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CIPFA response to the HM Treasury consultation on the Fair Deal policy

13 June 2011

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13 June 2011

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

Dear Sirs

Consultation on the "Fair Deal on pensions" policy

CIPFA is pleased to offer its comments on the HM Treasury consultation on the Fair Deal policy on public sector pensions.

General Observations

We understand from the consultation paper that the review of the Fair Deal policy was prompted by comments in the Independent Public Service Pensions Commission interim report published in October 2010. Specifically the report concluded that the Fair Deal policy creates a barrier to the plurality of public service provision, making it more difficult to achieve the efficiencies and innovation which new providers can bring to public service delivery.

CIPFA works constantly to seek ways to improve public financial management and would welcome any measures that facilitated the more effective and efficient use of public funds. Improving competiveness in the marketplace for the provision of public services, particularly in the provision of back-office services where the market is characterised by a small number of large companies, should help to improve quality and drive down costs, all of which is to the benefit of the public finances and public services.

However there is little evidence provided to support the assertion that the Fair Deal policy, in isolation, is responsible for the lack of diversity in the outsourcing sector.

Therefore we would caution against placing too great an emphasis on Fair Deal as being the major barrier to entry to potential new/smaller service providers. Fair Deal does place a significant responsibility upon outsourced service providers but this should be seen in the context of a wider range of structural and technical issues that might restrict new providers from entering the public sector marketplace.

In particular:

- The public competitive procurement process requires significant investment by bidding companies in terms of time and skilled resources. The lack of the necessary skills, internal capacity and finance to engage in the bidding process can act as a deterrent to companies, especially when pitched against established market participants with experienced, well-resourced business development teams.

- Irrespective of whether a public service is outsourced or provided in-house, the public sector body retains the responsibility, usually statutory, for the delivery of that service. The organisation therefore needs to manage any risks associated with outsourcing. Consequently public sector bodies need to assure themselves that a service provider has the ability to deliver services reliably, at the required quality and for the duration of the contract term. As a measure of the potential of a supplier to meet the quality and deliverability, providers may be required to demonstrate a satisfactory track record in the delivery of similar services in similar circumstances. This may prove problematic for smaller/newer providers.

- Public sector contracting bodies will also need to manage the risk to service disruption that might arise from the failure of the contractor. This will usually involve ensuring that the financial health of the company can withstand any claim for damages arising from service failure or seeking some form of guarantee from a parent company that offers the same assurance. Where the costs of ensuring service continuity are high, such requirements or guarantees may outstrip the company's resources, particularly for smaller companies.

- The lack of access to finance to fund contract set-up and implementation (the Government itself has already recognised this as the primary stumbling block for small business[1]) may also reduce the ability of small companies and new providers

Indeed it might be argued that the removal of the Fair Deal policy might actually be detrimental to the Government's wider policy aims of encouraging social enterprises, employee mutuals etc that may be "spun out" of the public sector. The reasoning behind this is that the potential loss of public sector pension scheme benefits upon moving to a new structure outside of the public sector may act as an impediment to those individuals who might otherwise lead or participate in the creation of such public sector service supplier entities.

We believe therefore that the policy aim, to increase the plurality in public service provision, will not be achieved by simply focussing on the Fair Deal policy, and that to be successful, and to the extent that government is able, the above issues should also be addressed.

We are also concerned that the stated policy objectives overlook the potential effects of the removal of, or changes to, the Fair Deal policy on public sector pension funds. As detailed in our response to question 3, any new policy direction on pensions, Fair Deal included, that results in a direct reduction in pension scheme membership will have consequences for the long-term sustainability of the pension scheme and the wider public finances.

[1] "Backing Small Business", BIS, 2010 - http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/10-1243-backing-small-business.pdf

We would also draw your attention to the impact that the withdrawal of the Fair Deal policy would have on the tender evaluation process and basis on which price comparisons of competing bids would be made.

If potential service suppliers were no longer required to provide comparable pension arrangements to transferring staff, this would place the public sector in-house bid at a disadvantage in almost every case. Unlike non-public sector suppliers, the public sector employer is not in a position to remove pension costs from its bid as pension scheme membership is not granted at the discretion of the employer but is a statutory entitlement associated with being employed by certain organisations[2].

This would lead to an imbalance in the bid costs that could only be rectified if pension costs were to be removed from the financial analysis of bids. However we do have some reservations about bids being assessed on anything other than a full cost basis and the resultant lack of transparency that would arise.

Response to specific questions

Specific comments on the questions for respondents are attached in Annex A.

I hope that you find these comments a useful contribution to the discussion on the Fair Deal policy. If you have any questions regarding any of our comments, please contact Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

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[2] For example, the Local Government Pension Scheme (Administration) Regulations 2008 4(2) states that "A person may be an active member if he is employed by a body which is listed in Schedule 2". Schedule 2 of the regulations lists organisations such as local and county councils, police and fire authorities, National Park Authorities etc.

Annex A

Question 1: 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.

We believe the list set out at paragraph 1.7 of the consultation paper covers the main affected parties although we note that employee and employer representative groups are not specifically mentioned.

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

See response to Question 4.

Question 3: 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.

We note the four policy objectives set out in paragraph 3.2 and would agree that, although they may to some degree appear to be conflicting, these are all relevant to the discussion on the Fair Deal policy. However this summary of the policy objectives does appear to overlook the Fair Deal policy from the perspective of the pension schemes themselves.

Any new policy direction on pensions where a public service is outsourced to be delivered by an independent provider that results in a direct reduction in pension scheme membership will have consequences for the long-term sustainability of the pension scheme and the wider public finances.

As we set out in our submissions to the Independent Public Service Pensions Commission, the employee contributions into public sector pension schemes make a significant contribution to the public finances. In 2009-10, UK public sector employees contributed around £7 billion into the unfunded public sector pension arrangements across the UK. These contributions were used to defray the £27.5 billion cost of paying today's public sector pensioners – around 25% of the total cost. By the time we reach 2015-16, this will have risen to approximately £10.8 billion (based on the latest Budget forecasts). When the contributions made by employees in the Local Government Pension Scheme are taken into consideration, this figure rises to almost £9.5 billion for 2009-10.

The latest UK spending forecasts place a great deal of emphasis on the employee contribution remaining intact throughout the course of this Parliament to avoid the contributions/expenditure gap widening further and therefore placing greater strain on the public finances. Indeed, this is further emphasized by the Chancellor's decision to seek to increase the contributions yield from public sector pension scheme members by a further £2.7 billion by 2014-15, the equivalent to an average 3% increase in employee contributions.

However there are already concerns that public sector pension scheme membership may reduce considerably as a consequence of the planned increases in contributions announced by the Chancellor, with a recent NAPF survey suggesting that up to 95%

of Local Government Pension Scheme members would be prepared to leave the pension scheme if contributions were to increase by 3% as planned[3]. Indeed evidence from some Local Government Pension Scheme funds suggests that the effects of pay restraint, benefit reductions, tax and National Insurance increases, inflation approaching 5% and the prospect of interest rate rises before the end of 2011 are already causing scheme members to leave on the grounds of affordability. This is supported by the latest figures for the Local Government Pension Scheme where membership levels have fallen to 75% of eligible employees (a 25% opt-out rate), from a long-time average membership of between 80% and 85%.[4]

If pension scheme membership were to reduce significantly as a consequence of these changes, and beyond that already assumed in the OBR forecasts, the sizeable contribution from employees which at present is supporting the cost of today's public service pension payments would be placed at considerable risk.

There would be similar implications for the Local Government Pension Scheme (LGPS). Recent research by a leading public sector pension scheme actuary shows that the Local Government Pension Scheme is maturing at a far greater rate that previously estimated as the number of active members in relation to deferred and pensioner members falls. Figures from Hymans Robertson show that the proportion of active members in the LGPS has fallen to 39%, down from 46% in 2004[5]. Hymans attribute the fall in active membership to budget reductions and efficiency programmes which have resulted staffing reductions.

A reduction in the active membership base means that funds are becoming mature more quickly than current assumptions allow for and will prompt funds into de-risking portfolios, moving into index-tracking, low risk investments such as bonds to match pension payment profiles. This reduces the ability of funds to pursue active, high-income generating investments, thus reducing fund income. This combined with reduced employee contributions would place greater pressure on the employer (and thus the taxpayer) to make up the funding shortfall. This conclusion is supported by Unison research which indicates that when LGPS opt-out rates reach 30%, this maturity tipping-point will be reached.[6]

Overall, changes to the Fair Deal policy that result in fewer active members remaining in public sector pension funds will exacerbate this position with all the concomitant adverse consequences for the public finances.

We would urge, therefore, that the review group include a further policy objective to ensure that any changes to the Fair Deal policy should not affect the long-term financial sustainability of public sector pension schemes through accelerated erosion of the active membership base.

[3] *Three percent hike leads to opt-out fears*, Pensions Week, May 2011

[4] *"Local authority workers pull out of UK pension scheme"*, IPE May 2011

[5] *"LGPS figures reveal maturity timebomb*" Pensions Week, May 2011

[6] *"LGPS faces negative cash flow through 30% exodus"*, Pensions Week, May 2011

Question 4: Is there a case for changing the current Fair Deal policy?

The Fair Deal policy was introduced in 2000 at a time when the then government was embarking on a programme of modernizing pubic service provision ("Better Quality Services"). This recognised that "this would result in some services or functions being provided by, or in partnership with, the private or voluntary sector, or restructured and organised in a new way within the public sector" and that "the involvement, commitment and motivation of staff are vital for achieving smooth and seamless transition during such organisational change."[7]

The policy sought to apply the principles set out in *"Staff Transfers in the Public Sector – Statement of Practice"* to ensure that transferring staff were treated fairly; to do so openly and transparently; to involve staff and their representatives fully in consultation about the process and its results; and to have clear accountability within Government for the results.

Since 2000, the UK has become a regional leader in public sector outsourcing. In 2010, the value of the UK public sector outsourcing market reached £80 billion, representing 92% of all public sector outsourcing in the Europe, Middle East and Africa (EMEA) economic area and 77% of all contracts signed in 2010.

In fact the 2010 position shows that UK public sector outsourcing has grown significantly when compared with the averages levels between 2005 and 2009 of 84% and 57% respectively. In 2010 alone the six largest new outsourcing contracts were valued at over £7 billion[8].

This year on year growth in UK public sector outsourcing would seem to indicate that the Fair Deal policy has not stood in the way of the development of innovative and flexible solutions to the provision of public services. Indeed by clarifying the roles and responsibilities placed upon the public sector and the contractor, it might be argued that Fair Deal has played a positive role in this growth.

Equally, as we have set out above, we do not believe that at this stage there is sufficient evidence that changing the Fair Deal policy alone will achieve the stated policy aims and indeed that the policy aims themselves overlook the potential impact on public sector pension schemes and the associated impact on the public finances.

We would suggest therefore that this exercise be used as an opportunity to gather more evidence on the extent to which Fair Deal policy might impact upon the development of the outsourcing market for public sector services and to examine in greater detail the potential impacts upon public sector pension schemes and the public finances of any changes to the policy. This would allow for further future consultation, underpinned by a sound evidence base, to look at whether changes are necessary and how they might be implemented

[7] "Staff Transfers in the Public Sector – Statement of Practice" January 2000
[8] Outsourcing Yearbook 2011

Question 5: If so, what should the policy cover, including:

a) what (if any) stipulations should be made regarding the level and type of future pension provision following transfer to be provided for future accrual;

b) what should be the treatment of previously accrued benefits? For example should CETV's be the norm or should bulk transfer agreements continue to be used and, if so, in what form; and

c) what should the requirements be on subsequent compulsory transfer to an independent provider or return to the public sector?

Question 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 and 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 taxpayer compared to the current Fair Deal arrangements; and

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

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

Question 8: The Government welcomes views on 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.

In view of the comments expressed above we think it premature to consider these questions in any detail at this stage.