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South Australian State Ombudsman Investigation of the *Electricity Industry Superannuation Scheme*(EISS)

Submission from the South Australian Government Superannuated Employees Association (trading as S.A. Superannuants)

Prepared by Dr Raymond Hickman on behalf of S.A. Superannuants

About the author: Dr Hickman is a former President of S.A. Superannuants and currently the member of its Executive Committee having the main responsibility for research and information. He is a retired University academic and, in retirement through his involvement with S.A. Superannuants, has represented the interests of members of defined benefit pension schemes at both State and Commonwealth levels. Dr Hickman has completed the Diploma of Superannuation Management offered by the *Association of Superannuation Funds of Australia* (ASFA). His full set of qualifications is:
Adelaide Teachers College, 1966: Diploma of Teaching
Adelaide University, 1968: Honors Bachelor of Science (First Class)
University of New South Wales, 1972: Doctor of Philosophy in Chemistry
South Australian Institute of Technology, 1989: Master of Applied Science in Pharmacy
ASFA/Macquarie University, 2005: Diploma of Superannuation Management

Part A

In this part A of the submission S.A. Superannuants (the Association) provides a brief comparison of taxed and untaxed superannuation funds and sets out, at a general level, its concerns about the change in tax status for EISS pensions.

In part B of the submission the Association has taken the Legislative Council motion referring the matter to the Ombudsman for investigation and supplied detailed arguments relevant to each part of the motion. Copies of documents referred to in the submission have been supplied as attachments.

Notes: In this submission

i. The words *scheme* and *fund* have the same meaning.
ii. ‘Rule 29(4)’, ‘the tax offset’ and ‘the method used to calculate EISS taxed-source pensions’ refer to the same thing.

Taxed and Untaxed Superannuation Funds

Before 1 July 1988 superannuation funds paid no tax on the money received as contributions or on the earnings of assets they held. On 1 July 1988 a 15% contributions tax was introduced on contributions made from pre-tax income of members and/or employers and a tax rate of up to 15% became payable on the earnings of assets.

However, constitutional limitations on the taxation power of the Commonwealth allowed state governments to go on running superannuation funds that were not subject to the new taxation regime applying from 1 July 1988. Most state governments opted, either on 1 July 1988 or by the mid-1990s, to allow their funds to be subject to the new regime with this providing substantial net benefits to most members of pension schemes at no significant additional cost to the Government employers. Only South Australia and West Australia remained outside these new arrangements. The funds that are not subject to the taxation arrangements introduced on 1 July 1988 are called *constitutionally protected funds* and/or *untaxed funds.* Pensions paid from these funds are referred to as untaxed-source pensions.

Where funds are subject to the taxation arrangements introduced on 1 July 1988 they are called *taxed funds* and the pensions they pay are called taxed-source pensions.

The effect of the taxes on fund income introduced on 1 July 1988 has been to reduce the assets of every taxed fund compared to what the fund assets would be if it had continued as an untaxed fund. Consequently, for the same level of employer contributions paid into a taxed fund on the one hand and an untaxed fund on the other hand, the pensions paid from a taxed fund will have to be smaller.

It would have been politically hazardous for a government to legislate a change that reduced retirement incomes. The 1988 Government of the day (the Hawke-Keating Labor government) avoided this hazard by allowing recipients of pensions paid from taxed funds to pay less personal income tax on their pensions than do recipients of pensions having the same gross value paid from an untaxed fund. This reduction in tax payable on taxed-source pensions was initially due to a 15% tax offset that recipients aged 55 and over could claim. The offset was calculated on the entire taxable amount of the pension but only the fraction of the pension accruing after 1 July 1988, and funded by employers, was reduced by 15%.

In this way employers were compensated for the 15% contribution tax that became payable on employer contributions from 1 July 1988 and pension recipients, except those with very small pensions, ended up with more after-tax income. People in receipt of small pensions received little or no advantage but did not have their net incomes reduced. These legislative arrangements, made by the Hawke-Keating government, are accurately described by saying that they were designed to make most people better off and no-one worse off.

The Government's objective was not to maximise its tax take from superannuation, but to bring forward the collection of tax. It could have sought to maximise its tax take, as well as bring it forward, by allowing people to claim the 15% tax offset on only the part of their pensions that had been reduced. This would have seen everyone ending up no better off and no worse off. The Government did not choose this option and instead provided the incentive of a tax offset on the entire taxable amount of the reduced pension. The incentive was quite significant as the following, typical example shows.

1. Consider a person retiring from a taxed fund after 1 July 1988 with half their fund membership completed before that date e.g. a person with 34 years membership retiring in 2005.
2. Compared to the pension this person would have received if his/her fund had continued as an untaxed fund the pension paid from the taxed fund would be reduced by half of 15% i.e. 7.5% of the amount funded by the employer.

3. If the amount funded by the employer is 80% of the total amount of the pension the reduction would be 80% of 7.5% = 6% and the taxed source pension will be 94% of the value of the pension that would have been paid if the pension fund had continued as an untaxed fund.
4. This person has lost 6% of the untaxed source pension and if we assume that this 6% would have been taxed at 31.5%, the person would have received only 4.1% in their hand. To compensate for this loss of 4.1% the person is able to claim a 15% tax offset on all, or nearly all, of the taxed-source pension. The value of this is about 15% of 94% = 14.1% of the value of the pension that would have been paid if the pension fund had continued as an untaxed fund.
5. In summary, the person in this (typical) example has lost 4.1% of the untaxed-source pension value to compensate employers for tax paid by the fund and then regained 14.1% through the personal income tax system for a net gain of 10%.

The example above explains why the Federal Government was able to introduce taxes on fund income that reduced gross benefits without there being a murmur of protest either from members or from the superannuation industry.

In 2007 the Howard-Costello Coalition government made taxed-source pensions tax-free from age 60 and allowed a 10% tax offset on the taxable amount of untaxed-source pensions. These were very significant changes to the way superannuation pensions are taxed in the hands of the pension recipients. However, there were no significant changes made to the taxation of superannuation fund income and no fund, other than EISS, attempted to claim that the change to personal income tax rates had the potential to increase employer costs for pensions.

Change in Tax Status for the *Electricity Industry Superannuation Scheme (EISS)*

The *Electricity Industry Superannuation Scheme* (EISS) was previously the *Electricity Trust of South Australia* (ETSA) superannuation scheme. The ETSA scheme was an untaxed scheme and EISS also operated as an untaxed scheme for some years. But effective from 1 July 2000 EISS has been a taxed scheme. Beginning in late 2002 EISS began to pay its pensions as taxed-source pensions and they were reduced in their gross value from the value they would have had as untaxed-source pensions. Reductions were justified but the common percentage reductions made by EISS were above 15% and no EISS members obtained an advantage from the change. This led to dissatisfaction that grew steadily as the number of EISS members receiving the new pensions increased.

It is the Association's assessment that the superannuation provisions of the *Electricity Corporations Act 1994* (as modified by the *Electricity Corporations (Restructuring and Disposal) Act 1999*) are sound and that they intended for pensions of the *Electricity Industry Superannuation Scheme* (EISS) to be reduced on the same basis as outlined above. Employers were to be protected from significant increases in their costs but were to gain no advantage from EISS becoming a taxed fund. The intrinsic tax advantage that goes with paying a pension from a taxed fund should have flowed to members as happened with comparable interstate pension funds. This assessment is based on a reading of Section 11-*Treasurer may vary rules in relation to taxation*, Part F of Schedule 1 *Superannuation* of the *Electricity Corporations Act 1994* (as modified by *Electricity Corporations (Restructuring and Disposal) Act 1999*). This reads as follows:

> ***11—Treasurer may vary rules in relation to taxation***
> *(1) The Treasurer may, after consultation with the trustee of the Scheme, insert into the Rules a rule or rules relating to changes in benefits for members and employer costs in relation to those benefits, following the Scheme's loss of constitutional protection.*
> *(2) A rule inserted by the Treasurer may—*
> *(a) prescribe a decrease in the level of gross benefits; or*
> *(b) require benefits to be paid on an untaxed basis or partly on an untaxed basis; or*
> *(c) make provisions of the kind referred to in both paragraphs (a) and (b),*

in order to avoid or reduce an increase in employer costs caused by changes in the incidence of taxation as a result of the Scheme's loss of constitutional protection.
(3) Subject to subclause (4), the change in benefits effected by a rule made under this clause must not result in the level of net benefits to which a member, or a person in respect of a member, is entitled being less than the level of net benefits to which he or she would have been entitled if the Scheme had not lost constitutional protection.

The long-running dispute that has led to this Ombudsman's investigation is about whether or not the South Australian authorities responsible for the rules of EISS have failed to ensure that all EISS rule changes were compliant with all parts of Section 11. The particular rule in dispute is rule 29(4) dealing with the reduction of pensions. The rule reads:

(4) In the case of a benefit paid as a pension, the formula determined in accordance with sub-rule (2) of this rule shall be such as to ensure that:

(a) the amount of the reduced pension from a taxed source which would be received after tax and after taking into account a taxation rebate on pension payments at a rate of 15%
Equals

(b) the amount of the pension prior to its reduction which would be received after tax assuming that it is paid as a pension from an untaxed source.

Attachment 1a provides the current Rule 29 including 29(5) which also applies to pensions. An earlier version of Rule 29 is also provided in Attachment 1a.

There are a number of worrying features of 29(4) that should have attracted the attention of both the EISS Trustee and the Department of Treasury and Finance officers who advised the then-Treasurer Kevin Foley to authorize its use. These include:

- it involves no relationship between the pension reduction and the tax cost of paying the pension from a taxed fund. Consequently this rule does not comply with 11 (1) above and could only meet all the requirements of Section 11 by some unlikely accident.
- it uses income tax rates applicable to personal income (which are progressive up to 45%) when superannuation fund income has only been subject to tax from 1 July 1988 and at a flat rate of 15% on contributions with up to 15% tax payable on investment earnings. This makes it a rule that could be expected to reduce most pensions by considerably more than the tax cost of paying the pensions from a taxed fund. This can be said confidently, and before recourse to detailed calculations, because it is common knowledge that money entering, and held within, the superannuation system is concessionally taxed compared to personal income.
- it uses the word 'equals' rather than an expression such as 'not less than' or 'is at least equal to'. Using 'equals' prevents members from getting any advantage from the change to a taxed-source pension and ensures that, if there is an advantage to be had, it goes to employers. This is forbidden by 11(2) above of the *Electricity Corporations Act 1994* (the EC Act) and, as far as S.A. Superannuants is aware, there is no precedent for it in the other Australian jurisdictions.

The greatest worry that S.A. Superannuants has about rule 29(4) is the possibility that it was known to be unlawful by both EISS and the Department of Treasurer and Finance at the time it was adopted. We consider that, over the long period since rule 29(4) was adopted, claims made by us, and by EISS members, that the rule is invalid have not been honestly dealt with by either of these entities.

An example of this, in the case of EISS, is its failure to tell members that it supported and recommended adoption of 29(4). Instead it has represented 29(4) to its members as a rule that it is using only because it is required to do so by the Treasurer.

The Department of Treasury and Finance has obtained Crown Law advice on the validity of the EISS rules (including Rule 29(4)) that is informed by a single, dubious document. This was an Explanatory Memorandum to the EISS rule changes and it is discussed in considerable detail in Part B of this submission. Other documents, that S.A. Superannuants believe would have led the Crown Solicitor to give different advice, were not provided to him.

Part B

This Part B of the submission has a structure provided by the 17 October 2012 Legislative Council motion that has led to this investigation. The components of the motion are distinguished from the submission by being highlighted in shaded boxes with the corresponding submission material being presented after each shaded box.

Much of what is set out in this submission has been communicated to both EISS and the Department of Treasury and Finance (DTF) over the last six years or so. Attachment 1b provides a copy of a paper and covering letter sent on 6 December 2007 to the EISS Chairman, Mr Mark Day, by S.A. Superannuants. Attachment 1b also includes another paper and covering letter sent to Mr Day on 11 September 2008 by the author of this submission. Mr Day did not respond to either letter.

Attachment 1c provides a copy of the letter in which the Association first notified the then-Treasurer Kevin Foley of its concern about EISS taxed-source pensions.

The crucial point made to both EISS and DTF is that Rule 29(4) is a rule designed to reduce the employer cost for EISS taxed-source pensions compared to what the cost would be if they had continued as untaxed-source pensions. Neither entity has attempted to dispute this in meaningful terms.

The position being adopted by DTF is that it has an Explanatory Memorandum to the EISS Rule changes that says there is no change in employer costs arising from those rule changes. DTF also cites Crown Law advice that all the rules are fully compliant with the EC Act. However, the Crown Law advice is informed only by the Explanatory Memorandum. Other documents that might have been provided to Crown Law were not provided.

The EISS position is that all responsibility for the validity of the rule change rests with the Treasurer. It has not acknowledged to its members that it supported and recommended the adoption of Rule 29(4).

Neither entity seems prepared to consider the possibility that the Explanatory Memorandum is misrepresenting the effect of Rule 29(4) on employer costs for pensions. Neither is prepared to give its own answer to the question -does Rule 29(4) reduce employer costs for pensions compared to what employer costs would be if the pensions continued as untaxed-source pensions? This is the question EISS members, and this Association, want answered. It is the critical question as far as compliance with the EC Act is concerned, and the first question listed for investigation in the Legislative Council Motion.

On 17 October 2012 the Legislative Council adopted the motion that has led to this inquiry. The first part of the motion reads:

> That this council:
> 1.notes the concerns of pension scheme members regarding the Electricity Industry Superannuation Scheme (EISS) and the set of documents providing the basis of that concern provided to members of parliament by the organisation SA Superannuants and Mr Richard Vear, a pensioner of EISS;
> 2. refers the following matters to the Ombudsman, pursuant to Section 14 of the Ombudsman Act 1972 for investigation and report:
>
> (a)determine whether or not the method used to calculate EISS taxed-source pensions is designed to reduce employer costs for those pensions compared to what the cost would be if the pensions continued as untaxed-source pensions; and

Attachment 1d provides the main set of documents sent to members of parliament and referred to in the Legislative Council motion. These are:

- the printed version of an e-mail sent to all members of the House of Assembly and Legislative Council
- the three documents that were attached to the e-mail
- a document provided to the Hon Iain Evans MP, Shadow Treasurer, which he used in a Parliamentary speech and which is, as a result, substantially included in Hansard.

The Association's view that Rule 29(4) is designed to reduce employer costs is supported by basic considerations and actual EISS experience.

Basic considerations pointing to reduced employer costs for EISS pensions

1. Most members of the EISS pension division (also known as division 3) have significant amounts of pre-1 July 1983 service and have paid at least part of their personal contributions from after-tax income.
2. When a superannuation fund moves into the taxed superannuation environment:
   a) the proportion of the assets it holds that is equal to the proportion of member service completed before 1 July 1983 is not subject to tax.
   b) the amount of the assets it holds that is equal to the amount of contributions paid by members from after-tax income is not subject to tax.
   c) It is only the amount of asset left after subtraction of the amounts in a. and b. from the total asset value, on which tax is payable at a rate of 15%.
   d) If the fund has an unfunded liability at the time of its move then it is eligible to make use of Pre-1 July 1988 Funding Credits (PJFCs) as employers make the contributions needed to extinguish the unfunded liability that had accrued by 1 July 1988. PJFCs reduce the amount of the contributions on which the 15% contribution tax is payable.
   e) Once a superannuation pension commences the assets backing the pension are no longer subject to tax on the earnings they produce.
3. The combined effect of 1. and 2. is that, on its move into the taxed superannuation environment, and during the process of achieving full funding, the assets backing EISS pensions would have been depleted by much less than 15%.
4. The reductions made to EISS pensions using Rule 29(4) take no account of the tax paid by EISS and are based entirely on personal income tax rates and thresholds applying to pensions in the hands of

recipients. This ensures that most EISS pensions that have commenced as taxed-source pensions since 2002 have been reduced by 15% or more.

The above-listed facts make it an arithmetic certainty that Rule 29(4) must reduce the employer cost for EISS taxed-source pensions compared to what the cost would be if the pensions had continued as untaxed-source pensions. This rule was developed by a Mercer actuary, the late Mr Allan Archer. It was recommended to the Department of Treasury and Finance, in a 1998 Review co-authored by Mr Archer, as a rule that would reduce employer costs for State Superannuation Scheme pensions. The relevant pages of this review are provided as Attachment 2. The entire review is about 90 pages in length and contains a lot of detailed calculations and explanations.

The basis that the authors of the 1998 review give for their claim that Rule 29(4) would provide savings if applied to the State Scheme are set out in Attachment 2 on pages 61 and 62 (Sections19.16 - 19.19). On page 62 in section 19.19 the saving to be made from one pension of $30,000 p.a. is calculated to be $58,000 and 14% of the pension value. On page 63 in Section 19.21 the potential saving over the entire State Pension Scheme is stated to be $540 million. The Association considers that the calculations are correct in all important respects and that they are just as relevant to EISS as to the State Pension scheme.

There is another Mercer Document dealing with the EISS rules for which Mr Archer was the sole author. This is a 2002 Explanatory Memorandum to the EISS rule changes, including Rule 29(4). A copy of this memorandum is provided as Attachment 3. The memorandum is a four page document that contains very little detail by way of calculations or explanations for the claims and assertions made in it. The memorandum was provided to the Department of Treasury and Finance by Mr Archer and it was the only document given to the Crown Solicitor when his advice was sought on the question of whether the method used to reduce EISS pensions complies with the *Electricity Corporations Act 1994.*

The memorandum, in its introduction, made the claim that the rules it was recommending be applied to reduce EISS benefits would have no effect on employer costs. It seems very odd that Mr Archer would say this without making some reference to the 1998 Mercer Review, of which he was a co-author, and which had predicted large reductions in employer costs for pensions from application of the Rule 29(4) to the State Pension Scheme. The Department of Treasury and Finance should have sought an explanation from Mr Archer of the obvious contradiction between his 2002 Explanatory Memorandum and the 1998 Review. Without an explanation for this the Explanatory Memorandum is very unconvincing and this should have been recognised by the Department of Treasury and Finance. Other properties of the Memorandum make it even more unconvincing:

- It is dated 27 June 2002 which is only one day before the Treasurer authorised the rule changes.
- The Department of Treasury and Finance cannot find a copy of the letter commissioning the actuarial work that backs the memorandum.
- The Department of Treasury and Finance cannot provide, and apparently never saw, any details of the actuarial calculations that Mr Archer claims were done.
- There is an invoice for work related to the memorandum (Attachment 4) which appears to have been sent first to EISS but paid by the Department of Treasury and Finance on the authority of a Deputy Under-Treasurer. The invoice lists an amount for the actuarial calculation of rollover tax but not for calculation of other tax costs or the savings to be made through benefit reductions. These latter calculations would have been much more demanding than the calculation of the rollover tax.

These features of the Explanatory Memorandum make it something that should not have been relied on as a basis for making reductions to EISS pensions.

The 1998 Mercer Review of taxation status for the main South Australian superannuation schemes, including the State Pension Scheme, was followed by another Mercer Review in 2004. Relevant pages of this review are provided as Attachment 5. The 2004 review was carried out by a Mr Martin Stevenson and was an update of the 1998 Report. The 2004 Review is about 30 pages in length and, like the 1998 review, contains a lot of detail by way of calculations and explanations. Mr Stevenson reached the same conclusion about the effect of the Rule 29(4) on employer costs for state scheme pensions as had the 1998 review. Furthermore, Mr Stevenson refers repeatedly to EISS experience as he discusses the effect that Rule 29(4) will have on employer costs for State Scheme pensions. If the method was having a different effect on employer costs for EISS pensions than it would have on the costs for State Scheme pensions Mr Stevenson would surely have made this clear.

On page 7 of his report Mr Stevenson writes:

> *'In the Lump Sum Scheme/Pension Scheme there is a net tax advantage in moving from an untaxed environment to a taxed environment. These advantages could be used to increase members' benefits and/or reduce employer costs. If members' benefits are maintained at current levels (after allowing for tax effects), then savings of the order of $450 million are estimated for the employer.'*

On page 9 Mr Stevenson writes:

> *'To ensure that employer contributions remain the same (before and after the fund becomes taxable) other superannuation funds have adjusted benefits (other than death benefits and the insured component of disability benefits) to the following level:*
> *Current (untaxed) benefit x (1-.15 B/C x P)*
> *Where B = the period in days of contributory service that began on 1 July 1988*
> *C = the period in days of contributory service*
> *P = the proportion of the benefit deemed to be employer financed'*

Here Mr Stevenson is advising the Department of Treasury and Finance of two things:

- There is a tax advantage available from moving a pension fund to the taxed environment and that advantage can pass to either members or employers
- In other Australian states the advantage was obtained by members with employers' costs being held the same

So, there are two Mercer Reviews contradicting the Explanatory Memorandum and each is more substantial and convincing than the memorandum. This is because each sets out the basis for saying that Rule 29(4) will reduce employer costs for pensions. This basis is that the rule uses personal income tax rates (usually averaging more than 15%) for the entire amount of the pension rather than the flat rate of 15% payable by a superannuation fund on only part of the contributions and earnings of the fund.

The Explanatory Memorandum makes its claim of no change in employer costs without mentioning that pensions are to be reduced using personal income tax rates rather than rates applicable to superannuation funds. There is no reference to the fact that this approach will have the effect of reducing pensions by much larger percentages than is the case for lump sum benefits. On pages 2 and 3 of the Memorandum, under the heading *Actuarial Analysis,* a set of figures is produced without an explanation of how they have been obtained.

In late 2011 the Association learned via a Freedom of Information (FOI) application that when the Department of Treasury and Finance sought a legal opinion on the validity of the EISS rule changes made in 2002 it provided the Crown Solicitor with only the Explanatory Memorandum. The Crown

Solicitor was not given the much more substantial 2002 and 2004 Mercer Reviews. This led to the Association requesting the Opposition Shadow Treasurer, Hon Iain Evans MP, to ask the Minister for Finance, Hon Michael O'Brien MP, the following question:

> *Does the Minister know that the Department of Treasury and Finance holds Mercer Reports of 1998 and 2004 that both describe the EISS method for the calculation of taxed-source pensions as a method that would have the effect of reducing employer costs for those pensions compared to what the cost would be if the pensions continued as untaxed-source pensions?*
>
> Minister O'Brien responded by saying:
> *Yes. However, I am advised that the Mercer actuarial reports to which you refer are reports relating to the main scheme, and <u>not</u> the EISS scheme. The comments in those Mercer reports are not relevant to the EISS scheme and cannot be applied to the EISS situation as a result of the restructuring and financing agreements that were involved in the sale of the electricity business. As the superannuants have been advised on numerous occasions, there are very different funding and tax positions between the State Superannuation Scheme and the EISS. One fundamental difference is that at the time when the EISS scheme moved into the taxed environment, there were no existing pensioners in the scheme for which tax benefits could be claimed.*

The Association wrote to Mr O'Brien early in August 2012 to say that it does not matter if, at the time a pension fund moves to the taxed environment, it has no members who are pensioners and it does not matter if it is fully funded or completely unfunded, Rule 29(4) will still reduce employer costs for the pensions. Our detailed reasons for saying this were set out in the letter, a copy of which is provided as Attachment 6. The letter invited the Minister to have his advisers tell him, and us, if there are serious inaccuracies in our letter. We have not been advised of any inaccuracies, serious or otherwise.

Actual EISS experience confirming reduced employer costs for pensions

It is one thing to say that Rule 29(4) is not going to reduce employer costs for pensions and to pluck out of the air, as the Explanatory Memorandum does, figures consistent with this claim. But it is another thing altogether to prevent people from seeing evidence to the contrary in the actual taxation experience of EISS.

a) Annual taxation experience of EISS 2000-2006

EISS entered the taxed superannuation environment effective from 1 July 2000 and tax was payable on the assets accumulated at that date as described in 2 (a) – (c) on page 6. The assets held by EISS on 1 July 2000 were valued at $116.7 million and the tax paid on these assets was $6.2 million or 5.3% (see Attachment 7). This small percentage of tax payable is consistent with EISS members having a significant proportion of their service completed before 1 July 1983 and having made personal contributions from after-tax income.

The EISS unfunded liability had been extinguished by the end of the 2005/2006 financial year (see Attachment 8). In the period 1 July 2000 until 30 June 2006 the employer contributions to EISS totalled $317.3 million (see Attachment 9) - and the scheme utilised $238.8 million in PJFCs (see Attachment 10). Each dollar of PJFC reduces the employer contributions on which tax is payable by a dollar and so EISS paid tax at a rate of 15% on employer contributions of $317.3 million - $238.8 million = $78.5 million i.e. $11.8 million = 3.7% of the contributions made. This small percentage of contributions paid as tax reflects the significant proportion of member service completed before 1 July 1988 and the consequent ability to use PJFCs.

During the period 2002-2006 dozens of taxed-source pensions commenced and most were reduced from their values as untaxed-source pensions by more than 15%. This percentage reduction is much higher than would have been required to compensate employers for the effect of tax on assets held at 1 July 2000 and on employer contributions made to extinguish unfunded liability over the 2000-2006 interval. All the pensions would have been fully funded at the time of their commencement and no tax will have been paid, since their commencement, on the assets backing them.

Note: 1 July 1983 and 1 July 1988 are both significant dates as far as tax payable on superannuation money is concerned.

- 1 July 1983 is the date used in calculating tax payable on lump sum benefits. The part of a lump sum benefit that corresponds to service completed before 1 July 1983 is tax exempt on rollover.
- 1 July 1988 is the date on which superannuation funds first became liable to pay the 15% contributions tax and tax of up to 15% on investment earnings. It is the date used in the determination of the amount of pre-1 July 1988 Funding Credits (PJFCs) that a superannuation fund has available. Funds with PJFCs available for use are those that have unfunded liabilities for benefits accruing before 1 July 1988.

Other EISS experience confirming reduced employer costs for EISS pensions

1. On 23rd March 2003 Mr Archer provided the EISS Trustee with a series of reports on different parts of EISS related to different employers. The reports were all similar and one was entitled *"Electricity Industry Superannuation Scheme Report on the Financial Position of the Part of the Scheme relating to ETSA Utilities as at 30 June 2002".* In the Appendices to this report in *Appendix 4: Comparison with Previous Year* we read that the year ending 30 June 2002 had been a year in which the EISS investment return had been minus 7.7% and about 15% lower than the return that had been expected. But despite this the overall financial position of the scheme improved during this year of poor investment returns. This was also the year in which the benefit reductions were made for tax reasons. Investment earnings and tax changes are discussed as follows:

> *(a)* ***Investment earnings:*** *The investment earnings of the Scheme over 2001/02 was minus 7.7%. This was around 15% lower than the average return previously expected. This put a substantial strain on the Scheme's financial position in respect of the defined-benefit sections of the Scheme- principally the Pension Scheme and, to a lesser extent, the Lump Sum Scheme.*
>
> *(b)* ***Tax changes:*** *As it turned out, the financial strain from negative investment earnings was more than counterbalanced by the impact of tax reductions to benefits. Overall the tax reductions do not alter employer costs. However they have reduced the immediate funding targets, by reducing benefits built up to date by more than the assets.*

Here is an acknowledgement by Mr Archer himself that his rules for pension reductions had reduced benefits by more than the taxation changes had reduced the scheme assets. This is what had been predicted in the 1998 Mercer Report of which Mr Archer had been a co-author. It contradicts the claim that Mr Archer had made less than a year earlier in his Explanatory Memorandum when he said that rule changes for reduction of benefits would not alter employer costs. A copy of Appendix 4 is provided as Attachment 11.

2. The 30 June 2011 Actuarial Investigation of EISS includes the information that 'Untaxed pensions incur a higher employer cost.' (see Attachment 11a). This is confirmation of the validity of the case being made in this submission that Rule 29(4) reduces the employer cost for pensions compared to what the cost would be if the pensions were paid as untaxed-source pensions.

The Legislative Council motion continues as:

> (b)if it is a method designed to reduce employer costs, determine:
>
> (i)whether or not the EISS Board and the Department of Treasury and Finance knew this, or ought to have known this, at the time the rule was authorized for use;

The EC Act required the State Treasurer to consult with the EISS Trustee before inserting rules that reduced benefits and this gave the Trustee the opportunity, and the obligation, to be an active participant in the development of the rules. It also placed an obligation on the Department of Treasury and Finance to take into account the Trustee's view of what the rules should be.

Attachment 12 is a copy of a 5 May 2000 letter to the then-EISS Secretary, Mr Colin Lloyd, from Mr Allan Archer. The letter is headed 'Tax Reductions to Benefits: implementation steps' and first describes what will have to happen in order to get to the point where consideration can be given to rules for benefit reductions. Mr Archer then provides the following outline for the involvement of the EISS Board from that point on.

> *3. The Treasurer is then expected to consult with the Superannuation Board over the way the Scheme benefits (before tax) should be reduced so as to avoid an increase in employer costs arising from the loss of constitutional protection. (Refer clause 11 of Schedule 1 of the Electricity Corporations Act 1994)*
> *4. The Board will need to consider the most equitable way of making the benefit reductions to achieve the cost objective set by the Treasurer. It is anticipated that the Treasurer will rely upon the Board to be the most appropriate judge of equity in this area (given that there will be a range of benefit reductions which will give the required cost effect).*
> *5. Appropriate rule amendments will then need to be drafted for approval by the Treasurer*
> *6. The Board will need to inform members of the proposed changes and effect upon each member's ultimate benefits*

This shows that the Board, in 2002, would have been aware of its obligation, and opportunity, to be an active participant in the process leading up to adoption of the rules for benefit reductions, including 29(4).

Before the method for reducing EISS pensions was adopted both EISS and DTF would have known, or should have taken steps to find out, how pensions paid in other states had been adjusted when the schemes there became taxed schemes. This would have made them aware that the adjustment was by a much different method than Mr Archer was recommending. Attachment 13 is a copy of a 15 August 2005 letter the Association obtained from the *SAS Trustee Corporation*, which has responsibility for the New South Wales pension schemes, after it had asked the corporation for information about how the NSW pensions had been affected when they became taxed-source pensions. The letter from *SAS Trustee Corporation* advises that only the employer funded component of the pension accruing after 1 July 1988 is reduced. Attachment 13a provides a copy of a 1 May 2005 letter from the Victorian *Government Superannuation Office* (which has since become *ESSSuper*) and a page from the website of *ESSSuper.* The letter and webpage indicate that Victorian pensions were adjusted on the same or very similar basis as New South Wales pensions.

It is likely that EISS and DTF were both aware that Mr Archer's proposed method for reducing pensions was going to reduce pensions by much more than pensions had been reduced in New South Wales and Victoria. They would have also known that the New South Wales and Victorian Schemes had not experienced significant increases in employer costs as a result of the pensions being paid as taxed-source pensions, and that most members were made better off for the change. From this knowledge the EISS Board and the Department of Treasury and Finance would have known, or should have known, that Mr Archer's proposed method for reducing EISS pensions was designed to reduce employer costs for the pensions.

The Legislative Council motion continues as:

> (ii)whether or not, since the time of the rule's authorization, the EISS Board and the Department of Treasury and Finance have dealt appropriately with the representations being made to them about the validity of the rule; and

In the view of the Association neither EISS nor DTF have dealt appropriately with the representations made to them about the validity of rule 29(4). This is because the behavior of both entities has not met the recognized standards expected of authorities having responsibility for superannuation funds. These recognized standards are stated as covenants in the Commonwealth Government's *Superannuation Industry (Supervision) Act 1993* (SIS) which applies to all private sector superannuation entities. These include the covenants:

(a) to act honestly in all matters concerning the entity;
(b) to exercise, in relation to all matters affecting the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide;
(c) to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries;

Under SIS these covenants are deemed to be part of the Trust deed and/or rules even if they are not written into the deed or rules.

The public sector schemes operating under state legislation are not directly subject to SIS and this is so for EISS. It was originally intended that EISS would become a SIS fund to reflect the fact that, since privatization, all its employer-sponsors have been private sector employers. This intention was never carried out but it is still reasonable to say that the EISS Trustee and the Department of Treasury and Finance have an obligation to ensure that the standards defined by the above three covenants are met in the running of EISS. An expression used to concisely describe the obligation of the various states in the running of their superannuation funds that have been exempted from direct SIS regulation is that those states have been granted the exemption because they have agreed to run the funds *'in accord with the spirit and intent of SIS'*. Consequently, the Association believes that, in this matter of EISS taxed-source pensions, the conduct of EISS and DTF should be measured, for appropriateness, against the above covenants.

Conduct of the EISS Board

The EISS Board's dealing with a single member

Mr Barry Foster is an EISS member who had 41 years of service in the electricity industry and retired at the end of 2002. He was among the first EISS pension division members to feel the effect of its new rules. If Mr Foster had commuted 100% of his untaxed-source pension the tax payable on the lump sum would have reduced it by 5.7%. He did not want to commute his pension and was told that the only alternative then was to have his untaxed-source pension entitlement paid as a taxed-source pension which would be 17.1% less in its gross amount than the untaxed-source pension. He did not want to take his pension in this form and would have preferred to take the original untaxed-source pension. He is adamant that the person outlining his options made it clear that he could not opt for the untaxed-source pension. This person was Mr Archer who had developed the rules for changes to EISS benefits.

The written materials that Mr Foster was given at the time of his retirement are provided as Attachment 14. They say nothing about the possibility of him opting for an untaxed-source pension and the pension specified for him is a taxed-source pension. The materials include a sheet headed 'Benefit Reduction' which includes the statement 'This reduction is intended to represent the amount of tax that the scheme will become liable to pay in respect of your benefit.' So Mr Foster was led to believe that his pension reduction simply matched the tax that the scheme had to pay because the pension had been converted to a taxed-source pension.

Mr Foster was not accepting of the need for his pension to be reduced by such a large amount. On 25 March 2006 he wrote to EISS asking to be told the amount of tax that the scheme had paid in respect of his benefit. In a letter dated 2 May 2006 he got the answer:

> *'The amount of tax paid by the scheme in respect of your pension is almost impossible to determine.' (see Attachment 15)*

On 18 May 2006 he wrote again to ask if his pension had been reduced by an amount greater than that needed to avoid an increase in employer costs. In a letter dated 28 September 2006 he got the answer:

> *'The Board is required to adjust your pension in accordance with the rules inserted by the Treasurer, and has done so accordingly.' (see Attachment 16).*

In response to his pointing out that the commuted lump sum was reduced by tax by a much smaller percentage than was his pension he got the statement:

> *'You raise the issue of the difference between the adjustments to lump sums and pension benefits. The adjustment is very different because the taxation is very different.' (see Attachment 16)*

If the second sentence in the statement immediately above is saying that superannuation funds pay different amounts of tax on money backing lump sum benefits than on money backing pensions it is incorrect. The tax payable on contributions and earnings in a taxed superannuation fund are the same whether that fund pays benefits as lump sums or as pensions. When there is a pension that is to be converted from untaxed to taxed in a taxed fund, the tax payable on a lump sum, that the person elects to take from the fund by commutation of the pension, is calculated by the same method, and using the same tax rate of 15%, as is used to calculate the tax payable on the sum that the fund retains to pay the pension that has not been commuted and that is to be converted to a taxed-source pension.

If the statement is saying that EISS makes its adjustments to lump sums and pensions differently this is meaningless and evades the issue of interest to Mr Foster.

In the letter of 2 May 2006 (Attachment 15), that told him the tax payable in respect of his pension is almost impossible to determine, Mr Foster was told that he could have opted for an untaxed-source pension in 2002. He rejects this and has a clear recollection that he was led to believe that commutation, or a taxed-source pension, were his only options. The written statement he was given about his entitlement in February 2003 (see Attachment 14) contained information about commutation and a taxed-source pension only. It said nothing about him being able to opt for the untaxed-source pension.

In the letter of 28 September 2006 (Attachment 16), that told him lump sums and pensions had to be adjusted differently EISS admitted that the availability of the untaxed-source option was not made explicit for members until 2005.

Mr Foster has now accepted the EISS offer for him to revert to his untaxed-source pension because this makes him better off than he was with his taxed-source pension that involved a 17.1% reduction. But he would be better off with a taxed-source pension if it was reduced by only the percentage needed to meet employer tax costs *viz.* about 4-6%.

The EISS Board's dealings with pension division members collectively

Mr Foster is just one of many EISS members who have unsuccessfully tried to get an answer to the question of whether Rule 29(4) reduces pensions by more than the employer tax cost of paying them as taxed-source pensions.

On August 2nd 2007 the EISS Board Chairman, Mr Mark Day, wrote to the Treasurer to inform him about members' concerns over the pension reductions. A copy of Mr Day's letter is provided as Attachment 17. It included this statement:

> *'As the Board must operate the Scheme in accordance with the Scheme Rules it is important that any rules which the Board applies are valid. As the Board was not responsible for the relevant amendments made by the Treasurer, the Board considers it prudent to seek a review of the rule amendments made in June 2002.'*

The claim that the Board was not responsible for the relevant amendments made by the Treasurer is inconsistent with the fact that on June 7th 2002, EISS wrote to the Under-treasurer (see Attachment 18) saying that:

> *' The Board advises it supports and recommends the proposed rule changes that have been developed by Mr Allan Archer of Mercers.'*

Mr Day commenced his role of Board Chairman on 20th March 2002 and so he ought to have known about the June 7th 2002 letter.

Attachment 18a is a letter (with attachments) dated 1 August 2007 from Mr Day to Richard Bradshaw a lawyer representing unions to which EISS members belong. This letter and its attachments is a response to a letter that Mr Bradshaw had sent to Mr Day on 31 May 2007. Among the attachments to Mr Day's letter is a document dated 30 May 2007 entitled *'Fact Sheet for 4 June 2007 Meeting'*. This was prepared by EISS and provided to members before the meeting. The members looked at the fact sheet and provided a set of questions corresponding to its contents. The meeting was held and then EISS produced another document in which the members' questions are listed together with the answers that EISS supplied. This is another attachment to the 1 August 2007 letter and is headed *'EISS Superannuation Meeting 4 June 2007, at 6.00 p.m. ETSA Auditorium Proposed Questions'*. From this document we see:

A point 13. listed in the Fact Sheet was:

> *13. The Treasurer set the rules for the tax offset effective on privatisation. The Board's job is to administer those rules.*
> The members asked the questions:
> *Who provided the advice to the Treasurer in the first place? Did EISS provide advice about the rules? Can we see the memorandum from the Treasurer advising what these rules were? Does the memorandum provide the Board with any discretion or ability to interpret the rules for the benefit or otherwise of the members or employers?*
> The answer the members were given was:
> *You will need to ask the Treasurer.*

So, the members asked the direct question ‘Did EISS provide advice about the rules?’ There is a document (Attachment 18) that EISS produced and sent to the Under - Treasurer advising that the Board ‘supports and recommends’ adoption of the rules. But the members, instead of being told about this act of the Board, were told they would have to ask the Treasurer.

On 15 July 2008 Richard Bradshaw, wrote to Mr Day and on 18 September 2008 Suzanne Mackenzie, a lawyer acting on behalf of EISS, replied to the letter. Copies of these two letters are provided as Attachment 18b.

In numbered point 1. on the first page of his letter Richard Bradshaw acknowledges that the Trustee must administer EISS in accord with the EC Act, Trust deed and rules but then says ‘our agreement is subject to the qualification that the rules must be valid.’ In numbered points 2. - 4. Mr Bradshaw puts a view that, as a matter of honesty and good faith, the Board is obliged to ensure that Rule 29 is not reducing employer costs. Mr Bradshaw says this without making a mention of the Board having supported and recommended adoption of Rule 29(4). This indicates that he was not aware of the fact that the Board had done this. If he had been aware he would have been even more insistent about the Board’s obligation to establish the true impact of Rule 29(4) on employer costs.

The Suzanne Mackenzie letter rejects Mr Bradshaw’s view. In a section on page 2 headed ‘Invalidity of Rule 29’ she sets out points from which it is clear that the EISS legal advice was that it should not be concerned about the validity of Rule 29 even if it was, or became, aware of reasons why the rule might be invalid. In the point numbered 13. we read ‘the Queen’s Counsel’s opinion confirms that clause 11 (2) of Schedule 1 of the EC Act is a spent force and does not bind the Board and is not relevant to the correct interpretation of rule 29’. It seems remarkable that any legal adviser would tell EISS that it bore no responsibility for, and should take no interest in, the validity of rules that it had supported and recommended. However, the Suzanne Mackenzie letter does not refer to the 7 June 2002 letter that EISS had sent to the Under-Treasurer and this allows the possibility that the EISS legal advice was obtained without making this known to the lawyers who were providing the advice.

On 3rd December 2008 Mr Day wrote to Mr Andy Dennard, Secretary, Australian Services Union (Attachment 18c).

Referring to the concerns of EISS pension division members over the method being used to calculate taxed-source pensions Mr Day, in a numbered point 1., writes:

1. *“When Mr Archer (the actuary) provided advice to the Treasurer on the changes to superannuation benefits following privatization of the industry and hence the Scheme, we understand that he did so on a scheme-wide basis. We have a Queen’s Counsel opinion that confirms this was the correct approach for the Treasurer to adopt.*

   Consequently, we acknowledge that there are ‘unders’ and ‘overs’ as the benefit reduction formula applies to particular members and the corresponding employer costs. The Board has publically discussed this with members previously.

   The way the benefit reduction is calculated on a taxed pension may mean that the cost of a Division 3 taxed pension may be lower than the cost of a Division 3 untaxed pension. However, it is not the Board’s job to determine whether the condition relating to employer costs under clause 11(2) of Part F of Schedule 1 of the EC Act is or has been satisfied – this was a matter for the Treasurer to determine at the time of making the rule amendments. Regardless of whether the Board considers the rules to be equitable, the role *of the Board is to apply the rules. The rules require that pensioners receive the same benefit after income tax without regard to how this impacts on employer costs."*

In the first paragraph the words 'we understand' imply that the Board had not seen for itself the actuarial advice that the Treasurer relied on.

The references to the actuarial advice being 'scheme-wide' and there being 'under' and 'overs' in employer costs are unconvincing in the absence of examples. If the pension division is a scheme (and it is referred to as a scheme in EISS annual reports) then it should not be necessary for any pensions to incur extra costs for employers because such pensions could be paid as untaxed-source pensions.

The first sentence of the last paragraph in point 1. above acknowledges that taxed-source pensions may have a lower cost than untaxed-source pensions. Also relevant to this point is Mr Day's letter to the Treasurer provided in Attachment 17. The letter on its second page says:

> *'However, the formula applied pursuant to Rule 29 of Division 1 of the Scheme rules operates in a way that provides in most cases for pensions to be reduced by more than 15%, depending on the amount of the pension.'*

Clearly pensions that might increase employer costs have to be the pensions of relatively small amounts that are subject to reductions of less than 15%. These pensions are in the minority and it would be in the interests of most members receiving them, as well as employers, for the pensions to be paid as untaxed-source pensions.

The last sentence of the last paragraph in point 1. above acknowledges that the pensions are being reduced without taking account of how the reduction affects employer costs. This is surely an admission that Rule 29(4) cannot be valid. It seems likely that Mr Day and the EISS Board have an opinion on whether or not their pension reduction rule has been designed to reduce employer costs, and on the consequential question of whether or not it complies with the EC Act, but are not prepared to give that opinion. This is in spite of Mr Day's saying to the State Treasurer in his letter of August 2nd 2007 (Attachment 17) that it is important for the Board to know that the rules it is applying are valid. Once again Mr Day assigns all responsibility for the validity of the rules to the Treasurer making no mention that EISS had supported and recommended their adoption.

On the 12th of March 2009 Mr Day wrote to members of the EISS pension division about the method being used to calculate taxed-source pensions. The letter, which is provided as Attachment 19a, has an appendix that sets out in chronological order the Board's work carried out in connection with Rule 29(4) which it refers to as the tax offset. For the year 2002 the appendix lists the insertion of the tax offset rule by the Treasurer but does not refer to this having been done after the EISS board had acted to support and recommend insertion of the rule.

On page 2 of the 12 March 2009 letter we read:

> ***Review of employer costs***
> *The Board has been asked on a number of occasions whether employers' costs were reduced when the Offset was introduced. The Board has not asked for a formal review of this:*
>
> *firstly, because the original actuarial review requested by the Government at privatisation stated that 'scheme-wide', there was no reduction in employer costs and*
>
> *secondly, regardless of what the answer is, the Board has no power to take any action.*

The judgement and impact of the Offset on employer costs was the Treasurer's responsibility under the Act. If the Board wishes to act in a way that increases employer costs, it requires the permission of the employers. The employers have formally been asked if they would consider altering the Offset to align directly with the 15% tax rate. No employers have been prepared to do so.

The above section from the letter is just a small part of a very lengthy account of what the EISS Board has done in response to members' concerns about the Offset and there is no disputing that this is a great deal. However, it does not tell members that the Board supported and recommended adoption of the 2002 rules. The Board certainly would have incurred considerable expense on legal advice, and devoted a lot of the time of its in-house staff, to this matter. But all this expense and effort can be fairly described as being made to justify its refusal to form its own opinion on the main question that members were asking. This question was to the effect – *has my pension been reduced by a method that was designed to deliver savings to employers?*

Attachment 19b contains copies of two documents dealing with the rule changes made in June 2002. One document is a Newsletter dated October 2002. On its second page under the heading 'Scheme taxation changes' the newsletter provides information about benefit reductions. The first paragraph reads:

'As part of the process of moving to a taxed status , the State Treasurer has now reduced gross-of-tax benefits in the scheme.'

There is no mention of the fact that the Board had recommended and supported the reductions. The pension scheme is lumped together with the other EISS schemes in a way that suggests pension benefits were reduced by the same method as benefits for those other schemes.

The other document is entitled 'Tax on benefits, & the 'Contribution Tax Offset'. It is undated but EISS members have told the author of this submission it was published in late 2005. By this time pension division members were noticing that their pensions were being reduced by much more than were lump sums even when the lump sum was obtained by commutation of the pension. The document addresses this issue as follows:

'For lump sum benefits, the Contribution Tax Offset is limited to 15% of the part of the gross benefit due to membership after 1983. This is because, when the scheme was untaxed, members always had the option of rolling a benefit over to a taxed scheme. This would result in tax of 15% being deducted on rolling over, which was effectively a contribution tax offset of 15%.

There is no such limit to the offset on pension benefits. The reduction will depend on the amount of the pension and the tax rate at the time the pension starts, amongst other things.

This means that the effect, as a percentage of your original pension, can be greater than 15%. Why is this? Because the improvement in the tax on pensions due to the change in the Scheme's tax gets more valuable as your pension (and your average marginal tax rate) increases.'

These paragraphs have been written to confuse not to clarify. From the last sentence, particularly, it seems likely that whoever wrote this would have known that tax costs, expressed as percentages, were about the same for people with the same employment history regardless of whether the benefit was a lump sum or a pension.

Conduct of the Department of Treasury and Finance

The Association first raised its concerns about EISS taxed-source pensions with the State Treasurer in 2006 (refer Attachment 1c). This was after we had learned that Rule 29(4) was being used to calculate EISS taxed-source pensions. We made clear our reasons for thinking Rule 29(4) was invalid and in doing so referred to the 2004 Mercer Report. A copy of a letter received from the Treasurer in reply to our concerns is provided as Attachment 20. This letter tells us that we were incorrectly interpreting the EC Act when we said it only allowed for benefits to be reduced ‘to the extent needed to avoid or reduce an increase in employer costs arising from a change in the incidence of taxation’. The Treasurer’s letter did not explain what the error was in our interpretation and nor did it refer to the 2004 Mercer Report or the earlier 1998 Report.

We requested the Treasurer to obtain Crown Law advice about the validity of Rule 29(4) and, after initially declining, he did so. Much to our surprise the Crown Solicitor advised that the rule was valid. The Association Vice-President, Mr Clive Brooks, retired as a Senior Solicitor from the Crown Law Office and so is not inclined to denigrate its work. But the full set of facts about EISS taxed-source pensions do not appear to allow the possibility that the method for calculating them is compliant with the Electricity Corporations Act 1994. This led Mr Brooks to persist with attempts to establish what documents had been provided to the Crown Solicitor. In late 2011, he was able to establish, with the assistance of the Ombudsman’s Office, that the Crown Law Office had been given only the 2002 Explanatory Memorandum when its advice was sought. The 1998 and 2004 Mercer Reviews were not provided to the Office and we believe, had those reviews been considered by the Crown Law Office, it would have advised the Treasurer that Rule 29(4) was not valid.

The only explanation the Government has given for providing the Crown Solicitor with the Explanatory Memorandum, but not with the 1998 and 2004 Mercer reviews, is that the latter two reports were relevant only to the State Pension Scheme and not to EISS pensions. This is highly implausible (refer to Attachment 5) and it is reasonable to consider the possibility that the Crown Solicitor was not given the 1998 and 2004 Reviews because those responsible for the decision knew the Crown Solicitor would have to recognise them as evidence that rule 29(4) was invalid.

Attachment 21 is a copy of letter dated 19 June 2008 from the State Treasurer to the Hon Bob Such MP in response to representations that Dr Such had made about EISS pensions on behalf of one of his constituents. This was Mr Richard Vear who is an EISS member in receipt of a taxed-source pension. Mr Vear was claiming that EISS pensions were being reduced by a method that delivered savings to employers. The Treasurer’s response describes the claim that EISS pensions were being reduced by more than they should be as having been ‘thoroughly investigated by the Crown Solicitor’ who ‘concluded that the rule changes made in 2002 are entirely valid…. The letter admits that ‘Treasury and Finance does not hold copies of the actuary’s worksheets that were used by the actuarial consultant to calculate the required offset.’

Attachment 22 is the Treasurer’s response to the letter sent to him on 2nd August 2007 by Mr Mark Day, the EISS Chairman (Attachment 17). In the second paragraph of this letter the Treasurer says to Mr Day:

> *‘I note the comment in your letter that the Board does not wish to indicate that it necessarily agrees or disagrees with the views expressed by some members’.*

It seems extraordinary that the Treasurer did not note Mr Day's summary appearing at the end of the same letter.

> *'As the Board must operate the Scheme in accordance with the Scheme Rules it is important that any rules which the Board applies are valid. As the Board was not responsible for the relevant amendments made by the Treasurer, the Board considers it prudent to seek a review of the rule amendments made in June 2002.'*

In this passage Mr Day is telling the Treasurer that it '*was not responsible for the relevant amendments made by the Treasurer'* when the Under-Treasurer had been sent a letter by the Board to say that it recommended and supported the June 2002 amendments. The Treasurer himself had advised us , EISS members and members of parliament of this.

The Treasurer's letter concludes with the following paragraph:

> *I can advise you that the Crown Solicitor has considered the matter raised in your letter. The Crown Solicitor has indicated that he is of the view that the rule changes made in 2002 are entirely valid and comply with the provisions of Clause 11 of the Act, after taking into account the increased employer costs that had to be offset*

Included in Attachment 22 is the Minute recommending that the Treasurer approve the letter to be sent to Mr Day. On the second page of the Minute the following dot point appears:

- *In accepting the rule change in 2002, the Treasurer noted the following:*
  - *The present value of the scheme's tax liabilities were estimated to amount to $44 million; and*
  - *The tax costs for current members could be covered by;*
    - *Reducing member gross benefits at a level that maintained the same net benefit for members which would save the scheme $19 million, and*
    - *Using the pre-July 1988 funding credits which would save the fund $25 million*

These are the unsubstantiated figures that the Explanatory Memorandum contained and it seems likely that the Crown Solicitor was put in the position of having to give his advice assuming that the figures are correct. The minute also refers to the written advice that the Crown Solicitor had provided. The Association hopes that the Ombudsman will look at this advice, having in mind the content of this submission, and make his own assessment on whether or not the briefing provided to the Crown Law Office was adequate.

The Legislative Council motion continues as:

> (iii)whether or not it is a method that complies with the Electricity Corporations Act 1994 (as modified by the Electricity Corporation (Restructuring and Disposal) Act 1999) and the Heads of Government Agreement on Superannuation;

Does Rule 29(4) comply with the EC Act?

The *Electricity Corporations (Restructuring and Disposal) Act 1999* made changes to the *Electricity Corporations Act 1994* (EC Act) that anticipated conversion of the *Electricity Industry Superannuation Scheme* (EISS) from an untaxed-source scheme to a taxed-source scheme. These modifications provided for the State Treasurer, after consultation with the EISS Board, to authorize EISS to apply rules to reduce benefits, including pensions, to the extent required to 'avoid or reduce an increase' in employer costs arising from the taxes payable by the scheme after it became a taxed-source. The requirements to be met by the rule changes are set out in Section 11, Part F of Schedule 1 *Superannuation,* in the EC Act. The relevant parts of Section 11 are reproduced below.

Note: The extract from the EC Act below includes the term 'constitutional protection'. This term refers to the fact that untaxed-sources exist only because of constitutional limitations on the taxation power of the Commonwealth. When a state changes one of its schemes to a taxed-source it must give up this constitutional protection for that scheme.

> ***11—Treasurer may vary Rules in relation to taxation***
> *(1) The Treasurer may, after consultation with the trustee of the Scheme, insert into the Rules a rule or rules relating to changes in benefits for members and employer costs in relation to those benefits, following the Scheme's loss of constitutional protection.*
> *(2) A rule inserted by the Treasurer may—*
> *(a) prescribe a decrease in the level of gross benefits; or*
> *(b) require benefits to be paid on an untaxed basis or partly on an untaxed basis; or*
> *(c) make provisions of the kind referred to in both paragraphs (a) and (b),*
> *in order to avoid or reduce an increase in employer costs caused by changes in the incidence of taxation as a result of the Scheme's loss of constitutional protection.*
> *(3) Subject to subclause (4), the change in benefits effected by a rule made under this clause must not result in the level of net benefits to which a member, or a person in respect of a member, is entitled being less than the level of net benefits to which he or she would have been entitled if the Scheme had not lost constitutional protection.*

Sub-clause 11 (1) requires that there be a relationship between the change in employer costs and the rule or rules for changes to benefits. This did not happen with pensions, where Rule 29(4) used only personal income tax rates to calculate the taxed-source pension value. The change in employer costs associated with the pension being paid as a taxed-source pension was ignored. This, by itself, makes the Rule 29(4) invalid.

Sub-clause 11 (2) requires that the rules must not reduce employer costs and are restricted to just avoiding an increase in those costs or keeping any increase to a minimum. This placed an obligation on the Treasurer, and the EISS Board, to be very confident that the rule changes were not going to reduce employer costs and, in that way, pass to employers a tax advantage that otherwise would have gone to members. The Association believes that both EISS and the Department of Treasury and Finance officers advising the Treasurer knew, or ought to have known, that the method for calculating pensions (Rule 29(4))was going to reduce employer costs. Thus 11 (2) is not complied with and the rule for reducing pensions is invalid on this account also.

The EISS rule does comply with 11 (3) but this provision only sets the floor below which no pension can be reduced. It does not authorize all pensions to be reduced to this extent, which is what Rule 29(4) does.

Does Rule 29(4) comply with the *Heads of Government Agreement on Superannuation*?
The *Heads of Government Agreement on Superannuation* is an agreement in place between the Commonwealth and all states. A copy of the agreement is provided as Attachment 23. The first paragraph of the agreement is as follows:

> *'The Commonwealth and the State and Territory Governments recognise the need to apply national standards to certain aspects of superannuation without distinguishing between employees of the public and private sector. For example, it is important that members'*

accrued entitlements are securely protected, and that there is consistency of taxation outcomes for members' superannuation benefits.'

Rule 29(4) does not provide a taxation outcome that is consistent with that of members of other comparable funds. Rule 29(4) denies EISS pension division members the outcome of a tax advantage that members of other comparable funds have obtained and were intended to obtain under Commonwealth taxation arrangements. Therefore Rule 29(4) does not comply with the *Heads of Government Agreement on Superannuation.*

The Legislative Council motion continues as:

(c)if the method does not comply with the Electricity Corporations Act 1994 (as modified by the Electricity Corporation (Restructuring and Disposal) Act 1999) recommend a method for calculating taxed-source pensions that does comply with that act and with the Heads of Government Agreement on Superannuation;

How should taxed-source pensions be calculated?

The following formula was described in the 2004 Mercer Report as a formula that has been used in other states to reduce pensions (refer Attachment 5). It keeps employer costs constant and, in most cases, increases member's after-tax benefits.

T = U x (1- 0.15A/B x P)
Where:
T = gross value of the taxed-source pension;
U = gross value of the untaxed-source pension;
A = the member's post 30 June 1988 service;
B = the member's total service;
P = the proportion of the pension financed by the employer

This formula has been used in other states to calculate the value for taxed-source pensions. It, or something closely related to it, should be used to calculate EISS taxed-source pensions. It will be referred to from now on in this submission as 'the alternative rule'.

The 0.15 appearing in the alternative rule is the 15% tax rate that has applied to employer contributions since 1 July 1988 and this is applied to the employer-funded proportion of the pension accruing after 1 July 1988 (A/B x P). **Consequently this formula would comply with sub-sections 11 (1) and 11 (2) above.** It would also comply with the Heads of Government Agreement on Superannuation. The table below displays the Association's estimate of the pension reductions resulting when the alternative rule is applied to pensions that commenced between 1996 and 2011 where the pension recipient has completed 35 years service and has funded 20% of the pension with personal, after-tax contributions.

Year pension commenced	% reduction needed to meet employer costs
1996	2
2001	4
2006	6
2011	8

The percentage reduction increases as the pension commencement date gets later and this is because the fraction of the pension accruing after 1 July 1988, and on which tax is payable, gets larger.

It is illuminating to now refer to the experience of Barry Foster described on pages 12-13 of this submission. Rule 29(4) applied to his pension reduced it by 17.1% but if the alternative rule had been applied the reduction would have been only 4.1%. If he had commuted his pension to a lump sum the reduction in the lump sum needed to meet the tax cost would have been 5.7%. This is very persuasive evidence that Rule 29(4) reduces pensions by far more than the tax cost of paying them as taxed-source pensions.

Under the alternative rule it would only be after a person's pension has been calculated that the after-tax values for the original untaxed-source pension and the new pension would be compared to ensure that 11 (3) is being complied with.

This process for deciding on the value of a taxed-source pension using the alternative rule better matches the wording and structure of Clause 11. It satisfies the requirements of subclauses 11 (1) and 11 (2), with subclause 11 (3) operating as a 'no-detriment' provision.

The Legislative Council motion continues as:

> (d)review the Mercer Strategy reports (Review of Taxation Status of the SA Government Superannuation Funds) of 1998 and 2004, commissioned by the Department of Treasury and Finance and determine whether or not these strategy reports underpin the method of reducing EISS pension benefits to its members, as it has been applied since July 2002:

There is nothing in either the 1998 or 2004 review to suggest that Rule 29(4) would lead to employer savings when applied to the State Pension scheme but not if applied to the pension division of EISS. What these reviews predicted for the State Pension scheme would have been achieved with the pension division of EISS. Any claim to the contrary needs to be supported by detailed arguments and calculations before it is given any credence.

The Legislative Council motion continues as:

> (i)in this matter include a review of the decision to provide the Crown Solicitor with a copy of the 2002 Mercer Explanatory Memorandum on EISS rule changes, but not copies of the 1998 and 2004 Mercer Reports on Taxation Status of SA Government Superannuation Funds. This advice was sought on the legality of the EISS pension reduction method, due to a request from the EISS Trustees, to the Treasurer Hon K. Foley.

DTF has very recently (refer to page 9 of this submission) advised the Minister for Finance that the reason for not giving the Crown Solicitor copies of the 1998 and 2004 Mercer reviews was that they were relevant to the State Pension Scheme only and not to the pension division of EISS. This claim has to be supported by detailed arguments and calculations before being accepted. If this cannot be done the obvious conclusion to be drawn is that the Minister was wrongly advised. In this event DTF must be held to account.

The Legislative Council motion continues as:

> (ii)in this matter, review also the advice given to the Minister for Finance that the 1998 and 2004 Mercer reports were only relevant to the State Pension Scheme and its possible transfer to the taxed superannuation environment but not to the transfer of the EISS pensions, from the untaxed arrangements that applied to the ETSA Superannuation Schemes, prior to privatisation.

If this advice cannot be backed with detailed explanations and calculations the obvious conclusion to be drawn is that the Minister was wrongly advised. In this event DTF must be held to account.

The Legislative Council motion continues as:

> (e) review the EISS submission, dated 4th August 2006, made as part of the 2006 public consultation process conducted by the Federal Government on its 'Plan to simplify and streamline superannuation' to determine if:
>
> (i)this submission shows that the EISS Trustee was aware, or should have been aware, that its pension reduction method had been designed to reduce employer costs for taxed-source pensions below that for untaxed-source pensions and deliver an advantage to employers.

A copy of the EISS submission is provided as Attachment 24. On the second page there is a Table that shows a $52,000 p.a. untaxed source EISS pension, on conversion to a taxed-source pension before 1 July 2007, would have a gross value of $42,659 p.a. (this is a reduction of 18%) and an after-tax value of $40,270 p.a. For conversion after 1 July 2007, and with the untaxed-source pension being eligible for the 10% tax offset that was part of the Federal Government's 'Simpler Super' reforms, the after-tax value of the untaxed-source pension rose to $45,470 p.a.

The submission says that more members will choose the untaxed-source pension and this will cause an increase in employer costs. This is certainly true but EISS should have recognised that making a 10% tax offset available on pensions in the hands of recipients could not have altered the employer cost for an untaxed-source pension compared to the cost for the corresponding taxed-source pension.

If Rule 29(4) was a rule that reduced pensions only by the amount of tax that the EISS fund had paid on the money funding the pensions the introduction of a 10% tax offset on the pension in the hands of the retiree would not alter this.

The situation may be represented as follows:

i. Let $A be the amount required to fund an untaxed-source pension.
ii. If $B is the amount of tax payable when the amount $A is transferred into the taxed superannuation environment, then
iii. $A - $B = $C is the amount being used to fund the taxed-source pension

The 10% tax offset that the pension recipient is able to claim in his annual tax return does not alter $A or $B and therefore, should not alter $C or employer costs.

The only way to explain how the 10% tax offset could alter employer costs is to recognise that it is causing the partial loss of an advantage that the employers got when use of Rule 29(4) was authorised. This rule reduced employer costs by more than the tax paid, $B, and reduced the taxed-source pension cost below $C. If the 10% tax offset is taken account of, in Rule 29(4), it only raises the cost back towards the value it should have had in the first place.

If the alternative rule had been used for reducing pensions the advent of the 10% tax offset would have been of no significance. All, or nearly all, members would be happily accepting the reduced, taxed-source pension and would not be opting in greater numbers for the alternative untaxed-source pension.

The Legislative Council motion continues as:

> (ii)the EISS Trustees' changes to its 'Taxation Rules' 29 to 31 that became effective in July 2007 were made to ensure that employers continued to receive an advantage at the expense of EISS pension division members.

When the 10% tax offset was introduced the EISS Trustee changed rules 29(4) and 29(5) to their current wording as set out in Attachment 1a. It was under no obligation to do this and without these changes members would have had a case for the 10% tax offset to be used in the calculation of the after-tax value of their untaxed-source pensions. This would have seen the $52,000 p.a. untaxed-source pension, referred to above, become a $45,470 p.a. taxed-source pension if the person receiving it was aged 60 at the time the pension commenced. The reduction in the untaxed-source pension would be 13% rather than 18%. A 13% reduction would still deliver a savings to employers but not as large a saving as they were getting with the 10% tax offset not counted.

It seems likely, at the time it made this rule change, the Trustee would have known, or at least suspected, that its Rule 29(4) was delivering a saving to employers. The fact that it still made a deliberate decision to change the rules to eliminate the possibility of members getting an advantage from the 10% tax offset suggests that the Trustee preferred the interests of employers over that of members.

In Attachment 18a, in the letter dated 1 August 2007 sent by EISS Chairman, Mr Mark Day to Richard Bradshaw, on page 2, in the numbered point 7, Mr Day refers to a clause in the EISS Trust Deed saying:

> *Clause 4(4) of the Trust Deed requires employers to approve any variation or replacement of a rule which would result in an increase in the contributions to be made by an employer or increase the liability of the employer under the scheme in any way.*

On page 4 in numbered point 3 Mr Day says the changes made to the rules in 2007

> *'were made to ensure that the rules continued to provide the same gross benefit to members at the same cost to employers from 1 July 2007'* .

The Board had no obligation to keep employer costs the same as they were before 1 July 2007 and employers are not given any right by Clause 4(4) to expect this. The Board does not need the approval of employers to keep its rules unchanged, only if it wants to change them in a way that would increase costs. It was open to the Board to leave the rules unchanged and allow members to get the advantage of the 10% tax offset in the form of an increased taxed-source pension.

Employers might well have argued that counting the 10% tax offset increased their costs compared to what the costs were before the tax offset applied and they would be right in saying this. But this was an opportunity for the Board to show its commitment to members and conduct an independent investigation to determine if the rules it had supported and recommended on June 7 2002 had reduced employer costs for pensions. In this way it would have been able to demonstrate to employers that Rule 29(4) was operating to give them an advantage they were not entitled to.

The Legislative Council motion continues as:

> (f)review the appropriateness of allowing the organisation, Mercer, to continue for so long as the sole provider of actuarial advice to EISS and the Department of Treasury and Finance on the matter of transferring untaxed funds into the taxed superannuation environment, when Mercer had compared the rights of fund members and employers in such a transfer by saying, on page 63 of its 1998 report:
>
> 'The government may need to cope with demands from members of the pension scheme that they, as well as the Government, should share in the gains achieved. An important part of the response would be that these people are still members of schemes, which have been closed because of their generosity, and yet their benefits have been continued. Thus they should have little to complain about if the advantage of applying the PJFC [pre-July 1988 Funding Credit] is not passed through to them, so long as they are not detrimentally affected. A critical point is that the benefit reductions should be such as to remove the windfall gains, but not to the extent of causing detriment to any members'; and

This statement expresses a strong bias against members of the pension scheme, and is so outrageous it should have disqualified both Mr Archer, and Mercer, from giving further advice about the move of a pension scheme into the taxed superannuation environment.

The statement refers to the removal of ‘windfall gains’ from members. These gains would not have been windfall gains but gains that members were entitled to get and which members of comparable interstate schemes had already received. The irony is that rule 29(4) does provide a windfall but it goes to employers.

It was quite inappropriate for the Department of Treasury and Finance to rely solely on Mr Archer’s Explanatory Memorandum when advising the Treasurer on the EISS rule changes. A person other than Mr Archer, and/or a company other than Mercer, should have been used. Furthermore any recommendations for rule changes should have been backed by detailed arguments and calculations.

The bias against members, and in favour of employers, seen in the 1998 Mercer Report can be clearly seen in the 2004 Report of another Mercer actuary Mr Stevenson. He acknowledges that other states had changed their pensions on the basis that members got the advantage intrinsic to the taxed superannuation environment and then goes on to assume that in South Australia the advantage would go to employers.

In Attachment 5 on page 10 of the review under a Table setting out pension reductions for pensions of different values Mr Stevenson writes:

> *‘The reductions in the above table are calculated assuming that the pensioner has no other income. This produces a lower reduction that (sic) that necessary ‘to break even’ where there is no other income; and conversely produces a higher reduction where the pensioner have (sic) losses on other income. Generally, the reductions err on the side of generosity to pensioners.’*

The last sentence of the above passage carries the remarkably audacious suggestion that the other income of pensioners might have been used to make reductions to pensions even greater than those set out in the table. In other words, on top of the advantage they had been given from reductions made to employees' superannuation, employers might have been given an additional advantage derived from the retired employees' non-superannuation income. The 1998 Mercer Report also contained the same suggestion (refer section 19.11 on page 60 of Attachment 2)

The Legislative Council motion concludes with:

> (g)any other relevant matter.

Dr Raymond Hickman
For S.A. Superannuants
November 19 2012