

CONSULTATION ON REVISED BOARD LEADERSHIP, TRANSPARENCY AND GOVERNANCE PRINCIPLES

South East Water response

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1. Introduction

This is South East Water's response to Ofwat's consultation on board leadership, transparency and governance principles.

We support the objectives of the revised principles to promote transparency and accountability.

South East Water already satisfies the requirements relating to the composition of the board and its committees. We have an independent chair, independent non-executive directors are the largest group compared to other groups on the board and the nomination, remuneration and audit and risk committees are chaired by and have a majority of independent non-executive directors.

All decisions relating the South East Water are taken by its board and no matters are referred to any holding company.

We would support the introduction of a licence condition that independent non-executive directors should be the largest group on the board. However we do not support the proposal to have a majority of independent directors on the board for the same reasons as those set out in the consultation document.

We have reservations on the introduction of a licence condition to meet all the principles. A licence condition should take account of the nature of the relevant principle and in particular whether or not it would require judgement and interpretation.

We believe that how companies meet principles that relate to the role and conduct of the board (including reporting requirements) should be assessed by Ofwat through the Company Monitoring Framework. We believe this would provide an equally strong, if not stronger, incentive for companies as the Company Monitoring Framework has a significant component of relative competition. It would also allow flexibility for companies and give Ofwat the means to influence best practice through annual assessments.

We also believe that the UK Corporate Governance Code should remain the source of the core requirements relating to corporate governance complemented by Ofwat's principles.

We welcome this opportunity to comment on proposed potential changes to the instrument of appointment but a better process would be to complete a consultation with the industry as a whole before applying the same changes to particular companies.

2. Responses to questions

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

We agree with the overall objectives set out in the document.

In respect of the second objective, we suggest to review the wording as follows: “The board’s leadership and approach to transparency and governance engenders trust in companies and accountability for their actions.”

We support an ethical requirement for accountability, however accountability is also a matter of scrutiny by third parties (made possible by the required transparency by companies). Boards cannot ensure that unrelated and independent third parties will act in a particular way.

QUESTION 2: 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 with an approach consisting in setting out principles and letting boards decide how best to meet them. This allows boards to define their approach to governance, reflecting circumstances and strategies and gives them the flexibility to adapt their approach as appropriate. This is also consistent with the overall governance approach defined in the UK Corporate Governance Code.

QUESTION 3: 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 the general “comply or explain” principle of corporate governance should apply also in respect of the principles set out by Ofwat. It would be useful to define with additional objectivity how companies would be expected to explain deviations with principles and how they still meet the relevant overall objective. Reference to the framework set out by the FRC in their publication “What constitutes an explanation under ‘comply or explain’?” may bring additional clarity in this area.

There should also be, as has been suggested in the consultation document in respect of proposed licence conditions, adequate flexibility to take account of temporary situations that may not allow companies to comply with the principles at all times due to legitimate external circumstances.

QUESTION 4: Do you agree with our proposed principle for purpose, values and culture?

We agree with these principles and approaches of governance that promote the definition of a coherent set of principles and practices by companies that include cultural and other behavioural considerations. This is in line with the work carried out by the FRC for example in their report on corporate culture and the role of the board.

QUESTION 5: Do you agree with our proposed board leadership and transparency principle?

We generally agree with the principles subject to the following comments and concerns.

We note that companies will already report on director's remuneration and performance related pay in their directors' remuneration reports and to fulfil the requirements of section 35A of the Water Industry Act 1991.

The sub-principle requiring companies to provide an explanation of their dividend policies and dividends paid and how these take account of delivery for customers and other obligations (including to employees) should recognise that when defining dividend policies and dividend payments directors must take account of company law and regulatory requirements (including price controls) and act independently in the long term interests of the company and in accordance with their duties (which require them to have regard to the interests of customers, stakeholders and employees). A statement recognising that boards are responsible for defining their dividend policies and dividend payments in the long term interests of the company and in accordance with their duties should be added to sub-principle ii to reflect a wider range of relevant considerations. This would be necessary if a licence condition was imposed to meet that requirement. The principle is expressed as a reporting and transparency requirement and should be strictly limited to that, but the possibility of a licence condition brings the question of its enforcement and which criteria would be considered in assessing whether or not the sub-principle had been met. To what extent could this have the effect or be seen to contradict decisions made by the board after due consideration of their duties is uncertain and a cause for concern.

Sub-principle v currently requires the annual report to include where relevant (i.e. presumably where the decision is not unanimous) details of vote casts. We are opposed to this and request for this particular aspect of the sub-principle to be removed for being

inconsistent with the duty of confidence of directors and the concept of a unitary board (understood here as a board where decisions are made by consensus) and the principle that the board as a whole is responsible for its decisions and the management of the company. Anonymous reporting on split votes may be an alternative.

QUESTION 6: Do you agree with our proposed principle for the stand-alone regulated company?

We generally agree with the principles subject to the following comments.

Sub-principle iii, under the “stand-alone regulated company” principle, suggests that all decisions should be made by the whole board. We believe this is a drafting issue and that the sub-principle intends to deal with committees that would not be committees of the board of the regulated company but this needs to be clarified. In cases where committees are already committees of the board of the regulated companies, they will make decisions in accordance with their terms of reference, and even if these decisions are considered to be decisions of the board, we believe that the wording of the sub-principle should be clarified.

When referring to sub-principle iv, under the “stand-alone regulated company” principle, the consultation document refers to issues arising from cross-directorships which could give some shareholders access to information on several companies. The wording of the sub-principle however refers to “significant shareholdings” which is not otherwise defined. The intended meaning of this expression should be clarified or replaced with a reference to cross-directorships.

The avoidance and management of conflicts of interest is a crucial part of governance and compliance with company law, however, the current drafting of the sub-principle should refer to this being done in accordance with company law. To the extent the sub-principle relates to conflicts of interest it does not seem to recognise or be fully consistent with relevant provisions of company law including those relating to authorisation especially sections 175 and 180 CA06. We suggest that the sub-principle should refer to board taking action to identify, avoid or manage conflicts of interests in accordance with company law.

QUESTION 7: Do you agree with our proposed board effectiveness principle?

We agree with the principles and believe that companies would already comply with these principles by following the requirements of the UK Corporate Code and the current Ofwat principles and the interview process for directors’ appointment on the board of regulated companies.

QUESTION 8: Do you think that the requirement for an independent chair should be a stand-alone licence obligation or should we allow some flexibility? If the latter, what mitigations would be appropriate where a company does not have an independent chair?

We believe that the sub-principle combined with a licence condition requiring independent non-executive directors to be the largest group would be appropriate. We do not believe that a licence condition requiring the chair to be independent is necessary.

It would be appropriate for the principle to recognise that there will be cases where a company may not have an independent chair for a temporary period due to unforeseen circumstances.

QUESTION 9: 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 believe that the proposed approach is appropriate subject to our observations below on the proposal to include in the licence a new condition to meet the principles.

QUESTION 10: Do you agree with our proposal to insert a requirement in companies' licences that they must meet the principles?

Whether or not to include a new licence condition should depend on the nature of each principle and how it may be enforced.

The main reason for including a new licence condition is to be able to enforce it. For some of the principles, such as those relating to the number of independent non-executive directors, it would be straightforward to assess whether or not the principles are met.

For principles relating to the "role and conduct" of the board, whether and the degree to which the principles are met will involve interpretation and judgement. These principles are not well suited to be enforced through a licence condition as Ofwat would have to substitute its own judgement to the judgement of the board (or decide not to enforce).

For this second category of principles, an alternative would be to assess whether companies have met the principles through the Company Monitoring Framework which would also provide Ofwat with opportunities to set out its expectations, examples of best practice and influence companies' corporate governance practices. This would create a strong incentive for companies to achieve the highest standards of governance and avoid issues that would

arise from an attempt to enforce the principles through a licence condition. There are fundamental reasons why the framework of corporate governance has been defined in the UK and elsewhere as a set of principles against which companies report rather than strict obligations prescribed by legislation (or regulatory instruments).

The requirements to have regard to the UK Corporate Governance Code in the instrument of appointment, company law obligations and the Water Industry Act 1991 (e.g. s35A on performance related pay) already include requirements covered by the principles and therefore a new licence condition to meet the principles defined by Ofwat is not necessary.

We consider that a licence condition could be imposed to have independent non-executive directors as the largest group as this can be objectively measured.

QUESTION 11: Do you agree with our proposal for an appeal mechanism and a change process in the proposed licence condition to meet the principles?

QUESTION 12: Are there specific instances where individual companies' licence conditions might conflict or overlap with the revised principles?

If a licence condition to meet with the principles was introduced in the licence, it is suggested that disputed changes to the principles would be referred to the CMA as a similar mechanism exists in the licence in respect of changes to the RAGs. We understand that the proposal seeks to extend an existing mechanism. However the function of the CMA is not to deal with corporate governance and it would not be the most appropriate body to decide on these matters.

Corporate governance is intrinsically linked to company law, accounting standards, related legislation (national but also in other jurisdictions), listing rules and national and international developments in corporate governance (that are directly relevant to a number of investors in water companies). The Financial Reporting Council is the expert body that is best placed to define corporate governance principles in the UK.

The licence already requires companies to have regard to the principles of the UK Corporate Governance Code and we believe this condition should be maintained to ensure consistency with the developments of corporate governance in the UK. This is necessary for listed companies and companies with listed debt.

We do not suggest that a new condition should provide that disputes about changes to the principles should be referred to the FRC but are highlighting the fact that it is not the function of the CMA to deal with corporate governance matters. This is another argument supporting our position that the current licence conditions relating to corporate governance are sufficient, that a new licence condition to comply with the principles is not appropriate and that the additional principles that Ofwat will set out (other than those relating purely to board composition) should be applied through the CMF rather than through a licence condition.

QUESTION 13: Do you agree that we should insert a requirement in companies' licences that independent non-executive directors should be the single largest group?

A specific licence condition that independent non-executive directors should be the largest group on the board of the regulated company would be acceptable. (Please see our comments above on which principles may be covered by a licence condition and which should not.)

QUESTION 14: 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 with the proposal as it ensures that only one set of criteria would apply. Considering that companies must have regard to the UK Corporate Governance Code under their licence and that listed companies must also comply with the code, using the criteria of the code avoids inconsistency that could arise if Ofwat was to develop or use different criteria. (Please also refer to our comments above on the role of the FRC in defining corporate governance requirement.)

QUESTION 15: 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?

We do not support a requirement to have a majority of independent non-executive directors even with flexibility on whether or not there is an independent chair. This would result in large boards in order to achieve a balanced representation of independent non-executive directors, investors nominated directors and executive directors. Alternatively, if companies wanted to control the size of their board they would then need to reduce the size of groups other than independent non-executive directors which would contradict the requirement to achieve a balance of skills and experience on the board.

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