

March 2023

**Protecting customer interests on
performance related executive pay:
Proposed guidance**

About this document

This document sets out our proposed guidance relating to the scope and application of the performance related executive pay (PRP) recovery mechanism we intend to apply, as outlined in our PR24 final methodology. Under this mechanism, we will be able to adjust revenue allowances, so that customers do not fund PRP awards if a company is unable to demonstrate that their decisions reflect our expectations.

This policy will apply both to the remainder of the 2020-25 period (2022-25) with adjustments made at PR24 and the 2025-30 period.

The technical details of the operation of the mechanism will be set out in our PR19 Reconciliation Rulebook for the current (2022-25) period, and in the PR24 Reconciliation Rulebook for 2025-2030.

Foreword

Water companies are monopolies established to provide an essential service. They have a range of obligations to customers, communities and the environment and, through their appointments, a privileged status. Remuneration, whether that be for investors through their returns or executives through their performance related executive pay, should closely reflect and take account of these responsibilities, reward excellence and, importantly, should not reward poor performance or failure. Demonstrably aligning incentives and outcomes in this way is vital to sustaining the trust of, and accountability to, customers, regulators, and wider society.

We recognise the role performance related pay plays in incentivising and rewarding strong performance and driving improvements where needed. Nevertheless, in a context where the performance of the sector continues to be called into question, particularly with regard to environmental performance, we do not consider that all companies are applying PRP in a way that lives up to the standards that we all expect.

The PRP recovery mechanism we outlined in the PR24 Final Methodology aims to address this. We expect it to motivate greater focus and scrutiny in remuneration committee and board decision-making: whether the metrics and targets chosen are appropriate, and how wider performance is recognised.

It provides additional protection by enabling us to step in to ensure customers are protected and do not fund PRP where a company does not meet the expectations we have set out. In such circumstances, the costs will be borne by investors.

In anticipation of remuneration committee decisions to come with respect to 2022-23, and for the rest of this price control period, both company policies and executive bonus payments need to be aligned with these expectations.

While not every company is starting from the same position, all companies will need to demonstrate that customers' concerns, including those relating to environmental performance, have been recognised and what has changed as a result.

Commenting on this guidance

If you wish to comment on this guidance, please email the Ofwat governance team at governance@ofwat.gov.uk

The closing date for comments is 1 May 2023. If you wish to discuss any aspect of this consultation, please contact governance@ofwat.gov.uk

We will publish our final guidance on our website at www.ofwat.gov.uk as soon as is practicable, after the closing date for comments. Subject to the following, by providing a response to this document you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed, which we will consider when deciding what information to publish.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our privacy policy explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this guidance note, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

Introduction

Companies are responsible for setting performance related executive pay (PRP) and related policies. Nevertheless, we expect such policies and decisions to reflect each company's role as a monopoly provider of an essential public service, and to take account of the importance placed on this by customers and other stakeholders in terms of trust and accountability.

At PR19 we set a clear expectation that PRP should demonstrate a substantial link to stretching performance delivery for customers and the environment. We have developed and reinforced transparency requirements on PRP in recent years, including through our Regulatory Accounting Guidelines. Our licence objectives on Board Leadership, Transparency and Governance introduced in 2019 further reinforce the high standards of corporate governance we expect from water companies and emphasise the importance of their governance arrangements in engendering trust and ensuring accountability.

Transparency of the relationship between pay and performance is also 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 committee reports to explain how any awards reflect overall performance, which includes taking appropriate account of emerging risks and issues. Regulatory Accounting Guideline 3 sets out the information which each company should publish in this area, including explaining how any performance related pay award is justified in the context of company performance overall.

PRP recovery mechanism

In our PR24 Final Methodology we set out that we were considering the introduction of a new end-of-period reconciliation mechanism. This was to underscore our expectations with respect to performance related pay awards, including the exercise of judgement by remuneration committees with respect to overall performance. This consultation confirms our intent to introduce this new mechanism to adjust revenue allowances so that customers do not fund PRP where a company does not meet the expectations we have set out, and as reflected in this guidance note.

We expect this mechanism to apply for the remainder of the 2020-25 period (including 2022-23), through reconciliations at PR24, as well as for 2025-30 at PR29. We expect to make our final decisions regarding the total amount of revenue disallowed through the PRP recovery mechanism as part of the reconciliation process for PR19, and PR24 respectively, enabling us to take account as appropriate of any intervening factors (such as the application of malus or clawback provisions). However, we will signal our provisional views each year, so that this can be taken into consideration for future decision making.

The details of the operation of the mechanism will be set out in revisions to our PR19 reconciliation rulebook, which we will consult on in due course, and in our PR24 reconciliation rulebook.

We may update our guidance or expectations drawing on findings from our ongoing monitoring of the sector.

Factors 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 performance related pay awards also reflect those expectations. Factors we propose to 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 for customers 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.
- **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 their 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;

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

- 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).

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.

Scope and application of the mechanism

We are clear that fairness and objectivity will be key drivers of our assessment with the overarching 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 performance related pay award in 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. 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 will apply to executive directors who are members of the regulated company board. The awards pertaining to each individual executive will be considered separately.

As noted above, 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.

Commenting on this guidance

We would welcome comments on this proposed guidance by 1 May 2023.

Please contact the governance team at governance@ofwat.gov.uk if you have further comments or questions.

**Ofwat (The Water Services Regulation Authority)
is a non-ministerial government department.
We regulate the water sector in England and Wales.**

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