

January 2019

Trust in water

Board leadership, transparency and governance – conclusions on revising the principles

About this document

This document summarises the responses to our [consultation on revising the board leadership, transparency and governance principles](#) in July 2018 and sets out our conclusions following consideration of respondents' views and further analysis.

We have published responses to our consultation in full on [our website](#) and provided a list of respondents in appendix 1.

Alongside this document, we have published the final version of the [2019 board leadership, transparency and governance principles](#), which will supersede the previous principles with effect from 1 April 2019.

These decisions are intended to apply to the largest regulated water companies in England and Wales and to licensed infrastructure providers.¹ It may not always be proportionate for smaller companies (new appointments or NAVs) to meet the principles. However we still expect them to demonstrate exemplary governance and to meet the principles where they can.

¹ In this document, when we refer to “companies” we mean those companies holding appointments as water and/or sewerage undertakers under the Water Industry Act 1991 and any licensed infrastructure providers for a project specified under the Water Industry (Special Infrastructure Projects) (English Undertakers) Regulations 2013.

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1. Introduction

1.1 Background

We introduced the [board leadership, transparency and governance principles](#) and complementary [principles for holding companies](#) in 2014. These principles ('the 2014 principles') were developed in response to changes in the world of corporate governance and the nature of ownership in the water sector.

Our principles-based framework aimed to give companies ownership of the issues and drive noticeable improvements in their governance arrangements. While the principles sought to reflect best practice in corporate governance where relevant to this sector, they also emphasised the importance of strong board leadership in the sector and the special responsibilities attached to regulated water companies providing an essential public service. To date we have assessed and compared how companies have applied these principles within the [company monitoring framework](#).

Since the 2014 principles were introduced, we have seen some improvements in the governance arrangements of companies, but developments in the sector and wider economy have reinforced the important role of effective corporate governance and strong board leadership in driving high standards and securing the proper discharge of regulated water companies' functions. Poor corporate behaviour and some significant service failures have undermined trust in the sector. These developments led us to revisit the board leadership, transparency and governance principles.

1.2 Our July 2018 proposals

We reviewed the 2014 principles, considering the evolving corporate governance landscape and taking into account the position and role of regulated water companies. We [consulted](#) on consolidating the principles for regulated and holding companies into a single set of revised principles for regulated companies.

Reflecting their importance, we proposed all companies have a licence obligation to meet the principles. Alongside this we proposed to simplify the specific licence conditions relating to corporate governance that some companies currently have in their licences, bringing licence conditions for all companies to a consistent standard.

We also consulted on whether to introduce additional licence requirements for independent non-executive directors to be the largest single group on boards or a majority, and for boards to be independently chaired.

2. Responses to our consultation

In this section we summarise our July 2018 proposals, the responses to our consultation questions, and our final decisions based on our consideration of responses and subsequent analysis.

We address in turn:

- our overall approach to the principles;
- the content of the principles; and
- our proposals for licence obligations.

2.1 Our overall approach

Our July consultation

We set out a proposed framework to give companies the autonomy and flexibility to deliver the highest standards of accountability and responsibility for their behaviours while also reflecting their own circumstances.

We set out four high-level objectives we expect all companies to achieve, and proposed a consolidated and updated set of principles to replace the 2014 principles for regulated and holding companies. In addition to the objectives, this was structured into four main principles and accompanying subprinciples (the content of which we cover in more detail in section 2.2).

We said we recognised there may be circumstances where a company is unable to deliver against aspects of these principles and that companies should clearly explain how the approach they have taken is in line with the objectives of the principles.

Reflecting the importance of these principles to this sector, we also consulted on a new licence obligation for all companies to meet the principles and considered further obligations on company board composition (which we discuss in section 2.3).

Respondents' views

Almost all respondents agreed with the objectives of the principles which we set out in our consultation, with a few respondents providing specific comments on their wording which we address in section 2.2. Nearly all respondents agreed with our stated aim of setting a framework to give companies autonomy and flexibility to

deliver the highest standards of accountability and responsibility for their behaviours, with the majority agreeing that our overall approach achieves this aim.

Most respondents noted the suitability of a principles-based approach rather than more prescriptive rules to better reflect companies' individual circumstances, and a number highlighted the flexibility of such an approach to deliver better outcomes for customers and other stakeholders. However two respondents disagreed with our overall approach and said we should adopt more prescriptive requirements.

A number of respondents noted the more prescriptive nature of the proposed subprinciples, while accepting they contained some flexibility for how companies comply with them. Some said our proposals appeared to be overly prescriptive in parts and asked for clarity on what was expected from companies in terms of delivering and explaining against the objectives, main principles and subprinciples.

Most respondents supported a “comply or explain” approach, similar to the approach taken for the UK Corporate Governance Code, but some sought further clarity on how this would work in practice and in concert with a licence obligation.

There were some further specific comments from respondents:

- One respondent suggested we adopt the UK Corporate Governance Code's use of “provisions” rather than “subprinciples”. One respondent suggested companies should only be required to meet the main principles and their objectives, and another recommended companies should explain how they have complied with all the principles as well as when they have not.
- A few respondents commented that our proposed approach, particularly in combination with a licence obligation may discourage companies from adopting alternative or innovative approaches if they are overly cautious about deviating from the subprinciples. Another respondent suggested the approach may reduce the incentive on companies to pursue continual improvements over time.
- As well as seeking greater clarity about how we would review explanations for deviation from the subprinciples, some respondents asked for clarity on temporary deviations due to unforeseen or unavoidable circumstances.
- Two respondents did not agree with our overall approach and said we should impose requirements on companies, without scope for alternative arrangements – they also considered the requirement to explain to be a weak incentive on companies. Another respondent said having regard to the UK Corporate Governance Code was sufficient to ensure good governance.
- One respondent asked for clarity on the role of company-specific governance codes, which companies developed as part of implementing the 2014 principles.

Our analysis and decision

We have carefully considered the views expressed by respondents and undertaken further engagement and analysis. As part of this, we recognised that some elements of our proposals could be improved and clarified. We also reflected on our aim to provide a framework that gives companies autonomy and flexibility as well as responsibility for their behaviours, and we considered whether our proposals effectively delivered that aim. This has led us to adapt our overall approach.

As a result, we have consolidated the “objectives” and “main principles” that we consulted on into a single set of overarching objectives. In order to better focus on what we are trying to achieve, we have clarified that it is these objectives that companies must meet and provide explanations for how they have done so. This change streamlines the principles as a whole and ensures that all stakeholders have greater clarity on what is expected from companies. The objectives are substantially principles-based and companies are responsible for meeting them.

Underpinning the objectives are guiding provisions that we would normally expect companies to adopt in order to meet the objectives. While the provisions are not rigid requirements, company boards should consider and reference them when explaining how they are delivering the objectives.

There may be limited circumstances where a company’s approach is not in line or even conflicts with a provision. Where this is the case, companies should fully explain how their arrangements nevertheless successfully deliver the objectives. The provisions are not exhaustive and companies should continually consider the best way to deliver the objectives, particularly as expectations from customers and other stakeholders change over time and best practice evolves. This approach ensures the focus is on the objectives, and clarifies the role of the provisions.

This approach to reporting is not the same as the UK Corporate Governance Code’s “comply or explain” approach, where companies either comply with a provision or provide an explanation for not doing so. Instead, companies must meet the objectives and set out how they have done so. The provisions should be considered and referenced by companies in their explanations of how they meet the objectives. This ensures companies have ownership and responsibility for considering how to deliver the objectives in the way best suited to their circumstances.

We will review how companies have met the objectives by taking into account the provisions, past issues and best practice in the sector and beyond to assess whether companies’ substantive behaviours in the round are delivering the objectives. We expect companies to provide explanations in their annual reporting and elsewhere so

that customers and other stakeholders are able to hold them accountable for how they deliver the objectives.

For ease of reference, from this point on when we refer to “the principles” we mean the overarching objectives, guiding provisions and our approach to assessing compliance as set out in the 2019 principles document.

In response to further specific issues raised by respondents:

- As we set out above, we have adapted our approach by ensuring the overall focus is on companies delivering the objectives, and we have adopted “provisions” to better clarify their role.
- We consider our adapted approach ensures that companies are able and encouraged to adopt innovative practices that best reflect their own circumstances and respond to future changes in best practice in the sector and wider economy. This should incentivise companies to strive for continual improvements in their governance arrangements over time.
- We consider that an appropriate and proportionate approach to compliance adequately addresses the potential risks of unforeseen or unavoidable circumstances arising which may lead to temporary deviation from the provisions. This is reinforced by our overall focus on objectives and the ability for companies to provide appropriate explanations where the provisions are not adopted.
- Only requiring companies to have regard to the UK Corporate Governance Code would not address the need for strong board leadership in a monopoly sector providing an essential public service. Because of our focus on the regulated company and the essential public service role of water companies, a bespoke approach is appropriate and necessary. While the UK Corporate Governance Code provides a relevant framework for good corporate governance, it has a different purpose. Nonetheless, to avoid confusion we have adopted the same or similar wording where appropriate.
- We do not consider an overly prescriptive approach is right for this sector because we want companies to take full ownership. Being too prescriptive also risks stifling innovative approaches and we consider it appropriate to give the sector space to adapt further and evolve to meet the legitimacy challenge. We consider transparent reporting should enable customers and other stakeholders to challenge poor practices and incentivise companies to strive for the highest standards. A licence obligation also makes companies accountable for delivering the objectives, which we cover in section 2.3.
- Reflecting the progress made since the 2014 principles were first developed, we expect companies to take ownership and continually consider their approach to meeting the principles in their business. This may be through their own governance code or other ways that are effective in doing this.

How it will work in practice

In summary and to provide clarity on our decisions, box 2.1 sets out how the new board leadership, transparency and governance framework will work in practice. It is replicated in the 2019 principles document.

Box 2.1 – How the framework will work in practice

Companies should meet the objectives and explain how they have done so. Under this framework, companies are responsible for delivering the objectives. Company boards must take ownership for delivering the objectives and actively consider how best to do so.

We would normally expect companies to adopt the guiding provisions in the course of meeting the objectives. While the provisions are not rigid requirements, company boards should consider and reference them when explaining how they are delivering the objectives.

There may be limited circumstances where a company's approach is not in line or even conflicts with a provision, or where they temporarily do not adopt a provision. Where this is the case, companies should fully explain how their arrangements overall successfully deliver the objectives.

The provisions are not exhaustive and companies should continually consider the best way to deliver the objectives, particularly as expectations from customers and other stakeholders change over time and best practice evolves.

We will review how companies have met the objectives by taking into account the provisions, past issues and best practice in the sector and beyond to assess whether companies' substantive behaviours in the round are delivering the objectives. While companies are responsible for meeting the objectives, we would expect to have dialogue with companies where they may fall short.

For clarity, nothing in these principles overrides or is intended as an interpretation of directors' duties as set out in the Companies Act 2006.

In section 2.3 we set out in more detail how the framework will work in concert with a licence obligation to meet the objectives.

2.2 Our proposed principles

2.2.1 Purpose, values and culture

Our July consultation

We asked whether respondents agreed with our proposed new principle on purpose, values and culture. We put it forward to reflect the importance of a regulated water company's purpose, values and culture in delivering long-term success, and building trust given its public service role. It also reflects the increasing focus in the wider economy on corporate values and culture, and the role of boards in driving them.

This new principle included a subprinciple based on the challenge we set companies in 2018 to produce an annual statement from the board, to sit in front of financial statements, focusing on how the company has set its aspirations and performed for all those it serves.

Respondents' views

Most respondents were broadly supportive of our proposed principle. There was widespread support for the aim of the principle, and respondents noted similarities with the UK Corporate Governance Code and welcomed the onus being on company boards. There was support to maintain the expectation of an annual board statement, first introduced for the 2017-18 annual performance reports.

The following issues or requests for clarification were raised by respondents:

- One respondent said the proposed main principle may be inconsistent with section 172 of the Companies Act 2006 which relates to directors' duties.
- A few respondents suggested the focus of the proposed main principle should explicitly reference customers, employees and the environment.
- One respondent said a company's purpose, strategy, values and culture should be aligned and consistent with those of its parent or sister companies.
- Two respondents were concerned by the reference to "monopoly providers" in the subprinciple on purpose. Three respondents said stakeholders should be engaged in developing a company's purpose.
- A few respondents asked for clarity on the subprinciple on an annual board statement – whether it should be in the annual report and how it fits with new board statements introduced for the 2017-18 annual performance reports.
- Some respondents suggested we should align with wording in related governance codes and guidance by the Financial Reporting Council. One

respondent suggested we instead refer to relevant sections of the Financial Reporting Council's codes and guidance and only set out differences where they are specifically relevant for water companies.

- One respondent highlighted the stepped nature of developing a company's culture and said our approach to compliance should avoid a "tick-box" exercise in order to encourage continual improvement by companies.

Our analysis and decision

In response to the issues raised or clarification sought by respondents:

- For the final objective, we have amended the wording so that companies should satisfy themselves that their purpose, strategy, values and culture reflect the needs of all those it serves. This clarifies that the principles are not intended to cut across existing directors' duties while reflecting the broad range of other stakeholders' interests to which companies should have regard, including customers and employees.
- We consider that the objective and provisions should not in principle prevent a regulated company from aligning its strategy, values and culture with parent or other group companies where it is appropriate to do so, but we would expect the particular role of the regulated water company to be appropriately reflected.
- Although the regulated company is a monopoly for almost all of the services it provides, on reflection we consider the key characteristic that should be reflected in the company's purpose is its role as a provider of an essential public service and have therefore amended the provision to reflect this. Taking into account responses, we have also amended the provision so that companies should consult with a wide range of stakeholders.
- To clarify, the provision on an annual board statement incorporates the expectation we set out in [IN 18/07: Expectations for monopoly company annual performance reporting 2017-18](#). As before, companies can decide the best way to communicate their annual board statement within their annual reporting.
- Our aim is to capture the issues most relevant to regulated water companies in the objective and provisions. While the UK Corporate Governance Code provides a relevant framework for good corporate governance, it has a different purpose. Nonetheless to avoid confusion we have adopted the same or similar wording where appropriate. After reviewing the final version of the 2018 UK Corporate Governance Code we have made some changes to the provisions, such as adopting "corrective" actions, and consider the final objective and provisions are consistent where appropriate.
- We recognise the development of a company's culture is likely to take time and be unique to its circumstances. With the focus of the principles on how companies are delivering the objectives, and our approach to compliance

involving a judgement in the round, companies should be encouraged to take ownership of their overall approaches rather than follow a tick-box approach. We consider our approach provides sufficient flexibility while incentivising companies to strive for continual improvement, for both this objective and more broadly.

The following box shows the final objective and provisions for purpose, values and culture.

Objective 1 – Purpose, values and culture

The regulated company board establishes the company's purpose, strategy and values, and is satisfied that these and its culture reflect the needs of all those it serves.

Provisions

- i. The board develops and promotes the company's purpose in consultation with a wide range of stakeholders and reflecting its role as a provider of an essential public service.
- ii. The board makes sure that the company's strategy, values and culture are consistent with its purpose.
- iii. The board monitors and assesses values and culture to satisfy itself that behaviour throughout the business is aligned with the company's purpose. Where it finds misalignment it takes corrective action.
- iv. Companies' annual reporting explains the board's activities and any corrective action taken. It also includes an annual statement from the board focusing on how the company has set its aspirations and performed for all those it serves.

2.2.2 Standalone regulated company

Our July consultation

We asked whether respondents agreed with our proposed principle relating to a standalone regulated company. The aim of the principle was to ensure that the board of the regulated company has the power to set its long-term direction and can make, and be held accountable for, all decisions regarding the company's regulated activities as though these were substantially its sole business. This included a new focus on responsibility for strategic decisions.

Respondents' views

Most respondents were supportive of this principle. There were a small number of specific comments, which are set out below.

- Several respondents requested clarification on the concept of “meaningful control” and the role of parent companies in the proposed subprinciple.
- One respondent said it would be impractical and inappropriate for parent companies to have no input or control over the operation of the regulated company or for the regulated company board to determine company strategy in isolation. Others noted that the board having accountability for a strategy does not preclude the input of others in setting that strategy. Some respondents also queried the extent to which reserved matters should be reported on or explained.
- A few respondents sought clarity or suggested changes to the proposed subprinciple on conflicts of interest, noting potential inconsistencies with company law, and the final 2018 UK Corporate Governance Code.
- Some respondents said that boards should be able to delegate decisions to committees, and queried whether the intent of our proposed subprinciples was for boards to be final decision makers for committee matters.

Our analysis and decision

Following our consideration of views expressed by respondents and further analysis, we have made a number of refinements to address these points:

- We have combined two subprinciples into one updated provision which makes it clearer that the regulated company should both set out any matters that are reserved for shareholders or parent companies, and explain how these are consistent with the board of the regulated company having full responsibility for all aspects of the regulated company's business. We agree with respondents who said accountability for a strategy does not necessarily preclude the input of others in setting that strategy.
- We have also made changes to address the potential ambiguity around the meaning of meaningful control, raised by some respondents, and have replaced this with “full responsibility” in keeping with the overarching objective.
- We have shortened the overarching objective so that it is more focused, and included the requirement for board committees to operate at the regulated company level as part of the relevant provision.
- We have also set out that committee decisions should be made “at the level” of the regulated company (rather than specifically “by the board” of the regulated company) to clarify that where appropriate, decisions should be able to be delegated to regulated company board subcommittees, in response to some

consultation responses. In line with the objective on board structure and effectiveness, we consider the regulated company board should be competent, and well run, and that it is important for board subcommittees to report into the regulated company in order to retain appropriate oversight.

- We have changed “eliminate” conflicts of interest to “manage” in order to reflect the final UK Corporate Governance Code, which had not been published at the time of consultation. It will continue to be important for companies to explain how any potential conflicts of interest are identified and managed, to ensure that board members can still provide an appropriate level of objective challenge.

The following box shows the final objective and provisions for the standalone regulated company.

Objective 2 – Standalone regulated company

The regulated company has an effective board with full responsibility for all aspects of the regulated company’s business for the long term.

Provisions

- i. The regulated company sets out any matters that are reserved for shareholders or parent companies (where applicable); and explains how these are consistent with the board of the regulated company having full responsibility for all aspects of the regulated company’s business, including the freedom to set, and accountability for, all aspects of the regulated company’s strategy.
- ii. Board committees, including but not limited to audit, remuneration and nomination committees, report into the board of the regulated company, with final decisions made at the level of the regulated company.
- iii. The board of the regulated company is fully focused on the activities of the regulated company; takes action to identify and manage conflicts of interest, including those resulting from significant shareholdings; and ensures that the influence of third parties does not compromise or override independent judgement.

2.2.3 Board leadership and transparency

Our July consultation

We asked whether respondents agreed with our proposed principle on board leadership and transparency. The principle aimed to engender trust and ensure that companies are accountable for their actions. We focused our reporting expectations on key areas rather than the reference in the 2014 principles to the standards set out in the disclosure and transparency rules for listed companies.

Respondents' views

Most respondents were supportive of our proposal, with a few comments on the detail of the wording. Three respondents considered the transparency elements to be too weak to affect behaviour.

The following further issues were raised by respondents:

- A few respondents raised concerns or sought clarity about disclosing votes cast by directors. Some suggested our proposal may impair decision making or be inconsistent with the role of company directors while others sought clarification about what we expected. In contrast, two respondents suggested we go further and require companies to report how each director voted on key decisions.
- One respondent suggested we change “key risks” to “principal risks” in the provisions to better align with the revised UK Corporate Governance Code. Another respondent suggested adding risks to service delivery.
- Some respondents said our proposal to explain how executive pay policy is linked to service delivery for customers may divert focus to the short term and that remuneration committees should retain some discretion. One respondent asked why we expect disclosure at the level of the regulated company. One respondent noted there are existing reporting requirements on executive pay in the Water Industry Act 1991. Two respondents suggested our proposed wording may not capture executive pay where it is determined at a group level.
- One respondent said that the proposed subprinciple on dividends should recognise that when determining a company’s policy on dividends directors are required to act in accordance with company law, regulatory requirements and in the long-term interests of the company. Another respondent said explaining the basis of dividends would not be enough to cause a change in practice.

Our analysis and decision

In response to the issues raised or clarification sought by respondents:

- As our intent is to show the scale of judgement and challenge that takes place on company boards rather than the specific voting record of individual directors, we have amended the relevant provision to say “the outcomes of votes cast” to

clarify that we are not expecting companies to report how individual directors have voted. We consider this is proportionate, would not impair decision-making and is in line with the role and obligations of board directors.

- As our intent is for companies to consider the same types of risks as mentioned in the UK Corporate Governance Code, we have aligned the reference to risks in the relevant provision with the 2018 UK Corporate Governance Code (which was finalised after we issued our consultation) to provide consistency for relevant companies. We would expect this to encompass risks to service delivery.
- We consider that it is important for customers and other stakeholders for there to be transparency on how performance-related executive pay is linked to service delivery for customers. While there are reporting requirements on executive remuneration in the Water Industry Act 1991 we consider our provision builds on and does not conflict with them. We do not agree that the provision would divert focus to the short term, and in any case would expect companies to consider incentives that are linked to long-term delivery for customers. The provision does not preclude company boards and their committees from using their discretion and judgement when determining remuneration policies.
- We have amended the provision on executive performance-related pay in order to better capture pay policies that are determined at a group level. We expect disclosure to be at the regulated company level because it is the company that we regulate and the primary focus for customers. Disclosure should also indicate how company boards are ensuring managers of the regulated company are focused and incentivised on delivery for their customers.
- We agree that when determining the company's policy on dividends, directors should be mindful of their duties under company law as well as their regulatory responsibilities as a director of a regulated water company. The focus of the provision on dividends is on transparent reporting, and we consider it does not cut across company law or the wider obligations of directors. In any case we would expect companies to explain the basis of their dividend policy with reference to all their obligations, including relevant legal and regulatory obligations. In conjunction with the wider legal and regulatory framework, which the provision on dividends builds on by enabling customers and other stakeholders to hold companies to account, we expect to see companies rise to the challenge of ensuring their arrangements are seen as legitimate by all relevant stakeholders.

The following box shows the final objective and provisions for board leadership and transparency.

Objective 3 – Board leadership and transparency

The board's leadership and approach to transparency and governance engenders trust in the regulated company and ensures accountability for their actions.

Provisions

Regulated companies publish the following information in a form and level of detail that is accessible and clear for customers and stakeholders:

- i. An explanation of group structure;
- ii. An explanation of dividend policies and dividends paid, and how these take account of delivery for customers and other obligations (including to employees);
- iii. An explanation of the principal risks to the future success of the business, and how these risks have been considered and addressed;
- iv. The annual report includes details of board and committee membership, number of times met, attendance at each meeting and where relevant, the outcome of votes cast; and
- v. An explanation of the company's executive pay policy and how the criteria for awarding short and long-term performance related elements are substantially linked to stretching delivery for customers and are rigorously applied. Where directors' responsibilities are substantially focused on the regulated company and they receive remuneration for these responsibilities from elsewhere in the group, policies relating to this pay are fully disclosed at the regulated company level.

2.2.4 Board structure and effectiveness

Our July consultation

We asked whether respondents agreed with our proposed principle on board effectiveness. The aim of the proposed principle was to retain key elements from the 2014 principles, such as the independence of the chair and committee and board composition, while developing it further – including by bringing a new quality dimension to board decision-making by asking boards to show how they address customer and stakeholder needs, and diversity.

The proposed principle also formalised the arrangements in place for Ofwat to meet with all non-executive directors prior to their appointment, to ensure a clear understanding of the special responsibilities attached to non-executive directors of a regulated water company.

We also considered whether having a subprinciple on the need for an independent chair went far enough, or whether this should be a requirement in the licence.

We also asked whether, in relation to a proposed licence condition on independent non-executive directors being the largest single group, we should use the criteria for independence as set out in the UK Corporate Governance Code or take an alternative approach and set out the criteria we would use. The balance of independent non-executive directors is now a provision underpinning this objective and we therefore deal with responses to this question below.

Respondents' views

Respondents were generally supportive of the proposed principle but several sought clarification of how it would be applied or suggested amendments to reflect how boards and committees operate in practice:

- A number of respondents considered that we should use the UK Corporate Governance Code criteria for determining the independence of non-executive directors. Some respondents suggested bespoke criteria should be adopted to reflect the unique nature of the water sector and ensure relevant experience.
- One respondent said the existence of other directorships within the same group should not be seen to compromise independence.
- Respondents sought clarity that where the term independent directors or members were used, this could include an independent chair.
- Some respondents asked for clarity about how we would judge the independence of the chair.
- Two respondents questioned the need for the requirement to have an independent chair in all circumstances.
- Some respondents suggested clarifying that knowledge and experience on committees was required at a collective (that is across the whole committee) rather than individual (that is for each director) level.
- One respondent suggested that there should be reference to succession planning in the principle.
- One respondent questioned the need for a board evaluation every year, suggesting every two years instead. Another wanted clarity on whether an annual assessment by external assessors was necessary. Two respondents proposed a requirement for independent evaluation of the board by an Ofwat-appointed body.
- One respondent called for additional wording to reflect that identifying customer and stakeholder expertise should lead to shareholder and customer interests being more aligned.
- Two respondents wanted company board appointments to be made from an Ofwat-appointed panel.

Our analysis and decision

We have considered the responses received, carried out further analysis and reflected on the final version of the 2018 UK Corporate Governance Code.

To accommodate our revised approach of moving from principles and subprinciples to objectives and provisions, we have made some changes. With the overarching objective, we have made the principle we consulted on a provision as we consider it a better fit. We have also combined this with another subprinciple that we consulted on to avoid duplication. We have also reordered the provisions so that they flow better by reference to the overarching objective.

We have introduced a new provision that independent directors are the largest single group on the board. This is because we are not proposing a licence obligation for this (see section 2.3). We consider “largest single group” more accurately captures the intent of the provision than “single largest group” as in the consultation.

We have also renamed the principle “board structure and effectiveness” to more closely reflect the content of the objective and provisions.

In response to the issues raised or clarification sought by respondents:

- The independence criteria used for the UK Corporate Governance Code includes a range of non-exhaustive factors that could impair or appear to impair the independence of directors. While boards should consider them when assessing whether a non-executive director is independent, the criteria cannot be applied rigidly. Companies will need to explain how, despite the existence of any perceived or actual conflicts for individual directors or other factors which may impair independence, they are still able to meet the overarching objective to have sufficient independent membership. In their explanations, companies will need to take their particular group structures and the regulatory environment in which they operate into account.
- We have updated the provision which relates to the independence of the chair to be clear that the test of independence applies on appointment only. This is because given the chair has a very close involvement with the company, we accept that this test is not appropriate on an ongoing basis. We have, however, clarified in the provision that the chair should demonstrate objective judgement throughout their tenure. The updates to the provision are consistent with the approach taken to independence of the chair in the final 2018 UK Corporate Governance Code.

- Where there are references to independent members or directors, this includes chairs where they are independent on appointment and continue to demonstrate objective judgement.
- In line with our approach of setting overarching objectives and relying on companies to deliver them without us setting prescriptive rules, we have included a provision for an independent chair. However as we set out above, we expect companies will normally adopt the provisions to meet the objectives but there may be limited circumstances where a company's approach conflicts with a provision. Where this is the case, companies should carefully consider, and explain how, their arrangements deliver the overarching objective. We consider there is a high bar on these issues, and we expect companies to challenge themselves and to take proactive steps to show that the objectives are being met through other means.
- We have removed the specific subprinciple on committee membership as this is now covered by the new provision on balance of membership on the board and its committees. This change is in line with our intent that knowledge and experience on committees is sought at a collective rather than individual level.
- We considered whether we should add a provision that the nominations committee should consider succession planning and note that this is covered in the UK Corporate Governance Code. However, we do not intend to capture everything that a well-run company would be expected to do as a matter of course in these principles, but rather to focus on aspects of board leadership and governance which we consider are particularly important for companies which deliver an essential public service within a regulatory framework.
- On balance, our expectation remains that board evaluations should be conducted annually as this is in line with current best practice and this is reflected in the relevant provision. But we want to encourage companies to be responsible for making the right arrangements – for example who should carry out the evaluation. While companies will need to account for how they have met the objective and will therefore need to explain their approaches, we do not think it is appropriate for Ofwat to prescribe these arrangements.
- We do not consider it appropriate to insert additional wording into provision (i) on board committees to state that identifying expertise should lead to shareholder and customer interests being more aligned. This is because it is for company boards to own the balance between those interests and it is therefore not appropriate for Ofwat set out prescriptive rules about this.
- Companies must ensure that their boards are effective and well run so that they can fulfil their responsibilities to their customers and other stakeholders. Decisions on board appointments sit squarely with companies, rather than Ofwat, so that they can be accountable for the effective running of the company.

The following box shows the final objective and provisions for board structure and effectiveness.

Objective 4 – Board structure and effectiveness

Boards and their committees are competent, well run, and have sufficient independent membership, ensuring they can make high quality decisions that address diverse customer and stakeholder needs.

Provisions

- i. Boards and board committees have the appropriate balance of skills, experience, independence and knowledge of the company. Boards identify what customer and stakeholder expertise is needed in the boardroom and how this need is addressed.
- ii. Independent non-executive directors are the largest single group on the board.
- iii. The chair is independent of management and investors on appointment and demonstrates objective judgement throughout their tenure. There is an explicit division of responsibilities between running the board and executive responsibility for running the business.
- iv. There is an annual evaluation of the performance of the board. This considers the balance of skills, experience, independence and knowledge, its diversity, how stakeholder needs are addressed and how the overarching objectives are met. The approach is reported in the annual report and any weaknesses are acted on and explained.
- v. There is a formal, rigorous and transparent procedure for new appointments which is led by the nomination committee and supports the overarching objective.
- vi. To ensure there is a clear understanding of the responsibilities attached to being a non-executive director in this sector, companies arrange for the proposed, final candidate for new non-executive appointments to the regulated company board to meet Ofwat ahead of a formal appointment being made.
- vii. There is a majority of independent members on the audit, nomination and remuneration committees and the audit and remuneration committees are independently led.

2.3 Licence obligations

In this section we address what we consulted on regarding licence obligations. Before setting out our analysis and decisions, we summarise our consultation position and respondents' views for the following key areas:

- the proposed licence obligation to meet the principles;
- specific licence requirements for board composition; and
- existing licence conditions that are relevant to board leadership, transparency and governance.

2.3.1 Proposed licence condition to meet the principles

Our July consultation

We proposed introducing an obligation in all companies' licences to meet the principles. We considered this was necessary to ensure consistently high standards of board leadership across the sector and that the objectives of the principles will continue to be met as company boards and investors change over time.

We also proposed that the licence condition would be accompanied by a mechanism that would allow companies to ask us to refer any revisions to the principles to the Competition and Markets Authority where they dispute those revisions and a process through which we would make changes to the principles.

Respondents' views

Respondents were divided on the proposed licence condition. Most respondents did not oppose it or were supportive. Some respondents agreed that it was a necessary step to ensure compliance. Some respondents called for more detailed requirements, with clear consequences for non-compliance.

Nearly half of companies that responded disagreed with the proposal. Many considered that the principles already carry enough weight given either existing licence conditions or other regulatory requirements.

Other points made by respondents were that the principles are not specific, measurable and targeted and therefore do not lend themselves to a licence condition; that a licence condition would undermine Ofwat's stated goal of allowing flexibility and autonomy to companies in how they choose to comply; and that Ofwat would need flexibility to update the principles with evolving best practice.

Most respondents agreed with the proposed appeal mechanism and change process. Some suggested a tougher threshold for the change process, where Ofwat would need to demonstrate that the existing arrangements are against the public interest. Others suggested that stakeholders' views should have equal weighting to companies' views on proposed changes to the principles.

2.3.2 Specific licence requirements for board composition

Our July consultation

We consulted on introducing further requirements into all companies' licences for the chair of the board to be independent and for independent non-executive directors to be the largest single group on boards. We also asked whether we should go further and consider whether, in fact, independent non-executive directors should be the majority on the board.

Respondents' views

A large majority of respondents disagreed with the proposed licence condition for an independent chair. Reasons given included that the licence condition to meet the principles would already cover this; that there is a need to retain flexibility with "comply or explain"; and that an independent chair is inappropriate in a single shareholder owned company. Most of these respondents agreed that the requirement should be retained as a subprinciple. The few respondents that agreed with the proposed licence condition thought that there should be no flexibility because independent chairs are essential for good governance.

Respondents were more evenly split on the proposed licence condition for independent non-executive directors to be the largest single group on boards. Around half supported or did not object to the licence condition. A few suggested we should go further by ensuring that the needs of service users and customers are more heavily weighted in decision making. Most companies who responded opposed a licence condition. Reasons given included concerns about regulatory uncertainty because of the need for boards to interpret the independence of directors; increasing the quantity of independent non-executives will not necessarily increase the quality of board governance; and the risk of a licence breach in the event of unforeseen, temporary non-compliance.

A significant majority of respondents did not see merit in going further by requiring a majority of independent non-executive directors on boards. They were concerned that this would carry additional costs, be impeded by the difficulty of finding suitable

candidates and make the size of the board unwieldy. A small minority of respondents thought that there were merits in the proposal, with some suggesting that it would be more appropriate as a subprinciple.

2.3.3 Existing licence conditions

Our July consultation

In our July consultation we said that alongside a licence obligation to meet the principles there may be scope to simplify existing conditions in some companies' licences relating to corporate governance. We asked for examples of instances where companies' licences may overlap or conflict with the proposed principles.

We have already introduced licence obligations to meet the principles for five companies who have had a change of control or structure since 2016. In doing so, we also removed certain existing conditions relating to corporate governance where there was a clear overlap.

Respondents' views

Some respondents supported simplifying existing licence conditions, however most respondents said they did not consider there to be any overlaps or conflicts. Where respondents did consider there to be potential overlaps or conflicts, they suggested:

- The requirement for companies to have “particular regard” to the UK Corporate Governance Code.
- The obligation relating to company boards having no fewer than three independent non-executive directors of most companies' licences.
- A few respondents said much of the ring-fencing conditions would benefit from review alongside our proposed licence obligation.

2.3.4 Our analysis and decision

As we have set out above, we have revised and streamlined the principles in light of consultation responses. Alongside this, we intend to pursue the introduction of a licence condition to meet the objectives set out in the principles. Streamlining the principles addresses some of the concerns raised by respondents, and we do not consider other arguments put forward by respondents against the inclusion of a licence obligation to meet the principles are compelling.

The aim of the licence obligation is to require companies to have a direct, enforceable obligation to meet the objectives. We consider that it is no longer sufficient that this important issue is dealt with by principles that sit outside the licence framework. There is an imperative to include a licence condition to prompt a step change to ensure that boards give regular consideration to how the objectives are best served and delivered. Additionally, we consider the licence obligation is necessary to ensure consistently high standards of board leadership across the sector and so that the objectives of the principles will continue to be met as boards and investors change over time.

In our view, a licence condition is a better long-term tool for driving accountability and responsibility for delivering our underlying objectives than the current approach. We intend to engage with companies on the licence condition before proceeding to modify licences. We expect to initiate a licence modification process under section 13 of the Water Industry Act 1991 for the largest regulated water companies in spring 2019. Similarly, we plan to engage before initiating an equivalent licence modification process with the licensed infrastructure provider (under section 171A of the Water Industry Act 1991). In box 2.2 we have included proposed licence condition text for further engagement with companies.

While we recognise that some companies already have a licence condition to meet the board leadership, transparency and governance principles, we propose to update those licences with the new version of the condition when we introduce it for all companies. This version will require companies to meet the objectives rather than the principles as is currently the case. For the avoidance of doubt, once the 2019 principles become effective on 1 April 2019, we would expect companies with the existing licence condition to meet the new objectives.

As currently exists in the licences of companies who already have a licence obligation to meet the principles, we are minded to include a mechanism in the proposed licence condition which would allow companies to ask us to refer any revisions to the objectives to the Competition and Markets Authority if they dispute whether any revisions are appropriate. This is similar to the appeal mechanism in companies' licences for the Regulatory Accounting Guidelines. The proposed licence condition also sets out the process to revise the objectives, including that we will consult and provide any relevant notice periods.

Although we consider the principles are sufficiently future proof, they may need to be updated from time to time – this could be by revising the objectives or the provisions. Before any changes, we would consult widely and carefully consider the views of all stakeholders. This consultation would precede any revisions which are subject to the proposed mechanism in the licence condition.

Some companies identified where they considered a licence obligation to meet the principles may overlap with existing requirements in their licences. Where we have previously introduced a licence condition to meet the board leadership, transparency and governance principles into companies' licences we have removed some existing obligations from these companies' licences. As part of introducing a new licence obligation to meet the objectives, we are considering which existing requirements it may be appropriate to remove from companies' licences and will engage further with companies about this.

In view of consultation responses, we will not progress with specific licence conditions on board composition at this time. Instead we are focusing on the licence condition to meet the objectives as a tool for promoting a focus on outcomes, rather than following detailed rules. We continue to believe that having an independent chair and independent non-executive directors as the largest single group on the board are important in demonstrating there is sufficient independent membership on the board, as set out in the objective on board structure and effectiveness.

In line with [our approach to enforcement](#), we will take a stepped approach where we have concerns that a company is contravening its obligations, or may do so in the future. We will usually pursue informal regulatory action with companies first where that is the most appropriate means of making sure that they meet their obligations. If this does not achieve the desired result, we may take formal regulatory action, including enforcement.

Box 2.2 – Proposed updated licence text (to be inserted in conditions I or P)

- x.1 The Appointee must, at all times, conduct the Appointed Business as if the Appointed Business were:
 - (a) substantially the Appointee's sole business; and
 - (b) a public limited company separate from any other business carried out by the Appointee.
- x.2 The Appointee must meet the objectives on board leadership, transparency and governance issued by Ofwat and revised from time to time and explain how they are doing so in their annual reporting.
- x.3 Ofwat may, from time to time, revise the objectives in any manner that it considers appropriate, provided that, before any revision takes effect, Ofwat:

- (a) consults the Appointee on a draft of the proposed revision;
- (b) has regard to any representations made by the Appointee;
- (c) publishes a final version of the revision, incorporating any changes made to the draft following consultation; and
- (d) gives reasonable notice (of at least one month) to the Appointee of the date on which that revision will take effect.

x.4 The Appointee may notify Ofwat, within one month of receiving notice of a revision to the objectives under x.3 (c), that it disputes the revision, and in that case:

- (a) the question of whether the revision is appropriate shall (unless Ofwat withdraws the decision to make it) be referred by Ofwat to the Competition and Markets Authority for determination; and
- (b) the revision shall not take effect unless and until the Competition and Markets Authority determines that it shall.

3. Future developments

In this section we set out:

- some considerations for companies' future reporting; and
- the next steps on implementation of our decisions.

3.1 Future reporting

In the new 2019 principles, we have updated our approach to ensure that companies focus on the objectives they need to achieve, are encouraged to reflect modern best practice as a matter of continual improvement, and avoid a tick-box approach.

One of the drivers for our review was to instil a renewed focus on the importance of board leadership and governance to the legitimacy of the sector and the standards expected. Going forward, we therefore expect to see companies sharpen their reporting and we intend to increase our own focus on how well companies are doing.

As we set out in section 2.1, companies should meet the objectives and explain how they have done so. This will require companies to think again about their practices and approach to reporting, and they should reflect that their audience is not only or even primarily Ofwat, but customers and other stakeholders.

The focus of the explanations that companies provide is important. In recent years, some companies have simply explained that they have adopted an alternative approach to that set out in the 2014 principles. While this has provided a greater level of transparency about practices, this approach does not help explain whether and how those practices actually deliver against the ambitions of the principles. The 2019 principles are clear that all companies will need to explain how their practices are delivering the objectives. Although not intended as an exhaustive guide to how to meet the principles, below we have highlighted some areas where we consider some companies will need to review their approach.

We do not consider it sufficient for companies to refer to letters from Ofwat as an explanation (or justification) for their arrangements without further explanation, as this does not provide sufficient transparency or explanation about how they are delivering the objectives. We expect to see companies providing up-to-date, self-standing reporting which clearly explains to their customers and other stakeholders how they have ensured their approaches meet the objectives.

The 2014 principles say that reserved matters must be documented and clearly articulated in the annual report, and that we expect companies to comply with the principles or explain. Companies have not always clearly articulated all matters that are reserved to shareholders or holding companies or provided adequate explanation (if any) of how certain reserved matters – that go beyond company law requirements – nevertheless allow the regulated company board to have full control of the business and be equipped to make strategic decisions about all aspects of the business. Examples include stating that the board “has a schedule of matters reserved for its decision” without setting out those matters; stating that certain strategic decisions are reserved to the holding company without providing further explanation; and companies requiring approval by the holding company of the company’s strategic aims and objectives, without further explanation. We consider this is an area where greater transparency is needed.

Previous explanations relating to having a non-independent chair, not having independent non-executive directors as the largest single group on the board, or why a board considers a director to be independent despite circumstances that could be considered to impair their independence, have not always addressed the question of whether these alternative arrangements deliver sufficient independent membership.

Transition

The 2014 principles will remain in place until April 2019, and companies will report against these in their 2019 annual performance reports. Having looked closely at the past practices highlighted above in relation to our expectations for delivery and reporting under the 2019 principles, we think companies should challenge themselves afresh in the next reporting year. They should ensure any explanations for practices that do not comply with the 2014 principles address how the alternative approach retains the confidence of their customers and other stakeholders by reference to the underlying principles. We will increase our focus in this area too.

We have decided not to include the board leadership, transparency and governance principles as a category in the latest company monitoring framework assessment (to be published later in January 2019) as we wanted to give companies sufficient notice of our renewed challenge to them under the current principles.

In their 2019 annual performance reports, we also expect companies to explain the steps they are taking towards ensuring they can meet the objectives of the new 2019 principles going forward. For example, we are aware that some company boards have already started to monitor and assess company values and culture to satisfy themselves that behaviours are aligned with purpose.

3.2 Next steps

The revised principles will come into effect from 1 April 2019. Subject to the licence modification process that we plan to initiate in the spring, we will aim for the licence condition to be effective from summer 2019.

For 2018-19, companies should report against the principles that were in place at the time (the 2014 principles). However, we expect companies to take on board the feedback provided in section 3.1 when preparing their reports and to explain any steps they are taking to transition to the 2019 principles.

When companies report in 2020 we will consider their arrangements in the round entirely against the 2019 principles.

A1 Consultation respondents

We have published all consultation responses in full on [our website](#).

Water companies

Affinity Water
Anglian Water
Bristol Water
Dŵr Cymru Welsh Water
Northumbrian Water
Portsmouth Water
SES Water
Severn Trent Water
South East Water
South Staffordshire Water
South West Water
Southern Water
Thames Water
United Utilities
Wessex Water
Yorkshire Water

Infrastructure provider

Tideway

Trades unions

Unison
Unite the Union

Consumer bodies

Consumer Council for Water

Individuals

Christopher Hodges and Ruth Steinholtz
Martin Blaiklock

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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