

CONSULTATIVE DISCUSSION PAPER ON ADMITTED BODY STATUS

1. As foreshadowed in paragraph 16.4 of the Department's recently-published consultation document "Where next? - Options for a new look Local Government Pension Scheme in England and Wales", I am now writing to seek views on some principles for possible regulatory development of the Admitted Body Status (ABS) provisions. These have been drawn up following discussions by the working group comprising key stakeholders in the contracting-out process.

ABS – Policy context and intention

2. The existing ABS provisions provide for administering authorities to enter into admission agreements with transferee admission bodies - predominantly profit-making private sector contractors dealing with functions which have been outsourced from local government under best value - to allow specified groups of employees to have continued access to the LGPS. They were originally introduced in 1999; in their current form they date from 2003.
3. It is important to set the arrangements in the context of Government policy on outsourcing, best value, and the fair deal for staff.
 - There is a commitment to partnership, diversity and plurality among providers
 - There are no ideological preferences between providers
 - The aim is to drive up performance standards
 - Fair deal means protection of workforce pay and conditions, including pensions.
 - Pensions protection can be provided either through a broadly comparable pension scheme, or through continued access to the existing public service scheme.
4. In the LGPS, ABS was introduced to allow contractors who took on local authority contracts to retain members of the Scheme in that arrangement, allowing them to continue to accumulate benefits under the one scheme whilst their employment is transferred between different contractors. It enables contractors to tender on a small scale where they could otherwise find setting up a broadly comparable scheme disproportionately expensive. In essence, its introduction in 1999 was intended, in pension policy terms, to provide a seamless transfer in an outsourcing contract context.

The current provisions

5. The existing provisions were drawn up in discussion with the key stakeholders: the contractors' representatives, the employer interests and the Trades Unions. The regulatory provisions are primarily set out

in regulations 5A and 5B and Schedule 2A to the LGPS Regulations 1997, with some other regulations (e.g. 75, 78) impinging on them.

6. Transferee Admission Bodies are treated as if they were scheme employers in relation to their employees in the LGPS, but their participation is contractual, not statutory. They are subject to the standard scheme employer requirements and certain additional provisions intended to deal with particular issues likely to arise from their different status. Among these are the liability to pay employers' contributions based on actuarial valuations, the potential for these to be higher than the common rate as for a short-life body the normal spread recovery period for recovering any fund deficits may be inappropriate, the requirement for a terminal valuation with the potential to have to pay an exit charge to meet any capitalised deficit, and the requirement for a risk assessment which will often require a bond or guarantee to be given to protect the fund in the event of commercial failure.
7. Under ABS, contractors are actuarially allocated assets in the relevant LGPS fund equal to the members' accrued liabilities at the start of the contract. These assets are rolled up in line with investment returns and contributions over the contract period, with the contractor liable to meet any shortfall between accumulated assets and accrued liabilities when the contract ends.

Need for a Review

8. In the view of the working group (and it is a view held more widely still), ABS remains in principle an attractive and useful mechanism for dealing with pensions in the contracting-out process; there is nothing in the fundamental concept which needs to be changed.
9. It is recognised that ABS provides pensions stability throughout the contracting-out process when contracts and the workforce may over time pass to successive generations of different contractors. It can promote good employee relations because pension benefits are independent of the contractor. Contractors do not have to make arrangements for a broadly comparable scheme and subsequent generation contracts are simpler to effect with no transfer of liability between contractors' schemes. Contractors' liabilities cease on crystallisation when the contract ends, and contractors are exempted from the Pension Protection Fund in respect of those members.
10. However, in the light of experience, concerns have been expressed – principally by the contractors – that the detailed arrangements are not being implemented as they were originally envisaged when first drawn up, and that this is beginning to affect the inherent qualities of the ABS regime and its best value context.
11. Perceived problems which have been identified are:

- some authorities are apparently specifying ABS as a contractual condition, whereas it has only ever been intended to be a matter of contractor choice;
- contractors have no direct control over costs, which are often volatile with significant increases in contributions rates during the contract; they lack any input into investment strategy, actuarial assumptions, or deficit spreading;
- contractors are expected to bear all the risk, including asymmetric risk at end of the contract where they are liable for any shortfall but cannot benefit from any surplus; potential debt charges on exit may thus make broadly comparable schemes more attractive to contractors;
- contrary to policy intentions, contractors may inherit significant past service liabilities with asset variations or changes in actuarial assumptions during the contract therefore having a disproportionate effect;
- the effect of FRS17 / IAS19 on contractors' balance sheets and the consequent impact on their ability to tender for new contracts;
- unnecessary additional costs arising from provision of indemnity bonds;
- consequent dangers of deterring reputable contractors from bidding or inducing overpriced bids for safety's sake; the number of contractors prepared to tender where ABS is a contract requirement and debts must be paid on exit may be limited;
- informed contractors will price pension risk into the contract, passing the risk back to the authority and obscuring the pricing of the tendered service; uninformed contractors may underprice the pension risk and default, creating the need to re-tender;
- informed contractors may be consistently eliminated at the early stage of bids, and that there is a consequential possibility that authorities may end up with poorer quality services, albeit at a lower price (although service level specification and monitoring procedures should ensure adequacy);
- informed contractors may initially bid low and address risk issues at preferred bidder stage to avoid early elimination; this runs the danger of authorities wrongly eliminating other contractors who do price in the risk at the outset and tender a marginally higher initial bid;
- there are thus potential higher costs to authorities either from paying more for the contract than strictly necessary or from accepting a lower bid from a less well-informed contractor who subsequently defaults.

12. On the other hand, it is reasonable to assume that the existing arrangements still offer financial advantages to local authorities in a market where there are uninformed as well as informed contractors. In the competitive market, authorities should be free to achieve the best deal possible for council tax payers and the transferring employees, without undue restrictions, and currently authorities may be able to

maximise the potential outsourcing savings where the pensions risk is transferred to the contractor and uninformed contractors underestimate it. However, this only applies while there is a significant body of uninformed bidders; as later generations of contracts are let and the pensions dimension is more widely recognised, under-estimating pensions costs is likely to become less common, and earlier savings based on such under-estimates are unlikely to be replicated. In considering options for the future development of the LGPS, the Department needs always to take the longer-term view.

Possible future approach

13. It is the Department's view that either ABS or a broadly comparable scheme should remain as available options to contractors. This reflects the Government's approach, in overall policy terms, to public sector outsourcing arrangements and the commitments under the Fair Deal for staff. While recognising that there will always be circumstances where a broadly comparable scheme will be a contractor's chosen route, the aim should be to make the advantages of ABS sufficiently attractive for it to be the scheme of contractor choice in the majority of cases. The Department therefore needs to ensure that the arrangements are robust and work well, are not unfairly disadvantageous to contractors, contracting authorities, other employers in the fund, or members, and that ABS properly supports the best value regime and, through it, council tax payers.
14. There do appear to be some potential weaknesses with ABS as it currently operates: risks of fewer bidders, unnecessary elimination of good contractors, higher costs, poorer quality services, and, in extremis, contractor failure. One potential solution which has been proposed by the working group to address these weaknesses and improve the attractiveness of ABS would be to develop pass-through arrangements.

Overview of pass-through arrangements

15. Pass-through would effectively remove pension risk from the equation. The contractor would pay contributions at a rate specified at the outset of the contracting process, with subsequent variations only for common factors (e.g. changes in mortality assumptions) or those within their control (e.g. abnormal pay movements), and the letting authority would retain and meet the actual cost of all the investment risk. Contractors would contribute only for membership accrued during the contract and would have no past service liabilities, nor ongoing liability at the end of the contract. The letting authority would effectively meet the actual cost of pensions rather than the cost inflated either by over-cautious risk assumptions or by the price of contractor failure in terms of quality delivery or financial performance. However, it would deprive authorities of the potential benefit of a lower bid, where the contractor has priced the pensions element at less than the true cost.

16. The potential advantages of such an arrangement are seen to be:

- The pensions element would be stabilised;
- contractors would compete on a level playing field, concentrating on the services tendered without the distraction of volatile pension costs potentially leading to outsourced services which are either too high on cost or too low on quality.
- contractors would price their bids more realistically without a margin for pensions risk;
- a level playing field could lead to increased competition;
- pass-through arrangements could ameliorate contractor concerns about back-door compulsion, since bidders' reservations about ABS in the LGPS largely stem from the total transfer of risk, and lack of control over costs with its unquantifiable effects;
- contractors might be more willing to adopt ABS, which outsourcing authorities and the trade unions might prefer;
- once all bidders were sufficiently informed as to how to load their bids to hedge against investment risk under the present system, pass-through could result in savings to authorities.

17. Explicit features of a pass-through arrangement might include:

- No transfer of past service liabilities;
- The outsourcing authority would set the future accrual rate at the outset, to be included in all bidders' tender prices;
- Subsequent actuarial valuations would distinguish between fluctuations due to common factors, those within the contractor's control and those due to fund performance;
- Increased costs arising from investment risk would be met by the contracting authority passing through the costs to the letting authority by adjustments to the contract price (possibly, as an alternative, through adjustments to the letting authority's own contribution rate);
- The contractor would meet the cost of contributions increases due to common factors such as increased longevity, and those due to factors within their control such as abnormal pay increases and abnormally high levels of ill-health retirements or redundancies;
- The letting authority would need safeguards to protect them from the effects on past service liabilities arising from factors within the contractor's control;
- No increase in contractor's contribution rate to reflect the short life of a contract and no crystallisation of liabilities or termination payments (exit charges) when the contract ends. Such increase and charges are inappropriate because the contract (and the staff) would either be taken over by a new contractor or revert to the local authority;
- Arrangements should equally suit open or closed agreements.

18. Current provisions require a risk assessment with, where necessary, a bond or indemnity to be provided. With a pass-through arrangement, there might be less need for a bond or indemnity (which contractors tend to regard as an unnecessary expense), but the Department's current view is that a risk assessment should still be required to examine whether contractor failure or default might place an additional strain on the fund and so on public finances.

Implementation

19. The original ABS provisions were set out in the LGPS regulations and backed up by non-statutory guidance. A move to pass-through arrangements would need to be reflected in revisions to contract provisions. Some amendment to the LGPS regulations would be necessary. Either detailed amendments could be made to the regulations, with revised non-statutory guidance to back them up, or less detailed regulatory provisions backed up by statutory guidance could be developed. In any event, in the light of concerns about compulsion, contribution hikes and exit charges, the Department and the LGE will, in the interim, review the original guidance material produced when the regulations first came into force.

Comments

20. Views are invited on the issues discussed in this paper. In particular, in addition to general comments, it would be useful to have specific views on the following questions:

- Are there compelling reasons for retaining the existing arrangements without amendment?
- Are they just in need of amendment?
- Is pass-through a satisfactory way of dealing with the perceived operational problems?
- Are there particular disadvantages to pass-through not identified in this paper?
- Are there other options (statutory or non-statutory) which could usefully be considered?
- If pass-through were adopted, are the features outlined above appropriate?
- Is the proposed apportionment of costs between contractors and letting authorities reasonable?
- Are there sufficient safeguards for contracting authorities?
- If other necessary safeguards are identified, how can these best be provided?
- Are there other features which need to be identified?
- Is a risk assessment necessary?
- How would such arrangements best be implemented?

Next steps

21. In the light of views expressed in response to this document, revised draft regulations and or guidance will be drawn up as appropriate. Any proposed amendments to the LGPS regulations will be subject to statutory consultation with all interested bodies in the normal way.

Responses

22. Comments on this paper should be sent to Lynn Corner, DCLG, Zone 2/F7 Ashdown House, 123 Victoria Street, London SW1E 6DE by 6 October 2006. Electronic responses should be addressed to Lynn.corner@communities.gsi.gov.uk
23. A summary of responses to this consultation will be published within 3 months of the close of consultation at www.xoq83.dial.pipex.com
24. This consultation follows the Government code of practice on consultations, which can be accessed at www.cabinetoffice.gov.uk/regulation/consultation/code/index.asp
25. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).
26. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, or itself, be regarded as binding in the Department.
27. The Department will process your personal data in accordance with the DPA and, in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

Department for Communities and Local Government

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