



## **Hermes: Corporate Governance of Public Service Infrastructure Assets**

*Peter Hofbauer, Head of Infrastructure at Hermes Investment Management, makes the case for an enhanced corporate governance regime for private infrastructure businesses providing essential public services in the UK.*

### **Overview**

Hermes has always believed high quality governance is essential to sustainable business success. It is integral to our management of risk, to the creation of sustainable value and to ensuring the activities of the businesses we invest in benefit stakeholders, the wider economy and society as a whole.

We engage with boards, shareholders and stakeholders across asset classes to ensure robust corporate governance structures and principles are implemented and applied. Our approach to best-practice governance is informed by a range of well-known industry standards, including the Financial Reporting Council's UK Corporate Governance Code<sup>1</sup> (the "Code") and the ICGN Global Governance Principles.

However, these industry standards are generally applicable to large, publicly listed businesses. In the world of private infrastructure companies, there are fewer appropriate reference points for best-practice governance.

### **Better governance is essential**

Few asset classes are as necessary, or significant, to the daily lives of individuals as infrastructure. These businesses provide essential social services, including access to water, energy, health and social care, and vital transport services. They can be integral to the continued functioning of the economy and society at large. In short, they are the basic physical and organisational structures and facilities needed for the operation of a society. In many cases, such services were historically provided by national governments, but ownership has increasingly transferred to private investors. Between 2015 and 2021, roughly 50% of the UK's national infrastructure pipeline is expected to be financed by private investors.

The UK Government is currently carrying out a consultation on strengthening the corporate governance regime for public and large private entities. It has also increased its focus on foreign ownership of critical infrastructure. We believe this provides an ideal context to explore the idea of an enhanced corporate governance regime for essential service infrastructure.

We believe a clear best-practice reference point for the governance of privately-owned essential service businesses that helps to articulate and align the objectives of Government, private investors and the public, can only be beneficial.

### **Mind the gap**

Notwithstanding the essential nature of infrastructure businesses, current enhanced governance requirements tend only to apply to companies that are particularly large, publicly listed or regulated, and do not typically distinguish the differing activities of the companies under discussion.

The UK Government's current consultation (the Consultation) seeks views on 1) shareholder influence on executive pay, 2) the connection between the board and key stakeholders; and 3) whether there are features of UK corporate governance that apply to listed entities, which should be extended to the largest privately-held companies.

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<sup>1</sup> The UK Corporate Governance Code, Financial Reporting Council, April 2016

As currently formulated, it is possible that infrastructure businesses providing critical public services may neither be listed, nor large enough (by virtue of turnover or number of employees) to fall within the proposed regime.

Whilst there are some alternative governance reference points for private investments – such as the Walker Guidelines for Disclosure and Transparency in Private Equity, and The Institute of Directors' Corporate Governance Guidance and Principles for Unlisted Companies in the UK – the former do not comprehensively cover the full range of governance best-practice matters and the latter are not widely referred to or adopted within the infrastructure fund industry.

Specific governance principles do apply to certain regulated utilities. These include Ofwat's governance principles for water companies and Ofgem's requirements for gas and electricity companies. These principles include: a requirement to appoint a certain number of non-executive directors to the Board who are independent from management and the shareholders; and transparency on specified matters including tax, business planning, and environmental and social metrics. In 2013/14 Hermes Infrastructure participated in several workshops with Ofwat and a select group of long-term investors to provide input and feedback in relation to the formulation and adoption of the Ofwat governance principles for the water industry.

However, the principles only apply to certain sectors and clearly there are a much wider range of infrastructure businesses that have a day-to-day impact on society. The range of topics covered is also narrower than those covered by, for example, the Code. Mandatory transparency on the items listed most often involves disclosure to the regulator, as opposed to stakeholders at large.

## **An enhanced regime?**

The lack of an enhanced voluntary or mandatory reference point for best-practice governance of essential infrastructure businesses means that private infrastructure investors are left to determine (and potentially negotiate with fellow stakeholders) which of the listed or regulated company guidelines or principles are most appropriate on a case-by-case basis.

While the listed company guidelines are helpful, some of the principles may not be appropriate (nor accepted) in a more bespoke private market environment. The result therefore may not always be a consistent, or optimal, outcome for investors, employees and other stakeholders.

Were a separate set of governance principles to apply to essential infrastructure assets, we have identified three key focus areas and several options that merit further consideration. These tie into and complement the areas on which the Consultation is focussed.

### **The Board**

For UK listed companies, shareholders are often distant from both the boards whom they elect and the management teams who are responsible for day-to-day management of the business. The Code specifies that the shareholders' role in governance is to appoint the directors and auditors, and to satisfy themselves that an appropriate governance structure is in place. Shareholders in public companies have a collective right to vote on director appointments.

By contrast, in private infrastructure investments, the boards of directors are often made up principally or wholly of representatives of one or more of the shareholders.

The scale of infrastructure investment often requires a large number of investors, who each seek rights to individually appoint a director of their choice. This right is typically enshrined in the Shareholders' Agreement established to govern the relationship between the institutional investors. As a result, boards can be large and, some may argue, at times verge on unmanageable.

Investor board representation in privately held infrastructure assets, while valuable for alignment with shareholders, can present certain additional challenges:

- For example, where the infrastructure business is owned by financial investors, boards may be made up of a number of individuals with similar backgrounds. This can mean the board is not sufficiently diverse, lacking the broad range of best-in-class skills, knowledge and experience that should ideally be present to enable it to respond appropriately to business needs at all times.
- Second, appointed individuals may often be required to act in two capacities – as a company director and as a representative of the shareholder, in relation to the exercise of shareholder voting rights, for example. In the UK, a directors' foremost duty is to promote the success of the company. Shareholders are subject to no such duty and, in the exercise of their voting rights, have the freedom to act solely in their own interest. The lines of individual duty, accountability and responsibility may become blurred where individuals wear a number of hats. The erosion of due governance processes in the name of efficiency can result in the valuable distinctions between shareholders, non-executives and executives becoming diluted. While the Companies Act contains a duty that directors must avoid conflicts of interest and imposes a duty on directors to exercise independent judgement, robust processes are required to support compliance and to ensure distinct, balanced, thorough and appropriate interactions and decision-making at all levels.

We believe the following enhanced governance requirements could have a beneficial impact in these areas:

1. **Initial and periodic documented board effectiveness reviews** – A board comprised of individuals with a diverse set of skills, backgrounds and perspectives will be better capable of appropriately managing risk and capitalising on opportunities. A requirement for infrastructure businesses to periodically and genuinely consider the Board's skills and diversity, the quality of debate and decision making, the adequacy of conflict management processes, and its overall effectiveness in a structured and documented manner could help ensure risks and opportunities are optimally managed. Such a review could be led by the independent chairperson referred to below and/or be aided by external governance advisers.
2. **Independent chair** – an independent chairperson can provide valuable assistance in steering robust and effective board debate and stewarding interactions between shareholders, the Board, sub-committees and management. For high-profile infrastructure assets, the independent chair should also be a source of comfort for stakeholders other than shareholders. Hermes Infrastructure has supported or procured the appointment of an independent chairperson in several of its investments with these objectives in mind.
3. **A minimum number of Independent Directors** - Ofwat and Ofgem each require the appointment of a specified number of independent non-executive directors to licensed operating company boards. Such individuals are typically selected based on their sector or industry experience, following extensive search and interview processes (including with Ofwat in the case of licenced water companies). The presence of independent, experienced industry professionals can provide comfort for investors, end users and other stakeholders.

## Shareholder value

Directors have a statutory duty to act in a manner they believe is most likely to promote the success of the company for the benefit of its members as a whole. This requires them to consider a range of ancillary matters such as the long-term consequences of any decision, the interests of employees and the impact of the company's operations on the community and environment. For most companies, 'success' equates to an increase in shareholder value.

When drafting this duty in 2006, the UK Government considered two potential approaches – the 'pluralist approach', which involved creating a direct duty to act in the interests of a company's stakeholders (including employees, the community etc.) and the 'enlightened shareholder value' approach, which retained the exclusive duty to shareholders, but obliged directors to "have regard" to other matters.

The Government chose the latter, based on a concern that directors would find it difficult to navigate conflicting and potentially competing interests of multiple stakeholders.

In many cases, the *long-term* interests of the company, its stakeholders and its shareholders will overlap. At Hermes, our mission is to deliver holistic returns to clients. This means delivering an acceptable nominal financial return while being mindful that this will affect the world in which our beneficiaries live and the value of their retirement incomes. As a result, in addition to making ESG-aware investment decisions, we seek to influence the positive behaviour of companies in which we invest, the operations of the assets they directly manage and advocate for beneficial improvements to the financial system in which we participate.

There is increasingly robust evidence of the relationship between well-governed companies and higher long-term returns. Direct evidence of this from our investment teams is supported by academic evidence, with a growing plethora of literature showing that sustainable investing does not jeopardise investment returns (see Clark, Feiner and Viehs, 2015) and a principled approach to investing can enhance portfolio performance<sup>2</sup>.

Our view is that short-termism and a lack of focus on ESG issues can erode long-term shareholder value. We therefore think an enhanced governance toolkit for infrastructure businesses, which ensures the interests of stakeholders (including end users, communities and employees) feature appropriately in the minds of directors would be valuable. The following options may warrant further consideration:

1. **Stakeholder committee** – an advisory committee made up of company management, shareholder directors/independent directors and other key stakeholders could be appointed, operating under agreed terms of reference. While seemingly radical, this would not be a significant move away from existing practices of certain licenced regulated utilities, including certain water companies, which already maintain customer service committees.
2. **Remuneration** – Aligning remuneration to matters other than financial returns (such as metrics related to environmental and social performance, like health and safety) is always an option for existing companies, and is something we actively promote in relation to our investments. Making this an expectation for essential infrastructure businesses would mean such conversations at remuneration committees are the norm. Hermes recently published a paper titled *Remuneration Principles: clarifying expectations*, which was referenced in the present UK Government Governance consultation.
3. **Transparency and disclosure** - Hermes encourages clear and transparent disclosure from the businesses we invest in, both for the purposes of our own risk management and opportunity analysis, and because of the thought processes such disclosure requirements prompt in executive management. Where infrastructure services have historically been provided by Government, key stakeholders would have had the right to certain information.
  - a. **Non-financial reporting** - The level of information and scrutiny to which Governments are subject may be an inappropriate benchmark, not least where part of the motivation for privatisation includes increased competition, which necessarily involves an element of confidentiality and innovation. However, making public reporting of key non-financial information a requirement for infrastructure businesses could reinforce accountability and good practice. Such reporting could include, for example, the key focus areas of any stakeholder committees.
  - b. **Comply or explain** – To the extent higher standards of disclosure or governance apply to either listed or regulated companies, infrastructure businesses could be required to comply with such standards, or explain their non-compliance in their annual reports. To the extent an enhanced code for essential infrastructure companies existed, compliance with the code could be a legitimate reason for non-compliance with any other higher standard.

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<sup>2</sup> There is also a lively debate in relation to the “enlightened shareholder value” approach and “Purposeful Companies” which is beyond the scope of this paper

## **Conclusion**

It may be that the case for implementing a formal, separate governance regime for infrastructure businesses that provide essential public services is considered by some as impractical and undesirable. As with public companies, a one-size-fits-all approach rarely works. Indeed, our approach to governance varies depending on the size of the relevant business, the complexity of its operations, the nature of key stakeholders and various other factors. We value the flexibility provided by the Code in this regard. However, we are strong advocates of an enhanced code applicable to privately-owned Infrastructure businesses in the interests of both shareholders and society as a whole.

We believe that the time is right for the Government and the infrastructure industry to actively consider implementation of some or all of the options set out above, or other initiatives that would deliver an enhanced governance framework for the benefit of infrastructure company boards, shareholders, stakeholders, and the public interest, and increase accountability. We look forward to engaging with our colleagues in the industry as well as the UK Government during 2017 on this essential topic.