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By email: FinanceAndGovernance@ofwat.gsi.gov.uk
Board leadership, transparency and governance consultation
Ofwat
21 Bloomsbury St
London
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Dear Sirs

Consultation on Board leadership, transparency and governance

We enclose our response to the above consultation.

If you have any questions about our response or would like to discuss any aspect of it, please do not hesitate to contact me.

Yours faithfully


Company Secretary, AnGLIAN Water Services Limited



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Registered in England
No. 2366656.

an AWG Company

**Response from Anglian Water to Ofwat's Consultation ("Consultation")
on reviewing and updating Ofwat's existing board leadership,
transparency and governance ("BLTG") principles.**

Q1 Do you agree with the objectives for the principles we have set out (in Table 1 of this chapter)?

A It is helpful to move to a single set of principles which replace the current (2014) BLTG principles and the Holding Company principles. The objectives set out on page 4 of the Consultation are broadly consistent with the aims of the corporate governance regime that applies to listed companies and, to this extent, we agree with these objectives. We also welcome the opportunity to simplify the existing licence conditions relating to corporate governance that many companies currently have in their licences. However, we have some concerns regarding:

- the potential conflict between the duties of directors imposed by Companies Act 2006 s172 ("s172") and the overarching focus of the Board on its role as "a monopoly provider of an essential public service"; and
- the detailed articulation of principle 3 (stand alone regulated company) to which we return below.

Q2 Do you agree with the aim of setting principles that enable autonomy and flexibility for companies to deliver the highest standards of accountability and responsibility for their behaviour and outcomes, reflecting their own circumstances?

A Yes we agree with this aim. However, given that most (perhaps all?) companies already have a licence condition which requires them to have particular regard to "the Principles of Good Governance and Code of Best Practice (or any successor document having a similar purpose and content) as may from time to time be incorporated into or approved for the purposes of the Listing Rules of the Financial Services Authority" there seems to be limited scope for differing approaches as between private and publicly owned companies unless Ofwat intends to remove this licence condition (which we would advocate).

In the light of the Wates review it would be helpful for Ofwat to acknowledge in the drafting of the Licence that different corporate governance regimes will apply to different companies. For very small WOCs who may not be subject to the Corporate Governance Principles for Large Private Companies - e.g. Portsmouth Water - it seems reasonable to expect that compliance with Ofwat's principles alone should be sufficient. In the case of Anglian Water, we would expect to comply with the Corporate Governance Principles for Large Private Companies in addition to Ofwat's principles (to the extent that the two sets of principles require different approaches).

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Q3 Do you agree that if companies are unable (exceptionally) to comply with specific principles, they should explain very clearly how their approach meets the spirit of the principles?

A We support the principle of "comply or explain" which remains a feature of the 2018 UK Corporate Governance Code (the "UK Code"). However, as it is now proposed that compliance with the BLTG principles should be enforced by way of licence condition, we are concerned that, in practice, it may be almost impossible to adopt an alternative approach for fear of breaching the licence condition. If Ofwat is willing to contemplate the existence of "exceptional instances where a company cannot deliver against a particular aspect of the principles" it is imperative that the drafting of the licence condition takes account of this possibility.

Q4 Do you agree with our proposed principle for purpose, values and culture?

A We note that this principle largely reproduces the UK Code which requires that:

"the board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture".

However, we note that Ofwat has not adopted the UK Code principle which states that

"a successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society".

The Wates Review consultation proposes a similar principle:

"A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks".

We recognise that Ofwat is keen to promote the legitimacy of the sector (hence wording which suggests that the purpose of the Company "should be consistent with its role as a monopoly provider of an essential public service"). However, as a matter of law, the paramount consideration for directors (pursuant to s172) is to take decisions which promote the success of the company for the benefit of its members as a whole. It is not possible to override this statutory duty. The purpose of a company set out in the UK Code (i.e. to promote the long-term sustainable success of the company, generating value for shareholders) is consistent with the s172 duty. However, Ofwat's proposed sub-principle (which requires that the company's purpose should be consistent with its role as a monopoly provider of an essential public service) appears to be inconsistent with the provisions of the Companies Act. We consider that the UK Code principle set out above (which references the need to contribute to wider society) would be more appropriate.

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Q5 Do you agree with our proposed board leadership and transparency principle?

A We agree with the overarching principle (i.e. that companies must demonstrate the highest standards of board leadership, transparency and governance). We are generally in agreement with the sub-principles.

Ofwat will be aware that extensive legislative requirements regarding transparent reporting of remuneration (including the provisions of The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013) are already in place.

We note Ofwat's proposed requirement (now incorporated in its IAP test for PR19 Business Plans) for a "substantial link to stretching delivery for customers". However, we question the need to supplement the provisions of the UK Code which already require that:

"Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy."

Equally, the Wates consultation proposes that:

"A board should promote executive remuneration structures aligned to the sustainable long term success of a company, taking into account pay and conditions elsewhere in the company".

We are concerned that Ofwat's proposed sub-principle might have the effect of diverting management focus from the long term success of the business. For example, it is surely undesirable for a disproportionate ("substantial") amount of executive remuneration to be associated with (say) short term CMeX performance in circumstances where management has no incentive to focus on long term investment in (say) resilience.

Q6 Do you agree with our proposed principle for the stand-alone regulated company?

A We agree that the role of the Board of the Regulated Business is (amongst other things) to establish the strategy for the business. However, we do not agree that the Regulated Business can determine its strategy in isolation. We therefore question the statement that "the board of the regulated company must have...the freedom to set, ... **all** aspects of the regulated company's strategy".

Inevitably, certain strategic decisions will be of such materiality that the views of shareholders must be taken into account. This principle is recognised by the application of the class tests which are a feature of the Listing Rules that apply to publicly owned companies. In particular, Listing Rule 10 recognises the need for Consultation and approval in respect of transactions etc that are "outside the ordinary course of the company's business and may change a shareholders' economic interest in the

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company's assets or liabilities". Ofwat should recognise that shareholders in a Regulated Business are entitled to an equivalent level of protection in relation to their investment.

We do not agree that it is necessary for the Board of the regulated company to "**eliminate**" conflicts of interests. Directors already have a duty to avoid a situation in which they have, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the Company. However, the 2006 Companies Act acknowledges that it is entirely appropriate for Boards to authorise conflicts and/or to put in place appropriate procedures to deal with conflicts. Taken literally, Ofwat's proposed requirement could have the result that shareholder representatives of privately owned companies cannot continue to act as directors of the Regulated Business because they may have a potential conflict of interest in relation to decisions about dividends. This is at odds with the following statement which appears later in the Consultation: "*We believe that there is a place for investors on regulated company boards in some ownership structures*".

Q7 Do you agree with our proposed board effectiveness principle?

A Yes – we generally agree with this principle. We would, however, suggest a change in relation to the sub-principle which focuses on committees:

"The independent directors on a committee should have the requisite knowledge and experience to enable them to provide appropriate challenge"

It is unrealistic to expect all members of all Board committees have appropriate experience. This is of particular concern in relation to the Audit Committee.

The UK Code requires that:

"the board should satisfy itself that at least one member [of the Audit Committee] has recent and relevant financial experience. The committee as a whole shall have competence relevant to the sector in which the company operates."

We suggest that Ofwat's requirements in relation to the composition of committees should be aligned with the UK Code.

Q8 Do you think that the requirement for an independent chair should be a stand-alone licence obligation or should we allow some flexibility? If the latter, what mitigations would be appropriate where a company does not have an independent chair?

A It is our understanding that a Chair may be independent of investors notwithstanding the fact that he/she chairs the ultimate holding company. However, a proposed justification for enshrining the principle of an independent chair as a licence obligation is to "*ensure that independent oversight of the board is not compromised by other interests (either from within the group or elsewhere)*". It would therefore be helpful to have absolute clarity as to the meaning of "independent of investors".

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Anglian Water's experience of an arrangement whereby the same person chairs both the Regulated Company Board and the Holdco Board has been a positive one. We do not believe that any conflicts have arisen which have impeded the proper functioning of either Board.

We disagree agree that there is case for a stand-alone licence obligation relating to the Chairman. However, if it is Ofwat's view that the independence of a Chair could be compromised by virtue of his/her role as Holdco chair, we would have no objection to an additional sub-principle which stipulates the need for additional INEDs such that INEDs constitute an absolute majority on the Regulated Company Board.

Q9 Overall, how well do the proposed principles meet the aim of enabling autonomy and flexibility for companies to deliver the highest standards of accountability and responsibility for their behaviour & outcomes, reflecting their own circumstances (rather than setting overly prescriptive rules)?

A Ofwat's second principle requires that *"Companies must demonstrate the highest standards of board leadership, transparency and governance."* Ofwat also mandates that *"Boards must meet or exceed these principles and demonstrate how they have done so"*. Ofwat also states that *"there are some approaches to delivering strong leadership, transparency and governance that are non-negotiable and should be followed by all companies as they are necessary components of any effective arrangement"*. In the circumstances, the principles appear to be relatively prescriptive. Moreover, as noted above, if compliance with the principles is enforced by way of Licence condition, companies will be discouraged from adopting alternative approaches. There is also limited evidence to suggest that Ofwat proposes to encourage "autonomy and flexibility" – particularly given that, historically, Ofwat's assessment of compliance (as part of the annual Company Monitoring Framework) suggests that a single/universal standard will be applied to all companies.

Q10 Do you agree with our proposal to insert a requirement in companies' licences that they must meet the principles?

A There is strong evidence to suggest that high levels of compliance have been achieved on a voluntary basis. For example, in Ofwat's 2017 Company monitoring framework all companies bar two were assessed as either meeting or exceeding Ofwat's requirements in terms of compliance with Ofwat's 2014 BLTG principles. However, we believe that there is a case for updating the current Licence Condition regarding good governance (referred to in our answer to question 2).

Whilst we do not believe that there is compelling case for introducing a Licence requirement mandating compliance with the principles, if Ofwat is minded to do so, it is critical that the drafting of the Licence Condition incorporates the protections referred to in the Consultation i.e.:

- details of the process through which Ofwat would make changes to the principles (including a requirement to consult and details of relevant notice periods); and
- details of the mechanism pursuant to which revisions to the principles could be referred to the CMA where an appointee contends that the revisions are unreasonable and/or inappropriate.

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Q11 Do you agree with our proposal for an appeal mechanism and a change process in the proposed licence condition to meet the principles?

A Yes (see answer to question 10 above)

Q12 Are there specific instances where individual companies' licence conditions might conflict or overlap with the revised principles?

A Yes. As noted above, the section of Condition F which requires companies to have particular regard to *"the Principles of Good Governance and Code of Best Practice (or any successor document having a similar purpose and content) as may from time to time be incorporated into or approved for the purposes of the Listing Rules of the Financial Services Authority"* appears to be redundant (and is certainly confusing.)

There is also a case to remove the following provision in Condition P given that the issue of Board composition is covered in the principles:

at all times the Board of the Appointee [must] contain[s] not less than three independent non-executive Directors, who shall be persons of standing with relevant experience and who shall collectively have connections with and knowledge of the areas within which the Appointee holds the Appointment and an understanding of the interests of the customers of the Appointee and how these can be respected and protected.

Q13 Do you agree that we should insert a requirement in companies' licences that independent non-executive directors should be the single largest group?

A We believe that this is better dealt with in the principles (as is currently the case).

Q14 Do you agree with our proposal to use the criteria for independence as set out in the UK Corporate Governance Code? Do you think that there are any merits in instead setting out an alternative approach whereby we would insert criteria for independence in the licence?

A Yes, we agree that Ofwat should use the criteria for independence as set out in the UK Corporate Governance Code.

Q15 What are your views on the merits of going further than our proposal and instead requiring that independent non-executive directors to be the majority on the board? If we take this approach, should this be a sub-principle or licence requirement?

A As noted above, we have no objection to an additional sub-principle requiring that independent non-executive directors to be the majority on the board. We do not believe that it is necessary to incorporate a licence condition which sets out this requirement.