

Public Sector Outsourcing

Managing the pension risks

March 2007

The market for public sector outsourcing contracts is growing with good opportunities for companies to provide more efficient services than the public sector. However the Government's gold plated protection for employees can mean that the pension risks outweigh the potential profits. This bulletin summarises the key issues contractors must consider.

Background

If a contract involves public sector employees – civil servants, NHS employees, local authority employees or teachers – the contractor must provide a broadly comparable pension arrangement. This means that as well as providing services to the public sector the contractor is also providing outsourced pensions. It is therefore vital to ensure that the same discipline is applied to pricing and managing pension cost and risk as is applied to managing other elements of service delivery.

What are the key issues?

- **Which pension scheme?** For local authority contracts, a key decision is whether to participate in the Local Government Pension Scheme or use its own scheme. In the latter case there is choice of scheme design - this choice involves a balance of risk and cost.
- **Past service transfers:** all employees must be offered the opportunity to transfer their benefits into the contractor's pension scheme. This means that a contractor has to price pensions as part of its bid. Watson Wyatt often helps contractors negotiate adjustments to the contract price to meet this shortfall – which can add in excess of 20% to the amount received.
- **Exit provisions:** what happens at the end of the contract? Contractors may need to top up pension plan transfer values, pay off a LGPS deficit as a lump sum or even pay a full buy-out debt. How the arrangement is set up at the start and monitored over the course of the contract can be critical in determining the exit costs and the timing of those costs.
- **Redundancy:** public servants have generous redundancy provisions that pass across under TUPE. For older employees, that includes early payment of pensions. Simple in theory, messy and expensive in practice.

For civil servants, the benefits vary by age and service and do not appear to satisfy the age discrimination requirements. How can contractors meet their TUPE requirements and satisfy age discrimination legislation?

The information in this document is based on UK legislation and practice. The Watson Wyatt commentary in this document is not intended to be comprehensive, nor to provide professional advice. It should not be treated as a substitute for professional advice on individual circumstances.

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- **Injury:** special benefits apply if an employee is injured as a result of his/her employment – in some cases a lifetime income guarantee of up to 85% of pay. Watson Wyatt has developed bespoke insurance solutions to assist contractors with these issues.
- **Second generation contracts:** to what extent do the above provisions apply if the former public sector employees are already working in the private sector?

This all adds up to managing pensions risk, which can be tricky over the life of a contract, typically 5-10 years.

How can we help?

It is critical that the key risks arising from outsourcing pensions are actively managed. Failure to do so can result in an otherwise profitable contract making a loss.

We believe that there are three main areas where Watson Wyatt is uniquely placed to assist contractors to provide effective pension provision in the context of public sector bids:

1. **Negotiation at take on:** Watson Wyatt has a wide range of experience in negotiating transfer values and determining a scheme design which ensures that the contract terms are as favourable as possible.
2. **Contract operation:** this requires effective cost and risk control over the course of the contract, taking into account the specific contract requirements.
3. **Contract termination:** this requires an informed negotiation by the outgoing contractor to minimise termination costs and risks.

To find out more about managing pension provision in public sector contracts, please contact your Watson Wyatt consultant or call Andrew Reid on 020 7222 8033 or Steven Dicker on 0161 839 1600.