PENSIONS: Holding all the cards

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Ruth Bamforth reports on the New Fair Deal provisions

Pension provision is an emotive subject. As time passes fewer private sector workers have access to future service pension benefits in defined benefit pension schemes. For these workers, the government's main concern is to ensure adequate minimum pension saving. In contrast, public sector workers continue to enjoy the more generous (although reformed) defined benefits provided by the public sector pension schemes. The protection of pension provision for public sector workers who transfer to the private sector is a political imperative, therefore. This article looks at these protections, in particular New Fair Deal, and highlights practical considerations for those involved in public to private sector outsourcing transactions.

Pensions and outsourcing: the basics

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In the majority of cases, an outsourcing arrangement will result in a TUPE transfer of staff. Broadly speaking, when a TUPE transfer occurs all the terms and conditions of the employees' contracts of employment will transfer to the new employer. Pensions (other than certain early retirement and redundancy benefits) are a key exception to this general rule.

The only legislative protection relating to pensions for transferring employees is contained in the Transfer of Undertakings (Pension Protection) Regulations 2005. This protection does not require a defined benefit pension scheme to be provided post-transfer where employees were members of such a scheme pre-transfer. In the public sector context, this means without more that the contractor does not need to provide transferring employees with a pension scheme which is as generous as the public sector one they belonged to before.

Successive governments have considered it unacceptable to require public sector workers to give up their defined benefit pension arrangements as a result of being outsourced to the private sector. Over the years the government has issued guidance and legislation (in relation to the local authorities and the best-

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value authorities) to require private sector contractors to offer transferring public sector workers 'access after the transfer to a good quality pension scheme'. This guidance is generally referred to as 'Fair Deal'.

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Fair Deal

Fair Deal was first introduced in 1999. It was then updated in 2004 and again in 2013. Fair Deal 2013 (usually referred to as 'New Fair Deal') has applied in respect of both initial outsourcing and all re-tenders where possible from 4 October 2013 (the publication date of New Fair Deal) and, in any event, from April 2015. Previous Fair Deal policy continues to apply to outsourcings which took place before these dates.

New Fair Deal: an overview

The basic principle of New Fair Deal is that public sector employees who are transferred to the private sector should be able to remain members of the public sector pension scheme. When a pre-existing contract is re-tendered, the former public sector employees should be transferred back into the public sector pension scheme they were in before the original transfer from the public sector took place.

New Fair Deal means, therefore, that for the first time contractors will be participating in unfunded public sector pension schemes. The 1999 and 2004 versions of Fair Deal ('Old Fair Deal') both required that transferred employees were provided with a pension scheme which was certified by the Government Actuary's Department as being 'broadly comparable' to the relevant public sector scheme. This approach was taken because it was, generally speaking, not possible for private sector employers to participate in unfunded public sector pension schemes. In practice this meant that contractors had to run a defined benefit pension scheme with all the attendant cost and regulatory consequences.

New Fair Deal applies to transfers from the following:

- central government agencies;
- the NHS;
- maintained schools (with certain exceptions) and academies; and
- any other part of the public sector 'under the control of government ministers where staff are eligible to be members of a public service pension scheme' (www.gov.uk).

New Fair Deal does not apply to local authority and best-value authority transfers. These transfers continue to be subject to the requirements of the Best Value Authorities Staff Transfers (Pensions) Direction 2007 which

gives statutory force to some of the Fair Deal principles. The Department for Communities and Local Government is currently considering its approach in light of New Fair Deal. That being said, private contractors are already able to participate in the funded Local Government Pension Scheme where they have not opted to provide their own 'broadly comparable' scheme.

It is important to remember that since December 2010 no minimum pension requirements have been in place for employees who are recruited to work on the outsourced services but did not transfer from the public sector. Contractors tend to put these new recruits into less generous pension arrangements. This disparity in pension provision is usually referred to as the 'two-tier workforce'.

Outsourcing in practice

Contractors need to be alive to the pensions issues which can arise over the lifetime of an outsourcing contract subject to New Fair Deal, from the bid stage to contract termination. The rest of this article does not consider local authority issues since the Department for Communities and Local Government is still considering how New Fair Deal will apply.

Bid stage

In the initial stages it is crucial that contractors understand the pensions issues which may affect their bid. In the first place a contractor needs to have the details of the employees who will transfer. The contractor needs to know:

- whether the employees are being transferred directly from the public sector (a first generation transfer), or whether the employees are being transferred from a previous contractor (a second generation transfer); and
- in relation to a second generation transfer, which public sector scheme the employees are linked to, as well as whether any of the employees were recruited directly to work on the contract and so have not been transferred from the public sector.

Once the contractor understands who will transfer, pensions issues are likely to feature in how the bid is priced.

The contractor will be a participating employer in a public sector pension scheme. At the outset the contractor will know what its rate of employer contributions will be. However, the contract may last for many years, during which time employer contribution rates may change following actuarial valuations of the public sector pension scheme. The contractor may seek to negotiate a contractual provision that the cost of any changes to the employer contribution rate will be covered by the letting authority. Each public sector scheme (and letting

authority) will adopt its own approach to this issue. For most NHS contracts, however, changes to contribution rates will be passed through by way of an adjustment to the contract service charges.

The contractor needs to be aware of the other costs and expenses which it is likely to pay in addition to normal employer contributions. The exercise of employer discretions or large increases to pay will affect costs. However, a key cost relates to redundancies. This is particularly important where the contractor expects a significant number of redundancies during the contract term. Redundancy benefits following a public sector TUPE transfer are complicated and often expensive.

Although redundancy benefits have been reviewed over recent years they are very generous benefits which the contractor will be expected to fund. After all it is up to the contractor to decide whether or not to make redundancies. It is important, therefore, that the contractor fully understands the cost implications of post-contract redundancies. Failure to factor in this cost, especially where the contract period is short, may risk the contract's overall profitability.

In addition to the above matters, the contractor also needs to be aware of the cost of the bulk transfer to reinstate employees back into the relevant public sector pension scheme. This is a particular issue on second generation contracts (for more on this please see below).

It is a long-established principle in local authority outsourcing that a contractor may be required to provide a bond or an indemnity to protect against the risk that the contractor does not meet its obligations under the Local Government Pension Scheme. This principle now applies to public sector outsourcing across the board as a requirement of New Fair Deal. The contractor needs to factor in the cost and feasibility of putting such a bond or indemnity in place. It is worth noting that the Department of Health has stated in guidance that contractors will not be required to provide a bond or indemnity, although this approach may change in due course. In contrast the Principal Civil Service Pension Scheme admission agreement requires the contractor to provide several indemnities including a full indemnity for any losses resulting from breach of the agreement.

Ongoing management

There are a number of pensions issues which the contractor needs to be aware of over the course of the contract. Some of these may also need to be factored in at the bid stage.

Over the course of a contract, transferring public sector employees may be reassigned within the contractor's business either permanently or temporarily. Where this occurs the contractor must consider whether or not the reassigned employees remain eligible for membership of the relevant public sector pension scheme. Should any employee not remain eligible for membership (for example, the employee is no longer working on the contract), the contractor will need to provide them with an alternative pension scheme.

New employees may be recruited to work on the contract. These employees will not be able to become members of the relevant public sector pension scheme. The contractor needs to decide what pension arrangements should be put in place for these employees and understand the cost of providing those benefits. In practice the pension arrangements for these new employees are likely to be less generous than the public sector pension scheme. It will be for the contractor to deal with any consequential employee relations issues.

Finally, as commented above, the contractor needs to have processes in place to monitor pay increases, redundancies and other matters which may affect pension costs and employer contributions to the relevant public sector pension scheme.

Contract termination: general

Both the current contractor and the new bidders need to understand what happens at the end of an outsourcing contract.

Currently the vast majority of all existing public sector outsourcing contracts will be subject to either the 1999 or 2004 version of Fair Deal. New Fair Deal sets out a default route for dealing with contract termination regardless of when the contract was originally let and applies, even if the current contractor is to retain the contract. Where the original contract was let before Fair Deal 1999, the contracting authority decides, on a case-by-case basis, whether or not New Fair Deal applies.

All the original former public sector employees who are still working on the contract at the termination date should be readmitted into the public sector pension scheme they would have continued to have been a member of had they not been transferred to the private sector. If that scheme has been closed to future accrual, New Fair Deal provides that employees should be given access to a relevant public sector scheme.

In addition to being admitted into a public sector scheme, the employees must be offered the opportunity to transfer their benefits in the contractor’s broadly comparable pension scheme into the public sector scheme with like-for-like service credits. New Fair Deal assumes that the original contract contains express provisions relating to this transfer. However, it may be that the original contract does not contain any provisions or that they may not always be as clear or as easily enforceable as they should maybe be.

In practice this bulk transfer issue is not going to be a concern for a new bidder to the contract. However, it may be a concern for the bid of an incumbent contractor where the terms offered by the incumbent contractor’s scheme are not sufficient to purchase the required service credits in the public sector scheme. It is important that incumbent contractor bidders clearly indicate whether they accept the bulk transfer terms offered by the authority or seek a price adjustment in their bid documentation.

It should be noted that the pension benefits for employees who are no longer working on the contract will not be transferred to the public sector scheme. Instead they will remain in the contractor's broadly comparable scheme.

It is worth also noting that broadly comparable schemes still have a role, albeit small, under New Fair Deal. New Fair Deal provides that 'in exceptional circumstances and where there are special reasons' that make it inappropriate for employees to be put back into a public sector scheme, a broadly comparable scheme may be put in place. Examples of 'exceptional circumstances' include where the incumbent contractor has a contractual obligation to provide employees with a broadly comparable scheme, and where the incumbent contractor may provide access to either a public sector scheme or a broadly comparable scheme and the letting authority is unable to comply with its procurement law obligation to treat economic operators equally.

The change in pension provision needs to be communicated to employees. The recent changes to the public sector pension schemes mean that employees may find themselves, for example, paying higher levels of member contributions in comparison to the broadly comparable pension scheme. In addition, where an incumbent contractor retains the contract, the contractor will need to carry out pensions consultation with affected employees as a result of them being transferred into a public sector pension scheme.

Contract termination: effect on broadly comparable scheme

The contractor's broadly comparable pension scheme will be affected by the termination of an outsourcing contract regardless of whether or not the contractor retains the contract. As well as the bulk transfer payment to be made from the contractor's scheme to the appropriate public sector pension scheme (discussed above), a debt calculated in accordance with s75 of the Pensions Act 1995 may be triggered (a section 75 debt) if the contractor participated in a multi-employer defined benefit pension scheme. A section 75 debt is triggered when an employer in a multi-employer defined benefit pension scheme (a broadly comparable scheme will be a defined benefit scheme) stops employing active members at a time when another employer still employs active members.

Whether a debt is triggered very much depends on who the contract employer is and the number of employers participating in the scheme. Is the employer an entity which employs a range of scheme members and not just those who are covered by the particular contract? Is it an entity which only employs employees covered by a specific outsourcing contract? Where a debt is triggered the cessation employer must meet its share of the scheme's deficit calculated on the conservative buy-out basis, unless one of the statutory easements is put in place.

Apart from the issues above which come to the fore on contract termination, New Fair Deal will have a wider effect on broadly comparable pension schemes. Over time as contracts are re-let, broadly comparable

schemes (unless they are used to provide pensions to non-outsourced employees) will stop having active members and instead only have deferred and pensioner members. Contractors (and scheme trustees) will need to be alive to the effect that the change in membership profile may have on the scheme, in particular in relation to funding, employer exit/winding-up debts and liability management. This last point may be relevant sooner rather than later for employers who do not sponsor their own pension scheme and so use schemes such as Prudential Platinum or Citrus to provide broadly comparable benefits, often for a relatively small number of employees.

Issues on participation in public sector pension schemes

Until New Fair Deal private sector contractors were not able to participate in the unfunded public sector pension schemes, including the NHS Pension Scheme, the Principal Civil Service Pension Scheme and the Teachers' Pension Scheme. These schemes have had to put arrangements in place to admit contractors as well as manage the ongoing participation risks.

The NHS scheme does not require a participation or admission agreement to be signed by the contractor. Instead, the contractor must apply for a pension direction by completing the NHS pensions application form. It can take up to three months for a pension direction to be put in place.

In contrast, the Principal Civil Service Pension Scheme and the Teachers' Pension Scheme both require the contractor to sign their standard participation/admission agreement. Substantial changes to the standard agreement are unlikely to be agreed.

New Fair Deal provides that an admission agreement to any public sector pension scheme may (but is not obliged to) provide for an exit payment to become payable by the contractor where there is a funding shortfall.

In the case of the NHS Pension Scheme, Department of Health guidance states that:

> … [a]s the NHSPS is funded by member contributions, it is anticipated that exit payments or additional payments will not arise, but the exiting member may nevertheless be liable for late payments penalties/interest
>
> charges accrued during its membership.

At present the regulations which govern both the Principal Civil Service Pension Scheme and the Teachers' Pension Scheme do not make provision for any exit payment. In addition, the model participation agreements are equally silent on the point. However, the model agreements require the contractor to comply with the provisions of the relevant scheme regulations. If exit payment provisions are inserted into the scheme regulations in the future, those requirements may be imposed on the contractor because of the way that the model agreement is drafted.

In conclusion

New Fair Deal revolutionises public sector outsourcing. For the first time contractors will be able to participate in the unfunded public sector pension schemes. New Fair Deal has not been in place very long. As time goes by both contractors and letting authorities will become more familiar with the issues it throws up. It will be interesting to see whether or not the unfunded schemes move to imposing exit debts on contractors where appropriate. If that is the case it remains to be seen whether the lessons from participating in the Local Government Pension Scheme are learnt.