

Alan Buchanan
Company Secretary

BRITISH AIRWAYS



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Derek Higgs, Esq
Non-Executive Directors Review
Room 2142
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London
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16 September, 2002

Dear Mr Higgs,

THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

This letter is written on behalf of British Airways Plc and sets out our response to the issues raised in your consultation paper dated 7 June 2002.

Before responding in detail to the seven issues you raise in your consultation document, it might be worth stating a few general points by way of background.

The recent economic downturn, particularly in the IT and telecommunications sectors, has resulted in the failure of several major organisations, the shock waves from which are still reverberating. Whilst it is important to learn the lessons from those failures, it is critical that we recognise and retain the strengths of the current system of governance in the United Kingdom. We strongly support the concept of the unitary board which has been developed in this country.

We also strongly support your view that an approach based on best practice is preferable to regulation or legislation. As a company listed on the New York Stock Exchange, we are affected by the consequences of the inadequately considered and overly prescriptive Sarbanes-Oxley Act of 2002. The United Kingdom should avoid repeating this error.

Turning to the issues on which you have requested comments, our responses are as follows:

What role should the non-executive directors perform, and how does this compare with the present position?

The primary purpose of the Board of Directors as a whole is to protect the interests of company's shareholders whilst taking into account the legal obligations of the company to its employees and creditors, amongst others, and the interests of relevant other stakeholders. The Board must also control and direct the business to enhance its long term value and create an open and honest reporting culture. Fundamental to this is the



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appointment and monitoring of the executive directors, particularly the Chief Executive, overseeing the company's strategy, monitoring risk and ensuring that the Company has a strong system of internal control.

In common with many UK companies and as recommended by the Combined Code, the Board of British Airways is led by a non-executive Chairman who is responsible for the running of the Board and ensuring its proper function. In this capacity, he is also the leader of the non-executive directors and the one who is able most closely to interact with the executives. The Board of British Airways currently has eleven members and comprises three executive directors and eight non-executives directors six of whom are independent and two of whom, including the Chairman, are former executives.

The Board of the Company has been structured in this way for many years and, whilst recognising that there is no "one size fits all" answer, it is a structure we would recommend. It permits us have diversity amongst the backgrounds and skills of our non-executives in a way which enhances the effectiveness of the Board.

The role of the non-executive directors is to represent the interests of the shareholders, as it is for any director of any company. There are several key elements to this. Non-executives provide constructive support and challenge to the executives both in terms of thinking generally and in relation to specific proposals, a process which our Chief Executive characterises as "pressure testing". As directors, non-executives make a key contribution to the strategic debates as well as lobbying and influencing on behalf of the Company. Service on the Nominations, Audit and Remuneration Committees is a crucial part of the way in which non-executives discharge their duties as directors. In our particular case, we also have a board committee consisting solely of non-executive directors which oversees safety and security, both of which are fundamental to our operation. As you know, the work of non-executive directors on these committees is vital. Through their work on the Nominations and Remuneration Committee, non-executive directors are responsible for making recommendations to the Board in relation to the appointment, retention, monitoring and, if necessary, termination of the Executive Directors, particularly the Chief Executive, as well as board evaluation and succession. Similarly, through the Audit Committee, they review the risk management and internal control systems as well as the financial reporting of the Company. The proper functioning of these committees is fundamental to the well being of the organisation.

There is a danger that as a result of recent events, non-executive directors will be expected to become all things to all men. For example, whilst non-executives have a monitoring and watchdog role, they are not auditors neither do they have the resources available to auditors to investigate independently or to verify the information which management provides them. Non-executives rely on management for their information about the business and, in some cases, about the particular industry.

In considering their role generally, one must also have regard to the time commitment and knowledge of the business that non-executive directors have. Absent special circumstances or additional responsibilities, most non-executives are expected to spend

around twenty four days a year working for their companies. This means that it would take them around ten years in the business to work the same number of days as a full time employee works in each year of employment. For those non-executives whose backgrounds are in a different sector or from outside the commercial world, this has a significant impact on their knowledge of the detail of the particular business.

Directors who have executive responsibilities have not only more time to learn about the organisation but also much greater access to information about the company, its performance and its internal workings. We are concerned that current law does not appear to recognise this adequately. Whilst we generally welcome the concept of codification of directors' responsibilities in the manner set out in the Company Law Review, we are concerned that the failure of paragraphs 3 and 4 of the draft Schedule 2 to take account of the part time nature of non-executive appointments may prejudice the position of non-executive directors.

British Airways identifies a senior independent non-executive director in accordance with the Combined Code recommendation. It appears to us that this role could be incorporated with that of a Deputy Chairman whose functions would be to deputise for the Chairman and to listen to shareholder or Board Member concerns about matters such as the chairmanship of the company.

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

The success of any system of governance, whether statutory or not, depends on the quality of the people involved. The key attributes for any director must be honesty, integrity and independence of mind, qualities applicable to executive and non-executive directors alike. Non-executives must be willing to make themselves unpopular should circumstances require it and, if necessary, to resign or "blow the whistle" in extreme cases.

Our non-executives directors have backgrounds in government service, the financial services industry, consumer products and the information technology industry as well as the transport industry. We believe that this diversity is helpful. British Airways derives significant benefit from the international experience of its board members; three of our directors are foreign nationals. It is also useful to have the experience of serving executives from other industries on the Board as well as those who have retired from executive responsibilities. Equally, it is clear that sufficient non-executives must have the necessary financial expertise to form the core of the Audit Committee.

It is certainly not getting any easier to find suitable candidates to act as non-executive directors. The recent decision of the board of Equitable Life to sue its former directors has highlighted the financial risk which non-executives take on in addition to the reputational risk of which they have always been aware. All directors are also aware that directors' and officers' liability insurance is becoming more restricted and more

expensive. Any pressure on non-executives to take on greater responsibility and any moves to increase their liability is likely to deter potential candidates.

As regards reward, money is not always the critical factor in motivating people to become non-executive directors. Moves to restrict the number of appointments a director can hold or to require a greater time commitment per appointment will undoubtedly affect the levels of reward needed to attract non-executives. Paradoxically, where a non-executive director depends on his or her income from the appointment, their independence may, in fact, be compromised.

In this context, we have noted that the draft Companies Bill does not appear to have any provision equivalent to the current Section 310 in the 1985 Act as amended. One assumes therefore that if directors, executive or non-executive, have complied with their obligations under Schedule 2 to the draft bill, the company would be entitled to indemnify them. This would be a positive development.

Do existing structures and procedures facilitate effective performance by non-executive directors?

We believe that the Combined Code has worked well in practice and that the companies listed in the United Kingdom are the stronger for it. It is important to recognise that not all issuers listed on the London Stock Exchange are incorporated in the United Kingdom. The “comply or explain” approach is far superior to the “one size fits all” approach recently demonstrated in the United States. It must be recognised that the Code cannot guarantee business success or the absence of fraud any more than legislation does.

Whilst further definition of the term “independence” would be helpful in deterring the proliferation of increasing restrictive demands from various lobbying bodies, we believe that the determination as to whether or not a director should be considered to be independent is, and should remain, a matter for the Board to determine in relation to individuals and the applicable circumstances. We would not object to a requirement on companies to set out their own guidelines as to how they judge independence in the annual report.

As stated above, we support the current committee structure recommended in the Combined Code. We would not support any move to restrict membership of committees solely to independent non-executives to the exclusion of non-independent non-executives. Non-independent non-executives play an important role on the boards and committees of many major companies. Committees should have the power to appoint their own advisers, e.g. remuneration consultants.

In relation to board numbers, a one size fits all prescriptive approach is inappropriate, however, boards should be small enough to allow constructive debate with a majority of non-executive members. It would be helpful to all directors to have a statement that they were entitled to rely on the work of board committees without themselves being



expected to second guess it. Companies should ensure that all committees of the Board have comprehensive terms of reference.

The recommendation to shareholders regarding the appointment of auditors should continue to be a decision by the Board as a whole on the basis of a recommendation by the Audit Committee after taking account of executive input. We do not support the US initiatives to have this become a decision of the Audit Committee alone. Where the auditors are to carry out non-audit assignments, these should be approved by the Audit Committee. The definition of audit work should be broadened to include regulatory reports, filings on overseas stock exchanges, due diligence and tax advice. Where possible, the chairman of the Audit Committee should either be a qualified accountant or have had executive responsibility for a finance department.

The company's internal auditor should have, at a minimum, a dotted line report to the Chairman of the Audit Committee who should also participate in the appraisal process. The members of the Audit Committee should meet with the external auditors and the internal auditors without any executive presence at least once per annum.

The procedures for the review of board effectiveness are a matter for the board, particularly the Chairman. We do not believe that anything would be gained by forcing companies to publish details of that process.

Companies already provide shareholders with sufficient information on every director to demonstrate why that person has been recommended to serve as a director by the Board, both in their annual reports and at the time of [re-]election.

We believe that independent-minded and honest people with integrity serving as non-executive directors will be able to challenge executive decisions and expose problems as well under the current system as under any other. Their ability to do this effectively, however, might be assisted by being able to obtain additional information from a source which does not report directly or indirectly to the Chief Executive such as the Company Secretary.

Do existing relationships with shareholders or others need to be strengthened?

Companies should not be required to offer major institutional shareholders meetings with non-executives other than the Chairman, the senior independent director or the chairman of a relevant committee where the subject of discussion should concentrate on governance, remuneration or similar matters to avoid confusion in the market between executives and non-executives commenting on performance.

Clearly a good Chairman will create the conditions for non-executive directors to be effective and this will include the promotion of constructive relationships, management of the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows. The building of trust between all

members of the Board will also be part of this process and will enhance board performance.

Non-executive directors should be entitled to access to all senior management. Such access should be made through the Company Secretary so that it is appropriately directed. Certain appointments (and termination of those appointments) should be in the gift of the Board as a whole such as the Company Secretary and the Head of Internal Audit.

Non-executive directors should use company secretaries as a channel of communication with the company and its senior executives. They should also use the Company Secretary as a sounding board and as a source of information. The Company Secretary should have sufficient resources to arrange for induction and training of directors as appropriate and sufficient independence from the executive directors to be able to assist a non-executive director to challenge management if necessary.

How can non-executive directors best be supported to perform their role?

Non-executive directors have a right of access to all levels of management to obtain information or clarification of information. Best practice would be for non-executive directors to contact the the Company Secretary to request information or seek guidance as to the appropriate individual for them to consult. In the event that a non-executive director considers he has received an unsatisfactory answer to his enquiry, he should take the matter to the Chief Executive or the Chairman.

Companies should arrange an induction programme and an ongoing training and development programme for all directors, whether executive or non-executive, to ensure that directors are informed of all new developments relevant to their role and also to ensure that they are sufficiently equipped to progress the ongoing development of the Group's businesses. The programme may include a combination of briefing papers, presentations, seminars and visits and should include some interactive sessions. The Company Secretary should be designated with responsibility for ensuring that the programme is maintained and that each director participates in it.

All companies should maintain an induction programme for newly appointed directors, whether executive or non-executive. The induction programme should be tailored to each individual director to reflect his or her own experience but should cover the company's constitution; group structure; significant contracts, joint ventures and strategic alliances; the group's principal businesses, products and assets; competitor analysis; the role, duties and responsibilities of a director; corporate governance; and the company's risk management processes.

The Chairman is responsible for ensuring that the performance of all directors is adequately reviewed and with sufficient frequency. It would not be sensible to be overly prescriptive as to how this must be done as it will be a question for each company.

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In summary, British Airways supports the unitary board and the best practice approach to developments in this area. We believe that the current system works well and that it should not be sacrificed by allowing unrealistic expectations to be placed upon it. We would support legal recognition of the part time nature of the non-executive role and other changes in relation to induction and training to support directors generally.

