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2 July 2020

Dear RPI Consultation Team

**Response to the HM Treasury and UK Statistics Authority ("UKSA") Consultation on the Reform to Retail Prices Index Methodology (the "Consultation") on behalf of the New Airways Pension Scheme ("NAPS")**

We welcome the opportunity to comment on the Consultation. This response has been prepared by British Airways Pensions on behalf of the trustee of NAPS (the "**NAPS Trustee**").

**Background**

NAPS is a defined benefit pension scheme established in 1984 for employees of various airline companies now within the British Airways plc group. As at 31 December 2019, the assets of the scheme totalled £19.0bn for a membership of over 63,000. The scheme has a corporate trustee company with 12 Trustee Directors (6 Employer Nominated Directors and 6 Member Nominated Directors). In 2015, Virginia Holmes was appointed as independent trustee chair.

As for many other defined benefit schemes in the UK, NAPS provides the majority of its scheme members with revaluation and indexation of pension benefits in line with the Pensions Increase (Review) Orders ("**PIRO**"). PIRO was set using the Retail Prices Index ("**RPI**") until the increase applied in 2010 after which it has been set using the Consumer Prices Index ("**CPI**").

Given the inflation linkage of the NAPS benefits, inflation is a significant exposure for the scheme with **REDACTED** of its liabilities linked to inflation. As such the NAPS Trustee has a policy to hedge its inflation exposure. This is in line with investment guidance issued by The Pensions Regulator in 2019 to trustees of defined benefit pension schemes.

The majority of the hedging in NAPS is carried out through physical assets, namely Index Linked Gilts ("**ILGs**"). ILGs are currently only issued by reference to the RPI. Indeed, together the scheme and the Airways Pension Scheme (the other main defined benefit pension scheme for current and former employees of the British Airways plc group) currently hold[1] c.1% of all ILGs in issuance.

**General Comments**

We note that the consultation asks questions in two key areas: the technical approach the UKSA will take to bring the CPIH methods and data sources into the RPI (the "**proposal**"), and the date at which the proposal would be implemented. We address both of these areas in our general comments below with wider context than the specific consultation questions allow. We also note that the consultation does not seek views on whether the proposal should be implemented.

The consultation document notes that the RPI is used throughout the economy and the government welcomes information on the potential wider impacts of the UKSA's proposal. As highlighted in the consultation document, the RPI is widely used by defined benefit pension schemes, both in revaluing defined benefit liabilities and through inflation-linked assets (for example ILGs, index-linked corporate bonds, property, inflation derivatives and infrastructure).

Indeed, we believe that defined benefit pension schemes will be the group most affected by the proposed change, with assets of c.£1.7 trillion backing liabilities of c.£1.9 trillion[2]. Naturally the precise consequences vary by scheme but will affect scheme members, the overall funding position of schemes and the corporate sponsors of schemes.

In relation to UK defined benefit pension schemes we would highlight the following key areas of impact of the proposal:

1. Members with benefits linked to RPI will receive lower benefits than previously expected as CPIH is expected to be lower than RPI.
2. In many cases, pension deficits will increase substantially. Many pension schemes have hedged CPI-linked benefits using (RPI-linked) index-linked gilts. The proposal

[1] Or are exposed to through derivatives. Based on 8 April 2020 figures.
[2] Source: The DB landscape – Defined benefit pensions 2019, The Pensions Regulator.

will therefore result in a fall in the value of these schemes' assets without a corresponding fall in the value of their liabilities.

3. As a consequence of the second item, additional cash contributions from the companies sponsoring the affected pension schemes will be needed.

<u>Member benefits will be reduced</u>

Replacing the RPI with the CPIH will have a material effect on the benefits paid to millions of defined benefit scheme members across the UK. This will affect members' financial planning and long term saving plans, potentially increasing dependency on state pension benefits and incidence of pension scams as members look for other ways to achieve the retirement benefits they had come to expect.

<u>Pension deficits will increase</u>

As stated above, in many cases, pension deficits will increase where index-linked gilts have been purchased to hedge CPI-linked benefits. In such cases, pension schemes' purchases of index-linked gilts were made on the reasonable expectation that the inflation indexation would be linked to the RPI under the prevailing calculation methodology. This expectation has been strengthened by a number of reviews which concluded that, despite known issues with the RPI measure, it should not be changed. In particular, we would highlight that both the Government and the UKSA have previously been supportive of the continued use of RPI in legacy situations.

The National Statistician recommended, and the Board of the UKSA accepted, in response to her consultation on improving the RPI in 2013, that the formulae used in the RPI should remain unchanged. This recognised that "there is significant value to users in maintaining the continuity of the existing RPI's long time series without major change, so that it may continue to be used for long-term indexation and for index-linked gilts and bonds in accordance with user expectations." There is no reason to believe that this statement is any less true today.

In HM Treasury's response to the UKSA's consultation in 2015 on "Measuring Consumer Prices: the options for change", it signalled its continued support for RPI, noting "The Government remains committed to using RPI e.g. in existing index-linked gilts which currently run out to 2068". This set an expectation that future changes would not be made to RPI in light of previous uncertainty.

Throughout this period, CPI (of which CPIH is a close variant) has been a widely used measure of inflation for other purposes and one that has been known to be around 1% pa lower than RPI. There will therefore have been a conscious decision taken to confirm the continued use of RPI. Indeed, NAPS has explicitly built in expectations of RPI exceeding CPI in its funding and risk management strategy.

At the same time as making the statements quoted above, and while CPI and CPIH have both been in existence, the Government has continued to issue significant volumes of ILGs linked to RPI.  Gilt holders could therefore have reasonably expected for the distinction between RPI and CPI / CPIH to continue going forward.  The proposed changes would, however, effectively rewrite the rule book retrospectively in respect of these issuances.

This issue is not isolated to index-linked gilts, but also affects the inflation swap market and insurance markets.

For NAPS, the funding level (on a technical provisions basis) would decrease by **REDACTED** under the current proposal if implemented in 2030, equivalent to an increase in the deficit of **REDACTED**.

Additional cash contributions will be required from sponsors

A worsening in the funding position will mean that the corporate sponsors of affected schemes (in the second category noted above) will be required to fund a larger deficit, thus leading to increases in deficit repair contributions.  This would add additional financial stress to such businesses, with a likely negative impact on the wider UK economy. This negative impact will come at a time when many UK businesses are already under acute stress as a result of the outbreak of Coronavirus.

Avoiding the negative impact

We would encourage the government and UKSA to consider an alternative approach to redefining RPI, whereby RPI = CPIH + x, where the margin x is to be agreed based on a fair value assessment of the expected difference between RPI and CPIH.  This would:

- avoid the negative impact on economic activity referred to above;
- help to mitigate the adverse impact on investors from receiving lower income streams from their assets than expected (including defined benefit pension schemes and their millions of members in the UK); and
- maintain the integrity of, and confidence in, the gilt market and avoid unintended value transfer, such that defined benefit schemes, NAPS included, would continue to be willing purchasers of issuance of ILGs in future;
- avoid dislocation and unintended consequences in other RPI-linked contracts, including inflation swaps, RPI-linked corporate bonds and other commercial and property contracts with RPI-linkages; and
- achieve the Government’s stated aim (of addressing the statistically inaccurate RPI methodology) but also ensure that there is no unfair transfer of wealth.

The timing of any changes should be transparent and communicated without undue delay. The current uncertainty around whether any changes will be made and, if so, where within the potential 5-year implementation window, will lead to pricing anomalies and a lack of investor confidence. Should the proposal to replace RPI with CPIH go ahead, we would favour implementation in 2030 which would lead to a slightly lower, but still materially negative, impact on NAPS and its 63,000 members.

**Confidentiality**

We are happy for British Airways Pensions to be listed as a respondent to the consultation and for this letter to be shared within HM Treasury and the UKSA.

We are also comfortable with extracts from this letter being published as part of the HM Treasury and UKSA response to the consultation, provided any background information or direct references to NAPS, including financial information and figures, are not published.

We hope the above is helpful. If you have any queries or would like further information please direct any reply to the Trustee Executive at the address set out above.

Yours faithfully

Virginia Holmes
**Chair of New Airways Pension Scheme Trustee Limited**