Outsourcing and Pensions

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Pensions issues are becoming increasingly important in the context of outsourcings and PFI projects. As pension deficits become more prevalent, the contractor looks for ways to limit their liability. An equal and opposite tension is the heightened involvement of the Unions. This can leave the local authority (Authority) with residual liabilities or an expensive contract. Nabarro Nathanson has considerable experience of advising all parties involved in these projects on the pension issues concerned. We briefly set out below the basics of the system and pick up some important considerations which need to be dealt with as early as possible in negotiations[1].

Basic Principles

Government policy is not to take any risk as to the extent to which pensions are excluded from the Transfer of Undertakings (Protection of Employment) Regulations 1981 ("TUPE"), but instead to require contractors to provide (broadly) equivalent benefits. Section 102 of the Local Government Act 2003 ("LGA") and the directions made under it will make this law.

There are two methods of securing compliance:

(a) The contractor provides a pension scheme for transferring employees which is "broadly comparable" with the Local Government Pension Scheme (LGPS) (the broadly comparable route); or

(b) The contractor is admitted to the relevant section of the LGPS (the Fund) (the admission route).

Due to the preference of staff and Unions, the admission route currently appears to be the most popular (with broadly comparable being the "fallback" position). We have therefore focused on this route only. However, although guidance suggests that good employment practice is part of providing best value, the Authority should be aware that this is only one element to take into account, together with all other relevant factors, in making its decision about who initially to award a contract to. It should also be aware of the cost implications of its decision.

Who is to be Included?

Most projects involve both Authority staff that will be transferred and staff recruited directly by the contractor to carry out the services. Accordingly, the Authority will need to decide who is to benefit from what sort of pensions terms.

(a) Code of Practice March 2003 (Code):

The Code will apply to contracts advertised after official publication. One of the main aims behind the Code was to limit the extent of the "two tier workforce" (i.e. staff recruited by the contractor being treated less favourably than staff transferred from the Authority). The Code requires external employers to provide new staff with one of the following:–

(i) membership of the LGPS;

(ii) membership of a good quality employer pension scheme, being either:
- a contracted out final salary based defined benefit scheme; or
- a defined contribution scheme (here the contractor must (at least) match the employees' contributions up to 6%); or

(iii) membership of a stakeholder pension scheme, (again the contractor must (at least) match employee contributions up to 6%).

(b) Equality

Even if the Code is complied with, there is no guarantee that pension provision will be of equivalent value to that of the transferring Authority staff. The Authority may, therefore, take the view that all staff (including non LGPS members and new recruits) should be treated equally. However, the Authority should bear in mind the cost implications of such a requirement.

Contribution Rates

(a) Calculation of Indicative Rates

The Authority and the contractor will ultimately have to agree a basis for the contribution rate to be paid by the contractor during the project. The Authority should request the relevant Administering Authority of the Fund to provide an initial rate (they will need to instruct the Fund actuary to do calculations). The Authority should provide an indication of contribution rates (ideally at ITN stage), but it should make it clear that the Administering Authority will want to firm up on the calculation at a later stage accounting for relevant changes.

It is common practice for the contractor's rate to be calculated using the assumption that the transferring Authority staff benefits are fully funded as at the transfer date.

(b) Contribution Rate Caps

More recently, external employers have begun to request contribution rate caps from Authorities in order to limit their pension liabilities. The Administering Authority will be unable to accurately assess or limit the contribution rates payable to the LGPS during the Project, as the rate needed will depend on a number of factors (including investment returns) and is primarily within the Fund actuary's remit to determine. Accordingly, the mechanism usually provides that the Authority reimburses any costs in excess of the cap. The contractor would argue that this assists the overall project being delivered within a reasonable budget (as without certainty or control on pensions costs, the contractor may have to build a significant contingency into its financial model). However, this clearly represents a risk to the Authority. Given that contribution rates to the LGPS cannot be accurately predicted, this is potentially an open ended liability. Before entering into such an arrangement, the Authority needs to consider the extent to which such an arrangement is appropriate, bearing in mind its fiduciary duties to tax payers (and also recent treasury guidance). There are also many variations as to how the cap can be framed and other options for assisting the contractor to keep control of pension costs. Accordingly, detailed legal and actuarial advice would be needed should such cap be requested.

Indemnity or Bond

In the case of the admission route, legislation requires the Authority to consider whether to require a contractor to provide a statutory form of indemnity or bond. Indemnities and bonds are supplied either by insurance companies or banks; the cover provided and the cost of the cover is different in each case. They are intended to cover the costs arising on premature termination of the Project Agreement as a result of the contractor's insolvency. The Administering Authority should be asked to obtain the assessment of risk from the actuary and the Authority should then pass this on to the prospective employers (if possible at ITN stage). Again, the Authority needs to make clear that the cost is at this stage, merely indicative, and will only be finalised just prior to the admission agreement being entered into. Recent changes in the legislation mean that it is now possible for the Authority to determine that an indemnity/bond is not required. However, unless the level of bond is assessed by the Fund actuary as nil, the Authority would have to consider such a decision carefully.

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[1] *The law regarding pensions matters is currently in a state of some flux, with the introduction of section 102 of the LGA which came into force on 1 April 2004. The details will be set out in directions which have not yet been published.*