DIAGEO
PENSION TRUST LTD

Diageo Pension Scheme – results of the 2018 actuarial valuation

I am writing to you on behalf of the Trustee to summarise the results of the actuarial valuation of the Scheme as at 1 April 2018. Please note, this letter is for information purposes only and does not impact your pension benefits.

I am pleased to report that the funding level of the Scheme has improved significantly since the last actuarial valuation in 2015 and the Scheme now has a small surplus. However, the cost per member of providing future service pension benefits to current employees remains significant despite the changes that the Company made to their benefits from 1 April 2018.

The purpose of an actuarial valuation is to review the financial health of the Scheme and to estimate how much money the Scheme needs in order to pay the pension benefits members have already earned as well as determine the contributions the Scheme needs to provide for benefits building up in the future for the active members.

We carry out a full valuation every three years, with annual updates in between. In the full valuation we review all the assumptions used in the valuation and make changes as appropriate, whereas the annual update reflects simply changes in Scheme membership, asset values and market conditions without any update in the assumptions.

The funding target
Under the requirements of the Pensions Act 2004, the Trustee is responsible for setting a funding target for the Scheme, known as Technical Provisions, being the amount of money that the Scheme needs to hold in order to provide the pension benefits that members have already earned. The Scheme Actuary helps the Trustee to consider the funding target in detail and check the Scheme's position in relation to the target.

Setting the assumptions
It is not possible to predict what will happen in the future with certainty, but it is possible, by using sensible assumptions, to estimate how much money is needed now to provide for the members' benefits. The Trustee takes advice from the Scheme Actuary on a number of assumptions about what will happen in the future. In particular, the Trustee considers the following principal assumptions:

- how long people might live – taking account of the actual mortality experience of the Scheme, the general pattern of mortality in the UK and estimates of how mortality might improve in future;
- what future inflation might be – based largely on the expectations of financial markets; and

- what returns the Scheme may be able to earn on its investments – based on a combination of the returns currently available on UK government bonds ("gilts") of duration appropriate to the liabilities of the Scheme and an assessment of the excess return which the Scheme might earn on the assets it holds, now and in future years.

As part of the process, the Trustee consults with the Company on these assumptions. The basis of the Technical Provisions, including details of the assumptions, is recorded in a formal document called the Statement of Funding Principles, which is approved by the Trustee and the Company.

The funding level

The Scheme Actuary will compare the Technical Provisions with the market value of the Scheme's net assets to get the funding level, which is expressed as a percentage. The net assets for this purpose include all the Scheme's investments, including the Pension Funding Partnership, but excluding the Additional Voluntary Contribution (AVC) investments of members. A funding level of more than 100% means that the value of the net assets is greater than the Technical Provisions (i.e. there is a funding surplus). A funding level of less than 100% means that the value of the assets is less than the Technical Provisions (i.e. there is a funding deficit). If a deficit is revealed, the Trustee and the Company must agree a recovery plan to eliminate the deficit.

Results of the actuarial valuation at 1 April 2018

As shown in the diagram below, the valuation as at 1 April 2018 shows that the Scheme has a surplus of £234 million. To put this another way, the Scheme's assets (excluding AVCs) cover 104% of the value placed on the benefits members have built up to date (the liabilities). This is a good improvement from the funding level of 97% shown in both the interim actuarial review at 1 April 2017 and at the last formal actuarial valuation at 1 April 2015.

The value of the Technical Provisions (liabilities)	**£6,585m**
The value of the Scheme's net assets (excluding AVCs)	**£6,819m**
Surplus	**£234m**
Funding level	**104%**

The improvement in the funding level is mainly as a result of positive investment returns since the last actuarial valuation and changes in demographic assumptions to reflect the experience of the Scheme and the latest research on mortality. As a result of the positive funding position of the Scheme, the conditional contributions agreed with the Company at the 2015 valuation do not need to be paid and no recovery plan is necessary.

While we are pleased to see this improvement, the Trustee is very aware that the benefit payments from the Scheme are expected to be made for a very long period and the funding level is likely to exhibit volatility over this period. The Scheme faces a number of key risks which could affect the funding level including a risk that investment returns are lower than assumed in the valuation, and also that the assets are volatile and move out of line with the liabilities, that inflation is higher than assumed and that members live longer than assumed. Other risks include long-term uncertainty around geopolitical, societal and technological shifts which may also impact on the funding, investments and sponsor covenant of the Scheme.

To mitigate these risks the Trustee has already put in place a number of measures and will continue to review these and take further actions as appropriate. The Trustee has a long-term goal of achieving “self-sufficiency” by 2030. In other words, being fully funded and invested in lower risk assets which are designed to move in line with the Scheme’s liabilities. A liability hedging programme is already in place and this will be maintained by the Trustee, so that changes in the value of the liabilities will be partially matched by changes in the asset values, thus reducing the funding volatility. The Trustee has also agreed with the Company that it would be appropriate for the Scheme to target continuing to hold some surplus that could be used as a buffer against future adverse experience. In addition, the Scheme retains its interest in the Pension Funding Partnership (PFP) with the Company, which provides a “back-stop” security for the Scheme in the event of a deficit in 2024 of up to a maximum of £430 million (the Trustee and the Company have agreed to review the terms of the PFP during 2019).

Over the coming months, the Trustee will also be reviewing the long-term investment strategy for the Scheme. An update on this will be provided in the 2019 Scheme review.

Contributions to cover the cost of future service pension benefits for active members
While the funding level of the Scheme has improved, the valuation has also shown that the cost per member of providing future service benefits for current employees remains significant despite the changes which the Company has made to future service pension benefits from 1 April 2018. As a reminder, from 1 April 2018, the Company changed the way active members (current employees) build up pension benefits in the future. Active members now build up benefits on a Career Average Revalued Earnings basis, full details of which have been communicated to those affected by the change. This change does not affect any benefits built up prior to 1 April 2018. Please note that these changes do not affect deferred members or pensioners.

From 1 January 2019, the Company will pay contributions of 38.25% of pensionable pay, less member contributions, to meet the cost of benefits building up in the future.

Company covenant
As required by legislation, the Trustee has conducted a thorough review of the Company’s ability and willingness to fund the benefits that have accrued in the Scheme, known as the “Company covenant”. The Trustee believes that the Company covenant is sufficiently strong to allow it to take a degree of investment risk within the Scheme. The Trustee will continue to monitor the covenant of the Company.

What is the funding level on the full solvency position?
Even though the funding level is currently more than 100%, the Trustee is required to advise members of the financial position of the Scheme in the unlikely event that the Scheme discontinued and the Company was unable to pay the benefits due. If the Scheme had been wound up on 1 April 2018, the Actuary estimated that the shortfall on the full solvency basis would have been some £1.3 billion, equal to a funding level of 84%. The full solvency position assumes that benefits would be secured by buying insurance policies; the cost of securing pensions in this way is significantly more expensive than funding them in the Scheme and this is the principal reason for the lower funding level.

It is important to understand that the Pensions Regulator requires us to report the full solvency position but this does not mean that the Company intends to wind up the Scheme. Furthermore, the law now stipulates that the sponsoring employer (in this case Diageo plc) cannot wind up a pension scheme unless it is funded on a full solvency basis. The only circumstances under which a scheme might be wound up without members receiving their full accrued benefits is if the sponsoring employer becomes insolvent and is unable to give the scheme any further support. In such a circumstance, the Pension Protection Fund (PPF) might step in and administer the scheme, but with some curtailment of benefits.

Further information about the PPF can be obtained on its website at www.pensionprotectionfund.org.uk.

Other matters

The Pensions Regulator requires that we tell you if there have been any payments from the Scheme to the Company in the last twelve months. We can confirm that there have been no such payments.

The Pensions Regulator's powers also allow it to intervene in the running of pension schemes if it believes this is in the members' best interests. For example, it can change the rate at which benefits build up in the future, give directions about working out funding targets or impose contribution rates on pension schemes. It has not needed to use its powers in this way for the Diageo Pension Scheme.

Where can I get further information?

Further details of the Scheme, including copies of the following documents, can be found on the pensions website at www.mydiageopension.com.

- **Annual Report and Accounts** for the year ended 31 March 2018, which includes the full accounts and membership figures, statements from the Actuary and Auditors, an update on the Scheme's investment performance and details of the Trustee and advisers.
- **Actuarial Valuation** - shows the funding position of the Scheme as at 1 April 2018.
- **Statement of Funding Principles** - explains the approach adopted for funding the Scheme.
- **Schedule of Contributions** - shows how much money is being paid into the Scheme.
- **Statement of Investment Principles** - explains how the Trustee invests the Scheme's assets.

Copies of these documents are also available from the Scheme Administrator, for whom contact details can be found below.

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Yours sincerely

Charles Coase, Chairman
Diageo Pension Trust Limited