Private sector contractors in a public service pension scheme

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Abstract Not so many years ago it would have been unthinkable for profit-making private companies to become participating employers in a statutory public service pension scheme. Nevertheless, on 13th January this year the regulations governing the Local Government Pension Scheme (LGPS) in England and Wales (and shortly those in Scotland and Northern Ireland) were appropriately amended by the Government to make this possible.

This paper sets out to explain the background to this fundamental change, how the new provisions will operate and, most importantly, the various statutory safeguards to be satisfied to ensure that taxpayers' money is not put at risk.

Keywords: *private contractors; Local Government Pension Scheme; participating employer*

Background

A UK Government White Paper, 'Modern Local Government in Touch with the People', published in 1998 stated that 'the government is committed to building a competitive economy with a flexible labour market, underpinned by the fair treatment of those affected.' The White Paper introduced the expression 'Best Value' and, in doing so, went on to say that 'competition undertaken in a climate where employees' rights are respected and where those employed in delivering services, in the private or public sectors, are involved is less threatening but just as challenging.... Well motivated and well-trained employees are vital in the provision of best value services whether they are

working for local councils, the private sector or the voluntary sector.' The White Paper concluded that the task for local government is to combine reassurances for employees with the necessary flexibility to allow transfers on a fair basis to other employers where this is in the public interest. The White Paper also announced that the Government was actively considering with its social partners in industry and the trade unions how pensions can be properly protected when local government services and the employees engaged on those functions are transferred to private contractors.

With this in mind, and as a result of changes made to the European Acquired Rights Directive which include

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permitting Member States to bring occupational pensions within the scope of their transfer law and which, the Government says, will ensure legislation is applied more consistently to the outsourcing of functions and partnership deals, it has for some time now been reviewing the Transfer of Undertakings (Protection of Employment) Regulations 1981. Better known as TUPE, the regulations implement the 1977 European Council's Acquired Rights Directive.

Broadly speaking, TUPE protects employees' terms and conditions (other than occupational pension arrangements at present) when the function in which they are employed is transferred from one employer to another. Employment with the new employer is treated as continuous from the date of the employee's start with the first employer. Terms and conditions of employment cannot be changed where the operative reason for the change is the transfer, although changes for other reasons can be negotiated.

To bring greater certainty to the processes involved in transferring staff to new employers, the Government plans to revise the TUPE Regulations to implement the amendments to the Acquired Rights Directive and to improve their operation. The intention is that TUPE will apply to all staff transfers under best value in local government ('public private partnership' contracts for central government outsourcing), and will protect employees during the life of an outsourced contract. It will build upon the new definition of a transfer introduced into the revised Directive, adopted during the UK Presidency in 1998, to achieve as great a degree of certainty and clarity as possible in the application of the TUPE regulations (including the reassignment of contracts). Recognising the option allowed by the

revised Directive whereby Member States can include occupational pensions within the terms which are protected by legislation when an undertaking is transferred from one employer to another, a consultation paper is to be published shortly with the aim of new TUPE Regulations being made later in the year.

Why the concern?

Employees who move from one local authority employer to another do so on statutory guaranteed day-for-day transfer terms for pension purposes. Similarly, by participating in the public sector transfer arrangements ('the Transfer Club'), moves to other Club member schemes do not lead to loss of pension expectations. However, this is not generally the case in moves to and from the private sector. As a result, more often than not, instead of transferring their LGPS pension rights to their new employer's pension scheme, transferees will retain as deferred benefits what their LGPS membership has earned to the point of transfer. They are then likely to lose out, as their eventual retirement benefits will be based on earnings when they were transferred plus subsequent cost of living inflationary increases, rather than on their earnings at retirement had they been allowed to remain in their local authority employment. With a real difference of, say, 3 per cent per annum between prices and earnings inflation, this will have a serious detrimental impact on a transferee's LGPS retirement benefits. Also, if after having reached age 50 or more, outsourced employees are made redundant, their deferred benefits will not become payable automatically as would have been the case if they had been made redundant by their former local authority employer.

As an alternative to deferred benefits,

outsourced employees could, as already mentioned, opt to transfer their accrued LGPS membership to the contractor's pension scheme. However, the transfer value available would usually be insufficient to guarantee a day-for-day transfer, 15 years' LGPS membership possibly reducing to a membership credit of ten years or less in the contractor's pension scheme.

Furthermore, when an employee either returns to local government employment at the end of the contract, or is transferred to another private contractor with a different pension scheme and the employee chooses to transfer his or her service in the contractor's scheme to the LGPS or the new employer's scheme, there will most probably be a further loss of pensionable service.

For benefits in respect of future employment, transferred employees have to rely on their local authority employer requiring the contractor to provide a 'broadly comparable' pension arrangement. Whether or not a scheme meets this requirement is a matter for decision by either the Government Actuary's Department or the actuary acting for the local authority. To satisfy this 'test' the contractor's scheme does not have to 'mirror' the LGPS provisions. It may provide limited inflation-proofing of benefits and less generous retirement opportunities, but better dependants' benefits and death-in-service lump sums.

Overcoming the problems

Early Summer 1998 saw the establishment of a working group (the Stakeholders' Group) representing the key interests in the LGPS, namely the United Kingdom Steering Committee on Local Government Pensions (the UKSC) for the local authority employers, the

Department of the Environment, Transport and the Regions (the sponsoring Government Department for the LGPS), the Trades Union Congress and the Association of Consulting Actuaries. The Stakeholders' Group agreed that:

- the present local government pension arrangements disadvantage local authority employees compulsorily transferred to the private sector; and
- every effort should be made to eliminate this without jeopardising either the statutory position of the LGPS or the interests of its other members.

The Group identified the following key principles to be covered by any alternative pension arrangements:

- local authority employees' pension rights should be safeguarded if they are transferred to a joint venture company or private contractor under best value or other outsourcing arrangements;
- at normal retirement age the former local authority employees should receive pension benefits at least equal in value to those which would have been earned had they been allowed to continue in local government employment;
- in the case of early retirement as a result of redundancy or permanent incapacity, retirement and death benefits should be payable in the same circumstances, at the same time and at the same level as if local government employment had continued;
- pension rights should be as secure as they would be in the LGPS even if the private contractor goes into liquidation; and
- any alternative arrangements must not

jeopardise either the statutory status of the LGPS or the interests of the other members.

After discussions with contractors' representatives, the CBI and the Association of Direct Labour Organisations, the Stakeholders' Group concluded that the most practical option was for private sector employers to be allowed to seek 'admitted body' status in the LGPS. With the support of over 85 per cent of local authority employing and pension fund authorities, the Stakeholders' Group produced a 'Heads of Agreement' which was collectively endorsed by the UKSC, the CBI Local Government Procurement Panel, the Business Services Association and the TUC. This was formally submitted to the Minister for Local Government in February 1999.

Non-local authority employers are 'admitted' to the LGPS by means of a formal, legal admission agreement drawn up between the interested parties. As a result:

- the transferred employees of the 'admitted body' are able to participate fully in the LGPS and enjoy the same rights and options as employees of local authorities;
- the LGPS Regulations treat the admitted body employer in exactly the same way as a local authority employer.

What did the Heads of Agreement cover?

The aims of the Heads of Agreement were to:

- remove any disadvantage to transferred employees' pension rights;
- retain flexibility in the selection of service providers/private contractors;

- avoid any significant inhibitions to competition on best value principles.

Matters covered by the Agreement included the following:

- *Scope*: all outsourcing is to be covered interpreting best value in its widest possible sense.
- *Approach*: a private contractor must arrange for transferring employees to:
 - (i) continue their LGPS membership with the pension fund authority which covers the employer awarding the outsourcing contract; or
 - (ii) transfer to its own pension scheme if this has been certified by the Government Actuary's Department as satisfying the 'broadly comparable' requirements.

A private contractor's pension scheme is broadly comparable when:

- it matches in every material aspect (including security) the benefits provided by the LGPS; and
- the bulk transfer payment through which employees transfer their pension rights accrued to the date of transfer will provide 'day-for-day' credits in the private contractor's scheme. The amount of the payment will be agreed between the contractor and the local authority as being of an amount sufficient to fund, in full, the service credits allowed in the contractor's scheme.
- *Employer's contribution rate*: if a private contractor is 'admitted' to the LGPS, the employer's contribution rate will be assessed on a unitised basis and be entirely separate from the rates payable by other employers in the fund. Also it will relate only to future LGPS membership and will not include making good past deficiencies.

Safeguards include:

- the early payment of pension benefits as a result of redundancy/early retirement (including any added years' augmentation granted at the employer's discretion) in the event of the contractor's insolvency must be covered by an insurance indemnity; and
- there will be provision for delayed employer's and employees' contributions to be offset against the contractor's charges.

DETR/Inland Revenue joint advice note

With the Local Government Bill (which implemented the Government's best value proposals) progressing through Parliament towards Royal Assent in July 1999 a joint advice note, prepared and agreed by the DETR and Inland Revenue, was issued in June 1999. The note explained that the policy basis for considering a more flexible approach to employees' concerns about future LGPS pension rights where outsourcing and partnership arrangements have been entered into between local authorities, private sector employers and other employers, stemmed from the Government's White Papers 'Modern Local Government: In Touch with the People' and 'A new contract for Welfare: Partnership in Pensions'. Both of these make it clear that future transfers should be based on fairness, flexibility, equality, partnership and the proper protection of pensions when a function is transferred from a local authority to a private contractor.

The joint note announced that the Inland Revenue and the DETR had agreed to implement, as quickly as possible, provisions giving a new category of employer access to the

LGPS. The new regulations will, for the first time, allow non-associated employers as defined by the IR to participate in the LGPS. As a result the Scheme will, in IR terms, become a centralised scheme with two types of non-local authority employers admitted:

- associated employers who meet the IR definition in Practice Note 21.1 of the IR12 (1997) Practice Notes, and
- non-associated employers who do not satisfy the definition of an associated employer in the Practice Notes.

Recognising that it would be some months before the new statutory provisions could be enacted, the IR and DETR agreed that, in the meantime, interim guidelines would apply as follows:

- non-associated employers could be 'admitted' to the LGPS on a temporary basis until the earlier of either 31st March, 2000, or the date the new statutory provisions came into effect, and
- where necessary, existing LGPS members could remain in the Scheme until their employer was able to be admitted under the proposed new statutory provisions.

National policy

Associated closely with the proposed new LGPS regulations, first issued in draft for statutory consultation purposes in June 1999, there have been several statements of policy guidance contained in Government documents:

- Staff Transfers from Central Government — A Fair Deal For Staff Pensions — Guidance to Departments and Agencies (HM Treasury, June 1999);

- Guidance on Best Value (DETR Circular 10/99, December 1999); and
- Staff Transfers in the Public Sector: Statement of Practice (Cabinet Office, January 2000).

The guidance in these documents seeks to back the Government's fair employment programme and its commitment to ensuring that the public sector (not only local government) is a good employer. The key principles recommended in all the guidance documents are:

- to treat staff fairly;
- to do so openly and transparently;
- to involve staff and their representatives fully in consultation about the pensions aspects of the staff transfer at an early stage; and
- to have clear accountability within the local authority for the results.

A paragraph in DETR's Best Value Guidance Note widens the scope to include all public sector contracting employers as follows:

'The Government also wishes to see that employees' pension entitlements are secured in staff transfers to the private sector. The Statement of Practice includes HM Treasury guidance on entitlement to Staff Transfers from Central Government: A Fair Deal for Staff Pensions. That guidance was drafted with specific reference to staff transfers from central Government Departments and Agencies, on whom it was binding immediately, but Ministers said at the time that they also wanted other public sector contracting authorities to make arrangements to meet the standards of protection for staff pensions which it set out, consistent with the law and good procurement practice.'

Elsewhere, the Guidance Note states that in order to ensure continuity of pension accrual in business transfers, transferred

staff should be offered membership of a pension scheme broadly comparable with their public service scheme, and which is actuarially certified to the standard of the criteria for broad comparability as set by the Government Actuary.

Where a broadly comparable contractor's scheme is the preferred option, the Guidance Note also refers to the need to agree bulk transfer terms with the scheme so that 'staff transferring will be able to transfer their accrued membership in their public service scheme into the contractor's scheme on a day-for-day, equivalent, basis'. It is therefore essential in every case for the exporting scheme's actuary to agree the bulk transfer terms with his or her opposite number, and for full recognition of the amount to be taken into account by all the parties in agreeing the final contract price.

The regulations are made

Somewhat later than intended, the LGPS (Amendment etc) Regulations 1999 came into operation on 13th January, 2000. As expected, subject to various conditions being met, the regulations allow employees transferred from a local authority to a private contractor under a best value or other outsourcing arrangement to remain in the LGPS if the contractor seeks and obtains 'admitted body' (non-associated employer) status, in that Scheme. Contrary to the expectations of some local authorities and contractors, the regulations are not retrospective.

In summary, under the regulations:

- An external provider is defined as a body which provides services or assets under a best value arrangement to an organisation defined by the Local Government Act 1999 as a best value authority, ie, a local authority or

similar organisation.

- A best value arrangement is defined as a contract or other arrangement made with a local authority for the provision of, or making available of, services or assets for the exercise of a function of that authority. In practice, this covers most (if not all) outsourcing arrangements as intended by the parties to the Heads of Agreement.
- A private contractor may choose to apply for admitted body status and where it and the local authority letting the contract meet the requirements of the new regulations, the pension fund authority *must* enter into an admission agreement for the contractor to become a participating employer in the LGPS. The local authority employer cannot make the contractor's application to become a participating employer a condition of the tender, nor can the transferred local authority employees demand that the contractor becomes a participating employer. However, if a contractor does not do so, it must provide a broadly comparable pension scheme in which transferred employees will not suffer any material detriment in overall terms of their future accrual of pension rights.
- When preparing a tender, a private contractor interested in becoming a non-associated employer in the LGPS must be told the likely employer's contribution rate.
- Before being allowed to become an LGPS participating employer, a private contractor will have to provide an indemnity or bond with an insurance company sufficient to meet the potential pensions liabilities if it should go into liquidation before the end of the contract and, thereafter, for as long as it has any liabilities to the LGPS fund.
- When a contractor becomes a participating employer, the transferred employees remain LGPS members unless they choose to opt out of the scheme.
- The admission agreement allowing the contractor to become a participating employer will not only apply to those local authority employees who are transferred to the private contractor but, if the contractor so wishes, also to new employees appointed later to work on the contract. As part of the agreement allowing the contractor to enter into an admission agreement, it must warrant that all of its employees who are LGPS members are employed 'in connection with' the provision of services or assets to the local authority. If an employee becomes employed on a non-local authority function of the contractor, membership of the LGPS ceases immediately.

Difficulties may arise when an employee is still employed in connection with the outsourced function but for significantly less than 100 per cent of his or her time. Local authority employers may decide to adopt the TUPE test, ie, where someone is employed principally (for more than 50 per cent) in connection with the function. Should the function again become the responsibility of a local authority in the future, employees covered by the TUPE regulations would be likely to transfer back to the local authority under those provisions and remain LGPS members. The same situation could arise if, on being re-tendered, the contract was 'won' by a different contractor which again sought admission to the LGPS.

There will no doubt be occasions when even the 50 per cent requirement cannot be sustained, for example, when a

single contractor may have secured several contracts with different local authorities and a transferred employee, initially employed 100 per cent on one contract is subsequently required by the contractor to share his or her time, say three ways, between contracts with three different local authorities. Assuming that the private contractor has entered into an LGPS admission agreement for the purposes of all three local authority contracts, although the employee is devoting only one third of his or her time to one contract, it would be completely inequitable for that employee to be excluded from continuing LGPS membership. The decision would be even more difficult if the contractor was admitted to the LGPS for only one or two of the local authority contracts.

The admission agreement

Generally the form and content of an admission agreement is a matter for discussion and determination by the interested parties. However, to bring greater certainty and clarity, an agreement with a private contractor must, as a minimum, incorporate specific terms and provisions prescribed by the new regulations. Most of these are self-explanatory including, for example:

- a requirement for the contractor to pay over all contributions and payments due, and a facility for the local authority involved to offset any outstanding amounts against monies due to the contractor
- a reference to the required indemnity or bond and a warranty by the contractor that such an indemnity or bond is and will continue in place
- an undertaking by the contractor that it will not do anything which could prejudice the Scheme's tax exempt approval status

- a requirement that the contractor will give immediate notice of any actual or proposed change in its status which could lead to a termination including a take-over, reconstruction or amalgamation, liquidation or receivership and a change in the nature of its business or constitution
- a minimum period of three months' notice to terminate the admission agreement, but automatic termination in the event that the contract ceases
- a right for the pension authority to end the agreement in the event of:
 - the insolvency, winding-up or liquidation of the contractor
 - a breach by the contractor of any of its obligations under the agreement
 - the withdrawal of approval by the Inland Revenue to the participation of the contractor as an LGPS employer, or
 - the contractor's failure to pay over monies due to the pension fund.

No doubt there will be other provisions written into admission agreements to reflect the terms of a particular contract.

The funding position

Unlike other public service pension schemes, the LGPS is funded. However, it is not subject to the minimum funding requirement imposed on private sector funded pension schemes by the Pensions Act 1995, as the benefits must be paid under statute irrespective of the funding level. The liability to pay pensions falls initially on the pension fund authority and ultimately the employer. The LGPS Regulations require the pension authority's actuary to set the employer's contributions at a rate sufficient to ensure final salary pensions can be repaid and to maintain as nearly constant a rate as possible.

The implications of this for a private contractor admitted to the LGPS are:

- the employer's contribution rate will be assessed and set in the light of the details of the employees transferred to ensure that the benefits which accrue for them are fully funded over the period of the contract. The contribution rate will be reviewed at each triennial valuation and might be varied during that period. In exceptional cases a contractor could be asked to fund a portion of an accrued deficiency. When this is a possibility it should be pointed out at the start of the tendering process;
- all the actuarial gains and losses arising within the contract period (including, for example, back-dated pay awards) fall on the contractor, following the triennial valuation;
- the costs relating to the strain on an LGPS fund when a contractor makes employees over the age of 50 redundant, and as a result their unreduced pensions come into payment immediately, will be charged in advance, or on an ongoing basis; and
- at the end of the contract, if it is not renewed, any deficiency will have to be met immediately by the outgoing contractor.

Implications for contractors

Although the new LGPS provisions will obviously be attractive to trade unions and employees facing a transfer to a private contractor, the prospective contractor must be fully aware of all the implications of becoming a participating employer in the LGPS. For instance, those contractors with their own pension scheme who are used to having some influence over the funding of that

scheme will find this is not the case in the LGPS as:

- the funding assumptions are determined by the LGPS actuary, whereas the contractor's scheme actuary advises it and the scheme's trustees;
- an LGPS fund's investment policy is decided entirely by the pension authority, not in consultation with its participating employers; and
- neither the pension authority nor the employers have any direct control over changes to the LGPS Regulations — these are decided by the DETR after general nationwide consultation with fund authorities, local authorities and other employers and the TUC.

Other issues a contractor should consider before becoming a participating employer in the LGPS include the need:

- to make good any deficiency immediately if it fails to keep a contract when that contract is tendered again in the future; and
- to remain a participating employer if it is to benefit from any further surplus, as the LGPS Regulations only permit this to be used by a reduction in the employer's contribution rate.

Also, in preparing their bids, contractors will need to consider:

- the actuarial assumptions used by the LGPS fund actuary,
- how the employer's contribution rate will initially be determined,
- the pension fund authority's investment strategy,
- whether the pension fund authority and the local authority employer will allow new employees working on the contract to become LGPS members,

- the cost of providing the mandatory indemnity/bond, and
- what other conditions must be met by a participating employer.

In summary, contractors should be

cautious and restrained when examining the possibility of becoming a participating employer (an admitted body) in the LGPS, and fully consider all other pensions options which may be available to them.