Western Power Distribution Group of the ESPS
Statement of Funding Principles (*SFP*)

The statutory funding objective

This statement sets out the Group Trustees' policy for securing that the statutory funding objective under Section 222 of the Pensions Act 2004 is met. The statutory funding objective is to have sufficient and appropriate assets to cover the Group's technical provisions.

Status

This statement has been prepared by the Group Trustees of the Western Power Distribution Group of the Electricity Supply Pension Scheme ("the Group") after obtaining the advice of Chris Vaughan-Williams, the Scheme Actuary, and having agreed the content with the Group's Principal Employer, Western Power Distribution (South West) plc ("the Company"). The Group is closed to new entrants.

It has been prepared with specific reference to the actuarial valuation carried out as at 31 March 2010, and will be kept under regular review in particular in relation to periodic funding up-dates and subsequent actuarial valuations, and updates on the Company's financial position.

Role of Independent Trustee

The Rules of the Group require the appointment of an independent trustee, currently The Law Debenture Pension Trust Corporation PLC ("the Independent Trustee"). The Rules require the Independent Trustee to be consulted during the preparation of an actuarial valuation under the terms of the Pensions Act 2004 and in relation to any recovery plan that is necessary as a result. If the valuation shows a surplus, the Independent Trustee's consent is required for any arrangements the Principal Employer may make to deal with that surplus. The Independent Trustee also has the ability under the Rules to call for an actuarial valuation separate to the statutory valuation; such a valuation would not be prepared under the terms of the Pensions Act 2004 and the consequences of a deficit or surplus being identified would be different to the position explained in the rest of this statement.

Technical Provisions

The technical provisions are the amount that will be needed to pay the Group benefits that relate to service up to the valuation date, if the assumptions made are borne out in practice.

The assumptions used to calculate the technical provisions are intended to provide a prudent estimate of the future experience of the Group, with a modest allowance for the future potential outperformance over gilts from continued investment in asset sectors such as equities.

Recognising that the Company's main activities relate almost exclusively to two long-term regulated electricity distribution businesses, the underlying assumption is that the Group will continue with benefits being met from the Group as they fall due.

Risks

The Group Trustees and the Company recognise that there are a number of risks inherent in the statutory funding objective and that additional funding may be required at future valuations if the experience of the Group is not in line with the assumptions made. The major risks are considered to be investment risk, longevity risk and sponsor risk.

Investment risk	The assets that most closely match the Group's liabilities are index-linked and to a lesser extent fixed-interest gilts of appropriate term. The Group invests in other assets such as equities that are expected, although not guaranteed, to produce a higher return than a matching portfolio of index-linked and fixed interest gilts. The Group Trustees expect that investing in such investment classes reduces the expected contribution required from the Company in the long-run. On advice from the Scheme Actuary, an allowance for the extra return expected from such investments may be taken into account in calculating the Group's technical provisions. If this extra return is not achieved over the long term, the shortfall will ultimately need to be met by increased contributions from the Company. The Group Trustees regularly review the Group's investment strategy taking into account the funding position, employer covenant and liability profile. The Group Trustees will consult with the Company before any changes are made to the investment strategy.
Longevity risk	Future improvements in life expectancy may be greater than anticipated. In setting the Group's funding target, mortality assumptions are made based on standard tables appropriate to comparable pension schemes with adjustments to reflect the Western Power Distribution Group's recent experience and other analyses, and to make allowance for future improvements in longevity. The mortality assumptions are reviewed at formal triennial actuarial valuations.
Sponsor risk	The Group Trustees recognise that, in certain circumstances, the Group could be discontinued in accordance with Clause 43 of the Group's provisions should the Company be wound up. There is also provision under Clause 42A for the whole of the ESPS to be discontinued should all of the original ESPS Principal Employers (other than EASL) which remain as participating employers so determine. If the Group were to be discontinued then the technical provisions at that time may need to be revised and the technical provisions applying before revision (or even those after revision) may prove to be insufficient to secure all liabilities without further contributions from the Company. In addition, there is a risk that the Company may at that time be unable to meet its obligation to contribute to the Group. Furthermore, the capacity of the insurance market may be insufficient at that time to secure the liabilities externally, if the Group Trustees wished to do so. The Group Trustees will monitor and review the Company covenant on a regular basis (see later section headed "Monitoring employer covenant"). However, the Group Trustees consider the probability of the Group being discontinued is extremely low.
Method and assumptions for calculating technical provisions	The Group Trustees consider that the Group should be valued on an ongoing basis using a discount rate that includes a prudent allowance for the extra return over gilts expected from other investment classes. The actuarial method to be used in the calculation of the technical provisions is the Projected Unit method with a control period of members' future working lifetimes (otherwise known as the "attained age" method). The assumptions to be used to calculate the technical provisions are summarised in Appendices A and B.

Employer contributions

Employer contributions are assessed by calculating the cost of future benefit accrual using the same assumptions as for the technical provisions:

plus

- an estimate of the Group expenses (other than certain investment management expenses), expressed as a percentage of salaries
- contributions to meet any additional costs from early retirements and other benefit augmentations as they occur;

reduced by

- the contributions made by members

adjusted by

- the amounts needed to eliminate any shortfall or surplus relative to the technical provisions (see below).

There are no arrangements in place for any persons other than the participating employers and members to contribute to the Group.

Dealing with shortfalls

Should an actuarial valuation reveal a shortfall of assets relative to the technical provisions, the Group Trustees will prepare an appropriate recovery plan at that time and agree it with the Company. The shortfall will be eliminated by a combination of one or more of the following methods over a stated recovery period – (i) the payment of additional contributions and/or (ii) an allowance (where agreed by the Group Trustees and the Company) for the expected out-performance of the Group's assets compared to the discount rate and/or (iii) such other method as may be agreed.

In considering the actual recovery period the Group Trustees' principles are to take into account all relevant factors, including (but not limited to):

- the size of the funding shortfall;
- the impact of any significant known post valuation date experience;
- the business plans of the Company including how quickly it can reasonably afford to eliminate the shortfall;
- the Group Trustees' assessment of the financial covenant of the Company, including the impact of the Company's economic regulation by Ofgem (see below);
- any contingent security offered by the Company; and
- relevant legislation and prevailing market practice.

Subject to considering further the financial covenant of the Company, should future valuations reveal a larger than expected deficit, payments under an existing recovery plan will normally continue and be supplemented by additional payments and/or an extension of the recovery period. However, the Group Trustees and the Company can agree alternative arrangements, if appropriate.

The assumptions to be used in the shortfall elimination calculations will be the same as those for calculating the technical provisions. In addition (and without precedent for the approach that will be used thereafter), allowance will be made up to 31 March 2025 for the expected out-performance of the Group's assets compared to the discount rate (see Appendix A for further details).

Ofgem regulation	The Group Trustees have taken into account the following information provided by the Company. WPD is a regulated monopoly. The regulatory regime has been in place for over a decade and the price control formula is rational, stable and well understood. The Company's earnings are set by the regulator (Ofgem) via the formula and fixed in advance for five years. The earnings are stable and low risk. The regulator has a statutory duty to ensure WPD's financial viability and this is subject to an annual check requiring the directors of the Company to certify that they have sufficient financial resources to carry on the business for the following twelve months at the required level of efficiency. WPD is focussed on the business of distributing electricity and is a top performing company within the sector in terms of operational efficiency, cost control and customer service. The Company operates under a rolling licence with a 25 year notice period. The licence places very tight restrictions on what the Company can and cannot do and this is designed to protect the distribution network and the customer base. The regulatory regime provides an unusually strong level of security and stability. At the latest regulatory review, Ofgem agreed to fund approximately 76% of the estimated actuarial deficit based on a fifteen year deficit repair period and to fund almost all of the ongoing pension costs for the vast majority of active members by providing an allowance within WPD's overall pricing settlement for 2010-2015. Ofgem also re-affirmed their Pension Principles which (subject to an efficiency review by the Government Actuary's Dept.) have the effect of requiring future reviews to take into account the increase or decrease in the cost of providing pensions resulting from changes in the assumptions on which the allowance has been based. The Ofgem deficit repair allowance will be funded directly through WPD's revenues and, in cash terms over the Distribution Price Control Review Period 2010-2015, the allowance equates to about 76% of the cash costs being paid by WPD into the ESPS under the expected 2010 valuation deficit repair schedule.
Discretionary benefits	The Group Trustees and Company have agreed that, until further notice, allowance will be made in the technical provisions for discretionary pension increases in line with increases in the Retail Prices Index should inflation exceed 5% in any year. Allowance will also be made in the technical provisions for discretionary dependants' pensions, where there is no legal spouse.
Policy on reduction of cash equivalent transfer values (CETVs)	The ESPS provisions do not allow for any reduction to cash equivalent transfer values to other pension schemes. However, if after obtaining advice from the Actuary, the Group Trustees are of the opinion that the payment of full CETVs may have a serious adverse affect on the security of the benefits of other members and beneficiaries, the Group Trustees will consider what actions might be available and appropriate.
Payments to the Company	Payments can only be made to the Company if the Group winds up, and members' benefits have already been secured.

Monitoring employer covenant

Each year, the Company's Finance Director will present information to the Group Trustees addressing amongst other things:

- The strength of the Company's covenant and that of each of the Participating Subsidiaries (as defined in the Group provisions) within the Group, with reference to their current and continuing future ability to meet the funding requirements under the Group provisions and the funding requirements under the Pensions Acts 1995 and 2004 and the Electricity (Protected Persons) (England and Wales) Regulations 1990 taking into account its assessment of potential risks including those of a financial, corporate, technological or management nature.
- The operational performance vs. regulatory targets and the projected financial performance including profitability, debt and interest coverage ratios.
- The credit rating of the Company and Western Power Distribution (South Wales) plc.
- Any possible events that would lead to a change in the licence held by either the Company or Western Power Distribution (South Wales) plc or would materially adversely affect their respective businesses or those of a subsidiary.

On a quarterly basis, the Company will give further written updates to the Group Trustees on the information last provided to the Group Trustees updated to take account of any material changes.

The Company will also provide a written notification as soon as reasonably possible to the Group Trustees of any material changes to the information last provided to the Group Trustees or if it becomes aware that any such material change is likely to happen.

The Company will also send copies of its annual accounts to the Group Trustees as soon as they become available.

The Group Trustees will regularly review the need for further information on employer covenant such as an independent assessment.

Frequency of valuations

The Group's first actuarial valuation to which this statement applies is being carried out as at 31 March 2010. Subsequent valuations will normally be carried out every three years.

The Group Trustees will obtain an actuarial report on developments affecting the Group's funding level as at each intermediate anniversary of the valuation date. The Group Trustees may call for a full actuarial valuation instead of an actuarial report when, after considering the Scheme Actuary's advice, they are of the opinion that events have made it unsafe to continue to rely on the results of the previous full valuation as the basis for future employer contributions. However, the Group Trustees will consult the employer before doing so.

Signatures

This statement was agreed by the Group Trustees at their meeting on 9 November 2010.

Signed on behalf of the Group Trustees of the Western Power Distribution Group of the Electricity Supply Pension Scheme

D Harris

Name: D Harris

Position: Chairman of Group Trustees

Date: 9 November 2010

This statement has been agreed by the Principal Employer.

Signed on behalf of Western Power Distribution (South West) plc

Sally A Jones.

Name: S Jones

Position: Company Secretary

Date: 9 November 2010

Appendix A:
Method and financial assumptions for determining the technical provisions and employer contributions

Method	The actuarial method to be used in the calculation of the technical provisions is the Projected Unit Method with a Control Period of the members' future working lifetimes (i.e. the "attained age" method).
Financial assumptions	The approach to be used in determining each of the financial assumptions for calculating the technical provisions and the employer contributions is set out below.
Price inflation	2.75% p.a. The assumption is based on the Government's inflation target, but is also benchmarked against the difference between the market yields on fixed-interest and index-linked gilts at the valuation date to ensure the assumption is within a reasonable range of 'break-even' inflation, having regard to the basis as a whole.
Discount rate	**Pre-retirement**: The assumed price inflation plus the yield for index-linked gilts for a duration approximately equal to that for the liabilities for past service plus 2.0% p.a. **Post-retirement**: The assumed price inflation plus the yield for index-linked gilts for a duration approximately equal to that for the liabilities for past service plus 0.5% p.a. The additions of 2.0% and 0.5% will be kept under review at future valuations, in particular in the light of the Group's investment strategy and if market conditions around a valuation date were exceptional.
Pay increases	Each member's salary is assumed to increase in line with the assumed rate of price inflation plus 1.5% p.a.
Increases in pensions in payment	Excess over GMP: Price inflation Other inflation-linked pension increase assumptions are derived from the price inflation assumption allowing for the maximum and minimum annual increase, and for inflation to vary from year to year.
Revaluations of deferred benefits	The price inflation assumption (subject to review if there is a significant change in the level of this assumption).
GMP increases for statutory revaluation	The pay increase assumption.

Financial assumptions for technical provisions summary

A summary of all the financial assumptions for calculating the technical provisions for the valuation at 31 March 2010, determined using the approach outlined above, is set out below:

	(% p.a.)
Pre-retirement discount rate	5.65%
Post-retirement discount rate	4.15%
Pay increases	4.25%
Price inflation	2.75%
Rate of increases to pensions in payment in excess of GMPs	2.75%
Rate of increases to post-88 GMPs in payment	2.20%
Rate of revaluation of deferred pensions	2.75%

Additional assumptions for employer contributions

In determining Company contributions the same assumptions will be used as those for calculating the technical provisions together with the additional financial assumptions described below.

Allowance will be made up to 31 March 2025 for the expected out-performance of the Group's assets compared to the discount rate. The expected return on assets will be derived from the expected future Group investment strategy over the relevant period, together with assumed future returns from the asset classes, based on the advice of the Scheme Actuary and the Group's investment adviser, and subject to the agreement of the Group Trustees and the Company. The assumption for the valuation as at 31 March 2010 is asset returns that are initially 1.0% per annum over the discount rate tapering to 0.5% per annum over the discount rate after 15 years.

Expenses

2.4% of Salaries will be added to the cost of future benefit accrual. This allowance includes provision for the PPF and other levies collected by the Pensions Regulator.

Appendix B:
Demographic Assumptions

Post-retirement mortality	Pensioners: Normal health: 85% of standard tables S1PM/FA Ill health: 140% of standard tables S1PM/FA Non-pensioners: Normal health: 95% of standard tables S1PM/FA Ill health: 150% of standard tables S1PM/FA Improvements in mortality from 2002 are assumed to be in line with the 2009 CMI Core Projections for men and women with a long term improvement rate of 1.25% per annum.
Pre-retirement mortality	Males: Standard table AM92 with 65% scaling factor Females: Standard table AF92 with 65% scaling factor Sample rates are shown below.
Ill-health retirements	In accordance with a scale (sample rates are shown below).
Retirements in normal health (contributing members)	Members are assumed to retire at age 62 without reduction for early payment (or age 60 for pre 1 April 1988 female joiners).
Retirements for deferred members	The Normal Pension Age applicable at the date of leaving service, or, if left service under redundancy arrangements, the age at which unreduced benefits may be taken.
Withdrawals	In accordance with a scale (sample rates are shown below).
Family Details	A man is assumed to be three years older than his wife. 85% of males and 75% of females are assumed to be married on retirement or earlier death (for contributing members and deferred pensioners) or 75% of males and 65% of females at the valuation date (for pensioners) – "married" for this purpose includes having a dependent to whom a pension would be payable on death.
Commutation	No allowance.

Sample rates

The tables below illustrate the allowances made for withdrawals, deaths before retirement and ill-heath retirements from service at various ages.

Men

	Percentage leaving the Group in the next year as a result of		
Current	**Death before retirement**	**Ill health retirement**	**Withdrawal**
20	0.04	0.00	3.75
25	0.04	0.02	3.21
30	0.04	0.03	1.93
35	0.04	0.05	1.16
40	0.06	0.09	0.78
45	0.10	0.16	0.58
50	0.16	0.30	0.38
55	0.29	0.67	0.21
60	0.52	1.62	0.09

Women

	Percentage leaving the scheme in the next year as a result of		
Current	**Death before retirement**	**Ill health retirement**	**Withdrawal**
20	0.01	0.00	7.50
25	0.02	0.00	7.67
30	0.02	0.03	6.95
35	0.03	0.09	4.25
40	0.05	0.18	2.91
45	0.08	0.36	1.98
50	0.12	0.52	1.25
55	0.20	1.24	0.82
60	0.33	2.36	0.63

Sample life expectancies

The assumed improvements in life expectancy for active members in normal health are illustrated in the table below:

Current age	Male life expectancy on reaching age 60	Female life expectancy on reaching age 60
60	27.3	29.4
50	28.2	30.5
40	29.2	31.5