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FROM M C SCHOLAR
DATE 4 OCTOBER 1988

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr A J C Edwards
Mr Peretz
Mr Sedgwick
Mr Hibberd
Miss O'Mara
Miss Wheldon

Ch
No action for you now, but clearly need to get a move on.

INDEX-LINKED GILTS AND THE RPI

We have now had (Mr Plenderleith's letter of 30 September, attached) the Bank's follow-up to their letters of 6 and 13 September, in reply to my letter of 1 August.

2. The Bank's Counsel has endorsed the legal advice they have already received from Freshfields that it would not be proper for them to make a comparison between the RPI with and without the Community Charge in it. Notwithstanding this the Bank have, as we asked them to, given us their view on this comparison - which is that the balance of probability points to the exclusion of the Community Charge being detrimental to the interests of stockholders compared with its inclusion. They say that they cannot rule out the possibility that the level of detriment would be significant.

3. The Bank are troubled that their legal advisers and ours disagree, and wonder if a meeting might be arranged to attempt to resolve the disagreement.

4. Miss Wheldon is seeking the Law Officers' views on all these points. I will minute you again when we have their views.

MCS

M C SCHOLAR

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26/10.

IAN PLENDERLEITH
ASSISTANT DIRECTOR
HEAD OF GILT-EDGED DIVISION
01-601 4491

BANK OF ENGLAND
LONDON EC2R 8AH

30 September 1988

" Mr. Scholar
Mr. Sedgwick
Mr. Edwards
Miss O'Mara
Miss Wheldon T/Sol

D L C Peretz Esq
HM Treasury
Parliament Street
London
SW1P 3AG

Dear David,

INDEX-LINKED GILTS AND THE RPI

1 We have now consulted Counsel on the question as to whether we should make the comparison requested in Michael Scholar's letter of 1 August between the second and third options set out in his letter of 19 May. A record of the consultation is attached; it also covers a number of other points relevant to our determination.

2 As you will see, Counsel endorses the legal advice we have received and confirms the view that it would not be proper for us to make the comparison suggested by you in reaching our determination under the prospectuses.

3 This means that the difference of view between your legal advice and ours remains unresolved. This seems to us to be an unsatisfactory basis on which to approach a decision of considerable practical significance. Counsel has indicated to us that in similar situations in the past it has been possible to arrange a meeting between the various sources of legal advice in order to try to resolve the differences. We would like to suggest that this possibility should now be given serious consideration.

4 In the meantime, though we remain of the view that a comparison on the basis you have suggested should not be taken into account in our determination under the prospectuses, we have been considering further what advice we can give you, independently of our position under the prospectuses, on the effects on the interests of stockholders of option 2 as compared with option 3.

5 On the basis of the alternative options as you have specified them to us, the assessment of whether the omission of the Community Charge as per option 2, by comparison with its inclusion under option 3, would be materially detrimental to the interests of stockholders involves some difficult judgments. We set out the main considerations of which we are aware in my letter of 13 September. Taking account of all these factors, we continue to think that the balance of probability points to the exclusion of the Community Charge being detrimental to the interests of stockholders as compared with including it. As indicated in our letter of 13 September, we do not at this stage feel able to make an assessment of the scale of detriment, but we certainly do not feel that we can rule out the possibility that the level of detriment would be significant.

Yours sincerely,

[Approved by P Scott QC 30.9.88]

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NOTE OF CONSULTATION WITH MR PETER SCOTT Q.C.
ON 23 SEPTEMBER 1988
RE: INDEX-LINKED GILTS PROSPECTUSES

Present: Ian Plenderleith)
Merlyn Lowther) Bank of England
Vivienne Bronk)

Peter Peddie) Freshfields (Instructing Solicitors)
Alan Newton)

A. Preliminary Matters

The purpose of the meeting was to consider the questions raised by Instructing Solicitors in their Instructions to Counsel dated 20 September, 1988. Before proceeding to do so Counsel raised three preliminary points.

1. Counsel enquired as to the Bank of England's view of the meaning of "basic calculation". Mr Plenderleith thought that the expression referred to the method of calculation in contrast to "coverage" which related to the contents of the basket comprising the RPI.

Counsel considered that it was desirable for the Bank to be certain as to what it considered the basic calculation to be since the question of whether there had been a change in the method of calculation may be relevant to certain of the proposals (for example where the RPI is adjusted before rates are abolished). Counsel considered that a stockholder was entitled to have the question of coverage and of basic calculation looked at by the Bank both independently and together prior

to a consideration of the issues of fundamental change and material detriment. Counsel thought that it was arguable that the cumulative effect of a change in both coverage and basic calculation could result in a fundamental change which was materially detrimental.

Mr Plenderleith pointed out that it was not unusual for adjustments to be made to the weightings of the RPI. The basket comprising the RPI was a collection of commodities. As spending patterns changed, the quantities of commodities in the basket were adjusted to reflect such changes. Such an adjustment usually takes place annually. In making an adjustment to the weighting of rates to reflect their abolition (and the consequent cessation of expenditure on rates as an item in the basket), no departure from this system would be involved.

Counsel was nevertheless concerned since certain of the proposals under consideration envisaged an adjustment to the weightings of components within the basket prior to the abolition of rates.

2. In making a determination pursuant to the relevant paragraph of the gilts prospectuses, the Bank of England would be acting as an expert. Counsel advised that in its capacity as such it must look to such information as it considers relevant and should avoid giving any impression in correspondence with HM Treasury that it was relying on HM Treasury for the supply of all relevant information.

3. Counsel enquired as to the role and composition of the RPI Advisory Committee. Mr Plenderleith indicated that it was a non-statutory body consisting of representatives of various sectors of the economy with expertise on particular subjects. The committee advised the Department of Employment and its purpose was to establish the credentials of the RPI as something subject to independent scrutiny. Mr Plenderleith thought that in practice questions were only put to the Advisory Committee by Ministers.

Counsel thought that it would be helpful to consider the RPI Advisory Committee's terms of reference in case it was subsequently considered desirable for the Bank of England itself to put questions to the committee or to suggest that Ministers did so.

4. As a general point Mr Plenderleith stressed to Counsel that the Bank approached the issues described in the Instructions with an entirely open mind. He emphasised that no decision had yet been taken at any level in relation to the composition of the RPI. One point to be borne in mind was that in reaching any decision, Ministers would be mindful of the scope for challenge in the courts.

B. Questions raised in the Instructions

1. Would the Bank's determination be susceptible to judicial review

Counsel indicated that he wished to consider this issue in more detail. The law in relation to judicial review was in a state of flux. Counsel would revert to Instructing Solicitors on this question.

2. Is the practical effect of a challenge on private law grounds much the same as challenge by judicial review

Counsel considered that at the stage of litigation by a stockholder there could be very important differences between a private law action and an application for judicial review both in appearance to the public and in effect. Although not exhaustive of the differences, Counsel referred to the following distinctions:-

(a) an application for judicial review must be made promptly (generally within three months unless the time limits are relaxed) whereas an action for negligence may be brought at any time within the 6 year limitation period;

(b) the question to be answered by the court is different. In an application for judicial review the court would be concerned to see whether the Bank's determination was in conformity with the law. The construction of the gilts prospectuses was a question of law and the court could quash the determination where it was satisfied that the Bank, even though acting on advice, was wrong. In an action in tort for negligence in arriving at its determination, the stockholder would have to demonstrate that the Bank had breached its duty of care. In these circumstances the fact that it had gone to considerable lengths to obtain expert legal advice could be a complete answer to such a claim;

(c) the procedural aspects were different. In an application for judicial review discovery is limited and is at the discretion of the court. In an action in tort for negligence, full discovery would ensue. In addition, cross-examination of witnesses is unusual in an application for judicial review; in an action for negligence the persons involved in the making of the determination would be liable to be cross-examined in detail;

(d) theoretically the technical effect of the two courses of action would be different. A determination of the court pursuant to an application for judicial review is binding on the world whereas an action in tort for negligence is a private law remedy and binding only on the individual stockholder who instigated the action;

(e) the remedies available pursuant to an application for judicial review are discretionary and may not be awarded even where the plaintiff suffered loss; for example, if others had changed their position in consequence of the determination. In contrast, in an action for negligence, the court is obliged to award the plaintiff his remedy of damages if the elements of the tort are established.

If the Bank of England were faced with litigation in respect of its determination, it would be necessary to decide whether to challenge the route adopted by the plaintiff in any particular case.

3. The meaning of "fundamental change"

Counsel confirmed that he agreed with the analysis of the meaning of "fundamental change" put forward on page 2 of Instructing Solicitors' letter to the Bank dated 30 June, 1988. In particular, Counsel considered that the examples of a fundamental change set out at the bottom of page 2 of that letter were a useful guide to the nature of the changes which the Bank would be concerned about in making its determination.

Counsel considered that the expression "fundamental change" must be construed in its context in accordance with its ordinary and natural meaning. "Fundamental" connotes something that goes to the root or basis. To some extent that would be a question of degree. However, although the weight attached to rates was quite substantial, it was only part of the RPI and it was important to look at the relative importance of the other elements.

Counsel enquired of the Bank as to the closest example of an unequivocal fundamental change that they could envisage. Mr Plenderleith thought staple foods would be a very significant component. There was a discussion of the nature of an item such as petrol the price of which was extremely volatile. Counsel stressed that the motive for including or excluding an item from the RPI was irrelevant to the determination to be made by the Bank. However, the effect on the performance of the RPI could result in a change being a fundamental change for the reasons given in page 2, paragraph (iii) of Instructing Solicitors' letter (a change which produces a result which is incompatible with the purpose and use of the RPI). Mr Peddie thought that the removal of a commodity

such as petrol which has far reaching effects in terms of the RPI could also be a fundamental change of the type described in page 2, paragraph (ii) of Instructing Solicitors' letter (a fundamental alteration of the character of the RPI).

In the Bank's view, the abolition of rates was not ipso facto a fundamental change; items which were formerly included in the RPI have been abolished in the past without the fact of abolition being considered a fundamental change. However, Mr Plenderleith thought that it could be a fundamental change if the RPI were to continue to contain a non-existent item.

Counsel agreed with Instructing Solicitors' view that the question of what constituted a fundamental change was an extremely difficult one being in large part a judgmental question.

4. The application of Instructing Solicitors' analysis of fundamental change to the three options under review

Counsel confirmed that he agreed with the conclusions drawn by Instructing Solicitors on the application of their analysis of the meaning of fundamental change (contained in page 2 of the letter of 30 June) to the three options put forward by HM Treasury and set out on pages 3 and 4 of that letter, but stressed that the decision was one for the Bank exercising its own judgment.

5. Should the paragraph in the gilts prospectuses be read as a whole

Counsel confirmed that in the context of the meaning to be ascribed to the words "fundamental change", the relevant paragraph of the gilts prospectuses should read as a whole. Indeed, Counsel agreed this was the case whether or not there was any ambiguity. Counsel also confirmed that he agreed with the conclusions drawn by Instructing Solicitors on the interpretation of the paragraph and set out on pages 3 and 4 of their letter of 6 September, 1988 to the Bank.

Counsel indicated that, as a practical matter, he agreed with the point made in HM Treasury's letter of 1 August, 1988 that it is unlikely that there could be a change in the coverage or calculation of the RPI which was materially detrimental to stockholders but not fundamental for the purposes of the redemption clause. However, in construing the clause the likelihood of material detriment was not relevant to the question of whether there had been a fundamental change.

Counsel observed that if the expressions "fundamental change" and "material detriment" were the same there would have been no need to include the word "fundamental" in the relevant paragraph of the gilts prospectuses. He noted that HM Treasury had stopped short of saying this.

6. Application of the expression "materially detrimental to the interest of stockholders"

Counsel agreed with Instructing Solicitors' view that the test contained in the gilts prospectuses requires the Bank to have regard to the interests of stockholders in their capacity as stockholders and not in any other capacity.

Counsel also agreed that the requirement of materiality, being a question of degree, must add something to the requirement of detriment so that stockholders could reasonably be expected to accept some measure of detriment through a change in the RPI before the provisions for early redemption came into play.

Counsel did not consider that it would be disadvantageous for the Bank to form its view on the issue of fundamental change following the analysis suggested by Instructing Solicitors and, if it concluded that any particular proposal would not constitute a fundamental change, to reconsider that conclusion after considering whether the change would be materially detrimental to stockholders. This did not concede the

argument as to the construction of the relevant paragraph of the prospectus put forward by HM Treasury. Further, if the conclusion on material detriment is also in the negative, it gives the Bank additional comfort.

Market value

In the context of determining material detriment Counsel raised the issue of market value and whether that should be looked at by the Bank in arriving at its determination.

Mr Plenderleith thought that it would be very difficult to determine what movement in the market price could be attributed to a change in the RPI. The market in index-linked gilts was not very deep and was subject to extraneous forces. However, he pointed out that index-linked gilts had in fact risen in the last 7 to 10 days because of published inflation figures.

Counsel observed that the language of the prospectuses required the Bank to determine whether a change would be materially detrimental. To that extent it would be possible to exclude unpredictable factors, unless the unpredictability itself gave rise to material detriment. Counsel expressed the view that if something was taken out of the RPI which had been capable of measurement over time and a new factor was introduced which was uncertain in its effect, the introduction of that uncertainty could constitute the introduction of a factor which was materially detrimental to stockholders. The Bank did not consider that the introduction of a factor which was uncertain as to its future behaviour in itself constituted the introduction of a factor which was materially detrimental to stockholders since it was not known how that factor would behave. However public perception might be different. While the Bank was concerned to make a logical and analytical determination on the basis of all available information, it was concerned that a development such as a material fall in market value could be used to challenge its analysis in the courts.

Counsel thought that it was unlikely that the courts would wish to substitute their own determination for that of the Bank unless there was a strong suggestion that the RPI had been deliberately manipulated to the detriment of stockholders. To a large extent this was a question of how the Government presented the issue. Mr Plenderleith pointed out that public perception will be a difficult issue in the context of rates and the community charge and the distinction sought to be made between the cost of the occupation of property (rates) and a direct tax (the community charge). For example, the proposal for a double community charge where a person owns two properties causes confusion as to whether it is a housing cost.

On the question of market value, Counsel's advice was that in arriving at its determination, the Bank should consider as best it can whether it is likely that there would be a fall in market value as a result of a proposed change. If the Bank concludes that it is unlikely and yet subsequently there is a fall in market value, this should not put in doubt the integrity of the Bank's determination. Counsel acknowledged that the Bank could only do a rough and ready determination given the nature of the market.

7. Comparison of one hypothetical option with another

Counsel confirmed that his opinion on this question was exactly the same as that of Instructing Solicitors as expressed on page 4 of their letter of 6 September, 1988 to the Bank.

Mr. Plenderleith indicated that this was the most difficult issue facing the Bank in the light of the view taken by HM Treasury on the basis of its own legal advice. The Bank had so far declined to make a determination on the basis of comparative effect but they felt that they had to give serious consideration to whether or not they should do so first because the Bank is mindful of the fact that the Government has

taken senior legal advice which would appear to require the comparison to be made and secondly because of the potential danger that, if the Bank's determination was challenged, the courts would expect the comparison to have been made.

Counsel did not agree that the courts would wish to approach the matter in this way. He had a number of reservations in relation to the proposal:-

(a) he did not see at what stage the comparison could legitimately be made in the light of the construction of the language adopted by the Bank, Counsel and Instructing Solicitors.

(b) If a comparison was to be made, it seemed inappropriate to make a comparison with just one alternative, rather than with every conceivable option which might be available;

(c) he did not see what would be achieved by the comparison even if it produced a conclusion that the effect of not including the community charge would be more detrimental than including it. This would not affect the conclusions as to fundamental change or material detriment if the change proposed was simply removing rates;

(d) embarking on a comparative exercise which was not appropriate to the determination could be treated as part of the Bank's reasoning in reaching its decision;

(e) the Bank would run the risk of compromising its position as an independent expert by conducting a comparison which it did not consider appropriate;

(f) if the comparison was carried out it could be damaging for a stockholder subsequently challenging the Bank's determination to have access at the discovery stage to the Bank's views. For example if the Bank concluded that including the community charge

would prevent the removal of rates being materially detrimental, a stockholder complaining that he was not allowed to redeem when rates were dropped would not have to show that the Bank's decision would have been different if it had proceeded as H M Treasury suggest.

In view of the fact that HM Treasury had received advice which appeared to be different in significant respects from that of Counsel and Instructing Solicitors, the possibility of arranging for a meeting to discuss these issues between HM Treasury and the Bank's legal advisers was considered. Mr. Plenderleith was to consider whether this would be feasible.

30 September 1988

Freshfields
PCP/AMN/HGP11

chex.nh/aa/38

SECRET

FROM: A C S ALLAN
DATE: 5 October 1988

MR SCHOLAR

cc Sir P Middleton
Sir T Burns
Mr Anson
Mr A J C Edwards
Mr Peretz
Mr Sedgwick
Mr Hibberd
Miss O'Mara
Miss Wheldon T.Sol

INDEX-LINKED GILTS AND THE RPI

The Chancellor was grateful for your minute of 4 October, and noted that you will be putting up further advice when we have the Law Officers' views.

ACSA

A C S ALLAN