

National Grid response to the Proposed Revisions to the UK Corporate Governance Code

February 2018

About National Grid

National Grid is an international electricity and gas company based in the UK and north-eastern US. We play an important role in connecting millions of people safely, reliably and efficiently to the energy they use.

We welcome and support the consultation on the UK Corporate Governance Code (the Code). This submission highlights the considerations we believe the Financial Reporting Council (FRC) should take into account when finalising the revisions to the Code.

Executive Summary

We support the view expressed in the FRC's response to the BEIS Select Committee Corporate Governance Inquiry, which advises that the strength of the unitary board model, shareholder rights and the 'comply or explain' approach deliver economic success and should not be compromised.

We would encourage the FRC to focus on this view when considering the responses to the Code consultation.

In our opinion aspects of the proposed Code are overly prescriptive and go beyond current legislation, further eroding the board's authority and flexibility to oversee the running of the business on behalf of shareholders. We believe that any changes to the Code, including reporting requirements, must ultimately deliver additional transparency and benefit to both shareholders and stakeholders which in turn will help increase the confidence of customers, employees and the wider public.

Additionally, given the increasing lack of accountability from institutional investors and the prevailing attitude of many of those responsible for determining how institutional shareholders vote (i.e. comply or vote against), we expect that further prescription in the revised Code will lead to a more box ticking approach to compliance with investors less willing than at present to accept explanations in respect of deviations from the Code. Investing institutions should be accountable for and available to discuss their voting decisions rather than delegating to proxy advisors or hiding behind a general voting advisory letter.

We also believe that the current drafting of the Code overreaches the existing legislation in section 172 and in effect widens directors' duties beyond that prescribed by the Companies Act 2006, for example, the requirement in Principle A for directors to "contribute to wider society". This creates an unhealthy tension between the expectations and actual roles of a company's owners and the roles of boards and their directors. For example how would the board balance the contribution to wider society with pension deficit repair costs?

Under UK company law it is shareholders who hold boards to account for how they discharge their duties. This provides legal certainty and clarity. Enabling other stakeholders to enforce these duties could weaken shareholder engagement and result in competing interests.

Q1. Do you have any concerns in relation to the proposed Code application date?

We do not have any concerns with the proposed application date but would note that it is a short implementation period for December year end preparers.

Q2. Do you have any comments on the revised Guidance?

We would urge the FRC to consider the way that this Guidance is viewed by those within the corporate governance industry in particular proxy voting agencies. Elements of the revised Guidance are very prescriptive and form a 'checklist' for good practice. This will inevitably result in good practice examples being the benchmark for required practice.

For example, in relation to point 23, it may not be appropriate for the chairmen of the remuneration or nominations committee to make a statement at the annual general meeting. However this point, as currently drafted, sets this as an expected minimum standard. It is currently common practice for committee chairmen to provide personal introductions to committee reports in the annual report and accounts as well as attending the AGM to answer questions as appropriate.

We would also note concerns in relation to the additional guidance provided in points 19 and 30. The Code sets out that the board should explain how it has engaged with the workforce and other stakeholders and how these interests have influenced the board's decision making. Points 19 and 30 are more prescriptive as to the information and justification a board would be required to provide in relation to its decisions. We do not think that this is appropriate given that secondary legislation in relation to section 172 of the Companies Act 2006 is still pending.

Point 77 sets out that non-executive director appointment letters should be made available on the company website. This would be an extension of the existing rights for members to inspect directors' service contracts as set out in section 228 and 229 of the Companies Act 2006 and may require the current legislation to be amended. A summary of non-executive director appointment letters is also already provided in the annual report and accounts.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

We believe that companies should be allowed to design and choose the method of workforce engagement and consultation that best suits their needs. This is particularly relevant for companies with international workforces with a majority of workers outside the UK. These companies need flexibility to ensure that the method is most appropriate for their structure to ensure meaningful engagement.

We understand that it is the intention of the FRC that adopting an alternative method of workforce engagement, as long as it delivers meaningful, regular two way dialogue, would be in compliance with the Code. The revised Guidance on Board Effectiveness makes it clear that the choice of one of the three methods of workforce engagement is not prescriptive and boards may opt for innovative alternatives if they believe they would be as, or more, effective.

The Code should clarify that the requirement will be satisfied as long as the method chosen provides meaningful, regular two-way dialogue and a means for the board to listen to the workforce. We would encourage the FRC to amend the drafting of the Code to make this clearer.

We would also welcome further clarification on the definition of the term 'workforce'. We note that there may be practical implications in gathering views if the term 'workforce' is wider than those with

formal employment contracts as well as potential General Data Protection Regulation implications in approaching all members of the 'workforce'.

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

We support the UN SDGs and other NGO principles; however, we do not think that it is appropriate for reference to these to be included in the Code.

Q5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

We would propose that 25% would be a more appropriate definition of 'significant' for reporting purposes. This would then align with the requirements under English law of a special resolution requiring 75 per cent or more of the votes cast to be in favour of the relevant resolution.

We do not agree with the proposal that an update should be required within a six month period. We are of the view that mandatory interim reporting would be of limited value as it depends on the engagement from investors and may not be a balanced reflection of the view of investors as it could result in undue prominence of a particular view point. We would suggest that an update should be published in the next annual report, or at such earlier time as considered appropriate by the directors.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

As a FTSE 100 company we do not believe it is appropriate for us to respond to this question.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

Nine years is a generally acceptable period of tenure but enforcing a maximum period may restrict board succession planning.

We consider that length of tenure is just one factor to be taken in to account when considering the independence of a non-executive director.

We believe that the board should be able to consider all of the indicators of independence and still determine an individual to be independent even if they meet one or more of the indicators. The change to the Code removes the ability of the board to make such a determination. This will result in some companies not complying with this aspect of the Code and needing to provide an explanation. See our comments provided in the Executive Summary regarding proxy voting agencies and a 'box ticking' approach to compliance.

Imposing a restriction on independence may also impact the succession planning of a board. Highly skilled and experienced non-executive directors may not consider taking on a chairmanship within the same company as their time in the new position would be restricted to the remaining period of their original nine year tenure.

We would urge the FRC to retain the ability of the board to determine the independence of non-executive directors with reference to the indicators set out in the Code.

The current governance framework allows shareholders to raise concerns around the independence determination by the board of a director by contacting the company to discuss this and ultimately, if they feel it is appropriate, voting against the proposed annual re-election of a director.

Please also note our comments on the independence of the chairman at the end of our submission.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

As set out in response to question 7, we don't believe there should be a maximum period of tenure.

By way of a company specific example, our major UK regulatory review (RIIO - Revenue=Incentives+ Innovation+Outputs) can take three years. It would be inappropriate and to the detriment of the success of the company to arbitrarily replace a highly skilled non-executive director part way through this period due to their tenure expiring.

We don't however support indefinite periods of tenure. We would expect companies to provide a detailed explanation and justification of a non-executive director or chairman's tenure beyond nine years in the Annual Report and Accounts in the penultimate year of the nine year period and in each subsequent year of appointment.

Q9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

We agree that the changes proposed in Section 3 should lead to more action to build diversity.

We believe that creating an inclusive and diverse culture supports the attraction and retention of talented people, improves effectiveness, delivers superior performance and enhances the success of the company. While traditional diversity criteria such as gender, age and ethnicity are important, we also value diversity of thought, skills, experience, knowledge and expertise including educational and professional backgrounds.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

As a FTSE 100 company we do not believe it is appropriate for us to respond to this question.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

We support this proposal in principle but would note that diversity of thought, skills, experience, knowledge and expertise including educational and professional backgrounds are just as important as more traditional diversity criteria.

In relation to the practical implications, a definition of ethnicity would ensure that all companies are providing the same information and the interaction with data protection law should also be considered.

The scope in terms of geographic location of the workforce also needs to be clarified, for example would it cover the full 'workforce' including global employees even though it is a UK requirement?

Q12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

We are of the view that duplication between the Code and other requirements should be avoided. An example of this is the inconsistency between the various rules in relation to a suitably qualified financial person and the audit committee.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

Yes, we agree with the proposal.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We do not support the expansion of the remit of the remuneration committee. It is unclear if the committee is expected to take responsibility for oversight of all workforce policies or just those related to pay and what oversight would mean in practice. It is not the responsibility of the remuneration committee to oversee remuneration of the workforce policies and practices as this would lead non-executive directors into management territory.

The terms of reference for the Remuneration Committee of National Grid currently include the direct review of remuneration for the Executive Directors and Executive Committee members, currently totalling nine executives. This includes the review of performance and decision-making on base salary, annual incentive design and outcomes, long-term incentive design and outcomes, benefits policies and outcomes, pension contributions, and any other payments as applicable. The terms of reference also already include the review and noting of remuneration trends across the Group to ensure alignment throughout the Company e.g. salary increases for the wider workforce, employer pension contributions to the wider workforce, etc.

The primary challenge that would result from 'hard-wiring' a wider remit for the Remuneration Committee within the Code is related to governance of the Company. If the Executive Committee determines that a particular decision impacting its teams is appropriate, but the Remuneration Committee takes a different view, the final authority to determine the issue would be unclear.

A wider remit for the Remuneration Committee would also lead to an additional time requirement for Remuneration Committee members. This change could make it difficult for the Company to attract and retain competent Remuneration Committee members, increase the fees required to adequately compensate for the time commitment, and add to Company costs due to the additional time required to provide sufficient information to Remuneration Committee members to inform their views and ensure sound decision-making.

National Grid's view is that the Taylor Review's conclusion that the best way to drive up the quality of work for individuals is 'not national regulation, but responsible corporate governance, good management and strong employment relations...' is absolutely correct. That responsibility best sits primarily with the Group Executive Committee as it does today. If it did fall to the Remuneration Committee, it would likely delegate authority to the Group Executive Committee or other committees as appropriate (if possible under the Code) to discharge its responsibility.

A potential approach for retaining the spirit of the revised Code is to set a principle covering the provision of certain information to the Remuneration Committee for reporting purposes only. This might include diversity and inclusion reporting (including pay differences), pay ratios (which might be a broader dataset than that explicitly required in upcoming legislation), and remuneration information for the broader employee population that could inform the Remuneration Committee's decision-making related to Executive Committee members, e.g. average base salary increases, average annual and long-term incentive opportunities and outturns, pension contributions, benefit policies, etc. It could also include a full report of a company's engagement survey results to assure the Board that the Group Executive Committee is effectively exercising its corporate governance and employee relations responsibilities.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

Companies should have the flexibility to design their own executive remuneration as there is no single structure appropriate for all. We believe that the guiding framework set out in Provision 40 is sufficient and that there are disadvantages in trying to be too prescriptive.

As mentioned above, a potential approach is to set a principle covering the provision of certain information to the Remuneration Committee for reporting purposes to inform the Remuneration Committee's decision-making related to Executive Committee members to ensure all decisions are aligned to those for the rest of the Company. National Grid already does this as a matter of course, but it may be beneficial to have this hard-wired into the Code to ensure all companies make remuneration decisions for Executive Committee members that are informed by and aligned to the wider workforce.

In our view, shareholding requirements are a strong driver of long-term sustainable performance, and as such, we require the Chief Executive to hold shares with a value equal to 500% of his base salary in shares (approximately nine times his post tax salary) and other Executive Directors have to hold shares worth 400% of base salary.

National Grid agrees with the standard of a five year vesting and holding period as a further way to align remuneration with long-term sustainable performance, and has had such an arrangement since 2014.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

The provision of data and policies related to remuneration decisions for the wider workforce would ensure that discretion is applied to Executive Committee outcomes that is aligned to outcomes for the wider workforce. However, on balance, we think the changes could have a negative effect as any escalation of decision-making of policies impacting the wider workforce would risk less sound outcomes given the absence of the day-to-day involvement and reduced understanding of issues impacting the wider workforce versus those impacting the Executive Committee.

We would also note that additional prescription in the Code further undermines the ability of the committee to exercise discretion. Each additional box to 'tick' channels directors to a particular structure or form to avoid a negative vote.

Other comments

Leadership and purpose

We are concerned that the reference to the contribution to wider society in principle A is outside of the current statutory duties for directors under s.172 and inappropriate with secondary legislation in this area still pending.

Conflict of interest

Provision 7 states that “the board should take action to identify and eliminate conflicts of interest”. The use of the word ‘eliminate’ would suggest that conflicts of interest are not permissible, even if they do not impact a director’s independence or the situation is closely managed for example by the conflicted director not participating in related decisions. This change would seem to be inconsistent with the ability of the directors under section 175 of the Companies Act 2006 to authorise conflicts of interest.

Independence of non-executive directors

The proposed revisions to the Code in relation to independence removes the discretion of the board to consider a non-executive director to remain independent if they meet one or more of the indicators listed.

This change will result in more ‘non-independent’ non-executive directors and will have consequences for the balance of board and committee composition, in particular; audit, remuneration and nomination committees as members are required to be independent. It may also impact the appointment of a senior independent director.

A definition of what would be considered a ‘significant link’ would be helpful to ensure that there is consistency of application across companies.

Independence of the chairman

It is also proposed that the chairman’s independence be considered on the same basis as the non-executive directors rather than just on appointment. This would result in the chairman being deemed non independent if he serves for more than nine years. This may impact board succession planning and the progression of non-executive directors to chairman within the same company.

We are also concerned that this independence consideration could change the dynamics of the relationship between the chairman and executive directors. One of the chairman’s roles is ‘holding the ring between the non-executive directors and management’ undertaking neither a non-executive nor an executive role; this new classification would put chairmen firmly in a non-executive director role.

We believe that the current position of assessing the chairman’s independence only on appointment should be maintained to reflect the unique role the chairman undertakes.