

9 August 2018

RESPONSE TO OFWAT CONSULTATION  
*Consultation on revised Board Leadership, Transparency and Governance principles*

Professor Christopher Hodges<sup>1</sup> and Ruth Steinholtz<sup>2</sup>

We would like to contribute some comments relating to:

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

**The Undoubted Importance of Culture**

We applaud Ofwat for highlighting the importance of purpose, culture and values and the alignment of these to the needs of those served by a company. For a long time the evidence of the importance of these concepts not only to the success of the company, but to the interests of its stakeholders has been growing. We believe it is now overwhelming. Therefore, it is right that Ofwat should encourage water companies to develop and articulate their social purpose, identify the core values that will serve this purpose, and align their culture, via these values, to the important function they serve in society.

**Assisting Clarity**

We note that Ofwat considered the FRC's December 2017 consultation on revisions to the *Corporate Governance Code*, particularly in relation to the purpose, values and culture of boards, and will consider the conclusions prior to finalising your Principles on Board Leadership, Transparency and Governance (the "Principles"). We strongly encourage you to do so, particularly as they are embodied in the FRC's *Guidance on Board Effectiveness*, (the "*Guidance*") issued a few days after Ofwat's consultation. Indeed, we question why a separate document with slightly different wording is required, as this may create some confusion, and whether it would not be simpler merely to state which principles of FRC's *Code* and of its *Guidance* Ofwat wishes boards to follow, and if there are any different provisions or wording that apply because they are specifically relevant for water companies. More on this below.

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<sup>1</sup> Professor of Justice Systems, and Supernumerary Fellow, Wolfson College, University of Oxford; Head of the Swiss Re Research Programme on Civil Justice Systems, Centre for Socio-Legal Studies, Oxford; Fellow, European Law Institute.  
Research funding is received on different projects from BEIS, the Swiss Reinsurance Company, and the European Justice Forum. Professor Hodges advises a wide range of regulators and utility companies but is not paid by them.

<sup>2</sup> Founder and Managing Partner of AretéWork LLP. Ruth Steinholtz is a fully certified consultant in the use of the Cultural Transformation Tools, of which a CVA is one. She is not an employee of the Barrett Values Centre. Professor Hodges and Ruth Steinholtz have served as advisors for Southern Water, Ms. Steinholtz has received consulting fees in that connection.

Although we are in full agreement with the focus on purpose, values and culture, we would like to make a few suggestions and comments that we hope will be considered carefully prior to finalising these Principles. Some of them relate to the way the Principles are articulated, and although our suggestions may appear to be minor, we believe that they are of fundamental relevance and necessary in order to avoid unintended consequences. Some of the suggestions relate to the manner of “regulating” culture (whether by a regulator or by a Board), again, in order to avoid culture turning into just another word for compliance.

Principle 2.1 (i) states that the board should **promote** and **develop** the collective vision of the company’s purpose... and (i) says that the board **should make sure** that the company’s strategy, values and culture are consistent with its purpose. Subsection (iii) states that the board should **monitor and assess** values and culture to **satisfy itself** that behaviour ...is aligned with the company’s purpose.

The relevant provisions of the FRC *Guidance* are worth setting out here (we again highlight relevant text, which indicates a somewhat different, and/or more detailed approach to that proposed by Ofwat). They are:

Paragraph 11. An effective board **defines the company’s purpose** and then sets a strategy to deliver it, underpinned by the values and behaviours that shape its culture and the way it conducts its business....

Paragraph 12. A company’s purpose is the reason for which it exists. The board is responsible for **setting and reconfirming** the company’s purpose... Companies with a clear purpose often find it easier to engage with their workforce, customers and the wider public.

Paragraph 18. The board **sets the framework** of values within which the desired corporate culture can evolve and thrive. **Ownership of the values will be stronger if a collaborative approach is taken and both the leadership and the workforce are involved in a two-way process to define the company’s values.**

Paragraph 20. To have an impact on behavioural outcomes and influence the way business is done, values need to be embedded at every level of the organisation. Boards **will need assurance from management that it has effectively embedded** the company’s purpose and values in operational policies and practices. ...

Paragraph 21. ...The board is expected to **assess and monitor culture** for alignment with purpose and values. The first step is to establish a benchmark against which future monitoring can take place. One approach to monitoring culture might be to identify and track core characteristics that are typical features of a positive culture... and link this to commitment to company values.

Paragraph 22. It is important that the board **develops a common and consistent language around culture**, and **pays attention** to factors that can influence culture... Boards will also need to **be alert to signs** of possible culture problems...

Paragraph 23. Monitoring culture will involve regular analysis and interpretation of evidence and information drawn from a range of sources. Drawing insight from multiple quantitative and qualitative sources helps guard against forming views based on incomplete or limited information. **The workforce will be a vital source of insight into the culture of the company.**

Paragraph 25. The board will be **looking to identify areas of good practice** and excellence that can be used to drive up standards across the business, **reinforcing the value** that a healthy culture can add. It will also be **seeking evidence of business practices** that are consistent with company values.

As currently drafted, we are concerned that the summary nature of the Ofwat's Principle 2.1, particularly when taken as a licence condition, will create "tick the box" compliance type behaviour that is the antithesis of a healthy ethical culture, based on values and aligned with social purpose. Although we believe that the *Guidance* is somewhat simplistic in the examples it gives on how to monitor and assess culture, it otherwise provides excellent guidance about the role of a board in relation to purpose, values and culture and we do not see the need for Ofwat to rewrite aspects of the *Guidance*, using in some cases, slightly different vocabulary. For example, Ofwat says the board should "promote and develop" a collective vision of the company's purpose...and "make sure" that the company's strategy, values and culture are consistent with its purpose whereas the *Guidance* says, "An effective board **defines the company's purpose** and then sets a strategy to deliver it, underpinned by the values and behaviours that shape its culture and the way it conducts its business."

When taken with later suggestion of the importance of using a collaborative approach, we think the FRC's language better sets out the relationship between purpose, values and culture and furthermore guides the board towards the importance of consultation with stakeholders in determining the values, and therefore the culture of the organisation, as well as the alignment with strategy, which is one of the paramount responsibilities of the board.

"Ownership of the values will be stronger if a collaborative approach is taken and both the leadership and the workforce are involved in a two-way process to define the company's values." (*Guidance*, Paragraph 18)

Language is important precisely for this reason, as is methodology. It is critically important that the board not sit in the boardroom and determine the purpose, values and desired culture in isolation. Only a process by which all stakeholders (especially employees, who are living the culture) are consulted will produce the appropriate answers for the company in question. There is no one right culture, and there is no one set of values that will work for every company. This is why we are concerned that the effect of Ofwat's proposal (and draft wording) will be taken as prescribing a particular culture.

Indeed, the FRC in Principle 23 goes on to say, "*The workforce will be a vital source of insight into the culture of the company.*" We agree with this, and it is for this reason that we recommend the use of the Barrett Values Centre's Cultural Values Assessment ("CVA") in our book.<sup>3</sup> This is a well-established method of canvassing all employees (and other stakeholders), no matter how large or small the company, to establish the values and behaviours that characterise the culture, as well as the sources and causes of dysfunction and therefore culture risk in the organisation. The use of a CVA creates a common language with which to discuss culture and also a picture of the values that the participants believe would improve the culture and therefore the results of the company. It is a powerful tool that would enable a board to carry out the responsibilities outlined above, including the need to identify areas of good practice, and obtain evidence of alignment (or lack thereof) of purpose, values and culture.

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<sup>3</sup> C Hodges and R Steinholtz, *Ethical Business Practice and Regulation: A Behavioural and Values-based Approach to Compliance and Enforcement* (Hart Publishing, December 2017).

We recognise the need to collect evidence from a variety of sources, and encourage a company to do this; and we find a CVA to be the best way we have seen to tie it all together and understand the forces at work in a culture that may be driving culture risk. As employees become disenchanted, upset, feel they have been treated unfairly, or are otherwise disengaged, they are better able to rationalise misconduct and still feel they are fundamentally good human beings. The way to reduce misconduct is to reduce their ability to rationalise bad behaviour by creating a fair, healthy ethical culture that makes people proud to work for the company. A strong social purpose, such as the supply of clean water and effective sewerage, necessary for all life, aligned with an effective strategy, are the remaining elements that create the conditions for long-term sustainability.

Compliance with external rules will never be as effective to motivate the majority of the employee population and indeed an excessive focus on it will have the opposite effect. Ofwat must take note of this and ensure that its regulatory framework does not incentivise companies to engage in tick the box compliance. To do otherwise is to be complicit in lowering, rather than raising standards.

### **Issues on Enforcing Culture**

If culture becomes a license condition, then companies can be expected to respond, “Tell us what that means and give us specific things to measure”. That will lead at least some companies to “measure” culture by applying a “tick the box” approach in order to “comply” with the license condition, which will certainly not be appropriate. Whilst we do not think that there should ever be only one methodology, it is very important not to adopt a “tick the box” approach and to assess culture in a sophisticated way through the exercise of judgment to a wide range of evidence.

It follows that there may be a difficulty about enforcing a licence condition that there has been a failure of “culture” in a company. We are all for Ofwat exercising its powers to require companies to focus on their purpose, values and culture, for *them* to define these for themselves, and to show that they have followed a process satisfactorily. However, we have difficulty seeing how removal of a license from a particular company if it is considered not to have the desired culture will function. At what point do you judge that? When there has been one violation? Twenty?

Companies should be able to provide evidence of serious, consistent, holistic and genuine steps to create and maintain a healthy ethical culture. Such a culture is not created overnight; it takes time to transform a culture. Companies should also be able to provide evidence of such a culture based upon “evidence and information drawn from a range of sources. Drawing insight from multiple quantitative and qualitative sources helps guard against forming views based on incomplete or limited information.” (*Guidance*, Principle 23). We have written extensively on this in our book.

Many regulators have (frequently with justification) talked about having an innate sense (a feel, or smell) of when a company inspected has a bad culture. But now that we elevate culture to a more formal requirement, that sort of instinctive judgment will no longer suffice to justify formal action (even if it remains relevant in practice). In

seeking to enforce a general requirement to have an appropriate culture, may be it may be difficult for a regulator to prove (a) what a baseline ‘good’ culture is, or (b) quoting the proposed wording, that a particular company has a ‘bad’ culture, or (c) that a company’s culture is *not* ‘aligned with the needs of those it serves’.

The industry generally has not developed to the stage of having a consensus on the appropriate methodologies or at least acceptable types of evidence of *how* to do all this, and in particular how to “assess and monitor culture for alignment with purpose and values” as the FRC requires. Perhaps there will never be one right answer to this question. Finally, the existence of an ethical culture is a delicate thing. Changes to management may produce a temporary worsening of the culture, which can be dealt with by the board. If the company stands to lose its license, how likely is the board to want to share any issues it might be facing with Ofwat? Ofwat must be seeking to create cultures of continuous improvement and learning. We applaud Ofwat’s focus on purpose, values and culture and respectfully request it consider these suggestions in order to better accomplish its goals of creating a trusted sector and sustainable companies.