

**SENT BY EMAIL**

Board leadership, transparency and governance consultation  
Ofwat  
21 Bloomsbury Street  
London  
WC1B 3HF

21 August 2018

Dear Sirs,

**Board leadership, transparency and governance consultation**

Thank you for the opportunity to respond to the consultation on revised Board leadership, transparency and governance principles issued by Ofwat on 11 July 2018 (“Ofwat principles”).

We are supportive of encouraging water companies to apply ever higher standards of governance in accordance with generally accepted best practice, such as the Financial Reporting Council’s (FRC) UK Corporate Governance Code (“UK Code”) (supplemented by the FRC’s Guidance on Board Effectiveness (“Guidance”)) and believe that the Ofwat principles are a positive development in this area. We do, however, have a number of comments on the detail of the revised Ofwat principles and the proposed incorporation of the Ofwat principles into water companies’ licences.

**General Comments**

The Ofwat principles broadly mirror equivalent provisions or principles in the UK Code 2018 recently issued by the FRC. There are, however, a number of instances where the language of the Ofwat principles does not mirror that of the UK Code in areas common to both. We believe the Ofwat principles should mirror the language used in the UK Code to avoid confusion and a lack of clarity about whether the requirements of Ofwat and the FRC are different in equivalent areas. The UK Code is widely accepted as being best practice in corporate governance and hence any deviations from the wording of the UK Code should be avoided unless there is a specific intention to go further than the UK Code requirements.

We note that Ofwat expects companies to comply with the Ofwat principles or explain how alternative arrangements meet or exceed the principles. However, where companies are non-compliant for unforeseen reasons (e.g. an unexpected departure of an independent non-executive director), it should be permissible for companies to explain that non-compliance and avoid censure for not having met or exceeded the Ofwat principles. Hence in exceptional circumstances, the UK Code concept of ‘comply or explain’ rather than Ofwat’s ‘comply or exceed’ should apply.

The Ofwat principles are presented as a standalone code and hence we assume that the intention is to replace the existing company-specific codes. We would, however, welcome clarification as to whether this is the case. Due to the high-level nature of many of the principles, we assume that water companies will still need to put in place, either publicly or internally, their own governance codes to cover the next layer of governance (e.g. the role, composition etc. of committees, the role of the company secretary, senior independent director

and so forth), and that companies should apply relevant parts of the UK Code and Guidance to inform this next layer of governance.

In Appendix 1 to this letter we provide our responses to the specific questions posed by Ofwat in the consultation document.

We would be happy to discuss any of the issues raised.

Yours faithfully,

[REDACTED]

[REDACTED]

**General Counsel & Company Secretary**

## **Appendix 1**

### **Q1: Do you agree with the objectives for the principles we have set out?**

Yes, we support the objectives set out in the consultation, subject to our comments set out below and in our accompanying letter.

### **Q2: Do you agree with the aim of setting principles that enable the 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?**

[Response to Q2 and Q3]

We agree that setting principles which enable individual Boards to determine the most effective means of complying and demonstrating the highest standards of governance and accountability is the most appropriate approach.

We accept that where alternative arrangements are made that deviate from, but meet or exceed the spirit of the Code, these should be explained clearly to stakeholders. However, there will also be circumstances where unforeseen events – such as the resignation of a non-executive director – might lead to a short-term breach of the principles. In this case, it would not be possible to explain how such arrangements met or exceeded Ofwat’s expectations and the company would therefore be non-compliant with the Ofwat principles and/or breach its licence if compliance with the Ofwat principles were to become a licence requirement. In such circumstances we believe Ofwat should adopt the well understood ‘comply or explain’ methodology employed by the UK Code rather than a ‘comply or exceed’ principle.

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

This principle broadly mirrors relevant sections in the UK Code 2018. However, the use of the word “monopoly” in Ofwat principle 1.i. is potentially inaccurate. Where competition has been introduced into the non-retail market, a water company subject to the Ofwat principles is not necessarily in a monopoly position. Moreover, the use of the word “monopoly” is unnecessary in the context of a governance code. We suggest the wording of 1.i. should be amended to be “...its role as a provider of an essential public service.”

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

This principle provides welcome clarification in respect of the expectations of Ofwat in respect of water companies’ disclosures and reporting.

Principle 2.iii. replicates an equivalent provision in the UK Code 2018, but Ofwat refers to “key risks” rather than “principal risks”. The concept of “principal risks” is understood and widely employed, including in the UK Code. On the basis that Ofwat is seeking to ensure that water companies apply high standards of corporate governance and the UK Code is widely considered to be a leading set of principles in the field of corporate governance, the Ofwat principles should follow terminology used in the UK Code.

If there is a divergence between the Ofwat principles and the UK Code, this begs the question of whether Ofwat expects a different standard to the UK Code. If this were the case, this would likely cause difficulties for listed water companies in particular, but all companies in general.

Principle 2.v. requires disclosure of details of board and committee membership, attendance “*and, where relevant, votes*”. It is not clear from the document the intention behind the words “where relevant”, but a requirement to disclose voting would go significantly beyond what other governance codes (including the UK Code) and regulations require. The disclosure of voting habits also potentially puts individual directors in a difficult position, as their views on particular issues would be publicised and open to regulator and public censure or disapproval.

In addition, if companies were obliged to disclose resolutions voted on, this could potentially infringe rules on inside information where a matter was voted on but has not (in accordance with the EU Market Abuse Regulation) already been made public at the time the annual report is published.

We believe that Ofwat should delete the proposed reference to disclosure of voting, it not being appropriate or necessary by any comparable governance code.

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

Whilst the board of the regulated company would remain legally accountable for the acts and omissions of the company, it must remain possible for the board to delegate matters to committees. For instance, it is common to delegate authority to board committees in areas such as audit and remuneration as well as in terms of creating sub-committees to approve matters such as disclosures to the market and/or the final version of a company’s accounts. On a strict reading of Principle 3.iii., the board of directors would be the only body empowered to make the final decision regarding such areas and hence a delegation would not be permissible, which is contrary to both best practice and would also be impractical.

In addition, it should be clarified whether the intention is simply for the board to be the final decision maker in respect of committee matters or in all matters. As a point of company law, the board cannot make all decisions, as certain matters are reserved to shareholders even where there is no shareholder agreement or similar.

With respect to Principle 3.iv., the UK Code requires the board to identify and “manage” conflicts of interest rather than eliminate them. As a practical matter, it is unlikely that it will be possible to “eliminate” conflicts of interest, particularly where directors are shareholder-nominated or where directors have other interests or hold appointments in other companies or organisations. Therefore, the language of this principle should be amended to reflect the equivalent UK Code provision.

It should be noted that directors will, in any event, be required to comply with their statutory duty to avoid conflicts of interest and adopt the practices and behaviours developed and widely applied to comply with this duty (e.g. declaring interests, recusing themselves from certain decisions etc.).

**Q7: Do you agree with our proposed board effectiveness proposal?**

We agree that it is appropriate that the chair should act independently of shareholders and management in accordance with Ofwat Principle 2.4.i. However, it should be clarified that this is not the same ‘independence’ test as would be applicable to independent non-executive directors for the reasons described below.

The consultation prior to the recent revision of the UK Code initially proposed that the chair should remain independent throughout their tenure in the same way as an independent non-executive director, but owing to the specific circumstances of the chair’s position, this is unlikely to be sustainable and the FRC recognised this. A chair will inevitably be less

independent and closer to the company/management due to the role and maintaining the same independence standards as an independent non-executive director would be unfeasible and impractical. We therefore see no reason to deviate from the UK Code definitions and concepts, including that the chair should be independent on appointment.

In Principle 4.vi., it is proposed that each of the board committees is led by an independent non-executive director. However, it is common (as in the case of Southern Water) for the board chairman to act as chair of the nomination committee. Accordingly, this principle should be amended to refer to the chairs of the audit and remuneration committees only.

**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?**

No we do not think it is necessary for this to be a standalone licence obligation. The requirement in the Ofwat principles that the chair should be independent of shareholders and management – but not meet the UK Code criteria for independent non-executive directors – is sufficient on the basis that companies will be required to comply with the Ofwat principles and hence does not require a separate licence requirement.

Please also refer to our response to questions 10, 11, 12, 13 and 14 below.

**Q9: Overall, how well do the 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)?**

Please refer to our response to questions 2 and 3 above.

**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?**

[Response to Q10 and Q11]

We do not believe that it is appropriate for Ofwat to incorporate a licence obligation to require companies to comply with the Ofwat principles. In certain areas, water companies (including Southern Water) are already obliged to act as if they were a UK-listed company under the terms of their licences, including in terms of the publication of financial and related information. Moreover, the existing Board leadership, transparency and governance principles operate on a voluntary basis and have been applied across the sector through the creation of water companies' own governance codes and in Southern Water's case the Southern Water Code. It does not appear that Ofwat has made the case that water companies are not already applying the corporate governance standards expected by Ofwat and hence it is necessary to provide an enforcement mechanism to mandate compliance, and indeed, Ofwat acknowledges in the consultation document that companies have "largely complied" with the existing principles<sup>1</sup>.

The Ofwat principles are a relatively high-level set of principles that companies will be expected to comply with and to demonstrate how they have done so. If it were to become a licence requirement to comply with the Ofwat principles, this would arguably cause the Ofwat

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<sup>1</sup> See page 3 of the consultation document.

principles to become incorporated into company's licences and therefore non-compliance (including unavoidable and unexpected non-compliance) would be elevated to the status of a breach of a company's licence and all the consequent repercussions thereof.

In addition, given that the Ofwat principles will operate on a 'comply or exceed'/'comply or explain' basis, who will determine whether a company's governance structure and activities meets or exceeds the Ofwat principles and accordingly whether the company is in breach of its licence obligations or not?

Any proposed licence requirement should reflect the commitment that revisions to the principles will be subject to a right of appeal to the Competition and Markets Authority, in the same way as changes to the Regulatory Accounting Guidelines.

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

We do not believe so.

**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 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 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 it be a sub-principle or licence requirement?**

[Response to Q13, Q14 and Q15]

We do not believe that it is appropriate or necessary to include a requirement for independent non-executive directors to be the single largest group in company's licences. Southern Water's licence already includes a requirement for there to be at least three independent non-executive directors on the board.

The requirement for the number of independent non-executive directors and how they are to be defined should be included in the Ofwat principles themselves and the definition should follow that of the UK Code<sup>2</sup>. Such an approach would enable companies to 'comply or exceed'/'comply or explain' not only how they have come to the view that a non-executive director is independent and hence maintain their discretion in this area, but also to avoid an accidental breach of their licence where circumstances give rise to there being fewer independent non-executive directors.

In addition, on the assumption that it would, in accordance with the UK Code, be for the board to determine whether a non-executive director is independent, if the requirement were to

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<sup>2</sup> Circumstances which are likely to impair, or could appear to impair, a non-executive director's independence include, but are not limited to, whether a director: is or has been an employee of the company or group within the last five years; has, or has had within the last three years, a material business relationship with the company, either directly or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme; has close family ties with any of the company's advisers, directors or senior employees; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; represents a significant shareholder; or has served on the board for more than nine years from the date of their first appointment.

become a licence obligation, this would create a great deal of uncertainty as to whether a company is compliant or not with its licence. For example, a company board, which has recently seen the replacement of its chairman and executive directors might determine that a non-executive director who has served for more than nine years on its board remains independent due to the changes in the board composition. Should such circumstances arise, who would determine whether a company had breached its licence?

The current requirement for independent non-executive directors to be the single largest grouping should, we believe, be maintained and this should be included in the Ofwat principles. We accept for the reasons set out elsewhere that the chair should not be included in the calculation of the number of independent non-executive directors.

The full wording of the UK Code provision which defines how a board should determine whether a non-executive director is independent or not would need to be replicated in full in any proposed licence obligation to ensure that it is clear what the legal requirement is as well as to maintain control of the definition as applicable to water companies. If the licence requirement were to simply refer to the UK Code, the FRC could, at any time, amend the definition with potentially serious consequences for the board compositions of water companies and knock-on impact on their compliance with their licence obligations. However, the inclusion of the FRC definition of independence would still give rise to the risk of uncertainty referred to above due to the discretion provided to the board under the UK Code.

A licence provision would also have address unexpected and/or unavoidable circumstances such as where an independent non-executive director departs at short notice and a water company falls below the minimum number of independent non-executive directors. There would need to be sufficient scope in the licence condition to allow companies to be non-compliant where exceptional circumstances arise. This again would create uncertainty, as the drafting of the licence provision would be unable to explicitly address all possible circumstances. This also relates to the point in the accompanying letter that water companies should 'comply or explain' rather than 'comply or exceed'.