Central Networks Group of the ESPS
Statement of Funding Principles (*SFP*)

The statutory funding objective

This statement sets out the Group Trustee's 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 Trustee of the Central Networks 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, WPD Midlands Holdings Ltd ("the Company"). The Group is closed to new entrants.

It has been prepared with specific reference to the actuarial valuation carried out as at 30 June 2011, and will be kept under regular review in particular in relation to periodic funding updates and subsequent actuarial valuations, and updates on the Company's financial position.

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 Trustee 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/high quality derivatives 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. The Group Trustee expects 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 Trustee regularly reviews the Group's investment strategy taking into account the funding position, employer covenant and liability profile. The Group Trustee 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 relevant 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 Trustee recognises 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 Trustee wished to do so.

The Group Trustee will monitor and review the Company covenant on a regular basis (see later section headed "Monitoring employer covenant"). However, the Group Trustee considers the probability of the Group being discontinued is extremely low.

Method and assumptions for calculating technical provisions

The Group Trustee considers 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 three years.

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).

The employers will also pay contributions in respect of the DC Section.

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 Trustee 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 Trustee 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 Trustee's 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 Trustee's 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 Trustee 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 the Group Trustee and the Company will agree whether to make an allowance for an element of the expected out-performance of the Group's assets compared to the discount rate having regard to the advice of the Group's investment adviser and Scheme Actuary (see Appendix A for further details).

Ofgem regulation

The Group Trustee has taken into account the following information provided by the Company.

In addition to the Company, the Group has two further participating employers who are also statutory employers – WPD East Midlands plc and WPD West Midlands plc (these two are collectively known as "Central Networks"). Central Networks comprise two regulated monopolies. The regulatory regime has been in place for over two decades and the price control formula is rational, stable and well understood.

Central Networks' 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 Central Network's financial viability and this is subject to an annual check requiring the directors of Central Networks to certify that they have sufficient operational and financial resources to carry on the business for the following twelve months at the required level of efficiency.

Central Networks are focussed on the business of distributing electricity and are fast improving companies within the sector in terms of operational efficiency, cost control and customer service. Central Networks operates under rolling licences with a 25 year notice period. The licences place very tight restrictions on what Central Networks can and cannot do and this is designed to protect the distribution networks 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 75% 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 Central Networks' overall pricing settlements 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 Central Networks' revenues and, in cash terms over the Distribution Price Control Review Period 2010-2015, the allowance equates to about 75% of the cash costs expected to be paid by Central Networks over the same period.

Discretionary benefits

For ESPS members, annual pension increases (on the excess over the GMP for pensions in payment) are in line with the increase in the RPI. However if, in any year, the RPI increase is higher than 5% the Company may resolve that a different pension increase applies, provided that increase is not less than 5%.

For EMEPP, MEPS and EGPS members, annual pension increases for pensions in payment on the excess over the GMP are in line with the increase in the RPI, subject to a maximum of 5%. The Company has the discretion to grant increases in excess of 5% in years when the increase in RPI exceeds this level.

For the purposes of calculating the technical provisions, pension increases will be assumed to be in line with RPI for ESPS members and will be assumed to be capped at 5% for EMEPP, MEPS and EGPS members.

The Group Trustee has discretion to grant pensions to dependants on the death of members. Allowance for this discretion will be included in the assumed proportion of members who will be married on death.

Secondary funding objective

The Group Trustee and the Company have agreed, in principle, that the Group should also have a secondary funding objective to reach a lower risk ongoing funding target over a longer timeframe e.g. 15-20 years' time. The full details of the secondary objective are to be finalised, but the overall risk premium within the discount rate would be lower (and therefore more prudent) than that within the technical provisions basis.

Policy on reduction of cash equivalent transfer values (CETVs)	The Group Trustee will ask the Scheme Actuary to advise them at each valuation of the extent to which assets are sufficient to provide cash equivalent transfer values (CETVs) for all non pensioners without adversely affecting the security of the benefits of other members and beneficiaries. Where coverage is less than 100%, the Group Trustee will take advice from the Scheme Actuary regarding whether to reduce CETVs and, if appropriate, the extent of such reduction. However, the Group Trustee will need to recognise that there are ESPS provisions that potentially restrict the ability to reduce CETVs. If at any other time, after obtaining advice from the Scheme Actuary, the Group Trustee is of the opinion that the payment of CETVs at a previously agreed level may adversely affect the security of the benefits of other members and beneficiaries, the Group Trustee will commission a report from the Scheme Actuary regarding whether and, if appropriate, the extent to which CETVs should be reduced.
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 Trustee 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 that of WPD East Midlands plc and WPD West Midlands plc. ▪ Any possible events that would lead to a change in the licence held by either WPD East Midlands plc or WPD West Midlands plc or would materially adversely affect their respective businesses or those of the Company or a subsidiary. On a quarterly basis, the Company will give further written updates to the Group Trustee on the information last provided to the Group Trustee, updated to take account of any material changes. The Company will also provide a written notification as soon as reasonably possible to the Group Trustee of any material changes to the information last provided to the Group Trustee 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 Trustee as soon as they become available. The Group Trustee 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 30 June 2011. Subsequent valuations will normally be carried out every three years, although the next valuation is expected to be as at 31 March 2013.

The Group Trustee will obtain an actuarial report on developments affecting the Group's funding level at dates that coincide with the Group's accounting year end. The Group Trustee 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 Trustee will consult the employer before doing so.

Signatures

This statement was agreed by the Group Trustee at their meeting on 27 April 2012.

Signed on behalf of the Group Trustee of the Central Networks Group of the Electricity Supply Pension Scheme

DHarris

Name: D G Harris

Position: Chairman of Group Trustee

Date: 27th APRIL 2012

This statement has been agreed by the Principal Employer.

Signed on behalf of WPD Midlands Holdings Limited

Sally A Jones

Name: S Jones

Position: Company Secretary

Date: 27th APRIL 2012

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 three year Control Period.
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.
RPI inflation	The assumption is break-even inflation derived from the difference between fixed interest and index-linked gilt yield curves at the valuation date.
CPI inflation	The assumption is derived at the valuation date by deducting 0.75% p.a. from the RPI inflation assumption at all terms. The difference between the long term assumption for RPI and CPI inflation may vary over time to reflect changing views of long term structural differences between the calculation of RPI and CPI inflation at the date subsequent calculations are carried out.
Discount rate	The discount rate assumptions are derived from the gilt yield curve at the valuation date with a pre-retirement risk premium of 2.0% p.a. and a post-retirement risk premium of 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 RPI inflation plus 1.5% p.a. at all terms.
Increases in pensions in payment	Inflation-linked pension increase assumptions are derived from the RPI inflation assumption allowing for the maximum and minimum annual increase, and the fact that inflation varies from year to year. The ESPS RPI pension increase assumption is derived using best estimate inflation volatility. For other pension increase assumptions the inflation volatility is derived from swap markets. A deduction of 0.4% p.a. at all terms is applied to the pension increase assumption for post 88 GMPs as those increases are now based on CPI capped at 3% p.a. The 0.4% deduction will be kept under review at future valuations.
Revaluations of deferred benefits	Deferred pension increases for ESPS and Retirement Balance categories: RPI inflation on the whole pension. Statutory revaluation: CPI inflation on excess over GMP.

GMP increases for statutory s148 revaluation

The pay increase assumption.

Financial assumptions for technical provisions summary

The table below shows the full gilt yield-curve forward rates (that apply from time t-1 to time t) used to derive the assumptions for calculating the technical provisions and the employer contributions for the valuation as at 30 June 2011 determined using the approach outlined above.

Term	Gilt yield curve	RPI inflation	RPI pension increases	LPI pension increases	Post 88 GMP increases	LPI pension increases with 2.5% cap
1	0.68%	3.58%	3.58%	3.43%	2.30%	1.91%
2	1.29%	3.01%	3.01%	2.86%	1.91%	1.57%
3	2.22%	2.36%	2.36%	2.34%	1.41%	1.08%
4	3.11%	2.63%	2.63%	2.68%	1.79%	1.48%
5	3.87%	2.91%	2.92%	2.98%	2.11%	1.81%
6	4.50%	3.23%	3.24%	3.31%	2.34%	2.01%
7	5.01%	3.53%	3.55%	3.61%	2.56%	2.21%
8	5.39%	3.81%	3.82%	3.85%	2.75%	2.40%
9	5.64%	4.03%	4.04%	4.04%	2.90%	2.54%
10	5.78%	4.19%	4.21%	4.18%	2.99%	2.62%
11	5.84%	4.31%	4.33%	4.28%	3.01%	2.62%
12	5.83%	4.39%	4.41%	4.35%	3.03%	2.63%
13	5.77%	4.44%	4.47%	4.40%	3.06%	2.65%
14	5.67%	4.46%	4.49%	4.43%	3.06%	2.65%
15	5.56%	4.47%	4.50%	4.44%	3.06%	2.65%
16	5.44%	4.46%	4.50%	4.44%	3.05%	2.63%
17	5.32%	4.45%	4.49%	4.44%	3.03%	2.61%
18	5.20%	4.42%	4.47%	4.42%	3.01%	2.59%
19	5.09%	4.39%	4.45%	4.40%	2.99%	2.57%
20	4.98%	4.35%	4.41%	4.36%	2.96%	2.54%
21	4.88%	4.31%	4.37%	4.33%	2.93%	2.51%
22	4.78%	4.25%	4.33%	4.28%	2.88%	2.47%
23	4.68%	4.20%	4.28%	4.23%	2.83%	2.42%
24	4.59%	4.14%	4.22%	4.17%	2.77%	2.36%
25	4.50%	4.07%	4.17%	4.12%	2.71%	2.29%
26	3.77%	3.23%	3.42%	3.28%	1.87%	1.45%
27	3.77%	3.63%	3.77%	3.69%	2.26%	1.84%
28	4.33%	3.83%	3.96%	3.90%	2.47%	2.05%
29	4.89%	3.92%	4.04%	4.00%	2.59%	2.17%
30	4.24%	4.08%	4.19%	4.17%	2.78%	2.37%
31	3.72%	4.08%	4.19%	4.19%	2.83%	2.42%
32	3.80%	3.85%	3.99%	3.98%	2.64%	2.24%
33	3.87%	3.75%	3.90%	3.89%	2.56%	2.17%
34	3.86%	3.74%	3.89%	3.89%	2.57%	2.17%
35	3.86%	3.74%	3.90%	3.90%	2.58%	2.19%
36	4.08%	3.74%	3.90%	3.92%	2.59%	2.19%
37	4.26%	3.87%	4.01%	4.05%	2.72%	2.33%

38	4.25%	3.92%	4.06%	4.10%	2.77%	2.37%
39	4.06%	3.83%	3.99%	4.02%	2.68%	2.28%
40	3.92%	3.66%	3.84%	3.84%	2.50%	2.10%
41	3.93%	3.67%	3.85%	3.83%	2.49%	2.09%
42	3.92%	3.66%	3.84%	3.81%	2.46%	2.06%
43	3.92%	3.66%	3.84%	3.80%	2.46%	2.06%
44	3.92%	3.66%	3.84%	3.80%	2.45%	2.05%
45	3.93%	3.67%	3.86%	3.81%	2.46%	2.06%
46	3.91%	3.66%	3.85%	3.81%	2.46%	2.05%
47	3.91%	3.66%	3.85%	3.81%	2.46%	2.05%
48	3.91%	3.66%	3.85%	3.81%	2.46%	2.06%
49	3.92%	3.67%	3.86%	3.82%	2.47%	2.07%
50 & above	3.91%	3.66%	3.85%	3.81%	2.46%	2.06%

The above inflation linked curves exclude the adjustment applied to allow for the RPI reference date used for actual pension increases.

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.

Without automatic precedent for the approach at future valuations, allowance will be made during the recovery plan for the 30 June 2011 valuation for an element of the expected out-performance of the Group's assets compared to the discount rate. The assumption is asset returns that are 0.5% p.a. higher than the discount rate at all terms for the recovery plan.

Expenses

1.7% 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

PN(M/F)A00 using the CMI2010 Core Projection factors for future improvements in mortality with an assumed long term improvement rate of 1.25% p.a. and no constant additional rate of mortality improvement. These tables are scaled using individual scaling factors produced by the Aon Hewitt Longevity Model (AHLM) adjusted to allow for relevant pensioner mortality experience. The average scaling factors for the 2011 valuation are set out below.

Membership Group	Average scaling factor
Male pensioner, <£8,500 p.a. pension	133%
Male pensioner, £8,501 - £13,000 p.a. pension	112%
Male pensioner, >£13,000 p.a. pension	97%
Male dependant	122%
Female pensioner, <£4,500 p.a. pension	118%
Female pensioner, >£4,500 p.a. pension	85%
Female dependant, <£4,500 p.a. pension	129%
Female dependant, >£4,500 p.a. pension	110%
Ill health past/future retirees (males and females)	200%
Active males	110%
Active females	122%
Deferred males	120%
Deferred females	118%

Pre-retirement mortality

Males: 65% of standard table AM92 Ultimate.

Females: 65% of standard table AF92 Ultimate.

Retirements in normal health

Contributing members:
All members retire at Normal Pension Age
ESPS Pre-88 male joiners are assumed to retire at age 60 with their pre-17 May 1990 benefits reduced by the applicable reduction factor.

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.

Ill – health retirement

Allowance made for retirements in ill-health (see sample rates below).

Withdrawals

Allowance made for withdrawals from service (see sample rates below).

Family details

A man is assumed to be three years older than his wife.

80% of members are assumed to be married at retirement or earlier death. This includes allowance for dependant members (including civil partners and children).

Commutation

No allowance made for members to commute pension for tax-free cash at retirement.

Sample rates The tables below illustrate the allowances made for deaths, withdrawals and ill health retirements from service at various ages.

Males
Percentage leaving the Group in the next year as a result of:

Current age	Death before retirement	Withdrawal from service	Ill health retirement
25	0.04	10.59	0.01
30	0.04	6.36	0.02
35	0.04	3.81	0.03
40	0.06	2.59	0.06
45	0.10	1.92	0.10
50	0.16	1.24	0.20
55	0.29	0.68	0.46

Females
Percentage leaving the Group in the next year as a result of:

Current age	Death before retirement	Withdrawal from service	Ill health retirement
25	0.02	10.74	0.00
30	0.02	9.73	0.02
35	0.03	5.94	0.06
40	0.05	4.07	0.12
45	0.08	2.78	0.24
50	0.12	1.75	0.35
55	0.20	1.15	0.83

Sample life expectancies The assumed improvements in life expectancy for an average active member 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	28.5
50	28.3	29.6
40	29.3	30.5