President: Peter Fleming
Ph. (08)8295 1832
Email: peterfleming8@bigpond.com

Secretary: Vic Potticary
PO BOX 568 Torrensville SA 5031
Ph: (08) 8352 6504
Email: cosme@senet.com.au

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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 SA Superannuants)

Prepared by Dr Raymond Hickman on behalf of SA Superannuants

About the author: Dr Hickman is a former President of SA 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 SA 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).

The interest and involvement of SA Superannuants in this EISS matter

SA Superannuants (the Association) is an organization established in 1927 to represent the interests of retired South Australian government employees in receipt of lifetime superannuation pensions. The objects of the Association include the objects:

1. To deal with any matters affecting, or likely to affect, the welfare of its members.
2. To study and develop the interests of members.

The Association has had an interest in the taxation status of its members' pensions since 2001. The South Australian pensions are untaxed-source pensions while those paid by most other states (and in the private sector) are taxed-source pensions. The meanings of these terms are explained below. Taxed-source pensions deliver a larger after-tax income to their recipients than do the corresponding untaxed-source pensions, and at no additional cost to employers. In 2001 the Association was interested, and is still interested, in the possibility of South Australian pensions being paid as taxed-source pensions on the basis that the change be voluntary for every superannuant and involve no increase in cost to the Government. The Association's own analysis of tax rules had indicated that this would improve the after-tax value of pensions for many state pension scheme members, be detrimental to none and cost-neutral for the Government.

From reading the relevant sections of the Electricity Corporations Act 1994 SA Superannuants concluded that the Act provided for EISS pensions to be converted to taxed-source pensions on the same basis as it would find acceptable for the state pension scheme. It was not until 2006 that the Association became aware that EISS pensions were being reduced on the basis that there was **no improvement in after-tax income for any member.**

This told SA Superannuants that the intrinsic tax advantage that goes with paying a superannuation pension from the taxed superannuation environment was being diverted to EISS employers. The EISS rules achieving this result are rules 29(4) and 29(5). The full set of rules for reduction of benefits inserted into the EISS rules by the Treasurer in June 2002 is contained in Attachment 1. The rules 29(4) and 29(5) have the effect of ensuring that no EISS taxed-source pension has an after-tax value greater than the after-tax value of the corresponding untaxed-source pension. To the best of the Association's knowledge when taxes were introduced on superannuation fund income in July 1988 the effect was to increase the after-tax value of defined benefit pensions for most recipients having eligible service that had commenced before the taxes were introduced.

Attachment 1

The Association has been gathering information about the circumstances surrounding the adoption of rules 29(4) and 29(5) since 2006. In the beginning the aim in collecting this information was mainly to establish if there existed documents with content that would give the Association cause to revise its belief that EISS pensions were being reduced by a method that had reduced employer costs for the pensions compared to what the cost would be if the pensions had continued as untaxed-source pensions. If it is only possible to avoid an increase in employer cost for pensions by ensuring that every pension recipient obtains no increase in after-tax income from the change there would be no point in the Association lobbying the Government to change the existing taxation arrangements for state scheme pensions.

As the Association gathered information about the processes that had led to adoption of rules 29(4) and 29(5) its Executive Committee became very concerned about the probity of acts done by Treasury Officers, and people at EISS, to put these rules in place. The Association does not want to have such acts accepted as a model for how changes might be made to the State Pension Scheme. The Association is also motivated by its desire to assist Mr Richard Vear, and other EISS members, to get an independent opinion on whether their pensions are being calculated by a method that is valid.

Judging probity

The Association considers that it has reasonable expectations for the probity of acts done by people who have the power to change the rules of a superannuation fund. They are simply expectations that go with covenants set out in the Commonwealth Government's *Superannuation Industry (Supervision) Act 1993* (SIS). SIS requires certain covenants to be kept by the Trustees of all superannuation entities. They 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 of a superannuation entity 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 (DTF) have an obligation to ensure that standards of probity consistent with the three covenants listed above are met in the running of EISS. Consequently, the Association believes that, in this matter of EISS taxed-source pensions, the probity of the conduct of EISS and DTF should be measured against the above covenants.

The balance of this submission is in two parts.

Part A

This part of the submission provides a brief comparison of taxed and untaxed superannuation funds and sets out, at a general level, the Association's 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 information and 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. 'Rules 29(4) and 29(5)', 'the tax offset', 'the method' 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% tax was introduced on contributions made from pre-tax income of members and by employers. 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. There was 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%. Thus the changes led to an increase in the after-tax value of most pensions.

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.

Example

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 it is assumed 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*

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.

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 in the example on page 4. 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.

Note: The extract from the EC Act above 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.

The long-running dispute that has led to this Ombudsman's investigation is about whether the South Australian authorities responsible for advising the then-Treasurer Hon Kevin Foley MP on the rules to be inserted into the rules of EISS to take account of taxation changes have ensured that all EISS rule changes were compliant with all parts of Section 11. The particular rules in dispute are rules 29(4) and 29(5) dealing with the reduction of pensions. In the material that follows these rules may be referred to as 'the tax offset', 'the method' or the 'the method for calculating EISS taxed-source pensions'.

There are a number of worrying features of 29(4) and 29(5) 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 their use. These include:

- They involve no relationship between the pension reduction and the tax cost of paying the pension from a taxed fund. Consequently they do not comply with 11 (1) above and could only meet all the requirements of Section 11 by some unlikely accident.
- They use 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 because it is common knowledge that money entering, and held within, the superannuation system is concessionally taxed compared to personal income.
- 29(4) 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 sub-clause (2) on the previous page and, as far as SA Superannuants has been able to ascertain, there is no precedent for it in the other Australian jurisdictions.

Part B

This Part B of the submission has a structure provided by the 25 September 2013 Legislative Council motion that has led to this investigation. The components of the motion are distinguished from the submission by being highlighted in unshaded boxes with borders. The corresponding submission material is presented after each of these boxes. Where extracts have been taken from attachments, to be included in the text of the submission, they are shaded and indented.

Attachment 2

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 2 provides a copy of a paper and covering letter sent on 6 December 2007 to the EISS Chairman by SA Superannuants. Attachment 2 also includes another paper and covering letter that the author of this submission sent to the Chairman on 11 September 2008.

Attachment 3

Attachment 3 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 Rules 29(4) and 29(5) are reducing 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 point out errors in our detailed arguments supporting this claim.

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, when the Crown Law advice was obtained the only document sent to the Crown Solicitor was the Explanatory Memorandum. This had been prepared by the firm Mercer. Other documents, also produced by Mercer and that might have been provided to Crown Law, were not provided. Furthermore, while DTF has attributed great weight to this Crown Law advice it has never made known the exact question on which Crown Law was asked to provide advice and this is discussed below in connection with parts 2 (d) and 2 (g) of the Legislative Council referral.

The EISS position seems to be that all responsibility for the validity of the rule changes rests with the Treasurer. It has not acknowledged to its members the existence of a letter, dated 7 June 2002 and addressed to the Under-Treasurer, which purports to express EISS support for the rule changes and recommends their adoption. Furthermore, key people at EISS appear to have only learned about the existence of this letter years after it was sent.

Neither EISS nor DTF seem prepared to consider the possibility that the Explanatory Memorandum is misrepresenting the effect of Rules 29(4) and 29(5) on employer costs for pensions. Neither is prepared to give its own answer to the question -do Rules 29(4) and 29(5) reduce employer costs for pensions compared to what the costs would be if the pensions continued as untaxed-source pensions?

On 25 September 2013 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 concern 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 and their associated administrative acts to the Ombudsman, pursuant to Section 14 of the Ombudsman Act 1972 for investigation and report on the EISS method for calculating its taxed-source pensions, and compliance of that method with the Electricity Corporations Act 1994 (as modified by the Electricity Corporations (Restructuring and Disposal) Act 1999.

The Legislative Council motion continues as:

a) Probity of processes resulting in a letter dated 7 June 2002 addressed to the then-Under-Treasurer being received by the Department of Treasury and Finance and accepted as coming from the EISS Board to advise that the Board supported and recommended rule changes for EISS developed by the financial services firm Mercer.

There are immediate probity concerns arising from the facts that:

- the letter is brief and lacking in detail considering that it deals with the important matter of reduction of benefits for EISS members;
- the letter refers to 'recent discussions between your officers and the EISS…' but the people representing EISS and those representing the Department of Treasury and Finance are not named, no date is given for any meeting and no details of the discussion or proposed rule changes provided;
- the letter has the name of the Board Secretary at the bottom but the signature is of another person that was, at the time, an employee of Mercer which was acting as the scheme administrator.

For this letter to be considered as authentic in its expression of the EISS Board's support for the method now being used to calculate EISS taxed-source pensions there will have to be solid evidence that, before 7 June 2002, the Board had been given notice of the intention to adopt the method and had made a formal decision to support this. Our inquiries, and those of Mr Richard Vear, indicate that this was not the case. The text of the letter is reproduced on the next page with the names of individuals removed. The intact letter is provided as Attachment 3a.

Attachment 3a

The letter claims that the EISS Board 'supports and recommends the proposed rule changes that have been developed by Mr (name of an Actuary) of Mercers'. The actuary identified in the letter is, regrettably, deceased and so cannot contribute to this investigation by his own testimony. Throughout this submission he will be referred to as the 'actuarial adviser'.

Attachment 4

If the claim made in the letter is true then Board minutes for a meeting held before June 7, 2002, would be expected to record a decision of the Board expressing its support for the rules, and an instruction that a letter be sent to the Under-Treasurer advising of this decision. However, an account given by the EISS Executive Officer, of Board meetings and

Minutes for the period July 2000 – July 2002 (Attachment 4), indicates that there is no record, in the Minutes of Board Meetings for this period, of such a decision being made or of the letter being authorised for dispatch. As discussed below it appears that neither the Executive Officer, nor the Board Chairman (who was Chairman at the time the letter was sent), knew of the existence of the letter until years afterwards. The account of events between July 2000 and July 2002, given in Attachment 4, indicates that there was no consultation with the Board between 16 August 2000 and 29 May 2002. The Executive Officer gave the account of EISS minutes as part of an EISS response to the Superannuation Complaints Tribunal which was investigating a complaint from Richard Vear.

THE ELECTRICITY INDUSTRY SUPERANNUATION SCHEME (EISS)

Adding power to your financial future.

Level 5, EDS Building, 108 North Tce, Adelaide SA 5000 Telephone (08) 8404 5707
GPO Box 854, Adelaide SA 5001 ABN 5792 3283 236

7 June 2002

The Under Treasurer
Department of Treasury and Finance
State Administration Centre
200 Victoria Square East
ADELAIDE SA 5000

Dear Sir

Proposed Rule Changes

I refer to recent discussions between your officers and the EISS about the proposed movement of the fund into the tax environment.

As part of the discussions there has been consideration of the proposed rules to apply when the fund officially loses its 'constitutional protection'.

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

Yours sincerely

Secretary to the Board

It would appear from Attachment 4 that the June 7, 2002 letter was sent to the Under-Treasurer on behalf of the Board but without the Board having authorised this action. It also appears that even after the letter had been sent no notice of this was given to the Board.

Attachment 5

The current Board Chairman was in his position in June 2002 and it would appear that he had no knowledge of the June 7, 2002 letter years after it had been sent. On 2 August 2007 the Chairman wrote to the Treasurer (Attachment 5) asking him to conduct a review of the validity of the rule for reducing pensions. In a summary to his letter the Chairman said:

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

If the Board had authorised dispatch of the 7 June 2002 letter it certainly bore some responsibility for rules 29(4) and 29(5) being in place. If the Chairman knew in June 2002 that the letter had been sent it seems unlikely that he would have forgotten about it. And it seems unlikely, if he knew about it, that he would have said that the Board was not responsible for the rule changes.

Attachment 6

The Board Chairman is not the only key person at EISS who appears to have had no knowledge of the 7 June, 2002 letter until years after it had been sent to the Under-Treasurer. When Richard Vear forwarded a copy of the letter to EISS, as part of his representations to the EISS Board, the EISS Executive Officer, in a Report to the Board at its meeting in February 2012 (Attachment 6), referred to Richard's communication, including the June 7, 2002 letter, by saying:

> 'In short, not a lot new, except that I hadn't seen the 2002 letter that he's dug out of a FOI request somewhere.'

Attachment 7

When the Executive Officer was appointed to his position in 2004 his background and qualifications were described to members in a September 2004 Newsletter (Attachment 7). He was described as an actuary, who previously worked for Mercer, the Scheme's administrator, for 11 years. He had spent much of his time at Mercer involved in the actuarial and consulting work of the Scheme, and had been actuary to the Scheme from January 2004.

Given his close association with EISS before and after the EISS rule changes were made this claim by the Executive Officer that he was unaware of the existence of the 7 June 2002 letter, until Richard Vear supplied EISS with a copy, suggests that its existence did not become known to the Board until 2012.

Attachment 8

On 5 July 2000, the then-Under Treasurer had written to the EISS Board (Attachment 8) to advise that Treasury would be recommending to the Treasurer that EISS lump sums be reduced by 15% of their post-1983 portion i.e. by less than 15% of the gross amount for members who had appreciable pre-1983 service. But this letter made no mention of pensions and there appear to have been no further, formal communications between the Under-Treasurer (or any other Treasury officer) and the Board concerning pensions in the interval from 5 July 2000 until 28 June 2002 when the rule changes took effect. This indicates that when the Under-Treasurer received the 7 June 2002 letter notice had not been given to the Board that there was an intention to recommend that the Treasurer accept the method proposed by the actuarial adviser for reduction of pensions. The only person who could have told the Board about the method was the actuarial adviser. He appears to have

not done so prior to 7 June 2002 (see Attachment 4). All this creates a reasonable basis for suspecting that the letter is a false document in terms of the *Criminal Law Consolidation Act 1935 (Section 140 Dishonest dealings with documents).*
The Legislative Council motion continues as:

b) Probity of processes resulting in receipt by the Department of Treasury and Finance of the Mercer Explanatory Memorandum dated 27 June 2002 which is a document that has been cited as providing evidence that the method for calculating EISS taxed-source pensions had no effect on employer costs.

Attachment 9

The Explanatory Memorandum (Attachment 9) is dated one day before the corresponding rules were put in place and was not seen by the EISS Board beforehand. This demonstrates a lack of probity in the processes associated with its production and subsequent use as the sole basis for claiming that the rule changes would not have an effect on employer costs.

Attachment 10

As a result of a Freedom of Information (FOI) application, SA Superannuants has established that the Department of Treasury and Finance is unable to produce any documents commissioning the work that the Explanatory Memorandum purports to describe. The only invoice recognisable as possibly being related to such work was an invoice dated 22 September 2002 (Attachment 10) from Mercer addressed to EISS for the amount of $2,788. The description of the services for which payment was sought was:

> 'For professional services during the period 27 April 2002 to 24 May 2002 in respect of work NOT covered by our consulting retainer contract.
> ITEMS CONCERNING THE CHANGES BROUGHT ABOUT BY THE NEW SCHEDULE 1 OF THE ELECTRICITY CORPORATIONS ACT 1994'

This invoice was approved for payment by a Deputy Under-Treasurer on 30 November 2002 and is marked as received by Finance on 2 December 2002. The invoice has attached a list of items and one of these is described as 'Actuarial calculation of the special rollover tax payable upon the scheme losing constitutional protection.'

The invoice was sent, in the first instance, to EISS who must have forwarded it to the Department of Treasury and Finance. One explanation for this would be that Mercer did not have a record of the firm carrying out any work related to EISS under contract to the Department of Treasury and Finance. This would also explain the Department's inability to find any documentation that commissioned such work. This allows the possibility that the actuarial adviser wrote an explanatory memorandum to a set of rule changes that Mercer had never been formally authorised to develop. However SA Superannuants agrees with some statements made in it about the conditions that the rule changes were required to meet under the Electricity Corporations Act 1994. These statements were:

> - **Page 1 of the Explanatory Memorandum:** 'Clause 11 of Schedule 1 of the Electricity Corporations Act 1994 allows the Treasurer to vary the rules of the Scheme following the Scheme's loss of constitutional protection in order to avoid or reduce an increase in employer costs caused by the taxation changes arising from the Scheme's loss of constitutional protection. As part of the privatisation process, The Treasurer indicated to the tenderers that he would vary the rules so as to avoid an increase in employer costs, to the extent permitted by a constraint contained in Clause 11.'
>
> This constraint is that a rule variation which reduces benefits may not result in the level of the net benefits received by members being less than the level of their net benefits had the scheme not lost constitutional protection…

- **Page 4 of the Explanatory Memorandum: '**…benefit reductions must not lead to a decrease in employer costs.'

There is a claim made in the Explanatory Memorandum on page 3, that benefits had to be reduced to the maximum extent allowed by the Electricity Corporations Act 1994 in order to avoid an increase in employer costs. This should have been recognised by the Treasury as highly implausible in the case of pensions. Treasury would have known that members of the EISS pension division had substantial amounts of pre-July 1983 service and that the pension division assets and liabilities were a large fraction of total EISS assets and liabilities. The fact that the rule proposed for reduction of pensions was going to see most pensions reduced by 15%, and more, was a clear indicator that employer costs were going to be reduced and that the claim made in the Explanatory Memorandum that employer costs would be unaffected was not likely to be true. With one exception, the figures used to support the Explanatory Memorandum claim are, at best, rough estimates. The one exception is the figure of $6 million for rollover tax. This could have been accurately calculated from the value of EISS assets held at 1 July 2000. The other figures are dependent on future fund experience after 30 June 2002. **The invoice and attached list of items in Attachment 10 now assume extra significance.** The item 'Actuarial calculation of the special rollover tax payable upon the scheme losing constitutional protection' corresponds to the $6 million figure. There is nothing listed that corresponds to any of the other figures found on page 3 of the Explanatory Memorandum ($30 million for tax on employer contributions, $8 million tax on investment earnings, $19 million for benefit reductions and $25 million for PJFCs). This provides a reasonable basis for suspecting that there was no actuarial work done to arrive at these figures.

Attachment 11

This possibility is supported by the fact that, in a letter of 19 June 2008 sent to the Hon Bob Such MP (Attachment 11) the then-Treasurer Hon Kevin Foley stated that Treasury did not have copies of the worksheets corresponding to calculation of the figures contained in the Explanatory Memorandum. Treasury's acceptance of these figures as being accurate without the evidence of worksheets detailing how they were obtained was, at best, reckless. It is reasonable to suspect that there were no worksheets and no actuarial calculations carried out for most of the figures. For this and other reasons set out below there is a reasonable basis for suspecting that the Explanatory Memorandum is a false document in terms of the *Criminal Law Consolidation Act 1935 (Section 140 Dishonest dealings with documents)*. To eliminate this possibility Treasury needs to have someone repeat the work and set out the detailed calculations that re-produce all the results claimed in the Explanatory Memorandum.

Conspicuous by its absence from the Explanatory Memorandum is any reference to the fact that the method for reducing pensions takes no account of tax rules and tax rates applicable to superannuation fund income, or the employment history of the pension recipient. The method uses only personal income tax rates and produces the two results that:

- the reduction applied to a pension would usually be more than 15%; and
- the reduction increases as the pension value increases even though tax payable on superannuation fund income is at a flat rate.

These features of the method for reducing pensions should have been recognised by Treasury as indicators that employer costs for pensions would be reduced by the method.

Also conspicuous by its absence from the Explanatory Memorandum is any reference to a method or formula used in the other Australian jurisdictions to reduce pensions in response to the taxes that became payable on superannuation fund income from 1 July 1988. In these other jurisdictions the reductions took account of the pension recipient's employment history and were usually much less than 15%. This was another clear indicator to Treasury that it was recommending to the Treasurer a method for reducing pensions that would have the effect of reducing employer costs for the pensions.

The circumstances surrounding the production and use of the Explanatory Memorandum provide a reasonable basis for suspecting that Treasury and the actuarial adviser worked together to ensure that the Treasurer would have no opportunity to see the possibility that he was being advised to authorise use of a rule for reduction of pensions that was not valid.

The Legislative Council motion continues as:

c) Inconsistency between the claim made in the Mercer Explanatory Memorandum of 27 June 2002 that EISS rule changes would have no effect on employer costs, and analyses contained in the Mercer Reports of 1998 and 2004 showing that the rule now being used by EISS to calculate its taxed-source pensions would reduce employer costs if applied to pensions of the State Pension scheme.

The Explanatory Memorandum (Attachment 9) is not addressed to anyone but is connected with the Department of Treasury and Finance(DTF) by information in the footer to the document indicating it was prepared for a DTF officer. This officer was Mercer's contact person for a 2004 Review of the taxation status of South Australian superannuation schemes and it is very likely that he was also the contact person for the 1998 review. This officer was also the person nominated as the contact for EISS in a 2 July 2000 letter from then-Treasurer, Hon Rob Lucas MLC, to the then-EISS Board Chairman, dealing with the changes that were to be made to EISS rules for taxation reasons(Attachment 12). The last two sentences of this letter read:

Attachment 12

> The proposed rule or rules would satisfy the provisions of subclauses (2), (3), (4) and (5) of Clause 11 of Schedule 1 of the *Electricity Corporations Act.*
>
> Should you have any questions on this matter please contact Mr (Officer's name and position), on (telephone number).

The person referred to in the letter from Mr Lucas would have prepared most, and possibly all, of the letters signed by Ministers in response to the representations made to them by the Association and Mr Richard Vear on the matter of the validity of the method for reduction of EISS pensions. This person will be referred to from here on in this submission as the 'DTF officer'.

Attachment 13

Probity and due diligence required that the method proposed for reduction of EISS pensions and claimed, in the Explanatory Memorandum, to be a method that would not affect employer costs, was recognised as the same method that the 1998 Mercer Review (Attachment 13) had said would produce large savings for employers if it was applied to the State Pension Scheme. Probity required that this apparent inconsistency be resolved and communicated to the Treasurer before he acted to make the EISS rule changes. The Association's concern is that, instead of this happening, Mr Foley made the rule changes being unaware of the inconsistency and remained unaware of it as he signed letters rejecting arguments being put to him later, by SA Superannuants, Richard Vear and others, that the pension rule was invalid.

The Legislative Council motion continues as:

d) Probity of the decision to provide only the Explanatory Memorandum of 2002, and not the Mercer Reports of 1998 and 2004, to the Crown Solicitor when advice was sought on compliance of the method with the Electricity Corporations Act 1994.

Attachment 14

In 2012 the Hon Iain Evans MP, Shadow Treasurer, asked the Hon Michael O'Brien MP, Minister for Finance, a series of questions on behalf of SA Superannuants and Richard Vear. Answers to these questions were provided by Treasury. The full set of questions and answers is contained in Attachment 14.

Question 7. The question was:

> Is the Minister aware that the 1998 and 2004 Mercer reports were not provided to the Crown Solicitor when he was directed to provide his opinion on the validity of the EISS method for calculating taxed-source pensions. He was provided with an Explanatory Memorandum, dated 27 June 2002 and written by a co-author of the 1998 Mercer Report which, in conflict with that report, expressly stated "employer costs are not expected to change as a result of the tax changes." Does the Minister agree that the Crown Solicitor should now be provided with a complete brief?

The Minister for Finance responded:

> I am advised that (and for the reasons given in the response to the previous question) the 1998 and 2004 Mercer Reports were not relevant. The Explanatory Memorandum relates to the EISS scheme specifically. I am advised that there is no conflict between the statements made in the EISS Explanatory Memorandum, and statements made in the Mercer reports dealing with the main State Superannuation Scheme. The differences in the outcomes in respect of the two schemes can be explained by the following:
>
> - As at the dates that Mercer Investigated the implications associated with the main State Superannuation Scheme moving into the taxed environment, the employer liability in respect of existing pensioners was significantly under funded. Therefore, there would have been significant tax benefits to be gained in funding those employer liabilities in a managed manner over a period of many years to gain the maximum advantage.
> - As at the dates that Mercer investigated the implications associated with the main State Superannuation Scheme moving into the taxed environment, the employer liability in respect of the already accrued but not yet payable pension liabilities was significantly under funded. Therefore, there were tax benefits to be gained over time in funding those past service liabilities.
> - Furthermore, there were no existing pensioners in the EISS scheme at the date the scheme moved into the taxed environment, as they had all been transferred to the State Scheme.

All three of the dot points immediately above are correct statements but they do not support the position that the Mercer Reports of 1998 and 2004 are irrelevant to EISS. **The second dot point outlines a characteristic that EISS shared with the State Pension Scheme.** The difference in outcomes of applying the EISS method to the State Pension Scheme, as opposed to EISS, is not that savings were to be made in the first case and not the second. The three dot points taken together mean that **savings were to be made in both cases** with the only difference being that, for EISS, the savings were made from pensions that commenced after the scheme had shifted to the taxed superannuation environment. The savings must have been used to reduce employer costs for EISS pensions because members gained nothing.

It does not matter if a pension scheme, at the time of its transfer to the taxed environment, has no pensioners, or has some members who are pensioners, or has all its members who are pensioners, and nor does it matter if the pension scheme is fully funded, or partly funded or entirely unfunded. In all these circumstances the EISS method for calculating pensions, after the transfer, will reduce employer costs for the pensions compared to what the cost would be if the scheme had not moved to the taxed environment. The only qualification that has to be made here is that the pension scheme must have a significant proportion of members with substantial amounts of pre-1 July 1983 service. **EISS had a large proportion of its pension division members in this category and whoever provided Mr O'Brien with the answer to Question 7 would know this.**

As a result of an FOI application made by SA Superanuants it is known that the Crown solicitor was given only the Explanatory Memorandum when asked to give an opinion on the compliance with the *Electricity Corporations Act 1994* of the EISS method for reducing pensions. If the Crown Solicitor was given any information at all about the Mercer Reports of 1998 and 2004 it seems likely it was that they were not relevant to the advice being sought. For reasons set out below under part 2 (g) of the Legislative Council referral there is a reasonable basis for suspecting that the Crown Solicitor was briefed in a way that had the effect of ensuring that the advice obtained would be advice on the wrong question. The right question for the Crown Solicitor is whether the method for reducing pensions is valid if it has the effect of reducing employer costs. The Mercer Reports of 1998 and 2004 are just as relevant to this question as is the Explanatory Memorandum. Furthermore, there is no reason to suspect that the Mercer Reports of 1998 and 2004 are false documents while there is a reasonable basis for suspecting the Explanatory Memorandum to be false.

It appears that the advice from Crown Law held by Treasury was sought after the EISS Board Chairman had written on 2 August 2007 to the Treasurer (Attachment 5) asking him to review the validity of the pension reduction rule. In his letter the Chairman referred to EISS members being concerned that their pensions were being reduced in a way that reduced employer costs. He set out the members' concerns as follows:

> **Issues raised by members**
> Some members of the Scheme contend that the rules inserted in Part XV of Division 1 do not comply with clause 11 of Schedule 1 of the Act in respect of pension benefits.
>
> They contend that there are two tests in clause 11 that the rules should satisfy:
>
> Test 1) that benefits may be reduced in order to 'avoid or reduce an increase in employer costs…as a result of the Scheme's loss of constitutional protection'. That is, employer costs could be higher after the Scheme became taxed, but not lower.
>
> Test 2) that the net benefit to which a member is entitled after the change in tax status must not be less than the net benefit to which the member would be entitled had the change in tax status not occurred.
>
> That is, members can't be worse off in that their net benefits after tax cannot be reduced. This test is subject to a number of assumptions.
>
> The Board understands that members are generally satisfied that the rules in Part XV satisfy Test 2. That is, members' net benefits after tax are not reduced by the changes.

Attachment 5

However, the Board understands that members believe that the rule amendments did not satisfy Test 1 – particularly in relation to the application of the reduction formula to pension benefits.

Attachment 15

The Treasurer's response to the Chairman's letter (Attachment 15) was made following the Treasurer's receipt of a Minute prepared by the DTF officer. This letter makes no reference to the EISS members' concern that pensions were being reduced in a way that had reduced employer costs. Nor does it make any reference to the Board Chairman's claim made in the letter of 2 August 2007 (Attachment 5) that the Board was not responsible for the rule changes. This is an odd omission given that the Treasurer presumably knew about the letter of 7 June 2002 advising that the Board had supported and recommended the rule changes. The Minute included the information that it was accompanied by a copy of the Crown Solicitor's advice to the effect that the rule for reducing pensions was valid.

The minute included in Attachment 15 refers to a set of figures on tax costs and savings to cover those costs. These are the same dubious figures as were contained in the Explanatory Memorandum even though, at the date on the Minute (30 November 2007), actual EISS experience had demonstrated at least one of these figures to be highly inaccurate. The Explanatory Memorandum had predicted EISS utilisation of pre-July 1998 Funding Credits (PJFCs) to have a value of $25 million. The actual value of PJFC usage in the period 2000-2005 was $36 million (see page 28 and attachment 27).
Note: The term PJFC refers to an amount of employer contributions that can be received by a superannuation fund that are exempt from the 15% contribution tax. The exemption can be claimed for contributions made to fund member benefits that had accrued prior to 1 July 1988. The value of PJFCs utilised by a fund is 15% of the amount of PJFC utilised.

The Legislative Council motion continues as:

e) Probity of advice and recommendations from the Department of Treasury and Finance to the EISS Board and the then-Treasurer Kevin Foley in connection with his authorisation of use of the method in June 2002, and to both Mr Foley and the Minister for Finance, Hon Michael O'Brien MP, in connection with representations about the validity of the method that have since been made by SA Superannuants and Mr Richard Vear.

Probity of consultation with EISS prior to the rule changes of June 2002.
The *Electricity Corporations Act 1994* required the Treasurer to consult with the EISS Board before inserting the new rules dealing with reductions to benefits on account of changes in taxation. Probity of this consultation process was the responsibility of the Department of Treasury and Finance.

Probity required that the consultation have the effect of making clear to the Board the workings of the new rules before they became operative. There were no serious time constraints affecting the consultation process because interim arrangements for payment of all EISS benefits, including pensions, were in place and could have continued indefinitely.

Attachment 15a

Attachment 15a is a copy of a 5 May 2000 letter to the then-EISS Secretary from the actuarial adviser. 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. The actuarial adviser 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

Attachment 4

This shows that the Board, in 2002, should 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 rules 29(4) and 29(5). But the following items of information contained in Attachment 4 indicate that the Board was merely a passive recipient of the new rules.

Attachment 12

- On 2 July 2000 the then-Treasurer, Hon Rob Lucas MLC, wrote to the EISS Board Chairman (Attachment 12) to advise that rules would be inserted into the EISS rules to reduce benefits following a move of EISS into the taxed superannuation environment. Mr Lucas said in his letter that the rules ‘would satisfy subclauses (2), (3), (4) and (5) of Clause 11 of Schedule 1 of the *Electricity Corporations Act.’*

Attachment 8

- On 5 July 2000 the Under-Treasurer wrote to the EISS Board (Attachment 8) advising that it was Treasury’s intention to recommend to the Treasurer that EISS lump sums be reduced by 15% of their post-1983 portion i.e by less than 15% of the gross amount for members who had appreciable pre-1983 service. This should have caused the Board to anticipate that reductions to benefits would take account of member employment history. Where a member had employment beginning before 1 July 1983 no tax would be payable on fund assets corresponding to this service. The Board should have been aware that many of its members, and particularly its pension division members, had substantial amounts of pre-1 July 1983 service. Receipt of the Under-Treasurer’s letter should have led the Board to anticipate that all members with pre-1 July 1983 service, including pension division members, would have their benefits reduced by less than 15%, and less by an amount reflecting the amount of the pre-1 July 1983 service. But the Under-Treasurer’s letter made no mention of what Treasury would be recommending for reduction of pensions or the possibility that, in contrast to lump sum benefits, service history would be ignored in reducing pensions. The EISS Board should have sought information about what might happen with pensions.

- At a meeting of the EISS Board held on 29 May 2002 the Board Secretary, tabled a letter dated 27 May 2002 from APRA (Australian Prudential Regulation Authority) advising that EISS had been granted a pre-1 July 1988 Funding Credit (PJFC) of $258.3 million. Provided that the significance of pre-1 July 1988 Funding Credits was explained to them, this information would have let the Board know that a substantial part of future employer contributions made to bring EISS up to full funding were not going to attract tax.

- Also at the 29 May 2002 meeting the actuarial adviser suggested formation of an *ad hoc* sub-committee of Board members so as to allow EISS Board consultation regarding the work being performed on behalf of the Treasurer on the taxation reduction to benefits. This indicates that, as late as 29 May 2002, the Board had not been informed by the actuarial adviser, or by the Under-Treasurer, of any details of the work that the actuarial adviser claimed was being performed ‘on behalf of the Treasurer on the taxation reduction to benefits’. Three Board members were appointed to the sub-committee. There is no evidence that this sub-committee reported back to the full Board before the rules were in place on 28 June.

- At the next meeting of the Board held on June 26 (two days before the rules were authorised for use) the actuarial adviser attempted to explain to the Board the workings of the tax reductions to benefits. The minutes report that the Board was confused and the Board Chairman asked for the explanation to be given again at the July meeting. The minutes do not indicate if the Chairman and the Board knew that the rule changes would be in place before the July meeting. This shows that, at the time the rule changes were made (28 June 2002), the Board was confused about the workings of the tax reductions to benefits. It seems likely that this was the first occasion on which the Board was given notice of the method that was going to be used for reduction of pensions. This would explain the Board's confusion because it would have heard that pensions were going to be reduced by a method that took no account of taxes paid by EISS. It would have heard that most pensions were to be reduced by more than 15% when much less than 15% tax had been paid on existing assets and no tax was going to be paid on employer contributions made to fund benefits accrued prior to 1 July 1988.

- Minutes of the July 2002 Board meeting indicate that the Board simply noted receipt of a letter from the Treasurer advising that he had inserted new rules for reduction of benefits into the scheme rules. This letter from the Treasurer was accompanied by a copy of the Explanatory Memorandum and there appears to be no reference in the Board Minutes to the fact that the Explanatory Memorandum had been signed by the actuarial adviser 1 day after the Board's last meeting at which they had been confused by his attempt to explain the workings of the rules.

- The actuarial adviser, as well as being adviser to the Government, had been the EISS actuary for many years prior to 2002, and in 1998 had been one of three Mercer people who had conducted a review of the taxation status of South Australian superannuation schemes. In this review the rule for reduction of pensions that EISS is now using was set out and recommended for application to State pension scheme pensions as a rule that would reduce employer costs for the pensions. EISS claims that it had no knowledge of the 1998 review and if this is true then the actuarial adviser failed to notify EISS of a potential conflict of interest he had arising from his involvement in the 1998 review and the comments it contains about members of pension schemes like the State Pension Scheme. These were comments to the effect that, because of generosity of the schemes, members were not entitled to share in gains to be made by the shift of the scheme to the taxed superannuation environment. EISS pensions are very similar to State Scheme pensions and the actuarial adviser would have had the same attitude towards them as he had towards State Scheme pensions.

All the above points paint a picture of :

1. the EISS Trustee Board lacking the assertiveness required to adequately defend the interests of its beneficiaries.
2. The actuarial adviser and Treasury working together to exploit this characteristic of the EISS Board and put in place a set of rules that should have been subject to much closer scrutiny than they received.

Attachment 13

Probity of the Treasury-Mercer relationship

The Department of Treasury and Finance had received a 1998 Mercer Report on taxation status of the main state superannuation schemes (Attachment 13) and this had been prepared by three people including the actuarial adviser. The 1998 Report included an analysis of the effect that the rule now being used by EISS for reduction of its pensions would have on employer costs if applied to the State Pension Scheme. The conclusion of the analysis was that the rule would substantially reduce employer costs. The relevant pages of the 1998 report are provided as Attachment 13.

In its 1998 review Mercer expressed a view that in any shift of the State Pension Scheme to the taxed superannuation environment members should make no gains from the change and the intrinsic advantage of paying the pensions from the taxed environment should be passed to employers. The authors of the 1998 review referred to gains that might have been made by members as ‘windfall gains’ that should be removed and transferred to employers. This is a wrong view. Gains by members cannot be described as windfall gains because the Australian superannuation system is designed to provide taxation gains to members, not to employers. Mercer demonstrated here its strong preference for employer interests over member interests by advocating a method that would give employers a windfall gain they had no right to receive. Mercer also offered to assist in achieving this result. Passages from the review that illustrate this include the following:

> ‘To achieve this though benefits under the Superannuation Act would need to be reduced and we anticipate that this exercise would need careful handling and very good communications.
>
> 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
>
> We would be pleased to help investigate the possible savings under various scenarios. For this work, our model would need to be refined so as to make it sensitive to the detailed issues which would need to be worked through should the project proceed to the next stage.’

The authors of the 1998 Mercer Report refer to pension scheme members as having little to complain about if the advantage of PJFCs do not flow through to them ‘so long as they are not detrimentally affected’. But a person is detrimentally affected if he/she is denied the opportunity to obtain a financial advantage. This is not just an opinion but is one of the provisions of the *Criminal Law Consolidation Act 1935 (definition of detriment in Section 130 Interpretation)..*

It was inappropriate for the authors of the review to offer an opinion that pension scheme members could not expect to share in the gains arising from a shift of the state pension scheme to the taxed superannuation environment. The fact of this opinion having been offered should, as a matter of probity, excluded all three authors of the report, and Mercer, as advisers to the government on the matter of rule changes to be made after a shift of EISS pensions to the taxed superannuation environment. Instead, the Department of Treasury and Finance allowed the matter to be controlled by the actuarial adviser and, as far as SA Superannuants and Richard Vear are aware, made no attempt to constrain him to the development of a rule for reduction of pensions that was fully compliant with the Electricity Corporations Act 1994. His claim made in the Explanatory Memorandum of ‘no effect on employer costs’ should have been subject to close scrutiny.

The fact of the actuarial adviser being the EISS actuary at the same time as he was developing rules to be approved by the Treasurer for insertion into the EISS rules provides a second reason why his Explanatory Memorandum should have been subjected to close scrutiny. He should have been recognised as an actuary likely to have a preference for the interests of EISS employers over EISS members.

Attachment 16

This is highly suggestive of Treasury allowing the actuarial adviser to have full carriage of the development of new EISS rules because it wanted the rule he had described in the 1998 review applied to EISS pensions and was confident he could deliver this. The likely motive for Treasury being keen to have the rule adopted by EISS was that it was hoping to be able to use that as a precedent for applying the rule to the State Pension scheme.

Attachment 16 is a document prepared in May 2007 showing that consideration has been given within Treasury to a movement of the State Pension Scheme into the taxed superannuation environment with a view to reduce employer costs while doing so.
On the first page of the document there is reference to the fact that the Mercer Report of 1998 and a later 2004 Report had concluded there was a tax advantage to be had from the move of the state pension and lump sum schemes into the taxed environment. This advantage was referred to as follows:

> The tax advantage could be used to increase members' benefits and/or reduce employer costs.

On the third page of the document one of the issues that is recommended for investigation is stated as:

> Modelling of the trade off between the reduction in gross benefits for members versus the potential savings to government in changing to taxed status. The Government would want to ensure that there would be no increase in the Government's superannuation liability, and the government would want to participate in a share of any savings.

The document includes a recommendation that Mercer be used as the adviser on this and other issues. A benefit of using Mercer rather than someone else is stated as:

> …they have been used as advisers in the transfer of the Electricity Industry Superanuation Scheme from the untaxed to the taxed environment…

It seems likely that the author of this document would have known that the move of EISS into the taxed environment had not increased members' benefits and so must have passed all the intrinsic advantage of moving to the taxed environment to employers.

Probity of the Treasury-Treasurer interaction
It is no criticism of the then-Treasurer, Hon Kevin Foley MP to say that, at June 2002, he was inexperienced in the role of Treasurer. It was the responsibility of the Under-Treasurer and other senior Treasury officers to ensure that he was well-briefed on the relevant issues before he authorised the EISS rule changes in June 2002. But all indications are that he was given no chance to assess the relevance or reliability of the Explanatory Memorandum. At best there was 24 hours between the Memorandum being finalised and the Treasurer signing the letter to EISS notifying them of the rule changes that would take effect the next day.

Attachment 17

The Treasurer should have been advised of the Government's obligation under the Heads of Government Agreement on Superannuation (Attachment 17) to ensure that tax outcomes for EISS members on the shift of EISS into the taxed superannuation environment were equivalent to the outcomes for all other taxed-fund members across both the private and public sectors. This should have led on to the Treasurer being advised of what had happened with pensions being paid by other state governments when those pensions were adjusted in their gross values to take account of the taxes on fund income introduced in July 1988. This would have given the Treasurer a chance to see that in other jurisdictions the reduction of pensions had been by a method different from the one he was being asked to approve.

It seems likely that the Treasurer was ignorant of the potential for conflict of interest on the part of the actuarial adviser arising from that person's views about 'generosity' of state pension scheme pensions and what should happen with them if the state pension scheme was moved to the taxed superannuation environment. It is also very likely that he was unaware of the analysis contained in the 1998 Mercer report co-authored by the actuarial adviser and which contradicted the Explanatory Memorandum by predicting a reduction in employer costs if the EISS method for reducing pensions was applied to the state pension scheme.

If Treasury cannot produce evidence that it did include this information in its briefing of Mr Foley in June 2002 then this would be a reasonable basis for suspecting that Treasury acted to ensure that he authorised use of the rule for reduction of EISS pensions while remaining unaware of the possibility that it might be an invalid rule.

Probity of Treasury acts after June 2002
2004 Treasury receives another Mercer Report updating the 1998 Report- In December 2004 Treasury received another report from Mercer dealing with the possible transfer of South Australian Superannuation funds to the taxed superannuation environment. This was an update of the 1998 Report. Mercer sent this report in the first instance to the DTF officer. The covering letter to the report, which was addressed to the DTF officer, commenced with the following three paragraphs:

> 'I refer to the "Contract for Services – Review of Taxation Status of the SA Government Superannuation Funds" and to our conversation earlier this year.
>
> The purpose of this letter is to provide an update of the Review of Taxation Status of the SA Government Superannuation Funds, performed in January 1998, (the previous report), and to estimate the likely financial consequences of moving the State's superannuation arrangements from an untaxed status to a taxed status.
>
> We are not tax professionals and before any action is taken as a result of this letter, advice should be sought from an appropriately qualified tax expert. However, through our experience of the financial outworkings of public sector superannuation funds in general, and the South Australian Government Funds in particular, we are qualified to comment on the effect of the main components of the taxation arrangements of the fund.'

Attachment 18

The covering letter to the 2004 Report, and the parts of the report dealing with pensions, are provided as Attachment 18.

On page 7 of the report one reads:

> *'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 one reads:

> *'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 the 2004 Mercer Report is advising the Department of Treasury and Finance of three things each of which should have been sufficient to alert it to the possibility that the rule changes it had recommended the Treasurer authorise EISS to use had reduced employer costs:

- There is a tax advantage available from moving an untaxed 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
- There was a formula being used elsewhere that took into account both the maximum superannuation tax rate (15% or 0.15) and employment history of pension recipients.

On page 10 the 2004 Mercer Report refers to EISS experience and reports that EISS is using the method for reducing pensions that keeps member benefits the same. According to the statement made on page 7, and quoted above, this is the way of reducing pensions that should generate savings for employers. Surely if there was something about EISS pensions that was preventing EISS employers from making these savings the 2004 Mercer Report would have described this.

Conspicuous by its absence from the 2004 Report is any reference to Mercer's 27 June 2002 Explanatory Memorandum written by the actuarial adviser and the claim it makes that rules, which included the EISS rule for reducing its pensions, would have no effect on employer costs. Treasury should have noticed the references made to EISS in the 2004 Mercer Report, the statement in the covering letter that the 2004 Report was an update of the 1998 Mercer Report and the absence from the 2004 Report of any reference to the Mercer Explanatory Memorandum of 27 June 2002. The inconsistencies between what the Memorandum claimed and what was set out in both the reports should have been drawn to the attention of the Treasurer and an explanation for the inconsistencies given, if there was an explanation.

Attachment 19

2006 Treasury resists release of the 2004 Mercer Report- The Mercer report of 2004 came into possession of the Association in March 2006 as a result of a Freedom of Information application made on its behalf by Mr Angus Redford who was then a member of the Legislative Council. At first the Treasury refused to release the document but this was reversed by a decision of the Ombudsman. Treasury's initial refusal to release the 2004 Mercer Report was surprising to SA Superannuants because the previous (1998) Mercer Report had been released to it in 2002.

The letter from Treasury (Attachment 19) that accompanied the release of the 2004 Mercer Report described a number of reasons for Treasury's reluctance to do so. It is worth setting out these reasons as they appear in the letter itself before commenting on them.

> ‘In releasing the report, we point out that the document is merely a preliminary step in what may potentially be a lengthy and rigorous decision making process for the government. The report simply canvasses competing options with particular emphasis on the advantages and disadvantages to the employer (the Government) and the employee.
>
> At this stage the report has the status of being a internal working document as it is considered that much more in depth analysis of the issue needs to be undertaken, and there also needs to be much more rigorous consideration of the implications of the available options.
>
> In particular, this report failed to specifically deal with the implications at the individual member level of moving funds into the taxed environment. It should be noted that neither the Treasurer nor the Government have considered this report or made any decision on this superannuation matter.’
>
> It should be noted that the report states that Mercers are not tax professionals and therefore the necessary tax advice should be obtained. It is for this reason that the report is tentative and its content cannot be relied on.

General comment: if Treasury had applied these standards of probity to the Mercer Explanatory Memorandum it would never have been accepted as providing an adequate basis for recommending to the Treasurer that he authorise adoption of the rules developed by the actuarial adviser. The Explanatory Memorandum, like the 1998 and 2004 Reports, had been prepared by Mercers and it was dated just one day before the rules it referred to were put in place.

Specific comment: at the time Treasury was claiming to observe the high standards set out above, the Treasurer was responding to concerns about the validity of the EISS rule for reducing pensions. The admission that ‘neither the Treasurer nor the Government have considered this report’ is damning for the probity of Treasury’s conduct in the matter. Had the Treasurer been given an honest briefing on the 2004 Report and its inconsistency with the Mercer Explanatory Memorandum he very likely would have recognised that the 2004 Report cast doubt on the reliability of the Explanatory Memorandum.

By 2006, when SA Superannuants gained access to the 2004 Mercer Report, it had learned from a member of EISS what it was doing with its pensions and it had expressed its concerns about this to the Treasurer making reference to the 1998 and 2004 Mercer Reports as it did so. The argument that the EISS pension reduction method was invalid went as follows:

1. EISS is recalculating pensions by applying income tax rates to achieve the outcome of the pension having an unchanged after-tax value when the 15% superannuation tax offset is taken into account.
2. The Mercer Reports of 1998 and 2004 provided advice to the Department of Treasury and Finance that this method of recalculating pensions would reduce employer costs.
3. The Electricity Corporations Act, 1994 as modified by the Electricity Corporations (Restructuring and Disposal) Act 1999 provides in subclause (2) of Clause *11- Treasurer may vary rules in relation to taxation* of *Schedule 1- Superannuation* for a State Treasurer to insert rules into the EISS rules for benefit reductions **but only to the extent needed to avoid or reduce an increase in employer costs arising from a change in the incidence of taxation.**

SA Superannuants said to Mr Foley that these three factual matters were sufficient to establish that the rules for recalculation of pensions by EISS are invalid because they must reduce employer costs rather than just avoid or reduce an increase in those costs. As a consequence the effect of the rules for recalculation of pensions must be to divert money away from EISS members, who are entitled to receive it, to employers, who are not entitled to receive it.

Attachment 20

SA Superannuants received a reply from the Acting Treasurer on 12/10/2006 (Attachment 20). Several features of this letter point to it being a communication of low probity.

Attachment 5

Attachment 21

1. The letter paints a picture of the EISS Board, and not the Treasurer, as being the main instigator of the rule changes made in June 2002. This is at odds with what the EISS Board Chairman said about the Board's role in his letter to the Treasurer of 2 August 2007 (Attachment 5). The Chairman stated that the Board was not responsible for the rule changes.
2. The letter reports that the EISS lawyer supported the rule changes. Attachment 21 is a document sent to all EISS pension division members in March 2009. The Appendix to the document indicates that EISS did not seek legal advice about the validity of the rules until September 2005.
3. In response to the SA Superannuants claim that EISS benefit reductions were allowable under the Electricity Corporations Act 1994 **'only to the extent needed to avoid or reduce an increase in employer costs arising from a change in the incidence of taxation'** the letter of 12/10/2006 says that this was **'not a correct reflection of the provisions of the Act.'** No attempt was made to explain why the claim was not a correct reflection of the Act.

When this letter of 12/10/2006 (Attachment 20) was received SA Superannuants was not yet aware of the existence of the Explanatory Memorandum or its contents. But Treasury was and whoever prepared the letter for the acting Treasurer to sign should have been aware that even the Explanatory Memorandum had conceded that employer costs were not permitted to decrease and pension reductions could only go so far as to avoid or reduce an increase in employer costs.

According to the answer given to question 8 in Attachment 14 Treasury now concedes that employer costs were not permitted to decrease and so the letter of 12/10/2006 would appear to be misrepresenting the requirements of the Electricity Corporations Act 1994.

Attachment 22

2008 Treasury admits it has no worksheets for the Mercer Explanatory Memorandum: In a letter dated 26 May 2008 (Attachment 22) Mr Foley advised SA Superannuants that he had chosen not to respond to further questions from them concerning EISS. His main reason for doing this was the fact that he had received Crown Law advice 'that the rule changes made in 2002 are entirely valid and comply with the provisions of Clause 11 of Schedule 1 of the Act, after taking into account the increased employer costs that had to be offset.' This leads to the reasonable suspicion that Crown Law was instructed to give its advice without considering the possibility that the figures for costs and savings set out in the actuarial adviser's (Mercer) Explanatory Memorandum of 27 June 2002 might be wrong. In his letter to the Hon Bob Such MP of 19 June 2008 (Attachment 11) Mr Foley revealed that Treasury did not have copies of the worksheets corresponding to calculation of the values. This makes it clear that the Treasury case that the rule changes of 2002 had a sound basis in law has always been flimsy. The quality of the Crown Law advice that all the rule changes are entirely valid can be no better than the quality of the calculations used to generate the values contained in the Explanatory Memorandum. And there is a reasonable basis for suspecting that calculations were never done for most of the values and that the Memorandum is a false document (see pages 10-11 of this submission).

Attachment 11

2012 Treasury provides incomplete and misleading advice to the Minister for Finance: As discussed earlier under 2 (d) of the Legislative Council referral the Hon Iain Evans MP, Shadow Treasurer, asked the Hon Michael O'Brien MP, Minister for Finance a series of questions on behalf of SA Superannuants and Richard Vear. Answers to these questions were provided by Treasury. The full set of questions and answers is contained in Attachment 14.

Attachment 14

Question 6. This question was:

> 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?

The Minister for Finance responded:

> 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.

In the SA Superannuants' representations to former Treasurer Foley, claiming that the EISS method for calculating taxed-source pensions was invalid, reference was made more than once to the Mercer Reports as providing confirmation of its own reasoning that the method must reduce employer costs. At no time did Mr Foley say to SA Superannuants that these reports were irrelevant. All he ever said was that its interpretation of Section 11(2), Part F of Schedule 1 *Superannuation* of the Electricity Corporations Act 1994 was incorrect and he never went on to explain why. The fact that EISS had no existing pensioners at the time it moved to the taxed environment did not stop the move from reducing employer costs for the pensions that had not yet commenced. Whoever provided Mr O'Brien with the above answer would have known this.

Question 8. The question was:

> If the method for calculating EISS taxed-source pensions was expected to reduce employer costs for those pensions would it be compliant with Section 11(2), Part F of Schedule 1 *Superannuation* of the Electricity Corporations Act 1994?

The Minister for Finance responded:

> The formula that reduced gross pensions was determined actuarially in order to comply with the provisions of Clause 11(2) Part F of Schedule 1 Superannuation of the *Electricity Corporations Act 1994*. It was determined in a manner to avoid or reduce an increase in employer costs, but not reduce existing employer costs. It also satisfied the Act by ensuring that members received a net benefit that was not less than their existing net benefit applying before the fund moved into the taxed environment.

This would seem to confirm that the rules inserted into the EISS rules in June 2002 by then-Treasurer Kevin Foley were forbidden, by the Electricity Corporations Act 1994, to have the effect of reducing employer costs. This is what SA Superannuants had said to Mr Foley in 2006 only to be told by the Acting Treasurer that this was '**not a correct reflection of the provisions of the Act.'** The 2006 letter from the Acting Treasurer would certainly have been prepared for him by a Treasury officer who must have known that the SA Superannuants' interpretation was correct.

It is fair to say that it took from October 2006 until May 2012 for the efforts being made by SA Superannuants, Mr Richard Vear, Hon Bob Such MP and the Hon Iain Evans MP to finally extract from Treasury a clear admission that the Electricity Corporations Act 1994 allowed reductions to EISS benefits only to the extent that avoided or reduced an increase in employer costs arising from changes in the incidence of taxation, and did not allow employer costs to decrease.

Attachment 20

Attachment 14

In October 2006 Treasury was advising the Treasurer that this was not a correct reflection of the provisions of the Act (Attachment 20). In 2012 it finally had to allow a Minister to know the truth of the matter and say that the EISS method for calculating its taxed-source pensions was required 'to avoid or reduce an increase in employer costs, but not reduce existing employer costs.' (Attachment 14). This is what SA Superannuants had been saying all along.

Another bit of incorrect advice has been provided to the Minister for him to use as an answer to another question.

Question 9. The question was:

> Can the Minister name any other Australian Superannuation Schemes, in either the public or private sector, that calculate taxed-source pensions by the same method as EISS is using for its taxed-source pensions? If so, what is the name of the scheme or schemes?

The Minister for Finance responded:

> Every scheme that has moved from the untaxed environment to the taxed environment, resulting in the fund becoming subject to tax has used a different method to reduce member gross benefits as applied in the untaxed environment. We are not aware of any other scheme that has used precisely the same method.

This answer implies that any difference there might be between the EISS method for reducing its pensions and the methods used by other funds is not significant. But the EISS method has the very distinctive features that it takes no account of a pension recipient's service history (pre-July 1983 or pre-July 1988 service) and no account of the tax that was actually paid by the fund as a result of the shift to the taxed environment. Treasury, which had provided these answers for the Minister, would have known that these features were not shared with methods used by either the corresponding New South Wales or Victorian funds. Treasury would have been well aware that in those other jurisdictions many members became better off as a result of the move of pensions to the taxed superannuation environment and without any significant increase in employer costs.

Attachment 23

2013 Super SA declines to answer questions from SA Superannuants: In March 2013 the Hon Iain Evans MP, Shadow Treasurer, provided SA Superannuants with a copy of a 2011 Minute he had obtained via a Freedom of Information (FOI) application (Attachment 23). The Minute had been prepared for the Minister for Finance. It included on its page 3 a statement that on a move of the State Pension Scheme into the taxed superannuation environment tax at the rate of 15% would be payable on the employer-funded assets transferred. No mention was made of the fact that where fund members have appreciable amounts of pre-July 1983 service the 15% tax is not payable on a fraction of employer-funded assets corresponding to this pre-July 1983 service.

Both the EISS pension division and the State Pension Scheme had most of their members with pre-July 1983 service. This suggests that Treasury was being selective in what it told Mr O'Brien because it wanted him to think reductions of around 15% for EISS pensions were to be expected.

Attachment 23A

The fact that the Minute referred specifically to the State Pension Scheme, and tax that would be payable if that scheme moved to the taxed environment, led the Association to make an approach to Super SA to settle two questions about tax payable when a superannuation fund shifts to the taxed environment. This approach was made via the letter provided as Attachment 23a. The letter was accompanied by the Minute referred to above. In the letter the following two questions were asked:

Tax matter 1: we ask the Board to confirm that on any move of State Pension Scheme assets into the taxed superannuation environment there will be no tax payable on a substantial fraction of the employer assets transferred and, if so, whether this part of the transferred assets corresponds to member service completed before 1 July 1983.

Tax matter 2: we ask the Board to confirm that following any move of the State Pension Scheme into the taxed superannuation environment utilisation of pre-1 July 1988 funding credits (PJFCs) will reduce the tax payable on contributions made to fund the part of pensions that had accrued before 1 July 1988.

Attachment 23B

After a long delay and dispatch of the letter again (Super SA acknowledged that it had received the letter and attachment in May but said they had been lost) SA Superannuants obtained a response and it is provided as Attachment 23b. The letter of response was dated 26 September 2013, one day after the Legislative Council referral had been made and the referral is used as a reason for not providing the answers sought.

Unless it turns out that SA Superannuants is wrong about the tax effects of pre-July 1983 service and pre July 1988 funding credits this provides a reasonable basis for suspecting that Super SA was prevented from providing answers to the questions because the answers would have contradicted the advice to the Minister contained in the 2011 Minute.

The Legislative Council motion continues as:

f) Whether the method used to calculate EISS taxed-source pensions has reduced employer costs for those pensions compared to what the cost would be if the pensions had continued as untaxed-source pensions.

There is only one indicator that the EISS rule for reducing its pensions had no effect on employer costs for the pensions. This is the Explanatory Memorandum of Attachment 9 and as stated earlier there is a reasonable basis for suspecting that this is a false document.

There are many indicators that the EISS method for reducing its pensions is having the effect of reducing employer costs for those pensions. These indicators are common sense, technical indicators, indicators in the form of actual EISS experience and indicators in the form of written statements of the EISS Board Chairman and Executive Officer. Each of these categories of indicator is discussed separately below.

Part A: A common sense indicator of reduced costs for EISS pensions

All parties to this dispute agree that the rule applied to reduce EISS pensions paid from the taxed environment did not provide any improvement for members in the after-tax value of their pensions. The Treasury and EISS claim that there was also no reduction in employer costs whereas SA Superannuants and Mr Richard Vear claim that the method has reduced employer costs. If Treasury and EISS are right then there is no tax advantage for anyone in the tax arrangements that apply to taxed-source superannuation funds. This is contrary to the common knowledge that the main advantage of saving through the taxed superannuation system is a tax advantage. This tax advantage is due to the fact that the maximum rate of tax payable by a superannuation fund is 15% whereas personal, marginal income tax rates may be as high as 45%, the common marginal tax rate is 32.5% and the overall average rate is well above 15%.

This emphasises that the onus was, and remains, on the Treasury and EISS to have a means of proving that there was no reduction in employer costs and proving that to a standard comparable in reliability to the proof that there was no improvement in after-tax benefits for members. But all Treasury and EISS have is the Explanatory Memorandum and its set of figures for which there is no method of calculation set out and for which worksheets cannot be found.

Part B: Technical indicators of 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 Rules 29(4) and 29(5) 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 from their value as untaxed-source pensions.

The above-listed facts make it certain that Rules 29(4) and 29(5) 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. These facts are the basis for the predictions made in the 1998 and 2004 Mercer Reports (Attachments 13 and 18 respectively) that application of rules 29(4) and 29(5) to the state pension scheme would generate employer savings.

So, as well as SA Superannuants and Richard Vear saying that employer costs must have been reduced and the Mercer Explanatory Memorandum is wrong in saying they were not, there are two reports also prepared by Mercer contradicting the Explanatory Memorandum and each is more convincing than the memorandum. This is because each sets out the basis for saying that Rules 29(4) and 29(5) 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.

Part C: Actual EISS experience confirming reduced costs for pensions

a) Annual taxation experience of EISS 2000-2006

Attachment 24

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 the previous page of this submission. 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% (Attachment 24). 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 their after-tax income.

Attachment 25

Attachment 26

Attachment 27

The EISS unfunded liability had been extinguished by the end of the 2005/2006 financial year (Attachment 25). In the period 1 July 2000 until 30 June 2006 the employer contributions to EISS totalled $317.3 million (Attachment 26) - and the scheme utilised $238.8 million in PJFCs (Attachment 27). 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.

b) A 30 June 2002 report on financial position

Attachment 28

On 23rd March 2003 the actuarial adviser 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* it is reported 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 (Attachment 28). 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.*

In the paragraph *b) Tax changes* the second sentence states *Overall the tax reductions do not alter employer costs.* **This cannot be true.** The tax reductions cannot have reduced the immediate funding targets without reducing overall employer costs.

Here is an acknowledgement by the actuarial adviser 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 the actuarial adviser had been a co-author. It contradicts the claim the actuarial adviser had made in his Explanatory Memorandum that rule changes for reduction of benefits would not alter employer costs.

Attachment 29

c) the most recent actuarial investigation of EISS

The 30 June 2011 Actuarial Investigation of EISS (Attachment 29) includes the information that 'Untaxed pensions incur a higher employer cost.' This is confirmation of the validity of the case being made in this submission that Rules 29(4) and 29(5) reduce the employer cost for pensions compared to what the cost would be if the pensions were paid as untaxed-source pensions.

Part D: Written statements of the EISS Board Chairman, and Executive Officer, indicating reduced costs for pensions

Attachment 30

EISS Board Chairman: on 3rd December 2008 the EISS Board Chairman wrote to the Secretary, Australian Services Union (Attachment 30). Referring to the concerns of EISS pension division members over the method being used to calculate taxed-source pensions the Chairman wrote:

> *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."*

The first sentence of this paragraph acknowledges that taxed-source pensions may have a lower cost than untaxed-source pensions. The only pensions that could have a higher cost as taxed-source pensions are those 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 paragraph acknowledges that the pensions are being reduced without taking account of how the reduction affects employer costs. This is an admission that Rules 29(4) and 29(5) are not likely to be valid. This paragraph and the rest of the letter creates a reasonable suspicion that the Chairman knows rules 29(4) and 29(5) are reducing employer costs.

Attachment 31

EISS Executive Officer: At a meeting of the EISS Board held on 27 July 2005 there was discussion of a paper (Attachment 31) prepared by the Executive Officer and dealing with the tax offset i.e. rules 29(4) and 29(5). The paper is dated 29 June 2005. On page 5 of the document it is reported that members had concerns about the tax offset. One of these concerns expressed by members was stated as:

> ‘ The offset is there to compensate the Scheme for contribution and investment tax paid to fund the benefit. The tax is at most 15%, so why is the offset greater than 15% in some cases?’

The paper does not attempt to answer the question that the members were asking which was – why is the offset greater than 15%? Instead the paper changes the subject immediately and says:

> ‘Looking at it slightly differently, the reduction in the gross pension is needed because: The aim is to equate after-tax pensions from taxed and untaxed schemes;

A little further down the same page the Executive Officer suggests to the Board that the answer to the member’s question of -why is the tax offset greater than 15%? - be given as:

> ‘The member is no worse off in net terms, so it shouldn’t matter what is the percentage reduction’.

With these two statements the Executive Officer is telling the Board that the only purpose of rules 29(4) and 29 (5) is to ensure that members do not end up worse off or better off and if the employers costs are reduced this does not matter. This is sufficient to create the reasonable suspicion that the Executive Officer knows that rules 29(4) and 29(5) are reducing employer costs. This possibility is strengthened later in the document. On page 8 the last two options of four, dealing with members’ concerns about the tax offset on pensions, are listed as:

> Place a limit on the current offset calculation of 15% or 17%
> Amend the offset calculation in line with the actuary’s suggestion.

Immediately after these two options it is stated that:

> ‘The final two options reduce the impact of the offset calculation, and impose a cost on employers compared to what is done now.
> The cost compared to pre-privatisation may in fact be lower, but the cost compared to now will be higher.’

In Attachment 7, which is the Newsletter advising EISS members of his appointment the Executive Officer tells EISS members ‘I have been involved with EISS before, during and after privatisation’.

Richard Vear was in contact with the Executive Officer around the time the paper containing these statements was prepared. Richard was trying to get an understanding of the method that EISS was using to reduce its pensions. In an email he was told by the Executive Officer.

> Richard,
> What is the 'contribution tax offset', I imagine you are asking? We are trying to find a name that describes the benefit tax reduction properly, and this is what we came up with.
>
> ‘You may have heard already from Tim Murray or Morna that we didn't discuss the contribution tax offset in depth at Wednesday's Board meeting. This was a decision made by myself and the Board's Chairman, as I was not ready to educate the Board fully on this matter. I have been busy discussing this with the actuaries at Mercer, as well as writing a longish paper on the issue. It is on the agenda for the next Board meeting on July 27.
>
> Tim raised the concerns that had been expressed to him that no work was being done to address this issue. I will assure you that this is not the case. I am keen to resolve this issue, but it is not simple, and before the Board can make any decisions, they need to understand it. That needs me to get a handle on the history as well as all the details, and the implications of making any changes.
>
> Give me a ring if you want to talk about it.

We see here that the paper of 29 June 2005 was written while the Executive Officer was busy discussing the tax offset ‘with the actuaries at Mercer’. The Executive Officer had in fact been an actuary at Mercer himself until early 2004 when he took up his appointment as the EISS Executive Officer. In his time at Mercer the Executive Officer was closely involved with EISS actuarial and consulting work. He had replaced the actuarial adviser as the scheme actuary. This creates the reasonable suspicion that it was known at Mercer that rules 29(4) and 29(5) had reduced employer costs for EISS pensions.

The Legislative Council motion continues as:

g) Whether the method complies with the Electricity Corporations Act 1994 including Schedule 1, Part F, clause <u>11: Treasurer may vary rules in relation to taxation</u>, sub-clauses (1) and (2).

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.

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 Rules 29(4) and 29(5) use 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 Rules 29(4) and 29(5) 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. There is a reasonable basis for suspecting that both EISS and the Department of Treasury and Finance officers advising the Treasurer knew that the method for calculating pensions (Rules 29(4) and 29(5)) 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 Rules 29(4) and 29(5) do.

Dubious Crown Law advice
The main reason that this dispute has not been resolved before now is that the Government claims to have Crown Law advice that the method for calculating EISS taxed-source pensions is fully compliant with the Electricity Corporations Act 1994.

EISS has legal advice that it is administering its rules correctly but EISS does not say it has its own legal advice that the rules are valid. It merely cites the Crown Law advice to the government that the rules are valid.

If the EISS pension reduction method is not reducing employer costs for pensions then it would have to be accepted that the method is valid. But if is reducing employer costs what is to be made of the fact that the Crown Solicitor has said that it is still valid? The only possible explanation is stated in the heading immediately below.

Advice from Crown Law is addressing the wrong question

Attachment 32

Very recently, the Association Vice-President, Mr Clive Brooks received a letter from a Crown Law Solicitor dealing with the advice that Crown Law gave to DTF on the validity of the EISS rules. A copy of this letter is provided as Attachment 32. The Attachment includes Mr Brooks' reply.

The letter of the Crown Law Solicitor suggests that DTF only has advice from Crown Law that the EISS method for reducing pensions is valid notwithstanding the fact that it allows a person receiving a pension to experience an ambulatory detriment i.e. a detriment emerging after the pension commenced. This can occur as follows: people starting their EISS taxed-source pensions soon after July 2002 began with pensions that were equal in after-tax value with the untaxed-source pension and that therefore met the requirement set out in subclause (3) of Clause 11 of Schedule 1 of the *Electricity Corporations Act 1994.*
But, since July 2002, marginal rates for personal income tax have become less creating the situation where the taxed-source pension recipient now has less after-tax income from his/her pension than would be the case if they were getting the pension in its untaxed-source form. **This is not the feature of the method for reducing EISS pensions that SA Superannuants and Richard Vear are saying causes it to be invalid.**

SA Superanuants and Richard Vear both agree that the requirement of subclause (3) continues to be met even if, after the commencement date, a taxed-source pension reduces in its after-tax value relative to the original untaxed-source pension. It is also agreed that the Mercer Review of 1998, and the actuarial analysis it contains, is not relevant to this question. **This was always the wrong question on which to seek Crown Law advice.**

The reason that SA Superannuants and Richard Vear have for saying that the method of calculating EISS taxed-source pensions is invalid is that it reduces employer costs and therefore does not meet the requirements of subclause (2) of Clause 11 of Schedule 1 of the *Electricity Corporations Act*. The right question to ask of Crown Law was whether a method for reducing pensions was valid if it had the effect of reducing employer costs for the pensions. The Crown Solicitor also needed to be instructed to take account of all documents dealing with the effect of the method on employer costs, not just the Explanatory Memorandum. When this right question is asked the 1998 and 2004 Mercer Reports, and the actuarial analyses they contain, become relevant. With only the Explanatory Memorandum as the indicator of the effect on employer costs the Crown Solicitor might well have assumed (or been told to assume) that compliance with subclause (2) was not the issue and then proceeded to give advice on whether subclause (3) was being complied with. This possibility is strongly indicated by the fact that the Crown Law Solicitor's letter (Attachment 32) says that the difference between the Government and the Association does not involve actuarial calculations.

Attachment 33

Legal advice to EISS: Attachment 33 contains letters exchanged between legal advisers to EISS and the Australian Services Union (ASU). The ASU became involved in this matter as a result of representations made to it by Richard Vear who was, at the time, an ASU member.

Legal advisers to EISS could not have been told of the existence of the 7 June 2002 letter to the Under-Treasurer because neither the Board Chairman nor the EISS Executive Officer knew about the letter at the time the legal advice was obtained. Furthermore, EISS appears to have told the legal adviser that it had never been given any evidence to indicate that the method for calculating its taxed-source pensions was reducing employer costs for the pensions. While it might be true that no conventional authority had ever said bluntly to the Board 'the method is reducing employer costs' there were many indicators pointing to this that should have attracted the attention of the Board. For example:

- A 2002 report to the EISS Board on the scheme's financial position (see Attachment 28) advised that the benefit reductions made to compensate employers for tax had seen the scheme's financial position improve in a year when investment returns had fallen 15% below the expected returns. The changes reduced benefit liabilities by more than the tax had reduced assets. This was clear evidence that employer costs had been reduced.
- Reductions made to lump sums obtained by commutation of pensions were much less than reductions made to the pensions. How else could this be explained other than to conclude that pensions were being reduced by more than the tax cost of paying them from the taxed superannuation environment?
- On page 8 of Attachment 31 the EISS Executive Officer refers to two options for dealing with EISS pension scheme member complaints about the large reductions made to their pensions by saying :

> 'The final two options reduce the impact of the offset calculation, and impose a cost on employers compared to what is done now.
> The cost compared to pre-privatisation may in fact be lower, but the cost compared to now will be higher.'

Here the Executive Officer has told the Board that employer costs for pensions may have gone down when EISS shifted to the taxed superannuation environment.

The legal advice to EISS deals with the possibility that the method for calculating taxed-source pensions is reducing employer costs by saying that subclause (2) of Clause 11 of Schedule 1 of the *Electricity Corporations Act* became 'a spent force' once the Treasurer had inserted the method into the EISS rules. The advice also told the Board it was under no obligation to investigate the possibility that the method inserted by the Treasurer was reducing employer costs.

The ASU legal adviser held that there was an obligation on the Board to obtain its own independent advice about the effect of the pension reduction method on employer costs. The ASU legal adviser argued that the pension reduction method could not be valid if it was reducing employer costs. The EISS legal adviser responded by saying that it did not disagree with this.

Overall the legal advice to EISS could be no more than an assurance that it had correctly applied the rules and if they were invalid that was no business of EISS.

The Legislative Council motion continues as:

(h) any other relevant matter.

3. resolves that, in all the circumstances of the case, administrative acts associated with these matters warrant investigation by the Ombudsman despite the availability of any alternative appeal, reference, review or remedy or the passage of time since SA Superannuants and Mr Richard Vear had notice of the administrative acts.