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Pensions briefing

RPI and CPI – How have the courts addressed various issues regarding scheme increase rules?

What is the background to the use of RPI and CPI in uplifting pension payments?

Legislation requires that preserved benefits held by deferred members of defined benefit (DB) pension schemes who left pensionable service on or after January 1, 1991 must be revalued to offset the effects of inflation between the date the member leaves service and the date he draws his pension. This is known as revaluation.

Similarly, since April 6, 1997, most DB schemes have been required to increase pensioners' pensions in payment by a minimum amount each year. This is known as indexation.

Both revaluation and indexation increases are subject to a specific percentage cap which is calculated using limited price indexation (LPI). This means the percentage increase to benefits is usually the lesser of the annual increase in whichever inflation index is used and (since April 6, 2005) 2.5 per cent.

Legislation does not stipulate how inflation is to be measured for the purposes of either revaluation or indexation. Instead, the Secretary of State is required to make an annual order specifying the rate to be used and, historically, the index used was the retail prices index (RPI). RPI has its origins in the "cost of living index", which was first published in 1914, with the modern RPI being published in 1956. The Consumer Prices Index (CPI) was introduced in 1997, following the EU's harmonisation of the existing index of consumer prices. RPI and CPI each take into account a different "basket of goods" and involve a different mathematical formulation in measuring inflation. CPI generally, to date, has produced a lower figure. However, neither index can accurately reflect the "cost of living" for actual scheme members, as this can be higher or lower than inflation depending on their level of consumption of various goods and services.

From April 2011, the then Government decided to switch to CPI rather than RPI to calculate increases in social security payments and public sector pension benefits. By 2013, the RPI was no longer considered compliant with international standards. On March 14, 2013 it was removed from designation as a "national statistic", though it continued to be used for government bonds and other purposes. The Consumer Prices Index including Housing (CPIH) was introduced on the same date, as a variant of CPI but including a measure of owner-occupiers' housing costs. The switch from RPI- to CPI-based (and subsequently CPIH-based) calculations was subsequently extended to the minimum statutory increases required for private sector pensions. However, the Government did not introduce an overriding or modifying statutory power allowing schemes to switch automatically to CPI (or CPIH) linked indexation or revaluation where RPI was "hard-wired" or written into the scheme rules. Therefore, the impact of the statutory change on indexation and revaluation in private-sector schemes depends on each scheme's trust deed and rules.

The remainder of this briefing looks at how the Courts have answered various questions arising when schemes have attempted to switch to CPI instead of RPI to calculate increases.

How does section 67 of the Pensions Act 1995 affect the replacement of RPI for CPI for indexation and revaluation purposes?

This question was addressed in *Dank and others v QinetiQ Holdings Ltd and another* [2012] (QinetiQ). The scheme rules provided that the applicable index to be used for both indexation and revaluation was the *"Index of Retail Prices…or*

any other suitable cost of living index selected by the trustees." The rules, therefore, permitted the trustees to choose an index, such as CPI, instead of RPI.

The indexation rule provided that pensioners would have their pensions increased on 1 April each year. The revaluation rule operated so that the increase would be calculated upon the deferred member reaching the scheme's normal retirement age, or the date of early retirement if this was earlier.

The Court held that:

- in respect of pensions in payment, members had an entitlement only to a specific rate of increase on and from 1 April in each year. Prior to that date each year, the member had an entitlement only to an increase by reference to an index which the trustees had the power to change. Once an index had been determined on 1 April, it could not be changed for that year without it being a detrimental modification, and therefore being voidable under section 67 of the Pensions Act 1995 (section 67). However, it could be altered before the following 1 April without falling foul of the legislation; and
- deferred members had no right to revaluation increases until they reached normal retirement age (or an agreed early retirement date). Until the calculation was carried out, the member had a right only to revaluation by reference to an index that the trustees could change. Section 67 would not, therefore, prevent the index being changed prior to a member's normal retirement age. However, once the calculation had occurred, this crystallised the right to whichever index had been used.

The result of this approach is that, in the case of two given deferred members, one taking an early pension just before the trustees changed the index from RPI to CPI and one just after, the first member's pension would be revalued by reference to RPI and the second by reference to CPI, notwithstanding that both members' benefits may have accrued when the index was RPI. The Judge noted that *"…the unfairness is the result of the fact that the value of neither member's pension is crystallised until the date on which the…revaluation actually takes place…".*

The subsequent decision of the High Court in *Arcadia Group Ltd v Arcadia Group Pension Trust Ltd and another* [2014] (*Arcadia*) and of the Court of Appeal in *Barnardo's and Others v Buckinghamshire and Others* [2016] (*Barnardo's*) endorsed this approach to section 67, where the Judge concluded that *"…members have a 'subsisting right' to increases and revaluation consistent with the definition of 'Retail Prices Index' but not to increases and revaluation specifically by reference to RPI"* in situations where the rules provide that a different index can be substituted. In *Barnardo's*, there was a further appeal to the Supreme Court, but on issues other than section 67, and these are discussed below.

Can different costs of living indices be used for different purposes?

In *QinetiQ*, it was argued that "Index" must mean only one index.

The Court rejected this approach and held that the definition of "Index" in *QinetiQ* could mean RPI for some periods or purposes and CPI for others. The Judge noted that this was not only because the law recognises that the singular includes the plural, (that is, "Index" can also be read to be "Indices") but also that the words "for particular periods or purposes" could be read into the definition of "Index". An alternative conclusion would make the scheme cumbersome, unworkable and inconsistent with business common sense. It could also, in many situations, act to the detriment of scheme members.

Does a definition of RPI as "the Government's Index of Retail Prices or any similar index satisfactory for the purposes of HMRC" allow another index, such as CPI, to be used instead of RPI?

The cases demonstrate that whether the trustees have the power to use CPI instead of RPI for revaluation and/or indexation purposes depends upon the precise wording in the rules.

In *Arcadia*, the rules provided that the relevant measure of indexation was "*Retail Prices Index [(or any replacement of that Index)]*". "Retail Prices Index" was in turn defined as *"the Government's Index of Retail Prices or any similar index satisfactory for the purposes of HMRC."*

The Court held that these rules allowed the trustees to choose an alternative index to be used other than RPI, as:

- the definition of "Retail Prices Index" did not provide that a similar index could only be adopted if RPI itself was discontinued or replaced. To interpret this otherwise would be to read words into the definition of "Retail Prices Index";
- it was apparent that there was some power of selection between indices. If, for example, RPI had been discontinued and HMRC suggested that either of two other indices would be appropriate, it could not be supposed that no one would have the power to choose between the indices; and
- the fact that the label "Retail Prices Index" was used rather than a more neutral term was not determinative; it was clear from the definition of that expression that the possibility of another index was expressly provided for.

Is CPI an index that is "similar" to RPI and "satisfactory for the purposes of HMRC?"

Depending on the wording of specific scheme rules, it may be that the trustees have the power to choose an alternative index, provided that alternative index is *"similar"* to RPI and/or "satisfactory for the purposes of HMRC". The Court in *Arcadia* considered whether CPI would satisfy these conditions.

The parties accepted that CPI was a "similar" index to RPI and this point was not, therefore, considered further. Equally, HMRC had confirmed in an email that CPI is a satisfactory measure for the purpose of indexation and therefore this did not need to be decided.

Who has the power to choose which index applies where the rules do not specify one?

In cases like *Arcadia*, it may be that the rules do not stipulate who has the power to determine which index applies.

In *Arcadia*, the Court considered the rules of the scheme as a whole, under which the principal employer could not alter any of the members' benefits without the trustees' consent. The Judge said that the trustees *"…can be seen as natural spokesmen for the scheme…[which] suggest[s] that they were intended to be involved in any exercise of the power of selection".*

The power of selection was, therefore, held to be vested in the principal employer and the trustees jointly.

Can CPI be used instead of RPI if the rules provide that either RPI is to be used "…or a replacement adopted by the Trustees…"

In *Barnardo's*, the schemes rules provided that, broadly, indexation and revaluation should be increased using the *"prescribed rate"*, which was defined as the lesser of 5 per cent and *"the percentage rise in the Retail Prices Index (if any)…".*

"Retail Prices Index" was defined as the *"General Index of Retail Prices or any replacement adopted by the Trustees without prejudicing Approval".* A second sentence expanded this definition and referred to the "replacement or re-basing" of the Retail Prices Index.

The High Court held that the scheme rules did not give the trustees the power to switch from RPI to CPI for revaluation or indexation, so long as RPI remained an officially published index.

In November 2016, the Court of Appeal (CA) upheld the first instance decision. The CA stated that pension increases were determined by reference to the Retail Prices Index, as defined above. The CA held by a majority that the natural meaning of the first part of the definition was that a "replacement" of the RPI had to precede the adoption of any such replacement by the trustees. The second sentence, referring to replacement and re-basement of the RPI, was helpful in interpreting the first sentence of that definition.

The CA's view was that RPI could only be "re-based" by the authority responsible for publishing it, and the same person had to carry out both the "replacing" and the "rebasing". The term "replacing" had the same meaning in both the first and second parts of the definition. It followed that any "replacing" could only be carried out by the authority responsible for publishing the RPI and that, without its official replacement, there was no other "replacement" which the trustees could adopt instead.

In November 2018, the Supreme Court dismissed a further appeal. It upheld the CA's decision that the correct interpretation was that the definition of RPI involved a two-stage test, and meant *"the RPI or any index that replaces the RPI and is adopted by the trustees".*

Barnardo's highlights the constraints that may arise from specific historic drafting. Employers' attempts to adopt CPI may encounter problems which need to be examined on a case-by-case basis where the scheme has retained a link to RPI.

When does RPI become an 'inappropriate' method of increase?

In *British Telecom v BT Pension Scheme Trustees* [2018] the High Court considered whether a switch from RPI to CPI could be introduced for revaluation. The BT Scheme rules provided that *"The cost of living will be measured by the Government's published General (All Items) Index of Retail Prices or if this ceases to be published or becomes inappropriate, such other measure as the Principal Company, on consultation with the Trustees, decides."*

BT argued that it was its own decision whether RPI had become inappropriate, or not. However, the Court's view was that the decision involved an objective test and there was no power for BT to make such a determination. In addition, the Court held that the use of RPI was not an inappropriate measure to use in protecting members' benefits from increases in the cost of living.

In December 2018, the CA dismissed BT's subsequent appeal, and upheld the High Court decision. Whether RPI was inappropriate was an objective state of affairs, which was inevitably fact-sensitive and a matter of evaluative judgment. In default of agreement by the employer and the trustees, the question had to be decided by the Court.

The Supreme Court denied BT permission to appeal in July 2019.

The ability of a scheme to swap from RPI to CPI as an inflation measure for benefit increases turns largely on the specific facts of the case and the drafting of the scheme's own rules.

What if RPI is materially altered – can a different Index be used?

In *Thales UK v Thales Pension Trustees* [2017] the governing documentation of the CARE section of the pension scheme provided *"if the Government retail prices index for all items is not published or its compilation is materially changed, the Principal Employer, with the agreement of the Trustees, will determine the nearest alternative index to be applied."*

Thales argued that RPI had been materially altered by the introduction of the house prices index into RPI. The High Court agreed with Thales that RPI had been materially altered as a result, and that the principal employer, with the agreement of the trustees, could determine the nearest alternative. However, the Court determined that the nearest alternative to RPI was not CPI, but RPI as materially changed. Although RPI had materially changed, due to the specific wording of the Thales scheme rules, RPI remained the appropriate Index.

In April 2020, a further judgment was reached by the High Court on the Thales' scheme increase rules, which stated:

"... the percentage increase in the retail prices index…..subject to a maximum of 5 per cent as specified by order under Section 2 of Schedule 3 of the Pensions Schemes Act."

At the time that the rule was drafted, the revaluation order under the Pension Schemes Act 1993 specified RPI, but from 2010 onwards the order referred to CPI following the Government's decision to switch to CPI, and consequently the two limbs in the increase rule were inconsistent.

The High Court agreed with the Pensions Ombudsman that the ordinary and natural meaning of this provision was that the rate of pension increases should be RPI, meaning that the first limb of the rule prevails. The result was that the switch to CPI (which had already been made) had to be unwound and affected members put back where they would have been, with interest.

What happens when RPI is acknowledged not to be a good measure of inflation?

In January 2020, in *Atos IT Services UK Ltd v Atos Pensions Schemes Ltd*, the High Court considered the RPI definition in the scheme rules. The Judge held that RPI meant RPI and will continue to mean RPI for so long as RPI is published by the Office for National Statistics (ONS), even though the ONS had acknowledged that RPI was not a good measure of inflation and preferred the use of a different measure.

The Judge held that the meaning of the expression *"the general index of retail prices (all items) published by the Office for National Statistics"* in the definition of RPI was RPI. Further, the meaning of the phrase *"or where that index is not published"* was where that index is not published for any purpose. Since the RPI is still published by the UK Statistics Authority (albeit because it was under a statutory duty to maintain and publish RPI), the trigger condition allowing the employer and trustees to agree a substituted index had not been met.

What happens when the composition of the applicable index changes?

In *Ove Arup & Partners International Ltd v Trustees of the Arup UK Pension Scheme* [2020], "The Index" was defined in the scheme rules as *"subject to Rule H1.03 (Changes in the Index), the Index of Retail Prices (All Items) published by the Office for National Statistics".* Rule H1.03 stated:

"If the composition of the Index changes or the Index is replaced by another similar index, the Trustees, after obtaining the Actuary's advice, may make such adjustments to any calculations using the Index (or any replacement index) as they consider to be fair and reasonable".

The employer applied for Court declarations on whether the trustees were obliged, or at least had the power for the future, either to change the relevant index from RPI to CPI or CPIH or, if this were not permitted, to make adjustments to calculations using RPI that would achieve the same effect. It argued that RPI had been "functionally" replaced by CPI and CPIH because those indices were regarded as the main measure of consumer price inflation from March 14, 2013.

Alternatively, the employer sought adjudication on whether three changes to RPI made between 2010 and 2017 amounted to a change of composition in the index, entitling the trustees to make adjustments to their annual pension increase calculations.

The Court considered two trigger events:

- Had the Index been replaced? The judge concluded that the Index had not been replaced because (following the Supreme Court in *Barnardo's*,) the "*...RPI is "replaced" only if it is discontinued and another similar index is introduced or declared by the responsible body to be in its place, and that the Rule does not contemplate any form of "functional" replacement".* So, the question of the powers and duties of the Trustees did not arise; and
- Had the composition of the Index changed? The judge's view was that *"a substantial change must be produced in the end result"* and that any such change could not be at a date earlier than the adoption of the latest set of Rules, as the relevant wording implied a future change. Therefore, each time a new set of rules was adopted, it re-set the clock and the "Index" as defined was the RPI as it existed at the adoption of the latest version of the rules in 2013.

The judge also noted that counsel for both the trustees and the employer had drawn his attention to the "numerous" cases that have addressed whether RPI could be replaced by CPI in other schemes, including several which considered what constitutes the "replacement" of an index. Bearing in mind the *Barnardo's* approach to the proper interpretation of pension scheme rules, he did not refer to them in his judgment, on the basis that:

"...they do not lay down general principles and even to the extent they indicate what the judge considered to be the normal or ordinary meaning of a word, it would be so necessary to expand on the particular context that it would be questionable whether any real assistance could be derived for this case."

Can unintended "hard-wiring" of RPI into a scheme's rules be altered by rectification?

In June 2020, the High Court handed down judgment in *Univar UK Ltd v Smith and others* in which it allowed rectification of the scheme rules after RPI had been mistakenly "hard-wired" into the increase rule. The impact of the decision on the scheme's funding position is expected to be a potential saving of about £23 million.

The principal employer claimed that the specific link to RPI in the scheme rules had been introduced by a drafting mistake during a document consolidation exercise in 2008. The previous rules had simply linked increases to statutory requirements.

The Court found that neither the employer nor the trustees had intended to change the increase rule. The Judge applied the subjective test of common intention for rectification and considered the collective intent of those making the decisions at the time. Of key importance was negligent advice received at the time, with the Judge finding that negligence *"not only does not prevent rectification, but is a ground for it".*

Much of the case then hinged on whether a lack of evidence proving that the employer was aware of the legal implications of the new wording constituted proof that it had been made by mistake. The Judge was ultimately satisfied that the effect of the new wording in the consolidation was unintended, citing the Court of Appeal's 2019 decision in *FSHC Group Holdings Ltd v GLAS Trust Corporation Ltd*, in which it was said that "*where an important change is made to an existing arrangement between the parties, the absence of any discussion of that change may itself be evidence that the parties did not intend it*". The employer had not appreciated the legal effect of hard-wiring the RPI into the rules, so the Judge concluded that it would be fair to assume the change did not accurately reflect the collective intent of the company in making those changes.

The *Univar* case provides a useful restatement of the principles of rectification. In 2008, none of the parties appreciated that the CPI might be introduced as an alternative statutory index in future, and to that extent did not foresee that there was a possibility that the RPI might at some point no longer be the minimum requirement for statutory indexation.

The judgment will be generally welcomed by the pensions industry as it has confirmed that any negligence by those drafting rule changes could be a ground for rectification.

For many schemes, there are significant funding differences depending on whether their benefit increases are calculated on the RPI or CPI basis. While the High Court judgment in *Univar* does not provide the firm precedent that many scheme employers seek, it does open the rectification door a little in circumstances where a scheme's rules allow. This case differs from many of the previous RPI/CPI claims in that rather than focussing on the precise legal interpretation of the increase rule concerned, the claim was brought on the basis that a drafting error had mistakenly hardwired RPI into the rules. The decision highlights how essential it is to record the intentions and decisions of all the parties when rule amendments or document consolidations are undertaken.

What next?

Many schemes continue to be interested in adopting CPI as a means of reducing scheme liabilities and improving the scheme's funding position, as it (to date) has generally produced a lower uplift to benefits than RPI. The ability of schemes to use CPI instead of RPI clearly depends upon the precise wording of the rules and the respective powers of the principal employer and the trustees in making any necessary amendments. Many schemes' revaluation provisions are drafted in terms of reference to the relevant legislative provisions and where this is the case, amendments relating to deferred benefits will not be required. However, indexation provisions are often set out in more detail, and in some cases may refer specifically to RPI. Where rule amendments are required to adopt CPI, any restrictions in the scheme's power of amendment will need to be taken into account, and CPI-based increases may be possible in respect of future service only.

Given that there are many variations on increase and revaluation rules, it is likely that questions such as those outlined above will continue to come before the Courts. Whilst some general principles can be drawn from these cases, they may be of only limited use for schemes with as yet untested RPI definitions. After the *Univar* judgment, some schemes may be tempted to try the rectification route. However, schemes should be wary of embarking on expensive litigation unless they have extensive and clear evidence that their increase rule has been unintentionally altered in the past.

The UK Statistics Authority has proposed aligning RPI, which is used by the Treasury but consistently overstates inflation, with CPIH. In April 2020, chancellor Rishi Sunak announced an extension to the related consultation, originally due to end on April 22, 2020, to August 21, 2020 amid the coronavirus pandemic. Depending on the outcome of the consultation, it is possible the issue may fall away entirely if there is no eventual differentiation between the RPI and CPI measures.

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