

NORTHUMBRIAN WATER LIMITED

RESPONSE TO OFWAT'S CONSULTATION ON REVISED BOARD LEADERSHIP, TRANSPARENCY AND GOVERNANCE PRINCIPLES

Northumbrian Water Limited (NWL/the Company) welcomes Ofwat's continuing focus on Board leadership, transparency and governance in the water sector and we appreciate the opportunity to contribute to the debate on appropriate best practice.

As we explain below, whilst we would be prepared to accommodate many of the proposed principles, we believe some go beyond what is appropriate for NWL as a single-investor owned company. Specifically, we do not support any Licence changes that would require Independent Non-executive Directors (INEDs) to be the largest group on the Board or that the Chairman of the Board, Remuneration or Nomination Committees has to be independent.

It may be helpful to provide some context for our responses. We do not agree with the assumed starting position that trust and confidence in every company in the sector has been eroded or that the legitimacy of the whole sector is in doubt. Indeed, we have robust independent evidence that there is a strong level of customer and stakeholder trust and confidence in NWL, and the whole Company continually strives to deliver an unrivalled customer experience. As recently reported, we have yet again made good progress across many of our key measures of success in 2017/18. Our overall operational performance has remained excellent, delivering for customers through low interruptions to supply, low levels of leakage, first class wastewater treatment compliance, good water quality, continued good progress in reducing sewer flooding, and bathing waters in the north east of England all meeting the required standard. This strong performance is reflected in some of the awards given to NWL in 2017/18; these include Utility Week's prestigious 'Utility of the Year' award, 'Water Company of the Year' and 'Customer Service Initiative of the Year' at the Water Industry Awards, as well as the overall UK Excellence Award in the British Quality Foundation's large private sector business category. This continuous focus on performance has led to us achieving a high level of customer trust with year on year improvements in this critical measure.

The NWL Board never loses sight of the need to work collaboratively with our stakeholders, and the Company's open and honest approach to customers remains a key element of our corporate culture built on clear values, against which all our business decisions are continually sense-checked. We believe that the Company's excellent customer service and strong operational performance are underpinned by the high corporate governance standards maintained by the NWL Board.

In this context, we believe NWL has always behaved appropriately and responsibly, to the highest standards, within the framework of our robust governance principles, without the need for a "one-size-fits-all" set of Licence conditions. We concur with leading authorities such as the Financial Reporting Council (FRC) that there is no "one-size-fits-all" version of corporate governance, which is why the UK has embraced the established "comply or explain" principle with such success. The "comply or explain" principle has also been reinforced by the latest FRC guidance on the UK Corporate Governance Code (UK CGC), published after the release of Ofwat's latest consultation document. We also take full account of the recommendations in the recent Wates Consultation, which is tailored for private companies such as NWL, and that specifically and importantly highlights that:

"Differing management and ownership structures means that a one-size-fits-all approach to corporate governance in large private companies is not appropriate".

As NWL's Chairman explains in his introduction to NWL's 2018 Annual Report and Financial Statements (the "ARA"), the primary purpose of the FRC's UK CGC is to protect dispersed shareholders in listed companies. We acknowledge that a highly fragmented shareholder base can introduce additional governance complexities, including heightened principal-agent risk, which may favour the appointment of an independent chair or for INEDs to be the largest group on the board. However, in a company with a single consolidated shareholder, principal-agent risk can more effectively be addressed through an appropriate number of shareholder appointed directors, which may also include the chairman.

Our Licence requires us to act as if we were a public limited company, having particular regard to (i) a board composition which ensures it acts independently and exclusively in the interests of the Appointee; and (ii) the FRC's guidance, including the requirement to explain our reasoning where the guidance is not appropriate to be followed.

Whilst deconstructing a board into sub-components can be helpful for theoretical discussions on the degree of inherent alignment, all NWL Directors remain very mindful that in discharging their duties they must always comply with The Companies Act 2006, including:

“A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole...”

We understand, from the previous open discussions within the sector, the primary drivers giving rise to this consultation. We therefore agree with the spirit of Ofwat’s main principles and the objectives behind them but, as set out in our responses to the specific questions below, it is not appropriate to try and achieve this through a new “one-size-fits-all” set of Licence conditions.

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

The objectives in Table 1 are as follows:

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.

We comment on each in turn, below:

1. We agree.
2. We agree that the board’s leadership and approach to transparency and governance can be a factor in engendering trust and can increase accountability. We do not agree that the board’s approach to these matters, of itself, engenders trust or ensures accountability. We consider that the service provided to customers and the outward facing behaviour of the company is more important to engendering trust than, for example, the precise composition of the board, in which many customers are not at all interested. Moreover, companies are already accountable for their actions, under an extensive set of legal and regulatory obligations, performance against which is heavily reported, audited and assessed.
3. and 4. We agree.

We believe NWL’s existing governance arrangements are consistent with these objectives as evidenced by our strong performance noted above which is aligned to the interests of our customers and stakeholders.

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?

We agree.

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?

We agree that if companies do not comply with specific principles, they should explain very clearly why not, and why the overall approach taken is appropriate in the circumstances and provides a good level of governance. The reference to meeting the spirit of the principles is a little imprecise and we would happily work with Ofwat to establish an appropriate form of wording to capture this principle.

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

We agree.

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

We agree, on the understanding that remuneration committees need to retain a reasonable degree of discretion. We do not agree that links to delivery for customers should be applied entirely mechanistically; there can be other legitimate factors in setting executive reward.

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

We agree.

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

We agree with the principle and with sub-principles ii. to v., on the understanding that the pre-appointment interviews referred to in sub-principle iv. are not intended to constitute vetting of any individual appointment. Any meetings would therefore constitute part of an induction process and, similarly, we would value the opportunity for the NWL Board to meet new Ofwat INEDs.

In relation to sub-principle i., we agree that there should be an explicit division of responsibilities between running the board and executive responsibility for running the business. As Ofwat is aware from discussions when the existing principles were introduced, we strongly support a tailored approach to the independence of the chair. Where regulated companies have, effectively, a single ultimate shareholder, then in those circumstances a shareholder-appointed chairman is likely to be warranted, in light of the billions of pounds of 'at risk' equity capital the shareholder is likely to have invested in acquiring the business, which is certainly the case for NWL. We believe this represents both good governance and sound stewardship. The effectiveness of the company's governance then depends on the quality of the chair and the other directors (including INEDs), and the overall balance of the board. The independent NWL Board evaluation carried out recently by Professor Giovanna Michelon reported a number of positive comments on the functioning of the NWL Board: the Chairman's style was described as "empowering" and he was said to "create an atmosphere where all people feel comfortable to comment and are very appreciative of other people's comments during meetings". Further comments included:

"everybody has had a good hearing, challenges are there, but also support";

"everybody has a chance to speak"; and

"[we] have created an environment where everybody feels comfortable giving their opinions and contributing to debate and conversation".

We do not believe there is any evidence to suggest that having a shareholder-appointed chair results in worse outcomes for customers. We appreciate that having an independent chair may be appropriate for some publicly-listed companies, but the drivers for that are principally to protect highly fragmented shareholder bases (in some cases running into hundreds of thousands of individual shareholders) and should not be mechanistically carried over to a privately-owned company with a single ultimate shareholder where the principal-agent risk can be addressed much more effectively through other means.

In respect of sub-principle vi., we agree that there should be a majority of INEDs on the audit, nomination and remuneration committees. We do not, however, agree that the nomination and remuneration committees need to be led by an INED. For the reasons set out above in this specific question response, we believe it is appropriate within NWL's ownership structure, for these Committees to be led by a shareholder-appointed Director (in the current case the Chair of the Company).

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?*

As we explain above, we do not agree with the proposed requirement for an independent chair in the case of privately-owned companies with a single ultimate shareholder. We therefore do not agree that this should be a Licence condition. We do not believe that further mitigation is necessary, beyond the strength and sound approach provided, in NWL's case, by the current balance of the Board as demonstrated by the Company's delivery to customers. We understand the need to continue to explain the appropriateness of this to NWL's circumstances in light of the FRC's UK CGC, which itself highlights that there is no "one-size-fits-all" approach to corporate governance.

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 do not think the proposed principles offer companies enough autonomy and flexibility, reflecting their own circumstances. We comment below in more detail on overall board balance, but we favour a more tailored approach in relation to the independence of the chair and the balance between INEDs and other directors, based on each company's own circumstances.

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

We do not agree that it would be helpful to insert a Licence requirement that companies must meet the principles and sub-principles. We believe the principles already carry enough weight to give them full effect and that the regulatory regime in the UK water sector is already, rightly, particularly exacting and demands a huge degree of disclosure and reporting. We therefore think that where good standards already exist, or can be encouraged by means of a principles-based approach, that is far preferable to further binding and restrictive Licence conditions.

We also note that Ofwat already has an opportunity to revisit Licences where there is a material change of ownership, and could do so again if our current ownership structure was to significantly change.

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

As we mention above, we do not agree that further Licence conditions need to be imposed. However, if Ofwat does take this course we agree that there should be an appeal mechanism. As drafted, the consultation document suggests that such appeals would be against the revisions being "reasonable and appropriate". That is, of course, a very low threshold for Ofwat to meet. A fairer approach would be if Ofwat had to demonstrate that the current provisions are against the public interest, in line with current competition law. Any further changes should be subject to a similar mechanism.

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

This is possible, but a detailed review would be needed once the final shape of the revised principles is clearer.

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

We do not agree that INEDs need to be the single largest group on the Board. We therefore do not agree that this should be in the principles or Licence changes and we believe any such Licence change would be disproportionate in our case. As we have explained in our ARA, we believe the NWL Board is well balanced and that there is no merit in arbitrarily disrupting that balance. NWL has four, rather than the required three INEDs under existing Condition P, all of whom are professionals of the highest calibre, with directly relevant experience, gravitas, expertise and knowledge of the business and the sector. They work extremely hard and play a pivotal role in the work of the NWL Board. The Senior INED, Paul Rew, comments in the ARA (at page 55):

"I can confirm that the INEDs are all satisfied that the balance of experience and expertise on the Board of NWL, its Committees, Sub-committees and the PR19 Board Sub-group ensures that robust compliance and good governance are achieved and that the interests of all the Company's stakeholders, and especially customers, are protected".

Mr Rew's comment builds on the Chairman's observation (on page 52 of the ARA) that "..... the Board continues to function as an integrated whole and that the composition of the Board ensures a sound balance and that decision making is not dominated by any single group." The Board of NWL has never taken any action which does not have the support of our INEDs. We believe the suggested proposal underestimates the power of the INEDs as a group and as independent professionals.

We also believe that adding additional INEDs would increase cost and make the Board more cumbersome, neither of which is in the customers' interests.

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?

We agree that Ofwat should use the criteria for independence as set out in the UK CGC, with the exception of those related to length of service. The latest FRC UKCGC guidance published after the release of this consultation, has now moved away from a position where nine years of service could be viewed as a 'loss of independence' for an INED, and the FRC's guidance has now clarified that this could be viewed as an indicator of 'potential loss of independence' which then needs to be tested and explained. NWL has found it extremely helpful to have INEDs who, whilst fully and demonstrably independent, have been able to develop a deep understanding of what is an extremely complex sector.

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?

For the reason given in our response to Q13, we do not see any advantage for customers or any other stakeholder in requiring an increase in the number of INEDs on the Board. If Ofwat decides, nonetheless, to take this approach, we do not believe it should become a Licence condition, as we believe this would be disproportionate in our case.

Northumbrian Water Limited

21 August 2018