WONDERFUL ON TAP

SEVERN TRENT

By email

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Dear David,

Protecting customer interests on performance related executive pay: proposed guidance

Thank you for the opportunity to provide comments on your proposed guidance relating to the scope and application of the performance related executive pay ("PRP") recovery mechanism, as outlined in the PR24 methodology. Whilst we note that the technical details of the mechanism are yet to be set out, we wanted to respond with our comments and offer our support to work with you on some of the practicalities of the guidance.

<u>Our view of the guidance</u>

We welcome active engagement from all our regulators. At Severn Trent, we recognise the unique responsibility that comes from being a private monopoly provider of an essential public service, and we strive to deliver excellent performance that leads the sector and that is recognised by our regulators, customers, and other stakeholders as doing so.

We support the principles of the proposed guidance, namely that PRP must demonstrate a substantial link to stretching performance, delivery for customers and the environment, and that there should be no reward for poor performance or failure. We also support the high-level factors identified in the guidance as being integral to good PRP decision-making, which we see as follows:

- Alignment to delivery for customers and the environment
- Stretching targets
- Assessment of overall performance
- Deferral, malus, and clawback

Appendix 1 sets out how our current executive remuneration policies and practices are aligned to both the PRP factors outlined in the guidance, and Ofwat's broader expectations and standards as articulated in the Regulatory Accounting Guidelines and Board Leadership, Transparency and Governance Principles.

Whilst we support the sentiment and principles of the proposed guidance, there are a few practicalities within parts of the guidance that we would like to clarify as part of our response, in particular:

- The use of financial measures in PRP design
- The role of UQ comparative performance in PRP targets
- The format and timing of Ofwat's 'in the round' assessment

The following section takes each of these elements in turn, sets out our interpretation of the element, highlighting any concerns, and provides suggestions for how to enhance the aspect. We would like to work in collaboration with you on these elements as the consultation progresses.

The use of financial measures in PRP design

We note in the proposed guidance that financial measures that are solely for the benefit of investors cannot be considered as relating to delivery for customers. We agree that total shareholder return is an example of such a measure that does not deliver value for wider stakeholders and is not appropriate to this sector. However, we believe there are financial measures that are relevant to all our stakeholders and reducing this focus could be detrimental to long-term sustainability.

By way of example, we include profitability elements in our Annual Bonus Scheme. This has broader relevance beyond shareholders in that it encourages the Executive Directors to operate a sustainable business. In practice, this drives a focus on financial resilience and ensuring that customer money is invested wisely, giving the Company the ability to invest in schemes that deliver positive outcomes for our customers and communities. Key examples of this within Severn Trent include:

- Our ability to respond to the Green Recovery and raise both equity and debt (c.£500m) in 2022 for investment in new water resource capacity, flood resilience and bathing rivers. This would not have been possible without strong incentivisation of financial resilience (an area in which we have been awarded to the top category from Ofwat every year this AMP).
- Our Affordability Scheme, which we expanded in May 2022 to provide support to an additional 100,000 customers, and our Societal Strategy, which we launched in November 2022 to enhance the life chances of 100,000 people in our region.

For these reasons we believe PBIT and RoRE, which we use in our LTIP, remain appropriate measures for inclusion within PRP schemes as long as they meet the other criteria, in terms of stretching targets and assessment in the round.

The role of UQ comparative performance in PRP targets

We are supportive of targets that take into account comparative sector performance, and we agree that these targets should be stretching to ensure that all companies are focused on improving their individual performance and therefore that of the sector overall. However, we do not agree that applying UQ as a default threshold assessment across all measures will drive performance in the way intended. Furthermore, it risks disincentivising those poorer performers that need to improve for the benefit of the sector and risks incentivising companies to choose targets where UQ is achievable rather than those in most need of improvement.

Instead, targets should be assessed based on how stretching they are for the individual company and whether they demonstrate improvement across a balanced range of measures that reflect the interests of broader stakeholders. Appropriate targets and reward should then be relative to the individual performance of the company. We do, however, recognise there are specific measures of high sensitivity where it would be inappropriate to pay out for a lower level of performance even in the case of improvement, for example Environmental Performance Assessment (“EPA”) ratings, pollutions or supply interruptions.

The format and timing of Ofwat’s ‘in the round’ assessment

In line with the proposed assessment described in the guidance to decide whether a company’s approach to PRP is in line with Ofwat’s expectations, the Remuneration Committee also undertakes an annual assessment of ‘performance in the round’. This assessment examines whether formulaic incentive outcomes are appropriate in the context of overall business performance for customers, the environment and wider stakeholders and considers several other factors, including regulatory investigations, environmental compliance beyond the measures contained in the schemes, treatment of the wider workforce and wider societal matters (such as affordability or the COVID-19 pandemic).

The proposed guidance does not go into enough detail on the timing and format of the ‘in the round’ assessment for us to provide many comments. Our suggestion would be that any assessment is provided by Ofwat in advance of remuneration disclosures and that individual companies enter into dialogue with Ofwat directly in the run up to disclosure, much like the relationship between the Prudential Regulatory Authority, the Financial Conduct Authority and financial services companies. We believe that neither water companies’ nor Ofwat’s interests would be served by a process in which the regulator’s view on the appropriateness of PRP payments were to emerge only after a company had been obliged to disclose its Remuneration Committee’s intentions. We would be happy to work with you on developing an appropriate timeline for assessment for the coming financial year that meets your requirements as well as the reporting requirements of companies.

In conclusion, we recognise that the sector faces significant reputational challenges at this time. Remuneration decisions made by poor performing companies have exacerbated this difficulty and we understand why Ofwat feels there is a need for further action. Whilst our company culture and values, as well as our governance structure, means that we believe we have never behaved in this way, we accept that the guidance needs to apply to the whole sector. We would welcome the opportunity to work in collaboration with you on this guidance and we would ask for clarification on the three points outlined above which will be required at pace to ensure that schemes are in line with expectations as soon as practicable. We believe that applied in the right way the guidance could be a help to remuneration committees and achieve positive outcomes for the sector; applied in the wrong way it could miss that opportunity and run the risk of reputational damage.

Please do not hesitate to contact me should you have any queries on any of the points outlined above.

Yours sincerely,

[redacted]

Sharmila Nebhrajani
Remuneration Committee Chair
Severn Trent Plc

Appendix 1: Executive remuneration policies and practices at Severn Trent

As a listed company, our Remuneration Policy is designed and overseen by the Board and is subject to an independent shareholder vote every three years, with our Remuneration Report being subject to an annual advisory vote. Our Policy is designed to incentivise exceptional, sector-leading performance for the benefit of customers, communities, and the environment, and to attract, retain and motivate our Executive Directors. We are one of a minority in the sector where three-quarters of potential executive pay is variable in nature, based on stretching targets that are reviewed annually by the Remuneration Committee. In this way, we ensure that our executives are rewarded commensurate with their performance, which we believe is more beneficial to all stakeholders than removing variable pay opportunity and driving up base pay costs.

The guidance highlighted four factors that Ofwat propose to consider when reviewing each company's approach to Executive pay. The following section takes each factor in turn and provides commentary aligned to the proposed guidance.

<u>Alignment to delivery for customers and the environment</u>

Our two performance related incentive plans – Annual Bonus Scheme and Long-Term Incentive Plan ("LTIP") – are structured to reflect the critical wider objectives the Board sets for us beyond pure financial performance.

The Annual Bonus Scheme is structured so that the majority (51%) of the reward is based on a combination of customer, environment and health and safety measures. Customer ODI measures make up over a third of the bonus, split into three buckets – 'Improve the Environment', 'Prevent Failure in our Networks' and 'Minimise Disruption to Customers' – to ensure we focus on performing well across all measures, rather than prioritising a few. Achieving the maximum pay out can only be achieved by demonstrating exceptional performance in all three buckets.

The inclusion of river health measures in our Annual Bonus Scheme is another good example of how the Remuneration Committee uses PRP to emphasise the areas of focus that are aligned to customer and environmental interests. In 2022, the Remuneration Committee introduced a new river health-based measure to further demonstrate our commitment to responding to heightened regulatory and public focus on water companies' compliance with statutory and licence obligations at wastewater treatment works. In so doing, 8% of the Annual Bonus Scheme is linked to the satisfactory delivery of our 'Get River Positive' pledge commitments. Alongside the 'Improve the Environment' ODI category, this means that 20% of the total annual bonus structure is aligned to measures designed to drive a positive impact on the environment.

The LTIP is structured such that 80% of the award is based on RoRE performance, which reflects long-term Customer ODI performance as an element of the overall outcome. The remaining 20% of the award is based on sustainability performance, which is aligned to our environmental commitments to reach net zero carbon emissions by 2023. Our sustainability LTIP measure focuses on two equally weighted areas, 'Direct Contributors to Carbon Reduction' and 'Innovation and Engagement for Carbon Reduction'.

<u>Stretching targets</u>

The Remuneration Committee's insistence on stretching targets means that we have not paid out the maximum possible bonus during AMP7 to date, despite delivering sector leading ODI performance and high levels of financial resilience.

We are supportive of targets that incentivise comparative sector performance; in 2018, we revised the LTIP such that maximum outturn could only be achieved if our RoRE performance was upper quartile relative to that of other WaSCs as assured and published by Ofwat. This was achieved for both LTIP awards that have vested since 2018.

Overall performance

In line with the proposed assessment described in the guidance to decide whether a company's approach to PRP is in line with Ofwat's expectations, the Remuneration Committee also undertake an annual assessment of 'performance in the round'. This assessment examines whether formulaic incentive outcomes are appropriate in the context of overall business performance for customers, the environment and wider stakeholders and considers several other factors, including regulatory investigations, environmental compliance beyond the measures contained in the schemes, treatment of the wider workforce and wider societal matters (such as affordability or the COVID-19 pandemic).

Every year, we set out the factors that the Remuneration Committee have assessed as part of their review of performance in the round for the year in question in our annual Directors' Remuneration Report. We continually strive for clear and transparent remuneration reporting and strongly encourage standardised reporting on remuneration decisions across the sector.

Deferral, malus and clawback

In the event the Remuneration Committee determines that wider company performance requires an adjustment to formulaic PRP outturns, they can do so using malus and clawback provisions, which feature as part of all of our incentive scheme rules. These provisions allow the Remuneration Committee to reduce or recoup any past incentive payments from individual executives if we later learn of information that was material to the incentive scheme outcome after the time of the award. Substantial use of deferral mechanisms in both the Annual Bonus Scheme and LTIP aids our ability to operate malus and clawback as required, though neither have been deemed necessary to date.