National Audit Office

Report
by the Comptroller
and Auditor General

Cabinet Office

Spinning-out MyCSP as a mutual joint venture

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Key facts

25%

estimated saving to the £18.37 unit cost per member, at seven-year contract end

£4.9bn

MyCSP paid to civil service pension scheme members, 2011-12

1.5m

former and current civil servants whose pensions MyCSP administers

£44.6 million	forecast total net present value of new business for MyCSP over the seven contract years
£4.9 million	estimated dividend income on the government's 35 per cent shareholding in MyCSP over seven years
£15.5 million	market value of cash and services Equiniti Paymaster, the private sector partner, offered for its 40 per cent stake in MyCSP
32 per cent	potential reduction in headcount for administering the civil service pension scheme
12 months	to establish the mutual joint venture, after publicly announcing plans to transform MyCSP

Summary

1 MyCSP is the organisation that administers civil service pensions for 1.5 million public sector employees (scheme members). It collects data on civil servants' work history and pays them a pension on retirement. The civil service pension scheme (the Scheme) relates to salary, with payments being made out of member contributions and general taxation. In April 2011, the Cabinet Office (the Department) announced plans to change MyCSP from a government activity into the government's first mutual joint venture, a process known as spinning-out.

2 To create the mutual joint venture the Department sold 40 per cent of MyCSP to Equiniti's Paymaster business (Paymaster), a private sector pensions' administration provider, and transferred for nil consideration 25 per cent of the newly formed company to its employees, with the shares being held in trust. The Department retained the remaining 35 per cent. At the same time as creating the new company the Department agreed a seven-year contract (with an option for the Cabinet Office to extend the contract for a further three years) with MyCSP Ltd for MyCSP to sell pension administration services back to the Department.

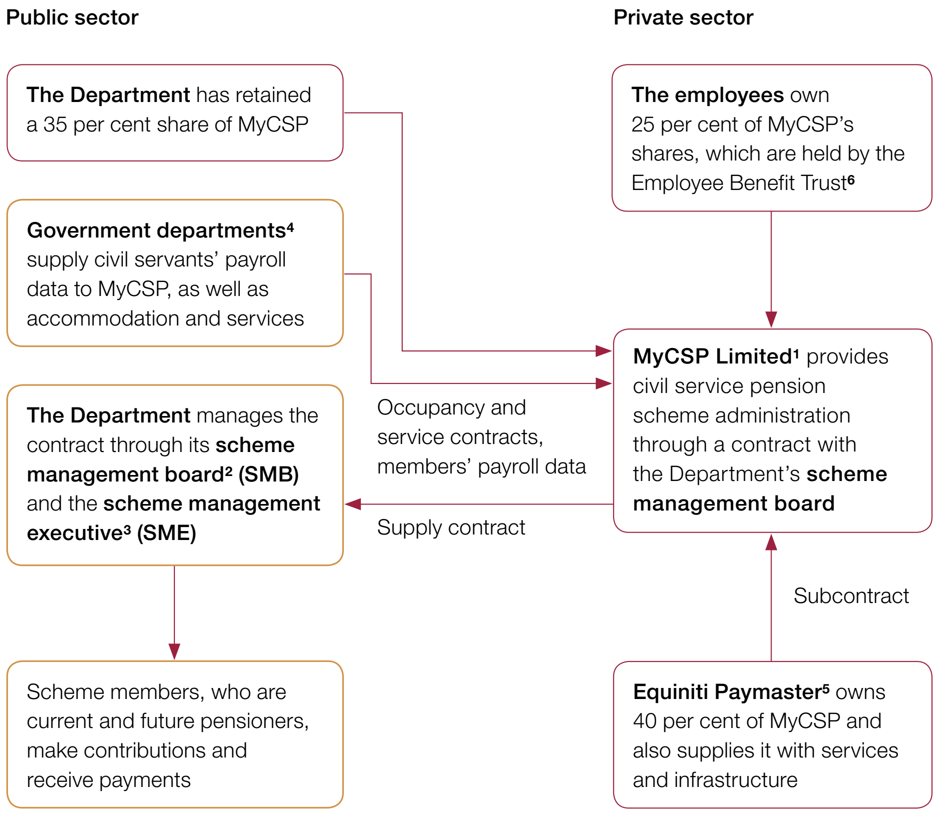
3 The transaction was complex, and the Department had to fulfil several different roles, for example being vendor and owner of MyCSP's shares, as well as purchaser of MyCSP's services for scheme members. **Figure 1** overleaf shows the structure of the transaction with details of the key parties. **Figure 2** on page 7 explains the corporate structure of the mutual joint venture.

4 At the time of the Department's decision to spin-out, MyCSP's service was expensive, its service quality was at the bottom of what the scheme management board (SMB) considered acceptable and it needed major investment. It was also in the middle of a longer-term improvement programme but still cost £18.37 per member per year, twice as much as the best-in-class public sector comparator.

5 The Department decided to spin-out MyCSP because it wanted the investment in infrastructure and expertise that a private sector partner could bring, to help transform the business. Public and private sector pension schemes require similar administration services. The Department decided to structure the transaction in two phases to give the private sector party time to bring its investment and expertise to bear on the transformation. The first phase would cover creating the mutual joint venture and a contract for ongoing administration services. But the price of transforming the IT infrastructure and operating model would be left open within a specified range. The second phase would fix a price for this transformation.

Figure 1

MyCSP has a number of different stakeholders



Notes

1 MyCSP Limited has a seven-year supply contract with the SMB (the customer for Scheme members and employers), with a three-year extension option, to administer the Principal Civil Service Pension Scheme. Figure 2 provides more information on MyCSP's corporate structure.

2 The SMB manages civil service pension arrangements for the Cabinet Office accounting officer and represents Scheme member interests. The SMB comprises 12 members. There are ten voting members including: the chairperson; one HM Treasury or Cabinet Office representative; four employers; and four Scheme members; and two non-voting non-executive members.

3 The SME support the SMB, undertaking day-to-day management and governance of the Scheme.

4 Government departments, as employers, have agreements with the SMB setting out their roles and obligations in supporting delivery. They provide Scheme member data to MyCSP on civil servants' work history. The Department for Work & Pensions (DWP), the Home Office, the Ministry of Defence and HM Revenue & Customs supply accommodation and facility services to MyCSP under contract.

5 Equiniti Paymaster owns a 40 per cent stake in MyCSP and has a subcontract to supply services and expertise to MyCSP.

6 The Employee Benefit Trust manages the 25 per cent trust holding owned by MyCSP employees.

Source: National Audit Office

Figure 2
MyCSP is a joint venture

MyCSP Ltd board

Chair

CEO MyCSP Ltd

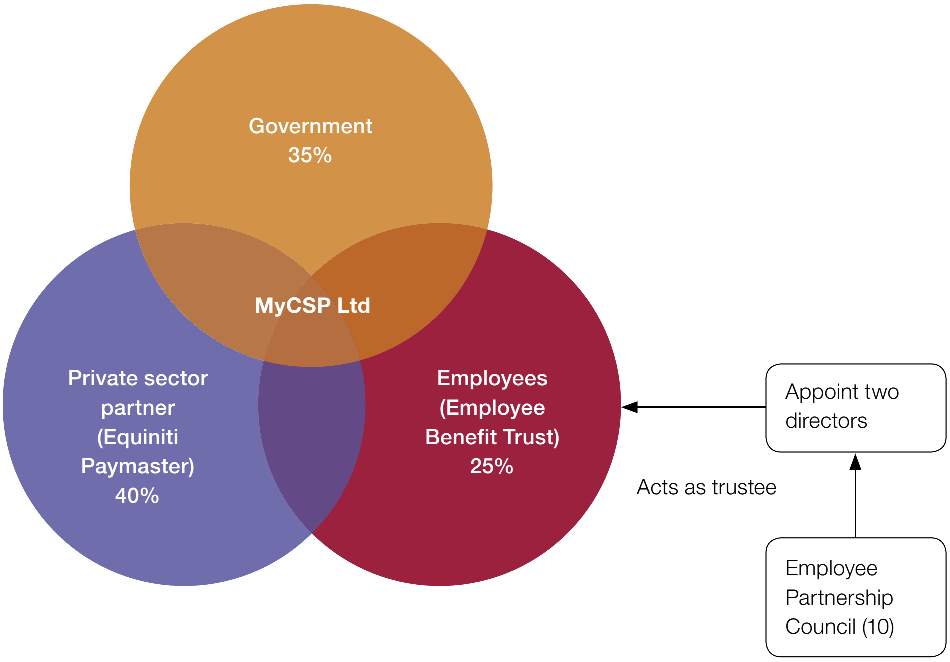
CFO MyCSP Ltd

Government non-executive director (NED)

Paymaster NED

MyCSP Ltd employees NED

(Support: mutual guardian/ company secretary)



Note

1 MyCSP Trustee Company Ltd holds the shares for the employees.

Source: National Audit Office

6 The Department identified this transaction as ripe for testing government's policy of promoting consideration of a wider range of alternative commercial delivery models. There was very little empirical evidence from the British public sector on which to base the value-for-money case. The government took forward the mutualisation on the basis of it being a 'pathfinder' that would gain vital evidence and learning on public sector productivity improvements.

7 Subsequent to the Department's decision to spin-out MyCSP, we qualified the civil service superannuation accounts for 2011-12 due to an error rate of 6 per cent by value of all payments made. MyCSP relies on data from government departments and organisations to make accurate payments. The qualification was an illustration of the data problems that MyCSP faces.

8 MyCSP has annual fee income of around £35 million, of which around £30 million comes from government departments, for administering civil service pensions. It currently employs around 400 people at five sites across England. Total payments were projected to be £191 million at current prices over the seven years. In 2015, the government is introducing a new scheme based on career average earnings, which will require much more complex data to administrate. The transaction cost £7.7 million, of which £4.9 million was on external lawyers and consultants. The Department estimates that the proportion of cost relating to the creation of the company as a mutual joint venture was £2.1 million.

Scope of the report

9 This report evaluates the spinning-out of MyCSP, and the evidence to date on its efficiency and effectiveness. We recognise that the deal was signed-off with ‘pathfinder’ status, and have evaluated its effectiveness in fulfilling that role also. We have benchmarked the spin-out against good practice from other business and asset transfers. We also evaluated MyCSP performance since it has spun-out against expectations, including protections for the taxpayer and the potential impact on quality for scheme members.

10 The report assesses whether the Department has secured overall value for money to date from spinning-out MyCSP, and the remaining risks to value for money, including:

- the current level of value for money offered by MyCSP and how well the Department appraised the alternative options for transforming it (Part One);
- how well the Department prepared for and executed the transaction (Part Two); and
- how well MyCSP has performed so far, whether the benefits are being realised and the risks to longer-term success (Part Three).

Key findings

Rationale for the deal and potential benefits

11 There is significant potential value in this deal for the government and scheme members. The cost to the government is projected to drop by 25 per cent to £13.78 per member per year by year seven of the contract. Furthermore, the Department has an option to extend the contract by three years to secure a cost of £10.08 per member per year at current prices, which is similar to the current best-in-class public sector comparator. Scheme members should receive a better quality of service underpinned by a payment mechanism that penalises MyCSP if it misses the service standard levels set out in the contract. The government may also receive income from dividends and any future sale of shares (paragraph 1.12, Figure 6).

12 Value for money for the deal rests on the status of the chosen delivery model as a 'pathfinder'. MyCSP needed investment to avoid further deterioration of its service and to replace outdated IT infrastructure, so the status quo was not an option. The Department decided to use MyCSP as a pathfinder to test government's policy of promoting consideration of a wider range of alternative commercial delivery models. However, the value-for-money case was uncertain because the Department was not explicit about pursuing the project as a pathfinder, the costs compared with alternative options, or the relationship of MyCSP's costs as a government activity to those of a stand-alone commercial entity. However, the Department wished to avoid bidders incurring unnecessary bidding costs in exploring alternative models which it considered unlikely to progress. There was also very little evidence in the British public sector on the impact of employee ownership. Furthermore, the Department tested the outsourcing option only informally with market providers, and did not test alternative ownership structures at all (paragraphs 1.3–1.11, 2.22).

13 The Department did not set up the transaction initially to maximise applicable learning. Pathfinders are innovative projects that government uses to generate knowledge and learning on good practice, so that problems can be avoided in future projects. They need to fully analyse costs, risks and alternative options, and include from the outset ways to capture and disseminate learning (paragraph 1.11).

14 The government's programme team and MyCSP suffered from a lack of continuity of key people throughout the transaction, which initially limited the scope for knowledge transfer and capturing lessons learnt. The Department is tracking MyCSP's progress through its representation on MyCSP's board, and now has an evaluation strategy to measure the longer-term impacts and changes in productivity (paragraphs 3.18, 3.19).

Planning and executing the transaction

15 The Department's early planning of the deal suffered from poor governance with no separation of duties between programme manager and contract supplier. In planning the transaction the government had five distinct roles, each with different and sometimes competing interests, but it had a relatively small team. The Department did not initially understand these various roles and there was therefore a conflict of interest and an imbalance of power between different parties. In particular, the chief executive officer of MyCSP, while negotiating the supply contract with the scheme management executive, was also head of the overall transformation programme. This meant he had control over allocating programme resources and access to senior management and information. This was not the case for other parties, in particular the scheme management executive. Furthermore, in common with all MyCSP employees, he had a potential personal financial interest depending on the choice of option (paragraphs 2.2–2.6).

16 **The Department's transaction timetable target and financial model did not reflect commercial reality.** The initial programme team and director did not have extensive experience or understanding of what was required in spinning-out an organisation. They set an ambitious target of executing the deal within three months, which had to be slipped repeatedly, finally taking 12 months. The financial model was prepared by a consultant on secondment to MyCSP. However, MyCSP gave the model limited exposure to the bidders or other operators in the market to test its commercial reality. The bidders we spoke to have highlighted its lack of realism. For example, there was unrealistic timing of cost reductions and optimism in revenue forecasts. MyCSP has since identified errors in the financial model totalling £1.7 million (paragraphs 1.8, 2.7–2.10, 2.18, Figure 14).

17 **The Department managed the transaction much better after it responded to the intervention of the Cabinet Office audit committee.** Four months into the planning, and in response to audit committee concerns, the Department put in place four key stakeholder tests that the transaction had to pass before it could proceed. Each test had a senior responsible officer and clear approvals processes and accountabilities. The tests covered the interests of government, MyCSP, the taxpayer, and current and future pensioners (paragraphs 2.11–2.13).

18 **The Department ran a good competitive procurement and despite a loss of competitive tension in the final stages it achieved an outcome consistent with the market.** There were 14 high-quality opening bidders, including existing pensions administrators and new entrants to the market, of which the Department shortlisted four. Bidders felt the government transaction team was high quality, but data for due diligence could have been of better quality. Also, they did not see the financial model or have any input into the supply contract, for example to incorporate innovations, until very late in the process. The signed deal gives MyCSP a 14 per cent projected mark-up of costs, which is consistent with a competitive market rate (paragraphs 2.16–2.19).

19 **The Department chose not to fix the price for years three to seven of the contract until after the contract was signed because of the uncertainty of the cost of transformation.** At contract signature the Department agreed a price range that allowed a 10 per cent drop or 5 per cent rise, to be fixed after six months of operation. This was intended to give the new company and its private sector partner time to understand the organisation's costs and the best way to transform the service. The deal contained a number of protections, such as gainsharing, and the government retained a substantial minority stake, which is good practice. A fixed price was finally agreed in March 2013, ten months after the deal was signed. The price is within the 5 per cent cap, but has £5.7 million of additional costs including items not identified in the original business case. The deal delays transformation for a year, but the total cost is within the estimate of optimism bias included within the business case (paragraphs 3.2–3.5, 3.11, 3.12, Figures 12 and 14).

Early progress of MyCSP and risks to achieving deal objectives

20 **MyCSP responded quickly to the early shock of markedly lower revenue than anticipated, but first-year profits were just over half of those expected.** MyCSP's business plan, which was reflected in the Department's business case, projected that £5 million (14 per cent) of MyCSP's first-year revenue would be from administering civil service redundancy compensation payments. This income stream depended on the actual number of redundancies with MyCSP taking the risk on volume. Redundancy income has been 92 per cent below expectation with MyCSP not projecting any improvement. In response, MyCSP has brought forward its redundancy programme, and brought some outsourced work back in-house, alongside a number of smaller efficiency savings. In its first year, MyCSP made a profit of £1.7 million, against an initial expectation of £3.1 million (paragraphs 3.7 and 3.8).

21 **The Department was over-optimistic in trying to set up a comprehensive performance payment mechanism from the start of the contract.** The payment mechanism increased in phases the number of performance indicators from eight to 162. The management information systems were not in place to measure performance, and the IT infrastructure to make the quality improvements was not envisaged to be in place until year three of the contract. The system is currently suspended while MyCSP remedies data problems inherited from the legacy organisation and completes the transformation plan. The Department has agreed an improvement plan with MyCSP for performance data (paragraph 3.14).

22 **MyCSP employees report rising levels of engagement.** Fifty-two per cent of employees would recommend MyCSP as a great place to work, more than double the amount prior to the company trading. Furthermore, 60 per cent of staff believe that senior leaders have a clear vision for the future, and 59 per cent value being an employee owner rather than just an employee (paragraph 3.10 and Figure 13).

23 **The Department has protections from service failure, but Paymaster has limited exposure in the event of catastrophic failure.** The contract has appropriate mechanisms, such as step-in rights, should MyCSP fail to provide an adequate service. The Department also seeks to influence MyCSP through the Department's own non-executive director. This individual potentially has a conflict between the company and taxpayer interests so the Department has established governance arrangements to help mitigate these. MyCSP's current financial model shows that it would need a 12 per cent drop in expected revenue or a 15 per cent rise in budgeted costs for it to start making losses. As MyCSP started with only £3 million of cash and relies on a single contract, it carries high risks relative to its market competitors. In the event of catastrophic failure of MyCSP, Paymaster's liability is limited to its equity, valued at £15.5 million at financial close, the value of the services it provides to MyCSP, and any associated liabilities contained within the key subcontracts covering the provision of these services. It would, however, also suffer reputational damage in its core area of business (paragraph 3.2–3.5, Figure 2 and Figure 12).

24 **The deal means that MyCSP now has a credible proposition for meeting the challenges of the 2015 pension reforms.** Paymaster is injecting £12.5 million of IT infrastructure and support and £3 million of cash to help enable MyCSP to meet the much more complex requirements of the 2015 career average scheme. MyCSP currently reports being on track to achieve the transformation needed for 2015. A significant proportion of the payroll data that government departments give to MyCSP is, however, poor quality. The Department and MyCSP are developing improvements to meet the requirements of the new scheme (paragraphs 2.21, 3.15 and 3.20).

Conclusion on value for money

25 At this stage the spinning-out of MyCSP has potential to achieve good value for money with a projected 25 per cent reduction in costs for the government and service improvements for members. However, the poor quality of existing data and infrastructure and the different understanding between the parties of some aspects of the deal mean that although the Department signed the deal in May 2012, it took another ten months to agree a final price to transform the service. Furthermore, the Department and MyCSP still face a number of large challenges, as shown by the Department currently suspending payment deductions for poor performance. Given these challenges, and the forthcoming 2015 pension changes, the government will need to remain actively engaged as customer, shareholder, and supplier. This will ensure that risks do not revert back to government and will capture fully the potential benefits of the deal.

26 The Department did not initially optimise the opportunities to learn from this transaction as a pathfinder, but has now reviewed the lessons learned from executing the transaction and has put in place an evaluation strategy. It did not evaluate fully the opportunity cost of the pathfinder and consequently lacks robust data against which to compare its performance, for example on the value given up for employee engagement. Staff turnover in the project team and in MyCSP has been high throughout the transaction, limiting scope for learning. For the transaction to achieve value for money the Department must press on with evaluating the longer-term comparative performance of MyCSP, and capture and disseminate the lessons learned from running the transaction.

Recommendations

Recommendations relevant to this transaction

a **The Department and other government departments need to resolve problems with the quality of data they supply to MyCSP.** Remedies will need to be in place in time for the new 2015 pension scheme.

b **The Department needs to ensure that the performance payment mechanism is fit for purpose as soon as possible.** The contract is currently weakened by the suspended payment mechanism. The Department is currently reviewing it with MyCSP and should ensure that management information is of sufficient quality to restart the mechanism.

c **To learn the lessons fully the Department needs to implement its evaluative framework to measure MyCSP's progress over the longer term.** The Department should ensure that it evaluates over the course of the deal productivity gains arising from the impact of mutualisation. It should use a variety of quantitative and qualitative methods.

Recommendations for future transactions

d **In future, business cases should fully appraise all the viable alternatives.** The business case did not include a proper assessment of the alternative delivery models. This would have helped the Department to understand the value of the different options, and would have allowed it to monitor the value for money of its chosen option against the alternatives.

e **Government should use the learning on governance arrangements for non-executive directors to inform future similar cases.** Government non-executive directors have a potential conflict of interest between their duties to the company and the taxpayer. The governance arrangements in this transaction have so far mitigated any risks.

f **In future transactions, the government should fully integrate commercial and operational experience to the team early on, so planning reflects commercial reality.** This is necessary so that the timetable, risk management, financial model, and project and task planning reflects realistically the commercial complexity of the transaction.

g **The government should use the insights and learning from this transaction in instances where it wants employee engagement to be a feature of future delivery.** MyCSP was spun-out with 25 per cent employee ownership, but the government should not presume that this is a benchmark figure. The Department had very little evidence from the British public sector for MyCSP's business case on the impact of employee ownership on productivity.

h **The Department should press ahead with standardising the legal documents and process for spinning-out public services to reduce the cost of execution.** The programme costs for this pathfinder transaction were £7.7 million, which is more than 20 per cent of MyCSP's annual income.

i **Where the government is planning future spin-outs it must properly separate the various different roles and decision-making.** This will ensure clarity of decision-making and proper accountability.