CWU

The communications union

TIME TO DELIVER

ROYAL MAIL PENSION FUND DEFICIT

> *Life can only be understood backwards, but it must be lived forwards.*
>
> ***Soren Kierkegaard*** *(1813–1855) Danish philosopher*

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ROYAL MAIL PENSIONS: TIME TO DELIVER

Mandates matter, manifestos must deliver modernisation

In 2005 Labour pledged to the British people:

"As we said in our policy document "Britain is Working", we have given the Royal Mail greater commercial freedom and have no plans to privatise it. Our ambition is to see a publicly owned Royal Mail fully restored to good health, providing customers with an excellent service and its employees rewarding employment. We will review the impact on Royal Mail of market liberalisation which is being progressively introduced under the Postal Services Act 2000 and which allows alternative carriers to the Royal Mail to offer postal services."

Since that commitment was given, a tussle inside the Labour Party and Government has sought to re-interpret that promise. On seven separate occasions, the Labour Party has determined that manifestos matter.

The cross party consensus on the Royal Mail Pension Fund deficit is that it be has to be dealt by Government. It is what the Labour Party want. That is why the Labour Party Conference 2009 decided the following Emergency Motion which was carried unanimously, with the unanimous support of the Labour Party National Executive Committee:

Royal Mail Pension Deficit:
"Conference notes that, in an interview screened on Sky News on 22nd September, Adam Crozier, Royal Mail's CEO, suggested that Royal Mail's pension deficit may have reached £10bn. The Trustees of the scheme met on Thursday 24th September, but did not announce the level that the deficit had actually reached. Conference recognises that it is vital to achieve an early end to this destablisation of the industry which can only alarm postal workers, and customers of the service. Conference therefore calls upon the government, as sole shareholder, to take on its responsibility for the deficit and engage with all the stakeholders to resolve this matter immediately following Conference."

In this document we set out the case for the matter to be settled by this Labour Government. To do otherwise would be an abrogation of the trust of the British people.

Labour can deliver – now is the time.

Billy Hayes

Billy Hayes
General Secretary
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Dave Ward

Dave Ward
Deputy General Secretary (Postal)

SUMMARY

- The Hooper review of postal services concluded that Royal Mail's pension deficit is a significant constraint on the business and poses a threat to the universal service. It argued that the best long-term solution would be for it to be managed by central government.

- The government's decision not proceed with the Postal Services Bill has meant this vital pension reform has been shelved. This position is untenable. The government must take responsibility for the deficit if the industry is to succeed.

- Members of the Royal Mail Pension Plan have contributed to improving affordability of the scheme through the reductions in their benefits introduced in 2008.

- Royal Mail is currently paying £280m each year to service the deficit alone. Adam Crozier has suggested that the deficit may have tripled to £10bn at the latest valuation. This will mean Royal Mail is unable to make the revised necessary level of repayments.

- Lord Mandelson has recognised that the government has a moral obligation to fund the deficit, but he suggests the public would not accept this argument without being assured of the future transformation of Royal Mail.

- The government must show political leadership, explain its moral obligation and act upon it.

- Debate around the Postal Services Bill shows that all parties agree that the pension deficit must be tackled if the company is to have a future.

- The decisive issue is not 'modernisation', 'transformation' or 'EU competition law'. The key is whether the government has the political will to honour its obligation to the industry and the workforce.

- There are a number of ways the pension deficit could be dealt with. These include, but are not limited to: an extended repayment period; a 'crown guarantee'; or, direct repayments.

- The deficit can be dealt with under existing legislation. The Postal Services Bill offered only one particular route. Avoiding legislation would mean the deficit could be dealt with quickly.

- The 2009 Labour Party conference unanimously passed a motion calling on the government to take on its responsibility for the deficit and to resolve the matter immediately following conference.

- It is now time for the government to act. It must take on responsibility for Royal Mail's pension deficit.

ROYAL MAIL PENSIONS

The Hooper Report and the Postal Service Bill

1 The Hooper review into postal services published its conclusion in December 2008 following a one year inquiry. The report's findings were endorsed immediately by the government. Among them were the following statements. [1]

"The costs and risks associated with the pension deficit… pose a constraint on Royal Mail's business and, therefore, represent a threat to the universal service".

"The constraints which the pension deficit imposes on Royal Mail, particularly in terms of investment, will make it harder to achieve the necessary efficiency improvements across the business and build an innovative, responsive service for customers with the universal service at its core."

2 The report concluded that the current approach, whereby the cost of the deficit is shared between customers, Royal Mail and the shareholder, is not appropriate or effective as a long-term solution. It argued that the best long-term solution would be for the risks associated with the deficit:

"to be managed by the body – central government – that has the size and resources best suited to perform that role in a way which does not threaten the universal service".

3 The report recommended that responsibility for the historic liabilities should be transferred from Royal Mail to the government. This proposal had the support of most stakeholders and made its way into the government's Postal Service Bill. The government stood to benefit substantially in the short-term from its proposals to take on the RMPP assets and liabilities. The government would have received £23.5bn in assets immediately. Though future liabilities were estimated at £29.5bn, the £6bn deficit would have been absorbed gradually over the lifetime of the scheme.

4 The government's decision not to go ahead with the Postal Services Bill, due to opposition to its controversial privatisation plan, has also meant the shelving of this vital pension reform and of regulatory changes to the postal market. This position is untenable. The government has to take on extra responsibility for the deficit if the industry is to succeed. The debates on the Postal Services Bill, which were confined to the House of Lords, demonstrate that the government has this obligation.

The Royal Mail Pension Plan: Background

5 The Post Office Staff Superannuation Scheme (POSSS) was established in October 1969 when the Post Office ceased to be a government department and became a public corporation. POSSS was a final salary scheme with accrual rates of 1/80th per annum. The scheme was shown to be in deficit within a few years of being created. The deficit was valued at £1.1bn in 1972, rising to £1.9bn in 1976. It was not until 1988 that the scheme returned to surplus.

6 The POSSS scheme was closed to new entrants in 1987 and the Post Office Pension Scheme (POPS) was established. This was again a final salary scheme, but with a 1/60th accrual rate. Both schemes had a normal retirement age of 60. The POPS moved in to deficit in March 2000 and a repayment schedule of annual £50m payments began in March 2001.

[1] *See Annex C.*

7 In 2000 POSSS and POPS were merged to form the Royal Mail Pension Plan (RMPP). The two schemes remained as separate sections within the plan. POSSS became section A and B and POPS section C. The RMPP closed to new members on 1st April 2008. Existing member benefits ceased to accrue on a final salary basis and accrual continued on a Career Average Revalued Earnings (CARE) defined-benefit basis [2]. A defined-contribution scheme was established for new entrants. The additional changes to the scheme included a commitment that accrued benefits/pensionable service up to April 2008 would be paid on a final salary basis and that the retirement age was changed from 60 to 65.

8 The 2008 changes represented a reduction in pension provision for all active and future pension scheme members. This means members of the RMPP have played their part in improving the affordability of the pension scheme.

9 In March 2008 the RMPP had a total of 452,131 members. 161,078 employee members, 113,296 deferred members and 177,757 pensioner members.

The Level of Deficit

10 The POSSS scheme moved in to deficit three years after its inception in 1972. At this stage the deficit was £1.1bn. By 1976 it had risen to £1.9bn. Revalued at today's prices, these deficit valuations were £9.5bn and £8.9bn respectively. POPS faired better, staying in surplus for its first 12 years, until 2000. The RMPP went in to deficit in 2001.

11 Pension schemes undergo two forms of valuation. The first – 'actuarial' valuations – are required every three years and form the basis of a deficit repayment schedule. The second, FRS17 or IAS19, is an accounting measure of pension fund assets and liabilities that companies are obliged to list on their balance sheet. Royal Mail's FRS17 valuation is highly volatile and has fluctuated by up to 40% in recent years. It is also often widely out of keeping with the more important actuarial valuation. For example in 2006 when the actuarial valuation stood at £3.4bn the FRS17 valuation stood at £5.6bn. The quoting of FRS17 valuation figures has been at times unhelpful and at worst misleading, given its volatility and the fact it has no bearing on the repayments made by Royal Mail.

12 The actuarial valuation of Royal Mail's pension deficit stood at £2.5bn in 2003. Following this and until the next valuation in March 2006, the business was making annual repayments of between £140m and £150m, based on a 40 year repayment schedule. The next actuarial valuation in March 2006 was £3.4bn. It was on this basis that the current 17 year repayment schedule of approximately £280m was agreed. The latest valuation took place in March 2009. The deficit level is yet to be made public. Adam Crozier, Royal Mail's CEO, has stated that the deficit currently stands at £10bn. Some estimates suggest it is even higher.

[2] *Pension entitlement under a Career Average Revalued Earnings (CARE) scheme accrues as a proportion of each year's pensionable earnings revalued in line with inflation (often with a cap).*

Table 1: **Royal Mail Pension Funds Actuarial Valuations 1988 to 2006**

Actuarial valuation valuation date (31st March)	POSSS		POPS	
	Funding level (%)	Surplus (deficit) (£m)	Funding level (%)	Surplus (deficit) (£m)
1988	103.6	219		
1989	109.6 (interim)		103.8	11.14
1990	122.8 (interim)		n/a	n/a
1991	122.4	1,442	n/a	n/a
1992	n/a	n/a		
1994	104.0	374	n/a	n/a
1995	n/a	n/a		
1997	101.9	206	n/a	n/a
1998	106.9	865	100%	0
1999	n/a	n/a	94% (interim)	(120)
2000	106.1	890	94.9%	(130)
	RMPP			
	Funding level (%)		Surplus (deficit) (£m)	
2003	82.5		(2,500)	
2006			(3,400)	

***Source**: Royal Mail clarification statement to Trade and Industry Committee 25 November 2005; Royal Mail Annual Report and Accounts 2007.*

Why a Deficit?

13 A major cause of the current deficit in Royal Mail's pension fund is the 13 year pension contribution holiday taken by the business between 1st April 1990 and 31st March 2003. While it is not strictly possible to measure the level of contributions that were missed, a rough estimate based on the level of contributions before and after the holiday, would be approximately £100m per year, or £1.3bn in total (approximately £1.9bn revalued at today's prices). Had it been invested at the time, the £1.3bn would be worth considerably more through a combination of investment returns and asset growth. This would have gone a long way towards preventing, or at least minimising, the current deficit.

14 Royal Mail claims that they had no choice but to stop making contributions to the fund during this period. In evidence to the then Trade and Industry Select Committee, Royal Mail stated:

"Under the Prescribed Basis (set out in Schedule 22 to the Income and Corporations Taxes Act 1988) employers have to take action to utilise any surplus assets above the 105% funding level on this basis either to improve benefits or take a contributions holiday… It did not make economic sense to continue making contributions, only to take a contributions holiday enforced under this legislation."[3]

[3] *Trade and Industry Committee, "Royal Mail after Liberalisation", Second Report of 2005–06.*

15 Assuming this to be the case, there is then collective responsibility for the deficit shared by the business, government and actuaries. The business could have done a number of things. It could and should have shared any savings. It could have reduced members' contributions that remained unchanged while the business was contributing nothing. It could have improved benefits. It could have voiced concern that preventing the scheme being in surplus could make future deficits more likely. By not paying in to the scheme Royal Mail made huge annual savings that it was not prepared to share. Scheme members received no benefit from this period of abundance but have been expected to share the losses by accepting inferior pensions.

16 Responsibility also lies with the government. Preventing companies from sustaining a sufficient surplus to mitigate the risk of future deficits was short sighted and potentially damaging. The government has a duty to make good the impact of this policy. Moreover, the government took advantage of Royal Mail's years of profit. For many years Royal Mail was required to generate funds for the Exchequer through the External Financing Limit (EFL) regime. The EFL ran between 1976/77 and 1998/99. A total of £2.48bn was generated for the government during this period. The ONS calculates that at today's prices this would be worth £4.1bn. As it recognised by previously proposing action on the deficit, the government has a duty to make good a situation it did much to create.

17 Royal Mail attributes the increased financial pressure they are under in part to the shorter deficit repayment periods introduced by the pensions regulator. Before 2006 the deposit was being paid off over a period of 40 years. The 2006 agreement with the trustees settled on a shorter repayment period of 17 years. Lower than expected investment returns and improved longevity assumptions have also had an impact on the pension deficit; however they are not, as Royal Mail claim, the only cause.

18 All stakeholders agree that the cost of servicing Royal Mail's pension deficit has become unmanageable. Following the 2006 valuation, Royal Mail pays approximately £280m per year towards the deficit alone. On top of this, regular pension payments are in the region of £550m a year, although these will reduce once the impact of the 2008 pension changes are felt. In 2007/08 the company paid the equivalent of 30% of pensionable pay in pension contributions. 20% of this was towards ongoing contributions and the remaining 10% went towards clearing the deficit. By 2010 the company anticipates paying 11% for current service, a reduction of 9%. However, with an anticipated actuarial valuation for 2009 of at least £10bn, if repaid on a similar schedule as 2006, a tripling of the pension fund deficit repayments to nearly £1bn might be expected. Clearly Royal Mail is not in a position to make these repayments and government intervention is essential.

The 2008 Pension Changes

19 In February 2007 Royal Mail announced a six month consultation on the closure of the RMPP. The fundamental problem Royal Mail sought to address was the £850m per year being paid into the scheme – to cover the deficit and ongoing pension liabilities – coupled with the risk associated with final salary schemes, where Royal Mail argued the viability of the company is highly exposed to changes in life expectancy and the performance of investments.

20 Disagreement with the CWU over Royal Mail's proposal for the pension scheme meant the issue formed a major part of the 2007 industrial dispute. Eventually the pension issue was decoupled from those of pay and modernisation as part of the resolution to the dispute. A joint statement from the CWU and Royal Mail was issued which outlined Royal Mail's revised pension proposals and provided a commitment to review them further during a period of formal consultation. The CWU although recongising the need for change, was clear that change had to be the subject of full negotiation and agreement. The union's position was detailed in our letter to the chair of the Royal Mail Pension Scheme Trustees dated 27th March 2008, see Annex D.

21 Royal Mail's revised pension proposals were as follows:

- Pensionable service before 1 April 2008 remained calculated on a final salary basis
- Service after 1 April 2008 calculated on a CARE basis
- Normal retirement age to rise from 60 to 65 from 1 April 2010
- Existing members able to take pre-April 2008 accrued pension unreduced at 60
- Scheme closed to new members from 31 January 2008 (this was later extended to 31 March 2008)
- A defined-contribution scheme to be introduced for new entrants

22 The union was successful at protecting past service, delaying the impact of an increase in pension age and in protecting future accrual for members through an indexed CARE scheme. The union was disappointed not to be able to retain a defined-benefit scheme for new entrants and sought improvements through the 60 day formal consultation and beyond.

23 Insufficient further improvements to the proposals coupled with Royal Mail's failure to respond to widespread negative feedback during the formal consultation meant that the CWU was unable to support the pension proposals. UNITE, who represent middle-management grades in Royal Mail, also rejected the proposals. Royal Mail went on to implement the pension changes without agreement.

WHAT THE POLITICAL DEBATE HAS REVEALED

24 The first reading of the Postal Services Bill was heard on 25th February in the House of Lords. This was a formality, and it was not until the second reading on the 10 March 2009 that the issues were debated.

25 The main elements of the Bill were:

- A proposal to privatise up to 49% of Royal Mail
- The separation of Post Office Limited which was to remain 100% publicly owned
- A sectionalisation of Royal Mail Pensions to reflect these changes – including the government Taking on the deficit up to the assumed introduction of the legislation in March 2010
- A reform of the regulation of the industry with the abolition of Postcomm and its functions being transferred to OFCOM

26 In his introductory remarks to the legislation, Lord Mandelson expressed government concerns about the future of the industry, but made it plain that the government is committed to the industry for the future:

*"I do not accept that postal services are locked into an inevitable decline. I believe that mail is still a critical part of our social fabric, our communications infrastructure and our economy". **(Hansard 1063 10/03/09)**.*

27 He did sound alarmed about Royal Mail's pensions deficit:

*"Its already massive pensions deficit is projected to increase significantly at the next tri-annual valuation. The Company will not be able to afford any extra deficit recovery payments required… There would be no money for modernisation". **(Hansard 1065 10/03/09)**.*

28 Clearly the future significance of Royal Mail is not dependant upon privatisation, but upon the role the industry plays in the broad economy. Equally, this continued value for the whole economy demands action on the deficit, before the company declines under the weight of repayments.

29 To Lord Mandelson there was a practical link between tackling the pensions deficit and modernising the industry:

*"The pension scheme represents a major burden for Royal Mail in spite of recent changes made to address it. In my view, it is inconceivable that the public will accept such a 'bail out' without the government taking steps that the company has a transformed future. The fact is that it has not modernised sufficiently under present policies. There needs to be a step change, and the public needs to see this. The new arrangements will also require the approval of the European Commission". **(Hansard 1067 10/03/09)**.*

30 We shall return to the need for European Commission approval in due course. For now, it is sufficient to note that Lord Mandelson says that the public will not accept the government taking on the pension deficit unless the company has a "transformed future".

31 This is not synonymous with privatisation. Were it so, Lord Mandelson would have so defined it. Rather, a transformed future, must be understood to be about the service and functioning of the industry, i.e. that it is sufficiently modernised.

32 The CWU certainly endorses the need for a transformation of the industry, and its complete modernisation. However, we do not accept that as identical to privatisation. The Compass pamphlet 'Modernisation By Consent' clearly demonstrates this.

33 Lord Mandelson was clear that the government has to take on substantial liabilities. The legislation would have created a new public pension scheme whose establishment the government would facilitate:

*"we estimate the total liabilities in the new scheme – as at 31 March 2010, the likely date of implementation – to be 29.5bn. Assets transferred to government are forecast to be £23.5bn. That means the government will absorb an expected deficit of £6bn". **(Hansard 1067 10/03/09)**.*

34 Clearly the absorption was substantially higher than any amount of money to be expected from the part privatisation. A rumoured figure of £3bn for a 30% share was widely circulated. Therefore it was never the case that privatisation would fund the deficit. It was always clear that the government would.

35 Moreover it was always clear that modernisation was the issue over privatisation, as Lord Mandelson expressed it:

*"… we cannot ask the tax payer to take responsibility for a pension deficit without assurance that Royal Mail will modernise". **(Hansard 1067 10/03/09)**.*

36 It did seem that the Tories were more insistent on the privatisation issue. Lord Hunt said:

*"… this Government's refusal to address the problems of the Royal Mail in a timely manner has led us to a place where there seems to be no other honourable, acceptable or equitable way out. We therefore regretfully agree with the Hooper Review that when a successful private partnership is found for the Royal Mail, the Government should step in to prevent the pension scheme going under". **(Hansard 1075-76 10/03/09)**.*

37 At first sight the Tories have a clear link between privatisation and the deficit. But what then is the issue of 'honourable' and 'equitable' other than an unintended reference to the obligation the government has to its own employees pension.

38 Other Tory speakers were less equivocal, Lord Fowler said:

*"On balance, I am persuaded by one measure – the plan to tackle the £6bn pension deficit, it is obviously massive, and it is difficult to see how the business can truly prosper and modernise with such a financial weight around its neck". **(Hansard 1089 10/03/09)**.*

39 The clearest expression of the issue was that of Lord Haskel (Labour):

*"The Minister says that if the tax payer is going to pay for the pension fund deficit, in return the tax payer has to get an improved letters service. I am afraid that I find this inter-relationship less than convincing. If the Government are going to fund the pension scheme deficit, they should do so because it is morally right because of responsibility and because of undertakings given in the past". **(Hansard 1084 10/03/09)**.*

40 Coming from a supporter of the Bill, this clear statement of government obligation elicited an interesting reply. Lord Mandelson said:

*"My noble friend Lord Haskel rightly suggested that as a government we are morally obliged to fund this pensions deficit, but I have to underline a point in conclusion about pensions… It is inconceivable that the public will simply go along with a bail out of this fund in this part of the public sector… The public will accept such a bail out only… if the Government takes steps to ensure that the company as a whole has a future and is engaged in transforming the service it provides". **(Hansard 1132 10/03/09)**.*

41 Lord Mandelson begins by accepting the 'moral obligation' – i.e. something which cannot be dependent upon vulgar commercial consideration. He then attempts to dilute this by suggesting that the public has less elevated moral standards than government. The public has to be assured about the future transformation of the company – not the issue of the debt the government owes to postal workers.

42 A clearer demonstration of political leadership would be to explain to the public why the government has a moral obligation. Is that too much to ask? It would also be a demonstration that the government does have a consistent grasp of morality, and will not allow itself to trade moral clarity for political expediency.

43 As the debate progressed, and the campaign against the Bill secured support, so the issue of expediency asserted itself. On the second day of the Committee Stage Lord Mandelson said:

*"… the Government intends to use the money received from the minority shares sale to benefit Royal Mail Group, including Post Office Limited. Obviously, there is a case for partially offsetting the cost of Government of taking on the pension deficit, and of course, anything that tackles the pension deficit releases Royal Mail revenue to invest in modernisation". **(Hansard 97 31/03/09)**.*

44 The disparity between the size of the deficit, £6bn according to the government, and the anticipated sale revenues, around £3bn has already been noted. But the additional suggestions of support for Post Office Limited and revenues for modernisation from this sum was stretching credibility far beyond breaking point.

45 Although the Bill was being debated in the House of Lords, the House of Commons Business and Enterprise Committee (BEC) had taken evidence earlier in the year on the Bill, and produced a report 'The Postal Services Bill' on the 1 April 2009. As a cross-party body of MPs its findings were an anticipation of the difficulties that the Bill would have faced had it ever reached the point of a debate in the Commons.

46 In its summary the report made the following conclusion:

"We agree with two key aspects of the proposals. First, that the government should take responsibility for the historic pensions deficit. Most of its liability stem from Royal Mail's time as a monopoly provider. It needs to be freed from them, as many of its European counterparts have already been freed. Moreover, pension fund members deserve to know that their pensions are secured. Second, we also agree that a new regulatory framework, in which the postal services are viewed as part of a wider communications market, is entirely appropriate.

*However, we do not consider either the Independent Review, or the Government has properly made the case that these two reforms, about which there is a broad consensus, can only be made as part of a package which includes the third reform – the involvement of a private sector equity partner in Royal Mail. Similarly, we are not persuaded that the provisions contained in the Bill allowing such a partnership are necessary or desirable." **(Report page 3).***

47 This represented an extraordinary setback for the supporters of the Bill. In the House of Lords the Bill was being supported by the government, and the two main opposition parties. The opposition from a minority of Labour Peers was led with great tenacity by Lord Clarke. Yet the BEC Committee, composed of MPs of the same parties, rejected the defining feature of the Bill.

48 The BEC Committee placed the issue of the pensions deficit in a larger context than that assumed by the government:

*"Over many years the Trade & Industry Committee warned about Royal Mail's Group pensions deficit. Competitors coming later to the United Kingdom market have not been burdened by such historic deficits. We note that in other countries the pension deficits of the universal service operators have been dealt with as part of the preparation for the postal market opening. We agree that Royal Mail's Group pension deficit needs to be tackled as a matter of urgency". **(Para 115 pages 38-39)**.*

49 The criticism implied was clear. The postal market had been opened earlier and more extensively in the UK than in the major EU economies. Yet less provision had been made by the government, or Postcomm, to protect Royal Mail's financial position.

50 Nor was this it case that national government provision had only been made for privatised companies like TNT and Deutsche Poste. The French national provider, La Poste was also aided on this count, whilst remaining a public provider. ***(See para 119 page 39)***.

51 Returning to the issue of State Aid under EU Law, as promised earlier, Lord Mandelson put the question as starkly as he could:

"…a bail out of a pension fund on this scale is clearly State Aid and is quite a tall order. It requires clearance by the European Commission. We will be in a position to obtain that clearance from the Commission if the measures that we are adopting to tackle the pension fund deficit are accompanied by modernisation, reforms and transformation of the business, which the legislation as a whole, including the introduction of a minority strategic partner aims to achieve. If anyone imagines that it would be simple or even possible to go ahead simply with a bail out of the pension fund and nothing else, I am afraid that they are not weighing properly the implications of that State Aid clearance. I do not think that we would get it. Therefore, the idea that we could simply

*go ahead with the part of the Bill relating to pensions and the changes that we are proposing that affect the regulation and get State Aid clearance as a result is fanciful. That is why we have no alternative, even if we wanted one, but to go ahead with the legislation in its entirety and not cherry pick bits of it". **(Hansard 985 31/3/09)**.*

52 Certainly there are ambiguities in Lord Mandelson's statement. Once again, he implies acceptance that "modernisation, reforms and transformation of the business" are not synonymous with privatisation. But he winds up suggesting that because of EU State Aid Rules the government have provided the only route to resolving the pension deficit problem in its privatisation proposals.

53 This was not a view shared by the BEC committee report. Referring to the 2nd EU Postal Directive the Committee wrote:

*"The universal service is a service of general economic interest and indeed one of the most appreciated of such services. The United Kingdom will be taking action to ensure continued provision of that service, and it is taking that action only after it had cleared that is necessary. The majority of the liabilities it assumes will date from before market opening. Royal Mail Group will be left with significant pension liabilities, and will lose the assets underpinning the pension scheme. The universal service provider will remain subject to regulation to prevent market abuse. In our view a strong case can be made for State Aid clearance for removal of part of RMG's pension liabilities without radical restructuring or compensating competitors." **(para 120, page 40)**.*

54 Although this is written on the assumption that there would be a new public pension scheme in line with the Bill which took over the existing assets, the general point about Royal Mail being the universal service provider was decisive, and was clearly being downplayed by government spokes persons.

55 For example, speaking on behalf of the government Lord MacKenzie said:

*"The Noble Lord has asked what would happen if State Aid is not forthcoming. My Noble friend the Secretary of State has made clear the linkage of these propositions. If the provisions in the Bill cannot be taken forward then the next evaluation would have to be undertaken and the Trustees would need to engage with the sponsoring employer in setting out a recovery plan consistent with the regulators direction and guidance on these issues." **(Hansard 998 31/03/09)**.*

56 Not that the government was coming under pressure from the official Opposition in the Lords. On the contrary, Lord Skelmersdale on behalf of the Tories endorsed the pension linkage and moved an amendment which would have prevented the Government from enacting the proposals to take on the deficit until the other proposals in the legislation had actually been implemented. (Hansard 1004-5 31/03/09)

57 Whilst agreeing with the government the Tories could not avoid the fact that failing to address the deficit had major consequences. Again Lord Skelmersdale said:

*"We agree with the Government that the rescue is necessary; the alternative, of sitting on our hands and letting a major pension fund close, possibly bringing down the PPF with it, is completely unacceptable. This regrettable necessity does not mean that we are particularly happy about having to spend billions of pounds of tax payers money in this way". **(Hansard 1048 31/03/09)**.*

58 The point about the Pension Protection Fund (PPF) was well made. Despite an investment portfolio worth £2.9bn, the PPF itself announced a deficit of £1.2bn in 2009. With Royal Mail's anticipated deficit of £6bn and growing, calling upon its assistance would bankrupt the PPF. But equally for the opposition, the fact remains that whatever the fate of the Postal Services Bill, the pensions deficit has to be addressed.

59 There was almost no debate as to how the deficit was created. But on behalf of the government, Lord MacKenzie did note that government action had played a part:

"I will just say this in relations to the pensions holiday: It was my understanding that the legislation of the previous government put pension schemes in this position. That may not have been dealt with earlier enough by a subsequent government. I was interested in the comment that the position was forced upon the Government by the Inland Revenue. That was an interesting prospective put by the Noble Lord. The pensions holiday is a matter of fact. There was a long period during which contributions were not paid into the scheme. It is difficult to discern what the subsequent funding arrangements might have been after the 2003 tri-annual valuation, had there been more funds in the scheme in the interim. However, that is history and we are where we are".
(Hansard 1050 31/3/09).

60 Such a fastidious manner in addressing this problem deferred responsibility for creating the deficit from any specific government, and seemed to imply that how the deficit came about was far less important than other matters being debated. However much the attempt is made to distance government from the creation of the deficit, the fact remains that it was the Conservative government, and the Labour government after it, whose actions created the deficit. Now is the time to address this for the sake of the industry and for the sake of those who work in it.

FINDING A SOLUTION

61 One of the most important conclusions that can be drawn from the debate around the Postal Services Bill is that all parties agreed that the pension deficit has to be addressed if the company is to have a future.

62 Now that the Bill is history, it is vital to act upon the pensions deficit. Current deficit payments are around £280m per year over and above the normal pension payment. If the deficit is the estimate offered in the House of Lords debate – £6bn – then the company faces doubling its payments. If the estimate is in the region of £10bn suggested by Adam Crozier in a Sky News interview on the 22 September, then the company faces its repayments being tripled. Either case is unsustainable. It is therefore crucial that the deficit is addressed as quickly as possible.

63 The CWU believes that the decisive issue on this is not 'modernisation', 'transformation' or 'EU Competition Law'. The key is whether the government has the political will to honour its obligation to the industry and the workforce.

64 If the will is there then there are number of ways to resolve this problem. These could include: agreeing a much extended repayment period which is long enough to allow the industry to function; providing a Crown guarantee on the deficit; or, direct government repayments to the fund. Doubtless there are other methods the government could employ once it chooses to do so.

65 It is important to stress that the deficit can be dealt with under existing legislation. The Postal Services Bill offered a particular route to deal with the deficit at the same time as Royal Mail was being legally restructured. This was convenient for the government, but not essential. After the Bill, the issue remains as important as ever. Avoiding, if possible, legislation means that the matter can be dealt with due speed.

66 Whatever the method finally chosen by government the issue of European Commission will have to be addressed. In the debates around the Bill the government confirmed that it had had preliminary discussions with the European Commission. No amount of questioning in the debates, or direct to Ministers outside the debates, was able to draw out how the Commission had responded. But the fundamental view presented by government spokesperson was that a 'transformation' of the industry is essential to win the Commission over. As pointed out earlier, this is not identical to privatisation, or exclusively linked to it.

67 The fact is that Royal Mail have been undergoing a series of restructuring initiatives since 2001 in parallel to a liberalisation of the postal market. It is also true that the current 'modernisation' negotiations between Royal Mail and the CWU amount to a further transformation, or restructuring, of the industry. It is only necessary for the government to marshal the arguments in this case in anticipation of addressing the Commission in future.

68 One way of achieving this would be the proposal summarised in Annex A. This has been prepared for the union by Thompsons Solicitors. Further proposals can be found in the annex produced for the union by Hilary Salt, see Annex B. We believe there are other routes which could be examined, once the government demonstrates the will to resolve the problem.

69 At the Labour Party Conference 2009, the following emergency motion was carried unanimously:

"Conference notes that, in an interview screened on Sky news on the 22nd September, Adam Crozier, Royal Mail's CEO, suggested that Royal Mail's pension deficit may have reached £10bn. The Trustees of the scheme met on Thursday, 24th September, but did not announce the level that the deficit had actually reached. Conference recognises that it is vital to achieve an early end to this destabilisation of the industry which could only alarm postal workers, and customers of the service. Conference therefore calls upon the Government, as sole shareholder, to take on its responsibility for the deficit and engage with all the stakeholders to resolve this matter immediately following Conference".

70 To date the government has yet to act upon the decision of the whole Party. Yet Conference was clear on the urgency of this issue – it wanted to 'resolve the matter immediately following Conference'. All that now remains is for the government to act on this in line with this generally understood obligation to do so.

ANNEX A
THOMPSONS SOLICITORS: ROYAL MAIL PENSION PLAN – DEALING WITH THE DEFICIT

There are restrictions on the way in which the Royal Mail Pension Plan (RMPP) can be funded:

- The governing legislation is the Postal Services Act 2000. It allows the Government to make loans to the Royal Mail Group (RMG)at commercial rates and to give guarantees for RMG's indebtedness. It does not give the Government a power to make grants.

- Any financial support for the RMG or the RMPP must comply with European law on State Aid.

With the political will there is scope within the constraints of the Postal Services Act 2000 and European State Aid rules for the Government to ameliorate or eliminate the RMG's pension problems.

Guarantees (1) – in the event of insolvency

The Government could give a guarantee that, if the RMG becomes insolvent, the Government will meet part or all of its pension liabilities.

This gives members of the RMPP the security of knowing that, in the event of an insolvency and a pension scheme deficit the members will not be transferred to the Pension Protection Fund.

More significantly such a guarantee would have the effect of reducing the amount of the deficit that has to be made good by enabling future liabilities to be valued on a less pessimistic basis.

Pension scheme liabilities are valued on the basis of assumptions about the future. If there is a risk that an employer may become insolvent, the trustee has to use more conservative assumptions, which, in turn, increase the estimate of liabilities. A trustee also has a duty to get the deficit, (which is treated as a debt owed by the employer) paid off as quickly as possible A trustee with a guaranteed deficit can afford to take a more realistic or 'relaxed' view about the future investment returns etc and allow a longer time-scale for paying it off.

Giving a guarantee that is only triggered in the event of insolvency does not raise European State Aid problems because it does not distort competition (provided the RMG pays the same levies etc). The guarantee pre-supposes that RMG is no longer a competitor to anyone.

Guarantees (2) – guaranteeing the RMPP's deficit while RMG is a going concern

This raises State Aid issues – see below.

- Without new legislation, the RMPP could be restructured as a sectionalised scheme with a separate section for past service liabilities accrued before a specified date.

- The Government could use its statutory power to guarantee the liabilities of the RMPP accrued before that date.

- Under the terms of the guarantee the Government could guarantee and, with State Aid approval, pay the deficit repair contributions required to account for both the full amount of the deficit that probably existed on a buy-out basis in 2001, and the worsening of that deficit caused by the fact that the assumptions made in 2001 have not been borne out in practice.

RMG already has a £1bn guarantee in place, funded by the Government: the required structure already exists.

State Aid

The Government would not be able to make payments to the RMPP under a guarantee, if RMG is a going concern, unless State Aid approval was obtained from the European Commission. State Aid approval was granted in 2006 enabling the Government to provide £4bn support for RMG (including the £1bn pension fund guarantee).

The Government intended to set the RMG up on an arm's-length basis with sound finances free from liabilities under the Postal Services Act 2000 but failed to do so properly.

It should have restructured the RMPP so that past service liabilities were ring-fenced and underwritten by the Government. That would have been consistent with both (1) the statutory private sector requirement on withdrawal from a pension scheme to pay the full cost of buying out past service liabilities; and (2) practice in other public sector "start afresh" cases (where past service liabilities have been ring-fenced and underwritten by the Government).

State Aid approval should be sought on the basis that this should have been done when the Post Office was restructured in 2001.

The Commission would normally expect State Aid to accompany a further restructuring of the business. The CWU suggestion that Royal Mail should be set up as a 'not-for-profit' company similar to Network Rail would be a restructuring. A sale of a stake in Royal Mail Holdings to a competitor (a partial privatisation) would simply distort competition and would not get past the Commission.

T THOMPSONS SOLICITORS

ANNEX B
REPORT TO THE CWU: MANAGING THE ROYAL MAIL PENSION PLAN

Hilary Salt Fellow of the Institute of Actuaries
Scheme Actuary
First Actuarial
15 December 2009

CONTENTS

INTRODUCTION AND SUMMARY

The actuarial valuation as at 31 March 2009 will show a rather higher deficit than as at 31 March 2006, and is likely to show a higher deficit than the FRS17 pension disclosure in Royal Mail Holdings plc accounts as at 29 March 2009.

Possible responses to this include:

- The Government should contribute to the scheme as the trustees require. The Government should abide by the standards of funding it has created. It should rise to the funding requirements of the RMPP in the same way as it requires of the private sector.

- The UK's funding standards derive directly from the European Union Directive 2003/41/EC, generally known as the Pensions Directive. The Government, as sole owner of the business, should ensure that contributions to the RMPP are sufficient to comply with the Pensions Directive.

- Postcomm should make allowance for sufficient deficit reduction contributions in its next price and service quality review, which is imminent. Postcomm should not frustrate the requirements of the law on scheme funding by making insufficient allowance for deficit contributions in its price controls. Postcomm has a statutory duty to ensure that the Royal Mail has sufficient financial resources to finance its regulated activities, and providing for the pension scheme is a part of that.

- The Government can and should create a Crown guarantee by which the State meets any deficit in the pension scheme if the sponsoring employer becomes insolvent. This would be analogous to a parent company providing a guarantee to a wholly owned subsidiary company. More directly, the Government could provide a Pension Protection Fund style of contingent asset to the RMPP. Again, the Government should apply to itself the standards of conduct it expects of the private sector.

Finally, if the outcome of the above is little or no additional contributions beyond those already planned, there need not be a negative reaction to worse funding news, such as further benefit accrual reductions or closure of the scheme to accrual entirely. We show in section 4 that there is a reasonable investment strategy by which the scheme can be expected to provide its benefits in full given the existing assets and deficit reduction contribution commitments. Or if the present rate of deficit reduction contributions is extended up to 40 years, the present investment strategy suffices.

WHERE WE ARE

Actuarial valuation as at 31 March 2006

The valuation for statutory funding objective purposes had the following balance sheet as at 31 March 2006:

Assets	£21,889m
Liabilities	£25,241m
Deficit	£3,352m

The annual contributions to clear the deficit were agreed to be £260m in the first year, the amount due increasing each year in line with the increase in the RPI, for a period of 17 years.

The key assumptions for valuing the liabilities were:

Rate of return before retirement:	7.25% pa
Rate of return after retirement:	4.5% pa
Rate of inflation	2.8% pa

FRS17

The funding position of the Royal Mail Pension Plan (RMPP) reported in Royal Mail Holdings Plc's accounts for the year to 29 March 2009 is:

Assets	£20,071m
Liabilities	£26,847m
Deficit	£6,776m

The key assumptions for valuing the liabilities were:

Rate of return	6.4% pa
Rate of inflation	3.2% pa

The effective date of the disclosures is very close to the effective date of the next actuarial valuation of the RMPP, which is due as at 31 March 2009. This makes them very useful for considering what the actuarial valuation might show.

Notwithstanding that the technical basis of the pension disclosures under FRS17 has little to do with the scheme specific funding regime, the Pensions Regulator uses it as one of its reference points to judge whether trustees have been prudent enough in the setting of their funding basis.

Postcomm also uses it as a reference point when making its pricing judgements. It is likely that the trustees will seek to set a scheme funding basis that shows a higher deficit than the FRS17 deficit. Since drafting this note, Adam Crozier has been reported as saying the deficit is at least £10bn.

THE WAY FORWARD

The scheme specific funding requirements

It is likely that the trustees of the scheme will produce a valuation on assumptions they think will be acceptable to the Pensions Regulator, which we would expect to show a considerable deficit. If so, we can think of the following reactions:

- The Government should contribute to the scheme as the trustees require. The Government should abide by the standards of funding it has created. As sole owner of the business, the situation is analogous to funding being provided by a parent company for a wholly owned subsidiary, which is common in the private sector. The Government should rise to the funding requirements of the RMPP in the same way as is required of the private sector.

- The UK's funding standards derive directly from the European Union Directive 2003/41/EC, generally known as the Pensions Directive. The Government, as sole owner of the business, should ensure that contributions to the RMPP are sufficient to comply with the Pensions Directive.

- If the amount of Government funding it can be persuaded to provide is insufficient to fund the scheme to the standard the trustees require, Postcomm should make allowance for sufficient deficit reduction contributions in its next price and service quality review. Postcomm should not frustrate the requirements of the law on scheme funding by making insufficient allowance for deficit contributions in its price controls.

- Failing sufficient deficit reduction contributions from either of these two sources, the analysis of section 4 shows that the scheme can be managed within its existing resources. Of course more resource would be preferable, but without it the scheme can be invested prudently and still expect to deliver its benefits in full. A large deficit should not be allowed to result in pessimism about the future and further benefit cut backs or even closure to accrual.

If there is conflict between the Government contributing to the scheme in accordance with the EU Pensions Directive and EU rules on state aid, that is, if complying with one EU requirement is a breach of the other, then let's press for compliance with the EU Pensions Directive.

Postcomm

Postcomm in its 2006-10 price and service quality review made allowance for the funding of the pension scheme deficit. Postcomm has a statutory duty to ensure that the Royal Mail has sufficient financial resources to finance its regulated activities, and providing for the pension scheme is a part of that.

It stated that it believed it would be appropriate to use any investment outperformance to further de-risk the RMPP's investment strategy.

The scheme management procedure outlined in section 4 adopts the lowest risk investment strategy that is affordable from time to time, and therefore is in full sympathy with Postcomm's view.

Although we have not assumed in section 4 that the deficit reduction contributions will increase, it is within Postcomm's power to increase the allowance for deficit reduction contributions in its considerations at the next price and service quality review. Any additional funding for the scheme provided for by price increases is to be welcomed. It would help minimise the equity allocation and the associated investment risk, which Postcomm has said it would like to see.

Additionally or alternatively, the length of the deficit recovery period could be extended, up to the 40 years allowed in the RMPP's trust deed. An extension of the deficit recovery period should not be used as a reason to reduce the annual amount payable. Indeed, the Pensions Regulator requires that deficit recovery contributions are not reduced if the deficit has worsened since the contributions were agreed.

Other regulatory activity going on at present includes:

- BT is negotiating with Ofcom for the inclusion of deficit reduction contributions in their pricing controls. BT's situation is unusual for not already including deficit reduction contributions in their regulatory regime.

- Ofgem's regulation of the electricity and gas networks has long allowed for ongoing pension accrual and deficit contributions. It is presently trying to devise a mechanism for seeking to distinguish between deficit arising from issues affecting all schemes, and deficit arising from energy company "mismanagement" of the scheme.

Contributions to deficit arising from issues affecting all schemes may be included within the pricing mechanism. Contributions to deficit arising from company mismanagement of the scheme may not be included within the pricing mechanism, but must be provided for by means of a reduced return to shareholders.

Crown guarantee

We feel that creating a Crown guarantee by which the State meets any deficit in the pension scheme if the sponsoring employer becomes insolvent is helpful, for the following reasons:

- It secures the members' benefits. While the maths in the section 4 shows that the scheme can expect to deliver the benefits in full while invested mostly in a low risk way, and there is scope to invest a greater proportion of the assets in equities if needs be, the ability of RMH to add further resource to the scheme is very limited and the risk of the scheme failing to provide all benefits in full is non-zero. A Crown guarantee would cover off that risk.

- It removes the risk of an extremely large scheme from entering the Pension Protection Fund. The Government has an interest in ensuring that the PPF works over the long term. Were RMPP to join the PPF with a large deficit, it would be extremely burdensome for the PPF and levy payers.

- It is legally possible. The Crown guarantee in relation to the BT Pension Scheme was not deemed state aid by the European Commission.

- It would reassure the Pensions Regulator in its role of monitoring the prudent management of pension schemes. The issuing of a Crown guarantee in connection with the RMPP, and the issuing of a parent company guarantee in respect of a wholly owned subsidiary company, seem somewhat similar concepts.

We are aware of the legal activity surrounding BT and its pension scheme's Crown guarantee. An EC decision of 11 February 2009 said that the exemption from the PPF levy due to the Crown guarantee constituted state aid and must cease. This was in the grounds that BT's competitors must pay the PPF levy and therefore so must BT, if BT is not to have a competitive advantage. BT is appealing.

Setting aside whether or not a Crown guarantee can be permitted to reduce the PPF levy payable, the primary purpose of it, which is to secure members' benefits, still stands.

Pension Protection Fund contingent assets

The Pension Protection Fund allows contingent assets to be set up and be counted in the calculation of the PPF levy. A contingent asset may be:

- A guarantee given by a parent company or group of companies
- Security over cash, real estate and securities
- Letters of credit and bank guarantees

The PPF provides standard legal forms for the setting up of a contingent asset. A contingent asset must be set up using these forms to count towards the calculation of the PPF levy.

It is not immediately obvious why the Government cannot enter into a PPF contingent asset agreement. As the owner of the Royal Mail it is the parent and presumably eligible to do so. A parent company guarantee of the Section 75 deficit could be very similar in effect to a Crown guarantee. The Government would merely be implementing a procedure available to all other companies, and therefore it might be argued that providing a PPF contingent asset is not acting anti-competitively.

It seems optimistic to hope that a PPF contingent asset could be used to reduce the PPF levy when a Crown guarantee, subject to appeal, may not. But nothing ventured, nothing gained.

LARGE SCHEME/RELATIVELY SMALL EMPLOYER SYNDROME

The balance sheet value of Royal Mail Holdings plc, before the pension scheme deficit, is £2,120m as at 29/3/2009.

The liabilities of the scheme in the company accounts is £26,847m as at 29/3/2009, 12.7 times the balance sheet value of RMH.

The wages and salaries of RMH were £4,605m in the year to 29/3/2009. The pension deficit in the company accounts is £6,776m, which is 147% of one year's salaries.

Relative to the size of its pension scheme, RMH is a small employer. In these circumstances, higher funding targets generate deficits that are unaffordable by the employer. Instead of setting an actuarial basis and asking for contributions to meet the deficit, planning the funding of the scheme is a function of both the contributions and the investment strategy, so that jointly the contributions and the investment income can be reasonably expected to provide the full benefits of the scheme.

The logic is as follows:

1) Decide the maximum rate of deficit reduction contributions that can be reasonably afforded by the employer. The total resources available to the trustees is the sum of the assets and the present value of the deficit reduction contributions.

2) Set the actuarial basis in all respects other than the liability discount rate. Determine the expected return on each of the main asset classes.

3) Calculate the liability discount rate that values the liabilities at the same amount as the assets plus deficit reduction contributions.

4) Choose an asset allocation which has an expected rate of return equal to the liability discount rate.

5) Repeat steps 1) to 4) annually, at each actuarial valuation or actuarial update.

Let us illustrate this in the case of the RMPP.

1) The present deficit reduction contribution rate is £290m for year ended 2009, increasing each year by RPI, payable for 17 years from the last valuation date, which is up to 31/3/2023. This is 6.3% of the £4,605m annual wages and salaries and;

   3.1% of the £6,410m turnover, and more than RMH's profits. For the purpose of doing some initial arithmetic, we will assume that the present schedule of deficit reduction contributions is the maximum reasonable ability of RMH to contribute.

2) To value the liabilities, we will use the actuarial basis of the pension disclosures in the company accounts as at 29/3/2009.

For the expected return on the assets we will use:

Equities: the composition of 5.15% dividend yield, 3.2% RPI, 1.1% real dividend growth and 0.2% expenses, gives a return of 9.7% pa.

Gilts: long dated gilt yield less 0.1% expenses is 4.1% pa

Corporate bonds: the iBoxx index yield on over 15 year non-gilt bonds less 0.4% allowance for defaults and expenses is 6.3% pa.

Liability Driven Investment: assume a return between those on corporates and gilts.

High yield bonds: assume a return between those on corporates and equities.

Property: a plausible rental yield plus expected rental growth less expenses might be 7.5% pa.

Cash: 0.5% pa bank base rate

3) We estimate that a liability discount rate of 7.2% pa produces the following balance sheet:

£20,071m	Assets
£ 3,197m	Value of 14 years deficit reduction contributions as presently planned
£23,268m	Total resources available to the trustees
£23,268m	Liabilities valued on a 7.2% discount rate

These figures are necessarily no more than rough estimates, but they are adequate to illustrate the principles of operation we are explaining.

4) An asset allocation designed to produce this return is:

Asset class	Asset allocation	Expected return
Equities **	40%	9.7%
Gilts **	9%	4.1%
Liability driven investment *	25%	5.2%
Corporate bonds *	11%	6.3%
High yield *	4%	8.0%
Property *	8%	7.5%
Cash *	3%	0.5%
Overall portfolio	100%	7.2%

* These allocations are all as per the scheme accounts for the year ending 31/3/2009.

** These allocations split the remaining assets between equities and gilts to obtain an expected return of 7.2% pa. The actual allocation between equities and bonds as at 31/3/2009 was 27% and 22% respectively, so the indication is to reinvest some gilts into equities in order to achieve the required expected return.

5) At subsequent funding reviews, if experience has been favourable in the interim, it would be possible to reinvest some equities into bonds. Conversely, if experience has not been favourable in the interim, some bonds would need to be reinvested into equities, to expect to make up the shortfall with higher future investment performance rather than by higher contributions.

The strategy is to invest to the maximum possible extent in matching bonds, to minimise funding risk, commensurate with expecting to generate enough investment income to provide the benefits in full.

To invest a greater proportion of the assets in bonds is unworkable, because there would not be enough investment and contribution income to expect to provide the benefits in full. To invest a greater proportion of the assets in equities than the minimum quantity needed to expect to provide the benefits in full would incur additional risk. In the short term, either the additional risk will pay off with investment outperformance, in which case the additional allocation to equities is unnecessary, or the equities will underperform expectations, in which case the additional allocation to equities is damaging.

The logical approach is to design the asset allocation to generate sufficient investment income to provide the benefits in full, no more and no less. The maths presented here indicates that this approach is workable.

The Pensions Regulator would hardly welcome a calculation of SFO technical provisions on a discount rate of 7.2% pa. But to set a figure for technical provisions that is higher than the combined value of the assets and the present value of the maximum plausible future contributions would be a paper exercise in arithmetic that is not attainable in practice. To invest the scheme as cautiously as possible commensurate with having sufficient expected return on the assets to provide the benefits in full is true prudent management, and this can be explained to TPR. If a Crown guarantee or PPF contingent asset could be provided, see section 3, it would reassure TPR.

Extending the recovery plan

If the present formula for annual deficit recovery contributions that increase each year by RPI starting at £290m in 2009, were to be extended to the full 40 years available, then we estimate that a liability discount rate of 6.4% pa as used in RMH's accounts produces the following balance sheet:

£20,071m	Assets
£6,803m	Value of 40 years deficit reduction contributions
£26,874m	Total resources available to the trustees
£26,847m	Liabilities valued on a 6.4% discount rate

Asset class	Asset allocation	Expected return
Equities	28%	9.7%
Gilts	22%	4.1%
Liability driven investment	25%	5.2%
Corporate bonds	11%	6.3%
High yield	4%	8.0%
Property	8%	7.5%
Cash	2%	0.5%
Overall portfolio	100%	6.5%

For practical purposes, that is in funding balance. The present asset allocation of the scheme could be expected to produce a little more return than 6.4% pa, as demonstrated in the next table:

Before anything else is done, such as increasing the annual amount of the deficit reduction contributions or adopting an investment strategy designed to produce a higher return, it is demonstrated that the current rate of deficit contributions and the current investment strategy are just sufficient to expect to provide the accrued benefits in full.

Nevertheless, it would be much better for the scheme to have more money, whether by a higher annual rate of deficit reduction contributions, or by a higher return on the assets.

Hilary Salt Fellow of the Institute of Actuaries
Scheme Actuary
First Actuarial
15 December 2009

FIRST ACTUARIAL – DEALING WITH THE DEFICIT

Detailed is a package of measures that taken together will enable a pensions solution without legislation being required. The package covers the following points:

- The Government should contribute to the scheme as the Trustees required. The Government should abide by the standards of funding it has created. It should rise to the funding requirements of the RMPP in the same way as it requires of the private sector.

- The UK's funding standards derive directly from the European Union Directive 2003/41/EC, generally known as the Pensions Directive. The Government, as sole owner of the business, should ensure that contributions to the RMPP are sufficient to comply with the Pensions Directive.

- Postcomm should make allowances for sufficient deficit reduction contributions in its next price and service quality review, which is imminent. Postcomm should not frustrate the requirements of the law on scheme funding by making insufficient allowance for deficit contributions in its price controls. Postcomm has a statutory duty to ensure that the Royal Mail has sufficient financial resources to finance its regulated activities, and providing for the pension scheme is a part of that.

- The Government can and should create a Crown guarantee by which the State meets any deficit in the pension scheme if the sponsoring employer becomes insolvent. This would be analogous to a parent company providing a guarantee to a wholly owned subsidiary company. More directly, the Government could provide a Pension Protection Fund style of contingent asset to the RMPP. Again, the Government should apply to itself the standards of conduct it expects of the private sector.

- A suitable investment strategy to be pursued with the Trustees.

- The introduction of a 40 year repayment schedule to cover the deficit recovery, as allowed for in the current Trust Deed and Scheme Rules.

First Actuarial are continuing their work on the solutions detailed above.

ANNEX C
EXTRACT FROM THE HOOPER REPORT

A new approach

157 Although Royal Mail is not the only business or public sector body with a significant pensions deficit, its circumstances are unique. Following the decision by Government to liberalise the market, Royal Mail is having to respond to new competitive pressures whilst also meeting its obligations to provide the universal service. And it is now having to do so against a background of falling volumes and revenues brought about by the digital revolution. A new approach is needed to tackling Royal Mail's pension deficit if the benefits of liberalisation are to be realised.

158 In other sectors previously dominated by a state-owned monopoly, Government has taken action to address historic liabilities in order to facilitate beneficial change in the industry. Changes to the rail industry in 1993, and the coal industry in 1994 are examples where action on pension liabilities was fundamental to enabling necessary restructuring of the industry – including in the case of coal against the background of a contracting market.

159 In the case of Royal Mail, the cost of the deficit is currently shared between consumers, Royal Mail and the taxpayer as shareholder. We doubt whether this is appropriate or effective as a long-term solution, particularly given the prospect of a significant increase in the size of the pension deficit.

> The increasing resistance of customers to paying higher prices for postal products, and falling letter volumes, mean that further price rises to meet the increasing cost of the deficit are unlikely to be effective. Instead, they are more likely to accelerate market decline driven by e-substitution. ***70 Source: Postcomm***

> Although Royal Mail does have scope for significant efficiency savings, the benefits of these savings will be fully absorbed in placing the company on a sustainable financial basis going forward. There is very little margin, particularly in the short term, to fund increased deficit contributions, and doing so could in fact endanger the universal service.

160 Other, short-term measures are possible. But, on their own, they would not address the underlying causes of the deficit, nor would they alleviate the adverse impact of the deficit on Royal Mail and the wider postal services market.

- The sale of GLS would be one option to reduce the pensions deficit. But since GLS generates cash, it may also weaken the ability of the company to fund the significant ongoing deficit payments that would still be required.

- A one-off injection of taxpayer funding into the scheme by Government would require clearance under state aid rules, and could well make it more difficult to obtain subsequent approval for longer-term measures to address the underlying cause.

161 A long-term solution is therefore essential. And it is our view that that the best long-term solution must be for the risk around the historic liabilities to be managed by the body – central Government – that has the size and financial resources best suited to perform that role in a way which does not threaten the universal service.

162 Provided that the constraints on Royal Mail's ability to modernise have been removed, we recommend that:

- The responsibility for the historic liabilities should be transferred from Royal Mail to the Government. This would leave Royal Mail with a much smaller scheme and liabilities that would no longer be of a size that called into question the financial viability of the business. It would relieve the cash and balance sheet constraint on new investment and increase Royal Mail's competitiveness. It would also benefit consumers by reducing the pressures on stamp prices.

- The Government should take responsibility for the historic liabilities in a way which provides an incentive on all stakeholders, including the unions, to modernise Royal Mail. It could, for example, take a staged approach in which the scheme's assets and liabilities related to pensioners and members with deferred benefits were transferred to separate, Government-backed arrangements. As active members left the company as a result of the modernisation process, their liabilities and assets could be also be transferred.

163 These recommendations are not a complete solution for the problems currently faced by Royal Mail. On their own, they will not bring about the company's modernisation. They are, however, a significant part of the solution if implemented with our other recommendations, especially partnership.

164 Detailed practical arrangements for transferring the risk associated with the pension liabilities should be a matter for Government. Options might include, for example, legislation to take over relevant assets and liabilities of the scheme and pay benefits from general taxation; the purchase of annuities; or the operation of a separate, managed fund. As part of this process, Government would need to obtain state aid approval from the European Commission.

165 We recognise that the long term impact on public finances arising from risks such as longevity could be significant. Nevertheless, we believe that the recommendation is consistent with our objective to reduce the risk to public finances and, therefore, to the taxpayer. It does not require the Government to fund the full deficit immediately. And by removing a very significant financial risk and business constraint, the transfer of historic pension liabilities from Royal Mail would result in a compensating uplift in the value of Government's equity stake in the business.

ANNEX D
ROYAL MAIL PENSION ARRANGEMENTS LETTER

27th March 2008

Jane Newell
Chairman
Royal Mail Pensions Trustees Ltd
Lloyds Chambers
1 Portstoken Street
London
E1 8PP

Dear Jane,

Royal Mail Pension Arrangements

Prior to the Trustees making their decisions on Royal Mail's proposed pension reform we want to set out the position of CWU on key aspects of the pension's debate.

1. The Pension Consultation Joint Statement

The Union's Postal Executive committee did agree a joint statement with Royal Mail supporting the need for pension reform as part of the consultation process.

From the outset we have been clear and consistent with Royal Mail and CWU members that the joint statement was agreed on the following basis:

- The consultation joint statement did not constitute an agreement to the final outcome.
- CWU wanted an informed debate and would undertake regional and branch seminars/meetings.
- We would listen and act on the views expressed during the consultation.
- At the end of the consultation and following further discussions with the company we would carry out our commitment to ballot CWU members on the final position.
- Pensions was decoupled from the pay and modernisation agreement. A letter from Brendon Barber (TUC General Secretary) was the mechanism that allowed decoupling to take place. Royal Mail agreed that CWU members would be balloted separately on the pay and modernisation agreement.

Royal Mail knows the afore-mentioned is the factual position.

2. The Pension Consultation

In work time briefs letters and DVD's Royal Mail told its employees the following:

- The consultation proposal did not represent the final outcome.
- The company were committed to ensuring the consultation was meaningful.
- The company would take into account the views of its employees before reaching the final decision.

The CWU wrote to Royal Mail on the 20th December 2007 setting out the reasons why we did not believe the company were carrying out a meaningful consultation. We also put the same views forward at meetings of the formal consultation group and in separate meetings with Royal Mail.

The Trustees will have seen the results of the consultation exercise. CWU believe these demonstrate the company have not carried out any of the commitments made to its employees. Royal Mail have treated the consultation exercise as a total sham.

3. The Reasons why CWU cannot support the Company's Pension Reforms

- The union continues to recognise there is a need for some kind of pension reform. However, we are convinced there are alternative and more acceptable ways of introducing such reforms.

  Since Christmas the Union has discussed a range of potential solutions and alternative approaches. These options have been formulated following independent advice from our pension advisors, First Actuarial. They have also been formulated in conjunction with views expressed during the consultation. Regretfully, Royal Mail have failed to consider any of these alternatives even though they reflect many of the views expressed during the consultation.

- The announcement of the government review of competition is a crucial development.

  Royal Mail consistently state that pension reform is being driven by the economic and competitive pressures facing the company.

  The government review provides Royal Mail and CWU with a fresh and significant opportunity to finally get to grips with the core of the problem.

  The truth is unless Royal Mail gain major concessions from government in both its regulatory and financial framework – the pressures facing the company will continue unabated. This means CWU members will face further pension reform in the near future.

  The company and the Trustees must prioritise the future financial strength of the company if we are truly acting in the best interests of all pension scheme members.

  The government review is due to conclude mid-summer 2008. There really is no need for the company or the trustees to act with undue haste. Decisions on pension reform should only be taken when the government review has been concluded.

- During the consultation it has come to light that the company's business plan is falling further behind the financial targets set. This in turn is linked to the government investment package.

  In our view the priority should be to ensure the company has a viable business plan going forward. The facts demonstrate otherwise. The business plan is fundamentally flawed and based on incorrect assumptions. This means the government investment package is completely inadequate.

The very same government package and business plan was originally heralded by the Chief Executive as the vehicle for ensuring the company could maintain a final salary scheme for existing employees. The Chief Executive wrote to all employees last year making that commitment. The company clearly got it wrong.

The correct course of action now is for Royal Mail to be honest about their mistakes and call upon government to review the investment package.

- The CWU believe that the government, as the owner and share-holder of Royal Mail, have a legal and moral obligation to protect CWU member's pensions arrangements.

When government announced the investment package and the Escrow account it presented itself to the media as saving the pension arrangement of Royal Mail employees. It is now incumbent upon all stakeholders to tackle these issues again directly with government and also through the review team. This should include the scrapping of the ill conceived ColleagueShare scheme in favour of releasing more funds to protect pensions.

- Royal Mail's approach to the consultation exercise is unacceptable to the union. The company should have explored alternatives and listened to the views of its employees. By contrast, the union has listened and acted on the views expressed. Furthermore, we are currently in the process of undertaking an individual member work place consultative ballot. Early results indicate CWU members will overwhelmingly reject the company's reforms. The full result will be declared on the 31st March.

- The union cannot support the introduction of inferior two-tier arrangements for new entrants.

- The union is concerned that the assumptions underpinning the last actuarial evaluation are too cautious. We believe these need to be urgently reviewed.

Summary

The union does recognise the Trustee Board acts independently of Royal Mail and we are grateful for the opportunity to submit our views.

We remain convinced there are alternative and more acceptable ways of reaching agreement with the union on pension reform.

We believe it is now incumbent upon the company and the trustees to take a step back and consider pensions in conjunction with the bigger picture.

There is an overall responsibility on Royal Mail and the Trustees to explore all avenues to ensure pensions are protected. In light of the points we have raised we respectfully ask the Trustee Board to reject the company's plans.

Yours sincerely,

Billy Hayes
General Secretary

Dave Ward
Deputy General Secretary (P)

ANNEX E
UK OCCUPATIONAL PENSIONS

1 UK pension provision currently depends on a mixture of state, occupational and private pensions generating income in retirement. The assumption that the state pension will make up only part of income in retirement has allowed state pension provision in the UK to drift far behind that of our European counterparts. The decline in final-salary schemes and the unpredictability of returns on defined-contribution schemes, combined with the government's reluctance to significantly raise the state pension, or even re-introduce the state pensions earning link, means that most workers face uncertainty and potentially a dramatic drop in income on retirement.

2 Occupational pension provision in the UK expanded rapidly over the course of the twentieth century. Many occupational pension schemes were already well established before the war – 2.5 million people were reportedly members of occupational pension schemes by 1936 – but it was in the post-war period that they really took off. Figures from the Office for National Statistics suggest that active membership (i.e. those paying in to the scheme) peaked in the late 1970s. In 1979 there were 11.6 million active members of public and private occupational pension schemes. By 2008 this had fallen to 9 million .

3 Final-salary pension schemes, the most secure and highly valued occupational pension schemes, usually provide retirees with a full service record (normally forty years) with either a half or two-thirds of their salary immediately prior to retirement. Rising costs and the changing labour market have meant the closure of many final-salary schemes to new members; membership has been declining steadily over the last 20 to 30 years.

4 The decline in active membership of occupational pension schemes has been most acute in private sector defined-benefit schemes that remain open to new members. In 1995 there were 4.9 million such members. By 2008 this had fallen to 1.1 million.

5 Active membership of both open and closed private sector defined-benefit schemes went from 5.1 million in 1995 to 2.6 million in 2008. The private sector makes up a third of members of both open and closed defined-benefit schemes. This is very low considering the private sector makes up four-fifths of the 29m people in employment in the UK.

6 Pressure to close schemes continues. A recent survey for PricewaterhouseCoopers (PWC) found that 81% of firms had closed defined benefit firms to new members and that 31% of firms with open defined-benefit schemes planned to close them. 96% of the companies surveyed saw defined benefit schemes as 'increasingly unsustainable' .

Why are pension schemes closing?

7 A number of factors have influenced the decline in final-salary pension schemes; among them, the decline in UK manufacturing and the restructuring of the UK economy. There is a correlation between the decline in heavy industry, and with it the decline in heavily unionised workplaces, and the decline in pension provision in the UK .

8 A mixture of government policy, changing actuarial assumptions and poorly performing investments, as described below, have affected the affordability of defined-benefit pension schemes and contributed towards their decline.

9 Contributions holidays: When pension funds were in surplus, during the late '80s and '90s, many employers took the opportunity to stop making contributions. Royal Mail took a 13 year contributions holiday, contributing significantly to the scheme's current deficit. Royal Mail was not alone. The TUC estimate that employers saved £18.5bn in contributions holidays and reductions in the 1990s. Employers benefited from the good times, receiving over 94% of all savings. Employees saw little, if no, benefit and continued to contribute in good faith during this period. They are now suffering the consequences of their employers' recklessness.

10 Government policy: Employers' willingness to take advantage of pension fund surpluses was encouraged by the policy of successive governments. In 1988 Chancellor Nigel Lawson capped the level of surplus pension funds could accumulate. In 1993, then Chancellor Norman Lamont reduced the value of tax relief paid to charities and pension funds. In 1997, as chancellor, Gordon Brown removed the tax relief on dividends paid to pension funds. Previously Advanced Corporation Tax (ACT) relief had allowed pension funds to reclaim the 20% tax on company dividends. Brown's decision to remove this tax relief, in exchange for reducing corporation tax – which he claimed would act as a counter balance by encouraging economic growth – has been blamed for creating a pensions 'time bomb'. It is estimated that in the 12 years since, £100bn has been wiped from the value of final salary pension funds. According to the Inland Revenue , tax relief from pension fund investment fell from £7.1bn in 1996/97 to £3.3bn in 2001/02.

11 Longevity: Increases in longevity has also impacted significantly on the cost of pension provision. People are living longer and therefore providing an adequate income in retirement is becoming more expensive. The life expectance of a 65 year old man rose from 14 years in 1985 to 19.5 years in 2005. Pension funds have had to make adjustments to account for these changes. Many have been slow in doing so, again impacting on pension fund deficits.

12 Increased longevity is an issue for pension funding in general, not just final salary pension schemes. In the case of a final salary scheme the employer must make sure the scheme is sufficiently funded and therefore contributions to the scheme must be increased to take account of people living longer. However, the value of defined-contributions schemes will also be affected – the longer the life expectancy the more expensive it is to purchase an adequate income in retirement – but the impact is felt by employees only, who bear all the risk.

13 Investment returns: Lower investment returns in recent years have further contributed to the under-funding of pension schemes. Lower interest rates and the current economic crisis have added extra pressure, as has a fall in share prices. Pension funds are amongst the largest investors in the UK. The development of London as a leading financial centre is in part attributed to the scale of pension fund investment in the UK . While institutional investors often see pension funds as an unnecessary cost and burden on companies, paradoxically it is the assets of these pension funds that they are investing.

14 FRS17: Measures taken to encourage proper pension funding may inadvertently have exacerbated the crisis. Financial Reporting Standard 17 (FRS17) was introduced in 2001 and became mandatory in 2005. It requires companies to record the value of their pension fund assets and liabilities in their annual report and accounts. The purpose of the requirement, to give a transparent account of assets and liabilities, is commendable, but nevertheless its impact has been mixed. While FRS17 isn't the cause of pension fund liabilities, it could be said to place unnecessary pressure on companies, by painting a particularly bleak and volatile picture of pension funding. If stock market conditions or interest rates fluctuate during an accounting period the company's results can be significantly affected by the pension fund and can increase pressure for it to be closed. FRS17 calculations are based on the most pessimistic assumptions about the value of assets and liabilities. They also produce volatile results with little smoothing of the effect of short term changes in the market.

15 FRS17 has caused confusion in the reporting of Royal Mail's pension deficit. The FRS17 valuation has been hugely volatile and has no bearing on the actuarial valuation made every three years, which is used to calculate Royal Mail's deficit repayments. The FRS17 valuation has fluctuated by as much as 40% year on year. When the actuarial valuation stood at £3.4bn in 2006, the FRS17 valuation stood at £5.6bn. In 2007/08 it had fallen to £2.9bn before more than doubling the following year to £6.8bn. FRS17 valuations are heavily reported in the press. They are used to apply further pressure for scheme closures, despite their importance arguably being overstated. Their volatility is used to suggest the spiralling nature of final salary debts, rather than an inherent feature of the accounting method.

16 Pension contributions to defined benefit schemes have had to increase steadily in recent years. Employer contributions now average 23% of employee earnings. Combined employer and employee contributions have risen to close to 30% of earnings. Defined-contribution schemes have also suffered from reduced investment returns, increased longevity and lower annuity rates. However, contributions have increased very little in recent years. While combined employer and employee contributions into defined-benefit schemes have risen from 15.8% in 2002 to 29.5% in 2009, combined contributions to defined-contribution schemes have risen from 8.5% to just 11% in the same period. Savings in defined-contribution schemes are seriously inadequate, but the lack of compulsion on employers means this particular pension time bomb is being ignored.

17 A combination of these factors has resulted in the closure of many defined-benefit pension schemes in recent years. Not all schemes that have closed have faced a genuine funding crisis. Some have been tempted to make savings and have used the pressure around other schemes as an excuse to close their own. Closure, however, does not necessarily result in immediate gains. Despite closure to new members companies must still continue to pay ongoing contributions and clear any pension deficit. Any gains will be long term and the company will need to continue funding the scheme, even as the number of active members dwindles. Closing to current members – preventing any ongoing accrual – means a greater saving, but any pension deficit will still need to be paid. Moreover, contributions to a defined-contribution scheme are likely to be made in its place and a low level contribution will become compulsory in 2012.

ANNEX F
THE PENSION PROTECTION FUND

The Pension Protection Fund

- The Pension Protection Fund (PPF) provides compensation to members of eligible defined-benefit pension schemes whose employer goes bust and whose pension scheme does not have sufficient assets to pay their pensions.

- The PPF began operating in April 2005 and is run by an independent board. It is accountable to parliament through the Secretary of State for Work and Pensions.

- There are approximately 7,800 pension schemes across the UK covered by the PPF.

- A number of schemes are exempt from PPF membership. These include: unfunded public service schemes; public service schemes providing pensions to local government employees; and, schemes covered by a Crown guarantee.

- The PPF is funded through the following sources:
  > A compulsory levy
  > The assets of schemes transferred to the PPF
  > Assets collected from insolvent employers
  > sInvestment returns

- The compulsory levy is divided in to two parts. The first, the scheme-based levy, is dependent on the level of a scheme's liabilities to members and accounts for 20% the total levy. The second part, the risk-based levy, accounts for the remaining 80% and is dependant on the risk of a scheme's sponsoring employer being made insolvent. The less risk a scheme poses to the PPF the lower the levy they pay.

- When an eligible scheme goes bust it is assessed and if there are insufficient assets to cover pension benefits at PPF compensation levels or above, the scheme will transfer into the PPF.

- Pension scheme members who have reached their scheme's normal retirement age before the scheme goes bust are generally entitled to 100% compensation, as are those who have retired on ill-health grounds and those receiving a pension relating to someone who has died.

- Members yet to retire receive up to 90% compensation when they reach retirement age, though the level of compensation is capped.

- Pension benefits are revalued every year, but are likely to increase by less than they would if they were being paid by the pension scheme rather than the PPF.

- Since the PPF was established:
  - > 104 schemes have transferred in with a total of 31,469 members. 12,723 are in receipt of compensation; 18,009 have deferred entitlement.
  - > In total £104m has been paid out. An average annual payment of £3,785.88 per person.

- The PPF is currently in deficit. The deficit increased to £1.23bn in 2009 from £517m the previous year.

- The fund's investment portfolio grew to £2.93bn in 2009 from £1.47bn the previous year.

- The compulsory levy on PPF covered schemes totalled approximately £700m in 2009, unchanged from the previous year.

ANNEX G
ROYAL MAIL PENSION PLAN – GOVERNANCE

- The Royal Mail Pension Plan (RMPP) is managed by an independent trustee company, Royal Mail Pensions Trustees Limited (RMPTL), which is separate from Royal Mail.

- RMPTL is run by eleven trustee directors. Five are nominated by Royal Mail, four are nominated by the unions, one is elected by a ballot of scheme members and there is a chair who is an independent trustee appointed by Royal Mail with union agreement.

- RMPTL receives support from an executive team which works with the trustees. It also employs the services of a range of professional advisors in finance, banking and law. Day-to-day administration is delegated to its Pension Service Centre.

- The trustee company is required by law to ensure the pension plan is properly run and that accrued benefits are protected.

THE RMPTL TRUSTEE DIRECTORS:

Jane Newell OBE JP BA FRSA
Chair, Independent Trustee

Mark Ashworth MA FCIS
A Director and representative of, Law Debenture,
a professional independent trustee of pension plans.

Phil Browne
Member of the National Postal Executive for the Communication Workers Union

Graeme Cunningham
Executive Council member of UNITE-CMA

Jonathan Evans OBE BSc
Company Secretary of Royal Mail Group

Martin Gafsen BA Solicitor MBA
Property Director and Royal Mail Group

Paul Kennedy
Midlands Divisional Representative for the Communication Workers Union

Geoff Lindey BSc FFA
Independent Trustee and former investment manager for pension funds

Alwen Lyons BA ACMA
Head of Mails and Retail Marketing in Post Office Limited

Lionel Sampson
Senior Policy Adviser, Postal Department, Communication Workers Union

Bob Wilde FCMA
Pensioner Trustee, formerly Head of Finance for the Post Office

USEFUL WEBSITES

CWU
www.cwu.org/royal-mail-pensions.html

Directgov
www.direct.gov.uk/en/Pensionsandretirementplanning

Hilary Salt (First Actuarial)
www.firstactuarial.co.uk

The Pension Protection Fund
www.pensionprotectionfund.org.uk

The Pensions Advisory Service
www.pensionsadvisoryservice.org.uk

Pensions Ombudsman
www.pensions-ombudsman.org.uk

The Pensions Regulator
www.thepensionsregulator.gov.uk

Royal Mail Group
www.royalmailgroup.com/pensions

Royal Mail Pension Plan
www.royalmailpensionplan.co.uk

Thompsons Solicitors
www.thompsons.law.co.uk

UNITE the union
www.unitetheunion.com

UNITE (The National Federation of Royal Mail and BT Pensioners)
www.pensioneronline.co.uk

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