Statement of Investment Principles

This is the Statement of Investment Principles (the "Statement") made by the Southern Electric Group Trustee Limited ("the Trustee") as Group Trustee of the Southern Electric Group of the ESPS ("the Group") in accordance with the Pensions Act 1995 (as amended). The Statement is subject to periodic review by the Trustee at least every three years and more frequently as appropriate.

In preparing this Statement, the Trustee has consulted with the Sponsoring Employer, Scottish and Southern Energy Plc ("the Company") and has taken written advice from the Investment Practice of Hymans Robertson LLP. The Trustee is satisfied that the investment adviser has the knowledge and experience required by the Pensions Acts to perform this role.

Further details on how the investment policy of the Group is implemented are set out in "Investment Implementation Document" which is maintained by the Trustee. This document can be made available by the Trustee upon request.

Scheme objective

Primary funding objective

The Trustee is required under section 222 of the Pensions Act 2004 to adopt a "*Statutory Funding Objective*". The *Statutory Funding Objective* is that the Group must have "sufficient and appropriate" assets to cover the expected cost of providing members' *past service benefits*[1]*".*

In addition, the Group aim to maintain a position where there is not, and there is unlikely to be, a material financial reliance on the Company to support the ability to pay members' benefits beyond that required to meet future benefit accrual.

The Trustee's long-term funding objective is to be 100% funded on a self-sufficiency basis by 2030, where "self-sufficiency" is assumed to be 100% on a gilts basis.

Investment objective

The Trustee's primary objective is to provide sufficient assets to pay benefits as they fall due. The Trustee has translated its objectives into a suitable strategic (asset allocation) benchmark for the Group. The strategic benchmark is consistent with the Trustee's view on the appropriate balance between seeking an enhanced long-term return on investments and accepting greater short-term volatility and risk. The strategic benchmark is reflected in the choice and mix of funds in which the Group invests.

The investment objective is a quantifiable statement comprising of a return objective and risk statement:

Return Objective

The Trustee aims to achieve a return on the Group's assets in excess of the return on the liability benchmark. The liability benchmark is the portfolio of gilts that best matches the liability profile of the Group.

The Trustee has set the asset allocation such that the projected excess returns generated by the assets over the liability benchmark together with the contributions paid into the Group provide at least a 2/3rd probability of achieving the long-term funding target (100% funded on a self-sufficiency basis by 2030).

[1] The phrase used in the legislation to refer to the expected cost of members' past service is "technical provisions".

Risk Statement

The risk statement defines the level of confidence the Trustee has in the funding ratio (i.e. the ratio of assets to liabilities) being above a certain level over a defined period.

The Trustee has set the current asset allocation so that the projected funding level on the Technical Provisions basis in 2027 must not be less than 60% (based on the average of the worst 5% of outcomes).

Sufficiency

The Trustee has a secondary *funding objective*, of there being an expectation of surplus assets, over and above the cost of providing members' *past service benefits*, being generated as actual experience, particularly investment returns, turns out more favourable than the assumptions adopted for the *Statutory Funding Objective*. The aim will be over the longer term to use some, or all of this surplus, to reduce the proportion of higher risk assets, and to adopt an investment strategy that is more closely matched to the nature of the *past service benefits*.

Investment strategy

The Trustee has translated their objectives into a suitable strategic asset allocation benchmark for the Group. All day to day investment decisions have been delegated to a number of authorised investment managers. The strategic benchmark has been translated into benchmarks for the individual managers which are consistent with the Group's overall strategy. The Group benchmark is consistent with the Trustee's views on the appropriate balance between seeking an enhanced long-term return on investments and accepting greater short-term volatility and risk.

The investment strategy takes due account of the maturity profile of the Group (in terms of the relative proportions of liabilities in respect of pensioners and non-pensioner members), together with the level of disclosed surplus or deficit on an ongoing and gilts basis. The Trustee monitors fund performance relative to their agreed asset allocation benchmark. It is intended that the investment strategy and liability benchmark will be reviewed at least every three years following actuarial valuations of the Group. In addition, the Group's de-risking and hedging framework and associated funding level triggers will be sense-checked on an annual basis.

To achieve their objectives the Trustee has agreed the following:

Choosing investments

The Trustee has appointed a number of investment managers who are authorised under the Financial Services and Markets Act 2000 to undertake investment business.

The Trustee has appointed each of its investment managers to deliver a specific benchmark or performance target, which overall will align to deliver the broader Group investment strategy. The Trustee ensures that all manager engagements have clearly defined benchmarks, objectives and management parameters.

Where appropriate, and where commercial considerations permit, the terms of the mandate and the basis on which the manager is engaged will be defined specifically for the Group. Where such tailoring is not directly achievable, the Trustee will invest in pooled funds where the objectives of the fund and the policies of the investment manager will be evaluated by the Trustee to ensure that they are appropriate for the needs of the Group.

Remuneration for each mandate is determined at the inception of each mandate according to value. Where appropriate to the nature of the mandate, the term of the mandate and the role the mandate plays within the investment strategy, the Trustee may agree to a fee structure where the manager is incentivised to deliver outperformance relative to an agreed benchmark, typically in conjunction with a lower proportionate fee. The Trustee periodically reviews the fees paid to all of its managers against industry standards.

The Trustee reviews the nature of the Group's investments on a regular basis, with particular reference to suitability and diversification. The Trustee seeks and considers written advice from a suitably qualified person when determining the appropriateness of each manager and mandate for the Group, particularly in relation to diversification, risk, expected return and liquidity. If, at any time, investment in a security or product not previously known to the Trustee is proposed, appropriate advice and training is sought and considered to ensure its suitability.

The Trustee recognises the long term nature of its liability profile and appoints its managers to invest in such a way that generates long term sustainable returns. The Trustee will carry out necessary due diligence on the underlying investment decision making process, to ensure the manager makes investment decisions over an appropriate time horizon aligned with the Group's objective.

The duration of each mandate is determined by the Trustee at the inception of each mandate. For open-ended investments, the Trustee generally engages managers on an ongoing basis with no pre-determined term of appointment. For such mandates, the Trustee expects the minimum duration of the appointment will be three years, this being the period over which performance of the mandate can be appropriately evaluated although all mandates are subject to ongoing review against various financial and non-financial metrics in addition to their continued appropriateness within the investment strategy. For close-ended investments, the Trustee expect the term of the appointment to be the lifetime of the investment.

Performance Monitoring

The Trustee reviews the performance of each of its managers and mandates on a regular basis against a series of metrics, including financial performance against the benchmark and objectives of the mandate, the exercise of stewardship responsibilities (including engagement with issuers) as set out in greater detail below, and the management of risks. Material deviation from performance or risk targets is likely to result in the mandate being formally reviewed.

The Trustee monitors its managers' performance against their respective benchmarks or targets on a quarterly basis over a long term time horizon of 5 years or since inception where appropriate. Managers are expected to provide explanation for any significant deviations away from benchmark or target. The investment advisor monitors the investment managers' for any changes in key personnel and significant business developments informing the Trustee and will advise if any action is required.

Kinds of investment to be held

The Trustee seeks to achieve the Group's investment objective by investing in a suitably diversified mix of assets. The Group may invest in quoted and unquoted securities of UK and overseas markets including equities, fixed interest and index linked bonds, cash, property, infrastructure, asset backed securities, private debt and pooled funds. The Group may also make use of contracts of insurance, derivatives and contracts for difference (or in pooled funds investing in these products) for the purpose of efficient portfolio management or to hedge specific risks. The Trustee considers all of these classes of investment to be suitable in the circumstances of the Group. In deciding the suitability, the Trustee has considered the role of each in targeting the overall investment objective taking into account the associated risks and potential rewards.

Balance between different kinds of investments

The Group's investment managers will hold a mix of investments which reflects their views relative to their respective benchmarks. Within each major market, each manager will maintain a diversified portfolio of stocks through direct investment or pooled vehicles.

Risk

The Group is exposed to a number of risks which pose a threat to meeting its objectives. The principal risks affecting the Group are:

Funding risks

- Financial mismatch – 1. The risk that Group assets fail to grow in line with the developing cost of meeting Group liabilities. 2. The risk that unexpected inflation increases the pension and benefit payments and Group assets do not grow fast enough to meet the increased cost.
- Changing demographics – The risk that longevity improves, and other demographic factors change, increasing the cost of Group benefits.
- Systemic risk - The possibility of an interlinked and simultaneous failure of several asset classes and/or investment managers, possibly compounded by financial 'contagion', resulting in an increase in the cost of meeting Group liabilities.
- Sponsor risk – the risk that the sponsoring employer does not/cannot make sufficient contributions to support the payment of Group benefits. This may lead to a greater reliance on investment returns to pay for benefits.

The Trustee measures and manages financial mismatch in a number of ways. They have set a strategic asset allocation benchmark for the Group which allocates a proportion of the Group's assets to "matching" assets. They assess risk relative to the strategic benchmark by monitoring the Group's asset allocation and investment returns relative to the benchmark. They also assess risk relative to the Group's liabilities by monitoring the mismatch in exposure of the assets and the exposure of the liabilities to changes in interest rates and inflation.

The Trustee keeps under review mortality and other demographic assumptions which could influence the cost of the benefits. These assumptions are considered formally at the triennial actuarial valuation and more often where appropriate. The Trustee seeks to mitigate systemic risk through a diversified portfolio, but it is not possible to make specific provision for all possible eventualities that may arise under this heading.

The Trustee considers the ability and willingness of the sponsor to support the continuation of the Group and make good any current/future deficit. The Trustee periodically reviews a number of key factors including sponsor covenant and size of deficit relative to a number of metrics.

Asset risks

- Concentration - The risk that significant allocation to any single asset category and its underperformance relative to expectation would result in difficulties in achieving funding objectives.
- Illiquidity - The risk that the Group cannot meet its immediate liabilities because it has insufficient liquid assets.
- Currency risk – The risk that the currency of the Group's assets underperforms relative to Sterling (i.e. the currency of the liabilities).
- Manager underperformance - The failure by the fund managers to achieve the rate of investment return assumed in setting their mandates.
- Environmental, Social and Governance (ESG) risks – the extent to which ESG issues are not reflected in asset prices and/or not considered in investment decision making leading to underperformance relative to expectations.
- Climate risk - The extent to which climate change causes a material deterioration in asset values as a consequence of factors including but not limited to policy change, physical impacts and the expected transition to a low-carbon economy.

The Trustee measures and manages asset risks as follows: the Trustee has set guidelines to ensure assets are invested in a range of asset classes and investment mandates each of which has a defined objective, performance benchmark and manager process which, taken in aggregate, constrain risk within the Trustee's expected parameters.

By investing across a range of assets, including quoted equities and bonds, the Trustee has recognised the need for some access to liquidity in the short term. The Trustee limits the value of assets invested in illiquid assets. The Group hedge a proportion of its exposure to global currencies back to Sterling to mitigate the effect of currency risk.

In appointing several investment managers, the Trustee has considered the risk of underperformance by any single investment manager. The Trustee regularly monitors the performance of investment managers. The Trustee does not expect managers to take excess short term risk and will regularly monitor the manager's performance against the benchmarks and objectives set on a short, medium and long terms basis.

Other provider risks

- Transition risk - The risk of incurring unexpected costs in relation to the transition of assets among managers. When carrying out significant transitions, the Trustee takes professional advice and considers the appointment of specialist transition managers.
- Custody risk - The risk of losing economic rights to Group assets, when held in custody or when being traded.
- Credit default - The possibility of default of a counterparty in meeting its obligations.
- Operational risk – The risk of loss as a result of fraud, cyberattacks, poor advice, acts of negligence or lack of suitable process.
- Legislative risk – The risk that managers of the Group fail to comply with changes to legislation such as General Data Protection Regulation (GDPR).

The Trustee monitors and manages risks in these areas through a process of regular scrutiny of its providers and audit of the operations they conduct for the Group or has delegated such monitoring and management of risk to the appointed investment managers as appropriate (e.g. custody risk in relation to pooled funds). Electricity Pensions Trustee Limited ("EPTL") is the Scheme Trustee to the Southern Group's parent Scheme, The Electricity Supply Pension Scheme ("ESPS"). EPTL regularly review the suitability of the Group's custodian and use the assistance of a third party provider to examine the services provided. This review is undertaken annually with periodic discussions throughout the year. When carrying out significant transitions, the Trustee seeks professional advice. The Trustee ensures that all advisers and third-party service providers are suitably qualified and experienced. Suitable liability and compensation clauses are included in all contracts for professional services.

Expected return on investments

The investment strategy aims to achieve a return on Group assets which, taken in conjunction with contributions, is sufficient over time to match growth in the Group's pension liabilities.

Realisation of investments

The majority of the Group's investments may be realised quickly if required. The property, secured finance and private debt investments may be difficult to realise quickly in certain circumstances. The Trustee's policy is to consider a range of factors when realising investments including:

- The established cashflow policy;
- The potential future returns and risks of the investment;
- The liquidity of the investment;
- The ongoing appropriateness of the investment.

The Trustee takes advice before realising assets of the Group.

Portfolio Turnover

The Trustee has expectations of the level of turnover within each mandate which is determined at the inception of the mandate, based on the Trustee's knowledge of the manager, investment process and the nature of the portfolio. Whilst the Trustee expects performance to be delivered net of costs, including the costs of trading within the portfolio, the Trustee expects managers to report on at least an annual basis on the underlying assets held within the portfolio and details of any transactions over the period. The Trustee will challenge its managers if there is a sudden change in portfolio turnover or if the level of turnover seems excessive. The Trustee will request turnover costs incurred by the asset manager over the Group reporting year. Where possible the Trustee will compare costs to the theoretical portfolio turnover and cost for an appropriate index.

Environmental, Social and Governance considerations

The Trustee recognises that the consideration of financially material factors, including ESG factors, is relevant at different stages of the investment process. The Trustee has explicitly acknowledged the relevance of ESG factors in framing their investment beliefs and these beliefs are reflected in the principles set out below and the broader implementation of strategy.

Strategic considerations

The strategic benchmark has been determined using appropriate long-term economic and financial assumptions from which expected risk/return profiles for different asset classes have been derived. These assumptions apply at a broad market level and are considered to implicitly reflect all financially material factors.

Given the inherent uncertainty, the Trustee has not made explicit allowance for the risks of climate change in setting their strategic benchmark. The Trustee periodically discusses climate change with their investment adviser and investment managers to consider the potential implications for the Group's investments.

Structural considerations

Given the discretion afforded to the active investment managers, the Trustee expects that their investment managers will take account of all financially material factors including the potential impact of ESG factors in the implementation of their mandate.

Within active mandates, the Trustee has delegated responsibility for the consideration of stock specific issues to their individual investment managers.

Within passive mandates, the Trustee recognises that the choice of benchmark dictates the assets held by the investment manager and that the manager has minimal freedom to take account of factors that may be deemed to be financially material. The Trustee accepts that the role of the passive manager is to deliver returns in line with the benchmark and believe the choice of benchmarks will deliver appropriate risk adjusted returns. The Trustee will review the index benchmarks employed for the Group on at least a triennial basis.

The Trustee has discussed the extent to which ESG issues, where relevant to the investment mandate, are integrated into the investment processes across all of their investment managers and are satisfied that the investment managers are following an approach which takes account of all financially material factors

Selecting investment managers

In selecting new investment managers for the Group, where relevant to the investment mandate, the Trustee explicitly considers potential managers' approach to responsible investment and the extent to which managers integrate ESG issues in the investment process as a factor in their decision making.

Consideration of non-financially material factors in investment arrangements

Given the objectives of the Group, the Trustee has not considered any non-financially material factors in the development and implementation of their investment strategy. The Trustee has not imposed any restrictions or exclusions to the investment arrangements based on non-financially material factors.

The Trustee should adopt, or ensure their investment managers adopt, the Financial Reporting Council's guidance on the responsibilities of shareholders and agents to act diligently and in the best interests of the ultimate owners. In particular, the Trustee should ensure that the Group's investment managers sign-up and adhere to the principles set out in the UK Stewardship Code, or the equivalent relevant country-specific regulations. In the event that a manager does not adhere to a recognised set of principles for responsible investment, the Trustee should take reasonable steps to ensure that they are comfortable with the policy that the manager has in place in respective of this.

The Trustee notes that the UK Stewardship Code applies to those investing in UK equity, and so is not applicable to the Group's other investment vehicles. The Trustee ensures that any manager appointed to other investment vehicles has a social and ethical policy that is aligned to the Trustees expectations.

Stewardship

The Trustee recognises that stewardship encompasses the exercise of voting rights, engagement by and with investment managers and the monitoring of compliance with agreed policies.

Voting and engagement

The Trustee has adopted a policy of delegating voting decisions on stocks to their investment managers on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. The investment managers are expected to exercise the voting rights attached to individual investments in accordance with their own house policy.

Where relevant, the Trustee will review the voting policies of their investment managers and determine that these policies are appropriate. The Trustee will request their investment managers provide details of any change in their house policy periodically.

The Trustee does not engage directly but believes it is sometimes appropriate for its investment managers to engage with key stakeholders which may include corporate management, regulators and governance bodies, relating to their investments in order to consider the management of conflicts of interest and improve corporate behaviours, improve performance and mitigate financial risks. Where necessary, investment managers are expected to notify the Trustee of any issue on which it may be beneficial for the Trustee to undertake further engagement. The Trustee will review engagement activity undertaken by their investment managers as part of its broader monitoring activity.

Responsibility for investment decisions has been delegated to the investment managers which includes consideration of the capital structure of investments and the appropriateness of any investment made. Where managers are responsible for investing in new issuance, the Trustee expects the manager to engage with the issuer about the terms on which capital is issued and the potential impact on the rights of new and existing investors.

The Trustee separately considers any conflicts of interest arising in the management of the Group and its investments and has ensured that each manager has an appropriate conflicts of interest policy in place.

Monitoring

Investment managers report on voting activity to the Trustee on a periodic basis. The Trustee will monitor investment managers' voting activity and may review managers voting patterns. The Trustee may also monitor investment managers' voting on particular companies or issues affecting more than one company.

The Trustee aims to meet with all their investment managers regularly. The Trustee provides their managers with an agenda for discussion, including issues relating to individual holdings and, where appropriate, ESG issues. Managers are challenged both directly by the Trustee and by their investment advisers on the impact of any significant issues including, where appropriate, ESG issues that may affect the prospects for return from the portfolio.

Not withstanding the regular monitoring of the managers the Trustee will engage with and may seek further information from their investment managers on how portfolios may be affected by a particular issue where appropriate. If the Trustees have any due concerns they will bring a manager meeting forward on the meeting schedule.

Additional voluntary contributions (AVCs)

The Trustee gives members the opportunity to pay additional contributions to purchase additional service within the Group. The Trustee monitors the performance, costs ,management and ESG considerations of AVCs in line with Pensions Regulator's requirements, in proportion to the value of the investments.

Governance Arrangements

There are a number of parties involved in the Group's investment arrangements. The Trustee has ultimate responsibility for the management of the Group and its investments but delegates a number of decisions and responsibilities to specialist advisers and fund managers.

The Trustee confirms that all parties to whom they delegate responsibility have the appropriate knowledge and experience required to take on this role. The Trustee expects each party to carry out the duties delegated to them with a view to giving effect to the principles in this statement, so far as is reasonably practical.

The Trustee has set guidelines and restrictions within which their advisers and investment managers can act. More detail on how the responsibilities are divided between the parties involved is set out in the Investment Implementation Document.

This document was reviewed and agreed by the Trustee on 17/09/2020.