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Board leadership, transparency and governance – Report on how companies are meeting the principles

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About this document

This document sets out our assessment of how companies are meeting the 2019 board leadership, transparency and governance principles. It includes areas for improvement in order to drive and support further progress in the sector.

Executive summary

This report sets out our assessment of how companies are meeting the objectives of our Board leadership, transparency and governance principles, in terms of the information provided through their 2019-20 annual reporting. It seeks to contribute towards the goal of making sure companies continually live up to and evolve in line with the highest and latest standards of governance.

We found a lot of good examples of how companies are meeting the objectives of the principles and of how they are reporting on this. There is also scope for companies to improve or go further, including in demonstrating – through the impact achieved – how the objectives are being met; how the approaches adopted best serve the regulated company and its customers; and how companies are considering and reflecting changing stakeholder expectations and evolving corporate governance practice and standards in meeting the objectives.

This report sets out specific examples of where companies clearly demonstrate how they are meeting the objectives, and where companies seem to fall short, including that:

- all companies clearly stated their purpose this year and explained the importance of their purpose in delivering an essential public service;
- companies generally could be clearer about how their dividend policies are applied in practice when making decisions on declaring dividends; and
- while all companies acknowledged the issue of diversity at board level, the degree of recognition varied across companies.

Compliance with the objectives of course goes beyond reporting, and relies on the ongoing actions and the behaviours of the company and its board. This report forms part of our wider and ongoing engagement with companies in this regard.

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1. Introduction

1.1 Background and approach

The updated Board leadership, transparency and governance principles ('the 2019 principles') have been in place since 1 April 2019. Since 1 August 2019 the 17 largest regulated water companies (appointees) in England and Wales and the only licensed infrastructure provider (Bazalgette Tunnel Limited, known as Tideway) – collectively 'companies' – have had a licence requirement to meet the objectives of the principles and to explain in an effective, accessible and clear manner how they have done so. Last year we published a report on the position that companies were in at that time to meet the objectives of the 2019 principles.

We put in place the board leadership, transparency and governance principles and associated licence conditions to reflect the important role that effective governance and strong board leadership have in driving high standards and securing the proper discharge of regulated companies' functions. The 2019 principles encompass four overarching objectives, each accompanied by guiding provisions. We would normally expect companies to adopt these guiding provisions in the course of meeting the objectives. However, the provisions are not exhaustive and companies should continually consider the best way to deliver the objectives, particularly as expectations from customers and other stakeholders change over time and as corporate governance best practice evolves.

This report sets out our assessment of how companies are meeting the objectives of the 2019 principles, in terms of the information provided through their 2019-20 annual reporting. A clear and transparent articulation of how the objectives are being met is essential, and we highlight where these explanations seem to fall short. This will help stakeholders hold companies to account for their performance on board leadership, transparency and governance. Compliance with the objectives of course also relies on the ongoing actions and the behaviours of the company and its board. We may further evolve our report in future years to incorporate wider observations beyond an assessment of what companies reported on.

We also do not want companies' annual reporting on how they are meeting the objectives of the 2019 principles to be a compliance 'tick-box' exercise. Our overarching goal, which this report aims to contribute towards, is to make sure companies continually live up to and evolve in line with the highest and latest standards of corporate governance. We want to play our part in supporting that as best we can, and so we also see our report as a tool and platform which is focused on sharing, exploring and learning from companies' insights and experiences.

The next section on overarching and cross-cutting findings is followed by a separate section for each objective. The report does not cover every issue related to board leadership, transparency and governance, and so for each objective we have sought to draw out examples of areas that need improvement as well as examples of practice that seem useful to share through this report. The absence of particular areas from this report does not mean that we will not include them in future years depending on where we consider it most appropriate to focus.

1.2 Overarching and cross-cutting findings

As we set out in the sections that follow, we found a lot of good examples of how companies are meeting the objectives of the 2019 principles and of how they are reporting on this. We have also seen progress since last year's report. For example, as explained in section 2.1 below all companies now have a clearly stated purpose in place.

There are also areas where some companies can clearly do better and we draw these out in the subsequent sections of this report.

We have identified the following overarching or cross-cutting findings.

- Having the right processes and approaches in place can be a prerequisite to change and sustained impact, and articulating those as part of company reporting helps to demonstrate a focus on compliance. Nonetheless it is important for companies to demonstrate, where relevant, the change driven and the impact achieved through compliance with the objectives. But companies have not always done this and so we look forward to a greater, targeted focus on this in future company reporting.

- Related to this, in many areas we observed that some companies were good at explaining the 'what' of approaches taken but not necessarily the 'why' in terms of explaining how these approaches best serve the regulated company and its customers. We observed this for example on reserved matters and group structures, as highlighted in the relevant sections below.

- There was limited demonstration of companies really thinking through dynamic and evolving interpretations of the objectives and the provisions, for example in line with changing stakeholder expectations or evolving corporate governance practice. These are not fixed. While the 2019 principles are relatively new and cover comprehensive ground, it is nonetheless clear that corporate governance thinking globally and nationally continues to evolve at pace, such as in the area of diversity of board membership. We expect companies to demonstrate that they have considered evolving standards where relevant in judging that they meet the objectives.

2. Findings by objective

In this section we outline each objective and the factors we considered in our assessment. We also set out examples of practice that seem useful to share and areas for improvement for companies to consider.

2.1 Purpose, values and culture

Objective 1: The board of the Appointee establishes the company's purpose, strategy and values, and is satisfied that these and its culture reflect the needs of all those it serves.

This objective reflects the importance of a regulated company's purpose, values and culture in delivering long-term success and building and maintaining trust given its public service role. It also reflects the increasing focus in wider society on corporate values, behaviours and culture, and the role of boards in driving them.

A clearly articulated purpose acts as a representation and indicator for the wider strategy, values, and culture of a company. A purpose is a clear statement of direction, which needs to be understandable, and used as the basis against which decisions, performance and progress are anchored and measured. We have approached our assessment of this objective within this context.

In our assessment we looked at whether companies have clearly stated their purpose and what information they set out about the active role their boards played in the development and promotion of that purpose, including through engagement activities. We considered how well companies explained the extent to which their purpose and strategy are aligned. We also looked for examples that demonstrate the efforts made by boards to embed the purpose and values in the company's culture.

Our findings

All companies clearly stated their purpose this year, and explained the importance of their purpose in delivering an essential public service. Ten companies changed their purpose from that which they reported last year; four companies (Yorkshire Water, Affinity Water, Portsmouth Water, South East Water) did not previously have a stated purpose, and have established one for the first time. We are pleased to see boards and companies clearly engaging with this objective.

Three companies have enshrined their purpose, or a version of it, into their articles of association (Anglian Water, South East Water, Dŵr Cymru). The process of changing articles of association to include the company's purpose will, amongst other things, require companies to engage explicitly with shareholders or members on their purpose.

Most companies provided a clear explanation of how their purpose was set, including the extent of engagement with stakeholders, as well as the board's ownership of this process. Some companies demonstrated a particularly comprehensive process of engagement with customers, employees, and wider stakeholders, and how this fed into a purpose that appropriately reflects the needs of those it serves (for example Affinity Water, South West Water, Yorkshire Water).

A number of companies clearly set out how they have integrated – or are starting to integrate – their purpose into their strategies, values, culture, and the overall delivery of their core services; and how their purpose underpins the actions of the board, executive team and employees through the company. Several companies (in particular Tideway, Hafren Dyfrdwy, Severn Trent Water, Northumbrian Water, South East Water, Thames Water, United Utilities, Yorkshire Water) provided a clear and thorough explanation of the relationship between their purpose and their strategy, with some using goals, aims and targets to demonstrate their approach and intent to measure progress.

A number of companies also clearly demonstrated the steps they have taken to embed their purpose into their culture, through principles and values, supported by ongoing employee engagement. Companies provided a variety of examples of board activities in regard to culture, for example most boards have either designated a director to focus on employee engagement or taken the approach of engaging through employee forums. This should help support the board's efforts to embed a purposeful culture, as well as provide feedback to the board and allow for progress to be monitored.

Southern Water is progressing the development of metrics to provide indicative measures of the company's culture. This is designed to allow key indicators to be tracked over time to show the impacts of actions being taken to influence the company's culture positively.

As set out above, we have observed through companies' annual reporting a focus on and articulation of the process of setting a purpose, and integrating that purpose through strategy, values and culture. However, we did not observe companies really reflecting on the difference the purpose has made; or on the concrete impact having a purpose, or a new or updated purpose, has had. This could be in terms of actions and behaviours that are different from how they would have been in the absence of that purpose, or in terms of corrective action taken in light of it. Or it could be in terms of how stakeholders are holding up – or are able to hold up – a mirror to the company in terms of how actions and behaviours align with stated purpose.

Ultimately what matters most is the impact that follows from having a strong purpose in place with strategy, values and culture aligned against it. This was a point raised in a report we commissioned last year by Purpose Union and the Impact Institute (and also referenced in our discussion paper on public value). In the context of Articles of Association, for example, the authors acknowledge that amending articles 'can potentially contribute to creating a purposeful company. They may signal the company's intent in this area and it can serve as a useful proof point.' At the same time they note 'we do not think it is necessary for a company to formally change its articles to be purposeful or have an impact, nor do we believe that this sort of formal change is sufficient for a company to describe itself as purposeful or impactful.'

We expect annual reporting in future years to incorporate a greater focus on the impact of purpose and of it being embedded through the company's strategy, values and culture; and on the lessons learned and insights derived that can usefully be shared with others.

2.2 Standalone regulated company

Objective 2: The Appointee has an effective board with full responsibility for all aspects of the Appointee's business for the long-term.

This objective aims to ensure that the board of the regulated company has the power to set its long-term direction and that it can make, and be held accountable for, all decisions regarding the company's regulated activities as though these were substantially its sole business.

In our assessment we looked at how the board has demonstrated that it is taking full responsibility for all aspects of the company's business. This included looking at evidence of long-term focus on the interests of the regulated company, and how the board ensures that it has the necessary information so that it can operate effectively. We considered how decisions were taken by company boards, including by considering companies' explanations as to the matters reserved for the group, or the parent company's board. We also looked at companies' explanations of the mechanisms that the board has put in place to identify and manage conflicts of interest among the directors on the board.

Our findings

It is important that a company clearly explains if any matters are reserved to its parent company or shareholders and, if so, what these are. This allows stakeholders to make a judgement on the extent to which the regulated company board has full responsibility for all aspects of the company's business. Most companies were clear on this, however two companies (Hafren Dyfrdwy and Portsmouth Water) did not provide any explanation as to the existence of any reserved matters or otherwise.

In addition to just listing reserved matters, Tideway set out the instances in the reporting year when shareholder approval was actually required in relation to reserved matters thereby providing additional transparency.

Even where companies explain which matters are reserved, it is important that they also explain how those arrangements are consistent with the objective. At some companies (Anglian Water, Thames Water, Southern Water, Yorkshire Water and Bristol Water), important issues such as (i) strategic matters, (ii) dividend policy and/or (iii) remuneration policy were reserved to the holding company, but it was not explained clearly how the regulated company board had full responsibility for all aspects of its business for the long-term in light of these arrangements.

Where potential conflicts of interest exist for individual board members, this could undermine the effectiveness of the board because its attention may not be fully on the interests of the regulated business but instead diluted or diverted by other interests. It can also have a significant impact on how stakeholders perceive the company as they may consider that outside interests are being put ahead of those of the regulated company. It is therefore important that companies explain both the policies in place to identify such conflicts and consider what action may be needed should a situation arise where there could be a conflict with interests outside the regulated company. This will help the board demonstrate that it has full responsibility for the company's business and this is not compromised by other interests.

All companies except Portsmouth Water explained the policies they have in place to address potential and actual conflicts and how these were applied. Some companies confirmed that no conflict situations had arisen during the year, or set out how they were addressed if they did arise. We consider that this level of transparency should be provided by all companies because it is important for stakeholders to be able to judge whether any conflict situations have been dealt with appropriately. All companies should be clear about both the policy in place and the results of it being applied in practice.

2.3 Board leadership and transparency

Objective 3: The board of the Appointee's leadership and approach to transparency and governance engenders trust in the Appointee and ensures accountability for their actions.

The aim of this objective is to ensure that the board is at the forefront of ensuring that stakeholders can have trust and confidence in the business. Given the role of water companies as monopoly providers of an essential public service, stakeholders rightly expect them to be transparent about, and accountable for, the actions and decisions they take.

A company's board will need to consider how its full range of decisions and actions contribute to its ability to meet this objective. Ultimately any of a board's actions could either undermine or enhance the trust which stakeholders have in the regulated company. The extent to which a board is transparent about both the actions which it takes and why it takes them will go a long way to determining the degree to which it can be held to account.

We have chosen a few areas to focus on for this year's assessment, which appear to have been particularly current for stakeholders in recent years and where poor reporting or behaviours can easily and significantly undermine stakeholders' trust. In our assessment this year we looked more closely at executive pay, dividends and the transparency of group structures.

Our findings

Executive pay is a key area that stakeholders are interested in. It is vital that they can see how performance related pay is determined, how it is linked to actual performance by companies and how the metrics used demonstrate a substantial link to stretching performance delivery for customers. We looked at both performance related pay which related to 2019-20 as well as what companies reported about their plans for annual bonuses and long term incentive schemes which apply from 2020-21 onwards.

There was a lack of transparency at six companies (Anglian Water, Dŵr Cymru, Wessex Water, Bristol Water, Portsmouth Water and South Staffs Water) on either or both of (i) the targets which were set or (ii) the actual performance against those targets for annual bonuses or long term incentive schemes which related to 2019-20. It is important that all companies are clear on both of these, to ensure that they can be held to account by stakeholders.

> Northumbrian Water clearly set out the targets for each metric which made up its annual bonus scheme alongside the actual performance in the year against each metric, whether the target was achieved, and if so, the percentage of the bonus award which was payable as a result.

We set out our expectations for performance related executive pay for the 2020-25 period in [Putting the sector in balance: position statement on PR19 business plans] and were clear that companies should demonstrate a substantial link to stretching performance delivery for customers. Most companies provided sufficient detail of their annual and, where applicable, long-term incentives for performance related executive pay for 2020-21 onwards to enable stakeholders to make a judgement on the element linked to delivery for customers.

For 2020-21 onwards, most companies have put in place performance related pay schemes where at least half the weighting for annual bonuses and long term incentive schemes appears to be linked to delivery for customers. However Affinity Water's annual bonus and SES Water's long term incentive payment scheme both fall short in this respect. Several companies met the good practice target we used as part of our PR19 assessment of at least 60%, by weighting, of metrics being linked to delivery for customers, for both annual, and where applicable, long-term incentives. It is important, in order to build and maintain trust in the company, that stakeholders are able to clearly see that executive directors are incentivised substantially based on delivery for customers. In this context not only is transparency about how payments are calculated important but companies also need to be clear about how the metrics they have chosen to incentivise stretching performance delivery for customers are sufficient to meet that outcome.

At four companies (Southern Water, Wessex Water, Portsmouth Water and South Staffs Water) there was not sufficient detail across both elements, where applicable, to make a judgement. In some cases this was because details were reported as still being finalised. We expect full details to be provided as part of these companies' 2020-21 annual reporting. This transparency will allow stakeholders to hold the board to account for the approach it is taking to performance related pay.

The payment of dividends is another area which is of particular interest to stakeholders. Transparency of the policy underlying the payment of dividends and its application is important so that stakeholders can hold companies to account for the distributions which they make to shareholders. It will help companies to engender trust where stakeholders can see that dividend policies take account of delivery for customers and other obligations (including to employees).

The dividend policies for most companies provided clarity about how delivery for customers and other obligations would be taken into account. However there is scope for two companies (Thames Water and Bristol Water) to improve clarity in this area. It was not clear how the policies for two other companies (Anglian Water and Dŵr Cymru) took into account delivery for customers and other obligations at all; however in neither case was it clear whether the policy was to be superseded and therefore a revised policy may apply to the 2020-25 price control period which may address this omission. Where dividend policies do not clearly take account of delivery for customers, this can undermine the trust which stakeholders have in companies because distributions may not appear to be justified.

Companies should also explain how those policies are applied in practice to determine the level of dividends declared. It is important that stakeholders can understand how the level of dividends declared is determined in each year so that they are properly able to hold companies to account. There is scope for all companies to improve in this area. In relation to the 2019-20 reporting year, companies did not adequately explain how the dividend policy was actually used in the decision-making on whether or not to declare dividends, and where dividends were declared, how the amount was decided. Greater transparency in this area is needed.

This transparency should extend to all dividends which companies declare and pay including those which may be retained within the group, including to service group debt or cover other costs, and not immediately paid up to external shareholders. It should also extend to instances where companies pay dividends to group companies which are characterised as being returned to the regulated company in the form of interest payments due on inter-company loans or repayments of the balances of such loans. The key is for companies to explain how the level of dividends leaving the regulated company has been determined regardless of what the dividend may subsequently be used for by the company receiving it. This transparency is important so that stakeholders can hold companies to account for the totality of the dividends which they declare.

Transparency of the structure of the group within which the regulated company sits allows stakeholders to understand both (i) the ownership structure of the company and (ii) the role of the different companies within the group, particularly as they relate to the regulated company. This is because that transparency will either help engender trust amongst stakeholders that the structure does not raise any concerns for them or allow stakeholders to hold companies to account for their choice of structure.

Companies generally provided group structure diagrams as part of their annual reporting and in some instances on their websites instead. It is important that where companies provide diagrams on their websites that these are easy to find. Companies' group structure diagrams contained varying levels of detail and were accompanied by differing levels of explanation (and in some cases no explanation). The key for companies when explaining their group structures is to do so in a way that engenders trust. This requires companies to not only be transparent about their structures but also to address issues such as the perceived complexity of structures or what may appear to be complex financial arrangements between the regulated company and other entities within the group. We look forward to a focus on the 'why' as well as the 'what' where relevant in future reporting.

2.4 Board structure and effectiveness

Objective 4: The board of the Appointee and their committees are competent, well run, and have sufficient independent membership, ensuring they can make high quality decisions that address diverse customer and stakeholder needs.

This objective reflects the importance of ensuring that boards have the right arrangements in place so they can operate effectively, including that there is sufficient independent challenge and judgement on boards in the context of the special responsibilities of a regulated water company delivering an essential public service. Boards should have the appropriate membership to ensure that the interests of customers and other stakeholders are appropriately taken into account in decision-making. It should be clear how the board structure allows directors to test, analyse and evaluate ideas and decisions.

In our assessment we considered the leadership and composition of company boards and committees, in the context of the group structure in which they operate. We considered the balance of independent members on the main board and key committees. We also looked at the information which had been reported on the balance of skills and experience and diversity of the board and any board evaluation which had been carried out.

Our findings

Most companies have boards and key committees which are structured in such a way that should prevent undue influence of any particular group over decision-making. However, we have identified room for improvement for some companies, which did not provide a sufficient or clear explanation as to how they are able to meet this objective in light of the particular board and committee structures they have chosen.

Those companies which have chosen not to have an independent board chair (Hafren Dyfrdwy, Northumbrian Water and Wessex Water) will inevitably find it more challenging to explain how they are meeting this objective. We were disappointed with the lack of clear acknowledgement of the impact of this arrangement from these three companies and consider there is scope for them to develop and improve their explanations, for the benefit of stakeholders' understanding.

For most of the reporting year, the chair of Thames Water's board acted as interim executive chair, which meant that he could not be considered independent for this period. The company did not explain how it was still able to meet the objective in light of this arrangement, given that it affected the independent balance on some board committees. We also note that Severn Trent Water did not provide a clear explanation for its stakeholders of how it is able to meet this objective given its board has the same membership as its parent company.

All companies carried out board evaluation exercises in the year. Most were facilitated internally, with a number of companies reporting that an externally facilitated evaluation would take place every three years. Most companies published details of the process that was carried out and any recommendations. It was particularly helpful where companies confirmed they had revisited the recommendations made in their 2018-19 board evaluations, and set out the action they had taken as a result.

Nearly all companies demonstrated the skills and experience of board and committee members in a clear manner, with some using tools such as a matrix diagram to show each board member's main areas of skills and experience at a glance.

Regarding diversity, we would like to see companies demonstrate that they have considered diversity in its broadest sense when making decisions relating to the membership of their boards and committees, ensuring the company is well equipped to make decisions that meet the needs of the company's wide range of employees, customers and other stakeholders. We had expected greater reference, for example, to the issues raised in the update report from the Parker review published at the start of 2020 which reflects on the limit to progress achieved since the original publication of the report in 2017[1]. While all companies acknowledged the issue of diversity at board level, the degree of recognition varied across companies, with some lacking specificity or limiting their consideration to gender diversity. The highest and latest standards of corporate governance continue to evolve, as society and its expectations evolve; and diversity is a clear area of corporate governance focus globally and nationally. The interpretation of objectives of the 2019 principles needs to evolve accordingly. We are interested to see how company boards develop their approaches to diversity going forwards.

> Severn Trent Water considered the recommendations from the Parker Review Committee Report around increasing ethnic diversity on company boards as part of its recruitment exercise for a new board member during the year.

[1] The Parker Review Committee Report was published in October 2017 and sets out recommendations and guidance on improving the ethnic and cultural diversity of UK boards to better reflect their employee base and the communities they serve. An update report was published in February 2020.

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