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1st May 2023

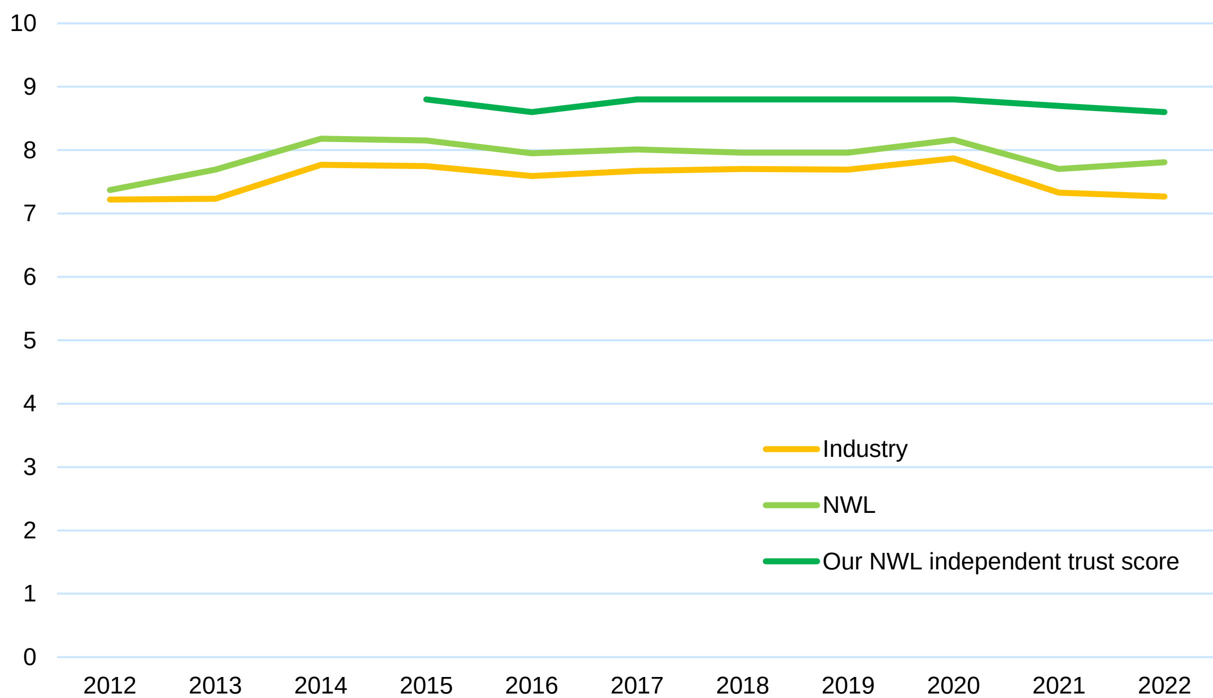
Dear David

Thank you for the opportunity to respond to the consultation on the Performance Related Pay (PRP) adjustment that Ofwat has proposed.

We agree with Ofwat that performance related pay needs to reflect service delivery to customers and the environment and be transparently reported to maintain trust.

Northumbrian Water (NWL) agrees that performance related executive pay needs to reflect the service delivered to customers and the environment otherwise there is a risk that customer and stakeholder trust and confidence can be eroded. This approach has been embedded in our performance pay process for executives and senior leaders for many years and trust amongst our customers remains stable and above the sector average. We transparently report these matters through our annual reporting.

Figure 1: Customer trust in NWL and the sector overtime



Sources: NWL customer tracking surveys 2021-22 – customers ranking out of 10 whether NWL is 'a company I trust' over the past year and CC Water Water Matters Trust scores (trust across our NWL operating areas and industry average trust score). Note CC Water Trust scores for 2022 embargoed until 10th May

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In this context we were pleased to see our policy recognised as good practice by Ofwat in its recent review of how companies were meeting its Board Leadership and Transparency principles. In which you noted that:

"Northumbrian Water clearly set out the targets for each metric which made up its annual bonus scheme alongside the actual performance in the year against each metric, whether the target was achieved, and if so, the percentage of the bonus award which was payable as a result."[1]

We further note that our executives have a relatively low level of performance related pay compared to other companies. Annex C to this letter contains some unattributed analysis of total executive compensation as can be seen from the chart NWL sits towards the bottom of the scale and the maximum incentivisation is 120% of base pay compared to as much as 300% in some other companies.

But we do not consider that Ofwat should be directly regulating performance related pay – there is no prima facie case for regulation in this space.

Economic regulation is established in the first instance to seek to mimic the dynamics of a competitive market (in the absence of the sector's monopoly characteristics Ofwat would not exist) and as such to focus in particular on those aspects of service provision which are not exposed to direct competition.

Whilst companies have monopoly water supply networks, they do not have any significant market power over labour markets for executives. This absence means that there is no prima facie case for regulation here. Staff can (and do) regularly move between different sectors and hence these sectors are in direct and genuine competition with each other for the best personnel.

In these competitive labour markets executive remuneration is not standardised and many different approaches are taken to find new and innovative ways to both attract staff and incentivise performance improvement. This takes place in different company contexts (e.g., driving performance in 'good' companies versus recovery in 'turnaround' companies, managing significant growth, driving near term innovation or performance versus long-term goals and value, etc). This results in significant variance for example between base pay and incentives, what is incentivised both in the short and long term and the quantum of incentivisation. This is an inevitable feature of the water industry in England and Wales operating in the private sector, and in competition for capital and talent and should be welcomed for the innovation it brings, rather than challenged.

Neither is there a strong precedent to do so.

Examples of other regulators directly regulating in this space are limited, and where they exist are targeted at different issues.

The NIC has acknowledged the link between executive remuneration and trust, advocated for increased transparency, and highlighted the importance of linking management incentives with consumer outcomes[2] – which Ofwat has already addressed in its Board Leadership and Transparency principles. However, the NIC is also clear that regulatory intervention should remain light tough and in particular that '*Regulators should not be responsible for setting executive pay'* – something which Ofwat's latest proposal strays dangerously close to.

While there is some evidence of intervention in this area by the Financial Conduct Authority, this is targeted at the specific issue of avoiding 'Material Risk Takers' being unduly incentivised to expose an

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[1] See: https://www.ofwat.gov.uk/wp-content/uploads/2021/02/Board-leadership-transparency-and-governance-%E2%80%93-Reporton-how-companies-are-meeting-the-principles.pdf pp.10

[2] As set out in section 2.1 of: Strategic Investment and Public Confidence (nic.org.uk)

organisation to excessive risk in order to gain short term incentive payments – an issue largely confined to the financial sector[3] and which Ofwat has not raised directly as an area of concern to date.

And the regulatory framework already provides sufficient incentive to drive the right outcomes for customers and the environment – Ofwat does not need to intervene further and doing so interferes directly with the governance and management control of companies.

There are already strong incentives on Boards not to overpay for executive remuneration and the cost of these rewards are already reflected in the cost allowances Ofwat sets during the price review - Ofwat already provides an efficiency challenge on these rewards. The proposals merely duplicate this existing challenge, while increasing regulatory burden and uncertainty.

At the same time Ofwat regulates cost and service targets through comparative benchmarking. This analysis seeks to isolate factors outside of management control and, once those factors are reflected, Ofwat sets stretching service and performance challenges for companies to achieve. This existing and well proven regulatory framework operates on the premise that better management of these businesses enables customers to enjoy lower bills or better service and overall better outcomes. By directly intervening on individual components, such as remuneration, Ofwat constrains the scope for Boards to innovate in executive remuneration, and reward to drive performance - a key tool in driving improved outcomes. The approach will definitely reduce innovation in this space and weaken the ability of Ofwat to set stretching service and efficiency targets.

Directly intervening in levels of PRP in this manner will also expose Ofwat itself to challenges and counter-challenges on the appropriate levels of remuneration. Indeed, the more Ofwat involves itself directly in areas that are rightly the purview of boards the more accountable it becomes for the outcomes delivered by the companies directly – Ofwat cannot reasonably be both so directive in its regulatory approach and also pretend that it is not reasonably interfering with management choices. Below we provide an illustration of the activities of a German Supervisory Board, gradually we can see that Ofwat are reaching across more and more of the categories in the figure below which illustrates the extreme approach Ofwat's regulation is now taking.

[3] More detail can be found in: SYSC 19D.3 Remuneration principles - FCA Handbook

Figure 2: Illustration of the activities of German supervisory boards- Ofwat's regulation now extends across almost all of these areas

	Activities	Description
Monitoring	Strategic monitoring	• Monitoring market developments and competitive position • Tracking the success of strategic initiatives
	Financial monitoring	• Defining the audit process and approving financial accounts • Tracking investments and financial measures
	Risk monitoring	• Monitoring the risk management system • Discussing major risks and necessary measures
	Evaluation of the executive board	• Assessing target achievement, competency, and integrity • Defining management compensation
Shaping	Appointments to the executive board	• Deciding on the appointment or dismissal of executive board members • Planning succession, promoting young talent
	Target setting for the executive board	• Agreeing on targets with the executive board • Defining the incentive and compensation system
	Involvement in strategic direction	• Participating in decisions on time frames, assumptions, and success metrics • Approving the overall strategy
	Decisions on transactions requiring approval	• Defining the approval requirements • Approving the budget, investments, M&A, capital measures, and dividends
Advising	Advice on key business decisions	• Discussing alternatives • Contributing experience and knowledge, questioning assumptions
	Provision of relevant expertise	• Providing specific content expertise • Supporting the implementation of particularly relevant issues
	Coaching of the executive board	• Promoting the personal development of executive board members • Acting as personal sparring partners and advisors
	Offering support with their professional network	• Referring relevant contacts • Discussing select topics with third parties

Source: BCG article

Finally, this reconciliation mechanism is proposed for introduction within the current period having not been set out in the PR19 final determinations. This is quite clearly ultra-vires and if Ofwat was going to introduce this mechanism then it should have done so in the Final Determination or through a licence modification.

Despite these concerns the document makes clear that Ofwat is minded to introduce a mechanism like this across the sector. If this is the case, then we would encourage such a mechanism to be applied selectively across the sector or a 'light touch' approach to be used if it is applied to all companies.

Whilst we do not consider this to be a proportionate and sensible area for economic regulation for the reasons we set out above, we recognise that Ofwat appears minded to progress a PRP mechanism.

Your initial letter to companies on this matter acknowledged that these concerns did not apply to all of the sector, and we understand that whilst Ofwat has met with several companies it has not spoken to all of them, including NWL. The concerns that have led to the PRP consultation are clearly not with all companies, and Ofwat has clearly reached a view on which companies' PRP approaches are appropriate, and which are not.

A proportionate, targeted and risk based approach, in line with Ofwat's better regulation duty, would therefore be to apply the PRP mechanism to those companies where Ofwat has already identified concerns and simply leave out of the reconciliation mechanism those companies where it does not have concerns. This would be more proportionate and targeted to the risk, best protect the innovation that we highlighted previously and also reward companies that have already done the right thing in this respect.

This would be consistent with approaches that Ofwat has adopted previously when prioritising interventions in line with its risk-based approach[4].

If Ofwat is still minded to introduce the mechanism across all companies, then we would encourage a light-touch approach to its implementation.

The consultation provides very limited information on the detail of the proposed mechanism and how it will operate. We have therefore made some suggestions based on considerations we have made as we have developed our own executive reward arrangements in Annex A.

We do not consider that any PRP mechanism should take account of the wider factors proposed.

Page 5 of Ofwat's consultation suggests that wider factors in relation to overall performance should also be considered including for example any ongoing enforcement action, Ofwat's view of financial resilience and performance as may be reflected in its Water Company Performance Report – i.e., factors wider than the specific metrics which may be referred to in PRP arrangements. We are not supportive of this unbounded approach.

PRP arrangements will only act as an effective incentive to individuals if the rules to calculate payments are clearly and unambiguously set out in advance of the period to which they apply. Consideration of the wider factors proposed by Ofwat suggests that a more subjective assessment would need to be made at the end of that period. In any event Remuneration Committees are generally vested with step-in rights, which is properly their responsibility to exercise, should wider issues become relevant.

On the specific case of taking into consideration any ongoing enforcement action when deciding on award decisions, these investigations can last some years and being 'under investigation' does not mean that a company has broken the law, or even done anything wrong. There should be a presumption of innocence before any guilt is proven. We are concerned that Ofwat's proposed approach would prejudge the outcome of any such action. In this regard we note the form of words which Ofwat has included in a Section 203 notice to NWL last year:

"This (notice) is to secure access to the information that we need to understand the existence, nature and extent of any such contraventions. <u>Serving the section 203 notice does not imply that we will conclude that there has been any such contravention</u> or that we will pursue formal enforcement action and/or impose a financial penalty…."

Should it be confirmed that a company has broken the law, we would expect proper application of Ofwat's enforcement policy and statement of financial penalties to fully address any detriment that had occurred to customers or the environment which is the stated aim of those policies. Indeed, these policies also generally seek to apply a further premium to deter others from similar contraventions. Further intervention beyond this should not be required and would amount to double jeopardy.

Finally, in a well-designed PRP policy, we would expect a reasonable degree of alignment between the metrics assessed and those included in Ofwat's Water Company Performance Report (see Annex B). Further consideration of Ofwat's report when assessing PRP payments would again amount to double counting.

We would be happy to discuss further with you any of the points in this response.

Best,

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[4] For example as set out in: https://www.ofwat.gov.uk/wp-content/uploads/2015/11/pap_pos1203regcomp.pdf

[redacted]

Andrew Hunter

Non-Executive Chairman

Annex A: Proposed principles and approach to the PRP mechanism

We suggest some principles that could apply to the proposed new PRP mechanism
Given the risks highlighted of a more prescriptive approach, we consider that the PRP should follow a 'light-touch' principles-based approach. This could include requiring companies to:

1. **Ensure that the majority of executive performance-related reward and remuneration is linked to service performance to customers and the environment.** This ensures that the majority of rewards are linked directly to service performance to customers and that financial performance would be a smaller subset of the metrics considered in setting incentives. Customers will tend to benefit too from financial performance of companies which for example will include driving cost efficiencies or raising finance cheaply both of which will reduce bills, etc. so these matters are not simply an issue for shareholders. Ofwat's new dividend policy licence condition and the associated guidance also aligns any distributions to performance to customers and the environment already. Therefore, a majority of the incentive linked to this performance appears appropriate. We already link 60% of incentives to these performance metrics but this would only apply any PRP where this was less than 50%.
2. **Ensure that both short and long-term performance metrics are linked to service performance that is important to customers.** Water companies are subject to a range of performance targets and metrics. These reflect the diverse role that companies have and the wide range of services we provide, for example ranging from customer service, environmental performance, and service performance. These metrics are set by different regulators and in totality there are too many of them to incentivize reasonably through these arrangements. There are also different metrics that might warrant inclusion for example because they are more or less relevant to the overall performance of individual companies or because they are more relevant to short-term and long-term incentive arrangements. So, Remuneration Committees' (Remco's) will need to make choices that reflect areas that need to improve or areas that are considered more important than others. The risk here is that Remco's include metrics that are not relevant. Ofwat could provide a long-list of metrics it considers acceptable for companies to choose from, companies would only be penalised if Remco's selected metrics outside this list and indeed Ofwat could introduce a process to ensure that any deviation could be discussed with Ofwat to avoid completely constraining choices. It would be overly prescriptive for Ofwat to suggest what the target performance areas are that 'must' be included in the PRP.
3. **Ensure that short-term incentive targets can only be paid based on meeting or exceeding the agreed PCL in the final determination.** Current PCL targets that have been set commonly across the sector are extremely challenging with most of the sector incurring net penalties. In many instances these targets are demonstrably stretching in an international context, i.e., they represent some of the most stretching performance metrics for a water utility anywhere in the world. Meeting the PCL would ensure that rewards reflect the service levels that companies signed up to and bonuses could only be paid where performance exceeds them. Public concerns around this could also be greatly helped by Ofwat and companies recognizing and reporting the level of stretch in these targets internationally wherever possible. Companies would not be permitted to set incentives for achieving short term performance targets that are less than the agreed PCLs.
4. **Ensure that total executive reward is below an independent benchmark level across comparative companies.** Ofwat should limit its intervention to any instances where companies appear to be paying too much reward to executives relative to an independent benchmark. As a company we use benchmark data from Willis Towers Watson, but other benchmark databases are available. We consider that benchmark reward would typically be taken from an average of other privately owned utilities or asset-intensive companies with similar market capitalisation values or FTSE 250 companies. Executive remuneration and reward are always likely to be a controversial topic in the public discourse and reaching a situation where the general public is 'happy' with executive pay is not a sensible goal. So Ofwat should focus the PRP on correcting egregious examples of this and the benchmark approach combined with the principles above would do this.

The above principles avoid a very prescriptive approach to regulation in this area that would remove any scope for innovation, risk an exodus of talent and make it more difficult for Ofwat to do its core job of regulating performance in the true monopoly context by constraining the role of boards.

The principles also provide more flexibility around long-term incentives which could be used, for example, by turnaround companies to provide decent incentives to improve their performance and would similarly allow some targets to be set around other important aspects such as health and safety or staff engagement which don’t represent service levels to customers and the environment but are clearly important to running these businesses effectively.

Finally, the principles still provide a clear mechanism that could be applied for an ex-post true-up of revenues where performance-related pay did not reflect these principles.

Annex B: NWL's STIP and LTIP targets and their alignment to customer priorities

The table below provides a full list of the Ofwat 'common' Performance Commitments, and the service metrics covered by NWL's STIP and LTIP arrangements. It also includes current STIP/LTIP targets and commentary on how stretching they are and relates them back to customer research including the Ofwat/CC Water research that was undertaken last year and a triangulation of various research NWL has done. From the table it should be clear that:

- there is very strong alignment between NWLs STIP/LTIP targets and the common Ofwat PCLs but not all are covered because there would be too many;
- targets are stretching with all but one (CRI) requiring the achievement of NWLs PCLs or better and four requiring performance to be at or very close to the industry frontier; and
- these service levels reflect customer priorities with all the 'High' or 'Mid' priority areas covered from Ofwat and CC Waters research which is also consistent with NWLs own customer research (triangulated from several sources).

Figure3: List of common Ofwat PCLs, inclusion in NWL STIP and LTIP, commentary on targets and alignment with customer research priorities

Overall List of all PCLs	STIP	LTIP	STIP / LTIP Target	Notes on STIP/LTIP Targets	Ofwat / CCW Research ranking	NWL triangulated ranking
CRI	Y	Y	<=3.00	Set to achieve substantial but deliverable reduction on prior year's performance and recognising the multiplier value that applies to NWL in this area.	N/A	High
ITS3	Y	Y	<=4:53	Set tighter than PCL	High	Medium
Leakage NW	Y	Y	<=109.6	STIP target in annual figures, PC in 3 yr average terms. Annual target set significantly tighter in order to achieve 3 yr average for PC	Mid	High
Leakage ESW	Y	Y	<=56.2	STIP target in annual figures, PC in 3 yr average terms. Annual target set significantly tighter in order to achieve 3 yr average for PC	Mid	High
Mains Repairs					N/A	Medium
PCC					Lower	Lower
Internal Sewer Flooding	Y	Y	<=207	Set to be consistent/better then PCL	High	High
Repeat Sewer Flooding	Y		<=31	Set tighter than PC to maintain continuous improvement		High
Discharge Compliance	Y		100%	Set at maximum (100%) compliance.	N/A	Medium
Pollutions (all)					Mid	Medium

Pollutions - Serious 1/2	Y	Y	0	Set at best possible performance (zero).		High
C-MEX	Y	Y	Top 2	Stretching target to be one of best in industry		High (expected by customers)
D-MEX	Y	Y	Top 2	Stretching target to be one of best in industry		High (expected by customers)
Sewer Collapses						Medium
Unplanned Outage						Medium
Risk of severe restrictions in a drought					Lower	n/a
PSR						n/a
Risk of flooding in a storm						n/a
GHG	Y		<=21.92	Set tighter than PC level to achieve ambition to be carbon neutral on operational emissions by 2027	Lower	Lower

Annex C: Comparison of NWLs compensation with other companies

The following information provides a breakdown of the total compensation for the CEO population.

Figure 4: Total compensation for CEOs for 10 Water and Sewerage Companies, 21-22