



Consultation on revised Board Leadership, Transparency and Governance Principles

1. Introduction

- 1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage customers in England and Wales. CCWater has four regional committees in England and a committee for Wales.
- 1.2 We welcome the opportunity to respond to Ofwat's consultation on its revised principles for water companies to adopt on Board leadership, governance and transparency.

2. Executive Summary

- 2.1 CCWater welcomes Ofwat's review of the principles for Board leadership, transparency and governance that were first applied in 2014. CCWater's research shows that the water sector has much to do to increase customers' perception of fairness, as a key requisite to improve the industry's legitimacy. Demonstrating how water companies' Boards are adhering to principles that help ensure companies are focusing on delivering customers' expectations may also help increase public trust in the sector.
- 2.2 As the water sector is largely a monopoly it is important that customers see that companies that provide essential services are meeting the highest level of Board governance and are transparent so as to allow scrutiny.
- 2.3 Since 2014, there have been changes in the good practice governance principles used by bodies such as the Financial Reporting Council, the Wales Corporate Governance Register and the UK Corporate Governance Code. We welcome Ofwat's assessment of good practice from these sources as part of the work in developing the revised principles.
- 2.4 CCWater broadly supports the four principles, but would specifically like to see:
 - The first principle on each Board's purpose, values and culture include more specific reference to them being focused on placing consumers at the heart of the business and its strategy.
 - While the principle on Board effectiveness states that, '*Boards should identify what customer and stakeholder expertise is needed in the boardroom and how this need is addressed*', this could be reinforced by adding, '*so that shareholder and customer interests particularly are more aligned*'. This would be consistent with Ofwat's incentives to focus company Boards and management on serving customers (for example, the introduction of the C-MeX incentive for increasing customer satisfaction).
- 2.5 We agree that a licence condition is required to ensure companies adhere to the principles. We would also like Ofwat to review company Board's governance, leadership and membership to test how well companies are adhering to the principles. This should include an assessment of Board effectiveness and whether the independent non-executive directors are providing sufficient independent scrutiny and challenge, in line with the UK Corporate Governance Code. As well as meeting new independent non-executive directors when they are first appointed, Ofwat should carry out follow-up communications or events to reinforce the principles and any relevant key messages.

3. Responses to the consultation questions

Q1: Do you agree with the objectives for the principles we have set out?

Yes. The four proposed principles, when applied by companies, should help ensure that Boards set a clear purpose, culture and values for their organisation, in a way that engenders public trust. This will also help ensure that Boards are accountable for their decisions. We also agree that this will help ensure the regulated company is ring-fenced and independent.

While these are high level principles to give companies flexibility in how to apply them, we have suggestions on how the principles could be improved in a way that will give consumers further benefits. This is described in our answers to the next questions.

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?

Yes. While the principles relating to each Board's purpose, values and culture should be non-negotiable and consistently applied to all companies (along with a duty to be transparent and independent from the holding company), we recognise that companies may need to do different things in order to comply with the principles.

We agree that Ofwat cannot prescriptively tell companies what they need to do. It is for companies to take actions and demonstrate how this has enabled them to comply with the principles. However, we expect Ofwat to review the evidence of companies' actions to comply with the principles and intervene where a company has failed to do so.

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?

Ideally, companies should demonstrate how they have complied fully with the principles. If they consider that they are unable do so (e.g. restructuring due to a merger), then they should provide a clear and detailed explanation as to why and produce an action plan to show how and over what timescale they will achieve compliance. Ofwat should intervene where the company's explanation and/or action plan is not acceptable.

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

Yes, though we think the principle should have a more explicit reference to consumers. In the explanation for Ofwat's rationale for the principle, the consultation paper says, *'In order to rebuild trust and confidence in water and regain sector legitimacy, there needs to be a culture change that gives the companies a renewed sense of purpose, and that puts customers at the heart of the water companies' businesses. This culture change needs to come from the top'*

However consumers are not mentioned in the text of the principle on Board's purpose, values and culture. Therefore the first line of the first sub-principle should state that, *'The board should promote and develop its collective vision of the company's purpose, which should be consistent with its role as a monopoly provider of an essential public service that puts serving consumers and meeting their expectations at the heart of its business'*.

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

Yes. We welcome the new principle that requires company Boards to demonstrate how its performance related executive pay and dividends policies reflect delivery of its commitments to consumers. We also support the reinforcement of the transparency principle and the requirement for Boards to explain the risks to the business and how they have been considered and addressed. This should include risk to the services delivered to consumers.

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

Yes. The revised wording of this principle reinforces the need for the regulated business to be ring-fenced from its ownership structure and for the Board to set and be accountable for a regulated business strategy, in tandem with the need for a clear purpose at principle 1.

We note the emphasis on regulated companies having ‘meaningful control of the business’, which does not exclude the holding company(ies) that may occasionally need to be included in strategic Board decisions.

Q7: Do you agree with our proposed board effectiveness principle?

Yes. The independence of the Chair from management and investors is an important principle, along with the requirement on companies to demonstrate how Board members offer required skills, experience, independence, diversity and knowledge. The principle mentions how Boards need to show how stakeholder needs are addressed and explains how Boards should include non-executive directors.

While the principle states that, ‘*Boards should identify what customer and stakeholder expertise is needed in the boardroom and how this need is addressed*’, this could be reinforced by adding, ‘*so that shareholder and customer interests particularly are more aligned*’.

Ofwat has introduced incentives (such as C-MeX) intended to focus company Boards and management on delivering for customers. This suggested addition to the principle may help ensure that Boards understand customers’ interests and develop strategies that reflect this. This may also help increase the level of public trust and legitimacy in the sector and help reinforce the requirement to set a clear purpose, values and culture at principle 1.

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?

We agree that enshrining the independence of the Chair will help mitigate the risk that the independent overview of the Board is compromised by investors. Ideally, there should be a licence condition to reinforce the importance of this principle.

If a company wishes to be an exception to this, Ofwat should require the company to clearly show how the Board will meet a commitment to allow sufficient independent challenge and judgement, with a focus on serving the interests of consumers.

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 and outcomes, reflecting their own circumstances (rather than setting overly prescriptive rules)?

We agree that the principle should be high level to give companies the flexibility in how to apply them. A prescriptive approach from Ofwat may not encourage any innovations in the governance Boards may wish to apply.

However, it is important that Board’s actions comply with the principles and are evaluated periodically and challenged if necessary. Therefore Ofwat should periodically require Boards to demonstrate how they are complying with the principles, and to produce an action plan to show how and when any required improvements will be applied.

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

Yes. This is needed to ensure companies are compliant with the principles, and to demonstrate to the public that companies are required to have strategies and governance that are focused on consumers’ interests.

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

The appeal mechanism should be allowed as this will ensure Ofwat is complying with the available mechanism for companies to refer disputes to the Competition and Markets Authority (CMA).

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

We are unaware of any circumstances where an individual company's licence conditions may conflict or overlap with the principles.

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

Yes. As independent central challenge to the company and its Board is one of the principles, licence requirements to ensure non-executive directors are the largest group on the Board is welcome. As set out in our response to question 7, at least one non-executive director should have a role to represent consumers' interests.

However, in order to give greater assurance that independent non-executive directors provide sufficient scrutiny and challenge, there should be a process of evaluation by Ofwat to measure how effectively this is applied. While the appointment of a non-executive director may not show any conflict of interest at face value, if the non-executive director was recently employed by the water company or by a key supplier/contractor of the company, this may dilute the level of scrutiny and challenge.

As part of its periodic assessment of how the principles are being applied, Ofwat should assess how well non-executive directors have fulfilled their 'independent' roles. As well as meeting new independent non-executive directors when they are first appointed, Ofwat should carry out follow-up communications or events to reinforce the principles and any relevant key messages.

We would like to see this assessment of Board effectiveness included in Ofwat's reviews of how well companies have applied the principles.

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?

Yes, as these are widely applied, accepted and understood tests for Boards to demonstrate the independence of non-executive directors. This should be the context of Ofwat's assessment as proposed in our response to question 13.

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?

While increasing the number of independent non-executive directors does not by itself lead to a better functioning Board, moving the balance further in the direction of independent directors could lead to a strengthening of an independent voice on the board. This would be more beneficial if at least one has a role representing consumers' interests, and if this is reinforced with a periodic review of Board effectiveness and how well the principles are being adhered to.

We would welcome this as a sub-principle underpinned by a licence requirement to comply with the principles as a whole.

Enquiries

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