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Dear Trevor

Thank you for your letter of 24 February which set out your professional opinion on the Treasury's Directions on valuations and employer cost cap in the public service pension schemes. As you will be aware, these Directions and accompanying material (including our correspondence) were published on 13 March 2014.
I have noted your view that while the Directions would, in the round and to a significant degree, meet the Treasury's principles for the valuations and the operation of the employer cost cap mechanism, and in the round were technically complete and coherent, it would be important to keep them under review.

As a result of these review processes, and as work to complete scheme valuations has progressed, an issue has come to light which will necessitate a technical change to the Directions. When drafting the Directions our policy intention required - and still requires - that the employer cost cap should be determined:

1. using the same membership profile which is used to determine the employer contribution rate [direction 50(d)]
2. as though the benefits available to members are those which would be available if there were no transitional protection [direction 53(6)]
3. using assumptions which ignore the impact of behavioural effects caused by members' old scheme service and transitional protection [direction 53(5)]

However it now appears that these particular directions do not work exactly as intended, in particular because a literal interpretation suggests that direction 53(5) goes further than necessary to meet point 3 above and undermines point 1 above. This is because assumptions are also needed to produce the membership profile used to determine the employer contribution rate - so adjusting these assumptions in line with direction 53(5) would produce an employer cost cap based on an artificial membership profile.

I therefore propose to bring forward minor and technical amendments to the Directions to ensure that the directions will deliver our policy intention. In addition to direction 53(5), the amendments apply to direction 40(4). The amendment to direction 40(4) resolves the same issue in respect of the "cost cap future service cost" (used when comparing the employer cost cap with the cost of the scheme at subsequent valuations). The amendments are set out in Annex A.

I would be grateful if you could offer your professional opinion on these revisions to the Directions, particularly whether the revised directions will deliver our policy intention. I look forward to receiving your views in respect of this statutory consultation.

Yours sincerely

Julian Kelly

Annex A: Employer cost cap methodology – revisions to Directions

Current versions

40.—(1) The cost cap future service cost must be calculated, to the nearest 0.1% of pensionable payroll, as the contribution rate required to cover the expected cost of benefits accrued by members of the scheme during the implementation period.

(2) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in direction 14 must be adjusted so that the assumed rate of increase is 2% on 11th April 2016.

(3) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in direction 16 must be adjusted so that the assumed earnings measure revaluations of career average re-valued earnings under section 9 of the 2013 Act is– (a) 4.75% on 11th April 2016;

(b) 4.75% on 10th April 2017;

(c) 4.75% on 9th April 2018; and

(d) 4.75% on 8th April 2019.

(4) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in directions 18(e), 18(f) and 19 must be adjusted as if no members of the scheme;

(a) have any benefits accrued in any connected scheme; and

(b) have any entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.

(5) For the purpose of calculating the contribution rate in paragraph (1), the expected cost of benefits accrued by members of the scheme during the implementation period should be determined as if no members of the scheme have any entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.

53.—(1) The valuation report for the preliminary valuation produced in accordance with direction 50(g) must state, to the nearest 0.1% of pensionable payroll, the proposed employer cost cap, being–

$$A\text{-}B$$

where–

A is the contribution rate required to cover the expected cost of benefits accrued by members of the relevant old scheme during the implementation period; and

B is the contribution yield expected from normal member contributions to the relevant old scheme during the implementation period.

(2) Subject to paragraphs (5) and (6), A and B in paragraph (1) shall be calculated as if the relevant old scheme was subject to the assumption in direction 50(c).

(3) For the purpose of calculating A in paragraph (1), the assumptions specified in direction 14 must be adjusted so that the assumed rate of increase is 2% on 11th April 2016.

(4) For the purpose of calculating A in paragraph (1), the assumptions specified in direction 16 must be adjusted so that the assumed earnings measure revaluations of career average re-valued earnings under section 9 of the 2013 Act is– (a) 4.75% on 11th April 2016;

(b) 4.75% on 10th April 2017;

(c) 4.75% on 9th April 2018; and

(d) 4.75% on 8th April 2019.

(5) For the purpose of calculating A in paragraph (1), the assumptions determined in directions 18(e), 18(f) and 19 must be adjusted as if no members of the relevant old scheme have any–

(a) benefits accrued in any connected scheme; and

(b) entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.

(6) For the purpose of calculating A in paragraph (1), the expected cost of benefits accrued by members of the relevant old scheme during the implementation period should be determined as if no members of the relevant old scheme have any entitlement to exceptions made under section 18(5) to (7) of the 2013 Act.

Revised Directions

40.—(1) The cost cap future service cost must be calculated, to the nearest 0.1% of pensionable payroll, as the contribution rate required to cover the expected cost of benefits accrued by members of the scheme during the implementation period.
(2) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in direction 14 must be adjusted so that the assumed rate of increase is 2% on 11th April 2016.
(3) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in direction 16 must be adjusted so that the assumed earnings measure revaluations of career average re-valued earnings under section 9 of the 2013 Act is– (a) 4.75% on 11th April 2016;

(b) 4.75% on 10th April 2017;
(c) 4.75% on 9th April 2018; and
(d) 4.75% on 8th April 2019.

(4) For the purpose of calculating the contribution rate in paragraph (1), the assumptions specified in-

(a) direction 18(e);
(b) direction 18(f); and
(c) direction 19, apart from those made to determine the expected scheme membership over the implementation period;

must be adjusted as if no members of the relevant old scheme have any benefits accrued in any connected scheme or entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.
(5) For the purpose of calculating the contribution rate in paragraph (1), the expected cost of benefits accrued by members of the scheme during the implementation period should be determined as if no members of the scheme have any entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.

53.—(1) The valuation report for the preliminary valuation produced in accordance with direction 50(g) must state, to the nearest 0.1% of pensionable payroll, the proposed employer cost cap, being–

$$A\text{-}B$$

where–

A is the contribution rate required to cover the expected cost of benefits accrued by members of the relevant old scheme during the implementation period; and
B is the contribution yield expected from normal member contributions to the relevant old scheme during the implementation period.

(2) Subject to paragraphs (5) and (6), A and B in paragraph (1) shall be calculated as if the relevant old scheme was subject to the assumption in direction 50(c).
(3) For the purpose of calculating A in paragraph (1), the assumptions specified in direction 14 must be adjusted so that the assumed rate of increase is 2% on 11th April 2016.
(4) For the purpose of calculating A in paragraph (1), the assumptions specified in direction 16 must be adjusted so that the assumed earnings measure revaluations of career average re-valued earnings under section 9 of the 2013 Act is– (a) 4.75% on 11th April 2016;

(b) 4.75% on 10th April 2017;
(c) 4.75% on 9th April 2018; and
(d) 4.75% on 8th April 2019.

(5) For the purpose of calculating A in paragraph (1), the assumptions determined in-

(a) direction 18(e);
(b) direction 18(f); and
(c) direction 19, apart from those made to determine the expected scheme membership over the implementation period;

must be adjusted as if no members of the relevant old scheme have any benefits accrued in any connected scheme or entitlement to exceptions made under sections 18(5) to (7) of the 2013 Act.
(6) For the purpose of calculating A in paragraph (1), the expected cost of benefits accrued by members of the relevant old scheme during the implementation period should be determined as if no members of the relevant old scheme have any entitlement to exceptions made under section 18(5) to (7) of the 2013 Act.