The centralised multi-employer scheme and LGPS admitted body routes are the most straightforward administratively, but offer only very limited choices as to benefit structure and investment strategy, and little flexibility over the employer contribution rate.

Assessing the pensions risks
The financial risks relating to funding for pensions on outsourcing contracts can be very different from “normal” defined benefit risks: they can crystallise in the short term, and the contractor may need to make substantial extra cash injections towards, or at the end of, the contract. This can happen for two main reasons:

- Under LGPS admitted body agreements, the contractor will usually need to ensure that its section of the LGPS is fully funded at the end of the contract.
- The Fair Deal guidance requires contractors to pay at the end of a contract a bulk transfer on a basis at least as good as for the original bulk transfer from the public sector scheme at the start of the contract.

In both cases, this effectively means that, unless the pension scheme is fully funded at the end of the contract, the contractor is likely to have to make a top-up payment. This may be a substantial and unexpected extra cost.

Contractors should take these risks into account when pricing a contract.

The contractor’s dilemma
Most pension schemes, including the LGPS, continue to invest a considerable proportion of their assets in equities, particularly where these relate to the benefits of active members. By anticipating the extra returns which equities are expected to produce, compared with lower risk investments like gilts, employers can pay lower contributions.

In general, the much higher volatility of equity investments can be “averaged out” over the long-term as pensions are paid over many future years. On fixed-term public sector contracts, however, these risks can
crystallise at a particular point in time, for example at the end of the contract term. If equities have performed poorly, a substantial top-up payment is likely to be required.

An alternative would be to invest the pension scheme only in gilts. This will greatly reduce the risk of having to make a top-up payment at the end of the contract. However, the contractor will have to pay considerably higher contributions during the contract – allowing for these extra costs in tender pricing could make the bid uncompetitive.

**Managing the risks through investment strategy**

Financial modelling techniques developed by LCP can help contractors understand and manage these risks.

Actuarial Risk Analysis projections look at thousands of equally likely simulations of possible future experience, based on LCP’s economic model.

By running the analysis over a number of different investment and contribution strategies, we obtain an indication of the risks associated with any particular strategy.

The contractor can then make an informed judgment on the extent of the risks it is willing to take, compared with the extra running costs of using a more cautious investment strategy.

**We can provide advice on:**

- The exposure to pension risks under the contract and how to mitigate this
- The best route for meeting the Fair Deal broad comparability requirements on a contract
- The cost allowance to be included in contract bids for pensions and redundancies
- Reviewing contract and/or admission agreement wording from an actuarial perspective
- Negotiating with local authorities over the allocation of pensions risks and the level of the bond
- Benefit design for GAD passport sections
- Liaison with GAD over obtaining, updating and maintaining GAD passports
- Liaison/negotiation with pension scheme trustees over implementing the agreed arrangements

### An example five-year contract

The projected range of outcomes after five years is:

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<th>1. Typical equity-based investment strategy</th>
<th>2. Investment in gilts</th>
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</thead>
<tbody>
<tr>
<td>Loss</td>
<td><img src="image1" alt="Graph" /></td>
<td><img src="image2" alt="Graph" /></td>
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<tr>
<td>Range of possible outcomes (as proportion of payroll)</td>
<td><img src="image3" alt="Graph" /></td>
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**Redundancy benefits**

All the main public sector schemes provide generous benefits on redundancy.

Historically, both the PCSPS and the NHSPS have provided an immediate unreduced pension with enhanced service on redundancy over age 50 (55
for certain members from April 2010). The calculation and provision of this benefit is straightforward under the public sector scheme. However, it becomes much more complicated following transfer to the private sector:

- The basic pension element (light blue below) is covered by the Fair Deal requirements, and is met from the contractor’s pension scheme.
- The “top-up” element (dark blue below) is deemed to transfer under TUPE as a contractual entitlement, which is a direct responsibility of the new employer. The resulting redundancy payments are termed “Annual Compensation Payments” (“ACPs”).

These two elements can be illustrated as follows:

A company taking on employees on a contract where there are likely to be redundancies needs to understand the potential costs of making these payments now or in the future.

Over the last few years, the Government has attempted to change the redundancy benefits to make them closer to those provided in the private sector. In particular, they intend to remove the right to an enhanced early retirement pension to all except a very limited group of employees who have long service and are close to normal retirement age.

This approach has been challenged by the unions and, currently, (October 2010) it is not clear what the final position will be. The coalition government is enacting legislation which will limit a member’s total benefits under the CSCS to one year’s earnings on compulsory redundancy and 15 months earnings on voluntary redundancy for 12 months – the intention being to reach an agreement with the unions on permanent changes during this period.
Typically, when tendering for a contract, a bidder is provided with a list of employees and an indication of the capital cost for each employee of the enhanced benefits payable on redundancy. However, this shows only the costs if the employees were made redundant on the employment transfer date. No indication is given of how these costs will develop over time as the employees get older and accrue more service.

In this period of uncertainty, it will be important to understand the basis on which these benefits have been calculated and how the changes being discussed might change them in the future. Further, the redundancy costs for apparently similar employees can develop in very different ways, and contractors should be aware of this when pricing and managing the contract.

The main public sector schemes

From a pensions perspective, there are three main types of public sector outsourcing contracts and schemes in England & Wales:

- Central government contracts, where employees transfer from the Principal Civil Service Pension Scheme (“PCSPS”)
- NHS contracts, where employees transfer from the NHS Pension Scheme (“NHSPS”)
- Local authority contracts, where employees either transfer from or remain in the Local Government Pension Scheme (“LGPS”)

The PCSPS and NHSPS are unfunded “pay-as-you-go” schemes, effectively financed from general taxation.

The LGPS, however, is funded, with around 100 separate local authority funds financed largely from council tax. A valuation of each LGPS fund is undertaken on a three yearly cycle with the latest 2010 round of valuations indicating increased contribution requirements.

The Independent Public Service Pensions Commission, chaired by Lord Hutton, published its interim report on public sector pensions in October 2010 and suggests far-reaching changes. The final report is due in April 2011. At present, it is unclear what changes will be made to the public sector schemes.

The report also acknowledges that the Fair Deal, combined with the current format of public sector pensions, acts as a barrier to non-public service providers, reducing the efficiencies and innovation that could potentially be achieved, and that it would be unwise to allow the current arrangements to continue. However, no specific solutions are put forward in the interim report, and it is not clear whether the Commission’s final report will look at this in any more detail.
Contact us
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