What constitutes a 'material change' to RPI? (Thales UK Ltd v Thales Pension Trustees Ltd)

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Pensions analysis: Henry Day, barrister at Radcliffe Chambers, examines the decision in Thales UK Ltd v Thales Pension Trustees Ltd and considers what assistance it can offer practitioners when construing a pension scheme's indexation and revaluation provisions.

Original news

Thales UK Ltd v Thales Pension Trustees Ltd [2017] EWHC 666 (Ch), [2017] All ER (D) 21 (Apr)

The Chancery Division in a claim under CPR 8 by the claimant company interpreted the provisions of a company pension scheme and provided answers to the questions set out in the particulars of claim. For the purposes of revaluation and indexation of pensions, the company had sought to replace the Retail Price Index (RPI) with another index which would cost less to implement.

What was the background to the case?

The claim was brought under Part 8. The claimant company, Thales UK Limited, sought answers to a number of questions concerning the construction of provisions of the Thales UK Pension Scheme—an occupational pension scheme under which the company is the principal employer. In particular, the company asked the court to construe the powers that it and/or the scheme's trustees, Thales Pension Trustees Limited, have to change the index by reference to which:

- a member's salary is revalued for the purposes of calculating his career average revalued earnings (CARE) benefits under a 2008 scheme deed (ie before the benefits are put into payment on a member's retirement) ('CARE revaluation')
- a member's CARE pension benefits are increased annually under the 2008 scheme deed (ie after the benefits have been put into payment on a member's retirement) ('CARE pension increases')
- certain final salary benefits, built up prior to 2008 in legacy defined benefit (DB) schemes, are revalued while a member remains an active CARE member of the scheme or an active member of the company's separate defined contribution pension scheme ('legacy final salary revaluation'), and
- certain final salary pensions in payment are increased annually under a 1991 deed and rules applicable to members who had transferred into the scheme from the Thales Optronics Pension Scheme (TOPS) ('TOPS indexation')

The index previously used for the above purposes was RPI. In order to save costs, the company hoped to establish that the Consumer Prices Index (CPI) could be used instead.

What issues were raised?

Two provisions of the scheme were at issue.

In relation to the calculation of CARE revaluation (as well as CARE pension increases and legacy final salary revaluation), the relevant rule under the 2008 deed provided that:

'…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'.

RPI continues to be published. The issue, therefore, was whether the compilation of RPI had 'materially changed', and, if it had, what the 'nearest alternative index' was.

The second question concerned TOPS indexation. The relevant provision stated that:

'…if the Retail Prices Index is revised to a new base or if that Index is otherwise altered after a date which is relevant in respect of a pension in terms of this Rule, all subsequent variations in that pension will be on a basis determined by the Trustees having regard to the alteration made to the Retail Prices Index'.

The company did not seek to argue that RPI had been rebased. The question was what 'otherwise altered' meant, and, further, if a relevant alteration had occurred, how the trustees were to determine an appropriate alternative basis for indexation.

What arguments were made by the parties?

The company's arguments

The company contended that the necessary material change (in relation to CARE revaluation, CARE pension increases and legacy final salary revaluation) and alteration (in relation to TOPS indexation) had occurred, and therefore that an alternative index could be substituted for RPI.

In relation to CARE revaluation (as well as CARE pension increases and legacy final salary revaluation), by way of background, the company pointed out that CPI had not been in common use in 2008 when the CARE Rules were adopted and that there had been no intention at the time specifically to confer RPI-based benefits. There was, accordingly, nothing in the relevant rules that presupposed retention of RPI.

A number of historic changes or alterations to RPI were canvassed (although only those post-dating 2008, being the date of the relevant deed, were relied on in the case of CARE revaluation, CARE pension increases and legacy final salary revaluation). These included:

- in 1993, the replacement of the community charge by council tax and the inclusion of spending on foreign holidays
- in 1994, the inclusion of spending on domestic holidays and the inclusion of a measure of depreciation in owner-occupied housing
- in 2010, changes to the price collection for certain items of clothing and footwear and the measurement of mortgage interest rates
- in 2011, improvements to the treatment of seasonal items by using price movements for similar items for missing months
- in 2012, the estimation of new car prices by reference to prices from dealer websites instead of movements in second hand prices

- in 2013, a change to the collection of private housing rents through the use of data from the Valuation Office Agency instead of from private letting agents and the announcement by the Office for National Statistics (ONS) that the UK Statistics Authority was going to 'freeze' the formula used to determine RPI
- in 2017, the incorporation of the new UK House Prices Index (UK HPI) into the way in which RPI is calculated

The company argued, moreover, that, as well as the basic fact of such changes, their effects and cumulative impact should also be taken into account—the court should have regard not simply to a given change in isolation, but to the consequences of that change and to the way in which, as a result of all such changes and their consequences taken together, RPI had altered over time.

With specific regard to the TOPS Rules, the company contended that the phrase 'otherwise altered' should be construed broadly, in accordance with normal English usage. According to the company, the meaning of the phrase encompassed any change in the character or composition of RPI, not just essential or fundamental changes to its method of calculation.

The trustees' arguments

The trustees argued that no material change (in relation to CARE revaluation, CARE pension increases and legacy final salary revaluation) and no relevant alteration (in relation to TOPS indexation) had occurred.

As to the company's preliminary point concerning the circumstances in which the CARE Rules were adopted, the trustees contended that the selection of RPI had been a deliberate choice, taken in a context where CPI was an alternative available index. RPI was therefore, by implication, the default index.

Against this background, the main plank of the trustees' argument was that RPI is inherently non-static. It reflects changes in purchasing patterns, available information and statistical techniques. It is, by its nature, constantly evolving—changes to it are to be expected as part of its normal operation. The kinds of changes that the company had put forward were of such a type, and were to be distinguished from a material change to the method by which RPI is actually compiled. It was with such material changes that the relevant scheme provisions were concerned.

The trustees further contended that a material change to the compilation of RPI was to be distinguished from the effects of any such change. The relationship between any given change and its effects may prove disproportionate. Moreover, it would be administratively unworkable for the scheme to be required to take into account the effects of particular changes—a lapse of time between a change occurring and its effects becoming apparent would not uncommonly arise, and benefit increases would need to be applied in the interim. If the effect of the change as well as the change itself had to be taken into account, it would create uncertainty at best and impossibility at worst.

Substitute index

On the assumption, contrary to the trustees' case, that a material change or a relevant alteration had in fact occurred, the court was also required to consider the questions of the nearest alternative index to be used for

purposes of CARE revaluation (as well as CARE pension increases and legacy final salary revaluation), and of how the trustees should have regard to the relevant alteration for purposes of TOPS indexation.

The company submitted that, when selecting an alternative index, the attributes of that index should be considered, and that, in the case of TOPS indexation, the trustees had a wide discretion in determining an appropriate new basis for increasing benefits.

The trustees' position appears to have been that RPI as changed would, in any event, constitute the nearest alternative to RPI as it previously stood, and therefore that RPI as changed would be the appropriate index to adopt.

What did the court decide and why?

CARE revaluation/pension increases and legacy final salary revaluation

Warren J did not derive much assistance from the parties' submissions on the background to the adoption of the CARE Rules. The nature of the inflation protection intended could only be ascertained from analysis of the relevant provisions themselves.

The rules in question required the court to focus on the actual compilation of RPI. The effects of a change to the index and of accumulation were therefore irrelevant. The contrary conclusion would have required the trustees and/or the company constantly to monitor such changes and their effects. Such a requirement would have been unduly onerous and could not have been intended.

A change was held to be material if it resulted in RPI functioning and operating so that it either failed to fulfil its original purpose (that is, to provide a measure of inflation for the typical household) or did so in a manner materially different from the way it had before the change. In reaching this conclusion, Warren J drew assistance from the first limb of the rule in question, which provided that the company, with the agreement of the trustees, could determine an alternative index if RPI ceased to be published—this, he said, was an (extreme) example of the kind of material change to the functioning and operation of RPI with which the rule was concerned.

By the same token, routine changes to the way in which RPI is compiled were, as the trustees argued, simply an inherent aspect of the proper maintenance of the index. They did not constitute material changes.

It followed that changes in the treatment of, for instance, mortgage interest rates, seasonal items, car prices and rental data did not constitute material changes in compilation since they were simply improvements in data or methods and formed part of RPI's normal management.

Equally, the change in 2010 to the price collection of some items of clothing and footwear was of no relevance—the change was intended to be minor and, taken in isolation and ignoring its wider effects, did not constitute a material change in the compilation of RPI. Nor did the ONS's announcement in 2013 that the RPI formula was going to be frozen constitute a material change—a freeze, arguably, is the opposite of a change and, in any event, quite what was meant by the announcement was opaque and its consequences unpredictable.

The only relevant change that Warren J identified was the introduction of UK HPI into RPI in 2017. This constituted a material methodological change to the way that RPI was compiled, involving an alteration to the population coverage of the index. It was not merely a routine adjustment consequent upon available data.

TOPS indexation

Warren J was more sympathetic to the company's arguments concerning indexation under the TOPS Rules. He agreed that, as the company contended, 'altered' should be construed widely. Each of the various changes mentioned above was consequently sufficient to trigger the exercise of the trustees' power to determine an alternative basis of indexation.

Substitute index

Warren J emphasised that, since a material change (for purposes of CARE revaluation, CARE pension increases and legacy final salary revaluation) and a number of relevant alterations (for purposes of TOPS indexation) had occurred, the company and/or the trustees (as appropriate) were required—not simply authorised—to determine an alternative index for CARE revaluation (as well as for CARE pension increases and legacy final salary revaluation) and a new basis for TOPS indexation.

Warren J also made clear that this determination had to be made within a reasonable time (specifically, under the TOPS Rules, in time for implementation of any increases to pension). It was not open to the company and/or the trustees to rely on the relevant provisions of the scheme after a reasonable time had elapsed in order to adopt an index that was more favourable (ie, cheaper to implement).

As to what constituted an appropriate alternative index or new basis, Warren J held that RPI in its current form should continue to be used. The requirement under the provisions in question to determine 'the nearest alternative index' and to 'have regard to the alteration' at issue meant that an alternative index could not be adopted simply because it was perceived in certain quarters to be 'better'. Rather, the alternative had to be the index that most closely reflected the compilation of RPI before the relevant change (in the case of CARE revaluation, CARE pension increases and legacy final salary revaluation) or the nature of the alteration (in the case of TOPS indexation).

For purposes of CARE revaluation (as well as CARE pension increases and legacy final salary revaluation), that index was RPI as changed by the inclusion of UK HPI. The same reasoning applied in the case of TOPS indexation. Since none of the alterations that had occurred prior to the introduction of UK HPI had materially altered RPI, the trustees could not have relied on any of them to depart from RPI as thereby altered. The introduction of UK HPI was a material alteration but was not sufficient to warrant the substitution of a different index.

Warren J also held that the company and/or the trustees were only required to determine an alternative index once following any given change or alteration. The relevant rules imposed no requirement to make such a determination each time the index was applied for purposes of revaluation or indexation.

What implications does the judgment have for other pension schemes in relation to changing the index used to increase and/or revalue pensions?

The judgment focuses largely on the construction of the particular rules at issue. In the absence of rules worded in identical or very similar terms, the conclusions that Warren J reached on the specific questions before him are therefore unlikely to be of direct relevance to other schemes.

The underlying message of the judgment—the importance of carefully reading and applying the precise wording of a scheme's indexation or revaluation provisions—is, however, a fundamental one. In that regard, Warren J helpfully summarised (at para [16]) the broad principles governing the correct approach to the construction of a pension scheme's rules, by reference to *Barnardo's v Buckinghamshire* [2016] EWCA Civ 1064, [2016] All ER (D) 20 (Nov) per Lewison LJ at paras [8]–[10] and per Vos C at para [68] and to *Stevens v Bell* [2002] EWCA Civ 672, [2002] All ER (D) 301 (May) per Arden LJ at paras [26]–[32].

The judgment also includes brief consideration (at paras [130]–[134]) of the general fiduciary duties that a pension scheme's trustees are under. In particular, Warren J observed that, where trustees have an unfettered power (unlike under the rules at issue) to change the index by which members' benefits are uprated, it will be open to them to select any index, regardless of whether a change to RPI has occurred, provided they act properly in the exercise of their fiduciary obligations—taking into account what they ought to take into account, leaving out of account what they ought to leave out of account and, typically, if they consider such a substitution to be in the interests of the scheme's beneficiaries.

Lastly, the judgment sets out (at paras [21]–[34]) the ways in which RPI and CPI are compiled, the similarities and differences between the two indices, and the changes they have historically undergone. This discussion is likely to provide a useful point of reference for trustees and employers wrestling with related RPI/CPI issues.

It is interesting that Warren J not only found in favour of the continued application of RPI in the context of the case but also recognised the relevance of RPI more broadly—while holding that the respective merits of RPI and CPI were not relevant to the questions of construction he had to answer, he went on to observe that both indices protect scheme members from the effects of price inflation, that, notwithstanding the introduction of UK HPI, RPI continues to serve the purposes it did previously, and that RPI remains widely used.

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