

Abolition of contracting out – consultation on a statutory override for Protected Persons Regulations

January 2013

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Introduction

This consultation invites views from stakeholders as to whether or not employers should be permitted to change the pension scheme rules which apply to protected persons in order to make adjustments for the additional NI costs they face as a result of the end of defined benefit contracting out, following the introduction of the single-tier state pension.

About this consultation

Who this consultation is aimed at

We welcome comments on this consultation from pension industry professionals, pension schemes, trustees, industry, pension scheme members and member representative organisations but we would be interested in views from any source.

Purpose of the consultation

This consultation seeks views on whether or not, following the abolition of defined benefit contracting out as part of the reforms to the state pension system, employers should be permitted to override the protected persons regulations in order to offset the additional costs they will face as a result of the end of contracting out and the loss of the NI rebate.

Scope of consultation

This consultation applies to England, Wales and Scotland

Duration of the consultation

The consultation period begins on 18 January 2013 and runs until 14 March 2013.

The Government's new Consultation Principles were introduced on 17 July.

(The new Principles are at <http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>).

How to respond to this consultation

Please send your consultation responses, by email preferably, to:

PROTECTED.PERSONSCONSULTATION@DWP.GSI.GOV.UK

Or by post to:

Department for Work and Pensions

Contracting out policy

Level 1, Caxton House, Tothill St, London SW1H 9NA

Please ensure your response reaches us by 14 March 2013.

When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and where applicable, how the views of members were assembled. We will acknowledge your response.

Queries about the content of this document

Please direct any queries about the subject matter of this consultation to:

Department for Work and Pensions
Contracting out policy
Level 1, Caxton House, Tothill St, London SW1H 9NA

Email: PROTECTED.PERSONSCONSULTATION@DWP.GSI.GOV.UK

How we consult

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact:

Central Freedom of Information Team
Caxton House
Level 4, Caxton House, Tothill St, London SW1H 9NA

Freedom-of-information-request@dwpgsi.gov.uk

The Central FoI team cannot advise on specific consultation exercises, only on Freedom of Information issues. More information about the Freedom of Information Act can be found at www.dwp.gov.uk/freedom-of-information

This consultation is being conducted in line with the new Cabinet Office Consultation Principles. The key principles are:

- departments will follow a range of timescales rather than defaulting to a 12-week period, particularly where extensive engagement has occurred before;
- departments will need to give more thought to how they engage with and consult with those who are affected;
- consultation should be 'digital by default', but other forms should be used where these are needed to reach the groups affected by a policy; and
- the principles of the Compact between government and the voluntary and community sector will continue to be respected.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Elias Koufou
Legislation Manager
Caxton House
Tothill St
London SW1H 9NA
Phone 0207 449 7439

Elias.koufou@dwp.gsi.gov.uk

In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. Please also make any suggestions as to how the process of consultation could be improved further.

If you have any requirements that we need to meet to enable you to comment, please let us know.

We will publish the responses to the consultation in due course in a report on the consultations section of our website www.dwp.gov.uk/consultations. The report will summarise the responses and the action that we will take as a result of them

Chapter 1 – Background

1. The Government published a consultation paper on state pension reform, ‘*A State Pension for the 21st Century*’, in April 2011¹. The consensus among respondents was that the state pension system needs to be reformed largely because of its complexity, with around three quarters of organisations who responded supporting the single-tier in principle². As announced in the White Paper, ‘*The single-tier pension: a simple foundation for saving*’, the Government now plans to introduce a single-tier flat rate state pension for new pensioners from April 2017³.
2. With the introduction of the single-tier pension, the State Second Pension will close. As a consequence, contracting-out of the State Second Pension - giving up entitlement to the State Second Pension in return for a lower National Insurance (NI) rate for employer and employee – will come to an end for defined benefit (DB) pension schemes. When contracting-out ends the minimum requirements for contracted-out DB schemes (known as the “Reference Scheme Test”) will no longer apply since there will be no need to ensure individuals become eligible for an amount of pension in their contracted-out scheme broadly equivalent to the additional State Pension to which they may otherwise have become entitled. Both employer and employee will stop receiving the NI rebate and instead pay the full rate of NI - the same rate as is paid by other employers and employees who are not contracted out.
3. Many organisations who responded to the Government’s consultation on state pension reform told us about the significant implications that ending contracting out for DB schemes would have for sponsoring employers, schemes and employees. For employers, the end of contracting out will have cost and administrative implications, the biggest of which will be the loss of the contracted-out NI rebate. They will have to pay the same rate of NI as all other employers, meaning the employer NI rate for each contracted-out employee will increase by 3.4 per cent of employee earnings between the Lower Earnings Limit (LEL) which is currently £5,564 and the Upper Accrual Point (UAP), currently £40,080.
4. Some respondents to the consultation said that private sector employers would want to balance the cost of paying higher NI contributions by reducing their future scheme liabilities, and hence the level to which they must continue funding their scheme. This could be done by reducing future pension benefits or by increasing employee contribution rates to their pension schemes.

¹ www.dwp.gov.uk/docs/state-pension-21st-century.pdf

² <http://www.dwp.gov.uk/docs/state-pension-21st-century-response.pdf>

³ <http://www.dwp.gov.uk/single-tier-pension>

Chapter 2 - protected persons

5. The Government considers it is right to enable private sector employers to change their scheme design to offset their additional NI costs. In the White Paper, the Government announced that it intends to give powers to employers in order for them to change scheme rules for this purpose without trustee consent – see Annex A for an extract from the White Paper. How this would impact on employees and others is described further in the impact assessment for the White Paper. The legislation that will achieve this is contained in the Pensions Bill.
6. This consultation is concerned with whether Government should permit employers who sponsor schemes which have ‘protected persons’ to override the protected persons rules. The draft legislation is framed so that it could be used either to override the protected persons rules, or not, depending on the outcome of this consultation.

Protected persons

7. Some former nationalised industries, now in the private sector, are limited in their ability to change scheme rules by legislation made at the time of privatisation. The legislation is specific to a number of industries and is collectively referred to in this document as the “Protected Persons Regulations” (PPRs). In broad terms the PPRs require the new private sector employer to continue to provide pension benefits for employees who were employed at the time of privatisation which are at least as good as those they were receiving in the public sector, and prevents the employer or the scheme from making changes which reduce future pension accruals or increase employee contributions.
8. In two instances (coal and electricity) scheme changes can be made in limited circumstances if approved by a majority of the members. In the case of Rail any amendment of the scheme which is less favourable is not feasible. In the case of London Transport, any amendments will not have effect unless the member consents to them. The overall effect of these requirements makes it likely that none of these employers would be able to use the legislative power to amend scheme rules to adjust for the additional NI Contributions payable as a result of the abolition of contracting-out, unless the PPRs are overridden by the legislation.
9. If the PPRs are not overridden, such employers would face the additional cost of paying full-rate NI contributions, without being able to make a corresponding change to reduce their pension scheme liabilities. Annex B contains a summary of the legislation which restricts the ability of trustees and employers to amend scheme rules which are applicable to ‘protected persons’.

10. Private sector employers affected by PPR said in discussion following the Green Paper that the end of contracting out would leave them in the position where they could reduce scheme benefits for the majority of employees – those not covered by the PPRs – whilst not being able to make changes for scheme members / employees covered by PPRs. In some cases employers will face large increases in costs which they cannot absorb into running costs. Without being able to make an adjustment for the increased NI costs for employees, which is a direct consequence of a Government change in policy, employers would have to consider what other ways were open to them to make up for this loss and, in some instances, they may have very limited options.
11. Sponsoring employers affected by the PPR rules were clear that they would not have a differential treatment for protected and non-protected persons⁴. They consider this to be unfair and would have serious negative implications for industrial relations. Some schemes have a mixture of members who are 'protected persons' and those who are not, which would make it difficult to single out non protected persons.
12. The Government considers it is necessary to examine further whether it is fair and appropriate to permit employers who wish to, to make this limited change to future benefits – accrued benefits up to the point of change would not be affected. It recognises the need to balance the rights and expectations of both employers and employees. That is why, before making a decision on the issue, the Department is seeking the views of affected stakeholders on whether or not to give employers the power to make a one-off change to scheme rules which apply to the protected persons for this purpose.

⁴ Some employers have taken steps to reduce benefits for non-protected members of schemes.

Chapter 3 – who is affected

13. Data suggests that, out of a total private sector contracted out membership of 1.7 million, around 50,000⁵ individuals are covered by the protected persons legislation. This represents up to 3% of those in private sector DB pension schemes. The main industries affected that we are aware of are railways, London Transport, coal and electricity. We estimate that around 400 employers may be affected. The distribution of affected employees according to type of industry is shown in table 1 below. It should be noted that by 2017 (the earliest date for the introduction of single tier), the number may be lower as some members will have retired.

Table 1: estimated numbers of affected employers and members

Industry*	Employers	Employees
Electricity	c.134	c.10,000
Rail (including London Transport	200	36,000
Coal	33	1,800

Impacts on employers if they are not permitted to change scheme rules for protected persons

14. The override is designed such that if protected persons were to remain protected, employers will not be able to adjust to the loss of their NI rebate. The question, therefore, arises for employers as to how to pass on the increase.

15. The impacts on employers, some of whom are in price-regulated industries, of not being permitted to change scheme rules are described further in the attached impact assessment at Annex C. In summary, it is the Department's expectation, based on discussions with the affected employers, that employers who are not permitted to change rules for protected persons will instead pass the increased NI costs onto consumers, via higher prices. So employers would not, ultimately, bear the cost of not being able to change scheme rules for protected persons.

Impact on members of schemes who are protected persons if scheme rules are amended

16. The impacts on individuals of amending scheme rules currently protected by the PPRs are described in the impact assessment at Annex C. Annex D

⁵ Source : industry estimated figures

illustrates some potential outcomes for protected persons. It is important to bear in mind when considering the illustrations that employers will have flexibility in re-designing their schemes. Employers will be free to adjust accruals or employee contributions or to make other changes going forward. They may choose to use a combination of different changes. As mentioned previously, these are listed changes and employers would still be required to consult with employees.

17. The overall impact on individuals needs to take account of the new single tier state pension that they will receive on reaching state pension age. Such an analysis is set out in some detail in the impact assessment published alongside the state pension reform White Paper. It shows that for nine out of ten people reaching state pension age within twenty years of the introduction of single tier, the increase in contributory state pension received is greater than the extra NI Contributions paid and potential loss of occupational pension if they are in the private sector. So the vast majority of people close to retirement will have a higher overall income in retirement compared to the losses they might experience as a result of the end of contracting out.

Chapter 4 – Summary

18. In summary, the arguments from the perspective of employees and employers in relation to whether or not the Government should permit employers to override the protected persons legislation are:

From the perspective of an employer with scheme members who are protected persons:

- The end of contracting out, following the introduction of the Single-tier state pension, will leave employers in the position where they could reduce scheme benefits for the majority of employees – those not covered by PPR legislation – whilst not being able to make changes for those covered by PPR. In the interests of fairness and affordability rule changes should be allowed for all employees including those who are protected persons.
- Preserving the protected status for a minority of employees whilst the majority may face an increase in workplace pension costs would be very difficult to communicate.

From the perspective of a scheme member who is a protected person:

- Protected persons have had their pension benefits protected in legislation since the 1990s.
- Protected persons could expect their protected status to continue until they retire – is it fair now for those rights to be removed?
- As protected persons tend to be a minority of scheme members, so maintaining the pension benefits for these members would not affect the costs of the scheme much overall.

Consultation questions

Question 1

19. Do you consider it is fair and appropriate for the Department to introduce legislation to allow employers to override the PPR to change scheme benefits for members who are 'protected persons', thereby enabling employers to offset the cost of the additional employer National Insurance which they will face as a result of the end of defined benefit contracting out?

Question 2

20. In looking at this issue, the industries we consider where there would be impacts are coal, electricity and rail. We think there are no impacts in the atomic energy and gas sectors. Are you aware of other industries which might be affected?

Annex A - Extract from the White Paper, *The single-tier pension: a simple foundation for saving*

- [Extract from the White Paper, The single-tier pension: a simple foundation for saving](#) (54KB) 

Annex B - Summary of the legislation which restricts the ability of trustees and employers to amend scheme rules which are applicable to ‘protected persons’

The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (SI 1990/346)

These Regulations are made under Schedule 14 of the Electricity Act 1989.

The relevant provisions are:

- no amendments of relevant scheme rules are allowed where such amendments would result in accrued or future pension rights of protected persons being reduced or protected employees’ contributions being increased, except in certain specified circumstances;
- a new employer should provide future pension benefits in an alternative scheme which are no worse than transfer date rights;
- a protected employee has a right to accrue pension rights on a change of employer (where that employer does not currently have any protected employees in the relevant scheme) that are no worse than transfer date rights;
- future pension rights to be provided (on total or partial wind up of the Electricity Supply Pension Scheme) should be no worse than future pension benefits for those employees immediately prior to the date on which they ceased to participate in the Scheme and moved to the alternative scheme.

The Coal Industry (Protected Persons) Pensions Regulations 1994 (SI 1994/3070)

These Regulations are made under Schedule 5 of the Coal Industry Act 1994.

The relevant provisions are:

- no amendment can be made to a relevant scheme which results in the reduction of accrued or future pension benefits for protected persons under the scheme or an increase in protected employees’ contributions, except in certain specified circumstances;
- protected employees are entitled to accrue future pension rights in the IWCSSS or IWMPSS⁶ in accordance with the rules of that scheme, or in an alternative scheme, on the same basis as other protected employees in that scheme. If the pension rights of protected persons already in a scheme are worse than the ‘participation date’ rights of those persons (because the scheme has been amended), new members (that is, protected persons whose change of employer does not affect continuity of employment) have a right to accrue rights on the basis of the ‘participation date rights’ of the current members;
- future pension rights in an alternative scheme shall be no worse than future pension rights provided by him under his former scheme on the date immediately before the date the employee ceased to participate in the former scheme as a result of total or partial wind up of the former scheme.

⁶ The Industry Wide Coal Staff Superannuation Scheme and the Industry Wide Mineworkers Pension Scheme.

Railway Pensions (Protection and Designation of Schemes) Order 1994 (SI 1994/1432)

These Regulations are made under Schedule 11 of the Railways Act 1993.

The relevant provisions are:

- a requirement that the employer provides an occupational pension scheme which provides future pension rights which are no less favourable than the relevant pension rights which the protected employee had under the 'designated scheme' (that is, the existing industry scheme which the protected person was a member of immediately before the coming into force of the Order, that is, immediately before privatisation);
- that any amendment of a pension scheme which would otherwise have the effect of making the relevant pension rights of a protected person less favourable than the relevant pension rights in his designated scheme shall have no effect in relation to those rights.

London Transport Pensions Arrangements Order 2000 (SI 2000/3386)

This Order is made under Schedule 32 of the Greater London Authority Act 1999.

- Article 5 of the Order provides that where continuity of employment is not broken, an employer must provide an occupational pension scheme which provides pension benefits that are materially at least as good as the pension benefits as the LRT Pension Fund provided before he joined the private sector company. In addition, where the pension scheme had been amended and has the effect of making future pension rights overall materially worse than the pension rights of the LRT Pension Fund, the amendment shall have no effect in relation to the rights of a protected person, unless that person has consented in writing to the amendment.

Annex C - Protected Persons Impact Assessment

- [Protected persons impact assessment](#) (260KB) 

Annex D - Illustrations of potential outcomes of the override on changes to accrual rates and member contribution rates

DWP has considered the potential changes in accrual rates or member contribution rates that would offset the loss of the employer NI rebate under a range of scenarios for a scheme with an accrual rate of 1/60ths and a Normal Retirement Age (NRA) of 65. Below are some illustrations of the potential order of magnitude of these changes to such a scheme assuming an average membership age of 45 years and average pensionable salary of £40,000 a year. These changes would be going forward and so apply from when contracting out ends.

1. To offset the loss of the employer rebate, it would be expected that the accrual rate would have to reduce from 1/60ths to about 1/70ths.
2. Otherwise the member contribution rates could be increased by about 2.7% of pensionable pay. The members' contribution rate increases would be in addition to the loss of the employee's rebate. The contribution rates do not have to increase by 3.4% because the 3.4% is calculated on a limited band of earnings whereas pension contributions are calculated on whole salary.

Note

- These changes are simply illustrative and should not be relied on for any other purposes. Precise impacts will depend on the design of the override and how an employer wishes to use the override.
- The changes will depend on the assumptions and method used to assess changes in benefits or member contribution rates. Different assumptions and method will produce different results.
- The changes to the scheme benefits and member contributions rates will vary depending on the actual scheme membership such as the age and pensionable salary of the members.