HM Treasury

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Dear Martin

Review of the SCAPE discount rate methodology

1. In June 2021, the Government launched a consultation[1] on the methodology for setting the SCAPE discount rate, the discount rate used in the valuation of unfunded public service pension schemes to set employer contribution rates. Having considered the evidence submitted to the consultation, this letter outlines the Government's proposed response.

2. The consultation outlined three proposed objectives of equal weighting for the SCAPE discount rate in order to evaluate possible discount rate methodologies:

   - *Fair reflection of costs* – the SCAPE discount rate should ensure contributions are set at a level which reflect the value of benefits being earned, ensuring that employers pay a charge that is appropriate for public service pension schemes and that employment decisions take into account the full cost of employing people.

   - *Reflect future risks to Government income* – the SCAPE discount rate should reflect that future tax revenues may turn out to be different to what is expected.

   - *Stability* – the SCAPE discount rate should support Government and employers to make long-term decisions on workforce expenditure and minimise large fluctuations in employer contribution levels where they are not caused by changes in expected future expenditure on pensions.

3. Responses to the consultation displayed a high level of support for these proposed objectives. The Government has carefully considered these responses and concluded that these three objectives are appropriate for the SCAPE discount rate. The Government has given each objective equal weighting in its consideration of possible discount rate methodologies.

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/996113/SCAPE_Discount_Rate_methodologyFD.pdf

4. However, the responses confirmed the Government’s view that there may be tensions between the three objectives, and that it may not be possible for a single methodology to fully achieve all three objectives. Therefore, methodologies have been assessed against the objectives in the round.

5. The consultation proposed that the following two methodologies were the most appropriate to be considered:

   - a methodology based on expected long-term GDP growth (the current methodology);

   - a methodology based on the Social Time Preference Rate (STPR).

6. Respondents were asked whether they agreed that these were the most appropriate methodologies for consideration, or whether alternative methodologies should be considered.

7. The consultation invited respondents to provide views on how these two methodologies performed against the proposed objectives, including whether modifications should be applied to help them better meet the objectives.

Proposed response

8. Having considered the responses submitted to the consultation, and with regard to the stated objectives, the Government believes that the SCAPE discount rate should continue to be set based on expected long-term GDP growth, using forecasts published by the Office for Budget Responsibility (OBR), with no modifications applied at this time.

9. The Government believes that this methodology will best ensure that workforce decisions made today fairly reflect the costs of pension benefits and ensure that pension promises are made in a way that is sustainable and affordable for future taxpayers.

10. The Government acknowledges that a methodology based on the STPR would better meet the ‘stability’ objective, although no discount rate methodology can avoid employer costs changing at valuations due to changes to other demographic and financial assumptions. A methodology based on long-term GDP growth performs less well against this objective. As long-term GDP forecasts are revised periodically by the OBR, this methodology is likely to result in more frequent changes in the SCAPE discount rate between valuations, which can result in larger movements in contribution rates and make it harder for employers to predict future pension costs.

11. Responses to the consultation and the Government’s analysis confirms an inherent tension between meeting the ‘stability’ objective and the other objectives. In this context, the Government believes that a GDP-based methodology best meets the overall balance of objectives. This evaluation is based on the assessed performance of that methodology against all three objectives, including its anticipated stronger performance against the ‘fair reflection of costs’ and ‘reflect future risks to Government income’ objectives compared to alternatives. Meanwhile, the Government will consider other measures to address the impact of this decision on stakeholders’ interests captured by the ‘stability’ objective.

12. As proposed in the consultation, the Government will align reviews of the SCAPE discount rate with the scheme valuation cycle, with the aim of conducting one review per cycle. This will significantly reduce the likelihood of the SCAPE discount rate changing within valuation cycles, and so give employers greater confidence when anticipating future pension costs.

13. Second, the Treasury will consider whether, and how, to share the risks of changes in employer pension costs arising from the 2020 valuation in recognition of the fact that current departmental budgets could not take into account new employer contribution rates from April 2024. Due to the ongoing uncertainty as to outcomes of the 2020 valuations, discussions with departments will only take place when the outcomes of the 2020 valuations are more certain.

14. The consultation document considered some modifications that could be applied to a GDP-based methodology in the following areas:

    - allowing for term-dependent GDP growth;
    - allowing for actual GDP experience.

15. Following careful consideration of responses, the Government do not intend to proceed with either of these modifications. Whilst it is recognised that both of these approaches could provide more accurate reflection of expected future income, they could also cause a GDP-based methodology to perform even less well against the 'stability' objective than a GDP-based methodology with no modifications. The Government does not think this would achieve an appropriate balance between the objectives and could produce an inappropriate level of instability and complexity in the context of how public service pensions are financed.

16. As stated in the consultation document, the Government intend to carry out a separate exercise to review the new level of the SCAPE discount rate in line with the chosen methodology at a future date. This will be announced in due course and informed by views of relevant stakeholders, the expected publication date of relevant assumptions by the OBR and the timetable for the 2020 valuations and implementing new employer contribution rates in April 2024.

17. I would be grateful if you could offer your professional opinion on the proposed approach outlined in this letter.

Yours sincerely

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