Division(s):N/A

PENSION FUND COMMITTEE – 3 JUNE 2011

CONSULTATION ON FAIR DEAL POLICY

Report by Assistant Chief Executive and Chief Financial Officer

Introduction

1. As part of interim report from the Independent Public Services Pensions Commission, Lord Hutton raised the question as to the extent that the current Fair Deal Policy coupled with public sector pension provision creates a barrier to the plurality of public service provision. The Commission concluded that it was a matter for Government to carefully consider the best way of moving forward with Fair Deal that delivers the objective of encouraging a broader range of public services providers, whilst remaining consistent with good employment practices.

2. On 3 March 2011, HM Treasury responded to the Commission by issuing a consultation document titled “Consultation on the Fair Deal Policy; treatment of pensions on compulsory transfer of staff from the public sector”. This report sets out the key elements of this consultation document, and invites the Committee to agree a response to HM Treasury, based on the draft response contained as Annex 1 to this report.

The Consultation Document

3. Chapter One of the consultation document sets out the reasons why the Government believes there is a need to review the Fair Deal policy. This is based largely on the findings of Lord Hutton’s Commission.

4. In the view of the Commission, Fair Deal creates a barrier to achieve the efficiencies and innovation which new providers can bring to public service delivery. In particular, the Commission argued that the costs of providing a broadly comparable scheme in the private sector tend to lead to an increase in costs for similar benefit, as well as exposing independent providers to new risks including those related to longevity and poor investment performance associated with a defined benefit scheme.

5. The Commission felt that the additional costs and risks would discourage providers (particularly small independent providers) from taking part in an outsourcing process.

6. The Commission argued that the costs of providing a broadly comparable scheme in the private sector are higher than the costs of providing the equivalent benefits in the public sector due to the different accounting requirements between the sectors, and in particular the ability of the public

sector to use the freedom provided by their constitutional permanence to set higher discount factors based on long term investment out-performance.

7. Chapter Two of the document sets out the basic principles behind Fair Deal which were to build on the TUPE requirements and protect the pension rights of staff compulsory transferred out of the public sector. Staff must be offered a broadly comparable pension by the new employer. Fair Deal also protects previous pension benefits such that if the employee elects to transfer these to the new scheme, they must be offered benefits on a day for day basis, with the contracting authority responsible for funding this through the contract price.

8. These protections are retained in the event that an outsourced service is re-tendered, or brought back in-house into the public sector. The protection is relative to the public sector scheme at the point of the initial out-sourcing and not at the point of any future re-tendering or return to the public sector. With the proposed changes to public sector schemes this could result in staff protected under Fair Deal being offered better pension terms than their equivalent colleagues within the public sector.

9. Chapter Three sets out the options for change, and assesses them against the objectives of:

- Delivering value for money
- Providing an appropriate level of protection to public sector employees' pension provision
- Removing barriers to plurality of public service provision
- Allocating the costs and risks of pension provision appropriately

10. The paper is clear that there are tensions between these objectives, and the requirement is to determine the most balanced option across all four objectives.

11. The consultation document argues that the no change option fails to deliver against three of the objectives, simply protecting the pension provision of current employees. The document repeats the arguments from Lord Hutton's Commission that allowing potential contractors to seek admitted body status to the relevant public sector scheme involves the Government in additional and inappropriate risk, given the lack of control it would have over contractor decisions on pay levels etc. The final report from Lord Hutton goes as far to say it is undesirable to allow non-public service employees to be members of the public sector schemes. The document also covers the difficulty contractors have in meeting cessation valuations at the end of their contract period where there is no ability to spread accrued deficits over a future time period.

12. The consultation briefly considers the scope for reforming the current Fair Deal policy, whether that is to the protection over future pension accrual or past pension benefits. Given the range of options possible here, the

document makes no assessment as to how such options compare to the four objectives going forward.

13. The consultation does consider ending the Fair Deal policy. Whilst ending the policy is seen as reducing costs for independent providers, and reducing the barriers to plurality of public service provision, the protection of pension provision of current employees would be removed, and the competitiveness of in-house providers would be compromised.

14. Chapter Four of the consultation document considers the question of to what extent any changes in the Fair Deal policy should apply to previous out-sourced arrangements at the point of re-tendering or return to the public sector. If the changes are not applied to re-tendered contracts then staff involved would be protected whilst colleagues being outsourced for the first time would not, creating inequality between staff and additional complications for providers bidding across both contracts. This Chapter also raises the question as to whether any protection should be against the public sector scheme at the point of the initial out-sourcing or that open to new members of staff joining the public sector at the time of the re-tendering.

Key Issues to be Considered

15. This Committee considered the issues around the Fair Deal policy as part of its overall consideration of the Interim Report from Lord Hutton at the December 2010 meeting. The Committee questioned the basic premise behind Lord Hutton's comments that Fair Deal created a barrier to the plurality of public service provision.

16. It is accepted that the arguments set out in the consultation document are fair in so far as they relate to the broadly comparable scheme option under Fair Deal. However, this is not necessarily the case under the admitted body option.

17. In the County Council, recent practice has been to seek to exclude pension costs from any tender evaluation. Early evidence had suggested that differences in pension costs had tended to reflect different levels of understanding of providers pension responsibilities, rather than real differences in costs.

18. As correctly identified by Lord Hutton and the latest consultation document, the costs of providing broadly comparable schemes and/or building in costs to cover longevity and investment risk do increase the overall costs of contractor tenders, as long as the contractor understands their responsibility. The more risk adverse the contractor the higher their tender price. Where contractors fail to understand their pension obligations, they under price the contract and then struggle to provide the service within the contract price.

19. The County Council sought to avoid these pricing anomalies by offering all contractors admitted body status to the LGPS, and adding a standard element to the tendered prices to cover the pension cost. As part of the service

contracts, the County Council has then managed the risks by assigning responsibility for variations in pension costs arising directly from the actions of the contractor to the contractor, and passing through all other variations to the Council. Contractors are therefore responsible for increased costs arising from any decision to award above average pay awards, or more generous decisions around ill-health retirements etc, whilst the Council retains risks associated with longevity and investment performance. The Council retains the ability to spread the costs of these risks over the long term, and beyond the individual contract terms agreed with each individual contractor.

20. Under such arrangements, the Council has met all four objectives set out in the latest consultation document within the existing Fair Deal arrangements. The Council would therefore argue for the retention of the current arrangements, including the retaining the ability of public sector schemes to admit private sector employees where they are employed under contracts with the public sector. Promoting admitted body status also avoids the issue of employees who have joined broadly comparable schemes returning to the public sector with protection to an old scheme, and therefore being better placed than new colleagues joining a revised public sector scheme.

21. In addition, the Committee's response to Lord Hutton stated that "We believe relaxation of Fair Deal will simply accelerate the race to the bottom you are rightly so keen to avoid and ultimately threaten public sector schemes and indeed services as more service models are developed to avoid pension obligations to the public sector workforce."

22. The 2010 Valuation calculated a future service contribution rate at 14.4% for employers. In addition employees contribute an average of around 6.3% making a total contribution to future pension benefits of 20.7%. Under the new workforce pension arrangements, minimum pension contributions have been set at 2% rising to 8% by 2017 of qualifying earnings (c£5,000 - £35,000). Of this minimum 8%, the employer has to pay at least 3%.

23. If the Fair Deal policy was to be ended, it would therefore be possible to outsource public sector provision and reduce the employer contribution from the current levels of 14.4% down to the minimum 3%, a saving of at least 11.4% of the pensionable pay bill. Given the financial climate facing the public sector, there will be clear pressure to maximise the outsourcing of public service provision to save this 11.4% of costs without any immediate impact on service delivery.

24. Large scale withdrawal from the public sector schemes, as well as contributing to the race to the bottom, would also threaten the continued existence of the public sector schemes. LGPS Schemes would need to adapt their investment policies as the Funds suddenly become more mature, with cash payments out exceeding new cash in, requiring a switch in investment to bonds and other low risk assets to ensure money is available to meet current liabilities. This switch will increase the overall cost of pension provision in respect of the remaining employees, further increasing the incentive to outsource the service.

25. Past experience would suggest that the initial rush to out-source public services to deliver the savings available through the end of Fair Deal would impact differentially on the work-force. Outsourcing has tended to focus on those areas of work which have the greatest proportions of low paid and part time staff. Historically this has also meant the impact has been greater on the female workforce.

Conclusion

26. Consistent with previous decisions of this Committee, the officers have drafted the attached response to HM Treasury arguing for the retention of Fair Deal, and the ability to admit private sector employees working on public service provision to public sector pension schemes. The draft also covers the eight specific questions asked in the consultation document.

27. Retaining Fair Deal, combined with appropriate arrangements within service contracts to pass through pension risks outside the control of the contractor would appear to best meet the objectives set out by HM Treasury in its consultation paper.

28. This approach also is best placed to deliver the wider pension objectives set out by Lord Hutton, ensuring adequate pension provision for public sector employees without the race to the bottom in terms of pension provision, and therefore an increasing reliance on state provision in old age.

29. Decisions on the affordability, sustainability and fairness of public sector pensions will therefore be properly addressed through the forthcoming Government consultation following on from Lord Hutton's final report. Decisions on value for money of public services can continue to be made through reviewing the plurality of provision, and the developments under the Localism Bill, with decisions focussed on efficiencies and effectiveness through improved ways of working rather than economy through cutting the pension provision of staff.

Recommendation

30. The Committee are RECOMMENDED to consider the report and the draft response as set out at Annex 1; and agree any amendments so that the response can be submitted to HM Treasury by their deadline of 15 June 2011.

Sue Scane
Assistant Chief Executive and Chief Financial Officer

Background papers: Consultation Document available from HM Treasury Website
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May 2011

Annex 1 Draft Response to HM Treasury

Public Service Pensions Fair Deal Consultation
Workforce, Pay and Pensions team
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Sir/Madam

Thank you for the opportunity to respond to your recent consultation document "Consultation on the Fair Deal Policy: treatment of pensions on compulsory transfer of staff from the public sector". This response is submitted on behalf of the Oxfordshire Pension Fund Committee which manages the LGPS Fund in Oxfordshire, and was agreed at their meeting on 3 June 2011.

The Committee did previously respond to the Independent Public Services Pension Committee in December 2010 rejecting the finding that Fair Deal acted as a barrier to the plurality of public sector provision, and raising the concern that any relaxation of the current Fair Deal policy could accelerate the race to the bottom in pension provision which Lord Hutton was keen to avoid. Whilst the arguments made by Lord Hutton do apply in relation to the outsourcings to broadly comparable schemes, they can be overcome through use of admitted body arrangements, and appropriately constructed service contracts. It is the Committee's view that the four objectives set out in the consultation document can indeed be best addressed within the existing Fair Deal framework. The Committee does not accept the argument that allowing private sector employees to be admitted to the relevant public sector scheme has to increase the pension risk taken on by Government, and has for a number of years mitigated this risk through the terms of its service contracts.

One of the key objectives set out in Lord Hutton's report was to establish the basis for a fair, affordable and sustainable framework for public sector pensions going forward. He strongly argued against the race to the bottom which would simply transfer the problem of funding from public sector pensions to state benefits in old age. It is the Committee's view that ending Fair Deal will directly conflict with this over-arching objective.

The average employer contribution towards future service pension within the Oxfordshire LGPS was calculated at 14.4% in the 2010 Valuation exercise. Combined with the average employee contribution of 6.3%, this leads to a 20.7% contribution towards future pension provision. This compares to the minimum 2% contribution required under the proposed workforce pension arrangements from 2012 (rising to 8% by 2017).

In the absence of the Fair Deal policy and given the current financial climate, public sector bodies will face considerable pressure to outsource as much provision as possible. Financial savings in excess of 10% can be made simply by cutting the pension provision of existing staff to the minimum levels required (anyone tendering above the minimum levels runs the danger of making themselves uncompetitive). Levels of private pension saving will therefore considerably reduce, increasing future pressure on the state system.

Wide scale outsourcing of public sector provision will also lead to significant change for what remains of the public sector pension provision. The majority of LGPS Funds are currently cash rich, collecting in more from contributions than they pay out in pensions. This allows them to take a long term view of the investment markets, so spreading risks and minimising costs. This position would reverse under the ending of Fair Deal, with Funds rapidly maturing, and having to divest from investments in equities to both meet the cash flow requirements as pension payments begin to exceed contributions received, and to reduce the investment risks to the Funds given the shorter time horizons. As well as creating risk to the sustainability and affordability of the public sector funds, this divestment from equities will directly impact the financial markets.

The Committee therefore supports both the retention of the existing Fair Deal policy, and the admission to public sector pension schemes of private sector employees engaged in the provision of public services. Combined with service contracts which assign pension risks to the appropriate parties, the Committee feels this option best meets the four objectives set out in the Consultation Document, as well as the wider policy objectives in terms of maintaining affordable, fair and sustaining public sector pension schemes and reducing reliance on the state in old age.

The Committee believes that questions of cost of public sector pension provision are best met through the forthcoming consultation following Lord Hutton's final report. Questions of value for money in public service provision can then focus on efficiency and effectiveness opportunities through the new service models, improved processes etc resulting from the plurality of public service provision and new developments under the Localism Bill, rather than a narrow focus on economy through reducing the pension benefits available to staff employed in public services.

Further details on the Committee's views are set out in our response to the eight specific questions raised in the consultation document below.

Yours sincerely

Sean Collins
Service Manager (Pensions, Insurance and Money Management)

On behalf of the Oxfordshire Pension Fund Committee

Specific Consultation Questions

1. <u>The Government welcomes views on whether there are any people or organisations who may be affected by this consultation other than those listed in 1.7.</u>

The Committee agrees that the people/organisations listed in paragraph 1.7 of the consultation document include all those directly impacted by the proposals around the Fair Deal policy.

However the Committee believe that the proposal to end the current Fair Deal arrangements will have much wider implications, and will therefore indirectly impact on a wider group of people and organisations. In particular, the Committee are concerned that the option to end Fair Deal will lead to a significant decline in membership of LGPS Funds, requiring Funds to divest from their equity portfolios to release resources to meet current pension payments, as well as to switch to lower risk assets to reflect the shorter term horizon the Funds would be working to. This consequence of ending Fair Deal would indirectly impact therefore on the organisations in which the LGPS currently invests.

2. <u>The Government welcomes views from respondents on how the Fair Deal policy operates in their experience, where this is considered relevant to future policy.</u>

Oxfordshire County Council has now for a number of years sought to exclude consideration of pension issues when evaluating tenders to the provision of public services.

Our previous experience is that those tenderers who fully understood their pension obligations did increase their contract price to allow for the additional risks in terms of longevity, poor investment returns etc and therefore did appear uncompetitive, or were not prepared to contract for services. Those organisations who failed to fully understand their pension obligations did not make sufficient provision within their contract price and therefore sought additional funding from the Council, or were not in a position to meet the outstanding pension liability at the point the service contract terminated.

To avoid pension issues clouding the results of tender exercises, the Council has encouraged potential contractors to seek admitted body status to the LGPS, and then added a standard cost to cover pensions to the basic tender price. In this way tender evaluations are based on price and service issues, rather than who best understands their pension obligations. Service contracts are agreed whereby all variations in pension costs are passed through to be met by the Council, except in specified cases where the variation is a direct consequence of the actions of the contractor e.g. awarding above average pay awards, a more generous approach to agreeing ill-health retirements etc.

Under such a model the Council has gained the benefits from out-sourcing in terms of both the efficiency and effectiveness of the service, protecting the pension rights of the staff, removed the barrier to providers participating in the tender exercise whilst not taking on any additional pension risk to that held before the outsourcing.

3 <u>The Government welcomes views on whether there are any objectives which should be taken into account other than those set out in 3.2 when developing future policy.</u>

The Committee believes that any review of future policy in respect of Fair Deal should consider the wider social objectives discussion by the Hutton reports. The first recommendation of the Commission's final report was that Government should make clear that the primary purpose of public sector pension schemes is to ensure adequate levels of retirement income for public sector pensioners. The Commission was also keen to avoid the race to the bottom in terms of pension provision, and an increased reliance on the state in old age.

The Committee therefore believe that any future proposal should ensure adequate levels of retirement income for those employees engaged in the provision of public services, irrespective of whether they are employed within the public and private sectors.

As such the Committee sees no justification for removing the protection for workers compulsory transferred out of the public sector, where the promised reforms of the public sector provision are targeted at providing adequate levels of retirement income through schemes which are affordable, fair and sustainable.

4 Is there a case for changing the current Fair Deal Policy?

The Committee does not believe there is a clear case for changing the current fair deal policy. The current arrangements in conjunction with appropriately constructed service contracts provide the best balance against the four objectives set out in the paper, and the additional objective above to ensure adequate levels of retirement income for those engaged in the provision of public services.

5 If so, what should the policy cover?

As the Committee do not support the case for changing the current Fair Deal Policy, they have not put forward consideration of alternative arrangements.

6 In setting out a proposal for future policy, respondents are asked to set out:

a) how it would deliver against the objectives set out in chapter 3, plus any others considered relevant;

b) the impacts on those involved, including employers and employees;

c) if possible, how much the proposal would cost or save the tax-payer compared to the current Fair Deal arrangements; and

d) any past experience, whether in the public sector or otherwise, which informs these proposals.

The Committee have set out above that the current arrangements provide the best fit against the objectives set out in chapter 3. In terms of delivering value for money for the tax payer there is a short term economic argument for ending fair deal and cutting the pension costs by over 10% of the pensionable pay bill. Such a change though is not consistent with the findings of Lord Hutton who is seeking to target adequate levels of retirement income. If pension costs can be cut below the future levels of public sector provision then it can be assumed that retirement income is being cut below adequate levels, so transferring the burden to the state and therefore back to the tax payer. Cutting pensionable pay will also run the risk of driving existing employees way from the provision of public services, increasing the costs of retraining, and reducing the efficiency and effectiveness of service delivery.

Clearly retaining the arrangements fully protects public sector employee's pension provision. We have also argued that the existing arrangements do not necessarily provide a barrier to plurality of public sector provision. This is based on our own experience within Oxfordshire where through offering admitted body status to contractors, and establishing appropriate risk assignments within the service contracts we have mitigated the costs and risks for contractors wishing to participate in an out-sourcing exercise. The service contract arrangements also ensure the costs and risks of pension provision is allocated appropriately.

7 The Government welcomes views on what approach should be taken when previously transferred public services involving Fair Deal staff transfers are re-tendered. The Government also welcomes details of any past experience informing respondents' proposals.

The County Council has recently re-tendered a public service contract where the initial out-sourcing was before the Council adopted its current approach, and the transferred staff were admitted to the successful contractors broadly comparable scheme. On re-tendering, the Council did adopt its current approach, supporting the admission of the successful contractor into the LGPS, and establishing a service contract with the appropriate assignment of risks.

As this approach is available under the current Fair Deal arrangements (with the one provisio below), the Committee would suggest that this is the appropriate approach going forward.

The one variation to the current arrangements that the Committee would support would be to ensure that any level of protection does move in parallel with the changes within the public sector schemes from which the employees were initially transferred i.e. staff should be protected against the public sector scheme available to new members, and not the one in place at the time of the initial outsourcing. This would therefore be equivalent to the position of workers who remain in the public sector itself, and those who remain in the public sector scheme through an admission arrangement.

8 <u>The Government welcomes views of what approach should be taken for employees returning to the public sector having been transferred out in the past under the Fair Deal policy. The Government also welcomes details of any past experience informing respondents' proposals.</u>
The approach outlined under 7 above would equally cover the arrangements where employees return to the public sector. The Council has no such experience of these cases.