

Corporate governance report

Introduction and corporate governance statement

The Board believes best practice in corporate governance is an important tool in helping it meet 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 2008 (the Code). The Code is available to download from the Financial Reporting Council's website at www.frc.org.uk/corporate/combinedcode.cfm or, alternatively, printed copies can be obtained free of charge from FRC publications, tel: 020 8247 1264, email: customer.services@cch.co.uk

This report, together with the directors' remuneration report, describes how the Company has applied the principles of the Code during the year. The Group has provided the information required under Disclosure and Transparency Rule 7.2.6 within the section headed 'Information pursuant to the Takeovers Directive' in the directors' report and business review.

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

The Board also ensures that business is conducted 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.

Board agendas are proposed by the Chief Executive Officer 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 2009/10:

	Board	Board (by telephone)	Nomination	Remuneration	Audit
Number of meetings	6	1	5	3	3
Sir Derek Wanless	6	1	5	3	3 ¹
Sir Patrick Brown	6	1	5	3	3
John Cuthbert	6	1	2	3 ¹	3 ¹
Chris Green	6	1	–	–	3 ¹
Claude Lamoureux	6	1	4 ¹	–	–
Heidi Mottram ²	1	–	1	1 ¹	–
Martin Nègre	6	1	5	3	–
Alex Scott-Barrett	6	–	5	3	3
Jenny Williams	6	–	4	–	3

Notes:

1. Not a member, but attended at the invitation of the Committee chairman.
2. Appointed to the Board on 1 March 2010.

A Board meeting, called at short notice and held by telephone conference, took place on 11 December 2009 to discuss the final determination.

At each meeting the directors receive reports from the Chief Executive Officer, 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 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. The Articles permit directors (other than the director having the interest in question) to authorise any situation 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. The Company will follow emerging best practice in line with the General Counsel 100's guidance paper.

Board balance and independence

Eight directors served throughout the year – 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 were 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.

Heidi Mottram was appointed as an executive director on 1 March 2010 and took up her position as Chief Executive Officer on 1 April 2010, immediately following John Cuthbert's retirement. Margaret Fay was appointed as a non-executive director of NWG and NWL on 1 June 2010.

The Company complies with the 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 58 and 59 and details of their service contracts are in the directors' remuneration report.

The Chairman and Chief Executive Officer 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 Chief Executive Officer 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.

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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.

Performance evaluation

A full evaluation of the performance of the Board, its committees and of individual directors was conducted during the year. Having engaged an external consultant to conduct last year's evaluation, the exercise was conducted internally this year. Each director completed a detailed questionnaire prior to a one-to-one meeting with the Chairman. The questionnaire was prepared by the Chairman and Company Secretary and was designed to address strategic issues and succession planning, as well as the approach of the Board to operational and financial matters, the role of the non-executive directors and the quality of information received by the Board. The performance of NWL's board, committees and individual directors was evaluated at the same time. Except in relation to Heidi Mottram and Margaret Fay, who have been appointed directors since the last AGM and will seek election as directors for the first time at this year's AGM, the Chairman's comments on the evaluation of the directors seeking annual re-election at the AGM are provided in the Notice of Meeting. The comments of the Senior Independent non-executive director on the evaluation of the Chairman are also provided in the Notice.

External appointments

Executive directors have generally 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. On 1 November 2009, John Cuthbert was appointed as a non-executive director of Bellway plc. This appointment was made following John's decision to retire from the Group earlier in the year.

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.

Nomination Committee

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 usual policy is to use external recruitment consultants or to advertise in order to identify suitable candidates.

Following the announcement of John Cuthbert's retirement, the Committee initiated a search for a successor. Heidi Mottram was identified as a suitable candidate by recruitment consultants and then interviewed by a specially authorised sub-committee of the Nomination Committee. She then had discussions with the Finance Director before her appointment was recommended to the full Nomination Committee and then the boards of NWG and NWL.

In addition to the appointment of Heidi Mottram, the Committee also recommended to the NWG and NWL boards the appointment of Margaret Fay, as an additional independent non-executive director. The Committee felt that an additional non-executive with strong business and political contacts, especially in the north east, would be a valuable addition to the boards. Margaret Fay was regarded by the Committee as an ideal candidate for this role and she was, therefore, approached by the Company to discuss the opportunity.

The Committee also considered extensions to the appointments of non-executive directors on the NWG and NWL boards whose contracts for services expired during the year. An extension to the appointment of Sir Derek Wanless took him into his seventh year as a non-executive director of the NWG Board and, having been subject to a rigorous review as required by the Combined Code, the Committee remains satisfied with his performance. Non-executive directors are appointed for a term of one year and all directors are now subject to annual re-election at the AGM.

The members of the Nomination Committee are now Sir Derek Wanless (chairman), Sir Patrick Brown, Heidi Mottram, Martin Nègre, Alex Scott-Barrett and Jenny Williams, and the membership is compliant with the Code.

Accountability and audit Audit Committee

The Audit Committee members during the year were 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. On 1 April 2010, Martin Nègre was appointed as an additional member of the Committee.

The Committee's membership complies with the Code. The Chairman and executive directors 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.

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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 controls (both financial and IT) 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, as detailed on pages 65 and 66;
- 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 financial approval rules;
- reviewing the Group's tax strategy;
- reviewing NWL's contract terms;
- 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 process.

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 revised 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.

On 26 May 2010, 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 believes that, as explained below, 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 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 2009/10 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 use of our standard accounting manual by finance teams throughout the Group ensures that transactions and balances are recognised and measured in accordance with prescribed accounting policies and that information is appropriately reviewed and reconciled as part of the reporting process. The use of a standard reporting pack by all entities in the Group ensures that information is gathered and presented in a consistent way that facilitates the production of the consolidated financial statements.

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. An additional risk-mapping exercise undertaken during the year is described on page 50.

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 executive directors 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, during the year, consisted 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). Heidi Mottram (Chief Executive Officer) joined the management team on 1 April 2010, following John Cuthbert's retirement. 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.

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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 pages 52 and 53, 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 executive directors 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 a monthly basis, the executive directors 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 executive directors 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.

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. 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
1 June 2010