

Board leadership, transparency and governance – principles

About this document

This paper sets out the principles that we expect companies operating in the water sector in England and Wales to apply.

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Board leadership, transparency and governance – principles

Part 1

1. Introduction

These principles set out the minimum Board leadership, transparency and governance principles that we expect each company to apply. We [consulted on our proposals](#) in September 2013 and each of the non-confidential responses are available on our [website](#). We have also published a summary of the comments that we received and where we have taken them into account in our final principles.

Most companies have a series of obligations in conditions F, P and K of their licences that encompass Board leadership, transparency and governance issues.

These conditions were put in place in the late 1990s and have largely remained unchanged since then. The obligations were put in place to ring-fence the regulated company; to make sure that there were safeguards to allow the regulated company to operate independently and have corporate governance standards commensurate with those of companies listed on the London Stock Exchange. In part, these conditions protect the regulated company (and its customers) from any potential negative impact should failures occur elsewhere in the group.

Since these obligations were introduced the world of corporate governance has changed. The standards that apply have been tightened, in the wake of significant failures in some markets. In addition, there is now greater focus in the media and elsewhere on the Board leadership and governance of individual companies. Customers, quite reasonably, expect companies that provide an essential public service to demonstrably operate to high standards of governance and leadership. Meeting these principles will allow the water sector in England and Wales to demonstrate that it recognises and fully meets the responsibilities that come from providing an essential public service. These principles set out our minimum expectations. We consider that the adoption of these principles, particularly by those companies that are in private ownership, will demonstrate that the water sector fully understands the need for it to operate transparently in the public interest.

The existing licence obligations were developed in the context of an environment where most of the larger water companies were part of a group that was listed. Companies with a listing on the London Stock Exchange are subject to the listing rules and the discipline that places on them both in terms of standards to which they must adhere and the way in which they report. The nature of ownership in the water sector has changed. The rise of more companies in private ownership has led to more complex structures and governance arrangements in some companies. In the light of this, we have reviewed current approaches to Board leadership, transparency

and governance. This review has highlighted areas for improvement in the water sector. From this, we have developed a set of principles that represent the minimum standards for Board leadership, transparency and governance for companies operating in the water sector.

We are introducing a self-regulatory approach, where companies' Boards take the lead in setting out how they meet or exceed our principles. We have adopted this approach as it means that ownership of Board leadership and governance rests where it should.

We recognise that in due course we will need to update companies' licences to bring them all into line with companies' practices.

We will review these guidelines and principles in January 2017, at the latest. Should the wider governance environment evolve – for example, changes to the UK Corporate Governance Code – we will review our published principles to make sure that they remain 'fit for purpose'.

2. Better Board leadership, transparency and governance

We are changing the way in which we regulate. By doing this, we are seeking to change the culture of the water sector and to facilitate companies taking greater ownership of and accountability for delivery to customers, now and in the long term. Regulating in this way should allow companies to focus on more innovative and sustainable ways of delivering for customers.

We are giving companies greater ownership and accountability by placing less emphasis on simply meeting regulatory requirements and by moving to a less intrusive regulatory approach. Implicit in this is the expectation that companies are operating to high standards of Board leadership and governance.

Water companies are responsible for providing a vital public service. It is in the interest of all customers that this service is provided without interruption and at the right service level. How a company is governed and led will play an important part in the delivery of the service it provides. A lack of strong Board leadership and governance can lead to problems with service delivery to customers.

Given that the vast majority of customers cannot choose which supplier provides their water and wastewater service, it is vital that companies maintain legitimacy in the eyes of those customers. Significant investment will continue to be needed in the water sector and the willingness of customers to pay for that investment will be reduced if companies do not do so. Strong governance and leadership, with the correct focus on customers, together with properly transparent reporting, can play an important part in maintaining and sustaining this legitimacy.

Some of the challenges that the water sector now faces – for example, climate change and population growth – are long term in nature and we are looking to companies to deliver in the long term. The leadership and governance of companies is key to ensuring that there is an appropriate focus on this long-term delivery. In making their decisions we recognise that Boards weigh many factors and sometimes this may include resisting short-term pressures for returns in favour of securing that the company can meet its continuing obligations.

Governance issues across the economy have also been highlighted by the Government, and are reflected in the policy focus of the Department for Business, Innovation and Skills (BIS). It is for companies and their Boards to make themselves aware of and apply best practice in terms of governance – for example, by acting on guidance issued by the Financial Reporting Council and keeping abreast of Companies Act 2006 obligations such as where Regulations are issued.

We sought comments on our proposed principles in September 2013. We have welcomed the constructive and positive response that has largely been taken by the water sector, in agreeing to the content and coverage of the principles.

Companies have universally told us that they will have codes in place by April 2014 and will be meeting the principles by April 2015. We welcome this as a demonstration that this sector is taking leadership so that it can retain the confidence of its customers and all its stakeholders.

Companies' Boards should take all reasonable steps to enable their directors to understand their responsibilities and obligations as directors. They should also establish and maintain adequate procedures, systems and controls to enable their companies to comply with their obligations.

Where a company's UK holding company is listed on the London Stock Exchange, the principles should essentially already be complied with at a group level. So, we expect to see the same principles applied by the regulated company.

Any departures from the principles should be by exception in the spirit of corporate governance for listed companies. A FTSE 100 company or a company with a premium listing on the London Stock Exchange seeking to depart from the UK Corporate Governance Code would need to explain this carefully and exceptions from compliance are expected to be few. As our approach relates to the public interest, we expect companies to discuss any departures with us and to explain them to their customers.

Small companies – the new appointments created since privatisation and one pre-existing small company (Cholderton) – are not currently expected to apply the principles. This is consistent with our approach to other regulatory reporting requirements. But it would be good practice for them to have regard to the principles where relevant.

3. Our approach

The principles in part 2 of this document represent minimum expectations.

We fully expect that some Boards will wish to adopt standards that exceed these principles. This is an approach that we wish to foster and look to companies' Boards, and particularly independent Chairs and independent non-executive directors, to take the lead in embedding the principles and high standards of leadership and governance. We will focus our attention on those companies that are not meeting the principles.

Below, we set out the timetable for companies to adopt to put in place a code and to meet the principles. Some companies have already shared their codes with us and told us the steps they are taking to meet our principles.

Date	Action
By 1 April 2014	We expect all companies to share their codes with Ofwat, including any steps they need to take to fully meet the principles by 1 April 2015.
April 2014	We will examine companies' codes. We are expecting them to fully meet our principles, so expect any recourse to companies on the content of their codes to be limited.
By 1 April 2015	We expect all companies to have a code in place and be in compliance with their code.
July to September 2015	We will consider the approach that we take to confirming that companies are implementing their codes. Potentially, this could be a statement from the Board, as part of the regulatory accounts.
2015-16	Review with companies whether the relevant licence obligations remain fit for purpose. Pursue modifications should they be necessary, for example where a company is not meeting our principles.
January 2017	Review the content and coverage of the principles to make sure that they continue to be fit for purpose. (We recognise that circumstances may arise that could prompt an earlier review, such as revised standards emanating from the Financial Reporting Council.)

Board leadership, transparency and governance – principles

Part 2

1. Principles

Principle	Rationale and expectations
<p>Transparency – reporting must meet or exceed the standards set out in the Disclosure and Transparency Rules</p>	<p>A key theme that overarches the principles is transparency. As monopoly providers of a public service, we expect companies to operate to the highest standards of governance and to set out clearly how they do this.</p> <p>Companies with strong governance supported by transparent and open reporting will help maintain the legitimacy of the water sector. It is for Boards to consider how best to demonstrate how they meet the principles.</p> <p>We also expect reporting to reflect material issues. Typically, this would involve discussing areas such as:</p> <ul style="list-style-type: none"> · group structure; · company performance; and · the key risks to the business. <p>We expect companies to ensure that the information is accessible to the audiences for this information. It will be for companies to determine the best means of making this information transparent. Typically, that could be through the use of media such as the annual report, regulatory accounts and websites.</p> <p>We consider that the Disclosure and Transparency Rules set out the standard of disclosure that regulated companies should operate – wherever applicable. For example, we expect companies' Boards to make sure that the form and contents of the corporate governance statement meets the requirements of the Disclosure and Transparency Rules for listed companies.</p> <p>In relation to transparency around the remuneration of directors, we expect companies to consider</p>

Principle	Rationale and expectations
	<p>whether and how to take account of the requirements (since 1 October 2013) that apply to the Directors' Remuneration Report for a quoted company.</p>
<p>The regulated company must act as if it is a separate public listed company</p> <p>An effective Board is fully focused on the regulated company's obligations</p>	<p>We expect the Board of the regulated company to have full control of the business. It should have ownership of the strategy, and there should be a strong independent element to the Board to provide constructive challenge and help develop proposals. It should provide clear direction for management and create a framework that supports directors in meeting their statutory and regulatory duties.</p> <p>We expect the Board to be in a position to make well-informed and high-quality decisions based on a clear line of sight into the business, and to make decisions that are in the best interests of the regulated company.</p> <p>Given the long-term nature of the water sector, it is important that the Board of the regulated company has the powers necessary to make strategic and sustainable decisions in the interests of the company for the long term.</p> <p>We expect a position where, by and large, a unitary Board operates and decisions are made at that level.</p> <p>It is important for companies in the water sector that the composition of the Board of the regulated company is sufficiently strong and is equipped to make strategic decisions about all aspects of the business. It should be clear to all members of the Board what decisions it is responsible for, and what (if any) exceptions there are to this. Exceptions, such as limited matters reserved for holding companies, should be clearly documented.</p> <p>In practice, we recognise there may be decisions where, as an exception, the holding company Board is involved. As a guide, companies should consider the number and nature of matters that are reserved for shareholders in a listed public limited company when deciding what matters are reserved to the holding company Board. These should be clearly articulated in the annual report.</p>

Principle	Rationale and expectations
	<p>It should be clear to stakeholders that the Board of the regulated company is leading the company, both in terms of accountability and legitimacy.</p>
<p>There must be significant independent representation on the Board</p> <p>Independent non-executive directors are essential to securing strong Board leadership and governance</p> <p>In line with best practice, boards should have the appropriate balance of skills, experience, independence and knowledge of the company</p>	<p>The water sector is unique in the way it operates. So, it needs companies with Boards that are equipped to balance the conflicting needs of customers, the environment, the business and shareholders. The primary focus of the regulated company Board is the strategy to deliver the service and performance to meet these needs.</p> <p>The contribution of independent non-executive directors is invaluable to Boards as they provide challenge and a different perspective to Board members who are more operationally involved with the business, or Board members who represent investors. The UK Corporate Governance Code sets out the circumstances in which a non-executive director may not be considered to be independent.</p> <p>We expect independent directors (including an independent Chair) to be the largest single group on the Board, compared with:</p> <ul style="list-style-type: none"> i. executive directors; and ii. Non-executive directors who are not independent. <p>A Board with a strong independent element is best placed to make decisions that are fully focused on the interests of the regulated company, independent of other objectives.</p> <p>We acknowledge that investors (who own the business) have a legitimate place on the Board of the regulated company; however, the number of investor representatives should be no greater than the number of independents (excluding an independent Chair).</p> <p>In consultation with companies most told us that it is best practice to limit executives on the Board to Chief Executive Officer and Financial Director. We are not setting standards in this regard; but we expect that there will be fewer executives than independent non-executive directors on the Board.</p>

Principle	Rationale and expectations
	<p>We expect all directors to attend and fully participate in each Board meeting. Regular use of alternates for Board members has a negative impact on the continuity and efficacy of the Board. We consider that there is not a routine place for alternates on companies' Boards.</p> <p>A Board that comprises high-calibre individuals with a diverse but relevant set of skills and experience is best able to balance the needs of customers, the environment, the business and shareholders. Periodically reviewing the composition of the Board, as well as evaluation of individual directors, will ensure that it remains effective. Unlike some other regulatory frameworks, we are not considering a 'fit and proper' test for non-executive directors. We recognise that individual Board members will each possess different personal attributes and areas of expertise. The Financial Reporting Council's 'Guidance on Board Effectiveness' sets out the personal attributes that are demonstrated by effective independent non-executive directors that lead to ethical leadership.</p> <p>The Board of the regulated company should carry out a formal and rigorous evaluation of its own performance. It should act on any weaknesses it finds, and report on how the performance evaluation was conducted in the annual report.</p> <p>There should be a formal, rigorous and transparent procedure for the appointment of all new directors to the Board. In line with best practice, Boards should have the appropriate balance of:</p> <ul style="list-style-type: none">· skills;· experience;· independence; and· knowledge of the company. <p>Decisions around new appointments should be made in the context of the skills and experience of the whole Board, not solely on individual merits. There should be a nomination committee as part of the governance of the regulated company, made up of a majority of independent non-executive directors, which leads the process and makes recommendations to the Board.</p>

Principle	Rationale and expectations
The Chair must be independent of management and investors	<p>An independent Chair should be independent of investors and management. An independent Chair is best placed to generate effective debate and to provide constructive challenge. This will contribute to the effectiveness of the Board. We regard this as particularly important in a consortium where individual investors may be remote and where shareholder composition can change on an ongoing basis.</p> <p>An independent Chair allows the company to demonstrate that the Board perceptibly acts independently and exclusively in the interests of the regulated company.</p> <p>There should be an explicit division of responsibilities between running the Board and executive responsibility for running the business. Consequently, the Chair should not be the CEO as they would be unable to bring the same impartiality or lack of preconception as a truly independent Chair. This will also be the case if the Chair is a former executive director of the company or another group company.</p> <p>The Chair should not be linked in any way to a shareholder, as this will affect the impartiality of the chair and therefore the effectiveness of the Board. This could also have a negative impact on the legitimacy of the company, and the water sector as a whole.</p> <p>We recognise that in very limited circumstances – for example, if the ultimate controller of the regulated company is a single entity – an independent Chair appointed with no link to that owner is unlikely to occur. In those circumstances, we would expect any departure from the principles to be discussed with Ofwat. As a minimum, we would expect there to be a senior independent non-executive director with whom all equivalent regulatory interactions would take place.</p>

Principle	Rationale and expectations
<p>Board committees, including but not limited to audit and remuneration committees will operate at the regulated company level</p> <p>There should be a majority of independent members on the audit and remuneration committees</p>	<p>All Board committees and accountabilities should operate within the regulated company. Independent non-executive directors should be the majority group on the audit and remuneration committees. Ideally, committees should be led by independent non-executive directors. Where committees, such as the remuneration committee, do not have a majority of independent members or are not chaired by an independent non-executive director we expect companies to explain why they consider their approach is appropriate.</p> <p>We expect Board committees to operate at the regulated company level to ensure that the focus is fully aligned with the aims and needs of that company, not the holding company.</p> <p>Final decisions on issues dealt with by each of the committees will be made by the Board of the regulated company and we expect committees to operate in a comparable way to those of listed company Boards.</p> <p>The independent directors on a committee should have the requisite financial knowledge and experience to provide appropriate challenge. This is also key to providing assurance and demonstrating the legitimacy of the committee.</p> <p>We expect details of the membership of committees, the number of times they met, and the attendance at each committee meeting to be reported transparently.</p>
<p>The group structure must be explained in a way that is clear and simple to understand</p>	<p>The structure of the group within which the company sits should be set out clearly and unambiguously. Customers can expect to know how the group which contains their company is structured, especially as the corporate structure for some groups is complex.</p>



Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
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