Admitted Body

Information Note for Awarding Authorities:
Pass-through for new Contractors

April 2023

Purpose

This note has been prepared by the Lincolnshire Pension Fund ("the Fund") to provide information for existing Fund employers ("the Awarding Authority") who are considering a TUPE transfer of staff to a third-party Contractor ("the Contractor"). It should not be used for any other purpose and should not be shared with any other third parties without the Fund's prior consent. It may be shared with the Contractor or any advisors involved in the outsourcing process.

In all cases, it is important for the Awarding Authority to engage with the Fund as early as possible to ascertain the best approach for the pension arrangements to any proposed outsourcing.

Background

From 1 September 2020, the Fund's policy is that new outsourcings will be set up under a "pass-through" arrangement (although exceptions will be considered on a case-by-case basis at the Fund's discretion).

The key principles behind any pass-through arrangement are:

- The Awarding Authority retains the key pension risks associated with the outsourcing. In particular, this means that any pension surplus or deficit at the end of the contract is retained by the Awarding Authority. Generally, the Contractor 'walks away' from the Fund on exit without paying any deficit or receiving any surplus, subject to any payments that the Contractor is liable to pay in respect of unpaid contributions or excess risks (e.g. early retirement strains) that are agreed in the contract.
- The Contractor pays a fixed contribution rate that is agreed in advance with the Fund and the Awarding Authority and applies during the full period of the contract, unless agreed otherwise. The contribution rate will be fixed at a certain percentage of pay, based upon the on-going primary contribution rate payable (expressed in percentage of pay terms) by the Awarding Authority.
- The Awarding Authority (and the Contractor) should decide at the outset who is liable for pension costs that arise due to items over which the Contractor exerts full control e.g. redundancy programmes where the staff involved receive enhanced pensions on early retirement. These excess risks should be agreed in advance and included in the tender documentation.

Typically, the majority of the pension risk is borne by the Awarding Authority and thus the liability is retained on its balance sheet – as such, generally, the Contractor would not be required to pay any deficit or receive any surplus at the end of the contract (subject to any agreed exceptions). This allows the Contractor to price with certainty, removing any premium for risk it may otherwise be pricing into its bid.

Ultimately the risk resides with the employer awarding the contract, therefore it is up to the Awarding Authority to decide the appropriate terms for the contract being awarded.

The key advantage of the pass-through is that all pension risks and pension contributions can be agreed in advance of the commencement date of the contract. These should be included within the tender documents or information for bidders and should enable clearer and more informed tender discussions for all stakeholders.

Pre September 2020 approach
Under the Fund's previous policy for new (outsourced) admission bodies the following principles apply:

- all past service pension benefits in respect of outsourced members are transferred from the Awarding Authority to the new Contractor;
- the Contractor is set up on a "fully funded" basis with the assets notionally allocated at outset set equal to the value of the transferring accrued pension benefits based on market conditions at the transfer date;
- the starting contribution rate is the cost of providing future service pension benefits only;
- the contribution rate is reviewed at every formal valuation date during the contract period to allow for experience and changes to assumptions/market conditions, and adjusted to take account of any past service surplus or deficit that has arisen since the last valuation (or outset);
- as required by the LGPS Regulations, a bond or other form of indemnity is taken out by the Contractor that is triggered in the event of its failure during the contract period; and
- when the Contractor reaches the end of its contract, the LGPS Regulations require a cessation valuation to be undertaken and any deficit (or surplus) is levied on the departing employer. Recent changes to the LGPS Regulations may now allow any surplus to be returned to the Contractor as an 'exit credit' upon cessation.

The Fund will also usually insist on early retirement strains and augmentation costs that arise during the contract being met via an additional lump sum contribution.

When the contract is terminated, the Contractor is able to make a "clean break" from the Fund with no further obligations other than paying any cessation debt (should one exist) and any early retirement strains, outstanding contributions and augmentation costs that are payable. The assets and liabilities left behind by the departing Contractor revert back to the Awarding Authority (as required under the LGPS Regulations).

Post September 2020 approach – "pass-through" policy for new Contractors
The Fund's policy (referred to as "pass-through"), is included in greater detail in the latest version of the Fund's Funding Strategy Statement ("the FSS"), however the main details are set out below:

Admission bodies

New admission bodies in the Fund are commonly a result of a transfer of staff from an existing employer in the Fund to another body (for example as part of a transfer of services from a council or academy to an external provider under Schedule 2 Part 3 of the Regulations). Typically these transfers will be for a limited period (the contract length), over which the new admission body employer is required to pay contributions into the Fund in respect of the transferred members.

The default approach (which took effect from September 2020) is for admission bodies to join the Fund under a pass-through arrangement. Under a pass-through arrangement, the letting authority retains the pensions risk. The admission body is responsible for paying the agreed contribution rate and also additional costs as set out in each admission agreement e.g. redundancy and early retirement costs.

Before September 2020, the default approach was a full risk transfer. Under a full risk transfer the admission body becomes responsible for all the pensions risk associated with the benefits accrued by transferring members and the benefits to be accrued over the contract length. The administering authority may consider requests for a full risk transfer from new admission bodies.

Funding at start of contract

For pass-through and full transfer of risk arrangements, it may be appropriate for the new admission body to be allocated a share of Fund assets equal to the value of the benefits transferred, i.e. the new admission body starts off on a fully funded basis. This is calculated on the relevant funding basis and the opening position may be different when calculated on an alternative basis (e.g. on an accounting basis).

For pass-through employers the funding position will be re-set at 100% at each triennial valuation, with the balancing assets moved to/from the letting authority's section of the Fund as required. No such re-set is carried out under a full transfer of risk arrangement.

There may be special arrangements made as part of the contract such that a full risk transfer approach is not adopted. In these cases, the initial assets allocated to the new admission body will reflect the level of risk transferred and may therefore not be on a fully funded basis or may not reflect the full value of the benefits attributable to the transferring members.

Contribution rate

The default approach for a new admission body with a pass-through arrangement will be for a simple fixed rate to apply. The minimum acceptable rate payable by a pass-through employer is the primary rate certified at the previous valuation for the letting authority. Consideration will be given to a variable rate in line with the cost of benefit accrual where the contract is for a long period.

- The simple fixed rate will be fixed at the outset and not re-calculated during the remainder of the contract. This will usually be set out as part of the commercial contract between the letting authority and the contractor. Where this rate differs from the cost of future benefits calculated by the actuary, the balance will be incorporated into the letting authority's certified rate.

- The variable rate would initially be set as the simple fixed rate, in line with the ceding employer's contribution rate, and then adjusted at each valuation in line with the change in the ceding employer's cost of future benefit accrual calculated by the actuary. The contribution rate may therefore change as a result of changes in the membership profile of the ceding employer and updated assumptions, such as future investment returns, inflation and life expectancy. The letting authority retains much of the market risk (e.g. asset performance) and experience (e.g. if inflation has been higher between the valuation periods than assumed).

For a full-risk transfer, the contribution rate may be set on an open or a closed basis. Where the funding at the start of the contract is on a fully funded basis then the contribution rate will represent the primary rate only; where there is a deficit allocated to the new admission body then the contribution rate will also incorporate a secondary rate with the aim of recovering the deficit over an appropriate recovery period.

Depending on the details of the arrangement, for example if any risk sharing arrangements are in place, then additional adjustments may be made to determine the contribution rate payable by the new admission body. The approach in these cases will be bespoke to the individual arrangement.

Why has the policy changed?

Awarding authorities often choose to outsource services to; improve service delivery, increase efficiency, reduce service costs, aid manpower planning etc. However, under the previous approach to outsourcings, all of the key pension risks transfer from the Awarding Authority to the Contractor for the duration of the contract. For many contractors, this may be viewed as an unexpected or undesirable by-product.

The previous outsourcing approach can lead to a great deal of uncertainty over costs for contractors during volatile market conditions e.g. large increases to regular contributions, big cessation debts etc. Bidders for

contracts are increasingly aware of these problems and may seek to price them into contracts via additional service charges which can undermine the purpose of the outsourcing.

The Awarding Authority will want to obtain the best value for the outsourced service. Offering contractors "pass-through" as a means for removing some of the uncertainty of the cost for paying for the outsourced members' pension benefits may be a way of helping to achieve this. Pass-through benefits are explained in greater detail in the following section.

Whether under the previous approach or the new pass-through approach, the Awarding Authority still retains long term responsibility for the risks as all the members' accrued benefits transfer back to the Awarding Authority at the end of the contract.

Furthermore, the Awarding Authority remains the ultimate guarantor for all pension obligations throughout the contract in the event of the Contractor becoming insolvent. This is unchanged whether adopting the previous approach or using pass-through.

Pass-through benefits

It is the recommendation of the Fund, as per the Fund's FSS, that operating a policy of pass-through for new outsourcings should be beneficial for all interested parties:

Awarding Authority

- ✓ Awarding authority may be able to negotiate better contract terms, i.e. no need for Contractor to build in margins for uncertain pension costs.
- ✓ Contribution rates and pensions risks are known in advance and are included in tender documents. This enables early and fully informed contract discussions.
- ✓ Easier to understand their pension responsibilities.
- ✓ Clearer and more consistent tendering process.
- ✓ Level playing field for all Contractors making a bid encouraging a wider pool of prospective bidders.
- ✓ Any surplus (if one exists) on cessation is generally retained by the Awarding Authority.
- ✓ Lower actuarial costs as no contribution rate assessment required at outset or at triennial valuations.

Contractor

- ✓ The Contractor bears less uncertain pension risk.
- ✓ Stable and potentially lower contributions for the Contractor over the term of the contract.
- ✓ Reduced or mitigated risk of pension cost volatility.
- ✓ No cash sum debt payment required on exit.
- ✓ Likely no need for accounting disclosures.
- ✓ Reduced administrative costs.
- ✓ Lower actuarial costs as no contribution rate assessment required at outset.

What pension risks could the contractor remain liable for?
When establishing a pass-through arrangement, the Awarding Authority should consider if the Contractor should retain responsibility for funding any risks that would be within its own control. These typically (but not exclusively) relate to strains arising due to:

- early payment of benefit on unreduced terms;
- augmentation of benefits; and
- excessive salary growth.

The Fund's current policy on early retirement requires the payment of any strains arising from early retirement to be paid immediately be the employer. As part of the contract terms, the Awarding Authority may consider requesting the payment of any strains arising during the contract be paid by the Contractor.

Monitoring excessive salary growth may be less practical for smaller outsourcings. Therefore, the Awarding Authority may wish to consider the significance of (or lack of) this risk if looking to establish such covenants with the Contractor.

As above, the contract for services or a side letter should detail which risks are being retained by the Awarding Authority and which risks are retained by the Contractor.

Risk mitigation
The Awarding Authority may place a condition on the Contractor to mitigate its exposure to some of the excess risks outlined above through the use of bonds. Insurance bonds can be taken out by the Contractor to provide cover for redundancies (i.e. early retirement strains) and unpaid contributions (if required), in the event of insolvency.

Other excess risks, such as excessive salary increases, may not be possible to mitigate. The Awarding Authority may wish to consider the significance (or not) of the risks being shared by the Contractor before placing any conditions on risk mitigation.

Implementing pass-through
Before going out to tender, the Awarding Authority should decide which risks it intends to pass to the Contractor and the fixed contribution rate that will be payable throughout the contract (noting that the default is for the Contractor to pay the same total rate as the Awarding Authority at the outset).

As set out above, it is important to document all of the risk sharing arrangements. Generally, these are not included in the Contractor's admission agreement to the Fund but are instead included in either the services contract or a side agreement. The services contract or side agreement will need to be carefully drafted to ensure that it is clear from the outset:

- exactly what risks are being retained by the Awarding Authority and which pass to the Contractor;
- the specific treatment of costs arising as a result of actions by the Contractor;
- who is responsible for future deficits and surpluses;
- what happens at the end of the contract;
- what happens if the Contractor fails or terminates the contract early;

- who pays what to whom in terms of contributions, including the amounts and timings of contributions payable to the Fund, and adjusting payments; and
- what is the pension provision for new entrants.

Where an Awarding Authority has implemented pass through arrangements, it should ensure that it keeps track of all the "retained risks" from those arrangements, passes the details to the Fund, and that they are appropriately allowed for at valuation and accounting exercises.

Summary

The Fund believes that using pass-through as the default approach for all new outsourcings will be in the best interests of all parties.

Pass-through is becoming more common in LGPS funds as contractors become more aware of pension risk and the financial consequences of adverse experience whilst participating in funds. The most competitive contract price is likely to be achieved if a contractor is offered pass through. Recent market conditions and changes in the Regulatory environment (e.g. contractors may now be able to access surpluses as an 'exit credit') may also make it more beneficial to awarding authorities.

The Fund's default approach is an arrangement where all the pension risk (and liabilities and assets) effectively remain with the Awarding Authority and the Contractor is set a fixed contribution rate for the duration of its participation in the Fund. However, the Awarding Authority may decide that the Contractor is held to account for any costs associated with employer driven decisions (e.g. excessive pay awards or early retirement strains etc.).

The arrangement should be clearly documented via the services contract or a side agreement between the Awarding Authority and Contractor. The admission agreement will not contain details of risk-sharing arrangements. However, these details must be shared with the Fund in all cases.

Appendix – Pass-through risks summary

Contribution rate

Employer's initial contribution rate	x%
Future contributions	Fixed at x%

Contribution rate X% of pay p.a. is set equal to the total equivalent % of pay rate in payment of the Awarding Authority at the date of commencement of the contract (unless instructed otherwise). This rate is known is advance and can be appropriately priced into the service agreement negotiated with the bidder.

Past service liabilities

Past service position at date of commencement	£
Value of past service liabilities transferred	0
The notional allocation of assets transferred	0

No past service liabilities are transferred to the Contractor. The Awarding Authority retains the ultimate responsibility for all liabilities, with the exception of any risks not shared, as outlined below (e.g. early retirement costs).

Risk summary

The Contractor (C) would be required to enter into a risk-sharing agreement with the Awarding Authority (AA) to confirm the division of liabilities along the following lines (noting, this is one example and the Awarding Authority and the Contractor should agree their own risk sharing arrangement):

Risk/Cost	Pre transfer benefits	Post transfer benefits
Market movements	AA	AA
Funding assumptions or strategy	AA	AA
Pay rises in excess of actuary's valuation assumption*	C*	C*
Early retirement/redundancy strain costs and augmentation**	C**	C**
LGPS changes	AA	AA
Surplus or (Deficit) at termination of contract	AA	AA

* Excess costs that the Awarding Authority may wish to pass responsibility to the Contractor

** Can be mitigated in the event of Contractor failure, by provision of a bond (or suitable alternative)

Checklist for Awarding Authority

Some of the key actions Awarding Authorities must ensure they follow when outsourcing a contract are:

1. Notify the Lincolnshire Pension's Admin team of the **potential outsourcing** as early as possible, to ensure the proper process is followed.
2. Ensure that the Awarding Authority fully understands the risks and implications of awarding a contract, asking for further information where necessary **prior to issuing the tender documents**.
3. Consider the **fixed contribution rate to be payable** by the Contractor – noting the default is to set the rate equal to the existing primary percentage rate in payment of the Awarding Authority.
4. Consider whether this rate should be **fixed for the duration** of the contract, or whether this is reviewed at any interim date(s) – noting Contractors may increase the contract price where there is any uncertainty of future contributions
5. Consider the **risks** that the Awarding Authority wishes to pass to the Contractor, e.g. early retirement strain costs.
6. Consider whether there should be a requirement on the Contractor to obtain **a bond** to mitigate some of these risks.
7. Draft an appropriate **risk-sharing document** that outlines the key risks and responsibilities of the parties involved prior to issuing the tender. This side agreement terms should be agreed and signed by the Awarding Authority and the winning bidder.
8. Ensure that the **admission agreement** is completed with the Administering Authority once the contact has been awarded.
9. **Pass details** of the finalised risk-sharing agreement to the Administering Authority.
10. **Notify the Pension Admin team** immediately of the termination or any changes to the contract.