

USS RESPONSE TO THE OPERATING AND FINANCIAL REVIEW

Kate Marshall
Corporate law and Governance
Department of Trade and Industry
Bay 4100
1 Victoria Street
London
SW1H 0ET

Your Ref:
Our Ref: PGM/dr/KM0408
Date: 4 August 2004

Dear Ms Marshall

Re: Submission for the Operating and Financial Review Consultation

I am writing to you on behalf of the Universities Superannuation Scheme Ltd, one of the UK's largest private sector pension funds, with assets of over £19 billion. USS Ltd welcomes the opportunity to respond to your consultation document.

As an institution that takes seriously its responsibility to be an active and long term investor, USS Ltd is of the view that disclosure of company strategies, risks and opportunities is essential if shareholders are to be able to make informed decisions on the likely long term performance of investments. USS Ltd therefore welcomes the introduction of the OFR as an opportunity for companies to be able to provide investors with details of long-term strategies and their implementation. The Fund also welcomes the coverage of governance and social and environment issues in the OFR for the same reasons, these are currently areas where companies are not reporting on key risks and opportunities to shareholders as effectively as they might or as is presumably happening internally to senior executives and the board.

USS Ltd believes that disclosure of risks and opportunities associated with these issues should be central to any corporate reporting, as extra-financial issues could significantly impact on the value of the companies in which we invest. Management of human capital, the costs and benefits of mergers and acquisitions, exposure to climate change, the importance of good corporate governance: there are a wide range of extra-financial issues where additional information would be of benefit to investors, and the OFR appears to be an excellent vehicle for provide it.

USS is of the opinion that in many cases, how a company is exposed via it operations to extra-financial factors, and how these exposures are managed, will fit the “materiality” or “to the extent necessary to understand the business” as defined in the Accounts Modernising Directive and the consultation document itself. USS Ltd believes that market largely lacks the information and tools to be able to assess accurately the implications of the extra-financial issues being requested in the OFR. Companies, on the other hand, are often managing these issues well, but failing to pass the information to shareholders via mainstream reporting or in meetings, and are therefore missing a potential opportunity to differentiate themselves from competitors. The OFR will therefore provide an excellent opportunity for more focussed communication on these issues.

The best companies are already providing shareholders with information well in excess of those required in the OFR, and therefore USS Ltd views the OFR as an opportunity to raise the standards of reporting on these issues across the market. The 2002 guidance by the Institutional Shareholders Committee required that shareholders be active in their ownership: the information required in OFRs will enable shareholders to put this guidance into better practice.

USS Ltd also agrees that directors need to take responsibility for the management and reporting of these extra-financial issues, which often have a significant bearing on the value of companies.

I would also like to comment on the recent upsurge of comment arguing for a delay to the start date. The OFR project has been in the development for some time now and a blanket delay would, I feel, be counter-productive. There may be a case for phasing some aspects of the project or for phasing levels of detailed required but whenever one starts, this will be the case. In any event, there is a strong case for actively structuring the initial phase in line with good practice thinking on “learning by doing”.

As long-term investors in the UK stock market and in most companies, we naturally have an interest in their well being. Where risk and reward is inaccurately priced by the market because of information asymmetries, it is pension fund members who generally end up picking the tab in one way or another. It is for these reasons that I hope that you find our submission persuasive and if you wish to discuss any of these issues further, please do not hesitate to contact me.

Yours sincerely

Peter Moon
Chief Investment Officer

USS Ltd Response to the Operating and Financial Review Consultation

Climate change and carbon exposure

USS Ltd welcomes the fact that the risks and opportunities associated with climate change are explicitly highlighted in the document. This issue poses significant challenges, both long and short term, for the companies in which we invest and to date far too little of the strategic response to this challenge has been reported by companies.

We would therefore expect the government to ensure, via its evaluation process, that companies appropriately confirm that the risks associated with climate change, from both policy and environmental perspectives, have been assessed and, if they exist, they are being appropriately managed. This would include both mitigation of carbon exposure and any potential adaptation to a changing climate within business strategies. Therefore, USS Ltd urges that, in the evaluation process undertaken to assess the quality and legality of these reports, special attention is given to the reporting of climate change risks.

We are also supportive of the comments made by the Institutional Investors Group on Climate change, which has responded separately to this consultation process.

Guidance for companies

Guidance will be needed to enable companies to identify what KPIs they need to use and report on. This is particularly the case for smaller companies, which are not used to reporting on SEE or other extra-financial issues. Indicative KPIs should be developed by government in consultation with companies, investors and other stakeholders to ensure that they are both applicable and useable by the end audience.

Question 2

USS is of the view that non-UK companies listed on the London Stock Exchange should comply with the requirements, as the information is still valid to UK based shareholders (a similar example to this would be the requirement for UK companies listed in the US to comply with the US Sarbanes Oxley Act).

We also believe that consideration should be given to extending the requirement for an OFR to large unlisted companies. Unlisted companies use the debt markets to raise capital and therefore investors are potentially exposed to them via this route. Issues which affect listed companies are also just as likely to impact upon unlisted companies and therefore access to OFRs is equally valid.

Question 4

USS Ltd is of the view that companies should be required to, as under the Combined Code, comply or explain: that is, if they omit details of particular potential risk issues, for example of the [types identified in section 4-7 of 7ZA](#), they should explain why such an omission has occurred. Without this, we cannot be sure that appropriate assessment of the issues has been undertaken. Such a comply or explain requirement is likely to improve the level of information supplied, and make companies consider more closely the significance and materiality of information for inclusion in the Review.

However, as with the Association of British Insurers (ABI) Guidelines for CSR reporting, which were developed by investors to encourage the voluntary disclosure of social, environmental and ethical risks in annual reports, companies should not be expected to include all details on all issues in the OFR. This could make the reports unwieldy and unusable by their intended audience, as relevant and important information could be lost in a fog of paperwork. Therefore, as with the ABI Guidelines, back-up and detailed information should be available via other reports produced for shareholders – e.g. annual reports, CSR/sustainability/environmental reports or from the company's Internet site – and signposted where necessary in the OFR.

Question 10

Some concerns have been raised by other commentators that the processes and systems necessary for the introduction of the OFR requirements in 2005 are too time constrained and therefore the process should be delayed. It is our view that with the introduction of any new system, there will always be learning experiences to go through and the introduction of the OFR is likely to be no exception. USS is of the view, therefore, that the

best course of action would be to get the OFR process up and running as proposed in the consultation. If there are concerns that the process is too time constrained with a 2005 deadline, then the most appropriate action for government is to ensure that the processes needed for timely adoption are adequately resourced. USS Ltd is therefore strongly opposed to any delay in the process.

That said, as indicated in our covering letter, USS Ltd believes that mechanisms for encouraging companies could be used to ensure that the system develops and becomes established. One way to do this would be for the compliance processes associated with the OFR to be phased in their implementation. Therefore, in the first year of operation, i.e. 2005, the processes should be in place to ensure that companies produce OFR's, but that the compliance processes regarding their content should be more flexible in this first year. We believe that this would permit companies greater experimentation with the types of information they include in the Reports, and enable a better learning environment for companies to assess their development of OFRs: this would help to avoid the boiler-plate that many commentators have highlighted.

Question 12

We are concerned with the idea that the OFR should be sent to all shareholders: this appears to be an additional financial and environmental cost that may be excessive. USS Ltd is of the opinion that summaries of the OFR should be possible, highlighting key points (as with summaries of current annual reports). Shareholders could then request full copies of the OFR if they wish access to it, and the full reports should also be made available to shareholders and other stakeholders via the internet (increasing numbers of listed companies maintain corporate internet sites).

In addition, the Government could consider establishing its own internet site to enable access to OFRs as they are submitted to the assessment body/listing body. The resources associated with this would not be significant, and it would provide a valuable resource.

Question 13

USS Ltd believes that there will not always be a need for details of Governance structures to be incorporated in the OFR, as these will be covered in other documents available to shareholders. That said, we would welcome additional information on and therefore guidance for companies regarding the reporting of governance structures where they relate to issues covered in the OFR (for example, identification of a NED responsible for CSR issues, whether there are elements of remuneration relating to CSR management, etc).

The issue that this raises, as with question 4, is that there needs to be a sensible process within the OFR for avoiding duplication: i.e. what goes in the annual report re risks (e.g., internal control statements as per current Turnbull guidance and subject to the current review, CSR risks and the ABI guidelines), CSR reports, etc. There needs to be a reference to the ability for companies to provide additional (non-core) information in additional documents. This should be worded in such a way as to avoid giving companies a signal that information is not needed, but to indicate that they have options to provide additional detailed information so the OFR is not a tome.

Question 17

Whilst there could be additional costs associated with collection and management of information associated with the OFR, and with the Board time (including the Audit committee) in consideration of OFR reporting, USS Ltd believes that such costs will be outweighed by the benefits of the OFR process to investors.