

Are you sitting comfortably? Ofwat investigation highlights deficiencies in compliance practices and culture

On 25 June Ofwat¹ announced that it was seeking to impose its largest ever penalty on Southern Water. Its decision came in the aftermath of a series of failings related to the operational management of a number of the company's UK wastewater treatment works.² The announcement followed a prolonged investigation by the regulator into various issues connected to the business.

Whilst the size of the penalty grabbed the headlines³, the published findings of the investigation are relevant to any company that operates under some form of regulatory control.

This Paper focuses on the regulator's comments around the need for companies to put in place adequate planning, governance and internal control systems. In particular, it explores the apparent weaknesses in Southern Water's own compliance systems, levels of management oversight and culture – all factors which ultimately influenced the regulator's decision to take enforcement action.

In particular, this Paper explores the following topics:

- the role and oversight of the board;
- asset management and investment;
- process controls and testing;
- the timely provision of training;
- transparency and whistleblowing; and
- the use of incentives.

As Ofwat's investigation comes at a period of heightened focus on business compliance behaviours and corporate transparency, its comments on these topics offer a timely reminder of good practice.

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¹ Ofwat is a non-ministerial government department, which acts as the economic regulator for the water and sewerage sectors in England and Wales.

² Notice of Ofwat's proposal to impose a penalty on Southern Water Services Limited, June 2019.

³ A financial penalty of £3 million, coupled with a commitment to give customer bill rebates totalling approximately £123 million.

Regulatory context

With the current trend of increased regulation, there has been a corresponding increase in regulatory oversight and scrutiny of corporate behaviours. While this is not news to businesses operating in the financial services industry (for example), it is clear that participants in other regulated sectors such as utilities, energy and telecoms are also facing, and will continue to face, increased focus on their businesses' compliance systems and practices. Having the right culture is considered key to meeting applicable licence conditions and statutory duties.

The Ofwat investigation is a particularly noteworthy case study - but it will not be the last. The trend for increased regulatory action is consistent with the current government's wider corporate transparency agenda, also evidenced through relatively recent legislation on issues as diverse as reporting requirements on modern slavery in supply chains to identifying corporate beneficial ownership.

Moreover, the Southern Water case has also added further fuel to the political debate in the UK over whether major utilities should be brought back into public ownership.

Factual background

In December 2016, the Environment Agency (the **EA**) alerted Ofwat to the fact that it was investigating Southern Water (the **Company**) in connection with certain data submitted by the Company that related to the performance of its wastewater treatment works. The Company itself then notified Ofwat of the EA's investigation in early 2017.

Ofwat launched its own investigation in June 2017 which focused on whether the Company had breached any of the statutory duties and licence-related obligations applicable to it for which Ofwat had regulatory jurisdiction. Ofwat's investigation was focussed, in particular, on various performance-related aspects of the Company's wastewater treatment works and its reporting of compliance-related information.

Ofwat's findings and proposed enforcement action were published on 25 June 2019 in the form of a notice. As required under law, Ofwat allowed representations on the proposed penalty (which were able to be made up until 19 July 2019). The EA's own criminal investigation, which is entirely separate to the Ofwat action, is on-going.

Lessons learnt

Ofwat's notice commented extensively on issues connected to the Company's corporate governance and compliance processes. There are clearly some interesting lessons to be learnt. The key takeaways for regulated businesses and their stakeholders are examined further below.

THE ROLE AND OVERSIGHT OF THE BOARD

A key aspect of the investigation concerned the adequacy of the Company's Board's operational oversight.

The regulator found that operational failures in the performance of the Company's wastewater treatment works were not fully brought to the Board's attention for a number of years. Instead, the Board was more typically presented with a picture of improving performance on environmental matters.

Although noting that members of the Board were, therefore, potentially unaware of the Company's actual wastewater treatment-related performance and the practices that were occurring on the ground, the regulator had a number of concerns with the Board's approach to these issues.

In particular, the regulator noted that it was the Board's responsibility to secure the reliability of the information that was reported to it, and to create a culture in which that was the expectation. Ofwat concluded that the Company's Board had not done this.

The regulator also indicated its expectation that boards generally should be diligent in ensuring that their companies meet certain core obligations and must, in particular, ask for the necessary evidence to ensure that their businesses have appropriate systems and resources in place to undertake any regulated activities. It suggested that boards should:

- (a) have appropriate lines of sight into the performance of their businesses' operations (which, in the Company's case, had been hindered by a lack of investment in IT systems and a failure to integrate end-to-end processes); and
- (b) ensure that appropriate assurance functions (both internal and external) are put in place in respect of any material parts of their businesses, allowing for departments, directorates and business units to be appropriately and independently scrutinised and challenged as necessary.

It was also noted that the Company's Board: (i) did not always provide appropriate oversight over the "values and culture" of the Company to satisfy itself that behaviours throughout the business were aligned with the Company's purpose; and (ii) failed to otherwise create a robust compliance culture where staff felt supported to "do the right thing".

The regulator did, however, take comfort from the fact that the Company had designed an action plan to ensure that similar issues would not arise again moving forward. In particular, the regulator commented positively on the plan's proposals to: (i) appoint a "Director of Risk and Compliance" to lead a new Compliance Directorate aimed at strengthening internal independence assurance capabilities; (ii) introduce a new Compliance and Risk Committee of the Company's Executive Leadership Team, tasked with providing regular compliance updates to the Company's Board; and (iii) give operational front line teams greater responsibility for reporting their performance, and to make them subject to further controls highlighting the accuracy of their reported performance.

The importance of these issues should not be underestimated. The regulator considered the Board's failure to ensure that it had clear lines of sight and to establish robust challenge and assurance functions to be aggravating factors when it came to calculating the proposed penalty – notwithstanding the fact that the Board's members were potentially kept in the dark around the operational shortcomings of the Company.

ASSET MANAGEMENT AND INVESTMENT

The regulator observed that there had been various management-related issues concerning asset operation, specifically around how the Company's wastewater treatment assets had been maintained.

Its observations in this area highlight the need for businesses to understand the condition of, and maintenance required for, infrastructure essential for their regulatory compliance.

Three of the regulator's concerns stand out in particular:

- (a) **there was a lack of clarity around the condition of the Company's wastewater treatment assets:** it was suggested that the Company had not, until very recently, had a clear enough idea about the general condition of its assets and/or the extent of work needed to make them compliant with applicable standards;

- (b) **there had been a general lack of investment:** a back-catalogue of maintenance works covering some 991 issues (with some 341 still open as at January 2019), with an estimated future investment cost of £26 million, was strongly indicative that historical levels of investment by the Company had not been sufficient to keep pace with the inevitable deterioration of the Company's assets. It also noted that, where investment needs had been identified by the utility provider, they were often not progressed for long periods of time; and
- (c) **management's approach was reactive rather than proactive:** the review concluded that the Company's approach to asset management tended to be reactive rather than proactive and, whilst there was evidence of an operational and maintenance focus on failing assets, capital investment was sometimes slow to materialise (even after multiple operating permit breaches).

In light of these issues, Ofwat therefore found that there had been a systemic failure by the Company to properly manage and operate its wastewater treatment assets which, in turn, allowed it to conclude that the Company had breached its statutory obligations.

PROCESS CONTROLS AND TESTING

Environmental permits and licences typically require for on-going sampling and testing to be undertaken to confirm that emissions from regulated facilities are within prescribed limits. Ofwat highlighted various deficiencies with the way that these exercises were conducted by the Company. In particular, it noted that the Company's:

- (a) sampling visits were co-ordinated, and so could be easily predicted; and
- (b) staff involved in the scheduling of the sample visits were not sufficiently separate from the operational teams, did not hold information confidentially, and openly discussed the predicted dates of when samples would be taken.

These factors, in turn, resulted in the relevant operational teams having sufficient confidence in the expected sampling dates that they could effectively plan for when the samples/tests would be undertaken, allowing for them to manipulate the assets (and therefore the results) as they deemed necessary.

Ofwat concluded that the effective operation of the sampling regime was critically important to securing the Company's compliance with relevant regulatory reporting requirements. It also concluded that there should have been more robust planning and control systems, and management resources, put in place to ensure proper oversight of the Company's sampling regime. Ofwat suggested that the Company would have benefited from having a more randomised set of sampling events, and a more confidential system (particularly around the management of sampling schedules).

Many entities conducting regulated environmental activities will be very familiar with the need to undertake sampling and testing exercises, and will have established their own processes for this. However, this case highlights the need to be vigorous in ensuring sufficient safeguards are built into the testing regime so as to guarantee the veracity of the results and to ensure appropriate levels of oversight.

THE TIMELY PROVISION OF TRAINING

The regulator also highlighted the importance of internal training and the need for remediation of identified weaknesses.

Ofwat noted that an internal audit and risk document presented to the Company's Executive Management Team in September 2015 identified a lack of training provided to operators and technicians at its wastewater treatment works, and that no training had been provided since 2011.

The regulator had particular concerns as to why it ultimately took five years to implement this training

and why no questions were raised earlier. It also made clear its expectation that management should provide appropriate and regular training for employees operating in complex, technical environments to ensure that they are properly equipped to carry out their jobs in an effective manner. However, it welcomed the plans put forward by the Company to develop both public health and environmental compliance training programmes, and to appoint “environmental advisors” to increase general awareness of environmental issues.

Ofwat’s comments are a useful reminder of the importance of training for all levels of employees (and the board) within a business whether it concerns environmental, health and safety or wider compliance issues such as anti-bribery measures or export controls. Regulators will look closely at the level of training (and supervision) employees were given in the event that an incident arises. It is therefore important that senior management (and most logically either the head of compliance or HR) has clear oversight and responsibility for all aspects of training for employees. This is something that can be easily over-looked given the day-to-day operational pressures of a business.

TRANSPARENCY AND WHISTLEBLOWING

The Company acknowledged that historical deficiencies in its organisational culture had potentially prevented employees from being comfortable with speaking out about inappropriate or non-compliant behaviours. This was attributed, in part, to ineffective whistleblowing policies. As a result, no staff came forward to report their concerns, despite reportedly being uncomfortable with how parts of the business were conducted, with some personnel also feeling generally pressured to act in an improper manner.

In addition to criticising the Board for failing to create a robust compliance culture, the regulator also took particular aim at the Company’s historical whistleblowing structures. For example, it cited a statement in an old version of the whistleblowing policy, placed in bold on the front page, which stated that, should any investigation conclude that any disclosure was designed to discredit another individual or group, or prove to be malicious or misleading, then the worker concerned would themselves become the subject of a disciplinary procedure or even action from the aggrieved individual.

The regulator was, however, reassured by the fact that the Company had taken, and was taking, a number of remedial actions around these points, including:

- (a) updating the aforementioned whistleblower policy and introducing a new code of ethics;
- (b) allowing anonymised reporting, both by way of telephone and online portal; and
- (c) putting in place a two year “cultural transformation program”, set to include ethical business practice training.

This reinforces the need to ensure that reporting systems for employees and third parties are sufficiently robust and do not lead to whistleblowers being adversely treated. It also demonstrates that a working environment not underpinned by a clear and positive “tone from the top” that promotes ethical business practices, and a “challenge” culture at all levels, can result in issues remaining hidden for prolonged periods of time and/or repeat violations arising. In the Company’s case, the underlying issues existed for a period of at least five years, while repeated contraventions also arose. These were two of the four aggravating factors cited by Ofwat when it proposed its penalty.

THE USE OF INCENTIVES

The Company reportedly acknowledged that its operational teams had unduly prioritised meeting targets connected to financial incentives over other non-financial outcomes.

Whilst the regulator found limited direct evidence of front line staff incentives or rewards being linked to improper actions, there was at least a potential that the Company’s incentive schemes for senior management could have led to inappropriate behaviours. The Company has, subsequently, stated

that this risk will be addressed by reviewing its current incentives and otherwise committing to operate in line with best practice in relation to the issue of executive pay.

Conclusions

Regulatory compliance is underpinned by balancing a number of key pillars, in particular (i) the discharge of statutory duties; (ii) the conducting of on-going operational risk assessments; (iii) a calibrated programme of operational expenditure and capital investment; (iv) the implementation and maintenance of compliance policies and procedures; and (v) the establishment of positive cultural values.

Ultimately, every operator has to find a way to balance each of these and it is naive to think that businesses get it right all of the time. That said, ensuring that the written compliance procedures within a business are fixed in the right way is an essential foundation – policies should be well written, implemented and followed; training regularly given across a range of compliance areas; whistleblowing channels established that are easily accessible and in which employees have confidence; and safeguards established that catch wrongdoing.

The harder piece is behavioural. Ensuring that employees and senior management behave in the right way, and make the right decisions for the business and its reputation, is essential. Whilst often talked about, and harder to pin down, the tone from the board of a business across all these issues is key. Get all of these elements right, and compliance will add value to a business and be a brand enhancer particularly at a time when investors are increasingly looking at businesses through an ESG⁴ lens.

⁴ “*Environmental, Social and Governance*”.

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