United Utilities PLC Group of the Electricity Supply Pension Scheme

Statement of Investment Principles

April 2022

1. **Introduction**

1.1 The Trustee of the United Utilities PLC Group of the Electricity Supply Pension Scheme ("the Group") has drawn up this Statement of Investment Principles ("the Statement") to comply with the requirements of the Pensions Act 1995 ("the Act") and subsequent legislation. The Group was formed following the split of the United Utilities Group of the Electricity Supply Pension Scheme. The Statement is intended to affirm the investment principles that govern decisions about the Group's investments.

1.2 In preparing this Statement the Trustee has consulted the Sponsoring Company, United Utilities PLC ("the Company"), to ascertain whether there are any material issues of which the Trustee should be aware in agreeing the Group's investment arrangements.

1.3 The Trustee has established an Investment Sub-Committee ("ISC"). It has delegated responsibility for operational matters, including regular investment monitoring and the appointment and termination of investment managers to the ISC. Any decisions regarding the Group's investment strategy are undertaken by the Trustee after receiving advice from the ISC.

1.4 The Trustee has also established a Joint Working Group ("JWG"). The JWG is a joint Trustee and Company Committee. Its role is to provide a framework to achieve an effective, integrated investment and funding strategy for the Group. The aim of the JWG is to achieve these goals whilst maintaining a decision structure where the Trustee Board (via the ISC) retains appropriate control over the investment of the Group's assets.

2. **Process For Determining Strategy**

2.1 The process for determining an investment strategy and choosing investments is as follows:

- Identify appropriate investment objectives;
- Agree the level of risk consistent with meeting the objectives set; and
- Build an investment strategy that achieves the above.

2.2 In considering the appropriate investments for the Group the Trustee has obtained and considered the written advice of its Investment Consultant, Mercer Limited ("Mercer), whom the Trustee believes to be suitably qualified to provide such advice. The advice received and arrangements implemented are, in the Trustee's opinion, consistent with the requirements of Section 36 of the Pensions Act 1995 (as amended).

3. **Investment Strategy & Objectives**

3.1 The Trustee’s objective is to invest the Group’s assets in the best interest of the members and beneficiaries and in the case of a potential conflict of interest, in the sole interest of the members and beneficiaries. Within this framework, the Trustee has agreed a number of objectives to help guide the strategic management of the assets and control of the various risks to which the Group is exposed. The Trustee’s primary objectives are set out below:

- To ensure the Group’s obligations to its beneficiaries can be met;
- To achieve an asset return above the return from gilts over the longer term, whilst recognising the need to balance risk control and return generation;
- To ensure consistency between the Group’s investment strategy and the return assumptions used by the Scheme Actuary;
- To pay due regard to the Company’s interests in the size and incidence of employer contribution payments.

3.2 The Trustee has decided to implement a Cashflow Driven Financing (“CDF”) strategy as part of a package of investment, funding and security measures.

3.3 A CDF strategy involves purchasing a range of income generating credit instruments to match projected benefit outgoings. The focus is on choosing investments with the right cashflow profile and a low probability of loss.

3.4 The intention is that the liability discount rate is set equal to the estimated yield on the asset portfolio less a margin for losses (for example due to defaults), manager fees and other costs. This discount rate will then broadly vary in line with market conditions (i.e. it will be ‘dynamic’ in nature), and as such the funding position is expected to be relatively stable. Any funding deficit will therefore need to be rectified via cash contributions and/or from asset outperformance.

The primary objectives of the overall CDF strategy are set out below:

- Generate sufficient returns to support the CDF discount rate, calculated as per the methodology in the Statement of Funding Principles;
- Maintain a stable funding position, subject to default losses and demographic experience being no worse than anticipated within the assumptions;
- Match projected benefit outgoings to the greatest extent possible. It is anticipated that the cashflow match of the CDF strategy will be at least 80% initially, with deficit contributions and the reinvestment of any excess income used to meet any ‘gap’ over time;
- Remove any residual risk (i.e. interest rate, inflation currency risks) to the greatest extent possible;
- The CDF strategy should be monitored regularly to test that the above objectives have been achieved.

3.5 The Trustee has designed an investment strategy to help achieve the above objectives. The strategic asset allocation is as follows:

Asset Class	Investment Manager	Allocation (%)
Global Buy & Maintain Investment Grade Credit	Legal & General Investment Management	50.0
Liability Driven Investment	Legal & General Investment Management	40.0
Secured Finance	Insight Investment Management	10.0
Total		**100.0**

3.6 There is no automatic rebalancing between the different portfolios that comprise the CDF strategy.

3.7 All the managers are regulated by the appropriate UK regulatory authority. The Group's assets invested with Legal & General Investment Management ("LGIM") are held in segregated portfolios, and the investment with Insight is held in a pooled fund; the Group Trustee's entitlement being to the cash value of the pooled fund units.

3.8 The managers have discretion over the investment of the Group's assets, subject to the restrictions detailed in the paragraphs below and in the respective Investment Management Agreements and Pooled Fund Prospectuses in place between the Group Trustee and the investment managers.

LGIM – LDI Portfolio (c. 40% of CDF Strategy)

Investment Objective

- This portfolio comprises of cash and gilts plus derivative exposures designed to deliver a 'completion hedge' of liability cashflow and inflation exposures, hedge non-sterling currency and rate exposure as well as provide liquidity in the form of a cash inflow/outflow facility.

- The LDI assets are structured in a passive or 'semi-passive' manner in order to provide the desired interest rate and inflation exposures.

- The LDI mandate acts as a 'completion portfolio' by meeting cashflows that are not matched by the Global Buy & Maintain Credit portfolio.

- It also manages collateral and valuation processes in combination with the Group's custodian.

- The mandate provides an integrated cash "pool" (via repo facility or cash) to receive and/or pay cash to smooth cashflow requirements.

- The mandate hedges non-sterling interest rate and currency risk from the Buy & Maintain Credit portfolio.

LGIM – Global Buy & Maintain Credit Portfolio (c. 50% of CDF Strategy)

Investment Objective

- The mandate seeks to capture the Credit Risk Premium and Liquidity Risk Premium available in credit markets through investing in a globally diversified portfolio of bonds, and through avoiding investments in securities which LGIM believes are likely to default or experience a significant deterioration in credit quality.

- The mandate also assists the Group in its management of its Liability Cashflow matching requirements.
- The currency and interest rate exposure of holdings in non-Sterling denominated bonds will be hedged back to Sterling using permitted derivatives.

In seeking to achieve the investment objective, LGIM shall not seek to breach the guidelines set out in the fund guidelines.

Insight - Secured Finance (c. 10% of CDF Strategy)

Investment Objective

- It is expected that this portfolio provides a material contribution to the margin above gilts in the short term and also provide some income to pay benefits. This portfolio should complement and provide diversification from the Buy & Maintain Investment Grade Credit portfolio.
- The secured finance strategy allocates capital primarily across a range of debt securities and instruments, whilst providing compensation for illiquidity, complexity and scarcity of opportunities, which would result from investing in private markets. The average weighted life of the portfolio is c.5 years.
- The Group has an allocation to Insight's pooled Secured Finance Fund, which targets an expected return of SONIA + 4% p.a. The Group also has a small allocation to the Secured Finance II Fund, which targets an expected return of SONIA +3% p.a.
- The target allocation within the Insight portfolio is a 100% allocation to the Insight Secured Finance Fund and Secured Finance II Fund (in aggregate), but Insight may invest in the Insight Liquidity Fund if required to facilitate transition activity.
- Insight currently distributes income from the Secured Finance Fund on a quarterly basis, which is used to help meet benefit payments.

Any non-GBP exposure within the fund is hedged back to GBP by Insight.

Hedging Objectives

3.9 The aim of the CDF strategy is to match a significant proportion of the Group's liabilities, to the greatest extent possible. Income generating assets (i.e. Global Buy & Maintain Credit and Secured Finance) are complemented by the Liability Driven Investment ("LDI") portfolio to remove residual interest rate, inflation and currency risk.

3.10 The Group aims to hedge 100% of the interest rate and inflation risk associated with benefits that are not cashflow matched liabilities. This is implemented through the Global Buy & Maintain Credit and LDI mandates.

3.11 Implementation of the LDI portfolio will be managed by LGIM using the cheapest instrument available, subject to the relevant collateral sufficiency and portfolio liquidity constraints (including any constraints on the use of Gilt Repo).

3.12 The Trustee recognises that although the Group's assets are invested in line with a CDF strategy, there may still be a mismatch between the interest-rate and inflation sensitivity of the Group's assets and liabilities due to the mismatch in duration between matching assets and actuarial liabilities. The Trustee has obtained and considered the written advice of Mercer and the Scheme Actuary, whom the Trustee believes to be suitably qualified to provide such advice, in agreeing upon the suitable level of matching assets relative to the Group's liabilities as part of the CDI strategy.

3.13 Although the Group aims to hedge 100% of its interest rate and inflation risk, at no point is it completely possible to fully replicate the interest rate and inflation sensitivities of the liabilities. In particular, there are no financial instruments that can replicate exactly the inflation-linked increases of the Group's liabilities. In addition, the liability profile (as represented by the Liability Benchmark Portfolio ("LBP")) will evolve over time based on market movements and changes in membership data.

3.14 In order to mitigate against the risk of implementing hedging against inaccurate liability data, which would result in a mismatch between the performance of the Group's assets and liabilities over time, the Trustee has agreed a framework for recalibrating the LBP on an ongoing basis:

- At a minimum, the LBP will be recalibrated on an annual basis to ensure gradual shifts in market conditions are captured and reflected;
- The LBP will also be recalibrated in the event of material changes to market conditions; this could be triggered either by a large change in inflation levels or by a large change in the level of volatility of inflation;
- Finally, material changes in membership data (i.e. large transfers out of the Group or early retirements) will result in a recalibration of the LBP.

3.15 The two non-annual metrics above will be monitored on a quarterly basis by Mercer and the Group's administrator, Railpen, respectively, with the recalibration of the LBP to be undertaken by Mercer following discussion with the ISC.

Additional Voluntary Contributions ("AVCs")

3.16 Whilst the main Group assets are invested in line with the above, members have four investment options in respect of their Additional Voluntary Contributions (AVCs):

- Aegon platform pooled investment funds:
  - LGIM Future World Global Equity Index Fund
  - BlackRock 50:50 Global Equity Index Fund
  - BlackRock Over 5 Year Index-Linked Gilt Index Fund
  - BlackRock Cash Fund
- In-Group:
  - Added years

3.17 In addition, legacy AVC investments are held with Prudential (with-profits fund). This arrangement is closed to new contributions.

3.18 The investment management arrangements for AVCs are reviewed at least annually.

3.19 There are no other Group assets.

4. Risk Management and Measurement

Risk Management Strategy

4.1 The Trustee considers a range of potentially financially material factors to which the Group is exposed over the anticipated time horizon for which the assets will be held. These factors are outlined in this section and section 11.

4.2 The Trustee's willingness to take on investment risk is dependent on the continuing financial strength of the Company and its willingness to contribute to the Group. The strength of the Company and its perceived commitment to the Group is monitored by the Trustee and the overall level of risk being taken will be reviewed if either of these deteriorates.

4.3 The CDF strategy that has been implemented by the Trustee has been designed and constructed in order to reduce risk. One of the criteria for the implementation of the strategy was that the deficit risk (as measured by the 1 year, 5% Value-at-Risk or "VaR") would be significantly lower than the previous investment strategy.

4.4 Despite this, it is important to acknowledge that residual risks remain. When deciding to take investment risk relative to the liabilities, the Trustee has carefully considered the following possible consequences:

- The assets might not achieve the excess return relative to the liabilities anticipated over the longer term. This would result in deterioration in the Group's financial position and consequently higher contributions than currently expected from the Company;

- The relative value of the assets and liabilities will be more volatile over the short term than if investment risk had not been taken. This will increase the possibility of there being a shortfall of assets relative to the liabilities in the event of discontinuance of the Group; and

- This volatility in the relative value of assets and liabilities may also increase the short-term volatility of the Company's contribution rate set at successive actuarial valuations, depending on the approach to funding adopted.

4.5 The Trustee has taken advice on these issues from its Investment Consultant and the Scheme Actuary. It has also held related discussions with the Company.

4.6 The degree of investment risk the Trustee is willing to take also depends on the financial position of the Group. The Trustee will monitor the funding level of the Group and its liability profile, with a view to altering the investment objectives, risk tolerance and/or return target should there be a significant change in either.

4.7 There are various risks to which any pension scheme is exposed. The Trustee's policy on risk management is as follows:

- The primary risk upon which the Trustee focuses is that arising through a mismatch between the Group's assets and its liabilities. The Trustee aims to reduce this risk as much as practicable through implementation of a CDF strategy.
- The Trustee recognises that whilst increasing risk increases potential returns over a long period, it also increases the risk of a shortfall in returns relative to that required to cover the Group's accruing liabilities as well as producing more short-term volatility in the Group's funding position. The Trustee has taken advice on the matter and considered carefully the implications of adopting different levels of risk.
- The Trustee recognises the risks that may arise from the lack of diversification of investments. Subject to managing the risk from a mismatch of assets and liabilities, the Trustee aims to ensure the asset allocation policy in place results in an adequately diversified portfolio.
- The documents governing the manager appointments include a number of guidelines which, among other things, are designed to ensure that only suitable investments are held by the Group. The Trustee has reviewed the investment guidelines for the mandates in place and have obtained and considered the written advice of Mercer whom the Trustee believes to be suitably qualified to provide such advice. The managers are prevented from investing in asset classes outside of the guidelines, without the Trustee's prior consent.
- The safe custody of the Group's assets is delegated to professional custodians (either directly or through the use of pooled vehicles).

4.8 Should there be a material change in the Group's circumstances, the Trustee will review whether and to what extent the investment arrangements should be altered; in particular whether the current risk profile remains appropriate.

5. Portfolio Construction

5.1 There are two primary 'building blocks' of a CDF strategy; investment grade corporate bonds (managed with a Global Buy & Maintain approach) and the LDI portfolio. A secured finance strategy accounts for the remainder of the initial CDF portfolio assets.

5.2 The Trustee has structured the Group's investments with the aim of reducing funding level volatility in a way that matches liability cashflows over time. The following broad controls are implemented by the Trustee:

- All other things being equal there is a preference to hold segregated investments, however pooled fund investments may be used at times given the size of the Group.
- To help diversify manager risk, multiple manager appointments are preferred where practical, although the Trustee is mindful of potential synergies between the Buy and Maintain and LDI mandates.
- At the total Group level and within individual manager appointments, investments should be broadly diversified to ensure there is not a concentration of investment with any one issuer. This restriction does not apply to investment in UK Government debt.

- No investment in assets without a readily available value without the prior consent of the Trustee.
- Investment may be made in securities and instruments that are not traded on regulated markets. Recognising the risks (in particular liquidity and counterparty exposure), such investments will normally only be made as part of a specific mandate where such instruments are permitted (e.g. Secured Finance) and/or with the purpose of reducing the Group's mismatch risk relative to its liabilities or to facilitate efficient portfolio management. In any event the Trustee will ensure that the assets of the Group are predominantly invested on regulated markets.
- The Trustee recognises that the use of leverage introduces an additional risk, whereby the economic exposure arising from investing in a derivative is greater than the capital committed to the investment.
- The Trustee recognises that the use of Gilt Repo introduces additional risks, including roll risk and settlement risk. Controls have been implemented within the LGIM guidelines to mitigate this.
- No direct investment in United Utilities Group PLC or subsidiaries is permitted.
- Additional restrictions may be imposed on certain managers. Full details of the restrictions are included in the Investment Management Agreements and Pooled Fund Prospectuses.
- Concessions to the restrictions can also be given to certain managers.

6. Day-to-Day Management of the Assets

6.1 The Trustee delegates the day-to-day management of the assets to the investment managers. The Trustee has taken steps to satisfy itself that the managers have the appropriate knowledge and experience for managing the Group's investments and that they are carrying out their work competently.

6.2 The Trustee has determined, based on expert advice, guidelines and ranges within which each appointed investment manager may operate.

6.3 The Trustee regularly reviews the continuing suitability of the Group's investments, including the appointed managers.

6.4 Each of the appointed managers has been set a specific objective by the Trustee. Details regarding the Trustee's arrangements with the investment managers are provided in section 12.

6.5 In the event of a change in investment manager, the Trustee may appoint a transition manager to facilitate the required asset transfer.

7. Monitoring

7.1 Arrangements are in place to monitor the Group's investments to help the Trustee check that nothing has occurred that would bring into question the continuing suitability of the current investments. To facilitate this, the Trustee meets with the Group's managers and receives regular reports from all the investment managers and the Investment Consultant.

8. Additional Assets

8.1 Under the terms of the trust deed the Trustee is responsible for the investment of Additional Voluntary Contributions ("AVCs") paid by members. The Trustee reviews the investment performance of the chosen providers at least annually and takes advice as to the providers' continued suitability.

9. Realisation of Investments

9.1 The investment managers have discretion in the timing of realisation of investments and in considerations relating to the liquidity of those investments within parameters stipulated in the relevant appointment documentation.

9.2 The Trustee monitors the allocation between the appointed managers and between asset classes, and rebalances the portfolio where required, taking into account the overall risk and cashflow match of the CDF strategy.

10. Cash flow and cash flow management

10.1 Cash flows, whether positive or negative, are used to move the Group's asset allocation and allocation to the individual underlying investment managers back towards the strategic allocation appropriate at that point in time.

11. Environmental, Social and Governance (ESG) Considerations

11.1 The Trustee believes that ESG issues have an impact on investment risk and return outcomes, and that good stewardship can create and preserve value for companies and markets as a whole, hence having the potential to benefit Group members in the long term. The Trustee also recognises that long-term sustainability issues, particularly climate change, present risks and opportunities that increasingly require explicit consideration.

11.2 The Trustee accordingly considers these issues in the context of anticipated time horizon over which the assets will be held.

11.3 The Trustee has undertaken ESG training facilitated by its advisers. As part of this training the Trustee carried out an ESG beliefs survey in order to assist with developing a policy in this regard.

11.4 The Trustee does not directly manage its investments and the investment managers have full discretion to buy and sell investments within the various portfolios, within the guidelines of their mandates. ESG considerations are however taken into account in the selection, retention and realisation of investments in the following ways:

- The Trustee considers the ESG research ratings published by its investment advisors, Mercer, when monitoring the Group's investment managers' capabilities. These ratings are reported quarterly and also considered as part of any new selection of investment funds.

- In annual meetings with the Group's investment managers, ESG issues are discussed and the manager is expected to discuss stewardship activities carried out on behalf of the Trustee for mandates where this is relevant. The CDF nature of the Group's investment strategy, notably the fact that the Group does not invest in equities, means that there are not typically any voting rights on the Group's investments.

- Whilst members' views are not currently explicitly taken into account in the selection, retention and realisation of investments, the Trustee welcomes views from members.
- An AVC fund option has been made available to members which takes into consideration environmental, social and governance issues and integrates these factors into how the fund is managed. For example, there is a focus on reducing carbon emissions and companies that don't reflect the values of sustainability are excluded from the fund.

11.5 The Trustee has given the investment managers full discretion when evaluating ESG issues and in exercising rights and stewardship obligations attached to the Group's investments. The Trustee seeks to confirm that the manager's ESG policies and actions are aligned with the Trustee's beliefs.

11.6 As noted above, voting rights are rare on the investments held by the Group. Should any such rights apply, they are exercised by the Group's investment managers in accordance with their own corporate governance policies, and taking account of current best practice including the UK Corporate Governance Code and the UK Stewardship Code.

11.7 However, the Trustee has not specifically asked for the views of the Group members in relation to ethical considerations and does not take into account any other non-financial factors (ie matters relating to the ethical and other views of members and beneficiaries, rather than considerations of financial risk and return) in the selection, retention and realisation of investments.

12. Investment Manager Arrangements

Overview

12.1 The Group's investment managers are appointed based on their capabilities and suitability as regards meeting the Group's objectives. Their appointments are therefore also based on their perceived likelihood of achieving the expected return and risk characteristics required for the asset class being selected for.

12.2 The Trustee receives advice from its Investment Consultant (the "Consultant") in relation to forward-looking assessments of a manager's ability to outperform over a full market cycle, for mandates where outperformance is the objective. This view will be based on the Consultant's assessment of the manager's idea generation, portfolio construction, implementation and business management, in relation to the particular investment portfolios(s) that the Group invests in. The Consultant's manager research ratings assist with due diligence and questioning managers during presentations to the Trustee and are used in decisions around selection, retention and realisation of manager appointments.

12.3 For mandates where outperformance is not the primary goal, the Trustee will seek guidance from the Consultant in relation to their forward looking assessment of the manager's ability to achieve the stated mandate objectives.

12.4 If the investment objective for a particular investment manager's fund changes, the Trustee will review the fund appointment, with the Consultant's assistance, to ensure it remains appropriate and consistent with the Trustee's wider investment objectives.

12.5 Some appointments are actively managed and the managers are incentivised through performance targets. An appointment will be reviewed following periods of sustained underperformance or failure to meet the mandate objectives, and the Trustee has put in place quarterly monitoring to seek to manage this risk. The Trustee will review the appropriateness of using actively managed funds (on an asset class basis) periodically.

12.6 Some appointments are managed on a segregated basis; the Trustee has specified criteria in the investment manager agreements for the respective manager to be in line with the Trustee's specific investment requirements. For example, the Trustee has appointed a Liability Hedge Portfolio manager, and the mandate agreements and guidelines are tailored to the specific requirements of the Trustee.

12.7 As the Trustee invests in pooled vehicles it accepts that there is no ability to specify the risk profile and return targets of the manager. However, appropriate mandates are selected to align with the overall investment strategy as stated in section 3 of this Statement.

Investment Manager Remuneration

12.8 The majority of investment managers are remunerated by way of a fee calculated as a percentage of assets under management. For liability hedging a fee is calculated based on the percentage of liabilities hedged. In each case, the principal incentive is for the investment manager to retain their appointment (in full), by achieving their objectives, in order to continue to receive their fee.

12.9 The Trustee reviews annually fee transparency and total expense ratio charges.

12.10 Investment managers are not remunerated based on portfolio turnover.

Evaluating Investment Managers

12.11 Investment managers are aware that their continued appointment is based on their success in delivering the objectives of the mandate for which they have been appointed to manage. If the Trustee is dissatisfied, then it will look to replace the manager.

12.12 The Trustee meets with its investment managers, with the Consultant also present, as deemed appropriate. During such meetings the Trustee is able to review the decisions made by the managers, including investment decisions, voting history (although voting rights are relatively rare given the nature of the Group's investments) and engagement activity with investee companies, and can question such activities.

12.13 The Trustee considers the Consultant's investment research and ESG research ratings within quarterly reporting. Through these ratings, the Trustee is able to assess for example how each investment manager embeds ESG into its investment process and how each manager's investment philosophy aligns with the Trustee's policies as stated in section 11.

Time horizon and Duration of Appointments

12.14 The Trustee receives investment manager performance reports on a quarterly basis, which present performance information over 3 months, 1 year, 3 years. The Trustee reviews the performance of the investments on an absolute basis and relative to defined benchmarks (over the relevant period) on a net of fees basis. The Trustee's focus is long-term performance but will put a manager "on watch" if there are short-term performance concerns.

12.15 If a manager is not meeting its performance objectives, over a sustained period of time, and after consideration of all relevant factors, the Trustee may take the decision to terminate the manager.

12.16 The Trustee is a long-term investor. Accordingly, it does not seek to change the investment arrangements on a frequent basis.

12.17 The majority of the funds invested in are open-ended with no set end date for the arrangement. The Trustee will retain an investment manager unless:

- There is a strategic change to the overall strategy that no longer requires exposure to that asset class or manager; or
- The manager appointment has been reviewed and the Trustee has decided to terminate the manager.

Portfolio turnover costs

12.18 The Trustee does not monitor portfolio turnover costs and has no set portfolio turnover targets; rather the Trustee assesses investment performance net of the impact of the costs of such activities.

13. Compliance with this Statement

13.1 The Trustee should monitor compliance with this Statement annually and obtain written confirmation from the investment managers that they have given effect to the investment principles in this Statement so far as reasonably practicable and that in exercising any discretion the investment managers have done so in accordance with Section 4 of The Occupational Pension Schemes (Investment) Regulations 2005.

14. Review of this Statement

14.1 The Trustee will review this Statement annually and without delay after any significant change in investment policy. Any change to this Statement will only be made after having obtained and considered the written advice of someone who the Trustee reasonably believes to be qualified by their ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of pension scheme investments. In addition, the Trustee will obtain written confirmation from the investment managers that they have complied with its requirements.

Signed on behalf of UU (ESPS) Pensions Trustee Limited

Signed: Colin Maloney Date: 20 April 2022

Name: Colin Maloney