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Protecting customer interest on performance related executive pay – recovery mechanism guidance

About this document

This document sets out our guidance relating to the scope and application of the performance related executive pay (PRP) recovery mechanism.

This mechanism will ensure that customers do not fund PRP awards for executive directors if a company is unable to demonstrate that its decisions reflect our expectations.

The financial adjustments which we identify need to be made as a result of this mechanism, will be implemented through the cost reconciliation model. Details of this can be found in our Reconciliation Rulebook.

1. Introduction

Transparency of the relationship between pay and performance is vital. All stakeholders should be able to see clearly how PRP is aligned to the delivery of stretching performance for customers and the environment. In addition to explaining clearly how individual performance metrics are used to determine awards, we expect remuneration committees to explain how any awards reflect overall performance, which includes taking appropriate account of emerging risks and issues.

The PRP recovery mechanism allows us to intervene to ensure customers are protected and do not fund PRP where a company does not meet the expectations we have set out.

We expect the mechanism to motivate greater focus and scrutiny in remuneration committee and board decision-making, including as to whether the metrics and targets chosen are appropriate, and how overall performance is reflected and recognised.

Regulatory Accounting Guideline 3 sets out the information which each company is required to publish in this area, including explaining how any PRP award is justified in the context of company performance overall.

We will keep this guidance under review.

2. Factors to take into account in PRP decision-making

Our [Aligning risk and return technical appendix](#) at PR19 and [Appendix 10 of our PR24 Final Methodology](#) set out our expectations with respect to the performance related pay elements of company remuneration policies for 2020–25 and 2025–30, respectively. We expect that each company's decisions on PRP awards also reflect those expectations. Factors we will consider in deciding whether a company's approach to executive pay meets our expectations include:

- **Alignment to delivery for customers and the environment.** The criteria for awarding both the short- and long- term elements of performance related pay in the year should demonstrate a substantial link to stretching delivery for customers and the environment¹. We will consider all incentives relating to each director, including any proportion relating to other group companies, when making this assessment. Examples of specific measures relating to delivery include customer service, water quality or pollution incidents. Financial measures which are solely for the benefit of investors cannot be considered as relating to delivery for customers and the environment.
- **Stretching targets.** Award decisions for the year should be based on stretching targets. Each company will need to consider what is stretching in the context of its own company and the metrics being used. An example of a target which could be considered stretching is one linked to sector upper quartile performance. By target, we mean the threshold at which any level of bonus is triggered, recognising that higher levels of performance may generate higher payments.
- **Overall performance.** Award decisions for the year should take into account overall performance delivered for customers, communities and the environment including factors which are wider than the individual metrics used as part of PRP arrangements. Factors which, when taken together or individually, may provide an indication of company overall performance could include:
 - performance against performance commitments not included as part of individual metrics;
 - financial resilience;
 - reputational issues, including significant events impacting customers and/or the environment in the course of the year;
 - compliance issues, including enforcement action or litigation; and
 - consideration of overall performance as may be expected to be reflected in our Water Company Performance Report (or equivalent publication) and Environmental Performance Assessment rating (as relevant).

¹ This expectation is consistent with directors' statutory duty under s.172 of the Companies Act 2006.

- award decisions should demonstrate that poor performance overall has not been rewarded and any exceptions to this, for example to reflect stretching short-term improvement targets as part of a longer-term turnaround.
- **Deferral, malus and clawback.** How discretion has been exercised in appropriate cases to use mechanisms such as deferral, malus, and clawback, for example, to defer awards pending the outcome of ongoing enforcement action, and/or to explain clearly why such mechanisms have not been used in relevant circumstances.

3. Scope and application of the mechanism

Fairness and objectivity will be key drivers of our assessment with the over-arching objective of protecting the interests of customers. Our assessment for the PRP recovery mechanism is not aimed at considering quantum of PRP or, beyond our broader expectation of a substantial link to stretching performance, if individual metrics are appropriate in and of themselves. Each company is responsible for setting performance related executive pay and related policies and for decisions pursuant to them.

We will consider whether individual metrics are appropriately stretching, and whether, taken as a whole, PRP metrics demonstrate a substantial link to customers and the environment. We will conduct an 'in the round' assessment to determine whether, on balance, the company's decisions on the PRP awards for the year meet our expectations, including with regard to overall performance.

Where relevant, we will make an adjustment based on the whole award of PRP for the corresponding year, except in exceptional circumstances. However, the final decisions regarding the total amount of revenue recovered through the PRP recovery mechanism will be made as part of the reconciliation process for PR19 and PR24 respectively.

The mechanism applies to awards made to executive directors who are members of the regulated company board. The awards pertaining to each individual executive will be considered separately.

We will report the outcome of our initial assessment for each company annually so that this can be taken into account in their ongoing decision-making. The detail of how any adjustments resulting from the PRP recovery mechanism will be made through the cost reconciliation model is set out in our Reconciliation Rulebook².

² At the time of the publication of this document, we are yet to make the updates required to the PR19 Reconciliation Rulebook, pending comments from companies. We will publish an updated version of the rulebook, incorporating the necessary changes shortly.

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