

Statement of Investment Principles – Defined Benefit

This is the Statement of Investment Principles (the “Statement”) made by the trustees of the Scotia Gas Networks Pension Scheme (“the Scheme”) in accordance with the Pensions Act 1995 (as amended). It is subject to periodic review by the trustees at least every three years and without delay after any significant change in investment policy.

In preparing this Statement, the trustees have consulted with the principal employer to the Scheme, Scotia Gas Networks Ltd (“the Company”) and have taken written advice from the Investment Practice of Hymans Robertson LLP.

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

Scheme objective

The Scheme’s funding objective is set out in detail in the Statement of Funding Principles based on the 31 March 2021 valuation. The main objectives are as follows.

Funding objective

The trustees are required under section 222 of the Pensions Act 2004 to adopt a “*Statutory Funding Objective*”. The *Statutory Funding Objective* is that the Scheme must have “sufficient and appropriate” assets to cover the expected cost of providing members’ *past service benefits*¹.

The trustees also consider the Scheme’s funding position against a low risk basis. This basis is intended to be a proxy for a level at which:

- the trustees could invest the assets in a very low risk strategy (largely matched to the liabilities) to minimise the risk of shocks to the funding level with a strong emphasis on meeting cashflow requirements; and
- the probability of being able to pay all benefits is high and the likelihood of having to ask the sponsor for further contributions will be low.

Appropriateness

The policy for securing the appropriateness of the assets is set out in this Statement of Investment Principles.

Investment strategy

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

¹ The phrase used in the legislation to refer to the expected cost of members’ past service is “technical provisions”.

The investment strategy takes due account of the maturity profile of the Scheme (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.

It is intended that the investment strategy will be reviewed at least every three years following actuarial valuations of the Scheme and will normally be reviewed annually. Written advice is received as required from professional advisors.

To achieve their objectives the trustees have agreed the following:

Choosing investments:

The trustees have appointed a number of investment managers who are authorised under the Financial Services and Markets Act 2000 to undertake investment business. The trustees have delegated all day to day investment decisions to these authorised investment managers. The trustees, after seeking appropriate investment advice, have given the managers guidelines as to the asset allocation, including control ranges for each asset class and or geographic region. Subject to their respective benchmarks and guidelines, the managers are given full discretion over the choice of stocks and are expected to maintain a diversified portfolio.

The trustees review the nature of Scheme investments on a regular basis, with particular reference to suitability and diversification. The trustees seek and consider written advice from a suitably qualified person in undertaking such a review. If, at any time, investment in a security or product not previously known to the trustees is proposed, appropriate advice is sought and considered to ensure its suitability and diversification.

Kinds of investment to be held

The Scheme may invest in quoted and unquoted securities of UK and overseas markets including equities and fixed interest and index linked bonds, cash, property and pooled funds. Where invested in pooled funds, the trustees are satisfied that the funds selected are consistent with the objectives of the Scheme, particularly in relation to diversification, risk, expected return and liquidity. The Scheme may also make use of derivatives and contracts for difference (or in pooled funds investing in these products) for the purpose of efficient portfolio management, as well as annuity contracts. The trustees consider all of these classes of investment to be suitable in the circumstances of the Scheme, however, will take into account the Scheme's objectives, funding position and the level of expected return required from its investments when determining the strategic asset allocation at any point in time.

Investment Strategy

The investment managers are instructed to deliver a specific performance target, which overall will align to deliver the broader Scheme investment strategy. The trustees ensure 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 Scheme. Where such tailoring is not directly achievable or appropriate, the trustees will invest in pooled funds where the objectives of the fund and the policies of the investment manager will be evaluated by the trustees to ensure that they are appropriate for the needs of the Scheme. The trustees are satisfied that the pooled funds selected are consistent with the objectives of the Scheme, particularly in relation to diversification, risk, expected return and liquidity.

Investment Management Remuneration

Remuneration for each mandate is determined at the inception of each mandate based on commercial considerations and typically set on an ad valorem basis (i.e. fees paid as a percentage of assets under management). Where appropriate to the nature of the mandate, the term of the mandate and the role the mandate plays within the investment strategy, the trustees 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 ad valorem fee. The trustees periodically review the fees paid to all of their managers against industry standards.

Investment Time Horizon

The trustees recognise the longer-term nature of the Scheme's liability profile and appoint their managers to invest in such a way that generates long-term sustainable returns. The trustees 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 Scheme's objectives.

The duration of each mandate is determined by the trustees at the inception of each mandate. For open-ended investments, the trustees generally engage with managers on an ongoing basis with no pre-determined term of appointment. For such mandates, the trustees expect 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 closed-ended investments, the trustees expect the term of the appointment to be the lifetime of the investment.

Balance between different kinds of investments

The Scheme'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.

Expected return on investments

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

Realisation of investments

The majority of the Scheme's investments may be realised quickly if required. The private debt instruments will be difficult to realise quickly, but are in run off. The bulk annuity insurance contracts that the trustees have entered into cannot be realised, but provide monthly income to meet a proportion of the Scheme's benefits. The trustees take advice before realising any of the Scheme's assets.

Risk

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

Funding risks:

- Financial mismatch – 1. The risk that Scheme assets fail to grow in line with the developing cost of meeting Scheme liabilities. 2. The risk that unexpected inflation increases the pension and benefit payments and Scheme 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 Scheme 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 Scheme liabilities. Climate change is a particular systemic risk that has the potential to cause economic, financial and demographic impacts.

Supported by their investment advisors, the trustees measure and manage funding risks in a number of ways.

They have set a strategic asset allocation benchmark for the Scheme. They assess risk relative to that benchmark by monitoring the Scheme's asset allocation and investment returns relative to the benchmark. They also assess risk relative to liabilities by monitoring the delivery of benchmark returns relative to liabilities.

The trustees keep under review mortality and other demographic assumptions which could influence the cost of the benefits. These assumptions are considered formally at the triennial valuation.

The trustees have entered into two bulk annuity insurance contracts in respect of a proportion of pensioner liabilities to help manage and reduce these risks. In return for the payment of premiums, the trustees hold annuity policies with insurers. All pensioners continue to be members of the Scheme and the trustees continue to have ultimate responsibility for the payment of benefits to their members. Under the policies, the insurers make monthly payments to the Scheme and carry the risk of longevity for a subset of the pensioners, as well as the investment risks for this proportion of the Scheme's assets.

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 Scheme cannot meet its immediate liabilities because it has insufficient liquid assets.
- Manager underperformance - The failure by the fund managers to achieve the rate of investment return assumed in setting their mandates.
- Currency risk – The risk that the currency of the Scheme's assets underperforms relative to sterling (i.e. the currency of the liabilities).
- 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.

Working with their investment advisors, the trustees measure and manage asset risks in a number of ways.

- They seek to mitigate systemic risk by investing in a diversified portfolio, but it is not possible to make specific provision for all possible eventualities that may arise under this risk.
- They ensure that there is sufficient diversification across a range of asset classes and within each asset class to reduce potential concentration risks.
- The majority of assets are liquid and readily realisable in the short term. The cashflow policy is reviewed on an annual basis and liquidity is monitored quarterly.
- They have appointed several investment managers to minimise the impact of a particular manager underperforming. In addition, each mandate has a defined objective, benchmark and guidelines and constraints which ensure that the risk within it are limited. The risk of underperformance is also mitigated by the inclusion of passive investment mandates within the investment portfolio.
- The majority of the Scheme's mandate are sterling-denominated or the manager is expected to hedge currency exposures back to sterling.
- The approach to the consideration of ESG risks including climate risk is set out in further detail below.

Other provider risk

- Transition risk - The risk of incurring unexpected costs in relation to the transition of assets among managers. When carrying out significant transitions, the trustees seek professional advice and consider the appointment of specialist transition managers.
- Custody risk - The risk of losing economic rights to Scheme assets, when held in custody or when being traded.
- Counterparty risk - The possibility of default of a counterparty in meeting its obligations.
- Operational risk – The risk of loss as a result of fraud, cyber attacks, poor advice, acts of negligence or lack of suitable process
- Legislative risk – The risk that managers of the Scheme fail to comply with changes to legislation.

The trustees, supported by their advisors, monitor and manage risks in these areas through a process of regular scrutiny of its providers and audit of the operations they conduct for the Scheme 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).

Manager engagement

Performance Evaluation

The trustees do not expect managers to take excessive short-term risk, and carry out regular monitoring of the Scheme's investments and managers. The monitoring includes a review of investment performance of each manager relative to their respective benchmark or performance target on a short, medium and long-term basis. The monitoring of the Scheme's investments and managers also includes a review of strategic and funding risks.

The trustees also seek information from their investment managers on meeting objectives of the mandates and exercising 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 trustees draw input from their investment advisors to provide input and analysis to support any such review of and engagement with its investment managers. Where necessary, the trustees will highlight any areas of concern identified during such reviews to the manager as part of its engagement process and request that the manager takes appropriate action. This may include concerns over performance, risk management, stewardship practices, investment process and operational issues and, where such concerns are raised, the trustees will require the manager to demonstrate levels of improvement. Failure to achieve the desired improvements may result in the mandate being reduced or terminated.

Portfolio turnover

The trustees have an expectation on the level of turnover within each mandate which is determined at the inception of the mandate, based on the trustees' knowledge of the manager, investment process and the nature of the portfolio. Whilst the trustees expect performance to be delivered net of costs, including the costs of trading within the portfolio, the trustees expect managers to report on at least an annual basis on the underlying assets held within the portfolio and details of transactions over the period. The trustees will challenge the manager if there is a sudden change in the portfolio turnover or if the level of turnover seems excessive.

The trustees will request turnover costs incurred by the asset manager over the Scheme's reporting year.

Consideration of financially material factors in investment arrangements

The trustees recognise that the consideration of financially material factors over the appropriate time horizon of the investments, including ESG factors, is relevant at different stages of the investment process. The trustees

further recognise that the financial materiality of any factor, including ESG factors, is context specific and that whilst some factors may be relevant to certain stocks/assets, they may not be relevant to others. The trustees will consider such factors in the development and implementation of their investment arrangements, for the purposes of determining the selection, retention and realisation of investments, where there is sufficient data or evidence to allow them to systematically do so. Where there is not sufficient data or evidence, they will require that their investment managers take such considerations into account within their decision making. The trustees have explicitly acknowledged the relevance of ESG factors in framing their investment beliefs, which are detailed in a separate Responsible Investment policy, 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.

The trustees periodically discuss climate change risk with their investment advisor and actuary to consider the potential implications for the Scheme. Given the inherent uncertainty, the trustees have not made explicit allowance for the risks of climate change in setting their strategic benchmark, however undertake scenario analysis to test the resilience of their investment strategy under a number of different climate scenarios.

Structural considerations

Given the discretion afforded to the active Investment Managers, the trustees expect 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 trustees have delegated responsibility for the consideration of stock specific issues to their individual Investment Managers. The trustees have discussed the extent to which ESG issues and climate change risk, where relevant to the investment mandate, are integrated into the investment processes of their Investment Managers and are satisfied that the Investment Managers are following an approach which takes account of all financially material factors.

In passive mandates, the trustees recognise 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 trustees accept that the role of the passive manager is to deliver returns in line with the benchmark and believe this approach is in line with the basis on which their current strategy has been set. The trustees will review any index benchmarks employed by the Scheme on at least a triennial basis.

Selecting new investment managers

In selecting new investment managers for the Scheme, the trustees, with input from their investment advisors, explicitly consider 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

The trustees have not considered any non-financially material factors in the development and implementation of their investment strategy. The trustees have not imposed any restrictions or exclusions to the investment arrangements based on non-financially material factors.

Stewardship

The trustees recognise 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 Scheme no longer has any investments in company shares and so does not have voting rights over any of its investments.

On an annual basis, the trustees will request their Investment Managers provide details of any change in their responsible investment or engagement policies. The trustees, in conjunction with their investment advisors review annually the investment managers' adherence to the UK Stewardship Code, UNPRI and other relevant industry codes or standards where applicable. In the event that a manager does not adhere to a recognised set of principles for responsible investment, the trustees will take reasonable steps to ensure that they are comfortable with the policy that the manager has in place in respect of this.

The trustees do not engage directly but expect their 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 trustees of any issue on which it may be beneficial for the trustees to undertake further engagement. The trustees 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 trustees expect 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 trustees separately consider any conflicts of interest arising in the management of the Scheme and their investments and has ensured that each manager has an appropriate conflicts of interest policy in place.

Monitoring

The trustees, working with their investment advisors, review the voting behaviour (where voting rights exist) of the Scheme's investment managers on an annual basis in conjunction with producing an Implementation Statement. Where the trustees deem it appropriate, they will engage with the managers to raise any issues of concern and request further explanation.

The trustees maintain a regular engagement programme with their investment managers and record a log of these engagement activities. The trustees provide their managers with an agenda for discussion, including ESG issues. Managers are challenged both directly by the trustees and by their investment advisors on the impact of any significant matter, including ESG issues, that may affect the outlook for the portfolio.

Should the trustees have a specific concern, they may decide to bring a manager meeting forward on the meeting schedule to ensure timely discussions and oversight.

Additional Voluntary Contributions (AVCs)

The trustees give members the opportunity to invest in a range of vehicles, at the members' discretion. The trustees give members the opportunity to pay additional contributions to purchase additional service within the Scheme. The AVC arrangement was reviewed in August 2021.

Governance Arrangements

There are a number of parties involved in the Scheme's investment arrangements. The trustees have ultimate responsibility for the management of the Scheme and its investments but delegate a number of decisions and responsibilities to specialist advisors and fund managers.

The trustees confirm that all parties to whom responsibility has been delegated have the appropriate knowledge and experience required to take on this role. The trustees expect each party to carry out the duties delegated to them giving effect to the principles in this statement insofar as is reasonably practical.

The trustees have set guidelines and restrictions within which their advisors 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.