

Response to Ofwat consultation on performance related executive pay

We recognise that demonstrating that performance related pay (PRP) is effective and appropriate is one of the key issues facing the water industry, and so we welcome the opportunity to respond to the Ofwat consultation “*Protecting customer interests on performance related executive pay: Proposed guidance*”.

This consultation response has been reviewed with members of the board and is sent on behalf of the remuneration committee chair.

Introduction

Our response initially sets out our views on four important factors that we believe an effective remuneration policy (for a regulated utility) should contain and the factors that should be adopted to make sure that the industry achieves and maintains high standards of governance and transparency, and most importantly, provides rewards for performance on the outcomes that are priorities for stakeholders.

We then considers the proposed factors that the consultation suggests should be used in PRP decision-making, and the proposed scope and application of the proposed PRP recovery mechanism.

The importance of focussing on customers and the environment

It is worth emphasising that we recognise the privileged status that we operate in as a monopoly provider of an essential service, and that this status means we have a range of obligations to customers, communities and the environment. We therefore support Ofwat’s view that remuneration, for investors and executives, should closely reflect and take account of these responsibilities, should always incentivise management to seek to exceed these expectations, and should never reward poor performance or failure.

We aspire to be a leader in the development, application and transparency of our approach to executive remuneration and to help drive strong standards both within our industry peer group and within the FTSE100. In line with Ofwat’s expectations, our remuneration committee (committee) is very clear on its role in making sure that PRP outcomes for executives are demonstrably aligned with performance across the range of stakeholder groups, with a clear focus on customers and the environment.

We recognise the importance that effective remuneration policies have in sustaining the trust of, and accountability to, customers, regulators, and wider society. We therefore agree that the criteria for both the short and long-term elements of any PRP policy should demonstrate a substantial link to delivery for customers and the environment.

Since 2020, around 63% of our PRP arrangements have been based on measures which directly link to delivery for customers, and in 2022/23 this included around 30% on environmental commitments and obligations. Indeed, to make sure we are focused on these priorities we consulted customers through a comprehensive research exercise and the customer service measures used in our long-term incentives since 2020 reflect the findings of that research. Our PRP outcomes are affected by our performance on important environment-related matters, such as reducing combined sewer overflows (CSOs) as part of our “Better Rivers” measure, our overall EA EPA rating, reducing sewer flooding, and reducing leakage.

The committee actively reviews the PRP measures annually, enabling it to continue to reflect the key and emerging areas of priority for the business and our stakeholders at the time of each new award cycle. This process also allows us to take account of the concerns of customers, regulators, investors and others in order to make sure that the company is meeting its broader duties to all stakeholders.

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As a result of this review process, over recent years we have increased the extent to which environmental performance affects executive PRP outcomes, and intend to increase this further in our PRP plans for the year ahead (2023/24).

The importance of achieving high standards of transparency and governance

We believe that the work Ofwat has already done through the licence requirements on Board Leadership, Transparency and Governance and the Regulatory Accounting Guidelines have been effective in reinforcing the high standards of corporate governance that are expected from water companies, and in emphasising the importance of governance arrangements in engendering trust and ensuring accountability.

We have tried to meet these high standards, with our remuneration reports seeking to transparently demonstrate the relationship between pay and performance and show how PRP is aligned to the delivery of stretching performance for customers and the environment. We agree that it is important to be transparent in justifying why PRP decisions have been taken, to demonstrate that poor performance overall has not been rewarded, and to justify in-year decisions within a longer-term context and plan.

The importance of deferral, malus, and clawback

We agree that it is important for companies to have governance mechanisms such as deferral, malus, and clawback within their remuneration policies so that committees can take appropriate action on PRP outcomes when required.

For a number of years our incentive plan rules have included malus and clawback provisions that enable the committee to withhold or recover payments. The circumstances where these provisions might be applied were extended in our current directors' remuneration policy, which was approved by shareholders at the 2022 UUG AGM. Should we ever deem it necessary to apply the provisions, we would state this in our remuneration reports along with a clear rationale for their use.

Our executive directors are required to defer at least 50% of any bonus received into shares and these only become available after a period of three years. Long-term incentive outcomes for executive directors are also assessed over a three-year performance period, followed by an additional holding period so that in total at least five years must elapse before any shares are due. This provides the committee with time to consider and respond appropriately to any matters that were not known at the end of the relevant performance period but become apparent during the holding or deferral period.

Further, our executive directors are required to build to and retain a personal shareholding in the company worth 200% of their salary. When combined with the holding and deferral periods required in our PRP arrangements, their interests are strongly aligned with the long-term performance of the company, not only during employment but also for at least two years after departure. As such, any performance issues or reputational concerns arising could have an effect on the value of their shareholding, both whilst still employed and after leaving.

We agree with Ofwat that malus and clawback mechanisms should be used as and when appropriate, and that in relevant circumstances where they could have been used but were not, the rationale should be explained transparently. Our committee has exercised and disclosed the use of such discretion in recent years by applying downward adjustments to the executive directors' bonus outcomes in both 2015/16 and 2017/18. These adjustments recognised performance issues that became apparent during the year, outside the initial framework for incentives.

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The importance of taking account of overall performance

We agree with Ofwat that award decisions 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.

Our remuneration policy enables the committee to override formulaic incentive outcomes (whether annual bonus or long-term incentives) by exercising discretion on outcomes if deemed necessary. Further, our long-term incentive plan contains a specific underpin whereby overall vesting is subject to the committee being satisfied that the company's achievements on its measures is consistent with underlying business performance. In practice, this means that in addition to reviewing performance against the specified measures the committee also considers the extent to which the formulaic outcomes are aligned with the experience of key stakeholders, including customers and the environment.

Clear disclosure is provided in our remuneration report of the targets used for PRP and the lenses through which the committee has considered the performance outcome, including the rationale for the pay-out received and/or the impact of any discretion used. These disclosures are provided both as part of the Annual Performance Report and in the UUG annual report.

Our specific feedback on the proposed PRP recovery mechanism

We understand why Ofwat is seeking to implement a mechanism to make sure and demonstrate that all companies apply PRP in a way that is focussed on delivering the standards that customers and other stakeholders expect. We welcome the opportunity to provide Ofwat with our observations on how it may do this, and now set out some comments about the proposed guidance for consideration.

Fairness and objectivity

The guidance makes it clear that fairness and objectivity will be key drivers of Ofwat's assessment via the proposed mechanism, to protect the interests of customers. The guidance further indicates that Ofwat will make its assessment under the mechanism "in the round" on the balance of company decisions. We agree that any assessment should be objective and as such that clear assessment criteria will need to be established as part of the detailed development of any mechanism. We also agree that Ofwat should look beyond the individual metrics within PRP arrangements, again with clear criteria being established to make sure that the assessment remains objective and transparently fair, and would not be seen as a subjective decision.

We agree with Ofwat's view that each company is responsible for setting performance related executive pay and related policies, and that the intention of the proposed mechanism should therefore be to assess the metrics used within executive PRP and associated policies (and their application), rather than the quantum of remuneration.

We are mindful that, now more than ever, we need the right skills and talent within the organisation to lead the transformational change that is required for the future. The PRP component of executive remuneration arrangements is therefore crucial in attracting and retaining talent, with water companies not just competing with other regulated businesses for individuals who are capable of improving organisational performance and consistently delivering for their customers and other stakeholders.

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Stretching targets

We support Ofwat's view that award decisions for the year should be based on stretching targets, recognising that higher levels of performance may generate higher payments. We also agree that each company will need to consider what is stretching in the context of their own company and the metrics being used. When determining the stretching nature of targets for PRP schemes the committee must include the extent to which executives will remain motivated and incentivised by targets they perceive as challenging but realistically achievable.

The guidance provided suggests that upper quartile performance on a measure might be an appropriate target, where "target" means the threshold level of bonus. We agree that a target linked to upper quartile performance, could be considered to be an appropriately stretching target for some companies, although for a company already at frontier performance it would not represent a sufficiently stretching target, whereas for a company lagging well behind upper quartile performance, it may be unachievable.

This is particularly relevant given the structure of incentive regulation in the industry, where it is likely in theory and observed in practice that companies will accept determinations which may embed some unachievable targets. In such circumstances, committees should still seek to incentivise management to deliver performance which gets as close to the target as possible.

Overall, whilst we agree that upper quartile performance may be an appropriate target in some circumstances, we consider that the more important point is that targets should be set for ambitious and stretching performance by management, given the context in which they are operating. This means that committees should be prepared to consider, set and review targets on that basis, be transparent about the basis on which they considered PRP arrangement to be stretching and to explain these decisions to stakeholders.

Using financial measures

Attracting and retaining investment in the industry is crucial for future delivery of services and investment in the interests of serving customers and the environment and, in general, investors expect that executives should be incentivised in a way that shows a meaningful link to investor interests alongside customer, environmental and other stakeholder interests. We agree with Ofwat that financial measures which are solely for the benefit of investors should not be considered as relating to delivery for customers, for the purposes of the assessment. If including financial measures in our PRP we opt for measures which we are satisfied can be of benefit to customers and/or the environment, for example, if they might result in additional investment that improves standards in those areas.

Engaging with companies on Ofwat's assessments

We would suggest that in advance of Ofwat issuing the outcome of its assessment of a company's PRP in any year there should be an opportunity for discussion with the committee so that clarifications or other relevant information can be provided (notwithstanding that company disclosures should be clear in any case, and so areas requiring clarification should be minimal). This would also allow consideration of the impact of deferral and holding periods on the PRP received by executives in any given year (and over time), and how any differences might be treated.

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When to adopt the proposed mechanism

We agree that the mechanism should be applied for the 2025-30 period at PR29, and on balance that it could be appropriate if the mechanism was also applied for 2022/23 and the remainder of the AMP7 period. However, this should be on the proviso that the application of the mechanism was relative to the existing published guidance and that a published and objective mechanism was applied.

According to the guidance, final decisions will be made as part of the reconciliation process for PR19, and PR24 respectively, although Ofwat will signal its provisional views each year so that this can be taken into consideration by the committee for future decision making. We support the principle that any mechanism should be applied as part of the reconciliation process, and that it would be beneficial and helpful for Ofwat to set out its views and feedback on an annual basis, as this would allow companies to actively address any issues and would be more effective in delivering the overarching objective of improving the nature of PRP mechanisms than any retrospective judgement would be.

Looking ahead

Overall, we firmly agree with Ofwat that performance related pay plays an important role in incentivising and rewarding strong performance and driving improvements where needed. This is true not only at the executive level but throughout the company, where an aligned PRP process can play a strong role in engaging and motivating the workforce to deliver results for customers and the environment.

We would be happy to further engage with Ofwat on the proposed PRP recovery mechanism, to help make sure that when it is implemented it achieves its objective of protecting customer interests in relation to executive PRP.

For reference:

[See here for Our 2022 Annual Report and Accounts](#)

- Page 166 – how our remuneration approach links to business strategy, including delivering for customers, the environment and other stakeholders
- Pages 170-176 – our current remuneration policy, including our various governance mechanisms
- Pages 181-182 – details about the PRP arrangements which have applied

ENDS
28 April 2023