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Your ref

Our ref

Date

31 October 2013

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Dear Jonson

Board leadership, transparency and governance - principles

Thank you for your letter of 19 September 2013 in respect of your informal consultation on draft principles.

As you will know, since I last wrote to you in June, we have published the annual reports and accounts for 2012-13 for both Southern Water and our holding company, Greensands Holdings. Having regard to the UK Corporate Governance Code, we included in those reports and accounts extensive disclosure on our corporate governance. We have also made further information available on our website, including our compliance with the Code.

We have been working on codification in the spirit of the Code for those areas where the Code is less directly applicable. Accordingly, we welcome your consultation on draft principles. We support your preference for self-regulation and I am pleased to enclose Southern Water's comments on your draft principles.

We are committed to maintaining high standards of corporate governance and are continuing to develop our own code to incorporate and reflect the relevant principles. We support your initiative and intend to achieve codification of governance that is appropriate to our structure and our service sector.

Yours sincerely

A handwritten signature in black ink, appearing to read "Colin Hood".

Colin Hood
Chairman

Board leadership, transparency and governance – principles: informal consultation

Southern Water's Comments

Board leadership, transparency and governance – principles: informal consultation

Southern Water's Comments

We welcome the publication of Ofwat's principles for board leadership, transparency and governance. We agree that it is important that the water sector operates to the highest standards of leadership and governance. In an industry supplying essential services, it is important that companies focus on customer service and apply good corporate governance. Southern Water is committed to maintaining high standards of corporate governance.

Ofwat and its Chairman have issued various papers and delivered speeches over the last nine months that promote customer legitimacy. We see leadership, transparency and governance as being a key part of ensuring customers are informed and are able to continue to have their say in services being delivered.

We support Ofwat's preference to introduce a self-regulatory approach. Good governance is dynamic and embedding a prescribed approach to governance in company licences could lead to less flexibility for companies to evaluate and continue to improve their governance in response to changing economic and social conditions and standards. We believe that board leadership and good governance are key features of board ownership of the company's business plan.

Principles of Good Governance

Corporate governance is the framework by which operational and behavioural standards for the Board, executive management and wider staff of companies are set. The governance system is underpinned by the following corporate governance principles -

- Boards of directors are responsible for the governance of their companies;
- Directors are responsible for promoting the success of the company for the benefit of its stakeholders as a whole, including shareholders;
- The actions of boards of directors must always be considered in the context of the obligations and responsibilities of directors to the company.

A large portion of the UK water industry is owned privately by institutional shareholders. These shareholders comprise, inter alia, pension funds, insurance companies and corporate entities that bought into the industry on the basis of historically stable, transparent regulation. Unlike an investment in a listed company, the shareholder's investment is not liquid. Accordingly, the shareholder requires satisfactory engagement between the company board and the shareholder (directly or via the ultimate parent board).

Satisfactory engagement may take a different form for each company but may include investor nominated directors being on the regulated company (RegCo) board and board committees and some matters being reserved for the ultimate parent company or shareholders. Key is ensuring the appropriate balance between the level of shareholder engagement and the responsibility of the directors. Provided the engagement is transparent, this can represent good governance and leadership. Furthermore, shareholder engagement is viewed by active shareholders as discharging their responsibilities under the UK Stewardship Code.

Ofwat's Draft Principles

Ofwat has set out a series of principles that company boards can build on in developing their own leadership and governance codes. We welcome this approach, as it is important that company boards take ownership of leadership, transparency and governance.

The draft principles focus significantly on the independent non-executive directors. It is important to balance this focus with the fact that the RegCo board is a unitary board where all directors take collective responsibility for the board decisions. All directors are subject to the same legal and regulatory requirements.

Generally, the draft principles are expressed to allow flexibility of application. We support this approach as it recognises the practicality of different ownership structures and enables companies to strike a balance between the interests of the company and its stakeholders, including customers and shareholders. We also recognise that this approach requires a continuing dialogue between the companies and Ofwat in order for Ofwat to be satisfied that an individual company's approach satisfies the principles.

Accordingly we would welcome a discussion with Ofwat on Southern Water's governance model, how we are continuing to work to best practice in this area and the further action we are taking to achieve governance that is appropriate to our structure and our service sector.

We comment on each of the draft principles in turn.

Draft Principles	Comment
1. Transparency – reporting must meet or exceed the standards set out in the Disclosure and Transparency Rules (DTRs)	As a provider of an essential public service, greater transparency is encouraged, though it is not clear which DTRs specifically should apply.
Reporting to reflect material issues	Unlisted companies could apply or exceed DTRs 1B (<i>Introduction (Corporate Governance)</i>), DTR 4.1 (<i>Annual Financial Report</i>) and DTR 7 (<i>Corporate Governance</i>) only. The balance of DTRs would appear to be inappropriate for private companies but could apply to the listed water and sewerage companies. “Material issues” is a general concept but allows companies to own the appropriate level of disclosure to ensure transparency. While many listed companies provide details on group structure on their website, there is no requirement on listed companies to do so. Although it is a matter for each company to disclose if it supports an appropriate level of disclosure and promotes transparency, we believe that disclosure of the group structure promotes good governance and customer legitimacy. We agree that disclosure will need to be accessible via the company annual report or website
2. The RegCo must act as if it is a separate public listed company	RegCos are ultimately controlled by shareholders so it is not clear what the phrase “full control” is seeking to achieve. Nevertheless, we support a well informed and high quality RegCo board having ownership of strategy and providing clear direction for management.

The RegCo board must, however, act in accordance with corporate law, relevant regulation and corporate governance principles, including taking consideration of shareholder views and shareholders' legitimate expectations for the company. These may include appropriate rights reserved to shareholders under their shareholders agreements.

The illiquid nature of investments in private companies and the consequent engagement between the RegCo board and shareholders (directly or via the ultimate parent board) can be reflected in a RegCo's own code adopting these draft principles.

Given the nature of reserved matters under a shareholders agreement, it is expected that reserved matters would only be exercised by the parent company board or shareholders by exception. Further, where reserved matters are determined by the ultimate parent company board or shareholders, the matter could be disclosed in the annual report.

In this respect, the reserved matters are similar to how shareholder resolutions are treated at a listed company annual general meeting.

3. An effective Board is fully focused on the RegCo's obligations

We agree that the board should be focused on the RegCo's obligations and legal obligations more generally.

Where an ultimate parent company board sits routinely with the RegCo board to consider the operational and financial performance reports, we do not believe that this detracts from the principle. In our view, the contemporaneous meeting of the boards greatly enhances discussion and understanding of the decisions and issues for RegCo and its directors and fosters support from the shareholders through their appointed representatives. It operates in effect as a unitary board.

To ensure good governance, specific responsibilities of the RegCo board can be reflected in the processes and decision-making procedures of the board. Parent company directors sitting with the RegCo board should have no right of decision or vote over matters to be determined by RegCo.

Where specified matters are to be determined by the parent company board or shareholders, the nature of these matters should be disclosed.

4. There must be significant independent representation on the Board

We agree that there should be significant independent representation on the RegCo board.

In addition, where a company is privately owned, we support the appointment of investor nominated directors to the RegCo board to ensure that shareholders' views and their expectations for the company are made known to the board. The number appointed could be equal to or less than the number of independents.

The presence of investor nominated directors facilitates the application of the corporate principle that actions of the boards of directors should be considered in the context of all stakeholders, including shareholders.

While we agree that a board with a strong independent element is well placed to take decisions that are focused on the interests of RegCo, those decisions must be taken in the context of corporate law and corporate governance principles, including due consideration of the interests of shareholders.

5. Independent non-executive directors are essential to securing strong Board leadership and governance

We agree that independent non-executives make a valuable contribution to the board through the challenge they provide and the different perspectives they bring.

Underpinning the quality of the challenge is the need to ensure that the RegCo board is populated with quality independent non-executives, which is the basis of the next principle.

6. In line with best practice, boards should have the appropriate balance of skills, experience, independence and knowledge of the company

We agree that the RegCo board should ensure that the board and its committees have the appropriate balance of skills, experience, independence and knowledge of the company.

How each RegCo implements the evaluative aspect of this principle should be a matter for itself, provided the process is rigorous, transparent and represents good governance.

We agree that the replacement and appointment of directors to the board should be pursuant to a transparent process that is set out in terms of reference that are available to all stakeholders.

While we support having a nomination committee at the RegCo level to lead the appointment process and make recommendations, we believe it is important that the shareholders retain their rights in respect of non-executive director appointments. We consider this best achieved by shareholder directors constituting an equal number of members of the nomination committee. Under Condition P, RegCo's Ultimate Controller is required to give legally enforceable undertakings to ensure that the RegCo board contains not less than three independent non-executive directors that have

the appropriate balance of skills, experience, independence and knowledge. An equal number of members of the nomination committee allows the Ultimate Controller to satisfy this requirement.

7. The Chairman must be independent of management and investors

We support the principle that the Chairman must be independent of management and investors.

8. Board committees, including but not limited to audit and remuneration committees will operate at the RegCo level

We support the principle that board committees should operate at the RegCo level.

9. There should be a majority of independent members on the audit and remuneration committees

We support the principle that there should be a majority of independent members on the audit and remuneration committees. This principle needs to be balanced, though, with the shareholders' important role in setting the structure of management incentives and we believe that the appointment of investor directors to the remuneration committee facilitates the role. The position also reflects Business Secretary Vince Cable's position on two new proposed binding shareholder votes being i) pay policy that needs majority shareholder support every three years, and ii) an annual advisory vote on last year's pay settlements.

Recommendations made by the committees may nevertheless be subject to ultimate parent company or shareholder approval if required. Any instances of non-approval could be disclosed in the annual report.

We agree that membership of committees, attendance and terms of reference should be reported transparently.

10. The group structure must be explained in a way that is clear and simple to understand

As noted above, there is no requirement on listed companies to provide details on a group's structure. While it is a matter for each company to decide, we believe that disclosure of the group structure promotes good governance and customer legitimacy.