

July 2018

Trust in water

Consultation on revised Board Leadership, Transparency and Governance principles

About this document

This document is a consultation on reviewing and updating Ofwat's [existing board leadership, transparency and governance principles](#).

It sets out:

- our proposals for updating the existing principles in light of the need to address legitimacy concerns in the sector and developments in corporate governance;
- our rationale behind the changes we are proposing to the principles; and
- proposed licence changes to embed the principles in all companies' licences, and to ensure that there is a minimum requirement for independent membership of the board.

This is part of Ofwat's wider package of work to rebuild trust and confidence and put the water sector back in balance, as set out in our April 2018 [Implementation letter sent to water company CEOs](#).

The changes proposed in this document would apply to the 17 largest regulated water companies (appointees) in England and Wales and the only licensed infrastructure provider (Bazalgette Tunnel Limited, known as Tideway). The size of smaller appointees (which we commonly refer to as new appointments and variations) means that meeting the principles may not always be proportionate for them. However we still expect these companies to demonstrate exemplary governance and to meet the principles where they can.

We welcome responses to this consultation by close of business on Tuesday 21 August 2018.

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1. Introduction

Background

The board leadership, transparency and governance principles were introduced in January 2014. They were developed in response to changes in the world of corporate governance, and because at that time the nature of ownership in the water sector had changed. The principles were introduced as a clear framework, rather than a set of prescriptive rules, to give boards ownership of the issues. The companies responded well, for example, increasing independent representation on boards.

However, while companies largely complied with our principles, the corporate behaviour of some companies, along with significant service failures, has damaged trust in the sector. Therefore in April 2018, Ofwat's Chief Executive wrote to companies setting out a programme of work to enable and challenge companies to rebuild legitimacy and put customers at the heart of their businesses. This consultation addresses one of those elements – a review of our board leadership, transparency and governance principles.

What are we trying to achieve?

Expectations for the behaviour of water companies are very high – arguably higher than for other companies. We know that for a company to adopt the right corporate behaviours, it must have the right culture and sense of purpose. Of course, this responsibility rests squarely with the individual boards, but by having the right principles for board leadership, we want to ensure that the whole sector is holding itself to the highest standards.

The existing principles have helped but clearly more needs to be done so that the regulated company board, through its leadership, sets the expectations for, and delivers the highest standards of culture and purpose. We are bringing forward proposals that improve, clarify and streamline our principles to achieve that end. These changes reflect and build on best practice in the wider world of corporate governance, but also respond to the particular challenges facing a sector delivering an essential public service through monopoly businesses.

We expect companies to take ownership of how they meet these principles: these should inspire companies to take full responsibility for understanding and delivering what is right for their customers.

What are we proposing?

We are proposing a new single set of principles that meet these aims and replace the existing [regulated company principles](#) and [holding company principles](#). Our intention is to provide a clear framework identifying objectives that all companies should achieve. And within this framework, companies should have autonomy and flexibility to deliver the highest standards of accountability and responsibility for their behaviour and outcomes, reflecting their own circumstances. The new streamlined set of principles, our approach to developing them, and our rationale are outlined in Chapter 2. The following table sets out the broad objectives of the proposed principles.

Table 1 Objectives of the proposed principles

Principle	Objective
1. Purpose, values and culture	The board of the regulated water company sets the purpose, culture and values for the organisation, reflecting its position as a monopoly provider of an essential public service.
2. Board leadership and transparency	The board's leadership and approach to transparency and governance engenders trust in companies and ensures that they can be held accountable for their actions.
3. Stand-alone regulated company	The board of the regulated water company has the power to set its long term direction, and to make, and be accountable for, all decisions regarding its regulated activities as though these are substantially its sole business.
4. Board effectiveness	Boards and their committees are competent, well run, and sufficiently independent, ensuring that they can make high quality decisions that address diverse customer and stakeholder needs.

Alongside these changes we are proposing that all companies should have a licence condition to meet these principles, reflecting the importance of these principles for ensuring that customers are at the heart of a water company's business.

Over and above the flexibility available to companies in terms of how they comply with the principles, there may (as now) be exceptional instances where a company

cannot deliver against a particular aspect of the principles. Where this is the case, they will need to clearly explain how the approach they are taking is in line with the spirit of the revised principles. This may require companies to challenge themselves afresh about whether their alternative approaches are really delivering the objectives sought – it may be that they need to go beyond what they have done in the past. The licence obligation requires companies to take ownership of deciding how the objectives are best served and delivering this for their customers.

However, 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. This consultation tests whether it is appropriate to introduce a further licence obligation setting a minimum requirement for independent non-executive directors to be the single largest group on the board, as well as for all boards to be independently chaired. The rationale for these proposed licence conditions is explained in Chapter 3.

Our review has taken into consideration the evolving corporate governance landscape. While our principles aim to reflect the privileged position that water companies hold, which can mean going beyond the standards expected of other businesses, where relevant we have drawn on best practice in the following areas:

- The Financial Reporting Council's (FRC) consultation in December 2017 on [proposed revisions to the UK Corporate Governance Code](#), particularly in relation to the purpose, values and culture of boards. We will consider the conclusions of this review before we finalise the principles.
- The principles emerging from the Wates Review, proposing corporate governance principles for large private companies. On 13 June 2018, the FRC issued a [draft of the Wates Corporate Governance Principles for Large Private Companies](#), together with supporting guidance for public consultation.
- The work of other regulators, such as Ofgem.
- Sustainability First's work considering board effectiveness in meeting customer and stakeholder needs in water and energy.

Consultation questions

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

- 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?
- 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?

2. Proposed principles

In this chapter we outline the proposed principles, explain our suggested changes compared with the existing principles, our reasoning for these changes, and set out the issues on which we seek views. The full set of proposed principles and sub-principles is reproduced in Appendix 1.

Like the existing principles, our proposed revised principles consist of a main principle and a set of related sub-principles. The main principle is set at a high level, whereas the sub-principles are more specific expectations that are relevant to the policy objectives.

We generally expect companies to comply with the principles and the sub-principles and in many cases there will be different ways that companies can do this, e.g. in how they explain their group structure or report on their performance related executive pay. It is for companies to decide how best to meet the principles and sub-principles. We are not prescribing how companies should do that in order to give them ownership to allow them flexibility and space for innovation.

There may be instances where companies feel that their particular circumstances mean that they need to take an alternative approach and therefore cannot comply with a particular principle or sub-principle. We expect such instances to be rare, and in these rare cases they should clearly explain how the approach which they have taken is in line with the overall objective of the principle in question.

We propose that the principles should include the following:

Boards must meet or exceed these principles and demonstrate how they have done so. Where companies take alternative approaches to any of the principles, they must explain how the arrangements they have in place meet or exceed the spirit of the principles.

2.1 Purpose, values and culture

The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned with the needs of those it serves.

- i. 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.
- ii. The board should make sure that the company's strategy, values and culture are consistent with its purpose.
- iii. The board should monitor and assess values and culture to satisfy itself that behaviour throughout the business is aligned with the company's purpose. Where it finds misalignment it should take corrective action.
- iv. Companies' annual reporting should explain the board's activities and any action taken. It should also include an annual statement from the board focusing on how the company has set its aspirations and performed for all those it serves.

Developing the principle

This is a new proposed principle. The existing principles do not include any expectations about the board's role in establishing and maintaining the company's purpose, culture or values. Given the critical importance of a public service company's purpose, culture and values in delivering long-term success, and building trust, we have been developing what we expect of companies' boards in this regard.

It also incorporates a new reporting requirement based on the challenge we set the water companies in 2017 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.

Rationale

Given their privileged monopoly status, water companies have a special responsibility to work as diligently for their customers as for their owners.

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.

Since we published the principles in 2014, there has been an increasing focus in the wider economy on corporate values and culture, and the role of boards in driving them. For example in 2016, the Financial Reporting Council published a report '[Corporate Culture and the Role of Boards](#)', and included many of the findings of this report when revising the UK Corporate Governance Code.

Additionally, the Wates Corporate Governance Principles for Large Private Companies also proposes a separate principle related to company purpose. The rationale behind its introduction is that companies with a clear purpose often find it easier to engage with their customers, workforce and the wider public and can identify and explain how events or developments affecting the company's long-term success have been addressed. Our proposed principle is therefore consistent with this focus, and the wider developments in corporate governance.

The proposed reporting requirement for a statement focused on how the board has set its aspirations and performed (in sub-principle iv), mirrors the challenge that we have already set companies for their 2017-18 annual performance reports.

Consultation questions

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

2.2 Board leadership and transparency

Companies must demonstrate the highest standards of board leadership, transparency and governance.

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

- i. 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 hold responsibilities elsewhere in the group, pay policies should be fully disclosed at the regulated company level;
- 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 key risks to the future success of the business, and how these risks have been considered and addressed;
- iv. An explanation of group structure;
- v. The annual report should include details of board and committee membership, number of times they met, attendance at each meeting and where relevant, votes cast.

Developing the principle

The objective of this proposed principle is to engender trust and ensure that companies can be held accountable for their actions.

The sub-principles outline specific areas where transparency is necessary, including some new areas we have identified, and streamlining of the existing principles. Firstly, we are proposing a new sub-principle to explain how executives' performance related pay is aligned with performance for customers. Companies will be responsible for demonstrating how their approach reflects customer interests including, for example, the extent to which the short and long-term performance related pay policies link to ODIs, totex, or other regulatory mechanisms. This should be fully transparent at the regulated company level. Similarly for dividends, companies should explain how their dividend policies, and dividends paid, take account of delivery for customers and other stakeholders.

The sub-principles also streamline previous stand-alone principles regarding risk disclosures and group structure, and we are requiring companies to disclose details

of board and committee membership, the number of times they met, attendance at each meeting and where applicable, votes cast.

The transparency requirements in the existing principles require companies to meet or exceed the standards set out in the [Disclosure and Transparency rules](#) for listed companies, where relevant. However given that the rules are extensive and large parts of them are not relevant to companies which are not listed we propose to make the principles more specific. The one area referred to in the rules where we are particularly looking for transparency is on performance related executive pay and we have set out a specific requirement on this in the proposed principles themselves.

Rationale

Given the essential service nature of water companies' businesses, it is important for customers and other stakeholders that companies are transparent about how executives are remunerated and how performance related elements of pay substantially relate to delivery to customers. Performance related pay can align interests of directors with those of customers and company investors. Transparency of the relationship between pay and performance can help customers see how performance pay is aligned to the provision of an essential service.

It is equally important that stakeholders can clearly understand how dividends are determined, as currently already set out in the RAGs¹. As set out in [Putting the sector back in balance – summary of Ofwat's decision on issues for PR19 business plans](#), we also expect transparency on how obligations and commitments to customers and employees (including pensions obligations) have been factored into a company's dividend plan and met when dividends are paid.

Finally, the purpose of the proposed requirements in relation to board decision-making processes, is to increase transparency of boards' decision-making so that they are more clearly accountable to their stakeholders for the decisions they take. This is because it is important to demonstrate to stakeholders that board decision-making is rigorous and transparent, and that directors are exercising their judgement.

¹ [RAG 3.10](#) Section 3.4.1 requires companies to report on the value of any dividend paid and provide a comprehensive explanation of the basis of the dividend.

Consultation questions

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

2.3 Stand-alone regulated company

The regulated company must act as if it is a stand-alone company, and have an effective board with full responsibility for all aspects of the regulated company's business for the long term. Board committees, including but not limited to audit, remuneration and nomination committees, should operate at the regulated company level.

- i. The board of the regulated company must have meaningful control of the business, including the freedom to set, and accountability for, all aspects of the regulated company's strategy;
- ii. Full explanation must be given of any matters that are reserved for shareholders or parent companies (where applicable), and how this relates to the objective of sub-principle i;
- iii. Each of the board committees should report into the board of the regulated company, with final decisions made by the board of the regulated company;
- iv. The board of the regulated company should be fully focussed on the activities of the regulated company; take action to identify and eliminate any conflicts of interest, including those resulting from significant shareholdings; and ensure that the influence of third parties does not compromise or override independent judgement.

Developing the principle

We have retained the existing principle regarding 'stand-alone' regulated companies but have merged existing requirements for board committees and clarified minimum expectations. The proposed principle includes a renewed focus on the board's responsibility for the long-term sustainability of the regulated company by articulating that the board should have full responsibility for all aspects of the regulated company's business.

A revised sub-principle i includes a new emphasis on 'meaningful' control, recognising that there may be limited circumstances where holding company boards need to be involved in decision-making. This proposed sub-principle also expands on what is meant by 'ownership' of the strategy, to include 'the freedom to set, and accountability for' all aspects of the regulated company's strategy.

Sub-principle ii now requires that a full explanation must be given of the matters that are reserved for holding company boards, building on the existing sub-principle that it should be clear what decisions boards will be responsible for.

Sub-principle iii restates the existing separate principle that 'Final decisions on issues dealt with by each of the committees will be made by the board of the regulated company'.

A new sub-principle iv sets out that board members should act wholly and exclusively in the interests of the company. In line with the UK Corporate Governance code, in fulfilling their role as board members, they should take care to ensure that other interests do not compromise or override their independent judgement. For example, cross-minority share holdings² may create a risk of potential conflicts of interest if confidential information relating to one appointee becomes available to another.

Rationale

Given that it is the regulated company that holds the licence and the obligations rest with it, it is important that the board of the regulated company has the power to act independently in the long term interests of its customers.

The proposed principle includes a new focus on responsibility for strategic decision making to ensure there is clarity about the accountability for decision making in relation to the regulated company. This is to make it clear that in areas where the board of a holding company has influence over decision-making, the board of the regulated company must still take ownership of those decisions, and expect to be held accountable for them by customers and stakeholders.

The remaining sub-principles have been updated in line with the revised emphasis of the main proposed principle. There are concerns that reserving strategically important matters for a holding company board could undermine the ability of the regulated company to act independently of the wider group. The proposed sub-principle ii places the emphasis on the regulated company board to justify how the reserved matters allows it to maintain accountability for the regulated company, and freedom to set its strategy without undue interference from shareholders or parent companies. The undertakings that companies are required by their licences to obtain from an ultimate controller will help boards of regulated companies to uphold this principle. This is because the undertakings prevent a holding company from taking action which would or may cause the regulated company to breach any of its obligations under its licence or any of its statutory obligations.

Proposed sub-principle iii is aimed at ensuring that there is greater clarity about the expectations in relation to regulated company boards, and the role of the holding

² Some investors have (minority) shareholdings in more than one water companies.

company in an environment where the regulated company is expected to behave as a stand-alone company.

Proposed sub-principle iv sets out the expectation that that, in fulfilling their role, regulated company board members should act wholly and exclusively in the interests of the company itself and not be unduly influenced by other interests, including those resulting from significant shareholdings in line with the UK Corporate Governance Code.

Consultation questions

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

2.4 Board effectiveness

Boards and board committees should have the appropriate balance of skills, experience, independence and knowledge of the company. Boards should identify what customer and stakeholder expertise is needed in the boardroom and how this need is addressed.

- i. The chair must be independent of management and investors. There must be explicit division of responsibilities between running the board and executive responsibility for running the business;
- ii. There should be an annual evaluation of the performance of the board. This should consider the balance of skills, experience, independence and knowledge, its diversity, and how stakeholder needs are addressed. The approach should be reported in the annual report and any weaknesses should be acted on and explained;
- iii. There must be a formal, rigorous and transparent procedure for new appointments which is led by the nomination committee and supports the main principle. Decisions should be made in the context of skills and experience of the whole board, not solely on individual merits;
- iv. To ensure there is a clear understanding of the responsibilities attached to being a non-executive director in this sector, companies should arrange for the proposed, final candidate for new non-executive appointments to a board to meet Ofwat ahead of a formal appointment being made. This includes candidates for chairs, independent non-executive director and investor representative director positions;
- v. The independent directors on a committee should have the requisite knowledge and experience to enable them to provide appropriate challenge;
- vi. There should be a majority of independent members on the audit, nomination and remuneration committees and they must be led by an independent non-executive director.

Developing the principle

It is well established in our existing principles and wider corporate governance rules that boards and committees must have the right balance of skills, experience, independence and knowledge of the company. The independent oversight and constructive challenge that independent non-executive directors bring is critical to demonstrating that a company is well run. But this alone will not drive the high quality decision making that is vital to protect the interests of customers and stakeholders. The aim of this proposed principle is to bring a new quality dimension to board

decision-making by asking boards to show how they address customer and stakeholder needs, and diversity.

This principle also formalises the arrangements we currently have in place for Ofwat to meet with all non-executive directors prior to their appointment, to ensure a clear understanding of the special responsibilities that attach to non-executive directors of a regulated water company.

This proposed principle retains the original elements of board effectiveness. For example, the need for regular board evaluation and for there to be a majority of independent non-executive directors on board committees with the requisite knowledge and experience.

This proposed principle also retains the existing requirement for an independent chair. Having significant independent representation on boards, including the chair, is important to enable decisions to be taken in the interests of the regulated company.

In Chapter 3 we propose a separate licence requirement for independent non-executive directors to be the single largest group on the board because we think this is a necessary component of any effective board arrangement. Through this consultation we are also exploring whether the requirement for an independent chair should become a separate condition of the licence and consequently taken out of the principles.

Rationale

The future success of water companies depends on having a firm grip on customer and wider stakeholder needs. This is true of all businesses but for a regulated monopoly water company it is central to how regulatory settlements are determined and how companies must operate. Directors have a company law duty to promote the success of the company for the benefit of its members as a whole. However, it is not always clear how directors of water companies take account of the views and interests of customers and stakeholders in its decision making, so we would like to give more prominence to these factors through our principles.

Enshrining the existing principle of an independent chair as an obligation into the licence would ensure that independent oversight of the board is not compromised by other interests (either from within the group or elsewhere). However, we are open to exploring whether any flexibility around this is desirable to take account of particular

circumstances, perhaps in relation to different ownership structures. Our objective is to ensure that there is sufficient independent challenge and judgement on boards, so we would expect any representations for flexibility to explain how this balance could be achieved in the absence of an independent chair – perhaps through the role or number of other independent non-executive directors on the board.

A diverse board is better for avoiding ‘group think’, for connecting with the range of customers an organisation serves, and for accessing a wide talent pool. The sector must be able to attract the best talent to meet the challenges ahead. At board level this is especially true so we are proposing that annual board evaluations also consider how diversity can play a role in achieving a plurality of views and high quality challenge around the board table. This is consistent with the direction of travel of the UK Corporate Governance Code, as well as the proposed Wates Corporate Governance Principles for Large Private Companies, which promotes diversity in board composition with regards to gender, social and ethnic background in order to provide a wide range of perspectives.

We have found the pre-appointment meetings we have held with non-executive directors of water companies a helpful opportunity to share insights on the challenges and opportunities facing the sector. These serve a useful purpose in supporting a shared understanding of the particular role of non-executive directors at a regulated monopoly water company. While Ofwat expects boards to determine their own appointments, incorporating the expectation that all non-executive directors and chairs should meet with Ofwat before their appointment into the principles will ensure that these valuable meetings continue.

Consultation questions

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

3. Proposed licence changes

In this chapter we set out proposed changes to companies' licences³ to ensure that companies deliver high standards of board leadership obligations and to ensure a level of consistency across the sector. Subject to respondents' views we aim to engage further with companies on proposed licence drafting in the autumn ahead of moving to a formal section 13 consultation on any proposed changes.

3.1 General licence requirement to meet the principles

We are proposing to insert a requirement to meet the principles in all companies' licences⁴. We have already taken the opportunity to introduce this condition or proposed to introduce this condition into the licences of some companies who have recently undergone a structural change⁵. We believe this requirement is necessary in order to ensure that there are consistently high standards of board leadership across the sector and that the objectives of the principles will continue to be met as boards and investors change over time.

By making this a licence condition, the onus will be on companies to explain how their practices are delivering or exceeding the principles. We recognise that good governance can be achieved through a variety of means, and we have developed the principles to be a platform for companies to take innovative approaches where these deliver or exceed the principles. We would be interested, for example in whether approaches like holding stakeholder AGMs might be desirable to meet the aims of the principle on Board leadership and transparency, but don't intend to prescribe such approaches. However, over and above the flexibility that companies

³ We are proposing that this requirement and the other proposed licence requirements in this section would apply to the 17 largest appointees and the only licensed infrastructure provider (Bazalgette Tunnel Limited, known as Tideway)

⁴ We first proposed this change in our recent consultation on [Change of control – general policy and its application to Thames Water](#). We are currently in the process of considering the responses to this consultation. We have repeated the proposal here to allow respondees to consider it in the context of the wider changes to the principles which we are proposing in this document.

⁵ We have made this change for Hafren Dyfrdwy, Severn Trent Water, South West Water and consulted on introducing this requirement into the licences of Thames Water and Portsmouth Water.

have in terms of how they deliver against the principles, there may also be some limited occasions where the particular circumstances of a company mean that it cannot deliver against a specific sub-principle. Where this is the case companies will need to explain how an alternative approach still ensures that the company meets the objective of the principles.

We expect that any alternative approaches will be few in number for any particular company.

In instances where a company is not complying with a particular principle and is unable to provide a satisfactory explanation, as set out above, we will consider that a company has not met the requirements of the principle.

We are proposing that the new licence requirement to meet the principles would, as it has been to date, be accompanied by a mechanism which would allow companies to ask us to refer any revisions to the principles to the Competition and Markets Authority if the appointee disputes whether the revisions to the principles are reasonable and appropriate. This is in line with the appeal mechanism in the licence that is currently in place for the Regulatory Accounting Guidelines.

We are also proposing that the licence obligation to meet the principles would set out the process through which we would make changes to the principles (including that we will consult and any relevant notice periods). In combination with the proposed appeal mechanism, we consider that this allows a clear and proportionate framework for companies to engage on future changes to the principles and to ensure the changes fall properly within the scope of the licence requirement.

In light of a general licence requirement to meet the board leadership, transparency and governance principles, there may also be scope to simplify specific licence conditions relating to corporate governance that some companies currently have in their licences. We will consider the scope for simplification alongside work to finalise our position on the proposed changes to companies' licences in this consultation. We would welcome examples of specific instances where individual companies' licence conditions might conflict or overlap with the revised principles.

Consultation questions

- Q10: Do you agree with our proposal to insert a requirement in companies' licences that they must meet the principles?
- Q11: Do you agree with our proposal for an appeal mechanism and a change process in the proposed licence condition to meet the principles?
- Q12: Are there specific instances where individual companies' licence conditions might conflict or overlap with the revised principles?

3.2 Specific licence requirements on board composition

We believe that having significant independent representation on boards is a necessary component of any effective arrangement.

We are proposing to insert into companies' licences a requirement for independent non-executive directors to be the single largest group on boards compared to executive directors and non-executive directors who are not independent. This is because we consider that having good independent challenge is central to good governance. Independent directors can bring:

- a different perspective to other directors which may help bring greater challenge and scrutiny of the executive;
- a strong focus on the interests of stakeholders of the regulated business, including customers; and
- diversity of views and experience which other directors may not provide.

We are proposing that we will apply the criteria set out in the UK Corporate Governance Code to assess whether or not a director can be considered independent. This is a widely applied, accepted and understood test. However we could take an alternative approach whereby we would insert criteria for independence in the licence. This would allow us to reflect any particular

circumstances for the water sector. This is an approach which has been taken by Ofgem, for example⁶.

There is a question of whether we should go further than independent non-executive directors being the single largest group on board and consider whether in fact they should be the majority. We acknowledge that increasing the number of independent non-executive directors does not by itself lead to a better functioning board. However it may be that moving the balance further in the direction of independent directors could lead to a strengthening of an independent voice on the board. We could do this through either adding as an additional sub-principle or as a licence requirement.

We believe that there is a place for investors on regulated company boards in some ownership structures and that any requirement for a majority of independent directors could lead to unwieldy board sizes. We are therefore seeking respondents' views on the right balance of independent and non-independent directors and (as set out in 2.4) whether, if flexibility on whether there was an independent chair was appropriate, a greater proportion of independent non-executive directors could be an appropriate mitigation.

Transition periods

While the proposed licence requirement may not imply any change for most boards, it could lead to some companies having to amend the composition of their boards. We propose to allow a transitional period for these changes until April 2020 and would expect to discuss this with the companies concerned.

We also note that there may be periods when due to unforeseen circumstances, eg the sudden, unexpected departure of an independent non-executive director, a company might find that it does not have a sufficient number of independent non-executive directors. We propose that we would insert wording into the licence clarifying that such limited exceptions would not cause a company to be in breach of the licence condition, where action is being taken to address board balance within a reasonable timeframe.

⁶ See, for example, section 43A of [Standard conditions of the Electricity Distribution Licence](#)

Consultation questions

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

4. Responding to this consultation and next steps

As we have set out elsewhere in this document, this consultation is part of our work to bring the sector back in balance. As part of this package, we have already set out our [decisions on targeted amendments to our PR19 methodology](#). We are also planning to publish a discussion paper about putting customers at the heart of everything that water companies do, and to consult further on improving ring-fencing arrangements (bringing all companies up to the highest current level of protections in licences). We plan to publish both of these in early autumn, following engagement with industry and other stakeholders over the summer.

We will consider responses to this consultation and publish a final set of principles in the autumn, with a view to them applying from early 2019. If we decide to proceed with our proposal to make some or all of the licence changes outlined in chapter 3, we will engage further with companies about the wording of these changes in the autumn before proceeding to a formal section 13 consultation.

We welcome your responses to this consultation by close of business on **21 August 2018**. Please email responses to FinanceAndGovernance@ofwat.gsi.gov.uk or post them to:

Board leadership, transparency and governance consultation
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We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information⁷, may be published or disclosed in accordance with access to information legislation –primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation, the Data Protection Act 2018, and the

⁷ See [General Data Protection Regulation definitions](#)

Environmental Information Regulations 2004. For further information on how we process personal data please see our [Privacy Policy](#).

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

5. Appendix 1 – Consultation questions

- Q1: Do you agree with the objectives for the principles we have set out (in Table 1 of this chapter)?
- 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?
- 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?
- Q4: Do you agree with our proposed principle for purpose, values and culture?
- Q5: Do you agree with our proposed board leadership and transparency principle?
- Q6: Do you agree with our proposed principle for the stand-alone regulated company?
- Q7: Do you agree with our proposed board effectiveness principle?
- 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?
- 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)?
- Q10: Do you agree with our proposal to insert a requirement in companies' licences that they must meet the principles?
- Q11: Do you agree with our proposal for an appeal mechanism and a change process in the proposed licence condition to meet the principles?
- Q12: Are there specific instances where individual companies' licence conditions might conflict or overlap with the revised 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?
- 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?
- 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?

6. Appendix 2– Proposed set of revised principles

Boards must meet or exceed these principles and demonstrate how they have done so. Where companies take alternative approaches to any of the principles, they must explain how the arrangements they have in place meet or exceed the spirit of the principles.

Main principles	Sub-principles
<p>1. Purpose, values and culture The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned with the needs of those it serves.</p>	<ul style="list-style-type: none"> i. 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. ii. The board should make sure that the company's strategy, values and culture are consistent with its purpose. iii. The board should monitor and assess values and culture to satisfy itself that behaviour throughout the business is aligned with the company's purpose. Where it finds misalignment it should take corrective action. iv. Companies' annual reporting should explain the board's activities and any action taken. It should also include an annual statement from the board focusing on how the company has set its aspirations and performed for all those it serves.
<p>2. Board leadership and transparency Companies must demonstrate the highest standards of board</p>	<p>Companies must publish the following information in a form and level of detail that is accessible and clear for customers and stakeholders:</p> <ul style="list-style-type: none"> i. 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

Main principles	Sub-principles
<p>leadership, transparency and governance.</p>	<p>applied. Where directors' responsibilities are substantially focused on the regulated company and they hold responsibilities elsewhere in the group, pay policies should be fully disclosed at the regulated company level;</p> <ul style="list-style-type: none"> 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 key risks to the future success of the business, and how these risks have been considered and addressed; iv. An explanation of group structure; v. The annual report should include details of board and committee membership, number of times they met, attendance at each meeting and where relevant, votes cast.
<p>3. Stand-alone regulated company The regulated company must act as if it is a stand-alone company, and have an effective board with full responsibility for all aspects of the regulated company's business for the long term. Board committees, including but not limited to audit, remuneration and nomination committees, should operate at the regulated company level.</p>	<ul style="list-style-type: none"> i. The board of the regulated company must have meaningful control of the business, including the freedom to set, and accountability for, all aspects of the regulated company's strategy; ii. Full explanation must be given of any matters that are reserved for shareholders or parent companies (where applicable), and how this relates to the objective of sub-principle i; iii. Each of the board committees should report into the board of the regulated company, with final decisions made by the board of the regulated company; iv. The board of the regulated company should be fully focussed on the activities of the regulated company; take action to identify and eliminate any conflicts of interest, including those resulting from significant shareholdings; and ensure that the influence of third parties does not compromise or override independent judgement.

Main principles	Sub-principles
<p>4. Board effectiveness Boards and board committees should have the appropriate balance of skills, experience, independence and knowledge of the company. Boards should identify what customer and stakeholder expertise is needed in the boardroom and how this need is addressed.</p>	<ul style="list-style-type: none"> i. The chair must be independent of management and investors. There must be explicit division of responsibilities between running the board and executive responsibility for running the business; ii. There should be an annual evaluation of the performance of the board. This should consider the balance of skills, experience, independence and knowledge, its diversity, and how stakeholder needs are addressed. The approach should be reported in the annual report and any weaknesses should be acted on and explained; iii. There must be a formal, rigorous and transparent procedure for new appointments which is led by the nomination committee and supports the main principle. Decisions should be made in the context of skills and experience of the whole board, not solely on individual merits; iv. To ensure there is a clear understanding of the responsibilities attached to being a non-executive director in this sector, companies should arrange for the proposed, final candidate for new non-executive appointments to a board to meet Ofwat ahead of a formal appointment being made. This includes candidates for chairs, independent non-executive director and investor representative director positions; v. The independent directors on a committee should have the requisite knowledge and experience to enable them to provide appropriate challenge; vi. There should be a majority of independent members on the audit, nomination and remuneration committees and they must be led by an independent non-executive director.

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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