

Jenny Block
Ofwat
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By email: governance@ofwat.gov.uk

28 April 2023

Dear Jenny,

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

Thank you for the opportunity to respond to the consultation document referred.

About Welsh Water and background to our response

Welsh Water is a not-for-shareholder water company supplying around 3.1 million customers in Wales and surrounding parts of England. We are unique in the water industry, existing for the sole purpose of serving our customers and the communities in which we operate. As we do not have shareholders, Welsh Water retains all profits for the benefit of its customers. Instead, we have members, who fulfil the governance role held by shareholders in a listed company, including an annual vote on our AGM resolutions.

Welsh Water is governed and run as if it were a listed business with regard to corporate governance best practice. In respect of remuneration we determine, govern, report and hold voting on our Directors' remuneration in line with the Ofwat Board Leadership, Transparency and Governance Principles and the Financial Reporting Council's UK Corporate Governance Code.

Our response to this consultation focuses on the impact of imposing direct regulatory intervention on water companies in the area of pay in general, as well as specific reference to our own pay models and the impact that we consider the proposal could have on our own pay structures. We also note for your consideration some points of detail around the mechanisms that are proposed.

General perspectives on Ofwat regulation of variable pay

We recognise and understand the public interest and scrutiny in the matter of executive pay. However, we do have concerns about the extent to which the proposals aim to intervene directly in the governance of remuneration within the water industry. We believe that the principles of sound regulatory practice and the wider public interest should take precedence here, and that the existing role of Ofwat, namely to focus primarily on the overall efficiency, allowed revenues and performance of companies, should be preserved.

We're not-for-profit. Every single penny we make goes back into looking after your water and environment. You can contact us in Welsh or English.

Rydym yn gwmni nid-er-elw. Mae pob ceiniog a wnawn yn mynd i ofalu am eich dŵr a'ch amgylchedd. Cysylltwch a ni yn Gymraeg neu'n Saesneg.

Dŵr Cymru Cyf. (No./Rhif 2366777)
A limited Company registered in Wales:
Cwmni cyfyngedig wedi'i gofrestru yng Nghymru:

Linea, Fortran Road, St Mellons, Cardiff, CF3 0LT

Intervening in compensation arrangements for company directors risks regulatory overreach and reactions which may lead to unintended consequences.

While this is our over-riding concern, there are a number of points of detail underpinning this.

1. We consider that re-opening previous regulatory determinations runs counter to the core principle of regulatory certainty in the determinations

Cost and revenue allowances, and associated reconciliation mechanisms, were finalised at the PR19 Final Determinations, and were reviewed in the round as part of companies' decisions on whether to accept those determinations. This concept of regulatory certainty is critical to water companies' ability to manage their businesses within each cycle, and we feel strongly that this should be preserved. The proposals appear to provide for open-ended discretion to claw back unspecified amounts of revenue both annually during the regulatory period and at the end. This over-rides the current PR19 regulatory determination by adding a further PRP recovery mechanism to the reconciliation process.

2. We are concerned about the introduction of an unfunded cost concept to executive remuneration

Water companies, through the profit incentive, are already naturally incentivised to link performance and executive pay, as poor performance results in revenue reductions through ODI penalties. It should be at the discretion of companies, through the oversight of the remuneration committee comprising independent and experienced directors, to determine the salary and bonus packages for the company leadership. This would result in the best balance between performance, in terms of outcomes and cost efficiency, and pay outcomes generally that are in the interests of all stakeholders.

3. Other external regulation (e.g. in the Financial Services Industry) has led to some perverse outcomes

We note that very strict regulation was introduced in the Financial Services industry in 2009 in response to the global financial crisis. Whilst we recognise that the nature of the intervention proposed in this consultation is less prescriptive than in the Financial Services sector, there are some lessons to be learned in our view. For example, through the formulaic curbs on variable pay, affected financial institutions typically responded by increasing fixed remuneration very significantly, in order to remain market competitive (an example of an unintended consequence of intervening in variable pay). Additionally, the regulatory compliance has been a huge additional burden and cost for many businesses in that sector. As a result, the FCA and UK Government is now proposing to reduce the scope of the regulations applying to the sector, including removing the cap on variable pay.

4. The proposals could deter the use of variable pay to target areas of under-performance

Performance-related pay should be used (with suitable checks and balances) to help target areas of weakness in the business, so as to incentivise improvements in those key areas. It may, however, be the case that a remuneration committee considers that an improvement which recognises progress against that company's plan, but still falls short of industry benchmarks, should warrant a payout of performance-related pay. If committees feel there is a risk that Ofwat will intervene in such determinations, this may lead companies to avoid targeting those key focus areas of the business on the basis that their judgments will be challenged.

5. The introduction of a new reconciliation mechanism is a disproportionate complication adding to the regulatory burden

The proposed new reconciliation mechanism is unsuitable, as the variable pay costs involved are very small in relation to overall company expenditure. Each new reconciliation mechanism increases complexity and adds to the regulatory burden. In this case the additional burden and cost of carrying out the reconciliation would not be justified by the benefit to customers.

In summary, whilst we fully support the concept of appropriate checks and balances on variable remuneration outcomes, as well as the need to explain and justify such outcomes publicly, it should remain under the remit of a company's remuneration committee to oversee, being accountable to shareholders (or in our case members) and other stakeholders.

General observations in relation to managing remuneration within the sector

1. *Effective recruitment and retention of executives may be impaired by additional regulation*

Recruitment of executive directors occurs in a marketplace in which water companies compete with companies within and outside of the sector for appropriately qualified and experienced executives. It is critical, especially at this particularly challenging time for the water industry, that these businesses are able to attract and retain executive directors (and other senior leaders) of the necessary calibre to execute the critical operational and environmental delivery needed. There is a risk that additional intervention from Ofwat in determining pay outcomes may be a barrier to hiring and retaining the highest calibre leaders (an issue that has impacted retention in the Financial Services Sector).

2. *Likely change to pay models*

We believe that the inevitable downside volatility in performance-related pay outcomes resulting from the proposals will reduce their expected value from the perspective of participants. As referred to above, we believe that the unintended consequence of this may be that water companies react by increasing fixed pay (i.e. salary levels) so as to give executives greater certainty of receiving competitive remuneration, as was seen in the financial services sector.

3. *Remuneration Committee versus Ofwat judgment on performance*

There appears to be a lack of consistency within the proposal on a fundamental underlying principle, around whether it is remuneration committees or Ofwat which should determine what constitutes stretching performance. On page 5 the document states: "Each company will need to consider what is stretching in the context of their own company and the metrics being used". Yet, this is undermined by the over-riding statements around the expectations that Ofwat has set out.

Related, how does Ofwat propose to make such judgments based on companies with different operational challenges, regulatory determinations and starting from different "base points"? A one size fits all approach cannot be applied here, in our view.

4. *Setting and measuring targets*

We also note several points of detail in the consultation document regarding certain target-setting principles. For example, on page 5 the document states that a stretching on-target (i.e. threshold) level of performance would be achievement of upper quartile against peers in order to trigger payout. We note that such an approach would disproportionately reward those companies whose performance "yo-yos" between lower quartile and upper quartile performance (through a cycle of low/high payouts from year to year), at the expense of those which achieve consistent second quartile performance for example (delivering a zero pay

out). In the executive pay market more generally, such relative performance schemes invariably start to pay out at a median level of performance.

5. The factors in PRP decision makes Ofwat challenge on outcomes highly subjective

The factors identified in the consultation for performance related pay decision making are in the main reasonable, and in fact are reflective of many of the factors considered by our own Remuneration Committee. However, the matter of the application of judgement is exactly that – a judgement. Based on the current level of detail set out in the guidance document it would not be possible for remuneration committees to second guess the judgements Ofwat would reach, when presented with the same information they themselves consider in reaching their decisions. We are particularly concerned that this additional layer of subjectivity undermines the credibility of remuneration committees, as well as devaluing the concept of performance related pay for executives.

Specific observations in relation to application to Welsh Water

The consultation document refers to executive bonus arrangements. It is important to point out that Welsh Water's executive pay approach is a variable pay model which links remuneration to performance and is characteristically different from a bonus. In the company's variable pay model, base salaries are set lower than the market level, with uplifts applied in relation to performance.

Under our approach, the Remuneration Committee carefully considers the target ranges for variable pay each year. In some cases, it considers that a degree of uplift may justifiably be applied in circumstances where performance remains below the regulatory target, with a higher uplift where targets are exceeded.

As our remuneration report makes clear, executive remuneration levels at Welsh Water are kept very modest relative to peers within the sector (with both fixed pay and the management of variable pay both in opportunity and actual payouts being conservative). We consider that introducing greater volatility into our variable pay outcomes would undermine the core philosophy of a remuneration policy that we consider has worked well at maintaining stability and continuity of leadership.

I would also like to reiterate my comments above regarding the critical role of remuneration committees in making assessment on performance outcomes. I can confirm that in Welsh Water's case the Remuneration Committee takes a very rigorous approach to both setting and scrutinising performance against the targets within the scorecard, coupled with considering whether a discretionary over-ride is warranted in the wider business context. In this regard, this over-ride mechanism was applied in 2022, to reduce the formulaic bonus out-turn.

Further guidance regarding the proposals

If Ofwat do choose to go ahead with the proposals (particularly at this time when all the water companies will be in the middle of making their FY 2023 variable pay decisions), it is important that the criteria which will apply to its decision making on whether performance related executive pay arrangements meet its expectations are publicised in more detail, transparently and in advance of any remuneration decisions being made by all of the companies. It would be inappropriate for Ofwat to make retrospective judgements on decisions taken by remuneration committees, without affording those committees the opportunity to consider the detailed criteria in reaching their decisions. This is particularly critical from a timing perspective, as companies need to seek annual approval for their remuneration reports at each AGM, so will need to be

provided with Ofwat's judgments ahead of their AGMs in order to be able to communicate fully to shareholders (or in our case members) about what they are voting for.

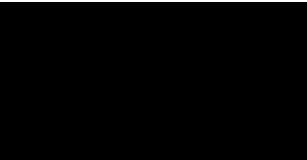
Whilst we note that this will be relevant annually during the AMP cycle, it will gain particular prominence at the end of each regulatory period, as committees will have no visibility over whether their decisions across the full five years will be challenged.

Conclusion

Overall, while we understand the concerns that have led to these proposals, and agree that executive pay should be, and should be seen to be, linked to company performance, we hope that this letter clarifies and explains the reasons for our having reservations over the proposals.

We thank you again for the opportunity to comment and would be pleased to contribute to further consultation if requested.

Yours faithfully



Joanne Kenrick

Non-Executive Director, Chair of the Remuneration Committee

Dŵr Cymru Welsh Water