Public sector pensions reform - what does it mean for the private and not-for-profit sectors?
LCP’s Public Sector Outsourcing Report examines some of the key areas of relevance within the main public sector pension arrangements, and suggests some immediate actions for outsourcing contractors to consider.

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.

For further information about public sector outsourcing contracts please contact Bart Huby or Tim Sharples, or the partner who normally advises you.

For further copies of the report, please download a PDF copy from our website www.lcp.uk.com or email enquiries@lcp.uk.com or contact Charlie Woods on +44 (0)1962 870060.

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LCP Public Sector Outsourcing Report 2011

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Summary of the benefit structures of the main public sector pension schemes
Private and not-for-profit sector organisations involved in public sector outsourcing need to ensure they understand the pensions risks. And they also need to keep a careful eye on how these risks are affected by the reviews of public sector pensions and the Fair Deal guidance currently underway.
Government spending cuts are leading to increasing scrutiny of public sector pensions, and their potential future costs to the taxpayer. There has been widespread press commentary and public opinion voiced on the impact of proposed changes – and threats of major strike action from some trade unions. Much less has been said, however, regarding the implications that spending cuts and changes within public sector pensions could have for the private and not-for-profit sectors, in particular for organisations bidding for public sector outsourcing contracts.

In this report, we examine the current position of the main public sector pension schemes, and the various changes which have been made or proposed by the Coalition government since taking power last year, including the review carried out by Lord Hutton.

We then look at the “Fair Deal” guidance which prescribes how employees’ pensions should be protected when they are transferred out of the public sector on outsourcing contracts, and how this may be affected by the government review of the Fair Deal currently underway.

Finally, we consider some specific issues that affect local government contracts, and recent changes to the redundancy terms that apply for public sector employees before and after transferring on an outsourcing contract.

With more and more public sector services likely to be outsourced, the consequences of these developments will be of interest both for organisations with a history of bidding for outsourcing contracts, and also for those who may be looking to enter into potential public sector ventures in the future.

The complex area of pensions within public sector outsourcing should not be underestimated, and in this report we also suggest some immediate actions for outsourcing contractors to consider.

For further information please contact LCP’s specialist Public Sector Outsourcing Group.

LCP 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 security in the event the outsourcer fails
- 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
Public sector pension schemes cover over 5 million employees, approximately one sixth of the employed labour force in the UK. As such, they are a key part of the UK pensions landscape. The breakdown of the membership of the main schemes is shown in the following chart.

Besides these, there are also a number of much smaller schemes covering firefighters, MPs and judges, among other groups.

The Local Government Pension Scheme (LGPS) is by far the largest scheme. It is also the only one which is funded, through some 100 local authority pension funds across the UK. Each Fund is administered and invested separately, but must follow the same set of LGPS regulations (with slight variations in Scotland and Northern Ireland). As they are separately funded, each Fund sets its own employer contribution rates.

The other main public sector schemes are all unfunded. However, for government budgeting purposes, notional employer contribution rates are set by considering a notional pension fund, which is assumed to earn investment returns equal to the CPI plus 3% pa. The resulting rate is used to determine the proportion of a department’s budget which is spent on pension costs and is transferred from that budget back to the Treasury.

Employer contributions are as a result set at a significantly lower rate than they would be in a typical funded pension scheme. For instance, the average employer contribution rate in the Civil Service is currently around 19%, which compares to a contribution rate of over 30% which might
2. The main public sector pension schemes

typically be payable by a private sector employer setting up a scheme offering similar benefits. This difference can make the cost of outsourcing a service from central government appear expensive because it means that employment costs are higher by some 10% of salary roll in the private sector.

**Benefit structures**

Until ten years ago all the main public sector schemes had the same basic benefits structure: final salary in nature with a pension of 1/80th per year of service and a separate lump sum of 3/80ths per year of service. Normal pension age was generally 60, and the major difference between the schemes was in the member contribution rates payable: ranging from 1.5% in the Civil Service scheme to 6% for non-manual employees in local government and the NHS, and for all members of the Teachers’ scheme.

Over the past decade, however, there have been significant changes to each of the schemes. The changes made in the past 5 years have been aimed at addressing the impact of the costs of increasing longevity, but have to a substantial extent only done so for new employees, with existing employees largely retaining the same benefits as before. The result is a complex range of benefits, with different structures applying to employees who joined at different times and/or for different periods of service. The main benefits provided by each scheme are summarised in the Appendix. One important new feature within the LGPS and the NHS scheme is the introduction of tiered contribution rates, where a member’s contribution rate depends on their salary level.

**Action Point**

Companies looking at outsourcing contracts need to understand the pension mix of employees being taken on, as there can be significant variation in pension costs between different sections of the same scheme. The range of benefits for different categories of member makes it more complex to provide broadly comparable benefits to transferring employees as, under the current Fair Deal guidance, each different benefit structure has to be broadly matched. Outsourcers need to understand the cost of providing the pensions which will be different to the headline employer contribution in the transferring scheme (and typically significantly higher).

Changes to public sector pensions are by no means finished, as we examine further in the next section which considers the impact of the various Coalition government initiatives, including the Hutton Review of public sector pensions.
As part of its programme for addressing the level of public sector debt inherited from the previous government, the Coalition government announced shortly after taking power a number of initiatives with differing timescales and effects. Each aims to reduce the cost to the taxpayer of providing pensions for public sector employees and to address the impact of increasing longevity.

**Coalition government initiatives**

- **Switch to CPI index for pension increases**
  Announced in June 2010, the switch from the RPI to the CPI as the inflation index for future increases to public sector pensions had the immediate effect of reducing the value of public sector pensions by around 15%. This change affected both future service benefits and benefits already earned. It reduced the capital cost of existing benefits by in the order of £200bn – equivalent to an average of around £16,000 for each of the 12 million members with benefits in the public sector schemes.

- **Increase to member contributions**
  In his October 2010 Spending Review, the Chancellor announced the government’s intention to increase public sector employee pension contributions (except for the Armed Forces) by an average 3% of pay, to be phased in over three years from April 2012. This aims to deliver annual savings of £2.8bn by 2014/15. The government is currently consulting on how to implement this, and has recently indicated that contributions for lower paid employees will not increase, with the rise for the highest earners being no more than 6% of pay.

- **Hutton Review**
  Shortly after the election, the Chancellor asked Lord Hutton of Furness to chair the Independent Public Service Pensions Commission, tasked with carrying out a fundamental review of public service pensions. The Commission published its final report in March 2011, setting out its recommendations on pension arrangements which are intended to be sustainable and affordable in the long term, and fair to both the public service workforce and the taxpayer. In the March 2011 Budget, the
government accepted Lord Hutton’s recommendations in full, as a basis for consultation with public sector workers and unions, and with a target for implementation by April 2015.

In practice, the government’s negotiations with trade unions over the short-term increases to member contributions and the longer-term Hutton reforms have become interlinked and contentious, and further strike action appears likely in the Autumn of 2011.

**Lord Hutton’s recommendations – what he really said**

Long-term structural reform of public sector pensions is inevitably a very complex, and political, issue. As such, it is not surprising that interested parties (and the press) tend to focus on one specific aspect at a time, so that the bigger picture can easily get ignored.

With the aim of providing an overview of all his key recommendations on future benefits, we provide the following table. This focuses on what Lord Hutton proposed should and shouldn’t change, and also on which key elements he felt should be left to the politicians to decide in the context of what, in their view, the public purse can reasonably and fairly afford.

**Lord Hutton’s key recommendations on public sector pension benefits**

<table>
<thead>
<tr>
<th>What should stay the same</th>
<th>What should change</th>
<th>What the politicians should decide</th>
</tr>
</thead>
<tbody>
<tr>
<td>They should remain defined benefit (DB) – in particular there should be no switch to defined contribution (DC), which has become increasingly the norm for the private sector in recent years</td>
<td>For future service, benefits should change from final salary to a career average revalued earnings (CARE) basis (see box overleaf)</td>
<td>The rate at which CARE pensions are earned for future service – ie the accrual rate</td>
</tr>
<tr>
<td>Past service benefit promises should be honoured in full – in particular the final salary link and retirement ages should be maintained for accrued benefits</td>
<td>Normal pension age for future service benefits should increase in line with the State Pension Age – currently 65 and due to increase to 66 by 2020 and to 68 by 2046</td>
<td></td>
</tr>
<tr>
<td>There should continue to be no cap on pensionable pay for past or future service benefits</td>
<td>There should be tiered employee contribution rates, with higher earners paying a greater proportion of their pay, across all the public sector schemes</td>
<td>The overall levels at which employees will pay contributions</td>
</tr>
</tbody>
</table>

The benefit structure of the reformed public sector pension schemes is important because, if the government gets it right, it could form the new benchmark for good pension provision.
What’s the difference between final salary and CARE?

Both final salary and CARE are defined benefit (DB) schemes, as the member’s pension is calculated based on their earnings and service. The key differences are:

In a **final salary scheme**, the member receives a pension based on their final pay at retirement (or earlier leaving service). For example, in a scheme with a 60th accrual rate, the member’s pension after 30 years’ service is $\frac{30}{60} = 50\%$ of final pay.

In a **Career Average Revalued Earnings (CARE) scheme**, each year the member earns an amount of pension based on their pay in that year, which is then revalued each subsequent year in line with an index. At retirement, each year’s accrual is then added up to give the total pension.

Which is better for members?

This depends on two things; firstly the index used for revaluing the CARE pension, and then, for each individual member, whether their pay goes up faster or slower than this index during their career in the scheme.

An important part of Lord Hutton’s recommendations is that the new CARE benefits should be revalued in line with average earnings (not prices) during active service. In contrast, CARE schemes in the private sector typically revalue benefits in line with price inflation, which over the long-term generally goes up at a lower rate than earnings.

Under Lord Hutton’s proposals, CARE benefits will be better than an equivalent final salary scheme for employees whose earnings increase at a lower rate than the national average, while “high flyers” whose earnings increase faster than average would be better off under a final salary scheme (see chart opposite).

It can be argued that a CARE scheme is fairer across the whole of a scheme’s membership than final salary because each member’s benefits more closely reflect the contributions they have paid throughout their career.
The proposed switch to CARE will affect high flyers much more than the average scheme member.

Issues for private and third sector employers

The various changes being made to public sector pensions by the Coalition government are clearly very important to employees in the public sector and to the taxpayer, but they are also important to private and third sector employers.

- Contractors bidding for public sector contracts will need to be aware of progress with public sector pensions reform. This is so that they can price their bids accordingly and also ensure that the contract terms include sufficient flexibility to enable them to reflect changes that reduce the costs of public sector pensions as they take place.

- Organisations that compete with public sector employers when recruiting will need to recognise the value of the revised public sector pension arrangements, once these are finalised, when setting the benefits package they offer new employees. It could even be that, if the Hutton reforms result in a genuinely affordable and sustainable new CARE scheme in the public sector, this will form the basis for a revival of DB pensions in the private sector (at least amongst organisations that are able to take the long term view).

Any changes within public sector pensions must be considered alongside the Fair Deal requirement when private and third sector bidders are looking to take on outsourcing contracts. This is considered further in the next section.
The Fair Deal

The aim of the Fair Deal is to provide greater protection to transferred employees’ pension rights than is provided by TUPE legislation, which provides only very limited protection to occupational pensions. The Fair Deal is currently being reviewed as part of the government’s more general review of public sector pay and pensions.

The Fair Deal for Staff Pensions was introduced in 1999 and is now statutory guidance which applies to all central government bodies who outsource services to the private sector. For local authority contracts, key elements of the guidance have been given legislative effect (from October 2007).

The Fair Deal requires contractors to provide broadly comparable pension arrangements to transferring employees (there are however no requirements for new employees who start working after the contract has commenced). There are three ways of achieving this:

- The contractor can offer membership of its own scheme with a benefit structure which meets the broad comparability test as certified by the Government Actuary’s Department. In practice, the benefit structure can only be slightly different from the public sector pension scheme being tested against.
- The employer uses one of the specialised multi-employer pension schemes run by commercial pension providers which offer a broadly comparable pension scheme “off the shelf” for a relatively low set up cost.
- If the contract involves members of the LGPS, the employer can become a participating employer in the relevant LGPS Fund and the employees’ benefits continue unchanged. This approach is referred to as the “Admission Body” route.

Whatever route is used, the Fair Deal increasingly means that contractors are having to provide significantly different pension benefits to different components of their workforce. This can lead to employee communication challenges; for example, two employees can be performing the same role, with one earning a generous defined benefit pension, and the other (eg a new employee on the contract) receiving a much lower defined contribution benefit.

The options for meeting the Fair Deal are compared in the table opposite for an employer considering taking on a relatively small number of employees under an outsourcing contract.

For an employer considering taking on a larger number of employees, or a number of such contracts, then the costs involved in running their own standalone scheme become more reasonable in light of the additional control that this gives the employer.
“Past Service Risks” arise because a contractor is required to offer employees the opportunity to transfer their past service pension rights into the new scheme. However, in practice, most employees leave their deferred pension in the public sector scheme. Under the standard LGPS Admission Body agreement the employer takes on liability for all members’ pensions, including those arising from prior service. Although the assets to cover this on Day 1 are provided, any investment losses or other adverse experience will mean that the employer has to make good the shortfall on the full past service pension position, which is not the case with the other (non Admission Body) routes.

### Reducing Risk
Contractors are increasingly managing to negotiate a reduction in the investment and funding risks under the Admission Body route. This is done by agreeing with the body outsourcing the contract that it will retain some or all of the associated risks, and negotiating appropriate wording in the main outsourcing contract.

During the consultation on the Fair Deal, the government has asked how Admission Body agreements could be extended to the unfunded public sector schemes in a way which does not leave all the risks with the taxpayer. It will be of interest to all parties involved with outsourcing contracts to monitor developments here.

### Action Points
- Are your bid team fully up to speed with the pensions issues that arise in outsourcing contracts?
- Are they making proper allowance for pension costs in their acquisition price models?
- Are they aware of the opportunities to reduce pensions risk through negotiating the terms of the contract?
5. Specific considerations for local government outsourcing

Many outsourcing contracts for local government services cover only a small group of employees. The ability to enter into Admission Body Agreements with Local Authority Pension Funds (LAPFs) often provides the only practical mechanism for pensions to be provided to these employees. However, contractors need to understand that the default form of agreement exposes them to significant risks, particularly as, upon signing the agreement, they effectively hand over control of all pension decisions for the transferring employees to the pension fund administering authority.

In particular, if market conditions change adversely during the contract, the contractor’s Admission Body section in the LAPF will become underfunded. This can lead to an increase in employer contributions following actuarial valuations and a substantial termination payment being levied at the end of the contract, as illustrated in the chart below.

![Chart showing pension obligations and termination payment](image)

Source: LCP research

Most LAPF administering authorities are unwilling to change the terms of the Admission Body Agreement to reduce contractors’ risks. However contractors can sometimes obtain significant protections through negotiating a transfer of risk back to the contracting authority in the main outsourcing contract. These negotiations can only take place as part of the main initial contract discussions, but contractor bid teams are often not aware of the potential risks involved in blindly accepting the standard pension provisions.

As the adjoining case study shows, the potential costs to a contractor of accepting the standard wording can be a significant percentage of employment costs over the whole term of the contract.

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**Case Study**

A council outsourced its parks’ maintenance service, and transferred thirty employees to the new contractor. The contractor became an Admission Body on the standard terms. The agreement provided for a cessation payment if the contract was broken before the end of the five year contract term. Two years in, the Council decided to terminate because government cost cuts meant that they no longer wanted to provide the service.

The contractor and the council negotiated the contract termination terms and the council agreed to pay the redundancy costs of the transferred employees. At the time, the contractor had been notified that there was a pensions surplus on the ongoing funding basis. However, following the contract termination, the pension fund sent the contractor a bill for a cessation payment equal to 30% of the salary roll of the employees who had just been made redundant. The payment was in line with the cessation provisions of the Admission Body Agreement and the contracting authority refused to help meet the payment even though they had triggered the cessation.

As the payment was in line with the agreement there were no grounds on which to challenge it. The Contractor involved LCP at an early stage in the next bid which they undertook.
More recently we have seen a greater willingness by some contracting authorities to use a “pass-through” arrangement whereby the contractor is not responsible for any risks on pensions relating to pre-contract service except those caused by the contractor’s actions (for instance, salary increases greater than assumed or the granting of enhanced redundancy terms). However, this position is still usually only reached after negotiation. Bid teams need specialist knowledge to understand the pensions risks and to ensure that these are correctly recognised in the contract pricing model.

The LGPS Pension Fund Lottery
Each local authority pension fund determines its own investment and funding strategy. Under an Admission Body Agreement, contractors normally have to keep the transferring employees in the same pension fund and pay contributions on their behalf. Therefore, the investment performance and contribution rates payable very much depend on the specific pension fund involved. The following graph shows the variability in investment performance over the three years ending March 2010 when the most recent actuarial valuations for the LGPS were completed. The graph shows results for ten LGPS funds drawn at random.

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**Random sample of Local Authority Pension Funds**

Annualised average underperformance of investments against benchmark over three year period to 31 March 2010

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<th>% pa</th>
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Source: LCP research

As investment losses are likely to have to be covered by additional deficit contributions, Admission Bodies in different pension funds will be facing significantly different increases in contributions following the 2010 valuations, depending on the performance of the particular fund’s investments. Potential increases to ongoing contribution rates therefore need to be carefully considered when bidding for local government contracts.

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**Action Points**

Ensure that pensions are included in the contract negotiations and that the risk of increased contributions both during and at the end of the contract are included in the pricing model.

Negotiate a risk sharing arrangement with the contracting authority where possible.
The calculation of redundancy benefits following a TUPE transfer of employment is both complicated and currently subject to considerable uncertainty over the legal position. Redundancy costs can be worth as much as seven times an employee's pay. A full understanding of these restructuring risks is, therefore, critical to the profitability of public sector outsourcing contracts.

**Background**

Redundancy benefits are not covered by the government's “Fair Deal” guidance. Instead, when an employee transfers employment out of the public sector to the private sector, their redundancy entitlement transfers contractually under TUPE. Therefore, any redundancy costs (including enhanced early retirement costs) become the direct responsibility of the contractor.

Public sector redundancy benefits are generous (particularly in the Civil Service and NHS) and, in most cases, significantly more than statutory redundancy pay. The system has however undergone some recent radical reform.

**“Old style” benefits**

Typically in the past, the form of the redundancy benefit was a cash lump sum, plus (if an employee was aged over 50 with sufficient qualifying service - or earlier in some cases) a pension, based on accrued service plus a service enhancement, payable immediately in full with no reduction for early payment. (Under the LGPS any service enhancement would be at the employer’s discretion.)

The basic pension entitlement was covered by the Fair Deal, but the cost of the service enhancement and paying the pension without actuarial reduction became contractual obligations for the new employer, in the form of “annual compensation payments” or “ACPs”. An example redundancy payment profile can be seen in the chart opposite.

The equivalent capital cost to the contractor of providing the contractual redundancy benefit could be up to seven times an employee's pay under these “Old style” benefits.
Redundancy issues

“New style” benefits
In order to address the high costs, complexity and the age discriminatory nature of the “Old style” benefits, significant changes have been made by the government to public sector redundancy benefits.

Under Civil Service and NHS employment, the “New style” benefits take the form of a cash lump sum, with an option for older employees to take immediate unreduced early retirement (but with no service enhancement).

Although generally cheaper than under the “Old style” benefits, costs to the contractor could still be worth up to four times an employee’s pay where the member has the option to take unreduced early retirement. Actuarial input can still be required to assess and model the cost of these benefits.

Legal uncertainty
There remains considerable legal uncertainty about whether “New Style” benefits apply to employees who transferred under an outsourcing contract, which pre-dates these changes in public sector redundancy benefits. Legal advice should be sought in order to ascertain whether current terms or the terms effective at the date of TUPE transfer should apply. The cost implications of any incorrect interpretation could be significant if challenged in the future.

Cherry picking - New versus old style benefits
Although this is usually the case, Civil Service redundancy terms are not always cheaper to the employer under the “New style” benefits. A clear policy on the approach being adopted should therefore preferably be put in place in order to avoid stakeholders attempting to cherry pick the results that are in their best interests.

Redundancy cost modelling
LCP has developed a range of redundancy cost modelling tools to help employers understand how their TUPE obligations on redundancy develop over time for their transferred employees.

Action Point
When bidding for public sector outsourcing contracts, bid teams need to consider very carefully any efficiency savings expected to be made as a result of restructuring exercises. Unexpected additional redundancy costs could occur if TUPE issues are not considered at an early stage.
### Summary of the benefit structures of the main public sector pension schemes

<table>
<thead>
<tr>
<th></th>
<th>Civil Service</th>
<th>NHS</th>
<th>Teachers</th>
<th>Local government</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Normal retirement age</strong></td>
<td>60</td>
<td>60</td>
<td>65</td>
<td>60</td>
</tr>
<tr>
<td><strong>Type of scheme</strong></td>
<td>Final Salary</td>
<td>Final Salary</td>
<td>CARE</td>
<td>Final Salary</td>
</tr>
<tr>
<td><strong>Pension Accrual Rate</strong></td>
<td>1/80th</td>
<td>1/60th</td>
<td>2.30%</td>
<td>1/80th</td>
</tr>
<tr>
<td><strong>Member Contributions</strong></td>
<td>1.5%</td>
<td>3.5%</td>
<td>3.5%</td>
<td>5.0%/6.0%</td>
</tr>
<tr>
<td><strong>Spouse's pension % of member's pension before commutation</strong></td>
<td>50%</td>
<td>37.5%</td>
<td>37.5%</td>
<td>50%</td>
</tr>
</tbody>
</table>

Source: LCP research
LCP Public Sector Outsourcing Report 2011

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