

GOVERNANCE OF PUBLIC SERVICE INFRASTRUCTURE

Hermes Infrastructure
Commentary, January 2018

For professional investors only

www.hermes-investment.com







In 2017, we shared our thoughts on the governance of privately owned infrastructure businesses and why improvements could be made to ensure greater stakeholder alignment.



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 Code¹ (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.

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

¹The UK Corporate Governance Code, Financial Reporting Council, April 2016

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 performance².

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.

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.

² 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

CORPORATE GOVERNANCE OF PUBLIC SERVICE INFRASTRUCTURE ASSETS

Stakeholders and the 'stakeholder committee' in private infrastructure businesses.

Peter Hofbauer, Head of Infrastructure at Hermes Investment Management, expands on the creation of a forum to facilitate deeper integration of wider stakeholder and public interest matters into board strategy and decision making.

OVERVIEW

In our recent paper outlining why we at Hermes Infrastructure believe that it is time to establish an enhanced corporate governance code for essential service infrastructure businesses, we made the case for sound and robust governance being the bedrock of efficient management of risk and the creation of sustainable value. We believe that good governance is essential for ensuring that the activities of the businesses we invest in benefit stakeholders, the wider economy and society as a whole. We highlighted the growing body of evidence that well-governed companies, which act in the interests of all stakeholders, are more likely to achieve higher long-term risk adjusted returns.

Recent public deliberations on corporate governance have focussed very much on the role of employees as stakeholders of public listed companies. The Conservative Party's 2017 manifesto, for example, includes a commitment to ensure that listed companies will be required either to nominate a director from the workforce, create a formal employee advisory council or assign specific responsibility for employee representation to a designated non-executive director.

However, by their nature infrastructure businesses delivering essential services involve a broad range of different stakeholders – each with their own interests – including end users of the relevant infrastructure service, local communities, employees and the environment all of whom should be positively and sensitively incorporated into key decisions. Indeed UK directors are obliged by section 172 of the Companies Act 2006 to do just that.

Our view is that establishing a board level forum for essential service infrastructure businesses – a 'stakeholder' or 'public interest' committee – where directors and stakeholder representatives across multiple groups could specifically consider the impact of decisions on all stakeholders, would not only facilitate deeper, holistic integration of stakeholder and public interest matters into board strategy and decision making, but could also offer significantly enhanced risk mitigation and potential for value creation.

GETTING STARTED

There is statutory grounding for such a committee's operations. Section 172(1) of the Companies Act legislates a director's duty to promote the success of a company for the benefit of all shareholders and in a way that considers amongst other things, the long term consequences of decisions, the interests of employees, the need to foster relationships with suppliers and customers, the impact of a company's operations on the community and the environment, and the desirability of maintaining high standards of business conduct ('s172 matters').

Whilst applicable to all UK companies, these concepts and principles should particularly resonate with businesses delivering essential services. Indeed the boards of many water companies, for example, already have Customer Service committees which specifically consider the company's interaction with one of its key stakeholders. Other water companies have adopted broader values (such as Severn Trent's 'Doing the Right Thing')¹ which promote careful ethical decision making in relation to a range of matters affecting stakeholders from environmental pollution to human rights.

FORWARD THINKING

As a forward thinking institutional investor we would encourage the establishment of a board level stakeholder committee, for water companies and other privately owned infrastructure businesses, which would send a strong and transparent signal that considering broader stakeholder interests is effectively integrated into the board and company DNA.

We propose that the committee be comprised primarily of board members. The status of the committee as a committee of the board would be important for ensuring that its deliberations were fully integrated into board deliberations and given an appropriate level of weight.

While many directors are aware of their S172 duties, a mechanism to ensure they remain mindful of these on a day to day basis can only, in our view, be beneficial. Under its terms of reference, the committee could be responsible for facilitating, directing and monitoring the board's consideration of relevant stakeholder interests to ensure that such interests are identified, fully appreciated and appropriately taken into account. Members of the committee could not only draw the board's attention to specific issues as they arose in the course of business-as-usual board discussions, but also act as a forum for deep dive reviews and undertake external engagement.

The aim would be to improve the effectiveness and efficiency of the board's compliance with its obligations under S172, rather than hinder or detract from it. By ensuring that detailed, targeted and appropriate information on holistic and individual stakeholder concerns is presented and debated as required, the committee would act as an enabler for all directors' due and proper performance.

While the committee would be comprised primarily of board members, we would anticipate representation from (or at least attendance, from time to time, by) relevant stakeholders and experts. While the identity and role of such representatives is likely to differ on case by case basis, depending on the range of stakeholders identified and disclosed by the board, we note that in all cases, due consideration will need to be given to the legal relationship between the relevant representative and the company (which will differ depending on whether they are a consultant, employee, volunteer or other) and the scope and obligations related to their role made sufficiently clear.

¹ https://www.severntrent.com/content/dam/stw/ST_Corporate/About_us/Docs/Severn_Trent_Code_of_Conduct_NEW_1.pdf

A MINDFUL APPROACH

We see support for a more sophisticated approach to stakeholders and corporate governance steadily increasing amongst forward thinking investors.

With this in mind, potential mechanisms for formalising the creation and ongoing role of such a committee, whether in the form of a code or otherwise, could include:

- A best practice standard that recommends the committee exists; and/or
- A requirement for an annual public statement by the Chairperson on behalf of the board of the company, that sets out, for example:
 - How directors have ensured due consideration of each of the matters set out in s172 of Companies Act in decision making
 - A description of how each of the directors have engaged with relevant stakeholders, experts and interest bodies in order to satisfy themselves that the interests, principles and potential impacts set out in those sub-sections have been fully understood and considered
 - A description of the way in which the board has identified and managed conflicts of interest between relevant stakeholders; and
 - The effectiveness of the board in remaining aware of and responding to changes in best practice in relevant areas; and/or
- A requirement for integrated, public, non-financial company reporting on s172 matters including explicit reference to the various matters considered as a matter of course.

The concept of a stakeholder committee (in a broader sense) has already been established in other sectors including audit, retail and healthcare² with various versions in existence which could be looked at for precedent.

THE END OF THE STORY?

We recognise that simply establishing a committee will not alone ensure the quality of considerations or outcomes and that all directors and chair persons must be genuinely engaged and committed to make a lasting contribution in these areas.

However, the commitment to creating governance structures that promote that public interest concerns are readily focused on by company leadership teams as a matter of course, would be the start of a worthwhile journey.

²The Audit Firm Governance Code 2016, refers to “public interest committees” or a “body which oversees the public interest. BT PLC has a Board Committee for Sustainable and Responsible Business – <http://www.btplc.com/Thegroup/Ourcompany/Theboard/Boardcommittees/CSRB/index.htm>. **Proctor & Gamble** has a Governance & Public Responsibility Committee; and **Unilever** has a board level Responsibility Committee responsible for oversight of “Unilever’s reputation as a responsible corporate citizen.”

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets

Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities

Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit

Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset

Multi asset inflation

Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore

For more information, visit www.hermes-investment.com or connect with us on social media:   

This document is for Professional Investors only. This document does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments; nor does it constitute an offer to purchase securities to any person in the United States or to any US Person as such term is defined under the US Securities Exchange Act of 1933. It pays no regard to the investment objectives or financial needs of any recipient. No action should be taken or omitted to be taken based on this document. Tax treatment depends on personal circumstances and may change. This document is not advice on legal, taxation or investment matters so investors must rely on their own examination of such matters or seek advice. Before making any investment (new or continuous), please consult a professional and/or investment adviser as to its suitability.

Any opinions expressed may change. The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed. All figures, unless otherwise indicated, are sourced from Hermes. For more information please read any relevant Offering Documents or contact Hermes.

The main entities operating under the name Hermes are: Hermes Investment Management Limited ("HIML"); Hermes Alternative Investment Management Limited ("HAIML"); Hermes European Equities Limited ("HEEL"); Hermes Real Estate Investment Management Limited ("HREIML"); Hermes Equity Ownership Limited ("HEOS"); Hermes GPE LLP ("Hermes GPE"); Hermes GPE (USA) Inc ("Hermes GPE USA") and Hermes GPE (Singapore) Pte. Limited ("HGPE Singapore"). All are separately authorised and regulated by the Financial Conduct Authority except for HREIML, HEOS, Hermes GPE USA and HGPE Singapore. HIML currently carries on all regulated activities associated with HREIML. HIML, HEEL and Hermes GPE USA are all registered investment advisers with the United States Securities and Exchange Commission ("SEC"). HGPE Singapore is regulated by the Monetary Authority of Singapore.

Issued and approved by Hermes Investment Management Limited which is authorised and regulated by the Financial Conduct Authority. Registered address: Lloyds Chambers, 1 Portsoken Street, London E1 8HZ. Telephone calls may be recorded for training and monitoring purposes. Potential investors in the United Kingdom are advised that compensation will not be available under the United Kingdom Financial Services Compensation Scheme.

BD00*** 0002504 01/18