

**Review of the role and effectiveness of non-
executive directors**

Consultation Paper Response

National Grid Group plc

The attached response represents the views of individuals and does not necessarily represent the views of National Grid Group plc any of its subsidiaries, associates or joint ventures.

A What role should non-executive directors perform, and how does this compare to the present position?
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Whilst the aims of the consultation paper are to examine the role and effectiveness of non-executive directors we would support the recently publicised view of other commentators that this exercise should not distinguish the role of non-executive directors entirely from the role of executive directors. There is no legal distinction between executive and non-executive directors and we would not wish this exercise to create one. In our view the success of the governance structure in the UK is, in part, due to the unitary nature of boards.

A1 What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?

It is generally accepted that the role of the board is principally the creation of shareholder value through directing and controlling the company and establishing the strategy and vision for the company. The role played by the board in the delivery of shareholder value is something that it should determine, formally set out, and present to shareholders. The role of the board does not necessarily overlap with any statutory statement of directors' duties as proposed in the Company Law White Paper although it may contain a reference to such duties.

The role of the Chairman is to direct and control the running of the board and to ensure that it conforms to all relevant rules and codes of practice. Equally the Chairman is responsible for the management of board succession. Whilst the board as a whole must consider continuity in its membership, it is important that this forms part of a Chairman's role.

The non-executive directors bring a crucial control element to the board by ensuring compliance with governance codes and best practice and, along with the Company Secretary, should report regularly to the Chairman and highlight any concerns immediately. Collectively the non-executive directors also bring essential qualities to the board such as specialised commercial and/or technical expertise, an independent perspective, an awareness of the differing approaches taken on issues by other companies and the ability to ask critical, incisive questions which management itself may find it difficult to express.

A2 What should be the key roles of non-executive directors on the board and what should be the balance between different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?

Non-executive directors should not all be expected to fulfil all roles. It is more important that the non-executive directors collectively cover a broad range of roles in enough detail. It is part of the role of the Chairman to ensure that there is a balance of skills and experience on the board.

The key roles that can be expected of non-executive directors are:

- strategic input
- leadership
- independent oversight
- governance
- compliance

Strategic input and leadership are qualities that should be expected from each member of any board, both executive and non-executive. The extent to which a non-executive director would become involved in the areas of oversight, governance and compliance would depend on their being independent and their level of previous experience (i.e. the chairman of audit committee should have relevant financial experience).

It is our view that non-executive directors should bring a mix of qualities highlighted above to the board and therefore that it is not possible to identify single items from the above list to allocate to individuals. It is the Chairman of the board who should have overall responsibility for ensuring that an appropriate balance of inputs to the board is achieved taking in to account the qualities of the individual non-executive directors. When recruiting a new non-executive director, the Nominations Committee as guided by the Chairman should ensure that any identified gaps – whether through a personal or formal analysis – are filled with candidates of the appropriate calibre to ensure that the balance of qualities is maintained.

Increasingly, it is recognised that there are certain specific qualities that are required of non-executive directors who are appointed to board committees. As the US Sarbanes-Oxley Act 2002 recognises, the chairman of the Audit Committee should be someone with the appropriate qualifications, experience and independent oversight to ensure that there is an appropriate level of transparency in the public eye. Equally, the chairman of the Remuneration Committee should bring a significant level of compensation and benefits experience to the table. For this reason it may be sensible for non-executives to limit the number of committees on which they sit (or for the company itself to impose a limit).

It is also recognised that, clearly, some non-executive directors may be appointed purely for their industry knowledge and the strategic advice that they could offer whilst others may be appointed because of their independent viewpoint.

A3 How does this compare to the present position?

Differences to the present position are:

- formally establishing the role of the board
- limiting the number of committees on which non-executive directors sit

Largely, and particularly since the corporate scandals of Maxwell, Polly Peck and BCCI, corporate governance measures have improved vastly to ensure a far greater level of transparency in the role and inputs that may be provided by non-executive directors. These measures have been brought about from previous attempts (Cadbury, Greenbury, Hampel and Turnbull) to underline the importance of corporate governance to UK plc.

Present concerns have arisen from the role played by the non-executive directors and management of some US companies, not least of which are Enron and WorldCom. In the US, the issue of corporate accountability has become a significant concern to investors as shortcomings in accounting and audit standards have come to light. It is increasingly recognised that the US corporate governance framework has not, to date, been as well developed as that in the UK and, as a result, a number of initiatives are in hand to improve corporate accountability.

Whilst we would not be in favour of far-reaching reforms of the current UK corporate governance framework, there is in our view further scope to develop and enhance the current non-legislative, best practice framework, for example in the areas of directors' training and the evaluation of boards.

A4 How independent do non-executive directors need to be for the different roles?

The Combined Code notes that 'All directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.' (A.1.5)

Whilst 'professional independence' is required for the general role of each director, for non-executive directors fulfilling a specific role (e.g. compliance) they would need to demonstrate independence from the company and the executive directors on the board. For effective governance, it is our view that the independence of any director is clearly subjective and cannot be rigidly defined. The definition of independence endorsed by the Association of British Insurers and the National Association of Pension Funds in their voting policy and incorporated in to the Combined Code of the UKLA Listing Rules (Provision A3.2) is appropriate in our view. However, it should be for the Chairman and the Nominations Committee to assess whether business or other relationships might materially interfere with the exercise of independent judgement by the non-executive director concerned. This assessment might be done as part of the board's regular review of its effectiveness and supported by recognised external reviewers.

There is a tendency amongst certain commentators to view non-executives as simply independent or not, based on arbitrary definitions such as length of service. We consider that where a director has served for a certain period this should not automatically rule out independence. Whilst using three, three-year terms as a general rule of thumb, all factors relating to a director should be considered. It is part of the Chairman's responsibility to ensure that a board refreshes itself on a regular basis and it should be for a board to determine what 'regular' should be, without using prescriptive rules.

A5 What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?

The principal areas where non-executive directors can protect the interests of the company lie in the consideration of new projects and resource issues. As directors without executive responsibilities and therefore no conflict of interest they can provide independent input to such decisions.

One situation which may give rise to concern arises where a Chairman and Chief Executive agree strongly on an issue. It is then possible for this level of agreement to become entrenched and harder for the board and its non-executive directors to effectively challenge them. Such situations can be avoided by ensuring the presence of a senior non-executive director on the board who can provide an appropriate balance.

To ensure that the non-executive directors as a group can be effective they need to represent a significant proportion of the board. The Combined Code (A.3.1) suggests that non-executive directors comprise not less than one-third of the board.

This is a useful minimum number which National Grid supports. Going forward, and following the proposed merger with Lattice Group plc, National Grid Transco's board will comprise a non-executive Chairman and non-executive Deputy Chairman. In total, there will be eight non-executive directors and seven executive directors on its board which will bring an even greater degree of transparency in the corporate governance framework.

A6 What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?

The role of Chairman requires a substantial time commitment, and that for a non-executive director also represents a significant amount of time (reading papers, board meetings, committee meetings, strategy days etc.). However, the actual amount of time could vary significantly, not just between companies but for each company dependent upon its current activity and between directors on a board dependent upon committee memberships.

To ensure that non-executive directors can devote the time required to each post the number of positions that any one person takes on should be limited but individual companies should be left to decide what might be appropriate in the circumstances. What is important is ensuring that the acceptance of any external directorship is agreed by the Chairman of the company on the basis that it does not materially interfere with the ability of the individual to undertake their principal role. In our view, the expected contribution of non-executive directors to company business has increased enormously in recent years given the public scrutiny that they are under and the complexity of corporate transactions.

The membership of non-executives on board committees should equally be limited to ensure full and appropriate consideration is given to these duties

Such restrictions will affect some individuals who may be required to limit the number of posts that they hold. In view of this the level of fees paid to non-executive directors should be reconsidered as a priority.

A7 Should there be a special role for a "senior independent" non-executive director?

The Chairman should preferably be an independent non-executive director and there does not appear to be a need in our view for a further director to be designated as the senior independent non-executive director. To single out such a role is potentially divisive and it erodes the perception of independence of the other non-executive directors.

However, a senior independent role could be considered to provide balance where the Chairman and Chief Executive have a close working relationship or where their positions become entrenched and, on occasion, dominate the rest of the Board.

A8 Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?

The proposed statement of duties will be useful in that it would clearly set out the legal duties of a director. It is also appropriate that there should be no differentiation between the duties of executive and non-executive directors.

B	What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?
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B9 **What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?**

The qualities required of new non-executive directors are often negative in nature; for example that they must not have any conflicts of interest, that they must not have other links to the company, etc.

It is obviously of equal value to specify general experience that non-executive directors should bring; vision, strategy, direction, and requirements more specific to a company's business; for example, in the case of National Grid, a knowledge of regulatory price controls.

Additionally all non-executive directors need at least a basic understanding of finance and of business issues. Whilst it is important that some of the non-executives on the board have specific knowledge relating to the industry/operations of the company, equally important is a broad range of backgrounds to provide diverse viewpoints so as to drive performance.

B10 **What personal qualities and attributes are needed?**

Each non-executive director appointed to the board of a company will bring with him or her a set of skills that is appropriate to the needs of the board as a whole. These skills may be financial, commercial, regulatory or others but which, together with other non-executive directors, will contribute to the development of a clear and coherent strategy to be implemented by senior executives and management.

All non-executive directors should have personal qualities such as an ability to scrutinise, analyse and constructively challenge management to make sure that when decisions are made, they are based upon informed debate and robust dialogue.

B11 **What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.**

The inclusion on the board, and as chairman of the Audit Committee, of a non-executive director with external experience as a finance director has proved invaluable. Furthermore, National Grid operates in a highly regulated environment and at least two of the non-executive directors with skills in economic regulation have added considerable value.

B12 **How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?**

We have found it time consuming to find new non-executives that meet our requirements. It is not, however, the processes which need to be improved, it is more to do with the pool of appropriately skilled people available and their willingness

to take on the role. Any attempt to prescribe a maximum number of external directorships that a person may hold as referred to above can only restrict the number and quality of people available.

The problems of finding appropriate new directors highlights the importance that should be placed on timely, regular succession planning and the need to refresh the board whilst maintaining its balance. This can be dealt with by the Nominations Committee.

B13 What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?

As referred to elsewhere in this document, the level of fees payable to non-executive directors are in our view inadequate to encourage new entrants in to the market. If a significant increase in the fee levels were achieved whilst restricting the number of posts that could be taken on the quantity and calibre of available non-executive directors could improve. Whether or not it is possible to introduce greater diversity into appointments is debatable given the breadth of qualities that are needed in the role.

The international nature of the board is largely dependent on the geographical spread of the company itself and the board's requirements for having individuals with international experience. Greater international diversity would also increase the pool of available directors and the range of experience that they could bring to a company's board.

B14 Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?

For the current levels of responsibility and increasing expectations placed on non-executive directors there is little doubt that the fees they receive are too low. It must be remembered that non-executive directors have the same legal responsibilities as executive directors and need some incentive to be prepared to accept the risks involved, especially in the current environment.

However, in order to ensure that the non-executives may remain independent fees should be paid in cash, and non-executive directors should never hold options as this could, or at least be perceived to, interfere with their judgement on company matters. There is also some benefit in a portion of the fees, between one-third and a maximum of one-half, being paid in shares. This is unlikely to affect the independent status of non-executive directors.

The relatively low level of fees currently paid to non-executive directors by most companies is likely to affect the number of individuals who are willing to accept posts as non-executive directors. Subject to the comments above, it could also have the effect that directors will be more willing to accept a larger number of posts, which could impact on their effectiveness.

Care needs to be taken, when considering the level of fees and the appointment of a non-executive, that an individual does not become too dependent upon this fee

income. This raises the risk of becoming, or being considered to be, less independent.

B15 Do you have comments on the issue of risks or insurance provision for non-executive directors?

Directors' liability insurance should be provided for all directors on the same basis regardless of their executive or non-executive capacity.

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

C16 How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?

Where companies are concerned with governance, the Combined Code provides the best practice benchmark. The flexible approach allows companies to explain any deviation from the rules outlined, but most would only do this in certain circumstances.

The Combined Code states that, 'The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.' (A.3.2). This statement is not particularly explicit when considering who is and is not independent. It may be sensible to supplement such a general statement with conditions outlining specific requirements for independence.

For example, non-executive directors will only be considered independent when:

- they have had no association within the last two years with any of the company's advisers (either currently in post or within the previous two years)
- they have no posts on boards where executives of the company also sit (either 'cross directorships' or not)
- they have not in the past held any executive post with the company

C17 Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?

Where the recommended structures are complemented by adequate terms of reference and processes they should allow non-executive directors to make an effective contribution to governance.

The ideal size of a board would depend on the company and the way in which it operates. What is of great importance is ensuring that the board manages its own workload appropriately by ensuring that there are appropriate delegations in place whilst reserving to itself a number of specific issues for consideration. The total number of directors on a board should always be such that it can still function effectively.

One additional consideration is that once a board exceeds 12 members experience has shown that in certain circumstances the nature of any discussions held changes. It is harder to have constructive and meaningful discussions with larger boards and more work may be delegated to committees as a result. Whilst there is no issue in principle with such delegation as long as it is progressively overseen and monitored, it is then possible that boards may become overly formal and committee led.

C18 Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?

The recent suggestions that the composition of Audit Committees be adjusted such that they should consist of only independent non-executive directors is useful in that it helps to assure shareholders of the independence of the committee.

As more concerns have been raised about audit and controls, both internal and external, the duties of the Audit Committee have been expanding. With the increasing level of responsibility being placed upon the Audit Committee and the public attention being paid to its role and accountability, it could be argued that Audit Committees are becoming overloaded. This may in part be countered by requiring that these committees meet more frequently, for example on each occasion that the board itself meets. Alternatively, boards could agree to separate out areas of non-core Audit Committee work and re-allocate it to a further committee. A number of companies, including National Grid Transco, are already moving in this direction and putting in place Corporate Social Responsibility Committees, Safety Committees, etc. Establishing such committees allows consideration of some non-financial risks (health & safety, environment or ethical) to be moved away from the Audit Committee reducing its workload and ensuring that all risks are adequately considered. Enabling full consideration of all risks, both financial and non-financial, is a clear benefit to companies and shareholders and in line with Turnbull recommendations. Failure to allow more time or to delegate out in this fashion is likely to affect the ability of the Audit Committee to fulfil its key objectives.

Other than an amendment to suggest that Audit Committees be established wholly of independent non-executive directors the Combined Code provisions are adequate.

C19 Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

As noted earlier, one of the more important duties of the Nominations Committee is to regularly consider succession planning. This is important to ensure that the board consistently has the right balance and range of skills and experience in its directors.

Where the terms of reference of either the Remuneration Committee or Nominations Committee allow for the provision of independent external advice the chairman of the respective committee should ensure that the advice is truly independent.

C20 What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?

There is currently a process in place for setting objectives and reviewing performance for individual directors and consideration is currently being given to broaden this to the board as a whole.

However, there should be objective processes to review the performance of both the whole board and of individual directors, executive and non-executive. A method that might work well in practice is some form of progressive review, which begins with self-assessment and which is increasingly recognised as bringing value. This could then be followed by an objective review to help ensure independence, possibly through the use of external advisers.

The overall management of objective setting and performance review is something that should fall ultimately to the Chairman and, as noted, should form an important part of their role.

C21 Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?

Any process of board review should be explained to shareholders and such a process could be subjected to some form of independent audit. The overall outcomes of any review of board performance and any actions the board plans to take following such a review might also be reported.

The performance of any individual director, however, should be a matter for the board, more specifically the Chairman, and details should not be reported to shareholders.

C22 Are non-executive directors able successfully to challenge executive decisions or exposure serious problems? Should it be made easier for them to do so and, if so, how?

Non-executive directors, of the required ability, are able to challenge the executive directors and highlight possible problems with any proposal put before the board. If they are not satisfied with the information available they should ask for more.

To ensure that the opinion of non-executive directors on a board is given more weight, consideration should be given to increasing the proportion of non-executive directors from one-third to half.

Additionally, to ensure independent oversight, non-executive directors should be included on any *ad hoc* board committees established to consider individual projects.

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

D23 How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?

The non-executive directors who chair the key board committees are available at shareholder meetings to answer questions that may arise. National Grid also decided to ask shareholders to approve its remuneration report in 2002 ahead of the recent legislative changes that have been made to require such an advisory vote to be sought.

In addition, we report fully on the way in which the board reviews internal controls within the Group and we are prepared to answer questions from any interested party on this. Our independent non-executive Chairman is also available to meet any institutional shareholder. However, our recent experience is that these institutions appear to be reluctant to take up the offer. We wrote to over twenty institutions recently offering to discuss our governance arrangements and explain issues to them whilst also hoping to understand better issues that are of concern to them. With the exception of one, none of the institutions responded. The offer was recently repeated with the same result.

However, relationships with shareholders require that the shareholders are willing to engage. Consideration needs to be given to both sides in order to improve the dialogue and to ensure that an appropriate level of responsibility is taken. This is a matter that was highlighted by the Myners Review of pension fund trustees *vis a vis* the investments that they make.

D24 To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?

It is important that the Chairman manages board meetings and that committee chairman do likewise to ensure that there is adequate opportunity given for debate to take place. One of the key issues to be addressed in the appointment of a chairman is to look at the skills required to do this.

It is also important to consider the dialogue between directors outside of formal meetings, at board dinners, strategy days and one-to-one meetings. These less formal discussions can lead to very useful exchanges of information.

However, whilst this informal method of information exchange can be useful it should be used in addition to and not to replace the formal processes and relationships.

D25 What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the Company?

Non-executive directors should only establish a relationship with the executive directors through the board. Any contact with senior management should be through board meetings, committees of the board or when the non-executive is seeking additional information on specific issues. Senior management would also be encouraged to attend the board for discussions on their area of the business.

Non-executive directors should have no contact with key advisers outside of board/committee meetings and board briefings without first discussing this with the Chairman. We have found it helpful to write up and agree between the Chairman and the Chief Executive their respective roles and areas of responsibility.

D26 How can Company Secretaries support effective performance by non-executive directors?

Effective performance can be supported by ensuring that all board and committee papers are circulated to non-executive directors in a timely manner. It is also important that the Company Secretary is available to answer any questions that the non-executives may have and to facilitate their access to independent professional advice where appropriate.

The Company Secretary should also act as a contact, source and mentor should non-executive directors require any further information.

The General Counsel should also have access to the directors as highlighted in the US Sarbanes-Oxley Act.

E	How can non-executive directors best be supported to perform their role?
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E27 How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

It is more likely that non-executive directors will have too much information than not enough. It should be part of the role of both the Chairman and Chief Executive to ensure that the quality of the information provided is such that non-executive directors can consider those issues which they need to and not have to sift for the important information. The non-executive directors have a responsibility to ensure they ask for and get information appropriate to their needs.

It is important to ensure that where possible non-executive directors have access to a cross-section of management, rather than just executive directors and their direct reports. This can be achieved by site visits, strategy meetings etc.

E28 What training and development opportunities are available? Could they be improved and, if so, how?

On the whole, the non-executive directors appointed to the board of National Grid have been experienced non-executives so we have not needed to undertake specific training. They are, however, briefed on the company and its internal control frameworks, given a reminder of their duties as directors and are given the opportunity to audit key areas of the company to gain first hand experience of the board's operations.

Companies should provide training and development for all members of the board. This should apply not only where a director may feel they would like a greater understanding but also to ensure that all directors are up-to-date on important issues.

E29 Can induction for non-executive directors be improved?

It is important to ensure that the induction for all directors is completed. Where necessary this should include terms of reference, the role of the post on the board, directors' duties, and extensive information relating to the company.

E30 Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

The Chairman brings to the attention of non-executive directors what matters need to be addressed and provides feedback on their performance.

F In what ways is the position different for smaller listed companies?

F31 To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

The same governance principles apply regardless of size, it is the implementation that is very different for smaller companies.

Different factors may also apply for different companies. Governance procedures and processes and the roles of individual directors may vary from company to company, size being only one factor that would make a difference.

Governance best practice needs to be clear but also flexible to allow for these differences.

G What can we learn from international experience?
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G32 What lessons can be learnt from international experience, either in terms of structures or behaviours?

It is important that best practice and experience should be shared, both nationally and internationally. However, it is important to note that because of market and cultural differences some lessons will not always be directly transferable.

G33 Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?

All models have their advantages and disadvantages but the UK model to date has served National Grid well.

G34 Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

No. The UK model works well and should not be fundamentally reviewed. However, best practice from other jurisdictions should always be considered and improvements introduced where appropriate.

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