Statement of Investment Principles

This is the Statement of Investment Principles made by Northern Gas Networks Pensions Trustee Limited, the Trustee of the Northern Gas Networks Pension Scheme (‘the Scheme’) 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 extensively with the principal employer to the Scheme and has taken and considered written advice from the Investment Practice of Towers Watson Limited.

In relation to the Myners Code of Conduct for Investment Decision Making, the extent of the Trustee’s adoption of the Code in relation to the Scheme is provided in a separate document, the ‘Myners Adherence Document’.

Scheme Objective

The primary objective of the Scheme is to provide pension and lump sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependants, on a defined benefits basis.

The Trustee’s over-riding funding principles for the Scheme are:

- to build up assets to provide for new benefits of active members as they are earned;
- to recover any shortfall in assets relative to the value placed on accrued liabilities over the longer term, and;
- to ensure that there are always sufficient assets of the Scheme (at their realisable value) to meet 100% of benefits as they fall due for payment to members.

The contribution rate is determined by the Trustee in conjunction with the Scheme Actuary taking these objectives into account.

The value of liabilities is calculated on the basis agreed by the Trustee and the Scheme Actuary. The funding position is monitored regularly by the Trustee and formally reviewed at each triennial actuarial valuation, or more frequently as appropriate.

In addition to funding in line with the statutory funding objective, the Trustee and the Employer have a long term objective of achieving a position of the Scheme being “self sufficient” by 31 March 2028. Currently the “self sufficiency” target assumes an investment strategy which will deliver a return equal to the redemeption yield on UK Government conventional gilts of a duration appropriate to the liabilities of the Scheme, plus 0.2% p.a. The current “self sufficiency” target will be reviewed and agreed at each valuation as necessary.

Investment Strategy

The Trustee has translated its objectives into a suitable strategic asset allocation benchmark for the Scheme. The 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 strategic benchmark has been translated into benchmarks for the individual managers which are consistent with the Scheme’s overall strategy.

The investment strategy takes due account of the maturity profile of the Scheme, the level of disclosed surplus or deficit (relative to the funding bases used) and the Trustee’s assessment of the covenant of the sponsoring employer.

The Trustee monitors fund performance and asset allocation relative to their agreed benchmark. It is intended that investment strategy will be reviewed at least every three years in conjunction with actuarial valuations of the Scheme, and will normally be reviewed annually. Advice is received as required from professional advisers.

All day to day investment decisions have been delegated to a number of authorised investment managers.

To achieve their objectives the Trustee has agreed the following:-

Choosing Investments: The Trustee will appoint one or more investment managers to manage the Scheme's assets. The existing managers are authorised under the Financial Services and Markets Act 2000 to undertake investment business. The Trustee ensures that, in aggregate, its portfolio is consistent with the policies set out in this Statement, in particular those required under regulation 2(3)(b) of the Occupational Pension Schemes (Investment) Regulations (2005). The Trustee will also ensure that the investment objectives and guidelines of any particular pooled vehicle are consistent with its policies, where relevant to the mandate in question. Where segregated mandates are used, the Trustee will use its discretion, where appropriate, to set explicit guidelines within the Investment Management Agreement to ensure consistency with the Trustee's policies, where relevant to the mandate.

The Trustee, after seeking appropriate investment advice, has given the managers specific directions as to their benchmark asset allocation. 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 majority of the Scheme's assets are invested in pooled funds managed by Legal & General. In addition, the Trustee has invested directly in a pooled UK property fund, a UK corporate bond fund, a pooled European loans fund and has a target allocation to secure income assets. The Trustee is satisfied that the pooled funds selected are consistent with the objectives of the Scheme, particularly in relation to diversification, risk, expected return and liquidity.

Some of the pooled funds in which investment is made are managed on an active basis, whilst others are managed on a passive basis. The manager of an active fund seeks to exceed the performance of the stated benchmark or target of the fund. The manager of a passive fund seeks to match, rather than exceed, the performance of a benchmark by investing in stocks in such a way as to replicate, as closely as possible, the composition of the benchmark.

The Trustee reviews the nature of the Scheme'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 in undertaking such a review. If, at any time, investment in a security or product not previously known to the Trustee is proposed, appropriate advice is sought and considered to ensure its suitability and diversification.

Investment manager engagement and monitoring: To maintain alignment, managers are provided with the most recent version of the Scheme's Statement of Investment Principles on an annual basis and are required to confirm that the management of the assets is consistent with those policies relevant to the mandate in question.

Should the Trustee's monitoring process reveal that a manager's portfolio is not aligned with the Trustee's policies, the Trustee will engage with the manager further to encourage alignment. This monitoring process includes specific consideration of the sustainable investment/ESG characteristics of the portfolio and managers' engagement activities. If, following engagement, it is the view of the Trustee that the degree of alignment remains unsatisfactory, the manager will be terminated and replaced.

For most of the Scheme's investments, the Trustee expects the investment managers to invest with a medium to long time horizon, and to use their engagement activity to drive improved performance over these periods.

The Trustee appoints its investment managers with an expectation of a long-term partnership, which encourages active ownership of the Scheme's assets. When assessing a manager's performance, the focus is on longer-term outcomes, and the Trustee would not expect to terminate a manager's appointment based purely on short term performance. However, a manager's appointment could be terminated within a shorter timeframe due to other factors such as a significant change in business structure or the investment team.

Managers are paid an ad valorem fee, in line with normal market practice, for a given scope of services which includes consideration of long-term factors and engagement.

The Trustee reviews the costs incurred in managing the Scheme's assets annually, which includes the costs associated with portfolio turnover. In assessing the appropriateness of the portfolio turnover costs at an individual manager level, the Trustee will have regard to the actual portfolio turnover and how this compares with the expected turnover range for that mandate.

Kinds of investment to be held: The Scheme may invest in quoted securities of UK and overseas markets including equities, fixed interest and index linked bonds, leveraged loans, cash, and property related investments, either directly or through pooled funds. The Scheme may also make use of derivatives and contracts for difference for the purpose of efficient portfolio management, or to hedge specific risks. The Trustee considers all these classes of investments to be suitable in the circumstances of the Scheme.

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 or return targets. Within each major market each manager will maintain a diversified portfolio of stocks through direct investment or pooled vehicles. Each passive (index-tracking) pooled fund managed by Legal & General will hold a mix of investments that reflects their respective benchmark indices.

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

Funding risks:

- Financial mismatch – The risk that Scheme assets fail to grow in line with the developing cost of meeting the liabilities.

- Changing demographics –The risk that longevity improves and other demographic factors change, increasing the cost of the 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 the Scheme's liabilities.

The Trustee measures and manages financial mismatch in two ways. As indicated above, it has set a strategic asset allocation benchmark for the Scheme. The Trustee assesses risk relative to that benchmark by monitoring the Scheme's asset allocation and investment returns relative to the benchmark. The Trustee also assesses risk relative to liabilities by monitoring the delivery of benchmark returns relative to liabilities.

The Trustee keeps mortality and other demographic assumptions, which could influence the cost of benefits, under review. These assumptions are considered formally at triennial valuations.

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.

Asset risks

- Concentration - The risk that a 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 – The risk that the Scheme's assets underperform in Sterling terms (i.e. the currency of the liabilities) due to exchange rate movements.

The Trustee manages asset risks as follows. They provide a practical constraint on Scheme investments deviating greatly from the intended approach by investing in a range of investment mandates each of which has a defined objective, performance benchmark and manager process which, taken in aggregate, constrain risk within their expected parameters. By investing across a range of assets, including quoted equities and bonds, the Trustee recognises the need for some access to liquidity in the short term. The risk of manager underperformance is mitigated to some extent by the inclusion of passive investment mandates within the investment portfolio. Currency risk is mitigated by using currency hedging where the Trustee believes it appropriate.

In appointing several investment managers, the Trustee has considered the risk of underperformance by any single investment manager.

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 Trustee seeks professional advice.

- Custody risk - The risk of losing economic rights to Scheme assets, when held in custody or when being traded.

- Credit default - The possibility of default of a counterparty in meeting its obligations.

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 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).

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

Realisation of investments: The Scheme's investments may be realised quickly if required. The holding in the European loan fund may be difficult to realise quickly in certain circumstances. The holding in the UK property fund is being wound down in an orderly manner by the investment manager, with capital expected to be distributed back to the Scheme over a c18-month period from the date of the wind-up (March 2020).

Environmental, Social and Governance (ESG) considerations: The Trustee recognises that long-term sustainability issues have a material impact on risk and outcomes, both financial and non-financial, though the Trustee's fundamental mission is to meet its financial obligations, and therefore financial considerations must take precedence. The Trustee believes that ESG factors, including climate change, affect risk and return in the medium to long-term, and as such should be taken into account when reviewing current and new investment opportunities. To the extent possible, the Trustee will delegate the responsibility to take ESG principles into account to its investment managers, and will periodically review these policies with the assistance of its investment adviser and engage with its investment managers as appropriate, this includes relevant matters including capital structure of investee companies, actual and potential conflicts, other stakeholders and ESG impact of underlying holdings. The managers have produced statements setting out their policy in this regard. The Trustee acknowledges that they act on behalf of the Scheme’s members in relation to ESG principles. Given the extent to which ESG principles are non-financial considerations, the Trustee will occasionally invite member views on the subject of ESG (this has been achieved most recently by including an article in the 2018 Trustee newsletter inviting member comments on the subject of ESG). The Trustee may re-visit this statement from time-to-time as deemed appropriate.

Exercise of Voting Rights: The Trustee has delegated the exercise of voting rights to the investment managers on the basis that voting power will be exercised by them with the objective of preserving and enhancing long term shareholder value. Accordingly, the managers have produced written guidelines of their process and practice in this regard. The managers are encouraged to vote in line with their guidelines in respect of all resolutions at annual and extraordinary general meetings of companies.

Additional Voluntary Contributions (AVCs): The Trustee gives members the opportunity to invest in a range of vehicles at the members' discretion.

Signed For and on Behalf of the Northern Gas Networks Pensions Trustee Limited as Trustee of the Northern Gas Networks Pension Scheme

August 2020