PLYMOUTH CITY COUNCIL

Subject:	DELT Pension Appraisal
Committee:	Cabinet
Date:	17 January 2017
Cabinet Member:	Councillor Darcy
CMT Member:	Lesa Annear (Strategic Director for Transformation and Change)
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Ref:	SRA/DPP 28112016
Key Decision:	No
Part:	I

Purpose of the report:

DELT is a Shared Service company jointly owned by the Council (50% voting, 70% distribution) and the Northern, Eastern and Western Devon Clinical Commissioning Group (CCG) (50% voting, 30% distribution). DELT's core objective is currently to provide ICT services to the Council and CCG. It is intended that DELT will grow its business both in the public and private sector.

The purpose of this report is to seek approval to change the accounting method for the pension liabilities of the employees who were in the Local Government Pension Scheme (LGPS) when they transferred to DELT. This change is intended to create a better position for DELT to grow. DELT obtained admitted body status (ABS) and closed the LGPS to new DELT employees in May 2016.

Growth aspirations mean that when DELT tender for new contracts or seek financial investment their financial position is subject to due diligence or will be credit/risk rated.

Under FRS102, accounting rules require DELT to provide for the deficit on the LGPS pension fund arising in respect of former PCC employees who transferred to DELT under TUPE arrangements in October 2014. In practice this means DELT is required to make an annual transfer from its Profit and Loss account to the Financial Statement (formerly referred to as the "Balance sheet") to ensure there are sufficient funds to cover any deficit between scheme assets and liabilities as independently determined annually by the scheme's actuaries. This is necessary because the LGPS scheme is a fully funded scheme. In 2015/16 the sum transferred was £0.336m. This represented approximately 25% of the DELT profit or a 22% reduction of the balance sheets net assets. These entries and provisions reduce profitability and weaken the balance sheet from the perspective of future customers and financial institutions.

The Council and CCG jointly own 100% of DELT and the Council remains liable for the LGPS pension position for the employees it transferred to DELT. It therefore makes good business sense for the Council to account for the pension liabilities of the DELT LGPS employees on the Council's balance sheet rather than on DELT's.

There are recognised financial and accounting options that permit such arrangements and changes.

Normally the Devon LGPS will complete a triennial actuary review for the Councils in the Devon administered LGPS. This takes into account a range of issues such the economic performance of the funds investments, the profiles of the employees in, joining and leaving the scheme and the pensioners funded and the rate at which deficits on the fund are planned to be mitigated. The outcome of all this highly specialist analysis is to set a new employers LGPS rate every three years. This is possible because the Devon LGPS remains open to new employees joining the City Council so the employer's rate can be reviewed periodically.

In contrast to this, the DELT LGPS is a closed scheme and is time limited for the duration of the 10 year DELT contract (of which 8 years remain). As no new employees can join the DELT LGPS scheme the employer's pension contribution rate needs to be fixed and set at a rate to reduce the risk of a deficit on the fund at the end of the contract period.

The changes proposed in the report will require DELT to amend the employer's pension contribution rate for the remainder of the 10 year contract (i.e. for the next 8 years). The DELT LGPS employer's pension contribution rate will be fixed at a rate to offset the majority of the risk the Council is taking by maintaining responsibility for the DELT LGPS pension liability at the end of the contract. Under TUPE regulations this risk remains with the Council anyway.

The changes proposed in the report do not impact on the pensions of the DELT employees who transferred to DELT with an LGPS pension.

Table 1. Closed Term Actuary Analysis (extract showing the residual 8 year position)

Closed Term	**Probability of a pension fund deficit at the end of the contract period** (with the employers pension rate fixed at the rates below for the number of specified years)								
Year	**1%**	**5%**	**10%**	**25%**	**50%**	**75%**	**90%**	**95%**	**99%**
8	55.9%	46.0%	41.1%	32.3%	22.0%	12.1%	9.8%	8.6%	7.6%

Table 1 shows the probability of a residual pension deficit at the end of the remaining 8 years of the 10-year contract (the black %s) where the employer's rate is fixed for 8 years at the rates shown in the table (the white cells). Thus, at a 50/50 chance of a deficit or surplus the employer's pension rate DELT would need to make to the fund is 22%. Given the probability of either a surplus or deficit occurring is 50/50 the level of that surplus or deficit is likely to be low.

The Corporate Plan 2016/17 -2018/19:

The pioneering approach and flexibility shown in changing the pension arrangements support the continuous growth of DELT. By working constructively and developing a sustainable ICT provision in the region and beyond we are confident DELT will increase quality jobs and valuable skills and support a wider supply chain in the city in the longer term.

Implications for Medium Term Financial Plan and Resource Implications: Including finance, human, IT and land:

There will be a range of direct and indirect financial implications relating to this technical change to the accounting for the DELT LGPS Pensions Liability.

1. The Council will increase its Pension provision on its Balance sheet as recommended by the actuary year end valuation report in accordance with the requirements of the IFRS102. This has no financial impact on the Councils Income and Expenditure statement and therefore does not affect the level of Council Tax. The pension provision is made in the Councils Balance Sheet where it remains until it is reappraised at the end of the contract or in the event it crystallises in the distant future (if the pension scheme was ever wound up or the DELT ABS was not extended or replaced with a new ABS for a different contractor).

2. DELT will have to increase its LGPS employer's rate for the remaining 8 years of the contract from 12.0% to 22.0% but it will not be required to transfer profit to cover the balance sheet pension liability in future.

3. Longer term we anticipate the changes will enable DELT to grow with the Council and the Northern, Eastern and Western Devon Clinical Commissioning Group (CCG) sharing the financial benefit (cost reductions and potential profit share).

4. Both the Council and DELT will need to backdate amendments to their accounts and possibly prior year Financial Statements and work with their respective External Auditors accordingly.

Other Implications: e.g. Child Poverty, Community Safety, Health and Safety and Risk Management:

There is a risk of a residual material pension fund deficit at the end of the contract. This has been mitigated by taking professional advice from the Pension Fund's Actuary to determine a suitable employer's pension rate for DELT. The changes proposed in the report do not impact on the pensions of the DELT employees who transferred to DELT with an LGPS pension.

The risk of state aid non-compliance is considered very low as DELT will have to increase the employer's pension rate by 10% to 22% to commercially balance out the benefit from the change in pension risk share arrangements.

Equality and Diversity:

Has an Equality Impact Assessment been undertaken? An Equality Impact Assessment has been completed and no adverse impact will arise as this is a technical finance adjustment

Recommendations and Reasons for recommended action:

Cabinet is recommended to

1. Approve the change of pension arrangements with effect from the 1 April 2016 so that the Council make provision for DELT LGPS pension liabilities at the end of the DELT contract on the Council's Balance Sheet rather than on DELT's Balance Sheet.

2. Delegate to the Assistant Director for Finance (Section 151 Officer) the responsibility of notifying the Devon LGPS Pension Fund Administrators of the proposed changes

3. Delegate to the Assistant Director for Finance (Section 151 Officer) the responsibility to work with Devon Pensions, DELT and to represent the Council to amend the Pensions Admission Agreement and any other contract to reflect the proposed changes

4. Instruct the Councils DELT shareholder representative to advise the DELT Board to amend DELTs employers' contribution rate for the DELT LGPS employees for the remainder of the DELT contract in line with the proposals in the Part II report.

Alternative options considered and rejected:
The following alternative options were considered and rejected

1. Maintain the current Pension arrangments – rejected as this does not help DELT to grow as effectively

2. A range of Pension arrangmeents have not been explored in detail becsue they are more complex and are not relevent because the Council co-owns DELT so picks up the eventual liability. The aim is to keep things as simple as possible.

Published work / information:
None
Background papers:

Title	Part I	Part II	Exemption Paragraph Number						
			1	2	3	4	5	6	7
Devon County Council DELT Services Pension Information	x								
Equality Impact Assessment	x								

Sign off:

Fin	Djn1617152 21-12-2016	Leg	ALT/27187	Mon Off	27193/DVS	HR	n/a	Assets	n/a	IT	n/a	Strat Proc	n/a
Originating SMT Member													
Has the Cabinet Member(s) agreed the content of the report? Yes													

Introduction

1.1 DELT is a Shared Service company jointly owned by the Council (50% voting, 70% distribution) and the Northern, Eastern and Western Devon Clinical Commissioning Group (CCG) (50% voting, 30% distribution). DELT's core objective is currently to provide ICT services to the Council and CCG. It is intended that DELT will grow its business both in the public and private markets creating a lower cost base for the ICT services provided to its owners.

1.2 The purpose of this report is to seek approval to change the accounting method for the pension liabilities of the employees who were in the Local Government Pension Scheme (LGPS) when they transferred to DELT. This change is intended to create a better position for DELT to grow. DELT obtained admitted body status (ABS) and closed the LGPS to new DELT employees in May 2016.

2. Financial Drivers

2.1 Growth aspirations means that when DELT tender for new contracts or seek financial investment their financial position is subject to due diligence or will be credit/risk rated.

2.2 Under FRS102, accounting rules require DELT to provide for the deficit on the LGPS pension fund arising in respect of former PCC employees who transferred to DELT under TUPE arrangements in October 2014. In practice this means DELT is required to make an annual transfer from its Profit and Loss account to the Financial Statement (also referred to as the Balance Sheet) to ensure there are sufficient funds to cover any deficit between scheme assets and liabilities as independently determined annually by the scheme's actuaries. This is necessary because the LGPS scheme is a fully funded scheme. In 2015/16 the sum transferred was £0.336m. This represented approximately 25% of the DELT profit or a 22% reduction of the balance sheets net assets. These entries and provisions reduce profitability and weaken the balance sheet from the perspective of future customers and financial institutions

2.3 The Council and CCG jointly own 100% of DELT and the Council remains liable for the LGPS pension position for the employees it transferred to DELT it makes good business sense for the Council to account for the pension liabilities of the DELT LGPS employees on the Councils balance sheet rather than on DELT's.

2.4 There are recognised financial and accounting options that permit such arrangements and changes.

3. A Pensions Overview

3.1 Normally the Devon LGPS will complete a triennial actuary review for the Councils in the Devon administered LGPS. This takes into account a range of issues such the economic performance of the funds investments, the profiles of the employees in, joining and leaving the scheme and the pensioners funded and the rate at which deficits on the fund are planned to be mitigated. The outcome of all this highly specialist analysis is to set a new employers LGPS rate every three years. This is possible because the Devon LGPS remains open to new employees joining the City Council so the employers' rate can be reviewed periodically.

3.2 In contrast to this, the DELT LGPS is a closed scheme and is time limited for the duration of the 10 year DELT contract (of which 8 years remain). As no new employees can join the DELT LGPS scheme the employers' pension contribution rate needs to be fixed and set at a rate to reduce the risk of a deficit on the fund at the end of the contract period.

3.3 The changes proposed in the report will require DELT to amend the employers pension contribution rate for the remainder of the 10 year contract (ie for the next 8 years) The DELT LGPS employers pension contribution rate will be fixed at a rate to offset the majority of the risk the Council is taking by maintaining responsibility for the DELT LGPS pension liability at the end of the contract. Under TUPE regulations this risk remains with the Council anyway

3.4 The changes proposed in the report do not impact on the pensions of the DELT employees who transferred to DELT with an LGPS pension.

3.5 DELT's current employers' rate for the duration of the original 10-year contract period is set at 12% and there are 68 employees of DELT who are in the LGPS DELT Pension scheme under the ABS.

3.6 The analysis shown in the table 1 is the summary result of the actuary running 10,000 economic scenarios and also considered the contributions as a percentage of salary that DELT would have to make under each scenario and modelled forecast economic average returns over 20 years for a range of asset classes (eg UK equities, Property, index linked gilts and corporate bonds)

Table 1. Closed Term Actuary Analysis.

Closed Term	**Probability of a pension fund deficit at the end of the contract period** (with the employers pension rate fixed at the rates below for the number of specified years)								
Year	**1%**	**5%**	**10%**	**25%**	**50%**	**75%**	**90%**	**95%**	**99%**
1	56.6%	43.6%	35.7%	23.4%	14.0%	14.0%	14.0%	14.0%	14.0%
2	57.4%	44.2%	37.0%	25.7%	14.1%	14.0%	14.0%	14.0%	14.0%
3	56.6%	44.5%	38.4%	27.4%	16.3%	12.5%	11.3%	10.7%	9.9%
4	56.0%	45.0%	39.0%	28.6%	17.8%	12.4%	11.0%	10.3%	9.3%
5	55.9%	45.1%	39.4%	29.6%	19.0%	12.3%	11.0%	10.3%	9.3%
6	55.5%	45.0%	39.5%	30.7%	20.1%	11.8%	10.2%	9.5%	8.7%
7	55.4%	46.3%	40.6%	31.4%	21.1%	12.0%	9.7%	9.0%	8.1%
8	*55.9%*	*46.0%*	*41.1%*	*32.3%*	*22.0%*	*12.1%*	*9.8%*	*8.6%*	*7.6%*

3.7 Table 1 shows the probability of a residual pension deficit at the end of the remaining 8 years of the 10-year contract (the black %'s) where the employers rate is fixed for 8 years at the rates shown in the table (the white cells). Thus, at a 50/50 change of a deficit or surplus the employers' pension rate DELT would need to make to the fund is 22%. Given the probability of either a surplus or deficit occurring is 50/50 the level of that surplus or deficit is likely to be immaterial.

Table 2. Further Scenarios Explanation

Probability of a pension fund deficit at the end of the contract period (based on 8 years of the contract to run)						
Probability Rate	Defciit	25%				50%
	Surplus	(75%)	From		To	(50%)
Requires a Employer contribution		32.30%				22.00%

3.8 Using table 2 as a further example, picking a probability of a potential deficit in the range 25% to 50% would require DELT to build in an employer's pension contribution rate of between 22.0% and 32.3%.

3.9 It is important to recognise some likely scenarios relating to the potential of a pension fund deficit. The Council may carry a provision as advised by the actuary but the reality of it crystallising into a cash sum to be funded at the end of the contract is low. The reason for this is because the pension fund is a funded scheme the provision relates to a future sum needed to pay out the pensions as employees retire in the future. The deficit would only crystallise in the short to medium term in the event that the pension scheme was wound up. At the end of the contract it is likely the Council will still require ICT services and so any recalculated deficit would simply roll for the duration of a new contract and mitigated over time. In the event that a new contract was retained by DELT the liability would still reside with the Council. If however, a new external contractor took over either DELT or the company then any pension deficit would be retained by the Council and a bond to protect this from increasing is likely to be required from the new contractor.

4. Impact on Plymouth City Council

4.1 In accordance with IFRS102 the Council will be required to make a provision on its Balance Sheet to cover the risk of the pension deficit crystallising. The likelihood of a deficit needing to be covered is already established as low in the medium term for reasons explained earlier in the report

4.2 The Council will not need to charge the Income and Expenditure account to fund the provision on the balance sheet because of the local government financial rules (therefore this does not impact on the Council Tax payer)

4.3 The Council will need to work with the External Auditors to ensure the financial entries in the accounts and the presentation of the 2016/17 year-end financial statements are correct.

4.4 The Council is already working closely with DELT to achieve these proposed changes and has been keeping the Devon LGPS Fund Administrators involved. The Council has been working with the Devon LGPS Fund Actuary Barnett Waddingham to prepare the scenarios and analysis in arriving at the appropriate pension fund valuations and employers rates.

4.5 There will be a requirement to formally request DELT make the changes once they are agreed, notify Devon LGPS Administrators and also work with the triparty signatories in order to amend the DELT Admissions Agreement.

4.6 The Council has also considered the implications of a challenge from an external ICT provider that it is at risk of any state aid breach. This specific point is covered in the Risk section of the report

5. Impact on DELT

5.1 Like the Council DELT will also need to work with its External Auditors to ensure the correct entries are incorporated into their accounts, backdated to the 1 April 2016 and that the Financial Statements (and Pension notes) for 2015/16 are restated correctly when drawing up the 2016/17 Financial Statements.

5.2 Whilst DELT will have a stronger Balance Sheet and a net improvement to its Profit and Loss accounts going forward it does bear some increased pension employers costs in each year of the 8 years remaining. The amount will ultimately be determined by the final employers' rate agreed by the Council and DELT using the Actuary's advice.

Table 3 Impact on DELT

LGPS Pensionable Pay	Employers Rate and £m's		
	12.0%	22.0%	32.3%
	£m	£m	£m
£1.724	0.207	0.379	0.557
Increase on base of 12%		*0.172*	*0.350*

5.3 Table 3 shows the financial impact on DELT of a change in employer's rate based on the pensionable pay and the increase from the current 12% to 22% and as an extreme for illustration 32.3%.

5.4 As the employers pension rate is fixed then it should be easier for DELT to factor this in when spreading this overhead within new contracts going forward as it seeks to recover its costs or drive margins to contribute to this cost.

6. Risks

6.1 The following Risks have been considered and mitigating action is shown in the table below.

Table 4 Risks and Mitigation

Ref	Risk	RAG	Mitigation
1	Risk of material pension deficit	L	Actuary advice and ongoing dialogue with DELT and the Devon LGPS Administrator to set the DELT employers rate at an appropriate level
2	Agreement of on acceptable LGPS DELT employers rate (too low and causing a material deficit)	L	Actuary advice and ongoing dialogue with DELT and the Devon LGPS Administrator to set the DELT employers rate at an appropriate level
3	Accounting entries and Financial Statements are incorrect	L	Engagement and dialogue with BDO the External Auditors
4	State Aid compliance.	L	Fixed contribution rate of 22% (increased from current rate of 12%) considered to be adequate compensation for change to pension risk share

7. Legal Opinion in relation to State Aid

7.1 The primary purpose of the State aid regime is to prevent EU Member States from providing financial advantages to their national economic entities which could distort competition in the internal market. This enables British economic entities to compete on a level playing field with competitors from other EU Member States.

Pensions and State Aid

7.2 The proposal to change the pension risk share arrangements for DELT so that the deficit that is currently shown on DELT's Balance Sheet is moved to the Council's Balance Sheet could be perceived as providing a selective advantage to DELT.

7.3 The "aid" is partly transparent as we are able to calculate the value of the deficit currently shown on DELT's balance sheet - £0.336m. This figure is above the de minimis threshold of €200,000. However, £0.336m also represent the provision made by the Council for the duration of the 8 years left to run on the contract and increasing the DELT employers rate from 12% to 22% compensates the Council for taking this risk. In addition, had the deficit remained on the DELT balance sheet it would have changed annually in line with the actuary annual revaluation required by IFRS102, meaning it could go up, remain the same or even reduce. The deficit figure of £0.336m may change going forward which may result in exit debt that differs from this amount. Under the terms of the current Admission Agreement, DELT will be liable for paying any exit debit. It is being proposed that the council picks up any exit debt going forward.

7.4 The current contribution rate under the Admission Agreement is 12%. This rate is not currently fixed and would usually change following an actuarial assessment. The following table explains how the pensions risk may be shared between the council and DELT going forward:

Type of risk	CURRENT POSITION - Which party currently bears the risk?	PROPOSED - How is the risk likely to be shared under the proposals?
Investment risk during the contract	New employer	Letting Authority
Inflation risk during the contract	New employer	Letting Authority
Salary risk during the contract	New employer	Mainly the Letting Authority
Mortality risk during the contract	New employer	Letting Authority
Any change in actuarial assumptions	New employer	Letting Authority
Number of members leaving during the contract	New employer	Letting Authority
Early retirements during the contract	New employer	Usually the new employer
Ill health retirements during the contract	New employer	Varies but we have assumed the Letting Authority
Discretions	New employer	Usually the new employer
Regulatory change	Depends on the details of the change but usually the new employer	Letting Authority

7.5 Taking on additional risk by the council could amount to a less obvious form of assistance to DELT. Some of this risk may not be quantifiable at present as it is difficult to assess the funding risk for the life of the contract.

7.6 Pass-through pension risk share arrangements are not "un-market like" provided that full compensation is received in return for the council in taking on board greater risk. The proposed fixed contribution rate of 22% following the Actuary's advice may amount to adequate compensation as that amount is assessed as being the rate that is sufficient to cover the cost of providing the benefits to the transferring employees for the period DELT has employed them. Furthermore, a private investor faced in a similar situation is likely to agree to the pension risk share as proposed in return for increased dividends. It is argued that the council is acting as a market economy operator by agreeing to the pass-through pension risk share on the basis of economic evaluations comparable to those which, in similar circumstances, a rational market economy operator (with characteristics similar to those of the council) would have had carried out to determine the profitability or economic advantages of the transaction.

7.7 The CJEU case of 2012/540/EU: Commission Decision of 20 December 2011 on State aid C 25/08 (ex NN 23/08) which involved a complaint that France had implemented aid in favour of France Télécom which reduced its financial charges (contribution rates) in part, and notably those relating to the financing of retirement pensions provides some assurance that provided compensation is given in return for the transfer of risk, the assistance will not be considered to be unlawful grant of state aid.