New Energy and Water Public Interest Network
New-Pin

Energy and water:
How effective is your board in delivering ‘future customer’ and wider stakeholder outcomes?

A Sustainability First check-list for
energy & water board effectiveness

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Purpose of this board effectiveness check-list

- Many organisations are active in the field of corporate governance
- This check-list is **focused specifically on the role of energy and water company boards** and how they secure the delivery of future customer and long-term public interest outcomes
- It is not a uniform picture. There are differences in governance between: energy and water companies; monopoly & retail activities; and ownership structures
- We draw on **26 interviews** with senior colleagues from the energy and water sectors – in companies and their regulators (Chairs, CEOS, Non Executive Directors [NEDs] and directors)
- We are grateful for the full and frank discussions and willing access
- In our research we heard some strong messages and a surprising commonality of views
- There is a lot of good work going on – but we also heard that there is value in pulling this together and embedding good practice
- The detail of our research is in the Annexes listed on slide 26
- For energy and water company boards, the check-list aims to
  - Address governance issues unique to the sectors in delivering long-term public interest outcomes
  - Highlight key questions and act as a catalyst for board discussion
  - Identify a good practice envelope so boards can continually ask what else they could be doing
- For the boards of regulators, the check-list aims to stimulate thinking on
  - Their own board's approach to securing better public interest outcomes, what appropriate returns might look like and how a long-term regulatory focus can be maintained as political pressures wax and wane
  - The signals they give to those that they regulate on these issues
- For public interest groups the check-list seeks to
  - Provide an opportunity to say how they see the role of energy and water company boards in ensuring the delivery of long-term public interest outcomes
  - Help them shape a constructive dialogue with company boards

Executive summary

(i) Overview

- Energy & water companies deliver essential services and are stewards of critical infrastructure. A focus at board level on meeting future customer and wider stakeholder needs, including those of the environment, is therefore vital
- Current approaches to board effectiveness are being disrupted by wider societal change. Diminishing trust in business in general, and the particular complexities this poses for regulated sectors, adds to this challenge
- Board approaches to governance need to evolve further to ensure consumer interests are put at the heart of how the company is run; enabling long-term customer outcomes to be delivered and to embrace the future
- Boards will clearly behave in their own fiduciary interests. However, those that fail to adapt will not be able to maximise the opportunities of the new world and even risk failure
- A more proactive stance by boards that seeks to shape and influence technological and structural change in the sectors is therefore essential
- Companies are already doing much good work in this area and there is good practice out there. However, societal and political demands are increasing
- There is a distance to go before some can provide sufficient evidence that they are 'doing the right thing' in terms of long-term public interest outcomes
- Our analysis shows that energy and water company boards face three major challenges in meeting future needs

(ii) Challenges

Challenge 1 - How to demonstrate that total returns are ‘acceptable’

- The monopoly characteristics of the sectors and short-comings with retail competition make this the key challenge for board effectiveness in energy and water
- Boards need to be able to demonstrate to regulators and the wider public that they have heard the views of their stakeholders and responded appropriately, that they understand the fast changing societal context in which they operate and that ‘future customer’ requirements sit at the heart of their decision-making

Challenge 2 - What boards can do to build better regulator/company relationships

- The complex, and sometimes disputed, web of responsibilities in the sectors along with opaque group structures can lead to an undue compliance mind-set and company inertia. Relationships between companies and regulators need to mature
- Companies that can demonstrate they are ready for more autonomy should be given more space to lead. Energy and water regulators should work with the Financial Reporting Council and investor groups as they implement the BEIS corporate governance reform programme and re-set the framework for company / regulator dialogue to focus on strategy and the ‘big’ picture

Challenge 3 - The important role of the Non Executive Director

- Around the energy and water board table, NEDs have a key role in providing assurance on the delivery of long-term customer outcomes, fulfilling fiduciary duties and dealing with political and regulatory risks
- These risks are already high as companies face a step change as they adapt to climate / technological transition. This needs more board level focus. Chairs and NEDs need to be able to show that they have responded in a fair, transparent and accountable way to future customer requirements to ensure their approach to governance is fit for the future

(iii) Sustainability First check-list for board effectiveness in meeting ‘future customer’ & wider stakeholder needs

1. Within your corporate structure, is it clear where responsibility sits for current and future UK customer needs across each part of the ownership chain?
2. How does your TopCo (or equivalent board) demonstrate due consideration to ethical / fair behaviour and conduct and how to deal with different interests – current / future consumers, the different communities in which you operate etc?
3. How are you strategically engaging with your customers and wider stakeholders to ensure your board risk appetite is appropriately aligned with the public interest and your risk framework captures any resulting issues?
4. Does your board have an agreed set of criteria as to what it means to be a ‘respected corporate citizen’ in the water or energy sector (eg in terms of gearing, tax etc) and does it assess how it measures up against these?
5. What is your board doing to ‘reclaim strategy,’ move from an undue focus on compliance and to demonstrate that you are embracing the spirit of Section 172 of the Companies Act (even if not listed) and acting as long-term stewards for the company and the sector?
6. Where appropriate, are you developing ‘safe spaces’ for board/regulator and board/sector dialogue, to discuss difficult issues such as the level of regulatory intervention / company autonomy and wider sector responsibility?
7. What is your board doing to create effective feedback loops to link the different parts of the complex system in which you operate?
8. Does your board have the appropriate skill-mix to understand current and future customer and wider stakeholder needs and does director induction sufficiently cover these issues?
9. How does your board set ‘the tone from the top’ to ensure that public interest values percolate down throughout your business, that staff are engaged on these issues and that reward and recognition practices take these into account?
10. The public is increasingly open to radical and new ideas for the energy and water sectors. How does your board address not just opportunity, but also ‘difficult’ risk (eg public ownership, difficult relationships)?

Why change is needed

High governance standards are key in energy & water

Essential services & critical infrastructure

Energy and water under-pin every aspect of UK economic life. They are central to physical & environmental well-being. This raises the bar for governance in the sectors in both retail and network companies

Significant investment

Needed to prepare for climate/tech change & replace aging network assets– up to £117bn for energy & £20bn in water/waste by 2020/21. Directors need to meet fiduciary duties but scale of investment leads to increased public interest

Stewardship

Effective stewardship is needed to meet Section 172 of Companies Act. It under-pins long-term performance and benefits companies, investors and wider stakeholders. There are different definitions of financial and environmental stewardship that can add to governance complexity

Bill payers

2/3 of future investment in energy and nearly all investment in water will ultimately be paid for through consumer bills. Public scrutiny inevitable and retail companies are the 'public face'

Active consumers

Consumers will increasingly be relied on to provide demand side services to reduce cost. In energy, pro-sumers are increasing. Companies that fail to recognise this reality will not be able to max. opportunities & even risk failure

Legitimacy, accountability, trust & political / regulatory risk

Private companies delivering what are often seen as public goods, with strong monopolistic characteristics & in situations of imperfect retail competition – with the prospect of windfall gains - need to be transparent and accountable. Good governance by companies & regulators is needed to do the right thing, build public trust & manage political / regulatory risk

Source: Sustainability First

There are different perspectives on why good governance in energy & water matters – here are a few

Government	Regulators	Companies	Investors	Public interest groups
Affordability Accountability Acceptability 'Daily Mail test' Returns Exec pay Tax	Legitimacy Excess returns Gearing Legal requirements Capture	Meet fiduciary duties to shareholders Compliance Second guessing the regulator	Returns Getting the right Chair / CEO Certainty The 'legal' owners	Affordability Single issues 'Daily Mail test' Legitimacy The 'moral' owners Tax, exec pay
High bills Poor reputation	Governance for low carbon transition	Opportunities & risks in low carbon & big data	Mobile Capital – especially for retailers	Big energy v active consumers & communities
Limited interest – until problems	Consumer engagement	Resources, assets, data	Regular & sufficient returns	Local issues & environment

Source: *Sustainability First*

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Meaningful public engagement must shape the board’s strategic thinking (i)

- For the reasons outlined in slides 8 and 9, the public have a legitimate interest in energy and water company governance
- *Meaningful* public engagement that shapes the board’s strategic thinking is essential to manage political and regulatory risk - and demonstrate that companies are meeting the requirements of Section 172 of the Companies Act
- To show that boards have given due consideration to future customers and long-term public interest outcomes, engagement needs to move beyond episodic market research on one-off customer services issues to giving consumer panels / groups a sustained role in driving strategy and board agendas
- For monopoly activities, PR19 in water is paving the way in this regard. RIIO2 will also be re-considering engagement in energy networks
- In energy retail, there aren’t the same regulatory incentives to give customers a ‘formal’ voice in business decisions - it has been assumed that market pressures will automatically do this. However, Principles Based Regulation is starting to increase board attention in this area
- The following slide provides a possible model of how public engagement can move beyond ‘window dressing’ to the heart of board decision making
- Most energy and water companies are already on this journey but some are still focused on the left hand side of the slide

For more on Section 172 of the Companies Act see slide 30 and 58

For more on Principles Based Regulation see slide 38

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Meaningful public engagement must shape the board's strategic thinking (ii)

Activity	Episodic customer engagement	Embedded consumer / citizen engagement	Doing things differently, collaboration
Focus	Operational	Strategic	Governance & principles underpinning business models
Objectives / purpose	**Current customer outcomes**	**Cultural / behaviour change**	**Innovation & legitimacy with citizens**

Some companies are still primarily focused on the left hand side of this diagram

*Need a 'Golden thread' from left to right – **across** the business & **over time***

Source: Sustainability First

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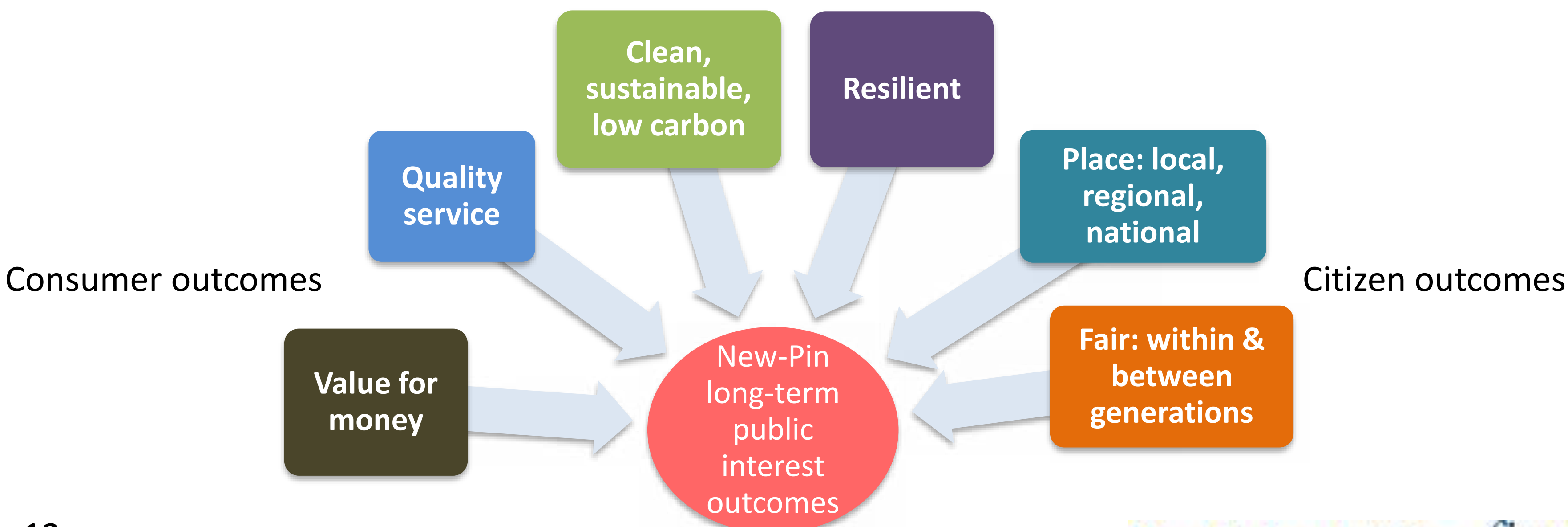
Meaningful public engagement needs to shape the board's strategic thinking (iii)

A new board focus is needed on 'future consumers' and the long-term public interest outcomes for energy and water. Since 2015, Sustainability First's **New-Energy and Water Public Interest Network** (New-Pin) has been systematically exploring what the long-term public interest is in the energy and water sectors. Through a series of deliberative workshops we have defined it as: Aggregate well-being of the general public, both short and long-term, comprising the combined interests of consumers, citizens, the environment and investors; for both today & tomorrow



Source: Sustainability First

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Twenty first century energy and water boards also need to embrace major 'societal disruptors'

1

Data, digital services & new technologies – old boundaries quickly breaking-down

- Supply, demand-side & retail blurring. Move from passive to active customers
- Consumer / citizen 'divide' changing with local / community approaches
- How risks & rewards are shared / shifting. Radical re-think forced by data & tech
- New business models emerging - greater focus on service

2

Rapid emergence of new voices & channels - social media / the young / devolved powers (including nations and metro-mayors)

- Stakeholders – plural/fragmented. Challenge legitimacy of status quo
- Existing governance – and engagement - approaches need updating

3

Public sector restraint / austerity – companies expected to deliver more

- Expectation not clear on energy and water company role and responsibilities – for society, welfare-provision and, particularly for water, the environment
- 'Inappropriate' pressure for companies to step into the vacuum left by austerity
- Political / regulatory risk as issues of fairness come to fore - within and between generations. Dividend payments by highly geared companies raise concerns

With all three disruptors, there will be new winners / losers & risks / opportunities for long-term public interest outcomes. Boards need to decide & ***explain*** what they think is an 'appropriate' response

Source: Sustainability First

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Challenges in delivering the long-term public interest in energy & water and Sustainability First check-list for boards to address these

Challenges in delivering the long-term public interest and Sustainability First check-list for boards to address these

- We have identified three challenges energy and water company boards face in delivering future customer outcomes / wider stakeholder
  - Challenge 1 – How to demonstrate that total returns are 'acceptable'
  - Challenge 2 – What boards can do to build better regulator / company relationships
  - Challenge 3 – The important role of the Non Executive Director
- We have identified the cause of each challenge, the risk it poses to the public interest, the impact it may have on delivering the public interest outcomes and how this risk can be mitigated
- For each public interest challenge, we then propose some questions which, taken together, make up our Sustainability First board effectiveness check-list
- Examples of good practice in each area are then highlighted
- The research on which this analysis is based is contained in the Annexes to this slide deck which are listed on slide 26

Energy and Water public interest challenge (i) How to demonstrate that total returns are 'acceptable'

What role can the board play to help move from this....

....to this, without pushing up the cost of capital?

'Acceptable' returns ensure a fair balance of interests across different stakeholders. In monopolies, this is relevant in the context of business plan submissions to the regulator. For retailers, it is relevant when considering the pricing strategy for that country of operations

Source: Sustainability First

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Board effectiveness check-list for the public interest
(i) How to demonstrate that total returns are 'acceptable'

Cause
- Company / regulatory risk appetite out of step with public interest
- Complex ownership structures
- In some companies, strategy made at 'TopCo'
- Locked into insular regulatory world

Risk to public interest
- Excess total returns
- Under-investment

Impact on public interest
- Unfair distribution of risk and reward between customers & shareholders
- Increased political risk leads to ad hoc policy and regulatory interventions
- Rising bills and consumer backlash
- Creaking assets

What to do - risk mitigations
- Mechanisms to ensure user voice heard & acted on, including at TopCo level (if applicable)
- Ensure company (whether listed or not) complies with Section 172 of Companies Act
- Board involved in communications / engagement strategy so can demonstrate doing right thing - & be seen to do so

Board effectiveness check-list
- How aligned is board risk appetite to public interest?
- How does board balance diff. aspects of public interest? Eg current / future
- Public open to radical ideas - are you also thinking creatively?
- Does TopCo or equivalent give consideration to ethical / fair behaviour?
- Consumer Panel sees key papers going to board?

Source: Sustainability First

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(i) How to demonstrate that total returns are 'acceptable'
Examples of good practice

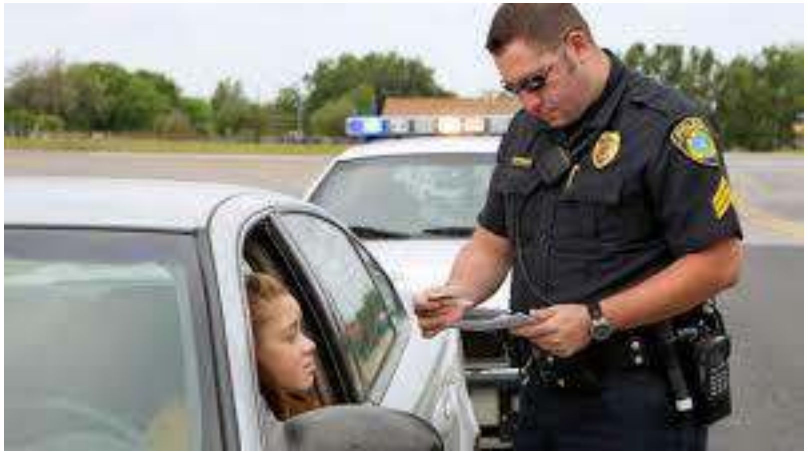
- Clear where responsibility sits for current and future UK customer needs across each part of the ownership chain / corporate structure. Where appropriate, clarity on how the UK societal context is 'fed upwards' to the TopCo or equivalent board, and how TopCo strategy feeds this back into the licensed company

- Non Executive board members provide assurance to regulators that there is a golden thread between engagement with consumer / citizen panels / challenge groups - and the board's consideration of public interest outcomes

- Investors on the board give consumer / citizen panels / challenge groups the opportunity to explore with them
    - How they take the UN Principles of Responsible Investment into account
    - What weight they give to Environmental, Social and Governance factors in their investment strategy for the company

 Source: Sustainability First

Energy and Water public interest challenge
(ii) What can boards do to build better regulator / company relationships?



What role can the board play to help move from this….

….to this, without political backlash and fear of regulatory capture?

Source: Sustainability First

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Board effectiveness check-list for the public interest
(ii) What can boards do to build better regulator / company relationships?

Cause
- Complex regulatory landscape & group structures
- Regulator as policeman
- Undue focus on process not long-term outcomes
- Unrealistic expectation of regulatory certainty

Risk to public interest
- Relationships – unconstructive / polarised

Consequence
- Lack of 'ownership' of the future
- Undue compliance approach by companies
- Company inertia - & risk aversion
- Limited innovation
- Potential under / over investment
- 'Shadow boxing' between companies & regulators

What to do - risk mitigations
- Shared future narrative to be developed by companies with stakeholders
- Commit to continually improve relationships
- Set right tone *throughout* organisation
- Stakeholder engagement set in long-term context

Board effectiveness check-list
- What is company board doing to reclaim strategy?
- Are there safe spaces for co./ reg. dialogue to step back from detail & give opportunity to co's to demo ready for > autonomy/ space to lead?
- Do feedback loops link different parts of complex systems?
- Criteria to be a 'respected citizen' (eg tax, gearing etc)?

Source: Sustainability First

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(ii) What can boards do to build better regulator / company relationships?

Examples of good practice

- Board develops a positive ‘future view’ together with their stakeholders – for themselves and for the sector

- Board ensures informal as well as formal mechanisms for board dialogue - with the regulator, for larger companies, and with the sector for all - to shape common understanding of desired long-term public interest outcomes

- Board gives evidence to regulator that their wider social and societal purpose is being delivered through their approach to stewardship of their long-term assets and resources beyond regulatory cycles- and that this approach has been informed by their engagement with their customers and wider stakeholders

 Source: Sustainability First

Energy and Water public interest challenge
(iii) The important role of Non Executive Directors in energy and water

What role can the full board play to move from this (wool over eyes) ….

…. to this, while retaining focus on long-term public interest outcomes ?

Challenge from independent NEDs is important in all boards. It is particularly so in energy & water; to ensure fiduciary duties are fulfilled and long-term public interest outcomes are delivered

Source: Sustainability First

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Board effectiveness check-list for the public interest
(iii) The important role of Non Executive Directors in energy &water

Cause

- Board agenda – poor balance of strategy and detail
- Exec / Non Exec - information asymmetry
- Engineers and economists - technical & ‘conservative’ disciplines prevail
- Failure to explain externally. Leads to nervous politicians & press

Risk to the public interest

- Weak challenge and scrutiny around the board table

Consequence

- Failures may go unreported until too late
- Focus on compliance. Board don’t know if Exec gives full picture.
- Lack of sector-wide leadership

What to do - risk mitigations

- Informal space for Board interactions & to hear from stakeholders - *together*
- Board diversity (including in *thinking*)
- Board culture enables openness about failures
- NEDs provide regs with assurance that golden thread links engagement & board consideration of public interest

Board effectiveness check-list

- How does board have a strategic focus on the public interest?
- Does board have ‘right’ skill-mix for public interest & is this dealt with in Director induction?
- How does board set tone from top / ensure public interest values percolate down?
- How does board address unpalatable risks e.g. public ownership, difficult relationships?

Source: *Sustainability First*

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(iii) The important role of Non Executive Directors in energy and water

Examples of good practice

- Chairs and Non Executive Directors have a mechanism to assess how the board is delivering key long-term public interest outcomes and to understand the barriers
- Regulators facilitate dialogue on long-term public interest outcomes for Non Executive Directors
- The board as a whole assesses how they measure up against Section 172 of the Companies Act – even if they are not part of a listed company
- The board works with groups such as Business in the Community and the Purposeful Company initiative to stay at the forefront of corporate governance best practice and takes an active interest in the current review of the Corporate Governance Code

There is increasing pressure in wider corporate governance debates for the promotion of the long-term success of the company to become the primary duty of directors. See slide 58

Source: Sustainability First

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Conclusions

- The boards of some energy and water companies need to adapt their approaches to governance to demonstrate that long-term public interest outcomes sit at the heart of their decision- making
- This is particularly important given the speed of change in wider society, and in the energy and water sectors themselves
- For many company boards, still a long way to go to demonstrate that they are doing 'the right thing'
- The relationship between company /regulator boards needs to mature for this to happen
- Energy and water company boards need to 'reclaim' strategy and thereby move from an undue focus on compliance
- Regulator boards need to send more nuanced signals to companies
- Board level discussions about investment need to move from an unduly narrow focus on assets. Need to invest in 'softer side' of governance - behaviours, conduct & relationships. Especially at TopCo
- Creating spaces to have a more informal strategic dialogue on direction of travel and the long-term public interest outcomes can support a greater sense of sector responsibility
- Engaging consumers and other stakeholders at the right point in these conversations can make this shift in approach more 'acceptable' and build trust. This is vital given digital change and the need for more transparency in the corporate world
- Section 172 of the Companies Act provides a lever to address wider stakeholder views and focus the business on long-term stewardship. In some companies, more could be done to use this lever to demonstrate a 'future customer' / public interest focus
- Large privately held firms in the energy and water sectors would do well to proactively consider how they also measure up against the Section 172 Companies Act requirements and not just wait for new secondary legislation in this area (see slide 58)
- Both listed and non listed energy and water companies have the opportunity to engage in current debates about corporate governance reform. They should ask themselves what this should look like in an energy and water context if long-term public interest outcomes are to be delivered
- Energy & water regulators also have an opportunity to work with the Financial Reporting Council and investor groups as they implement the BEIS corporate governance reform programme to re-set the framework for company / regulator dialogue to focus on the long-term strategic 'big' picture