Written evidence from the BP pensioners group DBP0080

After the closure date of written submissions to this Inquiry passed on 26 April 2023, several issues that we believe are highly relevant to your Inquiry have come to light concerning one of the UK's largest Defined Benefit Pension Schemes – The BP Pension Fund.

These include:

1. The decision last month of the sponsoring company to overrule the clear recommendation of the Fund Trustees and block a discretionary increase in the pensions payable to the members which would part-recognise the impact of inflation. The company has given several – but changing - reasons for its decision including financial impact on the Fund (despite the trustees proposing it) and BP's desire for equity of treatment between stakeholders in the UK and around the world (despite the BP UK pension scheme being UK based and subject to UK law).

2. BP's Annual Report has revealed a very large surplus of around £6 billion has accumulated in the Pension Fund. The Annual Report makes an assumption about the Company's right to recover that surplus - which we believe is in conflict with the interests and rights of the Pension Fund members.

3. Indications that the Fund Trustees and the sponsoring company have begun to progress plans to 'hive-off' the Fund to third party insurers now that it is closed to new members and new accruals. There has been no consultation with members about such a step.

In the short time since these matters came to light, over 900 members of the BP Fund have contacted BP or the Trustees to express their alarm at these developments and have demanded BP and the Trustees properly consult with the Fund members and most importantly explain how the above three factors are inter-woven.

As members of the Fund, we have volunteered to act as coordinators for this group of Pensioners – a group that is growing fast – and make representations to BP on their behalf. But BP has outright rejected our approaches.

We believe the issues raised with this Fund and its governance are pertinent to many other UK DB Funds. For that reason, we very much welcome the opportunity to provide your Committee with some brief evidence post-deadline. This evidence, focusing on Q7 '*How should scheme surpluses be treated?*', is attached.

Our evidence is confined to Question 7:

> *How should scheme surpluses be treated? For example, should they remain in the scheme or be shared between the employers and scheme members? Are the issues different between open and closed schemes?*

We provide this evidence on behalf of a group of over 900 members and beneficiaries of a major UK Defined Benefits (DB) pension scheme. Like many UK DB schemes, it has been closed to new members since 2010 and closed to existing member accruals since 2021. This scheme currently possesses a surplus.

In 2022, for the first time, the rise in pension did not keep up with inflation. BP has also recently rejected the BP Pension Fund Trustees recommendation to increase the annual pension paid at May 2023 by 9% to (partly) recognise inflationary pressures on Fund members. This decision and its reasoning raise important questions about the conflict of interest that companies like BP have as DB pension funds – especially those in surplus - reach maturity.

While we are in dispute with BP about its decision to reject the discretionary increase in pensions, our contribution here is confined to general points we believe are pertinent to UK DB funds in general and this committee's Inquiry.

1. Summary

1.1 The Termination and subsequent winding up of a Defined Benefit pension scheme creates considerable risk for scheme members. Trust Deed arrangements for schemes are, if similar to BP's, unsuited to protection of scheme members' interests and, consequently, stronger arrangements should be afforded to scheme members.

1.2 Commercial considerations will influence the financial outcome of this process. If similar to BP's, an employer/sponsor first issues the Trustees with a notice of termination. Subsequently, negotiations between the Trustees, many nominated by the employer/sponsor and an insurance company will lead to the insurance company trying to capture all or part of a scheme's surplus. Any residual surplus is then available to Trustees to decide whether to improve member benefits beyond those provided by the insurance company. However, the employer/sponsor has the opportunity to withhold permission for this enhancement and capture the residual surplus to improve its financial position.

1.3 Scheme members are passive observers in this process, relying on their interests being defended by the employer/sponsor and Trustees (some member-nominated). Effectively excluded from the process of deciding the fate of their pensions, they are set up to be the victims.

1.4 We urge the Committee to conclude that more rights and protections are afforded to defined benefit scheme members – particularly governing the process of transfer/sale to the insurance industry.

2. Context

- BP Pension Fund assets are substantial: £20bn (UK), £27bn (total)[1]
- The UK pension plan had a surplus of £6bn[2]
- There are some 60,000 members in the UK DB scheme[3]
    - 33,000 pensioners
    - 10,000 dependents
    - 17,000 deferred
- Of these, some 16,000 are aged in their 80s and 90s.
- The average BP DB pension: £18,000 pa[4]

2.1 Fund surpluses are one piece of a jig-saw and, accordingly, have to be considered against the wider picture.

2.2 Personal decisions whether to join a company, remain with it and ultimately resign or retire, have at their heart an individual's consideration of the total value and composition of the broad employment package offered by an employer.

2.3 Personal decisions fundamentally hinge on the balance between cash reward during employment (e.g. salary) and deferred cash reward in the form of a pension[5]. These are 'life-decisions': among a handful of very high-consequence decisions people take.

2.4 Salary and pension are indivisible for employees / scheme members. They are intertwined. Changes in one area inevitably have a substantial impact on the other.

2.5 Possibly the greatest decisions employees in DB schemes make, is whether to cash-in their pensions on or after retirement.

3. Who Owns The Surplus

3.1 Since 1928 the BP UK pension fund assets have come from:

a) payments into the Fund made by BP as part of each employee's benefits package[6];

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[1] BP Annual Report 2022 s24 p231 - $25bn (UK), $34bn (total) converted at 1$ = £0.80
[2] The $25.1bn fair value of the UK assets minus the $17.5bn future UK benefit obligations at 1$ = £0.80
[3] BP Pension Fund - Trustee's Annual Report and Financial Statements 31Dec21 p11
[4] Benefits paid (BP Pension Fund - Trustee's Annual Report and Financial Statements 31Dec21 p26) / no. pensioners + dependents (p11)
[5] Putting so-called employment hygiene factors to one side (e.g. holiday entitlement, maternity leave, etc) because legislation has improved this aspect of employment

b) Additional Voluntary Contributions e.g. salary sacrifice by employees;

c) occasional additional payments by BP to remedy any deficit;

d) transfers into / out of the Fund as a consequence of BP's acquisitions, divestments and mergers; and

e) capital appreciation/gains and investment income.

3.2 Pension funds are governed by relevant legislation, including Acts of Parliament and regulations, as well as their specific administrative agreements. The BP Pension Fund's agreements (Trust Deed and Trust Rules) record the detailed contractual arrangements between employer, fund Trustees, fund managers and scheme members. Booklets issued to scheme members summarise the detail.

3.3 The BP Pension Fund is legally owned by its Trustees, its assets being "… *held in trust and are completely separate from BP plc's finances*"[7]. However, the assets and liabilities appear on BP's Balance Sheet, with associated payroll costs having been taken through the Profit & Loss account. The Trustees (a mix nominated from BP and scheme members, all appointed by BP) are required to act in line with the pension scheme trust deed and rules; in the best interests of the pension scheme members; and impartially, prudently, responsibly and honestly.

3.4 The Fund has in the past been underfunded at times but adequacy was restored by BP committing to a medium-term funding agreement

3.5 The Fund is now in surplus and this surplus is available to meet the future needs of the scheme members – subject to the terms of the Trust Deed.

4. The fate of the surplus

4.1 The employer has the right to give notice of Termination of the Fund to the Fund's Trustees. The Trust Deed describes what will occur when the Trustees wind up the Fund (refer Annex). In summary:

- Existing payments have first call on the Fund and continue until formal termination of the fund;
- The second call on the Fund is the cost of winding down the Fund;
- Third, remaining assets will be used to either buy insurance policies for scheme members (a so-called Buy-Out) or transfer amounts to alternative funds requested by individual scheme members. These new benefits must closely match those previously provided by the Fund; and
- **Finally, any residual amount, with the agreement of BP, can be used by the Trustees to enhance the benefits of scheme members. Any residual amount after this enhancement is returned to BP**.

4.2 Clearly, it is not in BP's commercial interest to allow a fund surplus to be used to enhance scheme member benefits although that is the clear intent and primacy of the

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[6] On closing its DB scheme, BP gave employees a 20% salary uplift to compensate for moving to a DC scheme
[7] An important message to all members of the BP Pension Fund, CEO BP Pension Fund Trustees Ltd., June 2010

relevant clause of the Trust Deed. But it is clearly in BP's commercial interest for any surplus remaining on BP's balance sheet to return to itself. Even for a company of the scale of BP, the surplus is significant – potentially $bns and the claim to the surplus is already included in BP's accounts.

4.3 The Trust Deed and Trust Rules have evolved since the scheme was first offered to staff, often in response to legislative changes. Similarly, consultation with scheme members has evolved, timed around changes to the scheme and its administration. Future consultation with scheme members would be essential if: (a) the legislative framework changes; and/or (b) an employer and Fund Trustees consider any Buy-Out/transfer.

5. Size of Surplus

5.1 Surpluses can be calculated using a range of methodologies.

5.2 BP reports in its statutory accounts a deficit or surplus based on market-based valuations The Fund is in rude health using this measure.

5.3 The Fund also calculates its health using a more conservative methodology, one that insurance companies might use when assessing the assets and liabilities of a fund Buy-Out. Currently, BP's fund has an adequate surplus using this approach

5.4 Inevitably, an insurance company's list of valuation assumptions will include three items that are not currently faced by the Fund:

- Unexpected risk events – a financial buffer will be required to meet inflation-driven increases in pension payments, whether guaranteed or discretionary, and risks to asset values. Whereas the BP Pension Fund has a guarantee from BP that it will financially support pension rises up to 5% RPI.
- Corporate overheads – the publicly quoted insurance company carries considerably more overhead than the narrower management of BP's fund.
- Profit and dividend – insurance company shareholders have to receive an adequate return.

5.5 Together, these three items will consume part of the Fund at Buy-Out/transfer and reduce the surplus available for distribution to scheme members as enhanced benefits or returned to BP.

5.6 In a nutshell, the scheme members, who accumulated the Fund assets over many decades as part of their terms and conditions of employment, would in the event of sale to an insurance company have a portion of their surplus transferred to the insurance company for no gain in benefits. I.e. the pensioners would foot the bill for the transfer.

5.7 In this BP case, as sponsor of the Fund BP has the power to terminate the scheme under the Trust Deed but it does not have the power to approach or negotiate with third parties. On notice of termination being served, it falls to the Trustees, as the legal owner of the Fund assets, to explore winding up options that may include the purchase of an insurance policy or annuity contract from an insurance company, lump sum payments or transfers.

5.8 Substantial conflicts of interest exist in such a buy-out/transfer transaction:

- The sponsor of the Fund, BP in this case, would be seeking to maximise return to its shareholders. So, in advance of terminating the Fund they are motivated to:

  (a) reduce the insurance company's uncertainty about future liabilities e.g. establishing a precedent of no discretionary increases (as has just occurred in BP's case, for the first time ever);

  (b) avoid having to add funds to complete the winding up transactions and contract the transaction in a manner that enhances its reported financial results.

  c) preserve the size of the surplus, at the expense of the Fund members, with the aim of maximising its own opportunity for a windfall.

- Any buyer of the Fund will: (a) seek minimum obligations and uncertainty; (b) maximum asset transfer value; and
- The beneficiaries, the pensioners, will seek, as a minimum, the continuation of the retirement terms they were led to expect over decades of employment and retirement. In BP's case this would include making good the recent 11% erosion in the value of the pension paid with any surplus that remains being, as per the Trust Deed (4.1 above), used by the Trustees to enhance the benefits of scheme members <u>with the agreement of BP</u>.

5.9 This raises the prospect of unseemly squabbles between the DB funds' legal owners (the Trustees), potential buyers, and subsequently between the Trustees and the sponsoring company regarding any residual surplus. Each party has different interests, misaligned with the fund beneficiaries - who essentially 'own' the fund including its surpluses.

<u>6. Concluding Remarks</u>

6.1 While the ownership and governance of a fund including its surplus should be contractually unambiguous, commercial considerations will heavily influence the scale of the surplus at Buy-Out/transfer and how the surplus is distributed between employer, Buy-Out insurance company and scheme members.

6.2. The BP Pension Fund provides a useful exemplar of the conflict of interest that will arise between sponsor, trustee and members for DB funds approaching maturity. The Fund has a strong surplus. The trustees have recommended increases more closely aligned to inflation. But the Sponsor has withheld its consent on what are considered to be spurious grounds. As a consequence, over the past two years the members are 11% worse off in real terms.

6.3 Government has stated that it is not prepared to countenance a reduction in employer liabilities which might simply facilitate a transfer to shareholders of cash members are relying on to support them in retirement[8]. However, this appears to be happening in plain sight, at least in BP's case

6.4 Scheme members, the beneficiaries of the trust fund, have no opportunity to influence the outcome of commercial negotiations for a Buy-Out/transfer and are therefore likely to suffer sub-optimum future benefits.

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[8] Protecting Defined Benefit Pension Schemes – 2018 White Paper, CM9591, para 218

6.5 We urge the Committee to conclude that more rights and protections are afforded to defined benefit scheme members – particularly governing the process of transfer/sale to the insurance industry.

Annex – Winding Up of the BP Pension Fund

16 Winding up the Fund

16.1 Time of winding up

The Trustee may decide to wind up the Fund at any time after the Fund terminates. The Trustee will continue to provide benefits in accordance with the Rules until the Fund has been wound up and all the benefits secured. If the Principal Company is dissolved before the winding-up is completed, the power of alteration under Clause 17 (Altering the Trust Deed and Rules) may be exercised by the Trustee alone but not so as to impose further liability on the Employers.

16.2 Use of assets

When the Trustee winds up the Fund, it will pay all sums due before the winding-up started, including lump sums in respect of Members who have died within two years before the winding-up started. It will then set aside sufficient assets to pay the expenses of the winding-up. It will then use the rest of the Fund assets as described in Clauses16.3 to 16.7 below.

16.3 Securing benefits with an Insurance Company

The Trustee will buy an insurance policy or annuity contract from an Insurance Company in the name of each person entitled to benefits under the Fund, except those for whom it provides benefits under Clauses 16.4 (Winding up lump sums) or 16.5 (Transfers to other schemes). If the Trustee has bought suitable policies or contracts before the winding-up starts, it may transfer them into the names of people entitled to benefits.

The policies and contracts will comply with the Contracting-out, Preservation and Revaluation Laws and must be consistent with the Fund's tax status as described in Clause 8.5 (Tax status of the Fund). They will provide benefits that are, as nearly as practicable, the same as the benefits that would otherwise have been provided under the Fund for, and in respect of, the people for whom they are bought. Alternatively, a policy or contract may provide different benefits (including money purchase benefits) if the Member concerned consents.

16.4 Winding up lump sums

When winding up the Fund, the Trustee may pay an immediate lump sum instead of providing other benefits, if payment of a "winding-up lump sum" is permitted under Part 4 of the Finance Act 2004. The Trustee will pay the lump sum to the person in whose name they would otherwise have bought an insurance policy or annuity contract.

16.5 Transfers to other schemes

When winding up the Fund, the Trustee may make transfer payments in accordance with Clause 10.5 (Transfers to other pension schemes and arrangements) in respect of all or any of the people entitled to benefits under the Fund, instead of buying insurance policies or annuity contracts. A transfer of benefits in respect of contracted-out employment must be approved by HM Revenue and Customs in accordance with Section 50 of the Pension Schemes Act 1993 (powers to approve arrangements for scheme ceasing to be certified).

16.6 Surplus assets

If any assets remain after all benefits have been provided in full, the Trustee may, with the consent of the Principal Company (unless the Principal Company has been dissolved), use them to increase all or any of the benefits or provide additional benefits to any extent that it considers appropriate. Any assets then remaining will be paid to one or more of the Employers in such shares as the Trustee considers appropriate, after having consulted the Principal Company. The requirements of Section 76 of the Pensions Act 1995 (excess assets on winding-up) must be satisfied before any payment is made to the Employers.

16.7 Insufficient assets

If the assets are insufficient to provide all benefits in full, the assets will be used first in accordance with Section 73 of the Pensions Act 1995 (preferential liabilities on winding-up) and regulations made under it.

Any assets by reference to which the rate or amount of money purchase benefits is calculated will then be used to provide those benefits.

Any assets then remaining will be used to satisfy any remaining liabilities of the Fund to any extent and in any order of priority as the Trustee sees fit in its absolute discretion.

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