



Jonson Cox
Chairman
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

31 October 2013

Dear Jonson

Board leadership, transparency and governance – principles

Thank you for your letter of 19 September 2013 concerning Ofwat's consultation on Board leadership, transparency and governance. Our Board has now considered the principles and expectations set out for consultation and our observations are set out in this reply.

Our Board is committed to the highest standards of governance and is supportive of the principles of good corporate governance set out in the UK Corporate Governance Code and the UK Stewardship Code. At the core of the Code, is the recognition that a "one size fits all" approach does not reflect the diversity of the corporate world. The principle of "comply or explain" has endured throughout the evolution of the Code and has become the trademark of corporate governance throughout the business world. This approach allows flexibility, whilst ensuring that boards are accountable for demonstrating strong governance, leadership and transparency. The Code recognises that departure from specific provisions may be justified, where good governance can be achieved by other means, provided reasons for the departure are clearly explained. Our Board advocates a similarly flexible approach, whilst expecting fully to meet the principles and expectations set out by Ofwat, subject to the comments below.

Ownership models in the water sector vary widely from private companies with a single or small number of shareholders at one extreme to listed companies with widely distributed ownership at the other.

The former have executive board members, non-executive directors (NEDs) appointed by their shareholders and independent non-executive directors (INEDs) whilst the latter generally have only executives and INEDs. In the latter case, INEDs are required to be independent of management to manage the agency problem between management and shareholders. Thus they need to be in the majority versus executives. The current trend in code development for listed companies is to require shareholders to take a stronger more active role in company governance and this is evident in the UK Stewardship Code.

The shareholders in the privately held water companies are predominantly infrastructure funds and they are active investors who are represented on the board of the company usually in proportion to their ownership. They eliminate the agency problem between management and shareholders. Thus INEDs in these companies must be independent of both management and shareholders. They bring an invaluable perspective which, in the case of regulated water companies, includes an understanding of the interests of customers and how these can be respected and protected - but good governance does not require them to be in a majority over shareholder NEDs. Affinity Water has three shareholders represented on the Board and two shareholders represented on its Audit, Remuneration and Nomination committees.

In our Annual Report for 2012/13, we set out the changes in governance the Board has implemented since the change of ownership in 2012 and signalled further changes we would implement in 2013/14. In July 2013 we appointed an additional independent non-executive director, Patrick Bourke, to strengthen and balance the Board and to chair our Audit Committee. We also explained that the composition of our Board does not meet the Code provision for at least half the Board, excluding the chairman, to be non-executive directors determined by the Board to be independent. However, the composition is consistent with the Code's principle that no single director or group of directors can dominate the Board's decision making because:

- no individual investor has a majority of voting rights and none of the directors appointed by investors is individually able to veto Board decisions; and
- there is no arrangement between investors as to how to vote on particular matters; directors representing an investor act independently of those appointed by the other investors.

Each director understands his or her duty as a director to exercise independent judgment and, in discharging his or her duties, to have regard to customers, the long term consequences of decisions and the Company maintaining a reputation for high standards of conduct. As a Board, we value the contribution that all of our non-executive directors bring to the governance of the Company, and believe that the balance of skills, experience, independence and knowledge of the Company ensures strong leadership and governance. We are committed to maintaining significant independent representation on our Board and its Committees and our governance code will confirm we will retain four independent non-executive directors on our Board, alongside a chairman.

Our Board has not reserved any matters to shareholders for approval (there are matters which company law requires shareholders to approve). Should shareholders intervene with respect to a particular board decision, we would inform Ofwat and disclose this in our Annual Report.

Finally, I would emphasise our Board's continuing commitment to demonstrating leadership, transparency and governance. We believe that a self-regulatory approach is the right way forward and will provide flexibility to respond to changing circumstances of regulated companies and future developments in governance.

We are working to finalise our governance arrangements which we will set out in our governance code and submit to Ofwat in December and I would welcome the opportunity to discuss these arrangements with you prior to submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Phil Nolan', written in a cursive style.

Phil Nolan
Chairman