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Dear Nicky

Public Service Pensions 2016 Valuations

The Chief Secretary to the Treasury made a written statement about the quadrennial valuations of the public service pension schemes to the House of Commons on 6 September.

There are a number of significant issues arising from this written statement that Treasury ministers should be questioned about. I am writing to you as chair of the Treasury Committee to ask you to raise these issues with the Chief Secretary to the Treasury in writing or to call the minister and relevant officials to give oral evidence about the written statement to the committee. I am copying this letter to the other members of the Treasury Committee as well as Treasury and Shadow Treasury ministers.

- Background

Public sector pension schemes underwent significant reform under the Coalition government. Member contribution rates were increased by an average of 3.2% of pay, pension age increased significantly (generally from 60 to 66, 67 or 68) and benefits changed to be calculated based on career average salaries rather than final salary.

These reforms ensured that public sector pension schemes were affordable. A cost cap mechanism was also put in place to ensure that costs stayed within a narrow range of the level set when the reformed schemes were introduced in 2015. This protects both taxpayer and scheme members against unexpected changes in costs.

- Operation of the cost cap mechanism

In her written statement the Chief Secretary to the Treasury indicated that initial results show that the protections in the new cost cap mechanism mean public sector workers will get improved pension benefits from April 2019. This is a result of the estimated cost of benefits being lower than initially expected (likely to be due to factors such as lower mortality improvements than expected and public sector pay restraint).

The Chief Secretary to the Treasury also announced a review of the cost cap mechanism. The main apparent rationale for this review is that the results of the first operation of the mechanism were not to the Treasury's liking. It is important for the committee to question the minister about the rationale for the review and whether the outcome will respect the

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commitment made in December 2011 by the then Chief Secretary that the agreed reforms "will be sustained for at least 25 years".

- Discount rate

Part of the valuation process involves setting a discount rate in order to establish the employer contribution rate to these schemes.

It is important to emphasise that the employer contribution rate is simply a mechanism for ensuring that the cost of the benefits being accrued are reflected in decisions made by public sector employers.

Employer pension contributions are simply transfers from public sector employers to the Treasury so they do not represent real net public expenditure. Neither is the employer contribution rate the most relevant estimate of the cost of these schemes to taxpayers.

So changes to the discount rate will change the employer pension contribution rate but this does not affect the real cost of these schemes or change overall public finances.

As a result, any changes to the estimated cost of public service pension schemes arising from changes to the discount rate are explicitly excluded from the cost cap mechanism.

The written statement referred to "proposed changes to the discount rate". In a letter to the TUC published on the same day, the Chief Secretary stated that the proposed change was to reduce the real discount rate from 2.8% to 2.4%.

The proposed change to the discount rate raises a number of important issues that MPs must question ministers and officials about.

- Timing of the proposed change to the discount rate

The first issue is the timing of the proposed change in discount rate.

Following a recommendation from the Independent Public Service Pensions Commission, the Treasury launched a consultation on the discount rate in December 2010.

The consultation closed in March 2011 and in Budget 2011 the then Chancellor announced that the discount rate would be set at 3% above CPI.

The government also announced that: "Balancing the need for stability with the attraction of reviewing the discount rate periodically, the Government proposes to review the level of the discount rate every five years and the methodology every ten years. The Government may also review the discount rate "out-of-cycle" in the event of a significant change in circumstances."

In line with this policy, the discount rate was reviewed five years later and in Budget 2016 the then Chancellor announced that it would change to 2.8% above CPI for the first valuations of public service pension schemes under the cost cap mechanism.

However, before these valuations have even been carried out, and without a further proper review of the discount rate, the minister has just announced that the discount rate that will actually apply for these valuations will be 2.4% above CPI.

The written ministerial statement states that the proposed discount rate was changed "to reflect the Office for Budget Responsibility's long-term growth forecasts". The OBR's forecasts for long-term growth are revised regularly and a change to these forecasts hardly seems to qualify as a "significant change in circumstances" requiring an out-of-cycle review of the discount rate.

Ministers and officials should be questioned about the timing of this announcement and the basis for it. What significant change in circumstances justified an "out-of-cycle" review of the discount rate and what did the review involve?

- Impact of the proposed change to the discount rate

The issue of the timing of the proposed change to the discount rate is particularly important because of the potential impact the change could have on funding for public services.

The Financial Times reported on 8 September that the change to the discount rate could result in £4 billion a year in public sector spending cuts.

After taking into account the effect of all the relevant announcements, Prospect estimates that the impact could actually be about £5 billion a year from 2020/21 onwards, with over £2 billion a year of that coming from the NHS alone.

The rationale underpinning Prospect's estimates is as follows:

(1) In the Budget 2016 Red Book, the impact of reducing the discount rate by 0.2% was estimated to be £2 billion a year.
(2) At the time there was no indication that Treasury would recycle any of this money back into public services so this represented an expected cut in public services of £2 billion a year. (In its Economic and Fiscal Outlook report, the OBR stated: "the Government has also placed an additional £2.0 billion a year squeeze on departments in that year by raising planned public service pension contributions, in line with a lower discount rate, but not compensating them for the additional costs they will face. This reduces borrowing by displacing other departmental spending within existing expenditure limits, while reducing net spending on public service pensions".)
(3) The further reduction of 0.4% announced last week is therefore likely to increase employer contributions by £4 billion a year from 2019/20 onwards.
(4) The Chief Secretary stated that Treasury "will be supporting departments with any unforeseen costs for 2019/20". The impact in future years will be discussed as part of the Spending Review. Given the proposed treatment of the Budget 2016 change to the discount rate there will be little confidence that departments will be compensated for the additional costs.
(5) In her speech on the NHS on 18 June, the Prime Minister announced additional funding of £1.25 billion a year to cover "a specific pensions pressure". This would appear to refer to the impact of the Budget 2016 announcement on the discount rate. There is no compensation for other spending departments for the Budget 2016 change and there is no compensation for any spending departments for the latest proposed change from 2020/21 onwards.

Combining the above, the net impact of the various announcements, is for potential public sector spending cuts of £0.75 billion (to non NHS employers) in 2019/20 and £4.75 billion a year to all employers from 2020/21 onwards (including about £2.5 billion from the NHS).

Unless the NHS is compensated for the impact of the further change to the discount rate, which so far Treasury has not committed to do, the landmark announcement on NHS funding by the Prime Minister on 18 June will be completely undermined and rendered totally misleading.

Clearly it is vital that MPs ask ministers and officials about the impact of the proposed change to the discount rate on public services. Will public sector employers be compensated for the effect of the further proposed change to the discount rate after 2019/20?

- Summary

The Chief Secretary's written statement about public sector pension valuations leaves a number of very important questions unanswered. In particular the timing and manner of the announcement leaves a strong suspicion that the main intention is to make technical changes that obscure the real extent of public sector spending cuts announced in the next Budget and / or Spending Review. It is up to Parliament to hold government to account for its decisions and I urge you and your committee to investigate these issues further.

Prospect officials would be happy to discuss these issues in more detail with you or your committee if that was useful.

Yours sincerely

Garry Graham
Deputy General Secretary