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MANAGEMENT IN CONFIDENCE

Treasury Chambers, Parliament Street, SWIP 3AG
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12 September 1984

The Rt. Hon. Michael Heseltine MP
Secretary of State for Defence

Dear Michael

ROFs: GUARANTEE FOR PENSIONS AFTER PRIVATISATION

You wrote to me on 15 [14] August suggesting we should reconsider the position on ROFs pensions. I think the way forward is for us to meet again to discuss the questions you raise and I will ask my office to arrange a date. Meanwhile Treasury officials have prepared the enclosed note and I suggest this could form our agenda.

I am sending a copy of this letter to the Prime Minister, Willie Whitelaw, Norman Tebbit and Tom King.

Yours ever
Nigel

NIGEL LAWSON

ROYAL ORDNANCE FACTORIES: GUARANTEE FOR PENSIONS AFTER PRIVATISATION

Note by the Treasury

This note discusses proposals that pensions of existing employees of the Royal Ordnance Factories should be guaranteed by the Government after privatisation.

Background

2. The Consultative Document issued to the unions in October 1982 stated the Government's intention that the transfer of staff would not result in a worsening of their terms and conditions taken as a whole (i.e. including pensions). It suggested two possibilities for pensions in respect of service after the transfer: first, to continue to provide benefits which, taken as a whole were no less favourable than the civil service scheme (PCSPS): index-linking could be continued, but 'other arrangements could achieve equally beneficial results when account is taken of contributions and benefits'. Alternatively, if the new pension terms were less favourable, individuals could be compensated for any net worsening of their terms and conditions taken as a whole.

The current position

3. Since then, provision has been made in the ROFs Bill for transfers of staff to be made under the Transfer of Undertakings (Protection of Employment) Regulations 1981, with the effect that terms and conditions other than pensions will so far as possible be identical immediately after transfer. A Pension scheme has been drawn up modelled closely on the PCSPS, which transferees but not new entrants may opt to join. They may choose between preserving their pension rights in the PCSPS, in which case the value is indexed until age 60 when the pension comes into payment, or transferring them to the new scheme, which is likely to be more beneficial for employees whose pay increases post-vesting day exceed price increases.

The Government will make a transfer payment in respect of the latter, actuarially assessed to enable the new scheme to meet the transferred liability.

4. The basic pension provisions of the new scheme are broadly the same as the PCSPS, though there are a number of improvements, notably death-in-service lump sums are twice as great, ill-health and dependants' pensions are more generous, and there are to be automatic pensions for widowers.

5. Attention has focussed on the index-linking provisions. The stated intention is that pensions will be fully index-linked. Under the terms of the draft trust deed, the employer's contribution to the fund will be that recommended by the actuary as necessary to provide index-linked benefits up to a ceiling of 12 per cent (recently increased in negotiation from 11 per cent). Above the ceiling the employer's contribution is voluntary. There is also provision for the employer to agree with the Trustees a rescheduling of the contribution of up to 12 per cent over a number of years. There is the theoretical possibility that the contribution recommended to the fund could be greater than 12 per cent for a number of years and that full index-linking could thereby be jeopardised. MOD Ministers have acknowledged this publicly but have argued that the economic conditions which produced this situation could be such that the Government of the day would also be reconsidering the legislation governing civil servants' index-linked increases; alternatively, it might be increasing employees' contributions (see Annex A). The possibility does not therefore imply a worsening.

6. There seems a strong case for believing that the Government's undertaking to staff will have been met. The Ministry of Defence should perhaps seek the advice of lawyers experienced in Industrial Tribunals on the risk of an adverse judgement if ex-employees were to claim in court that their terms and conditions as a whole had been worsened, though the Treasury Solicitor's view given in November 1983 was that "In general, this [draft pension scheme] does not appear to contain detrimental provison....." So far as pensions are concerned, we would expect the transferees' scheme to be judged equivalent to the PCSPS in the index-linking provisions, and that the improvements

in other benefits might well tip the balance.

The case for a guarantee

7. The first main argument is that a guarantee would smooth industrial relations difficulties, making the transfer easier. The unions claim the Government has reneged on its promises, believing that they have been given an unqualified commitment to full index-linking. This is of course not the case - Annex A quotes Ministerial statements in the House. The unions are currently referring back to their members on the basis that there will be no Government guarantee, so officials should be in a better position to judge strength of feeling on the issue in a few weeks.

8. Second, the Secretary of State for Defence suggests that apart from whether the new pension scheme is likely to yield the benefits intended, a court might wish to consider whether the Government should divest itself completely of its responsibilities to staff. We would argue that this is a necessary feature of privatisation: the Government will discharge its responsibilities in respect of employees' past service (on pensions, by preserving benefits in the PCSPS or by payment of an agreed transfer value to the new scheme), but should not enter into new ones in respect of future service - which goes for pay and all other terms and conditions, including pensions.

9. The third is that in practice the risk of any guarantee being called is small; and if in the absence of a guarantee disaster struck, the Government might nevertheless decide to rescue the scheme, so why not take the credit for that now? The objections to a guarantee and possible alternatives are discussed below.

Form of guarantee

10. Guarantees have been proposed in two main forms:

(a) the Government should 'underwrite the scheme';

(b) a guarantee could be limited to a liquidation.

Objections to guarantees

11. On a basic level, both raise practical questions. The Government might be vulnerable to further changes in the scheme (over and above the improvements already incorporated in the current draft rules); to pay awards in excess of those it might have made; and would not necessarily receive the benefit of any increase it might have chosen to make to employees' contributions. The unions have asked loosely for a guarantee of full index-linking but this would of course be going further than the Government does for civil servants - any commitment would at least have to be restricted to civil service pension increases actually awarded. Under (a), there would be no incentive for the employer to pay contributions in excess of the 12 per cent ceiling into the fund in any year.

12. There are well-rehearsed objections of principle to any form of guarantee. The links between Government and Company are incompletely severed so privatisation is incomplete. The liability could endure for 40 years or more, till the pension of the last widow (er) of the last ex-employee ceases. Either the Government would accept that it had no control over this liability, or it would have to insist on adequate monitoring and control arrangements. Parliament would have to be informed and might insist on the latter course. If so, the Government's freedom to sell its holdings in the company might be restricted: it might be obliged to retain a controlling share. Mirroring this would be drawbacks for the ROFs themselves: management freedom would also be restricted.

Precedents and repercussions

13. Annex B discusses how pensions have been dealt with in transfers out of the civil service and privatisations of nationalised industries. There are no precedents for pension guarantees among the former. But British Telecom provides a precedent for Government liabilities in respect of pensions extending after privatisation. The Annex explains how this has arisen, through the adoption of a clause used in the British Aerospace Act, placing contingent liabilities on the Government in the event of the company going into liquidation. The exact effects of the clause are probably not widely

appreciated, but the unions apparently do believe a guarantee to have been given in respect of BT pensions.

14. A similar clause has been included in the Royal Ordnance Factories Bill. In this case however the clause has no effect on pensions matters because a new pension scheme is being set up on privatisation: the payment of the transfer value will discharge the Government's liability for pensions and the ROFs themselves will have no pension liability at the time of transfer. Nevertheless, it has been suggested that effect of the BT Bill should be replicated for ROFs pensions by the Government giving a guarantee of type (b).

15. Treasury Ministers have decided to resist extending the undesirable effect of the BT clause to other nationalised industry privatisations (cf. the Chancellor's letter of 17 April 1984). If it were extended to the ROFs, the Government would probably have to accept similer guarantees in all privatisations - whether civil service or nationalised industries. There would be repercussions for the Royal Dockyards, and possibly for British Airways, although the latter have already taken initiatives on pensions. No doubt the question would be reopened in civil service privatisations already underway, where pressure for guarantees has been resisted successfully. Although the risks of a guarantee being called for the ROFs might be small, they could be larger in subsequent cases.

Is there anything which can be offered?

a) Statement of comfort

16. In the absence of a guarantee, the Government is nevertheless likely to be an interested party. It will have obligations as a shareholder and the option to act if the company is in difficulties if it chooses. It has been suggested in the past that this position be recognised in some statement of comfort. Various forms of words have been considered, but the legal advice has been that any such statements are likely to constitute guarantees, so the idea has had to be rejected (cf. the Minister of State's letter of 1 November 1983).

b) Transfer payment to the new pension scheme

17. The Government's current liabilities in respect of past service of ROFs employees will be discharged either by eventual payment of their pension benefits preserved in the PCSPS, or, for those who opt to transfer rights to the new scheme, by the payment of the block transfer value. The transfer value is calculated actuarially, on assumptions about earnings increases, real investment returns, etc. The Government could offer to renegotiate the transfer value if, in the event of a liquidation say, it turned out to have been too small. But the question immediately arises why the transfer value has turned out too small: the original assumptions may have been vindicated for the economy generally, but pay increases awarded by ROFs may have exceeded the national average; the managers of the fund may have secured less good returns than average pension fund performance; or the rules of the scheme may have been improved retrospectively. The Government would remain vulnerable to factors outside its control when it ceased to run the ROFs directly, and such an offer would therefore have the disadvantages of a guarantee.

Alternatives

18. The Government would appear to have the following alternatives to making a guarantee:

(x) do nothing: take the chance that employees will feel strongly enough to apply to an industrial tribunal and that their claim will be successful; be prepared to pay whatever compensation a court awards;

(y) offer more: either to pay compensation to all employees on transfer at a level assessed as sufficient to eliminate or reduce to a tolerable level their resistance and/or chance of success in an industrial tribunal; or some further improvement to the Trust Deed or scheme rules, on funding or basic benefits.

19. The choice depends of course on the assessment of current risks vis-a-vis appeals to industrial tribunals, industrial action, etc. Further actuarial or legal advice could be sought by MOD. Subject to that, it is our view that the chances of an adverse judgement under (x) are remote.

20. If (x) were adopted, it would be for consideration whether to tell staff that if a court were to establish detriment, the Government would pay compensation to all. That course would invite litigation, but it would also demonstrate that the Government, on professional advice, has conviction that its stance is in line with its commitments.

Handling

21. We await the results of the unions' consultation of their membership in the absence of a guarantee. If the issue remains live, the lead in discussions with staff and unions remains of course with MOD. The Treasury would be willing to give a paper to the trade unions at national level on the Government's objections to pension guarantees. Alternatively, a Treasury Minister would be willing to be present at a meeting with the ROFs unions chaired by an MOD Minister.

Treasury
5 September 1984

Ministerial Statements in Standing Committee on Ordnance Factories and Military Services Bill

Under Secretary of State for Defence Procurement (Mr Lee)

March 1984

"... we propose in the new pension scheme, which is specifically designed for existing employees, to continue full indexation of pensions in line with the Pensions (Increase) Act 1971 on the same basis provided for by the Principal Civil Service Pension Scheme."

"... I said that (the transferees scheme) would be fully index linked, and, therefore, I stand by that".

April 1984

"We are talking about a hypothetical situation in which inflation of between 25 per cent and 50 per cent is running for a very long time, interest rates are not commensurately high, and - a further "if" - the Government do not legislate to control the index-linking of civil servants' pensions. There is a very thin possibility, or caveat, that there would not be total indexing .... In all normal circumstances, full index-linking will apply."

"Even on the most pessimistic assumption, index-linking can be maintained within the contribution ceiling of 17 per cent."

"The Government are satisfied that the scheme that has been put to the unions is no less favourable, in all realistic circumstances, than the current Civil Service Scheme enshrined in the PCSPS."

Minister of State for Defence Procurement (Mr Pattie) March 1984

(Mr Denzil Davies) "(In the civil service scheme) if inflation rises to 10 per cent, those on retirement pensions will get 10 per cent. Can the Minister tell me that that will automatically happen under the new regime, or is it a fact that if contributions have to be increased above 11 per cent it will be at the discretion of the company? That is the real difference between the present situation and what will happen in future."

(Mr Pattie) "Yes, that is the difference. The Rt Hon Gentleman will be aware that although indexation is provided for under current legislation, in the event of inflation getting into banana republic proportions one cannot envisage a situation in which the current legislation would be allowed to remain on the statute book".

CW

ANNEX B: GUARANTEES GIVEN IN PRIVATISATION AND CONTRACTING OUT

I. TRANSFERS INVOLVING CIVIL SERVANTS

To date no guarantees have been given in respect of pensions; some time-limited guarantees have been given in respect of redundancies. For completeness, the position on both is described below.

Hydraulics Research Ltd

There is no government guarantee of the pension fund. The Trustees of the fund will have a legally enforceable covenant with the company that the company will pay the employer's contributions professionally advised to be necessary to maintain pension benefits in line with civil service pensions for transferring staff.

The Government have guaranteed redundancy payments at civil service rates in respect of service before privatisation of staff transferred in the event of redundancies occurring within 2 years of the end of the two-year period when staff are still civil servants working for the company on secondment. After the expiry of this guarantee the right of transferred employees to redundancy payments at civil service rates in respect of service before and after transfer is to be secured by a mortgage on the company's land and buildings.

National Maritime Institute

No government guarantee has been given in respect of the pension fund, which will not guarantee index-linking.

The Government have guaranteed redundancy payments at civil service rates for staff transferred in the event of redundancies occurring within 3 years of the end of the two-year period of secondment. It is hoped that NMI Ltd will agree to continue to offer civil service terms after the expiry of this guarantee, but it may be necessary to take account of the company's extra liability in the original funding provided by the Government.

CW

Royal Military College of Science

Staff may transfer into the Local Government or Universities pension schemes. No specific guarantee has been given in respect of the rights of transferred staff, but both schemes are covered by the Pensions (Increase) Act 1971.

The Government have guaranteed redundancy payments at civil service rates in respect of service as civil servants of staff transferred, in the event of redundancies occurring during the first five year contract as a result of MOD action. Arrangements will be made for the new employer to take over the liability after the expiry of the guarantee, but some adjustment to the contract price may be necessary.

Audit Commission

The new pension scheme will not guarantee index-linking. No guarantees have been given regarding redundancy terms or pensions. NB. Other terms and conditions, notably pay, have been improved.

Historic Buildings and Monuments Commission

The pension scheme is expected to be un-funded and index-linked by analogy with the PCSPS. No specific guarantee has been given regarding redundancy payments, but the Commission will be publicly funded.

II. TRANSFERS INVOLVING NATIONALISED INDUSTRIES, ETC

Cable and Wireless

Existing scheme provided 3 per cent increase per annum for pensions once in payment with further increases being at the discretion of the company and the Trustees. Scheme unchanged by privatisation. No guarantee given.

CW

Britoil

Existing scheme provided no index-linking and was unchanged on privatisation.

Associated British Ports

Two-thirds of existing employees were covered by scheme that provided full index-linking: remaining one-third (registered dock workers) covered by National Dock Labour Board scheme which increases pensions at 3 per cent per annum once in payment. Schemes unchanged on privatisation. HMG will not guarantee or otherwise stand behind the Group or provide any financial support other than that which is statutorily available to all ports.

National Freight Consortium

Rules of existing scheme provided full index-linking analogous to Pensions (Increase) Act 1971. Scheme unchanged by privatisation. No guarantee given. Structure of scheme and chosen method of uprating now entirely a matter for the National Freight Consortium. Government funding restricted to deficiencies at date of sale and the emerging costs of certain pensions in relation to ex-BR employees transferred to NFC in 1968.

British Aerospace

Existing scheme provided 4 per cent increase per annum for pensions once in payment, with further increases being at the discretion of the Board. The scheme was unchanged by privatisation.

The British Aerospace Act 1980 provided that HMG stood behind all liabilities transferred to BAe on privatisation, in the event of subsequent liquidation. This was done with the various trading liabilities of BAe in mind, and in particular the contracts it had with overseas governments. But it would include liabilities to meet deficiencies in the pension fund in respect of past and future service of current employees at the time of privatisation. However, so far as has been ascertained, no such liabilities exist in the case of BAe, so there is no potential contingent liability on the Government in respect of the BAe pension fund.

British Telecom

When the BT Bill was prepared, DTI took the BAe provision as a precedent. Clause 66 of the BT Bill preserves, in the case of BT going into liquidation, the position of BT's creditors by obliging the Government to pay the company's debts to creditors in respect of obligations which were formally obligations of British Telecommunications and which were vested in the successor company on the transfer date. It has however become apparent that because BT is one those nationalised industries that have a contractual obligation to make good any deficiency in its pension fund, a by-product of the provision is to place a legal contingent liability on HMG in respect of any pension fund liabilities existing at the point of privatisation and which are transferred by Clause 66. Legal advice is that this contingent liability exists in respect of existing employees at the point of privatisation in respect of their service both _before_ and _after_ privatisation. It also covers pensioners. The practical effect is that if BT goes bankrupt, and its pension fund turns out to be deficient, the Government will have to make good that part of the deficiency which can be attributed to the service of employees in post at the point of privatisation. The liquidation of BT is not, of course, a very likely eventuality but the underlying legal liability will persist until all existing employees and their eligible dependants have died (unless at some point in the future the scheme is changed so materially that the Government could argue legally that the liabilities had been varied to such an extent as to make them no longer operable).

Amer sham

Employees were members of the UKAEA scheme (a notionally funded public sector scheme) and have remain ed so. The liability for any future deficiencies falls on that scheme rather than directly on the Government.

Econ Pol: Privatisation
Pt 11

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

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14th August 1984

NBPM
M.

Dear Nigel

I have seen Geoffrey Pattie's letter to John Moore of 21st July, about the question of a Government guarantee behind the Royal Ordnance Factory (ROF) pension scheme for transferred staff, and John's reply of 31st July. I am writing to you to express some disquiet at the way this issue has been developing and to voice my concern that we could, in following the path suggested by John, find ourselves jeopardising the Government's privatisation programme.

What I think we have all agreed on is to endeavour to set up a pension scheme for staff transferred to the ROFs which will be funded in such a way so as to yield benefits comparable to PCSPS ones, including full index-linking. Unless we do this, we run the risk of our ex-employees bringing successful action against the Government in the Courts. The scheme which in the event has been devised is a good one and on the actuarial advice received should, once transfer values in respect of past service in the PCSPS have been agreed, indeed yield such fully index-linked pensions.

But the other half of the equation was the fact that we had to limit in some way the Royal Ordnance Company's liabilities if such a full index-linked scheme was not to be a psychological impediment to would-be investors on flotation. There was also the risk that the

The Rt Hon Nigel Lawson MP

new Company could strangle itself by such an open-ended commitment to fund. To this end we introduced a ceiling, in terms of percentage of salary, on the employer's liability to pay contributions. This ceiling - which we have recently in negotiation increased from 11% to 12% - is high enough to be just compatible with the actuaries' assessment of what is needed to yield fully index-linked pensions.

There remains nevertheless the possibility that in adverse circumstances fully index-linked pensions may not be paid to transferred staff while they are being paid to Civil Servants. This may be either because contributions above the ceiling could be required, or, in trading difficulties the employers cannot afford contributions below the ceiling. The chances of this occuring may be remote - and indeed we have been arguing in both Houses and to the Trades Unions that they are very remote - and an industrial tribunal might decide that on the basis of negligible risk there is in fact no case for compensation. The Trades Unions have of course argued that if the risk is negligible, why can't the Government underwrite the scheme as it would, on our own assumptions, cost us nothing.

The real issue at stake - which a court would no doubt also wish to consider - seems to me to be not only the one of whether the new scheme is likely to yield the benefits it is set up to yield but also whether in fairness the Government can divest itself of its responsibilities to its staff in this way, leaving them open to risk, however small. Just because we could probably show that the risks are small, we could I think be embarrassed publicly for insisting on cutting all residual ties on Vesting Day. Furthermore, there is a precedent, albeit limited in its scope, in the form of British Telecom, which is well-known to the Trades Unions, and to the Opposition.

As regards what we are seeking to achieve through privatisation I cannot see that our acceptance of a residual commitment to these staff will in any sense cushion the new company or increase the risk of its not paying sufficient contributions into the pensions scheme. The Trust Deed is drafted to take care of that.

I appreciate that any contingent liabilities are in a sense untidy when we are trying to make as clean a break with the Public Sector as we can. But the liability is limited both in duration and the likelihood of needing to invoke it. A large proportion of the ROF workforce will have retired in the next ten years. It could only be invoked if the ROF company were in extreme trading difficulties, a situation in which the Government would in any event need to think carefully, or if there was a prolonged and severe economic crisis, say run-away inflation and low interest rates. The latter is the type of situation in which any Government would be re-considering the index-linking provisions for Civil Servants.

I do feel therefore, that we may needlessly be making a rod for our own backs over this issue, and that acceptance of our responsibilities towards existing staff may in the end assist, rather than hamper, our privatisation programme.

I believe it would be worthwhile to consider all these factors again in the wider context before making a final decision on the ROFs.

I am sending copies of this letter to the Prime Minister, Willie Whitelaw, Norman Tebbit and Tom King.

Yours ever

Michael

Michael Heseltine

cc N/O

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NBPM

4 October 1984

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D Nigel.

ROFS : GUARANTEE FOR PENSIONS AFTER PRIVATISATION

I have seen your letter of 12 September and Michael Heseltine's of 14 August on this subject and I would like to comment briefly on the BT privatisation which is mentioned in both.

2 I do not think that the arrangaments in the BT case really provide any relevant precedent for what Michael seeks which is, I understand, a Government guarantee that those employees of the ROFs who are transferred to the new ROC should continue to receive index-linked pensions. The "guarantee" we have given in the case of BT is different. As pointed out in the paper attached to your letter, it is <u>not</u> a guarantee of index-linked pensions and the Government's liability only rises in the event of BT plc going into liquidation. Neither are the circumstances of BT and the ROFs fully analogous. At the time of transfer to BT plc, BT's employees were not civil servants and nor is a new pension scheme being set up. BT's employees will continue to receive index-linked pensions when they retire from BT plc but this is a result of the terms of their existing pension scheme (which are not affected by privatisation) not any Government guarantee.

3 I am copying this letter to the Prime Minister, Willie Whitelaw, Michael Heseltine and Tom King.

Yours
Norman

NORMAN TEBBIT

JH3BBS

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