

**Board leadership, transparency  
and governance – holding  
company principles**

## About this document

This document invites comments on a series of principles that we consider should guide the governance arrangements of the holding company of a regulated company in the water sector in England and Wales. We set out our intention to publish this in [‘Board leadership, transparency and governance – principles’](#), which we issued for consultation in September 2013.

Meeting these principles will allow the sector 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 sector understands fully the need for it to operate transparently in the public interest.

We have deliberately sought to limit the coverage of these principles to those areas where we consider that the activities of the holding company could impact on the regulated company’s ability to meet its obligations. We recognise that a holding company’s governance arrangements will cover a far wider range of activities than are included here.

These principles are inter-linked and complement those we have set out for the regulated company. The latter have been accepted by all water companies and this has allowed us to keep the holding company principles to a minimum.

Most of the water companies have an obligation upon them to make sure that the regulated company Board is composed in such a way that the directors are able to act independently of the parent company; and where potential conflicts exist between the interests of the regulated company as a water undertaker and those of other group companies (including holding companies), the regulated company and its directors must ensure that, in acting as directors of the regulated company, they should have regard exclusively to the interests of the regulated company.

We are seeking comments on the proposed principles, but recognise that it is for each company and the group to which it belongs to describe how they meet these principles. As for the regulated company principles, we expect companies to adopt a self-regulatory approach and meet our final principles by 1 April 2015.

This will influence our considerations on the need to modify the obligations on companies so that we can make sure that these principles are adopted by companies and the groups to which they belong, in the public interest.

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## Responding to this consultation

We invite stakeholders to provide responses to this consultation by **7 March 2014**. You can email your responses to [ingrid.olsen@ofwat.gsi.gov.uk](mailto:ingrid.olsen@ofwat.gsi.gov.uk) or post them to:

Ingrid Olsen  
Finance and Networks Division  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Ingrid Olsen on 0121 644 7525 or by email to [ingrid.olsen@ofwat.gsi.gov.uk](mailto:ingrid.olsen@ofwat.gsi.gov.uk).

We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

## 1. Background

Following on from Jonson Cox's '[Observations on the regulation of the water sector](#)', in March 2013, Ofwat has engaged with companies and their investors to understand how we can provide confidence that this sector operates to high standards of Board leadership and governance. As a result of this constructive engagement, we are already seeing improvements to the transparency and extent of disclosures in companies' annual reports.

We have discussed extensively current governance arrangements, areas for improvement and the priorities for companies operating in this sector. We have welcomed the constructive and positive responses that we have had to our proposals.

We have published [principles on Board leadership, transparency and governance that apply to each regulated company](#). We are looking to each company to take a self-regulatory approach and develop a code that meets or exceeds our principles. We received responses to the proposed principles from each company, as well as from other stakeholders. They have told us that they will develop codes and meet our principles. The principles are largely unchanged, although we have clarified some points in response to the comments we have received.

Governance issues currently have a high profile in the media and with the public, and have been highlighted by the UK Government – for example, as a policy focus for the Department for Business, Innovation and Skills. There is an expectation that companies will operate high standards of governance and transparently demonstrate that they do so. Water companies provide an essential public service and need to maintain legitimacy among their customers and stakeholders more generally. Confidence in the sector is strongly influenced by the way in which it is perceived. Trust is hard won but easily lost, and trust can be built by demonstrating exemplary practice in terms of governance and disclosures.

The regulated company principles put the onus on the regulated company to demonstrate certain behaviours in relation to its interaction with its holding company. But we recognise that for the regulated company to operate to the highest standards, the holding company needs to do so too.

Investors have a clear and legitimate role to play in running the business of the regulated company through the holding company. For example, in our regulated company principles we acknowledged that investors have a legitimate place on the Board of the regulated company. Publications and guidance such as the Financial Reporting Council's 'UK Stewardship Code' and the ABI's 'Improving Corporate Governance and Shareholder Engagement' set out the roles of investors and identify good practice. The regulated company is providing an essential public service for which most customers are not able to choose their supplier. Customers and regulators have high expectations of the standard of disclosures and behaviours of the companies, and the groups to which they belong, in this sector. We see the involvement of investors as beneficial to ensuring that regulated companies are protected from any adverse impacts from the group structure of which they are a part.

In [IN 13/02, 'Board leadership, transparency and governance'](#), published in April 2013, we said that a small group of forward-looking financial sponsors had agreed to work with us to help develop governance standards. We have welcomed the constructive suggestions and challenges that we have received from this group. The principles that are set out below are Ofwat's principles. They are a set of principles which each holding company may consider adopting voluntarily in order to demonstrate that it is operating to the highest standards in relation to the interactions it has with the regulated company.

The principles will allow existing and potential investors to understand the expectations of those investing in a monopoly public service company. They will also allow the sector to demonstrate that it recognises and fully meets the responsibilities that come from providing an essential public service. And they set out the standards of transparency we expect from groups that contain companies providing water and wastewater services.

## 2. Existing licence and other requirements

The licence conditions that most of the regulated companies already have in place recognise the importance of the role and responsibilities the holding company has in relation to the operation of the regulated company. Most companies are required by their licence (condition P) to obtain legally enforceable undertakings from their ultimate controller(s)<sup>1</sup> that they will:

- provide the regulated company with all the information it needs to comply with its obligations under the Water Industry Act 1991 (WIA91) or its licence;
- refrain from any action which would or may cause the regulated company to breach any obligations under the WIA91 or its licence; and
- ensure that there are no less than three independent Non-executive Directors on the regulated company's Board.

The principles we have suggested do not place requirements on a holding company that are any more onerous than what is currently implied by the undertakings which a regulated company is required to secure from the ultimate controller.

In some cases, the holding company may already be required to adhere to certain guidelines, such as the 'Guidelines for Disclosure and Transparency in Private Equity'; our principles are seeking to complement rather than duplicate existing requirements.

In addition, the 'UK Stewardship Code' sets out principles for institutional investors in the UK of listed companies to follow, and describe practices that private companies may wish to consider and adopt, where relevant.

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<sup>1</sup> The 'Ultimate Controller' is defined in the licence as "any person who or which (alone or jointly with others and whether directly or indirectly) is (in the reasonable opinion of the Water Services Regulation Authority) in a position to control, or to exercise material influence over, the policy or affairs of the Appointee or of any holding company of the Appointee".

### 3. Proposed principles

The proposed principles are intended to complement those for the regulated company. As indicated above, the coverage of the principles is limited to those areas where we consider the activities of the holding company could have the greatest direct impact on the regulated company.

The principles cover the following areas.

- Transparency.
- Risk.
- Long-term decision making.

For the purposes of these principles, the holding company is the company that the regulated company states in its accounts to be its Ultimate Parent Undertaking and Controlling Party (and any intermediate companies between that company and the regulated company). We expect each company to be transparent about the group to which it belongs and the company to which these principles apply.

The holding company, together with the regulated company, can decide how best to make the disclosures which we have set out below, but should consider how they can be made easy to find and presented in an accessible form. The disclosures could, for example, be made in the regulatory accounts or annual report of the regulated company.

We are looking for a self-regulatory approach and a leading company may choose to set out clearly in a code how it meets our principles. Where a holding company does not meet a principle which we have set out, it may instead choose to provide an explanation of why that is the case and the approach that it has taken to meeting the spirit of the proposals. There is variation in the group structures and the holding company will need to consider the principles and suggested disclosures in the context of its particular structure.

We have set out below a series of principles that we consider should apply as a minimum to any company operating in this sector. We have set out in greater detail why we consider these matters to be important; and also how a holding company might demonstrate that it meets these principles.



## **Transparency – the key to maintaining customer legitimacy and confidence**

### **The holding company structure should be transparent, and explained in a way that is clear and simple to understand**

#### **Why?**

Some of the companies operating in the sector are part of group structures that are complex and difficult to understand. The UK Government has highlighted the importance of clarity in the reporting of company structures. Responsible owners of companies providing a public service should ensure that their structures are fully explained in a way that sets out where ownership and accountability lies, and who has an economic interest in the business.

As we have set out in our recently published principles for regulated companies, opaque structures can damage the legitimacy of the regulated company and the sector as a whole.

#### **How?**

As we explain in our principles for regulated companies, the structure of the group and in particular the place of the regulated company within the group should be clear and straightforward to understand and readily accessible. It should also be clear which company is the ultimate holding company. Any areas that lack clarity should be explained.

The role of each of the companies that have links or interests in the regulated company within the group structure should be explained clearly, including a description of the interaction between the holding company and the regulated company. It should also be clear what country each company is registered in. In the event of a group company being dormant/non-trading, this should be clearly stated.

There should be no hidden beneficiaries of the regulated company within the structure – the investors in the holding company should be set out clearly.

### **The holding company will provide information on debt and equity structures**

#### **Why?**

Transparent structures will help build trust and increase legitimacy with customers and other stakeholders.

Both the regulated company and the holding company have a responsibility to put forward information that is available to customers that sets out these structures in a comprehensive and comprehensible way.

**How?**

The holding company should publish information in an accessible way to make its debt and equity structures transparent and explain where and why it has considered it necessary to exclude any information (for example, for reasons of commercial confidentiality). This should also cover the capital structure of any other company with links to or interests in the regulated company.

**The holding company will transparently demonstrate directors' interests and the nature of those interests (other than where they are declared at the regulated company level)**

**Why?**

Although we expect the Board of the regulated company to operate independently, there will be some circumstances in which the Board of the holding company will make decisions that affect the regulated company. Therefore, it is reasonable for customers and other stakeholders to be able to access information about the holding company Board members. For example, it would be of interest to stakeholders if a director holds more than one position in the group.

**How?**

The holding company should publish a list of all its directors and have a clear process for disclosure of any relevant interests at least annually.

**The holding company will explain which matters that impact on the regulated company are reserved to the holding company Board**

**Why?**

We recognise that there will be some matters at the regulated company level (for example, a decision to appeal a price control determination) that the holding company will wish to reserve the right to be involved in. But it needs to be clear which matters these are so that stakeholders can see that they are appropriate and that the Board of the regulated company is leading the business, both in terms of accountability and legitimacy.

**How?**

As we explain in our regulated company principles, reserved matters should be clearly explained and disclosed (for example, in its code, annual report or on its website).

**The holding company will transparently demonstrate the governance standards that it applies, including how it meets these principles**

**Why?**

The governance standards of companies are under the spotlight, both at UK level and internationally. As the owner of a monopoly company providing a public service, a holding company has a responsibility to be at the forefront of the move to greater openness and the pursuit of best practice in corporate governance. A holding company can demonstrate its commitment to this by developing its own corporate governance code.

**How?**

We expect the holding company to demonstrate how it reviews corporate governance standards and makes the necessary changes to ensure that its approach aligns with current best practice. Any material changes to corporate governance that have taken place in the preceding year should be reported annually.

The holding company should address each of the principles set out in this document, with a thorough explanation of how each principle is met or why a particular principle is not met, in its annual report or on its website.

**Managing risk – the holding company will manage its risks in such a way that the regulated company is protected from risk elsewhere in the group**

**The holding company will not put the obligations and requirements of the regulated company at risk**

**Why?**

We expect the regulated business to be protected from risks in other parts of the group controlled by the holding company, so that the customers of the regulated company are not subject to service or cost issues as a result of activities elsewhere in the group. There are licence obligations in place that place a ring-fence around the regulated company. So, we expect the holding company to be mindful of these obligations and take steps to ensure that its activities do not impact negatively on the regulated company's ability to meet its obligations.

### How?

In carrying out its activities the holding company will ensure that it understands fully the duties and obligations of the regulated company contained within statute and its licence.

It should give full consideration to the undertaking required by condition P of the regulated company's licence ('condition P undertaking') – including that it refrains from any action which would cause the regulated company to breach any of its obligations. The holding company should explain how it has ensured that it has a full understanding of the duties and obligations of the regulated company and has given full consideration to the condition P undertaking.

### **The holding company should provide the regulated company with the information that it requests about the activities of the wider group**

### Why?

The regulated company should have access to the information that it needs about the wider group to assure itself that it is not at risk from activities elsewhere within the group. This includes a clear understanding and visibility of matters such as the:

- shareholder agreement;
- financing, strategy and management of the wider group; and
- the potential for this to impact on the regulated company.

### How?

The holding company should provide the regulated company with relevant information. Where the regulated company determines it needs additional information, clarification or explanation this should be made available to it.

### **The holding company should disclose any issues at the group level which may impact on the regulated company**

#### **Why?**

This demonstrates that the holding company understands fully the obligations and requirements of the regulated company (as it must do to comply with the condition P undertaking) and takes them into account in decisions that are taken at Boards of companies that sit above the regulated company Board. It demonstrates that the holding company has considered fully both its exposure to risk and in turn whether these may expose the regulated company to risk.

#### **How?**

The holding company should explain how it will identify and disclose such issues where they are identified (or confirm that there are none). We expect this information to be disclosed transparently and the consideration of issues to identify any immediate impacts, as well any potential negative impacts to the long-term future of the company (for example, in its annual report or on its website).

### **The holding company should allow the Board of the regulated company to run the business as if it is a separate, public limited company**

#### **Why?**

The Board of the regulated company needs the resources and managerial expertise required to allow the business to provide the services that it is licensed to undertake to its customers. This needs to be sufficient to make sure that the regulated company is fully equipped to meet its obligations.

#### **How?**

We expect the holding company to facilitate the ability of the regulated company to meet (or by exception explain any departures from) the principles that Ofwat has put in place setting out its expectations with regards to Board composition ('Board leadership, transparency and governance – principles').

The holding company should support the regulated company so that it can make strategic and sustainable decisions in the interests of the regulated business for the long term.

### **Supporting long-term decision-making**

**The holding company should support the regulated company in operating in a sustainable way (including making long-term decisions) in line with the long-term nature of the water sector**

#### **Why?**

The long-term provision of a public service is an important focus for the regulated company and the holding company should enable it to meet the medium- to long-term challenges that it faces, such as population growth and climate change.

#### **How?**

The holding company should make sure that the Board of the regulated company is provided with the support necessary to make strategic and sustainable decisions in the interests of the regulated business for the long term.

## 4. Next steps

We are seeking comments on these principles by **7 March 2014**.

We are expecting to publish final principles in April 2014. We will also provide details of the comments that we have received on the principles and how we have taken account of them.



Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gsi.gov.uk](mailto:mailbox@ofwat.gsi.gov.uk)  
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