



Ofwat Governance Team

11 Westferry Circus,
Canary Wharf,
London
E14 4HD
governance@ofwat.gov.
uk

01 May 2023

Southern Water Services Limited's response to Ofwat's consultation on "Protecting customer interests in performance related executive pay"

We welcome the opportunity to provide our comments on Ofwat's proposed guidance on "Protecting customer interests on performance related executive pay", which was published on 20th March 2023.

At Southern Water Services Limited (SWS), all elements of executive performance related pay ("PRP") are set, assessed and awarded by an independent remuneration committee of the board of the company. Consistent with the Board Leadership, Transparency and Governance ("BLTG") principles set by Ofwat, the remuneration committee of SWS is made up of a majority of independent non-executive directors and independent non-executive directors are the largest group on the SWS board.

This remuneration committee considers the design of schemes, sets targets and makes decisions on awards, including whether deferral, malus and claw-back might apply. The committee also considers personal objectives for individual members of the executive management team. Measures and targets are designed to incentivise performance (both non-financial and financial), which are for the benefit of SWS's customers, communities and its stakeholders. Executive remuneration is benchmarked to ensure that the company can attract and retain a strong management team, which again is to the benefit of SWS's customers and wider stakeholders.

SWS's board and its remuneration committee are of the firm opinion that no change is required to the existing requirements. Customers, communities and the environment are sufficiently protected by the existing regulations including the independence requirements of the BLTG, which were designed by Ofwat. Arbitration by Ofwat of the decisions taken by an independent remuneration committee would be an anathema to the principle of independence. Moreover, asking shareholders to then compensate the appointee company for a decision taken by an independent remuneration committee, whose independent members they have not appointed, would further damage the investment climate for the sector.

SWS agrees that transparency on executive pay is important for the water sector. The forward to Ofwat's guidance document outlines that Ofwat considers that not all companies are applying PRP in a way that lives up to expected standards. It is proposed that Ofwat discusses and addresses this with the individual companies where it has a concern, rather than making a further change to the regulation of the sector that is likely to have other, perhaps unintended, consequences.

There are some specific areas of the consultation that are of concern.

PRP recovery mechanism

The mechanism considered in the PR24 Final Methodology proposes that revenue is adjusted at the PR19 and PR24 reconciliations where a company does not meet (assessed on an annual basis commencing 2022-23) Ofwat's expectations in the guidance note. As noted above, we consider this highly troubling. It provides uncertainty for companies and boards in setting and assessing PRP, and contradicts the independence of boards and remuneration committees, both of which have been established under Ofwat guidance. It significantly increases the uncertainty and therefore risk to capital providers, which we believe is unhelpful given the need for significant amounts of capital in the next price control and coming decades as Ofwat and other stakeholders have outlined.

The introduction of a new mechanism during AMP7 would be a retrospective change to the PR19 Final Determination settlement. Furthermore, many remuneration committees, including SWS, have already made decisions relating to the 2022-23 year.

Targets


Ofwat's draft guidance refers to the need for stretching targets and gives upper quartile as an example of a stretching target. It then further suggests that this would be the threshold by which any level of bonus is triggered. This implies that bonus payments would only be payable in a quarter of companies at most, which we believe would make the sector unattractive compared to the market. Furthermore, given the numbers of metrics set by Ofwat and other relevant regulators, upper quartile performance across all – or even the majority of - metrics makes bonus payments even more unachievable. We believe this will not incentivise performance and could result in unintended consequences.

We believe that remuneration committees should set targets that are stretching but appropriate to a company's context. Where a company is in turnaround, as is the case with Southern Water, stretching targets may be more appropriate than the final determination and/or performance relative to peers. Ofwat has recently acknowledged this in its exchange of correspondence with Macquarie Asset Management in August 2021 at the time of the £1.1 billion investment in the Southern Water group by funds managed by Macquarie Asset Management. As such, the SWS remuneration committee requests Ofwat to explicitly confirm that, should it implement the proposed change to PRP in AMP7, this would not apply to SWS and that SWS's remuneration committee can set targets appropriate to its turnaround plan, with performance being capable of being assessed in the round, as well as against specific targets.

Overall Performance

The guidance proposes that award decisions should take into account overall performance delivered. Companies have tens of performance commitments. The need for all of these to be delivered, or even taken into account in PRP decisions, could result in PRP not being focused on the things that are most important to customers, communities and the environment. It could also result in PRP not being awarded despite key performance being delivered which could prevent the effectiveness of future incentivisation for executives.

The proposal also appears to contradict the guidance relating to the setting of performance targets and negates established PRP design principles that objectives should be smart, and that discretion

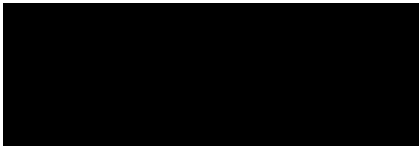


should be limited. It is accepted that some discretion is appropriate, and Southern Water's PRP schemes reserve that discretion, including in relation to the use of deferral, malus and clawback.

The draft guidance suggests that PRP decisions reflect enforcement actions and litigation. Whilst these may be relevant, the timing of such items needs to be considered. These often occur a long time after any event and in some cases years later. It would be unjust to affect the PRP of an executive who was not employed at the time an issue occurred.

I have recently been appointed as chair of Southern Water's remuneration committee following the retirement on 31 March 2023 of Paul Sheffield as a non-executive director. I would be happy to expand on any of the points made in this response.

Yours sincerely,



Malcolm Cooper