

By Gareth Llewellyn

The management of non-financial risks facing a business is essential not as part of a corporate governance box-ticking exercise but as part of maintaining a healthy or improved balance sheet. National Grid, as an international energy supplier, has been aware for some time of the importance of non-financial risks to its financial strategy. The author outlines some of the ways the company has managed such risks, to its benefit and to that of its shareholders.

# the Importance of Non-Financial risks to the bottom line

In recent years shareholders have become increasingly sophisticated in both the information they expect companies to provide, and their level of scrutiny of a company's performance. The now aborted OFR requirements envisaged a world

where companies themselves determined what information would be of relevance to shareholders in making a decision on their investment. This of course pre-supposes that companies themselves have a sufficient grasp of the risks posed to and by their business, and the relevance of those risks to the interests of their shareholders.

### Non-Financial Risks and Their 'Rising Profile'

In 1999, the Turnbull report looked at the role of the Board in assessing the robustness of corporate internal controls put in place to minimise risks and maximise opportunity. The step change introduced in this report had less to do with changes to the internal control framework than to the extension of the existing framework to cover non-financial risks. Hitherto, the focus had been predominantly on financial risks relating to liquidity, credit and market issues.

The focus on non-financial risks (i.e. those that are non-financial in origin but could have a financial or reputational impact) has taken some time to develop. There have been some concerns that the recent decision by the UK Chancellor of the Exchequer no longer to require companies to produce an Operating and Financial Review would again restrict the corporate view of risk primarily to financial issues. In fact, most large companies are already beyond this point. From many Annual Reports it is clear that companies are already quite open about revealing issues affecting daily corporate operations. Many of these issues are expressed at a level which provides useful context for an existing investor, but not for potential investors in a company.

Nevertheless, to see non-financial issues solely in the context of external reporting is to miss a significant business opportunity. Improving profitability by increasing operational efficiency is just as much about managing non-financial issues as it is about financial control.

### Employee Health

For example, employee health is an issue for all companies. Most CEOs will no doubt agree that

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the welfare of their most important asset is extremely significant for business performance. As for how important employee health is to a business, it is likely that few CEOs would know for instance the cost of their sickness absence. A company with 10,000 employees and an average absence rate of 3.1% (the low end of the range for industry from 1997 to 2001) of workdays lost will lose around GB£12m from the bottom line. BT identified that employee stress has resulted in direct losses of GB£1m per month, and indirect losses of around GB£3m per month. In National Grid's 2004/5 Annual Report and Accounts, it reported a sickness absence figure of around 2.4% for its UK operations and 3.5% in the USA. This rate of absenteeism, while average for the sector, was costing the company around GB£35m per year. By setting bonus-related targets for managers across the world, the company has already seen a benefit of over GB£7m, with managers taking a more proactive interest in the well-being of their teams. Consequently, it can be seen that a proactive focus on employee welfare can be as beneficial to the bottom line as it is to the health and morale of the workforce.

### Climate Change

Climate change has also risen up the agenda of companies involved in the recent EU emissions trading scheme. When the first phase of the scheme started in January 2005, the cost of carbon was around €4 per tonne of carbon dioxide. At the end of 2005, this figure was closer to €25 per tonne. On the face of it, this is a relatively minor change, but with some businesses receiving allocations of 1 million tonnes and more, the value of the asset has grown to a point of being potentially material.

As a world supplier of energy, National Grid finds itself at the centre of the debate on climate change. Its strategy has centred on a belief that,



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for most businesses, irrespective of their sector, climate change is really an issue of efficiency. Greenhouse gas emissions are a reflection of how efficiently we run our operations, and any drive to reduce emissions has to be good for the business. With the increase in energy prices over the past year, energy efficiency within operational and non-operational property can potentially bring significant benefits. With an energy bill currently in excess of GB£30m, an efficiency saving of just 5% is sufficient to cover the premium of moving completely to renewable energy. For companies with significant motorised vehicle fleets, efficiency is also the issue. For example, cars with emissions greater than 275g CO<sub>2</sub> per km can cost around GB£3500 or more in fuel costs alone when compared to cars with lower emissions. Scaled up across a fleet, these figures demonstrate that 'saving the planet' also 'saves' the company.

Consequently, it appears that an environmental issue has led, for some companies at least, to a change in the content of the balance sheet.

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### Safety

Many businesses view employee safety as being limited to slips, trips and falls, an unavoidable but natural part of business life. While directors are generally aware of their legal obligations to guarantee the safety of their employees, few understand the financial impact of poor safety performance. In one HSE example, a worker was injured while using an unguarded drill. The incident cost the company GB£45,000, the Managing Director was prosecuted, and the company had to make two people redundant to

stay in business. The financial benefits of a good safety record are illustrated by South West Water; between 1992 and 1998, improvements in safety saved the company over GB£2.5m.

In 2001 National Grid stated its vision for employee safety. At the heart of this vision was a belief that the company should aim to ensure zero injuries every day. Progress towards this goal has been good with 27% reduction in lost time injuries in 2004/5, and 24% in 2005/6. Safety is a moral issue, but is it all too easy to overlook the financial benefits of such improvements to the company. Using established measures, this level of improvement has benefited National Grid's bottom line by around GB£11m.

The benefits of a good safety record to employee morale, and thereby workforce retention, should not be underestimated. People expect to work in a safe environment and will 'vote with their feet' if they feel they are at risk from poor practices. The resulting need for recruitment and training in such circumstances is the hidden cost of poor safety performance.

### Morale and Motivation

One final area where the management of non-financial risks can reap significant rewards is that of employee morale and motivation. In 2004, National Grid undertook an employee opinion survey across its international operations. The survey canvassed the views of staff on issues as diverse as their awareness of company strategy, their perception of communications, safety practices and ethical behaviour. It was clear from the survey results that employees had significant empathy with the company's commitment to the management of key non-financial risks. The top four areas where employees empathised most with company commitment were safety, environmental performance, ethical behaviour and customer service. This indicates that employees want to work for a responsible business and be proud of its actions. All managers know the importance of a

well-motivated workforce if a company is to be profitable, and an employee view of how well the company manages non-financial risks is clearly an important factor in their motivation.

There are many other examples of companies adopting a proactive stance on non-financial issues, avoiding costs, reducing risks and enhancing their reputation. These are the benefits of a sound internal control framework applied to the extended list of risks proposed in the Turnbull report, and now enshrined in the revised 'Combined Code'.

### Management and 'Embedding' of Non-Financial Risks


In 2002, National Grid established a new Board Committee to oversee management of non-financial risks. The Risk and Responsibility Committee, made up solely of Non-Executive Directors, works closely with the Audit Committee to ensure that governance of all risks provides bottom line benefits. This is a recognition that improving environmental and social performance is more sustainable in the long run, if it also contributes to the value of the company. In determining the risk management priorities for the business, the Committee uses a 'Framework for Responsible Business' as its point of reference. This framework, created in 2001, states how financial and non-financial management will contribute to the corporate goals of:

- o sustainable growth
- o profits with responsibility
- o investing in the future

## Bonus-related performance targets linked to non-financial issues have proved the most useful tool in driving the bottom-line improvements envisaged by the Committee

The framework makes it clear that respecting human rights is a key component in ensuring long-term growth, managing waste makes an important contribution to profitability, and training and developing employees is a vital investment in the future of the company.

As it considers strategies on issues such as climate change, health management and inclusion and diversity, the Committee is mindful that the most effective way of embedding non-financial risk management into the business is to link these issues directly to financial performance. Bonus-related performance targets linked to non-financial issues have proved the most useful tool in driving the bottom-line improvements envisaged by the Committee.

Although for some companies corporate responsibility has been limited to soft issues such as community investment, or simply to an exercise in communications, when it works effectively, it is about managing non-financial risks. By applying responsible business practices throughout a business, it is possible to see real improvements to the bottom line, and also bring corporate responsibility from the periphery into the core of business strategy. 



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In the UK, National Grid is currently 2nd in Business in the Community's Corporate Responsibility Index, a constituent of FTSE4Good and in the 'premier league' in the environmental index. National Grid is also one of only two multi utilities listed in the Dow Jones Sustainability World Index. Gareth also presented at the CriticalEYE OFR Summit in November 2005.

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