

Board leadership, transparency and governance – principles

About this document

This paper sets out, for comment, the principles that we consider should apply to companies operating in this sector.

Contents

Part 1

1. Introduction	3
2. Better Board leadership, transparency and governance	4
3. Licence	6
4. Our approach	7
5. Next steps	8
6. Applying the principles	9

Part 2

1. Proposed principles	11
------------------------	----

Board leadership, transparency and governance – principles

Part 1

1. Introduction

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. These obligations were put in place to ring fence the regulated company and to make sure that there were safeguards to allow the regulated company to operate independently. 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 a far 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.

Listed companies focused on this sector are in the minority, with the majority of companies now in private ownership. Listed companies are subject to the listing rules and the discipline that places on them in terms of both standards that they must adhere to and the way in which they report.

The existing licence obligations were developed in the context of an environment where most of the larger companies were part of a group that was listed. The nature of ownership in the sector has changed. The rise of more companies in private ownership has led to more complex structures and governance arrangements in some companies and consequently fewer listed companies.

It is therefore the right time for us to consider whether the obligations that apply remain fit for purpose, and also to consider carefully the standards that we should expect – as a minimum – from companies operating in this sector.

Our preference is to introduce a self-regulatory approach, where companies' Boards take the lead in setting out how they meet or exceed our principles. This approach will mean that ownership of Board leadership and governance rests where it should. In due course we will consider the need to update companies' licences to bring them into line with companies' practices.

2. Better Board leadership, transparency and governance

We recognise the obligations within the current licence, in this area, may benefit from review and potentially updating to meet current governance standards and to reflect the changing ownership structures that operate in the sector. This is because ‘best practice’ in corporate governance, and its relevance in the sector, has changed over time.

In considering what represents the highest standards that should apply, we have also identified areas in the current licence that would benefit from updating. As an example, the current licence requires companies to have particular regard to the UK Corporate Governance Code (the Code) while acting as if they were separate public limited companies. However, while many of its requirements represent good practice, some aspects of the Code may not be as relevant to this sector or the ownership structures that are currently in place. In some regards the requirements of the Code could hinder the long-term focus of the sector.

In this context, we have been giving particular thought to what we consider the guiding principles in terms of Board leadership and governance for this sector should be. We have also been considering our options to make sure that this sector operates to the highest standards of leadership and governance.

We are changing the way in which we regulate. By doing this we are seeking to change the culture of the 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 who provides their water and sewerage service, it is vital that companies maintain legitimacy in the eyes of those customers. Significant investment will continue to be needed in the 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 this legitimacy.

Some of the challenges that the 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.

The remuneration and incentivisation of management plays an important part in ensuring that there is the right emphasis on customer outcomes as well as those of shareholders. The legitimacy of a monopoly public service company will also be affected by how transparent this remuneration structure is. Companies should do more than we see currently in most cases to explain how the remuneration of directors is linked to standards of performance in the regulated business. Where the reward of directors of the regulated company is awarded or paid at a higher level in the ownership structure, we would expect full disclosure in regulated company accounts in the spirit of having full transparency of remuneration structures and incentives.

Governance issues across the economy have also been highlighted by the Government, reflected in the policy focus of the Department for Business, Innovation and Skills (BIS) on '[Making companies more accountable to shareholders and the public](#)' and '[Reducing the impact of regulation on business](#)'. For example, BIS's recent paper '[Transparency and Trust: A discussion paper](#)' focuses particularly on the transparency with which companies reveal information about their ownership structures.

In addition, there has recently been a high level of media interest in governance. Criticism, in the main, has been directed at other regulated utilities; but some has focused on governance issues at some companies in this sector. The adoption of a voluntary code will allow this sector to demonstrate that it is taking leadership and collective responsibility.

3. Licence

Most companies currently have the following obligations in their licence, which are of particular relevance in the area of Board leadership, transparency and governance. For example:

- Condition F requires a company to conduct the appointed business as if it were substantially the company's sole business and the company were a separate public limited company. They should do this by having particular regard to the following, among other things:
 - that Boards are composed in such a way that they are fully capable of acting independently of their parent companies;
 - 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 as a water undertaker; and
 - the UK Corporate Governance Code.

- Condition K requires companies to ensure, so far as reasonably practicable, that if a special administration order were made, the company would have available to it sufficient rights and assets (other than financial resources) to enable the special administrator to manage the affairs, business and property of the company.

- Condition P requires companies to obtain legally enforceable undertakings from their ultimate controller(s) that they will:
 - provide the regulated company with all the information it needs to comply with its obligations under the Water Industry Act 1991 or its licence;
 - refrain from any action which would or may cause the regulated company to breach any obligations under the Water Industry Act 1991 or its licence; and
 - ensure that there are no less than three independent non-executive directors on the regulated company's Board.

4. Our approach

We have set out why we consider that there is a case to review and update licence obligations on companies. Our preference, however, is to adopt an approach that encourages companies to adopt leading practice, rather than using licence obligations to compel improvements. We recognise that a self-regulatory approach is consistent with better regulation principles, and provides companies' Boards with the opportunity to take a strong leadership role.

We are therefore setting out a series of principles that companies' Boards can build on in developing their own leadership and governance codes. The proposed principles represent our minimum expectations. In our wider discussions we have received representations in favour of principles that are significantly more stringent than those we have set out as a minimum in this document.

We fully expect that some Boards' approaches will exceed what is proposed here and that in time 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 chairmen 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.

We have undertaken extensive discussions since March this year on the content of the proposed principles with both the water company directors and investors. In ['Observations on the regulation of the water sector'](#), Ofwat's Chairman set out the approach that he anticipated taking to make sure that the sector demonstrably operates to the highest standards of Board leadership and governance. We therefore do not expect the proposed principles to represent any major surprises. However, we recognise that this paper brings together all the principles and the rationale and expectations that sit beneath them for the first time.

We welcome any comments that you have that will help to build on these principles, and are looking to companies to demonstrate how they are taking the lead on Board leadership and governance issues.

5. Next steps

Date	Action
By 31 October 2013	Comments on both our proposed approach and the principles themselves. We expect only to make changes by exception, given that these principles represent the minimum that should be currently expected of companies' Boards and there have been extensive discussions since March.
By 31 December 2013	<p>We expect leading companies to put in place a code that sets out how they currently apply the principles and the timeframe in which they will fully adopt the principles.</p> <p>We recognise that for some companies there will be structural issues that may mean that it will take them some time to fully adopt these principles. An example that has been drawn to our attention is the requirements of shareholder agreements, which we regard as subordinate to the licence. Some shareholder agreements have particular requirements that influence the composition of the Board and these may need to be reviewed to come into conformance with developing requirements.</p>
January 2014	We will confirm the final principles.
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.
By 1 April 2015	We expect all companies to have a code in place and that all companies are in compliance with their code.
2015-16	Review with companies the content of the licence and the principles. We are considering an approach – which could be put on the face of the licence – that requires a review of the principles every three years to make sure that they remain fit for purpose, unless changes in external requirements prompt an earlier review.

6. Applying the principles

We consider that the protection afforded by companies' Boards meeting these principles should be available to all customers served by the networks of regulated companies in this sector. We do recognise that there are significant differences in the size and constitution of different companies and that each company will take a proportionate approach to the way in which it meets our proposed principles.

Companies' Boards should take all reasonable steps to enable their directors to understand their responsibility 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. We therefore 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 substantial 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 carefully explain and exceptions would be few. As our approach relates to the public interest, we expect companies to discuss any departures with Ofwat and to explain them to their customers.

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

Board leadership, transparency and governance – principles

Part 2

1. Proposed 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 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. This would typically involve discussing areas such as group structure, company performance and the key risks to the business.</p> <p>We expect companies to ensure that the information is accessible to the audiences for this information. It will be 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 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>The RegCo must act as if it is a separate public listed company</p> <p>An effective Board is fully focused on the RegCo's obligations</p>	<p>We expect the Board of the regulated company (RegCo) to have full control of the business. It should have ownership of the strategy, and there should be a strong independent element 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 RegCo.</p> <p>Given the long-term nature of the water sector, it is important that the RegCo Board has the powers necessary to make strategic and sustainable decisions in the interests of the RegCo 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. Inclusion of executives and non-executives on the Board will mean that the Board takes full responsibility for the development of strategy, and takes accountability for the Board’s decisions.</p> <p>It is important for companies in the water sector that the composition of the RegCo Board 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 the RegCo Board 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 (HoldCo) 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 HoldCo Board. These should be clearly articulated in the annual report. Useful guidance may be found in the matters reserved in a listed company for shareholder approval.</p> <p>It should be clear to stakeholders that the RegCo Board 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, unique in the way it operates, 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 RegCo 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.</p> <p>We expect the independent non-executive directors to be the largest single group on the Board, compared to (i) executive directors and (ii) non-executive directors that are not independent. 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; however, the number of investor</p>

representatives should be no greater than the number of independents excluding an independent chairman.

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; however, we expect that there will be fewer executives than independent non-executive directors on the Board.

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.

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 regimes, 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 Guidance on Board Effectiveness sets out the personal attributes that are demonstrated by effective independent non-executive directors that lead to ethical leadership.

The Board 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.

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 skills, experience, independence and knowledge of the company. 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 at RegCo level, made up of a majority of independent non-executive directors, which leads the process and makes recommendations to the Board.

<p>The Chairman must be independent of management and investors</p>	<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 RegCo.</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 or a former executive director of the company or another group company as they would be unable to bring the same impartiality or lack of preconception as a truly independent Chair.</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 sector as a whole.</p> <p>We recognise that in very limited circumstances, for example, if the ultimate controller of the RegCo is a single entity an independent chairman 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>
<p>Board committees, including but not limited to audit and remuneration committees will operate at the RegCo 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 at the RegCo level. Independent non-executive directors should be the majority group on the Committees. Ideally committees should be led by independent non-executive directors.</p> <p>We expect Board committees to operate at the RegCo level to ensure that the focus is fully aligned with the aims and needs of the RegCo, not the HoldCo.</p> <p>Final decisions on issues dealt with by each of the committees will be made by the Board and we expect committees to operate in a comparable way to those of listed company Boards.</p> <p>The independents on a committee should have the requisite financial knowledge and experience to provide appropriate</p>

	<p>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 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk
September 2013

© Crown copyright 2013

You may reuse this information (excluding logos) free of charge in any format or medium, under the terms of the Open Government Licence v2.0. To view this licence, visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/version/2> or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.

