The new Fair Deal for pensions: opening the door to greater competition in public sector outsourcing.
LCP’s Public Sector Outsourcing Report examines and comments on some of the key issues and implications associated with the new guidance “Fair Deal for staff pensions: staff transfer from central government” issued by HM Treasury in October 2013. This report and the information it contains should not be relied upon as advice from LCP.

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 contracts.

This report may be reproduced in whole or in part, provided prominent acknowledgement of the source is given. Although every effort is made to ensure that the information in this report is accurate, Lane Clark & Peacock LLP (LCP) accepts no responsibility whatsoever for any errors, or omissions, or the actions of third parties.

This report is based on relevant guidance and legislation at December 2013.

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 Nelly Geudin on +44 (0)20 7432 6710.

© Lane Clark & Peacock LLP December 2013
LCP Public Sector Outsourcing Report

p5  Introduction and main findings

p8  1. The Fair Deal: opening the door to greater competition
   p10  Background
   p10  The new Fair Deal guidance
   p11  Where have the main public service schemes got to on implementation on the new Fair Deal?
   p11  How the new guidance will work in contracts

p12  2. Bidding
   p14  General bidding issues
   p16  Contract termination and bulk transfers (second generation transfer)
   p20  Redundancies

p24  3. Local government contracts
   p26  Potential impact of the new Fair Deal guidance on LGPS contracts
   p27  Implications of the new LGPS benefits for admission body agreements

p29  Appendix: The new public service pension schemes
   p30  Summary of new public service pension scheme provisions being introduced under the Public Service Pensions Act 2013
The impact for you of the new Fair Deal guidance depends considerably on whether your organisation is new to this marketplace or is an experienced participant.

**NEW ENTRANT**

The new Fair Deal removes the large bulk of pensions risks which have until now deterred many organisations from bidding for public sector contracts.

You can now bid for public sector outsourcing contracts without needing to put in place your own pension scheme for transferring employees. There are however some important pensions issues you will need to consider when bidding.

**SECTION 1: The new Fair Deal**

Background to the new Fair Deal guidance and how it will be applied in contracts for the various public service schemes.

See page 8

**SECTION 2: Bidding**

Issues when bidding for public sector contracts, including what happens at the end and re-bid of existing contracts, and specific issues where redundancies are anticipated during a contract.

See page 12

**SECTION 3: Local government contracts**

The position on local government “best-value” contracts - these are not directly affected by the new Fair Deal guidance, but have many similar pensions issues to consider when bidding.

See page 24

**EXPERIENCED PARTICIPANT**

There will be no need to provide your own broadly comparable pension scheme on future contracts. At the end of existing contracts, employees in your broadly comparable scheme will be able to rejoin their old public service scheme.

Future contract bidding should get simpler. Your focus is likely to move towards issues on bulk transfer terms at the end of existing contracts, and how to deal with your broadly comparable scheme once all the employees have transferred back to the public sector.

**WHAT’S NEW?**

**WHAT DOES IT MEAN FOR ME?**

**WHAT’S IN THIS REPORT?**
Outsourcing is an important part of the Government’s programme aimed at improving the cost-effectiveness and quality of public services, and the UK now has the biggest outsourcing market outside of the United States, with contracts worth £4bn being let every year.

The Government’s long-standing Fair Deal policy protects the pensions of employees transferred on outsourcing contracts, but has become increasingly problematic in recent years as companies and charities have moved away from providing defined benefit pensions for their main workforce.

We believe the new Fair Deal guidance, published by the Treasury in October 2013, can be a significant game changer, encouraging organisations which had previously been deterred from bidding for public sector contracts because of the pensions risks, to do so in future. As such it has the potential to significantly improve the cost-effectiveness of outsourcing public services.

For over 20 years LCP has provided specialist advice and support to organisations bidding for public sector contracts, and has been involved in lobbying the Government to make the kind of changes to the Fair Deal policy which are now coming into effect.

We very much welcome the new Fair Deal, and the opportunities it will bring for a much wider range of organisations to take part in this important marketplace. There is nevertheless considerable “devil in the detail” that such organisations will need to take into account when bidding, the key aspects of which we consider in this report.

Whether you are new to this market, or an experienced player, we hope you will find this report an interesting and helpful review of the new pensions landscape for public sector outsourcing contractors.

Bart Huby
Partner, LCP

HM Treasury response to further consultation on the Fair Deal policy

October 2013

…the Government believes that it should focus on the long term objective of achieving better value for money in the delivery of public services. In the Government’s view removing the costs and risks of defined benefits pension provision from independent providers of public services is the best way to achieve this objective.
Main findings

A major step forward for contractors.
The new Fair Deal guidance is a real improvement over the previous guidance, which has been in place since 1999. Once fully implemented, it will remove the large bulk of pensions risks on central government and NHS contracts, which until now have acted as a major barrier to entry to this market for so many organisations (see next page summary).

The option for employees on existing contracts to transfer their benefits back into the public sector at the end of a contract also gives contractors an opportunity to secure some current pensions liabilities at a much lower cost than by buying out with an insurance company.

There are shortcomings in the new guidance, for example the uncertainty over how it affects contracts currently mid-procurement, and the unnecessarily complicated provisions for dealing with bulk transfers at the end of an existing contract. Nevertheless we believe that, overall, the new Fair Deal is good news for all parties involved in outsourcing: the Government, the outsourced employees, and contractors.

But what about local authority contracts?

A very important area of public sector outsourcing which is not directly affected by the new Fair Deal guidance is that of local authority contracting, particularly under the “Best Value” regime. Transferred employees are able to remain in the Local Government Pension Scheme (LGPS), but the current rules mean that the outsourcing contractor still has to take on significant investment and funding risks on pensions, unless it is able to negotiate these out within the commercial contract.

Local authority contracts are particularly significant for the SME and charity sectors. It will be important, therefore, that the promised parallel review by the Department of Communities and Local Government (DCLG) of LGPS pensions on outsourcing contracts is carried out quickly and effectively in order to open up this area to greater competition too.
**Barriers to entry**

Once fully implemented the new Fair Deal will remove the large bulk of pensions risks and issues that have deterred many organisations from bidding for public sector contracts.

<table>
<thead>
<tr>
<th>Deterrent to outsourcing</th>
<th>Barrier under old Fair Deal</th>
<th>Barrier under new Fair Deal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial and longevity risks of defined benefit (DB) pensions</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Set-up and operating costs of providing a broadly comparable pension scheme</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Uneven playing field on pensions against public sector in-house bids</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Two-tier workforce issues</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Long-term residual legacy pensions liabilities remaining at end of contract</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Difficulties in allocating pensions costs and risks between partners on JV bids</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Adequacy of bulk transfer terms from public service schemes</td>
<td>✔</td>
<td>×</td>
</tr>
<tr>
<td>Lack of control over pensions risks and costs in separate trustee-run scheme</td>
<td>✔</td>
<td>×</td>
</tr>
</tbody>
</table>

The main continuing issue under the new Fair Deal rules is that employees who have previously transferred from public sector employment will generally have better pension benefits than their colleagues within the same organisation - meaning a two-tier workforce on pensions.

*The need to provide a broadly comparable DB pension is being removed. This may present new opportunities for your organisation.*

Alex Whitley
Partner
LCP
The Fair Deal: opening the door to greater competition

Background

The new Fair Deal guidance

Where have the main public service schemes got to on implementation on the new Fair Deal?

How the new guidance will work in contracts
Under the new Fair Deal outsourced employees can now remain in the public sector pension schemes, which are currently at different stages in terms of being able to implement the new policy.
1. The Fair Deal: opening the door to greater competition

A new regime aimed at simplifying pensions on outsourcing.

In October 2013 the Treasury published the long-awaited revised Fair Deal guidance, confirming that in future employees who are transferred out of many forms of public service employment on outsourcing contracts will be able to remain members of their existing public service pension scheme.

In announcing the new Fair Deal guidance, Danny Alexander (Chief Secretary to the Treasury) stated:

_The new approach will … achieve better value for money for the taxpayer by reducing the costs and risks to employers associated with the provision of broadly comparable pension schemes, thereby opening up public services to greater competition._

_Hansard, 8 October 2013_

**Background**

The Fair Deal policy was introduced in 1999 as non-statutory guidance, and is aimed at protecting the pensions of employees transferred from central government (including government agencies, the NHS, maintained schools, and any other parts of the public sector under ministerial control) to other employers, in particular on outsourcing contracts.

Until now, the Fair Deal guidance has required contractors to provide their own defined benefit (DB) pension schemes for transferring employees, at a time when the general trend in the UK has been towards defined contribution (DC) pension provision. This has resulted in many companies and charities being deterred from taking part in this marketplace; and in those contractors willing to take part increasingly applying significant risk premiums for pensions in their contract pricing.

The Fair Deal policy has been under review since in 2011 Lord Hutton’s Independent Public Service Pensions Commission found that it was a barrier to plurality in public service provision and recommended a review.

**The new Fair Deal guidance**

The new guidance was published on 4 October 2013, following an extended consultation process. It confirmed that in future transferred employees will be able to remain members of their existing public service pension scheme. Further, where an existing outsourcing contract is relet, eligible employees will in future normally return to the public service pension scheme of which they were originally a member.

The new guidance became effective immediately on 4 October 2013, but with the following caveats:
1. The Fair Deal: opening the door to greater competition

- There was no requirement for this to disrupt an existing procurement exercise underway at the time; and
- It is necessary for the various public service schemes involved to put in place appropriate regulations and/or procedures to admit new employers, so until this has happened it may be necessary to continue to operate under the previous Fair Deal guidance.

Where have the main public service schemes got to on implementation of the new Fair Deal?
The current position of the main public service schemes is as follows:

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Current position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal Civil Service Pension Scheme (PCSPS)</td>
<td>Scheme changes made in October 2013 and related guidance issued on 30 October 2013 with example pro forma admission agreements. The first new employer has already been admitted.</td>
</tr>
<tr>
<td>NHS Pension Scheme (NHSPS)</td>
<td>Already has flexibility to use the existing “Direction Body” regime, through extending this to the private sector. New guidance expected late 2013/early 2014.</td>
</tr>
<tr>
<td>Teachers Pension Scheme (TPS)</td>
<td>Some flexibility under existing arrangements. The Department for Education is currently consulting on its approach to introducing the new Fair Deal into the TPS.</td>
</tr>
<tr>
<td>Local Government Pension Scheme (LGPS)</td>
<td>Fair Deal guidance does not apply to local authority “Best Value” contracts – as these are covered separately by Department of Communities &amp; Local Government (DCLG) directions which require broadly comparable pensions to be provided. DCLG will in due course be considering what is needed to ensure the principles of the new Fair Deal apply to local authority contracts – though the timing of this is uncertain. The new Fair Deal does, however, already apply to some employers (eg Academies) with LGPS employees.</td>
</tr>
</tbody>
</table>

How the new guidance will work in contracts
The new guidance requires the contractor to have a Participation Agreement with the relevant public service scheme, and for provisions to be agreed under the outsourcing contract covering the extent to which any future changes in contributions are passed through to the contract price.

Contractors will normally pay the same employer contribution rates as all other employers in the public service scheme, but then makes provision to allow schemes to do the following:

- Vary contractor contributions at each funding valuation to reflect experience;
- Require additional contributions from the contractor to meet the cost of unusually high salary increases and other employer actions such as making employees redundant or exercising discretions under the scheme to increase benefits.

The scheme will also be able to require an indemnity or bond from the contractor if concerned about the covenant of an employer and its ability to pay the required contributions.
Content

p12 Bidding

p14 2.1 General bidding issues

p16 2.2 Contract termination and bulk transfers (second generation transfer)

p20 2.3 Redundancies
From the preliminary bidding stages to the end of contract term outsourcers need to keep a close eye on their specific contract terms and risks. This is essential to avoid unwanted surprises.
2. Bidding

What contractors should look out for when tendering for public sector contracts.

Organisations bidding for contracts will need to look carefully at a considerable range of potential pensions issues that may affect their bids. These issues are examined in this section, and split out under three main headings, which will typically be relevant in the following situations:

<table>
<thead>
<tr>
<th>Heading</th>
<th>Where relevant</th>
</tr>
</thead>
<tbody>
<tr>
<td>General bidding issues</td>
<td>Any outsourcing contracts where employees have previous public sector employment</td>
</tr>
<tr>
<td>Contract termination and bulk transfer issues</td>
<td>“Second generation” outsourcing contracts being re-bid at the end of their original term</td>
</tr>
<tr>
<td>Redundancies</td>
<td>Contracts where material numbers of ex-public sector employees are expected to be made redundant during the term of the contract</td>
</tr>
</tbody>
</table>

2.1 General bidding issues

Ongoing considerations throughout the outsourcing process

- Make sure you have all the details you need to price your bid properly
- Negotiate appropriate risk and cost mitigation within the contract
- Regular monitoring against agreed contract terms to avoid surprises

Understanding what’s going on

It will be important to identify early on in the bidding process:

- Whether the contract is being let under the terms of the old or the new Fair Deal. If procurement began under the old Fair Deal, is it possible to switch to the new Fair Deal to reduce pensions costs and risks?
Details of the employees who will transfer on the contract and are covered by the Fair Deal, including whether they are 1st generation transfers (ie direct from the public sector) or 2nd generation transfers from previous contractors, and which public service scheme(s) they are linked with.

For 2nd generation employees, what provisions apply in respect of bulk transfer options for their past service benefits, in particular if the new contractor is being asked to take into account in the bid any shortfall against the amount required by the public service scheme to secure like-for-like service credits (see section 2.2 for further details).

**Contract terms and pricing issues**

Assuming the contract is being let under the terms of the new Fair Deal, the following issues will need to be considered within bid pricing:

- What allowance to include for contributions to the public service pension scheme. This is likely to be in line with the current employer contribution rates to the scheme in question, but what will happen if these rates change following an actuarial valuation? It may be appropriate to negotiate a contract provision that the cost of any changes in contribution rates will be covered by the letting authority (subject perhaps to a cap/collar).

- How to allow for the impact of the end of contracting-out in April 2016. This legislative change will result in an increase in National Insurance contributions for both the contractor and the employees but, unlike private sector schemes, there is no provision for benefits in the public service schemes to be amended to reflect this increase in costs.

- The requirement under the auto-enrolment rules for any eligible employees not currently members of the relevant public service scheme to be enrolled into that scheme at each auto-enrolment event – this could result in a significant increase in costs if these employees do not then subsequently opt out.

- Will the contractor be required to provide a bond or indemnity to protect the public service scheme against the contractor not meeting its costs under the scheme? If so, what will it cost to secure such a bond or indemnity?

- What allowance to make for redundancy benefits and costs, if there is likely to be a significant number of redundancies during the term of the contract. Public service redundancy benefits following a TUPE transfer are complicated and can, in some circumstances, be very expensive. Redundancy issues are considered further in section 2.3.

**ACTION POINT**

Look now at any ongoing contract bids to see whether pension costs and risks can be removed or mitigated based on the provisions of the new Fair Deal.
Contract planning and ongoing management

A number of important issues relating to the ongoing management of pensions issues may also need consideration at the bid planning stage, including:

- What pension benefits will be provided for new employees working on the contract, and what will these cost? The Fair Deal guidance only applies to employees transferring out of public sector employment - new employees on the contract will not be able to join the public service scheme.

- If significant pay increases are likely to be made to any employees on the contract, it will be important to put in place processes to check that these do not accidentally result in extra contribution requirements to the public service scheme.

- If any of the transferring employees are likely to be reassigned within the business during the contract, either permanently or temporarily, procedures are needed to ensure that due consideration is given to their continuing eligibility for membership of the public service scheme. This should take into account that such employees need to remain wholly or mainly employed on the contract to continue in membership of the scheme.

2.2 Contract termination and bulk transfers (second generation transfer)

Understanding what happens at the end of an existing outsourcing contract is important, both for the current contractor and for bidders when the contract is re-bid. While the new Fair Deal recognises there may be occasional circumstances where, for fair competition reasons, a different approach needs to be adopted, the default route under the new Fair Deal is as follows:

- All original ex-public sector employees still working on the contract at termination should be readmitted to the relevant public service scheme, in the membership category they would have been in had they remained in the public service scheme throughout. This is the default position even if the current contractor retains the contract on re-let.

- All such employees should be offered the option of transferring their benefits in the current contractor’s broadly comparable scheme back into the public service scheme with like-for-like service credits. The benefits of pensioners and deferred pensioners no longer working on the contract will, however, normally remain in the current contractor’s scheme.
Will employees benefit from moving back into the public service scheme?

It is expected that most employees will welcome the opportunity to move back into the public service scheme in which they were previously members, as they are likely to see this as giving greater security for their pensions.

It is worth noting, however, that on many contracts readmission into the public service scheme will result in the employees paying higher levels of member contributions, compared with their existing broadly comparable contractor scheme. It may also result in the employees receiving less valuable pension benefits going forwards – for example, the pension increases in public service schemes are now linked to CPI inflation, whereas in many contractors’ schemes they are still linked to the generally higher RPI measure of inflation.

Such differences will need to be highlighted to employees and unions as part of the TUPE transfer consultation at the end of the contract, and this may result in some employee dissatisfaction with the new arrangements. Where the existing contractor retains the contract (so there is no TUPE transfer of employment), it will still be necessary to carry out a statutory consultation with affected employees in respect of the change in their pension benefits and contributions following transfer back into the public service scheme.

Bulk transfer terms on existing contracts

An important issue in the contract re-bid process will be the bulk transfer terms on offer from the current contractor’s broadly comparable scheme, and how these compare with the amount required by the public service scheme to provide like-for-like service credits. The new Fair Deal guidance envisages the following process taking place:

- At the start of the procurement process, the current contractor will provide details to the letting authority of the bulk transfer terms on offer. These terms will depend on a number of potential factors, including any specific provisions on bulk transfers in the rules of the contractor’s scheme and any requirements of the original outsourcing contract (since 2004 such contracts should include specific provisions regarding these bulk transfer terms).

- If the contractor’s scheme is unable to provide the full bulk transfer amount required by the original contract (due for example to underfunding), the current contractor will be required to make up the shortfall.

ACTION POINT

Contractors with existing contracts should ensure they know their bulk transfer commitments and begin planning for how these will be handled at contract end.
Separately, the public service scheme will provide details of the minimum bulk transfer terms necessary to secure like-for-like service credits for these employees.

If there is a shortfall between the bulk transfer terms offered by the current contractor and the terms required by the public service scheme, details of this should be provided to all bidders, who will then need to indicate in their bids how they would propose to deal with this shortfall.

If the successful bidder is not prepared to meet such a shortfall, ultimately the letting authority will need to make up the difference so that all transferring employees are offered the bulk transfer option with full service credits.

---

**Issues for contractors at contract end**

The requirement to provide a bulk transfer back into the public sector for those employees who elect to take it offers contractors a potential opportunity to secure existing DB pensions liabilities at a relatively low cost at the end of a contract (even if the contract is retained). This will be welcomed by contractors. In some cases it could even be possible to negotiate transfer of liabilities related to ex-public sector employees no longer working on the contract.

However, the process on contract re-bids requiring all bidders to take into account any shortfall in bulk transfer terms from the incumbent contractor’s scheme appears unnecessarily complicated, time-consuming and expensive. We would expect most bidders in practice to decline to include any allowance for meeting such a shortfall in their bids, so that the letting authority would ultimately need to make up the shortfall – but the process involved could take substantial time and resources to reach that conclusion.

Additional bulk transfer issues that contractors and bidders may need to consider include the following:

- Identifying which liabilities can be transferred back to the public sector scheme, clarifying the bulk transfer terms required under the existing...
contract, and agreeing them with the letting authority, can sometimes be problematic. Particularly for older contracts, it can be difficult to locate definitive documentation (if it ever existed), and in some cases the provisions are not clearly drafted or straightforward to understand.

- Subject to any contractual obligations, contractors are likely to wish to minimise the bulk transfer amounts payable from their schemes at the end of contracts, given that ultimately the public sector letting authority will need to make up any shortfall to enable members to transfer back into the public service scheme.

- If there is a significant shortfall between what the contractor is required to offer as a bulk transfer and the amount required by the public service scheme, the letting authority may put pressure on the contractor to improve the terms to narrow the gap. Similarly, other bidders may come under pressure to cover some of the shortfall, even though it is purely a historical issue.

- A bulk transfer is likely to be treated as a “settlement” under corporate pensions accounting rules and, where such a settlement is likely to be significant, the contractor may want to consider its potential impact on the organisation’s P&L for the year in question.

- The transfer of all remaining active employees back into the public service scheme could trigger the need for the contractor to make a substantial additional payment into its broadly comparable scheme, known as a “Section 75 debt”, for example where the contract is through a special purpose vehicle participating in a multi-employer scheme. Note that this could happen even if the contract is retained on re-let.

**Transferring liabilities back to the public sector**

The new Fair Deal offers current outsourcing contractors the potential to transfer back into the public sector significant amounts of their existing DB pension liabilities as contracts come to an end – at a substantially lower cost than would be needed to buy them out in the insurance bulk annuity market.

Nobody really knows exactly how much may be involved, but we believe a reasonable estimate may be that up to 200,000 employees on outsourcing contracts will transfer back into the public sector pension schemes over the next 5 to 10 years, with up to £30 billion worth of pension liabilities going with them.

As the central public service schemes are not funded, the resulting assets transferred across will be available to help reduce Government debt now, albeit the related additional pension liabilities taken on will need to be met by the State over the coming decades.
2.3 Redundancies

Public service redundancy benefits following a TUPE transfer are complicated and currently subject to significant uncertainty over the legal position (as illustrated by the two recent court cases considered in this section). They can, in some circumstances, be very expensive (particularly in the Civil Service and NHS), especially so if there are employees on 2nd generation contracts who transferred out of the public sector several years ago (in some cases they can cost up to seven times the employee’s pay).

Furthermore, redundancy benefits are contractual rights and the contractor will need to put in place separate administrative arrangements for them (and some other benefits – eg injury benefits), as they are not included in the main public service scheme benefits covered by the contractor’s Participation Agreement under the new Fair Deal.

Where redundancies are likely, a full understanding of these restructuring risks is critical to the profitability of public sector outsourcing contracts.

Early retirement rights on redundancy

As noted, redundancy benefits are not covered by the Fair Deal guidance. Instead, when an employee transfers employment out of the public sector, their redundancy entitlement transfers contractually under TUPE. Therefore, any redundancy costs become the direct responsibility of the contractor.

The Beckmann and Martin cases of 2003 and 2004 established a key principle, based on EU law, that redundancy early retirement rights transferred under TUPE as contractual entitlements, separately to normal pension benefits – which are excluded from TUPE but covered by the Fair Deal policy. However, the generally accepted interpretation of this has recently been brought into question by the recent Procter & Gamble v SCA case, as discussed below.
The Procter & Gamble case
The Procter & Gamble v SCA case ruling made in May 2012 has complicated matters by suggesting a different interpretation as to what early retirement redundancy rights transfer under TUPE.
Previously, the generally accepted position, based on the Beckmann and Martin cases, was that rights to early retirement pension benefits on redundancy transferred under TUPE, albeit that it was reasonable to offset against these rights any normal pension benefits payable in respect of the same periods of employment. However, the Procter & Gamble case ruling suggests that the rights that transfer under TUPE may only be in respect of the payment of the relevant early retirement pensions up to normal pension age.

An important difference here is that, under the previous position, it was understood that any early retirement pension relating to a service enhancement on redundancy would need to continue to be paid until the employee’s death; whereas under the Procter & Gamble ruling it may only need to be paid until normal pension age. It should however be noted that the Procter & Gamble ruling related to a dispute between two companies about the value of an indemnity in a corporate transaction, and this issue has not been tested in the case of an individual employee. The amounts at stake can be substantial, particularly where a significant number of redundancies are involved, so greater clarity on this issue would be welcome.

The chart below illustrates this uncertainty for an example of an employee made redundant at age 51 with entitlement to an unreduced pension based on enhanced pensionable service and a normal pension age of 60.
Recent changes to public service redundancy benefits

Public service redundancy rights have undergone some major reforms in recent years, including the following:

- Significant changes were made to redundancy benefits in the NHS in October 2006, and for the Civil Service in December 2010, in each case reducing materially the value of the early retirement redundancy benefits in many situations – though increasing the value of the redundancy lump sums in some cases.

- In the Local Government Pension Scheme, the earliest age at which an unreduced pension could be taken on redundancy was increased from 50 to 55 in April 2010, removing this valuable benefit for employees made redundant between ages 50 and 55.

These changes, and the increasing number of redundancies in recent years on public sector contracts, have raised the important question of what redundancy benefits apply for employees who TUPE-transferred out of public sector employment prior to the changes made to the relevant public sector redundancy benefits. Is it the redundancy terms that applied at the point of TUPE-transfer or is it the terms of the relevant public sector scheme at the point of redundancy?

Ultimately this is a question of employment law, and the answer will depend on the specific circumstances of the TUPE-transfer and what was agreed in the contract and communicated to the employees at that time. The position may also be impacted by the recent ECJ ruling in the Alemo-Herron v Parkwood Leisure Ltd case, as discussed below.

The Alemo-Herron v Parkwood Leisure Ltd case

On 18 July 2013, the ECJ handed down its long-awaited judgement in this case, in which it ruled that employees who TUPE transfer to a new employer are not entitled to benefit from collectively agreed terms where such terms are agreed after the date of transfer and where the transferee employer is not a party to the collective negotiations. This “static” approach (where it is the terms applying at the date of TUPE transfer that continue to apply in such circumstances) contrasts to the alternative “dynamic” approach (where future collectively agreed changes would override the terms at the TUPE date).

This ruling has generally been welcomed by outsourcing providers as it provides a degree of certainty about salary levels and related areas which may be affected by a collective agreement which they have no control over.
Importantly, however, a potential implication of the ruling to public sector redundancy benefits transferred under TUPE may be that the redundancy terms that applied at TUPE transfer will continue to apply to such employees (unless renegotiated), where the relevant public sector terms have been subsequently amended. This has particular significance for employees with ex-Civil Service or NHS redundancy terms, where there have in recent years been significant changes which have generally reduced the value of the relevant statutory redundancy terms.

**Administrative issues with redundancies**

Appropriate administrative arrangements will need to be considered by contractors for any employee benefits not covered by the Fair Deal, eg redundancy benefits and injury benefits. This is because membership of the relevant public service pension scheme under the Fair Deal will only cover the main pension benefits.

As an example, public sector employees who are members of the Principal Civil Service Pension Scheme (PCSPS) are also covered for injury benefits by the Civil Service Injury Benefits Scheme (CSIBS) and for redundancy benefits by the Civil Service Compensation Scheme (CSCS). Under the new Fair Deal, such employees will continue to be members of the PCSPS following a TUPE transfer on an outsourcing contract, but will no longer be covered by the CSIBS or the CSCS – although the contractor is required under TUPE to provide the same injury and redundancy benefits as under the CSIBS and the CSCS.

In such cases, we understand that MyCSP (the administrator of the PCSPS, the CSIBS and the CSCS) has agreed to provide contractors with a parallel administrative service to enable equivalent benefits to be calculated. Contractors should, nevertheless, be aware of the need to provide these benefits separately from pensions, and also of the possibility of a divergence between previously transferred employees' benefits and those under the relevant public service arrangement, should these subsequently be amended – as a result of the "static approach" ruling in the Alamo-Herron case.

**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.
Content
p24 Local government contracts
p26 Potential impact of the new Fair Deal guidance on LGPS contracts
p27 Implications of the new LGPS benefits for admission body agreements
For the time being at least, local government contracts will continue on the old basis, and contractors will need to take care to negotiate specific LGPS risk reduction provisions within each outsourcing contract.
3. Local government contracts

Specific considerations for LGPS contracts not covered by the new Fair Deal.

Local authority outsourcing contracts covered by the Best Value regime are strictly speaking not covered by the Fair Deal guidance (old or new), instead being subject to statutory directions issued in 2007 under the Local Government Act 2003. Nevertheless, like the Fair Deal these directions require the new employer to provide broadly comparable pensions to transferred employees who are members of the Local Government Pension Scheme (LGPS).

For many years now, the most common route taken in these circumstances has been for the contractor to participate as an Admission Body in the relevant Local Authority Pension Fund (LAPF), providing the employees with continued membership of the LGPS.

This approach has provided a convenient route for smaller companies and charities to take on Best Value contracts without the significant overhead of putting in place their own pension scheme providing broadly comparable benefits to the LGPS. It has however exposed such organisations to significant financial risks, unless they have been careful to reduce or eliminate them through specific risk reduction provisions within the outsourcing contract terms.

Potential impact of the new Fair Deal guidance on LGPS contracts

Outsourcers looking at contracts involving members of the LGPS should take note of what is happening with the Fair Deal for three main reasons:

- The Department for Communities and Local Government (DCLG) will be considering what is needed to achieve the principles of the new Fair Deal under local authority contracts – though the timing of this is uncertain;
- Some transfers of LGPS employees will be covered by the new Fair Deal – for example schools becoming academies, and contracts let by central government but covering employees who are in the LGPS (for instance, the Ministry of Justice has recently let contracts involving staff who are members of the LGPS); and
- The introduction of the new Fair Deal could be used as an argument for greater retention of pension risks under Best Value contracts by letting authorities. To illustrate, the following table contrasts the risks taken on by the contractor under a “plain vanilla” LGPS Admission Body agreement (ie one where the contractor has not been able to negotiate any risk reduction provisions on pensions into the commercial contract) with the position for central government contracts under the new Fair Deal.
Given that some contracts under the new Fair Deal will involve members of the LGPS, it will be interesting to see if the marked discrepancy between the variability of contributions and funding levels under the LGPS (due to the investment risks) and the unfunded schemes will be tolerated by contractors. The result may be that there will be increased pressure on letting authorities to retain investment risk (at least on past service benefits) so that there is parity between contracts involving members of all public sector schemes.

LGPS funds can be partially funded and can adopt a high risk, high equity investment policy because local authorities are, in the end, tax-raising entities. However, these investment risks are not appropriate for outsourcing companies and charities, particularly as they have no say in the investment policy pursued by the fund in which they happen to participate. On these grounds, we believe that local authorities will in practice generally have to retain the majority of the investment risk by putting a cap on employer contributions rates and termination payments for contractors.

Implications of the new LGPS benefits for admission body agreements
Details of the new LGPS benefits about to be introduced in April 2014 are shown in the Appendix to this report. Two key changes which will significantly affect the balance of the cost of pension benefits between younger and older members, and between employees with higher and lower expectations for future pay increases, are as follows:

- The pension accrual rate will increase from 1/60th to 1/49th of pensionable pay for each year of future service – ie by over 22%.
- The scheme design will change from final salary to CARE (career average revalued earnings) – so that benefits earned from April 2014 will increase each year in line with CPI inflation, instead of with the employee’s pay.

The LGPS fund actuaries currently assume that pay will increase in real terms over a member’s career. As a result, the cost of a benefit of 1/60th of revalued average pay is assessed as being smaller than the cost of 1/60th of final salary.
The new LGPS benefits have been calculated to be broadly equivalent in value to the old benefits over the whole LGPS membership (through the adoption of a more generous accrual rate). However, the membership covered by an admission body agreement typically has a higher than average age. The chart below illustrates the cost of benefits under the old and new benefit scales in the LGPS against age of member.

![Cost of benefits chart](image)

This shows that the cost of providing the new LGPS benefits after April 2014 will increase for an employer whose employees are older than the overall average age. As a result, many employers in admission body agreements will find that their contribution rates increase significantly when the 2013 actuarial valuation results are known.

Outsourcers will need to look to their contracts with local authority clients to see whether they can pass back some or all of this increase in cost back to the letting authority.

Some charities who have long-standing admission agreements, which are expected to terminate in a few years, as the last employees approach retirement age, may wish to consider whether the increase in contributions should be treated as a trigger to terminate the agreement and switch the employees into another pension arrangement.
The new public service pension schemes

Major changes are being introduced to the main public service pension schemes, for the Civil Service, the NHS, Teachers and Local Government, during the next two years.

Each of these schemes currently provides the substantial majority of active members with final salary pensions, with an accrual rate of either 1/60th, or 1/80th with an additional 3/80th lump sum for each year of service. Normal pension age is typically in the range 60 to 65 and pensions are guaranteed to increase in payment in line with CPI inflation.

Going forwards, the schemes will be significantly different, all moving to a CARE (Career Average Revalued Earnings) basis for future service with higher pension accrual rates than currently, and with normal pension age linked to State Pension Age. They will also include tiered employee contribution rates, with higher paid employees paying more, as a percentage of pay, and full protection of past service benefits (including continuation of the final salary link) up to the time the new schemes commence.

Some of the finer details have, however, been subject to individual consultation separately by each of the schemes, which has resulted in a complicated mixture of accrual rates, CARE revaluation rates and transitional protection measures across the various schemes – as summarised in the table overleaf.
Summary of new public service pension scheme provisions being introduced under the Public Service Pensions Act 2013

<table>
<thead>
<tr>
<th></th>
<th>Civil Service</th>
<th>NHS</th>
<th>Teachers</th>
<th>Local Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start date for new scheme</td>
<td>April 2015</td>
<td>April 2015</td>
<td>April 2015</td>
<td>April 2014</td>
</tr>
<tr>
<td>Type of scheme</td>
<td>Career</td>
<td>Average</td>
<td>Revalued Earnings (CARE)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Linked to State Pension Age (SPA) - currently due to equalise SPA at 65 for men and women in November 2018, and then increase to 66 in October 2020, to 67 by 2028 and to 68 by 2046. However it seems likely that future reviews will bring forward this increase in SPA.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normal pension age (NPA)</td>
<td>2.32% (≈1/43rd)</td>
<td>1/54th (≈1.85%)</td>
<td>1/57th (≈1.75%)</td>
<td>1/49th (≈2.04%)</td>
</tr>
<tr>
<td>Pension accrual rate</td>
<td>Optional at rate of £12 for each £1 pa pension commuted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate of increase to pensions in payment</td>
<td>In line with increases to the Consumer Prices Index (CPI)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rate of CARE revaluation in service</td>
<td>CPI</td>
<td>CPI + 1.5% pa</td>
<td>CPI + 1.6%</td>
<td>CPI</td>
</tr>
<tr>
<td>Rate of revaluation in deferment</td>
<td>In line with increases to CPI</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee contributions</td>
<td>Range to be agreed</td>
<td>Range to be agreed</td>
<td>Range to be agreed</td>
<td>Range from 5.5% to 12.5%</td>
</tr>
<tr>
<td></td>
<td>Average 5.6%</td>
<td>Average 9.8%</td>
<td>Average 9.6%</td>
<td>Average 6.5%</td>
</tr>
<tr>
<td>Past service protections</td>
<td>Pensions earned by service under the old scheme are protected and payable, where relevant, based on final salary at retirement or earlier leaving service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transitional protections for pension benefits</td>
<td>Those within 10 years of NPA at 1 April 2012 retain current terms; those within a further 3.5 years will have the option to stay in the old scheme for a limited period beyond April 2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Those within 10 years of NPA at 1 April 2012 retain current terms; those within a further 3.42 years will stay in their old scheme for a limited period. 2008 Scheme members can opt out of protection.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Those within 10 years of NPA at 1 April 2012 retain current terms; those within a further 3.5 years will stay in the old scheme for a limited period beyond April 2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Those within 10 years of NPA at 1 April 2012 receive an underpin to ensure pension is at least as valuable as under old scheme.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: LCP research
LCP provides advice on:

- The exposure to pension risks under the contract and how to mitigate this
- The best route for meeting the Fair Deal requirements on a contract
- The cost allowance to be included in contract bids for pensions and redundancies
- Bulk transfer terms to be provided at the end of a contract
- 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
- Calculating, costing and providing redundancy benefits for individuals who were TUPE-transferred from public sector employment

LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.