Merseyside
PENSION FUND

RPI Consultation Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

21 August 2020

Dear Sir/Madam

Response to Consultation on the Reform to Retail Prices Index Methodology

Merseyside Pension Fund is responding to the consultation issued by HM Treasury and the UK Statistics Authority (UKSA) on the UKSA's proposals to "reform" the Retail Prices Index (RPI) methodology. Merseyside Pension Fund is a part of the Local Government Pension Scheme and manages c.£9bn of assets (including more than £700m in index-linked gilts) on behalf of nearly 130,000 individuals and 200 employing bodies.

1 Do you agree that this proposed approach is statistically rigorous?

Whilst recognising that there are perceived statistical issues with RPI, RPI is a widely used reference in financial contracts and, arguably, has a purpose beyond being simply a measure of actual broad inflation.

2 What will be the impact on the interests of holders of 'relevant' index-linked gilts (i.e. 2½% IL 2020, 2½% IL 2024 and 4 1/8% IL 2030) of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

There will be no impact on holders of gilts maturing prior to 2025; there will be an impact on the 4 1/8% IL 2030 if the proposed change were to be implemented prior to its maturity.

3 What will be the impact on the interests of holders of all other index-linked gilts of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

There will be a material impact on the holders of index-linked gilts stemming from the proposed change, with the impact becoming more material the earlier that any change is implemented. Insight Investments estimate that if RPI is simply amended to match CPIH, it would result in a wealth transfer of £90bn to £120bn away from holders of index-linked gilts – predominantly UK pension funds and insurers – to the

UK government. Even the proposal to make this change has already had a significant impact on the prices of index-linked gilts.

Since 2010, RPI has increased by an average of 1% more than CPIH per annum, with a high degree of consistency, as noted in point 46 of the consultation. This allows a calculation of the impact on index-linked gilt holders of aligning RPI with CPIH. For example, among its various index-linked gilt holdings, MPF holds £39m of the 1 1/4% IL 2055 issue. If RPI was to be reduced by 1% from 2030, the value of this holding would immediately be reduced by £8m - 21% lower than would otherwise have been the case.

4 What will be the impact on the index-linked gilt market or those dependent on it of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

As a pension fund with CPI-linked benefits, we have taken measures to hedge some of our inflation liabilities using index-linked gilts. The changes proposed will be materially detrimental to our funding position. As explained in our answer to question 3, we will suffer from a reduction in the value of our index-linked gilt holdings without a commensurate change in the valuation of our liabilities. This will need to be made good either by increased contributions from our employing bodies (at a time when local government finances are under extreme stress) or by taking more investment risk within the pension fund (at a time when the valuations of many risk assets seem to be very full).

5 What other impacts might the proposed changes to address the shortcomings of the RPI have in areas or contracts where the RPI is used?

Changing RPI simply to mirror CPIH (even with a one-year time lag) would have far-reaching consequences throughout the UK economy, with significant transfers of wealth, primarily from pension beneficiaries and asset holders, such as pension schemes and insurers, to the government. As noted by the Institute and Faculty of Actuaries in their response to the House of Lords Economic Affairs Select Committee call for evidence into use of the retail price index , there will be many losers:

- Members of company pension schemes with RPI-linked increases
- Annuitants
- Holders of index-linked gilts
- People who have suffered personal injuries and who are beneficiaries of court awards
- People in receipt of long-term disability insurance

In addition, as a pension fund, we are invested in a number of property and infrastructure assets whose valuations are influenced by the level of inflation as measured by RPI.

Over the last ten years, there has been a move by pension funds to allocate capital to infrastructure, such that it is now an established asset class in its own right. We have made substantial investments into infrastructure not only for the defensive nature of the assets but also for the inflation linked cash flows. A good portion of the infrastructure market is exposed to RPI, whereby the underlying contracts explicitly reference the index. The change in the index will negatively affect the revenue of these assets, ultimately reducing the cash flows to us and reducing our ability to deliver on our obligations to members.

For example, we have committed £250m to GLIL, a long term investor in core, UK infrastructure with committed capital of £1.825bn. GLIL is backed by four Local Authority Pension Funds ("**LAPF**"), namely:

- Greater Manchester Pension Fund;
- Merseyside Pension Fund;
- West Yorkshire Pension Fund; and
- Local Pensions Partnership Investments (the entity which manages the assets of London Pensions Fund Authority, Lancashire County Pension Fund and Royal County of Berkshire Pension Fund).

The pension funds that are invested in GLIL have over 1 million members and in excess of £58bn in assets.

Since being founded in 2015, GLIL has invested over £1.1bn in a number of high-quality equity investments across UK infrastructure:

A large portfolio of PFI/PPP assets, helping fund the schools, hospitals and roads of the UK, these contracts are explicitly linked to RPI, and this change will negatively impact on the cash flows generated by this portfolio.

Equally GLIL owns over [750] MW of renewable energy, helping to fund the decarbonisation agenda of the UK, part of this subsidy regime is linked to RPI. The Renewable Obligation Certificate (ROC) is inflated with RPI annually; this change again will reduce the cash flows we receive.

Based on similar assumptions to those used in question 3, we estimate the cost to us in relation to our investment in GLIL alone could be between £5m and £6m.

6 Are there any other issues relevant to the proposal the Authority is minded to make of which the Authority or the Chancellor ought to be aware?

In common with many respondents, we believe that there should be an independent process to find a fair and equitable outcome that adequately addresses the economic implications of this change.

We share concerns that this consultation is too narrow, in that it exclusively considers (at least in terms of direct impact) the terms of "relevant gilts" (as defined at paragraph 19 of the consultation) and the requirements of section 21(2) of the National Statistics Act (the 'Act'). The "relevant gilts" will mature by 2030 and are a small proportion of the index-linked gilt issuance.

7 Which lower level or supplementary RPI indices are currently used, and what are they used for?

No response

8 What guidance would users of lower level or supplementary RPI indices find most useful for the ONS to provide?

No response

Yours faithfully

P Wallach

Peter Wallach

Director of Pensions