

PENSIONS ACT 2004, PART 2 CHAPTER 6**APPEAL TO PENSION PROTECTION FUND OMBUDSMAN****DETERMINATION BY THE PENSION PROTECTION FUND OMBUDSMAN**

Applicants : Mr D Tooth and Mr I Stevenson, as trustees
Scheme : Silk Industries Limited Pension Scheme

1. The Pension Protection Fund (**PPF**) Ombudsman has received a reference of a reviewable matter, following a decision by the Reconsideration Committee of the PPF dated 19 November 2008.

Grounds for referral

- The substantial variation in the probability of insolvency between the years 2006/07 and 2007/08 is not merited by the financial and commercial information relating to the Scheme Employer;
- Therefore the failure score and corresponding probability of insolvency upon which the 2007 levy was based are incorrect;
- Dun & Bradstreet (**D&B**) purported to explain the changes in the failure score by reference to a reduction in the Employer's retained earnings, the impact of FRS17 on the Employer's balance sheet and a drop in cash reserves;
- D&B do not appear to have taken into account the reduction in the Employer's debt over the corresponding period;
- The inclusion of the Scheme deficit in the balance sheet (in accordance with FRS17) cannot have altered the probability of insolvency of the Employer because it had already been noted in the 2006/07 accounts;
- An analysis of D&B's calculations and conclusions (summarised later) demonstrates that the process and methodology of calculating the probability of insolvency are flawed or lead to arbitrary results;
- It is submitted that the information upon which the 2007 levy calculation was based was incorrect in a material respect

Background

2. The Scheme is a single employer scheme. The relevant employer is Silk Industries Limited.
3. The referral relates to the Scheme's risk-based levy for the levy year 2007/08 which amounts to £83,269. This has been calculated by reference to a probability of insolvency of 0.014945.
4. For the levy year 2006/07, the Scheme's risk-based levy was £15,869.52. The probability of insolvency used in the calculation of the 2006/07 levy was 0.004714.
5. The Employer's failure scores have been: 77 in 2005/06, 91 in 2006/07, and 59 in 2007/08.
6. The Trustees have appealed the Company's failure score via Dun & Bradstreet's five stage appeal process. In their submission to D&B, in August 2007, the Trustees said that they considered the Employer's failure score for 2007/08 was incorrect for two reasons:
 - the Employer's consistent, stable and profitable performance, and
 - the impact of FRS17 on the recognition of pension fund liabilities.
- 6.1. With regard to the Employer's performance, the Trustees explained that the Employer was the owner of a trading enterprise, which had been established over 100 years; until November 2003, it had been owned by a public listed company; it was then acquired by its management and the listed company became a wholly owned subsidiary; since 2003, consolidated accounts had not been filed and D&B's calculations had been based on parent company data only. The Trustees provided a table of consolidated financial results for the years 2002 to 2006. Amongst other things, they noted that the total debt and interest cost had increased as a result of the management acquisition, but £2.32m had been repaid, including £940,000 ahead of schedule. They also noted that the ratio of liabilities to net worth had been steadily reduced since acquisition.
- 6.2. The Trustees also provided a table showing a comparison of profit after tax, total liabilities, capital and reserves, and liabilities/net worth, for the years

2005 and 2006, including and excluding FRS17. The Trustees argued that FRS17 imposed no new liabilities on the Employer, but merely changed the manner in which they were recognised for accounting purposes and, therefore, there was no reason for the failure score to be affected.

Appeal responses from D&B

7. In summary, D&B responded:

- There are two permissible grounds for appeal laid down by the PPF. These are: (i) if the data was incorrect at the time of the failure score calculation (30 March 2007), and (ii) if there was data in the public domain which D&B should have been expected to have had in the normal course of its business;
- Through historical analysis of failed businesses, it seeks to identify those characteristics which will predict the relative probability of a business becoming insolvent in the following 12 months;
- Some data elements have very high predictive qualities and others very low;
- Financial, payment, public record and demographic elements are all reviewed, but only those with measurable predictive qualities are applied to its scorecards;
- Posting the pension scheme deficit in the 2005 accounts had an impact on the failure score by reducing the ratio of total liabilities/net worth and reducing retained earnings; both of which are used in the standard failure score calculation;
- It does not disclose full details of its score calculation because this is commercially sensitive information;
- The data it held for the Employer had been checked for accuracy during the early stages of the appeal and had been found to be correct;
- Financial elements used in the calculation of the failure score were derived from the balance sheet and the P&L account, including total liabilities/net worth, pre-tax profit margin, retained earnings, cash, current assets and shareholders' return;

- The primary factors which influenced the change in failure score were to do with the declaration of the pension scheme liability and a decline in the cash position;
- The failure score for 2008/09 (54) did not represent a fall of 45%;
- The Employer's probability of insolvency had decreased by 45% (from 1.4945% to 0.8200%) from 30 March 2007 to 30 March 2008; the previous statement was a response to the Trustees' statement that "the score for 2008/09 has fallen by 45% with no apparent commercial reason"; it did not indicate that its conclusions had been based on incorrect analysis;
- Between March 2007 and March 2008, it had changed the underlying scoring models in line with the ordinary course of its business;
- The Employer's reduced probability of insolvency between March 2007 and March 2008 was mostly due to the changes in its methodology, which placed more emphasis on the employer's stronger characteristics of principals and trade payments;
- It was aware that details of the pension scheme were shown in the notes to the accounts for 2005; the elements used in its scoring model were those disclosed on the balance sheet and in the P&L accounts;
- FRS17 required a pension scheme surplus/deficit to be recognised in full on the balance sheet;
- It had been consistent in handling FRS17 compliance across its database and the purposes of the PPF;
- The posting of the pension scheme liability on the balance sheet in the 2006 accounts impacted on the financial section of the scorecard;
- The main change between March 2006 and March 2007 was in the financial section where the financial statements reflected a drop in retained earnings from £1.3m to £121k and a drop in cash from £496k to £148k;

- Its scoring methodology was based upon a consistent application of characteristics applied across five different categories to produce a balanced scorecard, which the PPF had adopted;
- It was bound to use its standard scoring methodology unless otherwise instructed by the PPF

Applicants' analysis of D&B calculations

8. The Applicants submit:

- D&B has said that it will be changing its methodology for 2008/09, which will have the effect of placing more emphasis on the Employer's stronger characteristics of principals and trade payments; if this is appropriate in 2008/09, why was it not appropriate in 2007/08?
- D&B has said that the main reasons for the increase in the probability of insolvency in 2007 were a drop in retained earnings (£1.3m to £121k) and a drop in cash (£496k to £148k); no weight was given to the reasons;
- The retained earnings were reduced by an FRS17 charge of £2.6m, which was offset to a large extent by a profit of £880k and a pension fund gain of £324k;
- The cash was reduced due to an early repayment of debt, which was reduced by £964k;
- These explanations were provided for D&B with the original appeal, in August 2007, but seem to have been ignored;
- There was an error in the letter informing them of the stage 5 decision, which suggests that D&B failed to understand the nature of their appeal;
- D&B states that the financial elements used in its scoring model are those disclosed in the balance sheet and profit and loss account; other information provided in the financial statements is apparently ignored, which suggests that the calculations are arbitrary;
- D&B states that it has been consistent in handling FRS17 compliance across its database and for the purposes of the PPF; their referral is not about D&B's database, but about the specific calculation of the probability of insolvency for

the Employer. It is possible for the calculation to be mathematically consistent with the database, but wholly unreliable in the case of a single company;

- Their original appeal included a table setting out the change between 30 April 2005 and 30 April 2006 if the pension fund deficit had been treated consistently in both years. If the deficit is recognised in both years, the retained earnings actually increases by £1.2m and the ratio of liabilities to net worth improved from 14.89 to 5.91. Both these measures are identified by D&B as material to the probability of insolvency, but both were construed in the opposite way by ignoring the deficit in 2005 and including it in 2006.

Reconsideration Committee's decision

9. The Reconsideration Committee's decision is summarised as follows:

- This calculation of the Scheme's levy was a reviewable matter by virtue of paragraph 19 of Schedule 9 to the Pensions Act 2004;
- The following factual matters were not thought to be in dispute:
 - The Scheme was a single employer scheme, as set out in the scheme return dated 19 January 2007;
 - A deficit-reduction contribution certificate had been submitted on 5 April 2007;
 - No other voluntary certificates were submitted in respect of the Scheme on or before the relevant deadlines.
- The Board had consulted on the risk-based levy over the period from September 2006 to March 2007;
- Under Section 175(5) (of the Pensions Act 2004), the Board was required to determine the factors by reference to which the levies would be calculated, the time at which the factors were to be assessed, the rate of the levies and the time at which they became payable;
- The Board published its determination of these matters for the year in question (the **PPF Determination**) on 1 March 2007;

- Reconsideration of the amount of the Scheme's levies was a reconsideration of the amount of the levies in a particular case and not a reconsideration of the PPF Determination;
- Neither the Committee nor the Board had any discretion to depart from the PPF Determination;
- The risk-based levy was calculated by reference to the formula $U \times P \times R \times c$ and subject to a cap (K) equal to 0.0125 multiplied by the Scheme's protected liabilities;

Specific Issues

- D&B's failure score
 - Paragraph 32, of the Schedule to the PPF Determination, provided that the failure scores were to be those which were or would have been assigned to the relevant employer by D&B in the ordinary course of its business; except for certain exceptions which did not apply.
- D&B's appeal process
 - Paragraph 32(e) of the Schedule provides for trustees or employers to appeal the D&B score and sets out the grounds on which D&B may advise the Board that the failure score previously notified was too high or too low;
 - The grounds on which D&B may revise a failure score are that it was based upon information which, on and as at 30 March 2007, was incorrect or incomplete when compared with the information which would normally have been taken into account;
 - The Trustees have appealed and been through all five stages of the appeal process.
- Changes in the probability of insolvency
 - Neither the Board nor the Committee has discretion to depart from the PPF Determination when calculating the levy;

- The normal methodology used by D&B does not allow for the effect of FRS17 to be removed from a failure score nor is the removal of the effect of FRS17 one of the exceptions provided for in paragraph 32;
 - It is the Board's position that the effect of FRS17 is not double-counted;
 - FRS17 is not a measure for the under-funding element of the calculation; under-funding is based on valuation data on either a Section 179 basis or a minimum funding basis;
 - Where the levy has been calculated correctly in accordance with the PPF Determination, it cannot be re-assessed on some other basis at the request of the scheme.
- Errors by D&B
 - The Committee is not aware of any error by D&B on the facts of the case;
 - D&B is an independent contractor from whom the Board obtains information required for the calculation of the levies, but it is not acting on behalf of the Board when it informs a particular company of its failure score on any particular date; this would normally be the failure score used by D&B for all purposes and not just for the Board;
 - The failure score assigned to the employer for the 2007/08 levy year has remained the same and has been confirmed to be correct through the five stage appeal process;
 - D&B does not disclose the detailed basis for its failure score assessment process or the effect that each of the many inputs has; this information is commercially sensitive;
 - The Applicant made a Freedom of Information request to the Board for this information, but the Board does not hold this information;
 - The Board does not accept that, in this case, there has been maladministration or a breach of a duty of care;

- Even if that were to be accepted, it would not require or permit the calculation of the levy; there is a statutory requirement for the Board to calculate the levies in accordance with the PPF Determination;
 - The question of compensation for maladministration or of legal liability for breach of a duty of care is a separate matter and is not the matter before the Committee.
- Discretions

Paragraph 5

Where the Schedule to the PPF Determination had failed to make the provision required for a calculation to be performed, the Board was able to take the appropriate steps to enable a calculation to be performed. In this case, the Schedule to the PPF Determination had made provision to enable a calculation to be performed.

Paragraph 6

Nothing in the PPF Determination should prevent the Board from reviewing the amount of the levy if it appeared that the information upon which the calculation had been based had been incorrect in a material respect. The failure score used by the Board was that which had been prescribed in the PPF Determination. The failure score was not materially incorrect, therefore paragraph 6 was not relevant.

Paragraph 12

There was the discretion for the Board to take steps to obtain further or amended information for the purposes of calculating the levies. However, it was under no obligation to do so where information has not been provided on or before the applicable deadline. Paragraph 12 was not relevant.

Paragraph 13

Where information necessary for the calculation of the levies had not been provided in the manner or format or by the time anticipated by the PPF Determination, the Board could use equivalent information provided in

another manner or format or at a different time. However, it was not under any obligation to do so. In this case, the Board had such information as was necessary to calculate the invoice and, therefore, paragraph 13 was not relevant.

Conclusion

- The Committee upheld the original calculation of the levies.

Written representation from the PPF

10. In addition to the points made by the Reconsideration Committee, the PPF submits:

- There was provision within the PPF Determination for D&B to provide the Board with a corrected failure score were it to become apparent that the failure score previously allocated was incorrect;
- D&B had not so notified the Board and therefore the Scheme's levy had been correctly calculated;
- The Board decided to use information from an external provider to calculate failure scores and incorporated this decision in the PPF Determination;
- It has never been feasible for the Board to commission a universe of failure scores created specifically for its own purposes;
- Subject to a few modifications, the Board must take D&B's system as it finds it;
- The decision to appoint D&B was made following a competitive tendering process after comprehensive consultation;
- D&B was deemed to be the best option for a standard, market-based approach to the assessment of insolvency risk because (amongst other things) of the extent of the coverage it could offer;
- The detailed approach applied by D&B in allocating failure scores is not a matter for the Board provided that its analyses are robust, objectively justifiable and applied consistently;

- For D&B to go beyond the balance sheet and P&L account in every case would introduce an element of subjectivity into the system and also increase costs.

Further representation from the Applicants

11. The Applicants submit:

- The PPF has offered no evidence to support the conclusion that the calculation of the 2007/08 levy is correct;
- There is no procedure available to conduct an independent check on the work of D&B; currently, if D&B was to make an error which it failed to recognise or admit to, the taxpayer has no recourse;
- They assert that there is material evidence to suggest that a mistake was made by D&B and they are dissatisfied with the reassurance from D&B that they have checked their own work;
- The method by which D&B were chosen and the cost of an alternative is of no consequence; there is an obligation on a public body to ensure the accuracy of the calculations it chooses to use to assess a tax or levy;
- The PPF's statement implies that a degree of inaccuracy is acceptable in order to save money;
- The refusal by the PPF to question D&B's work means it cannot possibly know whether D&B meets the requirement that its system be robust, objectively justifiable and applied consistently;
- D&B have acknowledged that a change to its methodology affected the calculations for 2008/09; therefore, by its own admission, its work is inconsistent;
- Use of all the published information in the accounts would not introduce any subjectivity into the system; it would introduce more facts to better inform the objectivity of D&B's work.

12. The Applicants have also submitted a copy of an e-mail from D&B, dated 12 June 2009. In this, D&B gave further details about the factors influencing the change in

failure score. For example, D&B referred to a change in failure score from 91 to 77, in August 2006, as a result of a mortgage with the Bank of Scotland being registered against the Employer. The score declined further (to 59) in March 2007 as a result of “a decline in the payment habits of the company, with the percentage of satisfactory trade experiences being paid prompt (*sic*) of within 30 days decreasing”. D&B also mentioned that the score changed from 59 to 54 in November 2007 as a result of the introduction of a new scoring algorithm. D&B explained,

“When the scores of some businesses improve, as has happened for many financial sector companies and government entities, this pushes down the relative ranking of other companies even if their underlying risk is unchanged.”

13. The Applicants submit:

- The change in the failure score in November 2007 was solely the result of a change in methodology by D&B;
- It led to an improvement in the probability of insolvency, which was unrelated to any change in the circumstances of the Employer;
- The scale of the improvement in November 2007 is evidence that the probability of insolvency previously calculated by the PPF, in March 2007, was inaccurate;
- The risk of insolvency of the Employer has been affected by evidence relating to companies other than the Employer;
- If the failure scores for other companies improves, the risk of insolvency for the Employer calculated by the PPF will deteriorate even if there is no change in its circumstances;
- The calculated risk of insolvency is entirely arbitrary;
- The calculation of the insolvency risk in March 2007 is wrong and not the correct basis for calculating the 2007/08 levy;
- The earlier failure by D&B to provide information relating to the calculation of the failure score prevented them from demonstrating that errors had been made in the calculation; for example, the mortgage related to routine annual

capital expenditure and the payment of invoices relates to five out of the 3,000 the Employer pays each year.

Subsequent submission by the Applicants

14. The Applicants submits:

- They accept that the required procedures have been followed by the PPF;
- They are still of the opinion that the failure score calculated by D&B as at 31 March 2007 is incorrect;
- They believe that they have obtained conclusive evidence to prove this and they have asked D&B to re-consider the score in the light of that evidence;
- The evidence relates to the payment of suppliers and was not made available to them during the appeal procedure;
- The Ombudsman has a responsibility to ensure that they are protected from an error by D&B even if the correct procedures have been followed.

CONCLUSIONS

15. This is a reviewable matter by virtue of paragraph 19 of Schedule 9 to the Pensions Act 2004.
16. The reviewable matter in question is the amount of the risk-based levy required of the Plan for the financial year 2007/08.
17. Under Section 175(5) of the Pensions Act 2004, the Board was required to determine the factors by reference to which the 2007/08 levies were assessed; those factors were set out in the PPF Determination. The PPF has correctly submitted that the Determination, itself, is not a reviewable matter, nor is the Board able to amend the Determination on an individual application for review or reconsideration.
18. The crux of the Applicants' referral is their belief that the failure score assigned to the relevant Scheme employer is incorrect. They reached this view because of the variation in the failure scores assigned to the Employer over the three levy years 2006/07, 2007/08 and 2008/09. In particular, they are concerned with the worsening score between 2006/07 and 2007/08, which they consider is not supported by the actual financial and commercial health of the Employer. D&B has confirmed that the

failure score for 2007/08 is that which it would assign to the Employer in the ordinary course of its business, which accords with the requirements of the PPF Determination.

19. One of the main changes between the 2006/07 and 2007/08 levy years was the introduction of FRS17, which requires the disclosure of a pension scheme deficit in a company's balance sheet. The Applicants argue that this should not have made any difference to the Employer's failure score because the deficit had been disclosed in the notes to the 2006 accounts. However, D&B only look at a company's balance sheet and profit and loss account. Although, in absolute terms, the introduction of FRS17 would not have affected the likelihood of a company becoming insolvent, it meant that a pension scheme deficit became visible to D&B and allowed it to refine its score. I do not agree that changes in D&B's methodology between years means that its approach is inconsistent. Not surprisingly, D&B's system is an evolutionary one. The consistency required of its methodology is between companies rather than between years. There is nothing to suggest that D&B has not been consistent in applying its methodology to the Employer.
20. The Applicants disagree with the way that D&B have assessed the Employer's risk of failure. D&B have been engaged by the PPF to provide the failure score it would normally assign to a company in the ordinary course of its business. The factors it takes into account and the weight that it places on them are for D&B to determine. The fact that the Applicants disagree with D&B's assessment of the Employer's risk of failure does not mean that the March 2007 failure score was incorrect.
21. There is provision within the PPF Determination for the review of a levy if D&B notify the Board that the failure score is incorrect or if it appears that the information upon which it has been calculated is incorrect in a material respect. D&B have not so notified the Board and, thus, a review has not been triggered by this route. The Applicants argue that the information used in the calculation of the levy is incorrect in a material respect. The failure score is not incorrect simply because there was information which D&B might either have taken into account or given greater weight to. It would be incorrect if D&B have used incorrect data in its calculations. The appropriate route for challenging the data used by D&B would be its own appeal system. The PPF Determination calls for the use of the failure score which D&B have

assigned to the Employer in the ordinary course of its business. I am satisfied that this has been the case here.

22. I find, therefore, that the Board has calculated the risk-based levy in accordance with the provisions of the PPF Determination and is not required to take any action.
23. The Applicants take issue with D&B's appeal procedure and its perceived lack of transparency. I understand their concerns and agree that it is difficult to challenge a conclusion which is not subject to independent scrutiny (or even full scrutiny by the business subject to the decision). However, D&B's system and the decision to use commercially available data in the levy calculation do not come within the scope of the reviewable matter before me. It is not the role of the Ombudsman to oversee the operation of D&B's internal systems; however sympathetic I might be to the Applicants' frustrations.
24. I would comment, however, that the cost of obtaining data, such as insolvency probability, is a valid factor for the PPF to take into account. Ultimately, the cost of calculating the levy has an impact on the level of levy required in respect of each scheme and it is not improper for the PPF to be mindful of this. There is a balance to be drawn between the sensitivity of the data and the cost of obtaining it.

TONY KING
Pension Protection Fund Ombudsman

24 August 2009