

# Information notice

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## Board leadership, transparency and governance

### Introduction

Effective leadership and governance is paramount to the regulator, customers, investors and stakeholders' confidence in the water sector. We recently wrote to the Boards of the water only and water and sewerage companies in England and Wales setting out our expectations in this area.

This information notice sets out our expectations of the way in which companies demonstrate their accountability.

### Background

As the economic regulator, we want to regulate effectively and efficiently at a minimum cost and burden to companies. If we are to deliver a less intrusive approach to regulation, and the incentives that can bring, we need to be confident that companies are operating to the very highest standards of corporate governance.

Companies operating in this sector provide a public service that most people use. As monopoly suppliers of a public service we expect companies to:

- deliver their customers' priorities;
- be honest and transparent about their performance; and
- demonstrate their accountability to their customers.

As highlighted in our chairman Jonson Cox's recent report and lecture, '[Observations on the regulation of the water sector](#)', board governance and leadership is essential to maintaining confidence in the sector.

Over time the structure of the sector has changed. Fewer companies are listed on the stock market, the capital structure of many companies has changed, and the corporate structure of some companies has become more complex.

We have long recognised the need for companies to operate to the highest standards of corporate governance and this is reflected in companies' licences. As a result, the regulated company in some companies has been protected from financial distress in circumstances where the groups that they were a part of were not.

We recognise that corporate behaviours and transparency of

companies rank highly in terms of maintaining legitimacy. Public trust, while hard won, can very easily be lost. Legitimacy of the sector is essential to maintaining customers' willingness to pay their water and sewerage bills and this is particularly the case where customers are hard-pressed to pay their bills.

### Our objectives

We expect companies to demonstrate transparently the actions they are taking to meet the highest standards of board leadership, transparency and governance.

We are placing particular emphasis on this now as it will influence the degree of confidence that we, and stakeholders, can place in companies' investment proposals at the next price review in 2014. We expect companies' Boards to draw an appropriate balance of risks and rewards between their customers and their investors.

We want companies to operate to the highest governance standards. This applies not only to the regulated company Board but also the way in which the holding

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water and sewerage sectors in England and Wales.

company operates and interacts with the regulated company. This includes the transparency of those interactions.

Many companies have a specific requirement in their licence to comply with the UK Corporate Governance Code (the 'Code'), which replaced the previous combined code. In our view, a well-run, responsible company will seek to implement and meet the standards and spirit of the Code as a minimum. It would also, by exception, explain its approach where its activities do not conform to the Code.

The disclosure requirements for listed companies only apply to some of the companies. But these requirements offer a model that all companies can follow to demonstrate to their customers and their stakeholders that they recognise the particular responsibilities and expectations that come with the provision of a public service.

### **Expectations for 2012-13 financial reporting**

Companies will shortly be presenting their financial performance for 2012-13. They will also be publishing their regulatory and annual accounts. We expect companies' boards to pay particular regard to:

- the obligations in their licences and the UK Corporate Governance Code;
- how they meet them; and
- the way in which they

transparently demonstrate that they are fully aware of and have met their obligations.

We recognise that the Code has been developed and refined particularly with shareholders – who are unlikely to be part of the Board – in mind. In unlisted companies it is more common for shareholders or their representatives to sit at the board table. They may have different information needs but also have direct access to management information. But we want the same spirit of disclosure to apply to making information available in the public interest as is available to shareholders.

Where information is currently only disclosed at a holding company level, but relates significantly to the regulated company, we expect clear and transparent disclosure to the Code standards. An example of this is the full disclosure of management contracts and incentive arrangements for any executive that is devoting significant time to the regulated business, or serving on the Board of the regulated company.

We recognise that at present the differing nature of companies' ownership structures means that the transparency of reporting across the sector presents a mixed picture. We are not seeking to prescribe uniform minimum standards. But we are seeking a high standard of leadership, transparency and governance across the sector that is led and implemented by company Boards.

Our initial analysis suggests that current performance is varied and some companies are far less transparent than they might be.

We will examine the way in which companies set out how they meet the requirements of the Code in their financial statements for 2012-13. Our focus will be on whether companies have adopted the spirit of the Code. We want to incentivise companies to adopt the spirit of the requirements and, where appropriate, move beyond them. We do not expect to see an over-reliance by companies on explanation rather than compliance.

We look forward to seeing improved transparency from companies during the 2012-13 reporting season.

### **Next steps**

As set out in '[Observations on the regulation of the water sector](#)', in the public interest, we are considering whether the measures in company licences meet current standards. We would prefer the sector to voluntarily address this rather than waiting for us to specify rules.

In '[Setting price controls for 2015-20 – business planning expectations: a consultation](#)', we proposed that Board leadership, governance and transparency in companies will form part of our risk-based review of companies' plans. Companies' approaches will inform our judgements when we set price controls in 2014.

Our assessments will be influenced by the way in which each company responds in demonstrating how they meet the Code and licence requirements in 2012-13, and any future proposals they have to develop their approach. So we are looking to companies and their Boards to actively consider their position and how they might respond. For some companies we expect to see a step change in the way they meet the requirements and in the way they set out how they comply.

As set out above, over the past ten years we have seen changes to the nature and complexity of company structures. This has led to some structures being more opaque than they used to be. A small group of forward-looking financial sponsors has agreed to work with us to help develop governance standards. These could potentially be supported by a code of practice for the holding companies of institutionally-owned companies.

As the work of this group progresses we will share its findings and conclusions more widely. We are looking to the sector, and its investors, to pick up the challenges identified voluntarily. But because of the significance of leadership, governance and transparency we

## More information

[‘Observations on the regulation of the water sector’](#), March 2013

[‘Setting price controls for 2015-20 – framework and approach: A consultation’](#), January 2013

[Water company licences](#)

[‘Setting price controls for 2015-20 – business planning expectations: a consultation’](#), April 2013

[2014 price review](#)

will consider the need for changes to companies’ licences to deliver our objectives, should that prove necessary.

Ahead of this, we welcome any actions that companies, and their investors, take to progress this. This is a high priority area for the Ofwat Board and we are keen to make swift progress. We are looking to establish with all the regulated companies and unlisted holding companies a real model of best practice. We recognise that this is best achieved by working together.

### Your views

We welcome any views that stakeholders have on how transparency and governance in the sector can be developed.

If there are any considerations that you think we should take into account please email them to [christopher.pepper@ofwat.gsi.gov.uk](mailto:christopher.pepper@ofwat.gsi.gov.uk).



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