

# Corporate governance report

## Introduction and general compliance statement

The Board believes best practice in corporate governance is an important tool in helping it carry out its responsibilities. The Board considers that, during the year and up to the date of this report, it has complied with the main principles and provisions of the Combined Code 2006. This report, the directors' report and business review and the directors' remuneration report describe how the Company has applied the principles of the Combined Code during the year.

The board of NWL also endeavours to maintain its own high standards of corporate governance and to comply with the Combined Code, wherever practicable.

The Board endeavours to act in accordance with the Group's Code of Conduct, which addresses the Group's responsibilities to a range of stakeholders and for the environment. This Code of Conduct is on the Company's website.

## The Board

The Board sets and implements the Company's strategy and ensures compliance with Group policies and legal and regulatory obligations. The Group's mission and strategy is set out in the directors' report and business review on pages 10 and 11.

Board agendas are proposed by the Managing Director and Company Secretary, with input from NWL's management team, for approval by the Chairman.

The Company has adopted terms of reference which set out the matters reserved to the Board for approval and matters which are, or can be, delegated to the committees and management. The Company has also adopted financial approval rules which set out the authorisation processes and financial limits to be applied within the Company to financial transactions. NWL has adopted its own version of these guidelines. Standing or Executive Committees can take decisions not delegated to specific committees between Board meetings. All directors receive notice of Standing Committee meetings and may participate if they wish. Decisions taken by the Standing or Executive Committees are reported at the next Board meeting.

The following table sets out the attendance of directors at Board and committee meetings during 2008/09:

Name	Board	Nomination	Remuneration	Audit
Number of meetings	6	3	3	3
Sir Derek Wanless	6	3	2	3 <sup>†</sup>
Sir Patrick Brown	6	3	3	3
John Cuthbert	6	2	3 <sup>†</sup>	3 <sup>†</sup>
Chris Green	6	–	–	3 <sup>†</sup>
Claude Lamoureux	5	–	–	–
Martin Nègre	6	3	3	–
Alex Scott-Barrett	6	3	3	3
Jenny Williams	5	2	–	3

<sup>†</sup> Not a member, but attended at the invitation of the Committee Chairman.

At each meeting the directors receive reports from the Managing Director, the Finance Director and the chairmen of any committees which have met since the previous Board meeting.

The Chairman ensures that important issues are given enough time at meetings and that all directors can express their views. This enables full and vigorous discussion of key items.

The non-executive directors met formally once without the executive directors and are in regular contact with each other throughout the year. The non-executive directors also met once without the Chairman but did not consider additional formal meetings to be necessary.

### **Authorisation of directors' conflicts of interest**

Directors now have a statutory duty, under section 175 of the Companies Act 2006, to avoid a situation in which they have, or can have, a conflict of interest with the Company's interests. However, there is no breach of this duty if the Board has authorised the matter in question. Changes to the Articles, which took effect on 1 October 2008, now permit directors to authorise any such situations and, during the year, directors were asked to confirm any known or potential conflicts of interest and a list of the interests thought to require authorisation was submitted to the Board in November 2008. At the meeting, directors (other than the director having the interest in question) were asked to authorise the situations giving rise to a known or potential conflict. A register of the interests which have been authorised is maintained by the Company Secretary and is available at every Board meeting.

### **Board balance and independence**

There are currently eight directors – the Chairman, two executive directors, the senior independent non-executive director and four other non-executive directors. Sir Derek Wanless is the non-executive Chairman. The executive directors are John Cuthbert (Managing Director) and Chris Green (Finance Director). Sir Patrick Brown is the senior independent non-executive director and the other independent non-executive directors are Martin Nègre, Alex Scott-Barrett and Jenny Williams. Claude Lamoureux is also a non-executive director but is not independent as he was, until 1 December 2007, President and CEO of OTPP, which holds 27% of the issued share capital of the Company.

The Company complies with the Combined Code's requirement that half of the directors, excluding the Chairman, are independent non-executive directors. The Chairman was independent on appointment. Biographical details of the directors appear on pages 46 and 47 and details of their service contracts are in the directors' remuneration report on page 59.

The Chairman and Managing Director have clearly defined written responsibilities which have been agreed by the Board. The Chairman leads the Board and creates the conditions for overall Board and individual director effectiveness, both inside and outside the boardroom. The Managing Director is responsible for running the Company's business on a day to day basis.

Sir Patrick Brown, as senior independent non-executive director, is available to shareholders who wish to raise any concerns and leads the non-executive directors in their evaluation of the Chairman's performance.

The non-executive directors bring to the Board many years of business experience as well as financial expertise and the ability and willingness to challenge and support the executive directors.

The General Counsel and Company Secretary, Martin Parker, assists the Board to ensure that good corporate governance compliance is achieved. He is also Company Secretary of NWL and is secretary to all Board committees.

### **Information and professional development**

All directors have access to independent professional advice to assist them in the performance of their duties, at the Company's expense, and to the Company Secretary for advice and assistance. The Chairman, with the assistance of the Company Secretary, monitors the induction and training requirements of directors. All new directors receive an induction information pack and are offered site visits and meetings with managers. Managers from within the Group submit papers or give presentations at Board meetings. Water industry representatives meet the NWL board to discuss current issues.

The Company Secretary ensures that directors are kept informed and that information flows effectively within the Group by:

- keeping in regular contact with directors;
- sending Board papers to directors before each Board meeting;
- sending briefing packs to directors in the months when Board meetings are not held; and
- providing a directors' team room intranet site containing Board and committee papers, minutes, analysts' reports and reference and regulatory documents, to which all directors have access.

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## Performance evaluation

A full evaluation of the performance of the Board, the NWL board and the committees was conducted during the year by an external consultant with significant relevant experience. Each director completed a detailed questionnaire prior to a one to one meeting with the consultant. The questionnaire was designed to address the dynamics of the Board and the effectiveness of its approach to strategic, operational and financial matters, as well as the contributions of the directors. The consultant observed the NWG and NWL board meetings in November 2008 and delivered a report to both boards in February 2009. The results of the evaluation were generally very positive and a number of actions were agreed, with a view to consolidating the performance of the boards.

The Chairman has also appraised the performance of each NWG and NWL director by means of one to one meetings. The Chairman's comments on the performance of the directors seeking re-appointment at the AGM are provided in the Notice of Meeting.

## External appointments

To date, executive directors have only accepted non-executive positions outside the Group where this would benefit either the Group or the local community. These positions have tended to be with educational institutions, economic regeneration groups or similar bodies. The Board has agreed that executive directors of the Company who are appointed to non-executive directorships of a more commercial nature may retain the fees, subject to obtaining the Chairman's consent before an appointment is accepted. Only one such external appointment per director will generally be permitted and there are currently no such appointments.

## Board committees

The Board has Audit, Nomination and Remuneration Committees to assist it in the performance of its duties. The Board sets the terms of reference of the Committees and receives regular reports from their chairmen at board meetings. The terms of reference of committees are available on the Company's website or from the Company Secretary.

## Remuneration Committee

The work of the Remuneration Committee and details of the directors' remuneration are set out in the directors' remuneration report on pages 54 to 63.

## Nomination Committee

The members of the Nomination Committee are Sir Derek Wanless (Chairman), Sir Patrick Brown, John Cuthbert, Martin Nègre, Alex Scott-Barrett and Jenny Williams, and the membership is compliant with the Combined Code.

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The Committee also reviews succession planning for the Board, NWL board and senior appointments and will make recommendations to the Board when appropriate. The Committee's general policy is to use external recruitment consultants or to advertise in order to identify suitable candidates. All non-executive directors are appointed for a term of one year. In accordance with the existing Articles, all directors are subject to re-election at the AGM at least every three years. However, an amendment to the Articles proposing that, in future, all directors will be subject to annual re-election, will be put to shareholder vote at this year's AGM. Please refer to the Notice of Meeting for further details on the proposed amendment. If shareholders approve the amendment, directors will be subject to annual re-election with effect from the 2010 AGM.

During the year, the Committee considered extensions to the appointments of non-executive directors on the NWG and NWL boards whose contracts for services expired during the year. Extensions to the appointments of Sir Patrick Brown and Martin Nègre take them into their seventh year as non-executive directors of the NWG Board and, having been subject to a rigorous review as required by the Combined Code, the Committee remains satisfied with the performance of these two directors. Following the announcement of John Cuthbert's decision to retire on 31 March 2010, the Committee has agreed the process to be followed in seeking a successor, prepared a person specification and engaged an executive recruitment specialist to advise on and assist in the process.

## Accountability and audit

### Audit Committee

The Audit Committee members are Sir Patrick Brown (Chairman), Alex Scott-Barrett and Jenny Williams. Alex Scott-Barrett is a chartered accountant and the Board is satisfied that he has recent and relevant financial experience.

The Committee's membership complies with the Combined Code. The Chairman, Managing Director and Finance Director are invited to Audit Committee meetings with the permission of its Chairman but have no right of attendance. Managers from within the Group are invited to Audit Committee meetings to discuss issues relating to their areas of the business. During the year, the Committee met with both the external Audit Partner and Internal Audit Manager to discuss audit business, without the executive directors being present. The Committee remains satisfied that the internal audit function is able to operate with independence and is not under any pressure from the executive management of the Company to produce particular results.

The Committee members receive regular briefings from the external auditors to enable them to keep up to date on financial reporting standards.

The purpose of the Audit Committee is to assist both executive and non-executive directors of NWG to discharge their individual and collective responsibilities in relation to:

- ensuring the financial and accounting systems of NWG and its subsidiaries are providing accurate and up to date information on their current position;
- ensuring NWG's published financial statements represent a true and fair reflection of this position; and
- assessing the scope and effectiveness of the Group's risk management systems and the integrity of its internal financial controls.

During the year its work included:

- monitoring the integrity of the financial statements of the Company;
- reviewing the Company's internal financial controls by considering reports of both the internal and external auditors, directing questions to management and reviewing the financial risks and controls information provided to them on an annual basis;
- monitoring and reviewing the effectiveness of the internal audit function by reviewing the scope of the annual audit plan, the results of those audits and monitoring the completion of actions identified during the audit;
- monitoring and reviewing the performance and effectiveness of the external auditors, in particular, by reviewing the scope and costs of the audit process;
- reviewing the external auditors' independence by monitoring the extent of the provision of non-audit services and receiving reports from the external auditors;
- monitoring the potential impact and management of significant risks to the business using a risk methodology (meeting the recommendations of the 2005 Turnbull Review Group guidance) which sets out and rates all identified risks, including operational, external, financial, environmental, social and governance risks;
- reviewing the Committee's terms of reference;
- reviewing the Group's accounting and treasury policies; and
- reviewing the Company's interim management statements, half-yearly and preliminary results' announcements and final published annual report and financial statements.

Given the importance of NWL to the Group's business, the Committee works closely with the Audit Committee of NWL. In particular, both committees review significant regulatory reports for Ofwat and regularly review NWL's debt recovery strategy and performance. In addition, meetings were held with the Ofwat Reporter during the year to discuss the June Return and Draft and Final Business Plans.

The Audit Committee Chairman reports to the Board following each meeting of the Committee and committee minutes are circulated to the Board.

### **External auditors**

Ernst & Young LLP have been the Group's auditors since 2003. The audit engagement partner is subject to change every five years and was last changed in 2008.

### **Non-audit services**

The Committee has approved a procedure for the approval of non-audit services to safeguard the objectivity and independence of the external auditors, which complies with the requirements of the Auditing Practices Board's Ethical Standard No. 5. The external auditors are not permitted to provide bookkeeping, financial information systems design and implementation, or internal audit outsourcing services. Permitted services require prior approval, either from the Audit Committee Chairman, if under £50,000, or from the Audit Committee, if over £50,000. The Company requires the auditors to report annually details of all non-audit services provided. A breakdown of the cost of audit and non-audit services provided by the auditors is set out in note 4 to the financial statements.

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On 27 May 2009, Ernst & Young confirmed to the Audit Committee, in accordance with ISA 260 (Communication of audit matters to those charged with governance), that they have considered their relationship with the Company and that, in their professional judgement, the objectivity of the audit engagement partner and audit staff is not impaired.

## Review of internal control

The Board has overall responsibility for maintaining a sound system of internal control and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the 2005 Turnbull Review Group guidance. The actions necessary to address weaknesses and otherwise improve the system of internal control are communicated to management. Internal Audit monitors implementation of these actions and reports back to the Audit Committee. This process has been in place throughout the year and up to the date of approval of the 2008/09 annual report and financial statements. There are inherent limitations in any system of internal control and even the most effective system can only provide a reasonable, and not absolute, assurance against material misstatement or loss.

The Board has reviewed the effectiveness of the Group's system of internal control, as follows, during the year. The Internal Audit team manages a process whereby all of the financial controls within the Group are identified and certified by the relevant manager as having operated for the full year. As part of a programme of work (which is agreed with the Audit Committee), these controls are tested throughout the year. A report detailing any areas of concern is produced after each audit. As part of the same process all of the key business risks are identified. Each risk is assessed on an unmanaged basis, the controls in place to mitigate the risks are detailed and the risk is then re-assessed after these controls.

Internal Audit's findings and recommendations are presented to the Audit Committee along with agreed actions. Internal Audit updates progress against any agreed actions until the control weakness is resolved.

## Organisational structure

The trading subsidiaries have their own boards of directors (the Subsidiary Boards) which are responsible for the operational and financial control of their own businesses. The Subsidiary Boards report to the Managing Director, or Finance Director, and to the Company's Board on matters including major strategic, financial, organisational, compliance and regulatory issues.

The NWL management team manages the major business of the Group and consists of John Cuthbert (Managing Director), Chris Green (Finance Director), Graham Neave (Operations Director and on NWL board), Ceri Jones (Regulation & Scientific Services Director and on NWL board), John Devall (Water & Networks (South) Director), Ian Donald (Customer Services Director), Diane Morton (HR Director), Colin Price (Technical Director) and Henry Wilson (Waste water & Networks (North) Director). The NWL management team meets monthly to consider and discuss progress against annual and monthly financial and operational targets. It prepares an annual budget and business plan for consideration and approval by the NWL board. NWL operates a balanced scorecard system which monitors progress against KPIs and which covers all areas of operation of the business.

The Board is able to monitor the impact of environmental, social and governance matters on the Group's business, to assess the impact of significant risks on the business and to evaluate methods of managing these risks through reports it receives from the Subsidiary Boards and the Audit Committee. The environmental risks considered to be significant by the Board are described on page 41, together with a summary of how NWL is managing these risks.

For a number of years, the Subsidiary Boards have performed a full annual business risk analysis to meet the recommendations of the 2005 Turnbull Review Group guidance. This methodology is described above in relation to the work of the Audit Committee. The results of the risk reviews are reported in detail to the Audit Committee and a summary is reported to the Company's directors. Accompanying the risk model is a detailed review of each company's internal financial controls along with either confirmation that the controls have operated throughout the year or details of any exceptions. Action points arising from these reviews are followed up as part of the internal audit process.

Some subsidiaries, such as NWL, consider risks more frequently. The Managing Director and Finance Director consider significant risks in a structured way on a monthly basis, assessing the likelihood and potential impact of the relevant risks both before and after risk management measures have been put in place. Further details about

how risks and uncertainties facing the Group are assessed and managed are included in the directors' report and business review on pages 40 to 43.

On a monthly basis, the Managing Director and the Finance Director compare the actual operational and financial performance of each business with its plan and budget. Targets are set to measure performance and regular forecasts are made.

### **Information and reporting system**

Each Subsidiary Board holds a copy of the Company's financial approval rules and terms of reference, which contain full details of the procedures for distribution of information and financial reporting. Each Subsidiary Board has developed financial control systems appropriate to its activities.

### **Budgets and business planning**

The Group prepares detailed medium term business plans and annual budgets which are reviewed by the Managing Director and Finance Director and submitted to the Board for approval. Business plans and budgets include an assessment of the key risks and success factors facing each business unit.

The approval of the Board is required for major investments, including those in new markets, and large capital expenditure programmes. The treasury strategy, which is approved by the Board, requires that investments are limited to certain money market and treasury instruments, and that the Group's exposure to any single bank, building society or market is controlled, with maximum deposits allowed with any single counterparty. The Group's investment strategy aims to fix interest rates for part of the Group's borrowings and investments for periods determined by the forecast cash flow of the individual businesses. This manages the exposure to the risk of changes in short term interest rates. Foreign currency exposure is also managed as part of the treasury strategy approved by the Board.

The Board, therefore, believes that there are effective systems in place to identify and manage significant risks and that it receives sufficient information to enable it to assess these risks.

The work of NWL's Corporate Responsibility Committee is described on pages 17 and 18 and on the corporate responsibility section of the company's website.

### **Investor relations**

The Company welcomes constructive communication with all its shareholders. Details of the Company's investor relations activities during the year are described in the directors' report and business review on page 15. Investor feedback reports from investor meetings, prepared by the Company's advisers, are considered at Board meetings and analysts' notes on the Company are made available to all directors on the Board's intranet team room. The Board believes that these methods of investor feedback provide the senior independent non-executive director and the other non-executive directors with a balanced understanding of the issues and concerns of major shareholders. The senior independent director is available to shareholders who wish to raise any matters of concern and the Chairman welcomes contact with any shareholders who have matters they wish to discuss. The Company has not received any requests from institutional shareholders to meet with non-executive directors.

All shareholders are encouraged to contact the Company with queries or suggestions. A welcome letter is sent to all new non-corporate shareholders, which includes information on services available to shareholders.

### **AGM**

Shareholders are encouraged to attend the Company's AGM at which they can meet and question the directors. The Company will make a presentation at the AGM to highlight the key business developments and events during the year. The full Board is expected to be available at the AGM to answer shareholders' questions. Voting at the AGM will be on a show of hands but the proxy votes cast on each resolution will be displayed after each resolution has been voted on. If the voting on a show of hands produces a different result from that which would have been achieved on a poll, the Chairman will call a poll so that the result of the voting on that resolution reflects the wishes of the majority of shareholders. The proxy votes cast at each AGM are disclosed on our website.

**Martin Parker**  
**General Counsel and Company Secretary**  
2 June 2009