

Severn Trent
PO Box 409
Darlington
DL1 9WF
stwater.co.uk
0345 7 500 500

Ofwat
21 Bloomsbury St
London
WC1B 3HF
By email: FinanceAndGovernance@ofwat.gsi.gov.uk

21 August 2018

Dear Ofwat,

Board leadership, transparency and governance consultation

We welcome the opportunity to comment on the above consultation, which is very timely given concerns over the legitimacy of the water sector. This response is being submitted on behalf of Severn Trent Water Limited (STW) and Hafren Dyfrdwy (HD) Limited.

We are very supportive of Ofwat's high-level objective to ensure that water companies are appropriately governed and adopt the right culture and sense of social purpose. While the nature of ownership of regulated water companies has changed in the sector since privatisation, we believe that there is scope for different governance models to reflect the circumstances of different companies in the sector. While many of the proposed changes are arguably required, we do not necessarily think that in all circumstances they are appropriate for STW and HD.

As a group of companies with a main market listed parent company, Severn Trent Plc supports the highest standards of corporate governance, and the group's governance framework complies with the requirements of the UK Corporate Governance Code (the Code). In line with the requirements of the Code and the UK Listing Authority's (UKLA) Listing Rules, Disclosure Guidance and Transparency Rules, the group's governance framework ensures the required and appropriate level of visibility and supervision of the activities of the Companies by the Board of Severn Trent Plc. Severn Trent Plc is not highly geared, and does not rely upon dividends from its operating subsidiaries to service its debts. In excess of 90% of the Severn Trent group's revenues are generated through the provision of regulated water and waste water services. As such, the group's purpose: to serve our communities and build a lasting water legacy; and its values which include putting customers first, reflect Severn Trent's understanding of the privileged position as a monopoly provider of an essential public service (for STW and HD).

We continue to believe that the Board's strong focus on the group's purpose and values, underpinned by rigorous and independent monitoring of the financial viability and adequacy of the group's risk management processes and internal control environment, provides the best possible supervisory model for both STW and HD. The current governance model for STW, whose directors are the same as those of Severn Trent Plc, was implemented in 2007 precisely to address perceived governance weaknesses at the regulated company level which persisted prior to that time. It is our belief that the customers and stakeholders enjoy a significant benefit by virtue of the robust challenge, scrutiny and oversight of their respective businesses provided by the independent directors of Severn Trent Plc.

We have provided answers to the specific questions in the attached annex. Should you require any further information please do not hesitate to contact me.

Yours sincerely,

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Director Strategy and Regulation

Annex to Board leadership, transparency and governance consultation

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

We support Ofwat's high-level objective to ensure that water companies are appropriately governed in the interests of their customers and other 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 support Ofwat's high-level objectives. However, we do not believe that there is a single governance model which meets the circumstances of all companies in the sector. As such, the principles should allow sufficient flexibility for companies with an appropriate control environment and governance to determine suitable arrangements which meet Ofwat's high-level objectives as well as reflecting their own circumstances.

For a regulated company which is a subsidiary of another company, it may be desirable or beneficial for its governance arrangements to draw upon the resources and experience of its parent. In particular, where the provision of regulated activities by a subsidiary of a listed company represents a substantial majority (say in excess of 80%) of the overall group's business activities, the parent company's own governance arrangements are likely to be aligned with Ofwat's objective to ensure that water companies are appropriately governed in the interests of their customers and other stakeholders.

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 companies should continue to be able to comply with the spirit, if not the letter, of the principles, subject to explaining how their own approach to governance provides adequate direction and control of the company in the interests of customers and other stakeholders.

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

In a listed group of companies, it is appropriate and advantageous for the high level purpose, strategy, values and culture of the regulated company to be aligned and consistent with those of its parent and sister companies. There are policies, systems and controls which apply throughout the group to ensure high standards of business conduct and ethics, risk management, financial control and bribery and fraud prevention which need to be applied consistently from the top down. It would be inappropriate for the board of a listed parent company not to have control of, or influence over, such matters as required by, among other things, the UKLA's Disclosure Guidance and Transparency Rules¹.

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

In a listed group of companies, it is appropriate for remuneration policy to operate at the parent company level, particularly for executive directors who are also directors of the regulated company. It is a legal requirement² for the remuneration of such directors to be determined by the board or remuneration committee of the parent company.

¹ <https://www.handbook.fca.org.uk/handbook/DTR/7/1.html>

² The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013: <http://www.legislation.gov.uk/ukxi/2013/1981/schedule/made>

Executive directors and senior managers of the regulated company may also not be directly employed by that company (as is the case for HD). As such, whilst it will be appropriate for them to have short and long-term performance targets linked to delivering for customers of the regulated entity, determination of the targets and assessment of performance should be done by the Remuneration Committee of the parent company, taking into account the views of the regulated company's board as well as the executives' other duties. Pay policy reporting by regulated companies will need to reflect these nuances. The group's remuneration policy and remuneration arrangements are fully and transparently disclosed in the Remuneration Committee report contained within the Severn Trent Plc Annual Report and Accounts.

In respect of risk management, STW and HD currently report the key risks to the future success of their businesses. However, Group's Audit Committee currently plays a critical, mandatory role in overseeing the financial viability and effectiveness of STW and HD internal control and risk management frameworks, and this must be allowed to continue.

Regarding the reporting of the Board's activities, we note Ofwat's recommendation that the Companies report, where relevant, votes cast at Board meetings. Both STW and HD will need to report in future on how their Boards have had regard to the matters in s.172 Companies Act 2006 when fulfilling their duties, and should report on the issues, factors and stakeholders the directors consider relevant in complying with that section. The disclosures will however, only be in relation to matters of strategic importance to STW and HD, and will not be a disclosure of specific decisions taken by the Boards or how individual directors' votes have been cast. We believe that this level of disclosure is appropriate to give the customers and stakeholders of both companies an understanding of how their respective interests are taken into consideration in the Boards' decision making, and expect that the specific disclosure of votes cast by directors would only ever need to be made in exceptional circumstances.

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

As a main market listed company, Severn Trent Plc is bound to comply with the requirements of the UK Corporate Governance Code and the UKLA's Listing Rules, Disclosure Guidance and Transparency Rules. These require, among other things, that the Severn Trent Group's governance framework ensures an appropriate level of visibility and supervision of the activities of both companies by the Board of Severn Trent Plc. We believe that this arrangement is beneficial to both STW and HD for the reasons set out above. Further, in excess of 90% of the Severn Trent group's revenues are generated through the provision of regulated water and waste water services by the STW and HD. As such, the group's purpose: *to serve our communities and build a lasting water legacy*; and its values which include *putting customers first*, reflect Severn Trent's understanding of the privileged position as a monopoly provider of an essential public service (for STW and HD).

Furthermore, executive directors of STW and HD and other senior managers who have accountability for the regulated entity's performance may be employed by another group company or have other duties in respect of other group companies. As such, matters relating to the appointment, remuneration and succession of executive directors and senior management may be more properly decided upon at parent company level, taking into account the views of the STW and HD Boards.

In a listed company, the Audit Committee is required³ to oversee the group's systems of risk management and internal control, as well as to ensure the integrity of the group's financial reporting. Whilst it is wholly appropriate that the regulated entity's Board should be accountable for delivery of that company's strategy, it would not be appropriate for the listed parent company's Board to have no locus with respect to the regulated company's activities.

³ <https://www.handbook.fca.org.uk/handbook/DTR/7/1.html>

Ofwat's sub-principle that the board of the regulated company should identify and eliminate any conflicts of interest and ensure that the influence of third parties does not compromise or override independent judgement. Notwithstanding that directors of STW are also directors of Severn Trent Plc, the directors of STW and HD are bound by company law duties to avoid conflicts of interests and exercise independent judgment at all times when acting in their capacity as directors of STW and HD. The Boards follow well established formal procedures in line with the requirements of s.175 and s.177 Companies Act 2006 to declare and consider potential and actual conflicts of interest at the beginning of every meeting.

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

We agree that Boards should have the appropriate balance of skills, experience, independence and knowledge of the company to be fully effective. We do not believe that a director's independence is automatically compromised by virtue of his or her other directorships in the Group, for the reasons stated above.

In line with corporate governance best practice, the Severn Trent Charter of Expectations and Role Profiles⁴ sets out clearly the defined roles of the Chairman, Chief Executive, Chief Financial Officer, Senior Independent Director and Non-Executive Directors, as well as the operation of the Boards. In accordance with the Code, it sets out a clear division of responsibilities between the roles of Chairman and Chief Executive.

The Charter of Expectations is used to assist in the ongoing assessment of the effectiveness of the Boards and that of individual Directors.

Regarding the effectiveness of Board committees, see the comments made in response to question 6.

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?

While we support the general intent in relation to Board effectiveness, we do not support the proposal for an independent chair to be a stand-alone licence obligation. In common with all the principles, we believe that companies should continue to be able to comply with the spirit, if not the letter, of the principles, subject to explaining how their own approach to governance provides adequate direction and control of the company in the interests of customers and other stakeholders. The latest version of the Code provides that a chairman need only be independent on appointment.

Appropriate mitigations are discussed above in respect of board effectiveness.

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)?

As described above, we believe that by being overly prescriptive the proposed principles would, in certain circumstances, limit the ability for STW and HD to deliver the highest standards of accountability, responsibility and oversight for their behaviours and outcomes. We continue to believe that regulated companies should be able to comply with the spirit, if not the letter, of the principles, subject to explaining

⁴ https://www.severntrent.com/content/dam/stw/ST_Corporate/About_us/corporate-governance-docs/Charter-of-Expectations-24.03.17.pdf

how their own approach to governance provides adequate direction and control in the interests of customers and other stakeholders.

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

We support the proposal to insert a requirement into companies' licences that they must aspire to meet the principles, subject to being able to explain circumstances in which it is not possible or desirable to comply with the strict letter of the principles and explaining how their own approach to governance provides adequate direction and control of the company in the interests of customers and other stakeholders.

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

We agree with this proposal.

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

The current governance model for STW, whose directors are the same as those of Severn Trent Plc, was implemented in 2007 by agreement with Ofwat. We would expect that this arrangement will be allowed to continue to operate, subject to STW continuing to report on its current governance arrangements and how its approach to governance provides adequate direction and control in the interests of its customers and other stakeholders.

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

Subject to our answer to question 10, we do not support the proposal for prescriptive, stand-alone licence obligations which would inhibit a company's ability to explain circumstances in which it is not possible or desirable to comply with the strict letter of the principles and explaining how their own approach to governance provides adequate direction and control of the company in the interests of customers and other stakeholders.

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 are supportive of an alternative approach, which preserves the arrangement currently applied by STW and which recognises the processes and procedures discussed above which safeguard the non-executive directors' objectivity in respect of both STW and HD. We believe that the application of the independence definition in the UK Corporate Governance Code to directors of a regulated subsidiary would not be appropriate or advantageous, provided the appropriate mitigations are in place as described in our answer to question 6.

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?

Subject to our answer to question 10, we do not support the proposal for prescriptive, stand-alone licence obligations which would inhibit a company's ability to explain circumstances in which it is not possible or desirable to comply with the strict letter of the principles and explaining how their own approach to governance provides adequate direction and control of the company in the interests of customers and other stakeholders.