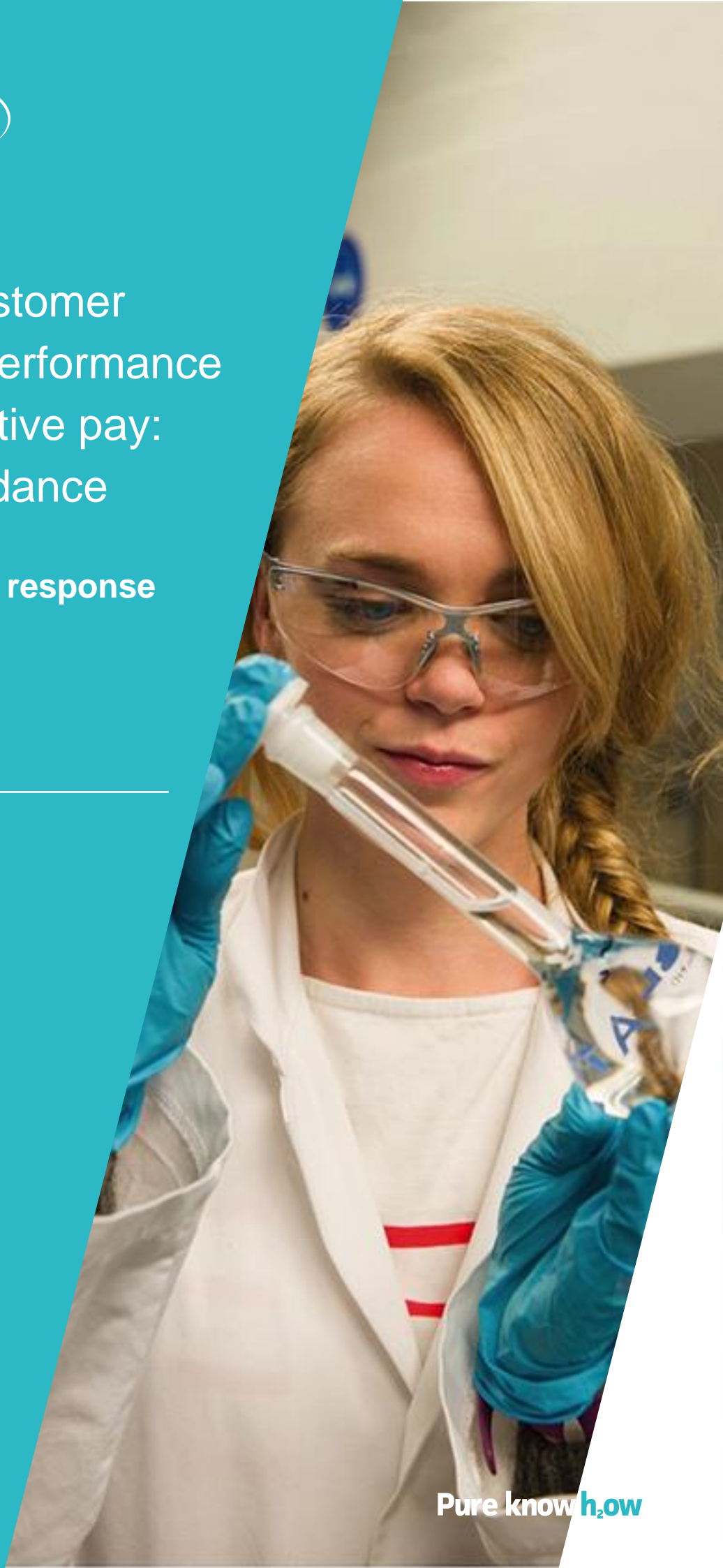


Protecting customer interests on performance related executive pay: proposed guidance

South East Water response

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1. Introduction

Thank you for consulting on a proposed mechanism relating to performance related executive pay.

The document issued for consultation is presented as a guidance on the scope and application of a new regulatory mechanism relating to performance related pay.

The PR24 methodology signalled the possibility of a new end-of-period reconciliation mechanism disallowing revenue recovery where remuneration decisions do not meet Ofwat's expectations. The PR24 methodology further stated that such a mechanism would apply for the remainder of the 2020-25 period (including 2022-23), at PR24 (i.e. the reconciliation process for PR19), as well as for 2025-30 at PR29 (i.e. the reconciliation process for PR24). Ofwat has stated that it would signal its provisional views each year during these two periods.

The PR24 methodology and the consultation document do not provide information on how such a mechanism would operate leaving the details to be set out in a revision to the PR19 reconciliation rulebook and to a future PR24 rulebook.

Our overall comment is that neither the final methodology nor the consultation document provide sufficient information to enable us to comment meaningfully on the proposal. In particular the consultation document does not provide any information on how the objectivity and predictability of such a mechanism would be ensured. This remains the most obvious defect of the proposal.

We set out below our two main comments on the proposal:

- Our first set of comments relate to the procedural issues raised by the proposal. They would be relevant to the implementation of any change to a price control, irrespective of the subject matter being considered. They are concerned with due process and the integrity of the regulatory system. They do not relate in any way to executive remuneration and how it may be considered by Ofwat as part of the regulatory regime.
- Our second set of comments relate to the fact that Ofwat's expectations are set out in generic terms and that the proposed mechanism will provide insufficient certainty and predictability and only limited concrete guidance to remuneration committees. These issues would become even more significant if a new mechanism designed to adjust revenue allowances was implemented.

2. Procedural issues arising from the application of the proposed mechanism to the remainder of the 2020-25 period.

Whether the PR24 methodology can be used to introduce a regulatory mechanism pertaining to the PR19 periodic review.

Ofwat's power to set price controls at periodic reviews are set out in Condition B of the instrument of appointment.

Each periodic review is carried out following the final methodology set by Ofwat for that purpose. Ofwat states in its consultation document that it is introducing a new mechanism that was first outlined in its PR24 methodology.

An end-of-period adjustment under the PR19 reconciliation rulebook may be reflected in the outcome of the PR24 periodic review but this does not mean it could be defined retrospectively in the PR24 methodology.

Periodic reviews are forward looking (as confirmed *inter alia* in sub-paragraph 8.4 and 8.6 and the definition of Review Charging Year). It follows that a new regulatory mechanism for PR19 (even presented as an end-of-period adjustment) cannot properly be introduced in the PR24 methodology that relates to the next period (i.e. 2025-30).

Concluding otherwise would infer a power to retrospectively revisit past periodic reviews and amend past final determinations including after the period for appeal to the CMA has expired or even after the CMA heard an appeal on a final determination.

Was the proposed mechanism part of the PR19 determination?

No regulatory mechanism designed to adjust the revenue allowance of companies by reference to an assessment of how they met Ofwat's expectations about performance related pay was described or referred to as a possibility in the PR19 final methodology or in PR19 final determinations. There is no reference to such a mechanism in the reconciliation rulebook published in 2021.

Consideration of whether a new mechanism could be introduced through a variation to the PR19 reconciliation rulebook

To the extent that any reconciliation adjustment is necessary in relation to a price control, during or at the end of the relevant period, this is set out in the reconciliation rulebook following principles defined in the final methodology and/or the final determination (and associated models). Where required this is also enabled by appropriate amendments to the conditions of the instrument of appointment.

Within the regulatory framework defined in Condition B of the instrument of appointment, the reconciliation rulebook may only have effect to the extent it implements and is consistent with principles defined in the final methodology and/or final determination.

Subject to appropriate consultation, Ofwat has some flexibility in defining the details of the implementations of these principles, but reconciliation rulebooks:

- Must deal with genuine reconciliations which were anticipated in the final methodology and/or the final determination for the relevant price control;
- Cannot set out mechanisms that were not contemplated in the final methodology and/or final determination for a relevant periodic review;
- Cannot be used to introduce mechanisms outside of a price review process (including those designed to amend a price control) set out in condition B of the instrument of appointment.

The proposed change is a change to a price control

Where a regulatory mechanism designed to adjust revenue allowances is not set out in the relevant final methodology or final determination, introducing such a mechanism is necessarily a change to a price control.

Consideration of relevant power to implement a change to a price control

Ofwat seeks to introduce a new regulatory mechanism amending a price control after the relevant periodic review process (i.e. the PR19 periodic review) has concluded.

The PR19 periodic review process concluded following publication of final determinations either on the expiry of the period of 2 months to refer a final determination to the CMA or when the CMA made its decision following a referral.

Ofwat does not argue, and we do not believe that its proposal would, satisfy the conditions for either an in-period adjustment under Part 3A of Condition B or an interim determination under Part IV of Condition B.

Considering that the PR19 periodic review has finally concluded, that the proposed change to the price control cannot be implemented as an in-period adjustment or as an interim determination and considering that the proposed change was not part of either the final methodology nor the final determination at PR19, there does not seem to be a basis for Ofwat introducing the proposed new regulatory mechanism in respect of the remainder of AMP7.

Ofwat does not state the source of any power it would have to retrospectively (i.e. after a period review has concluded) amend a price control.

How Ofwat would be able to implement its proposal for the remainder of the 2020-25 period and how it may overcome any procedural issues ought to have been a key consideration in its decision making.

It is surprising that the consultation document does not address these issue at all, as it is essential that this topics are explained thoroughly to provide companies with the information they need to be able to consider the proposal put forward by Ofwat.

Signalling the application of a new regulatory mechanism before final decisions on remunerations are made in respect of 2022/23 and the remaining years of the current AMP is insufficient to remedy the procedural defects highlighted above and the retrospective nature of its implementation.

As set out above, the application of a regulatory mechanism as contemplated in the consultation document for the remainder of the current AMP would be inconsistent with the provisions of Condition B of the instrument of appointment and good regulatory practice. It would constitute a retrospective change to a final determination and potentially a CMA re-determination which would further increase regulatory risks and hurt the trust in the stability and predictability of the UK water regulatory regime with likely consequences on financeability and investor appetite.

3. Insufficient definition, certainty and predictability of the proposed mechanism.

A key principle of our remuneration policy is that remuneration must reflect performance and is demonstrably linked to the delivery of the core purpose of the company to provide the public water service, high customer satisfaction and achieving strategic objectives.

We believe that the way we have determined executive remuneration and our detailed reporting are aligned with the broad expectations that Ofwat has set out.

The remuneration committee reviews the Annual Incentive Plan (AIP) annually and will implement the improvements it deems appropriate to ensure it remains effective. However, the remuneration committee is satisfied that the Company's remuneration structure and outcomes

already take into account service delivery and performance against stretch targets and that the construct of the AIP and the principles followed by the remuneration committee for its application are appropriate.

Our main concern about the proposed new mechanism is that it relies on generic expectations about remuneration in order to determine a financial adjustment that Ofwat will have to quantify.

These expectations, as currently expressed in broad terms, provide limited practical guidance to remuneration committees on how to concretely meet them when making specific remuneration decisions and on how to satisfy the tests, yet to be defined, that Ofwat will apply.

At the time of writing, no information has been made available to companies and their remuneration committees on the method that would be used to determine the quantum of any adjustment to revenue allowances.

Such a mechanism will be based on Ofwat's subjective assessment of:

- a) How the expectations it has set in generic terms should be translated into concrete remuneration decisions;
- b) Whether specific remuneration decisions meet Ofwat's interpretation of their generic expectations; and
- c) The quantum of a financial adjustment in cases where Ofwat would conclude that remuneration decisions do not meet their expectations.

Ofwat should provide much more clarity on how its expectations should be concretely interpreted and on how the proposed new mechanism would be applied.

However, it is likely that such a mechanism will be inherently subjective and lacking in certainty and predictability. It will amount to substituting Ofwat's judgement to that of directors in matters of remuneration.

Its opacity will make it difficult to demonstrate that its application satisfies the principle stated in legislation that in exercising their duties the Secretary of State and Ofwat shall have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed).

Such a mechanism will also impact the ability of the Company and the remuneration committee to attract and retain talent.

4. Conclusion

The silence on the procedural issues raised by the proposal and the absence of detail on how the mechanism would apply in a consultation pertaining to be a guidance on such mechanism is concerning as it does not provide the information companies would need to comment meaningfully on the proposal. This is detrimental to the credibility of the consultation process.

With regard to the important procedural issues raised in this consultation, in respect of the remainder of this AMP, it would be appropriate for Ofwat to consider an alternative approach based on an individual public assessment of companies' remuneration practices which we believe would provide a strong reputational incentive and allow more time to develop much needed clarity before an adjustment mechanism could be implemented for 2025-30.

Public perception of remuneration is linked to public perception of performance. Companies must obviously put in place all necessary operational measures to ensure the best delivery for customers but public perception of performance is also influenced by how performance is both defined and characterised by regulators.

Regarding the performance of water only companies, Ofwat's communication on performance has a direct impact on public perception (and may potentially indirectly influence companies' performance against customer satisfaction targets that it has set). Accurate communication on performance is essential to ensure remuneration does not remain a sensitive issue.

This is particularly relevant when considering targets which have been deliberately set at levels of stretch that only some and in the case of upper quartile measures only few can meet. When such targets are not met, characterising performance as poor or companies as failing will distort the public perception of companies and the sector unless sufficient care is given to explain the nature of the targets and provide a balanced view of improvements in performance delivered over time.

Companies operate within constraints, including those determined by the outcome of successive periodic reviews, and increasingly face real external challenges such as extreme weather due to climate change. Characterising performance as poor may detract from the need to recognise that each company's performance is determined by the specific characteristics of their network and supply areas which are not represented in aggregate data and models. It may also detract from the fact that each company has specific resilience challenges which will require appropriate investment over the medium to long term and would not have been addressed under past planning assumptions.

It is our view that in this context, communication by regulators should be more carefully balanced. This is relevant to the new mechanism proposed in the consultation document. Should performance assessment against stretching and upper quartile targets be used in applying the mechanism and "poor performance" attributed to failures in management then it

will further deteriorate the perception of the sector's performance by the public and the perception of remuneration.

Currently, remuneration committees, chaired by independent non-executive directors and with a majority of independent non-executive directors, have a more intimate understanding of the challenges companies face, of the constraints they operate in and of the performance of management teams when assessing remuneration. Ofwat will not benefit from the same insight when applying the mechanism it is proposing to implement.

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