

Yorkshire Water Performance Related Pay (PRP) Consultation Response

1. Introduction

- 1.1 We have reviewed Ofwat's PRP Consultation paper in detail and make specific points in relation to this below. However, we believe it is important to set out our overriding position first. We want to deliver for our customers and for the environment in Yorkshire. To do that we need to have the right people in role, appropriately remunerated, who can drive the company forward and improve our performance overall. A key part to recruiting new talent and retaining existing talent, is a competitive remuneration package. Whilst we note the consultation currently relates to those executive directors who are members of the regulated company board, on a wider point, this type of consultation and its proposals, if implemented as currently drafted, may make the company less attractive than others when seeking to recruit or retain this key talent. The ability to attract and incentivise current or new executives to our company is at risk.
- 1.2 Additionally, our response deals with these points in more detail below, but we would draw your attention to some key considerations:
- directors' duties under the Companies Act 2006;
 - the UK Corporate Governance Code;
 - general company law obligations; and
 - the ability for a remuneration committee and its Chair to have the appropriate autonomy to make decisions in accordance with policies and procedures already in place with a concern that those decisions, made in the circumstances at the time, could effectively be unilaterally overturned with no clear recourse.
- 1.3 We agree with Ofwat that water company decision-making on executive PRP should demonstrate a clear link to stretching performance delivery for customers, the environment and other stakeholders. Our current Directors' Remuneration Policy, together with our Executive Incentive Plan (**EIP**) rules and performance measures, demonstrate our dedication to these aims, as the company ensures high standards of corporate governance across the group.
- 1.4 We would welcome the opportunity to enter a constructive dialogue with Ofwat to find solutions that best achieve our common aims. Yorkshire Water already has high standards of corporate governance related to executive PRP which includes considering our obligations to our customers, the environment and other stakeholders, whilst balancing our obligations to other stakeholders in accordance with company law obligations (including directors' duties under the Companies Act 2006 and the UK Corporate Governance Code). We are concerned that Ofwat considers it necessary to fundamentally change the method by which it scrutinises company decision-making in this area.
- 1.5 Before we can properly respond to this consultation, it would also be important to understand in more detail how Ofwat envisages the PRP recovery mechanism will function in practice. Accordingly, we would encourage Ofwat to publish details as

soon as possible and in the meantime we reserve our position in terms of our ability to comment on the proposals in the round.

2. Our policies relating to executive director PRP already contain protections

2.1 We recognise the need for the interests of our customers, and those of the environment and other stakeholders, to be carefully considered in our decisions concerning executive PRP, and welcome Ofwat's efforts in continuing to work together with water companies in this area.

2.2 We have reflected these interests in our executive PRP decision-making for many years. In setting our Directors' Remuneration Policy (the **Remuneration Policy**), our People and Remuneration Committee (the **Remuneration Committee**) applies the UK Corporate Governance Code (the **Code**) to reflect best practice and to be fully transparent in the way in which we operate, including in relation to PRP. We also apply the 2019 Ofwat Board Leadership, Transparency and Governance Principles. Taken together, our Policy, the Code and existing Ofwat guidance establish very clear guardrails in relation to which our Remuneration Committee makes decisions and exercises discretion on executive PRP. Our current Remuneration Policy incorporates the following, among other measures, which already align with the "factors in PRP decision-making" listed on pages 5-6 of Ofwat's PRP Consultation paper, for example:

- (a) variable pay for our Executive Directors takes into account compliance with statutory and regulatory obligations, with a particular focus on delivery for customers and the environment and on regulatory performance;
- (b) payments/vesting under both our short-term and long-term variable pay elements are based on stretching performance targets and performance measures which are selected to promote the long-term success of the company and enhanced customer experience and which are reviewed regularly;
- (c) our short-term variable pay element has high threshold and target levels to reflect the greater emphasis placed on variable pay by the Remuneration Committee;
- (d) in addition to the performance measures set by the Remuneration Committee, both our short-term and long-term variable pay elements are subject to a performance underpin. The Remuneration Committee must be satisfied that the financial and non-financial performance of the business over the performance period warrants the level of vesting. By way of example, in order to align executive remuneration with underlying company performance for FY2022, the Remuneration Committee used its discretion to make a downwards adjustment to the vesting outcomes of the short and long term EIP awards for Executive Directors as well as all other senior employees in the company who are all subject to the same performance metrics in relation to the EIP scheme. Having the same performance metrics in place for the whole senior leader population ensures that the entire senior leadership at the company, and not just the executive directors, have a commitment and drive towards the same goals; and

- (e) both our short-term and long-term variable pay elements are subject to malus and clawback.
- 2.3 Our most recent Remuneration Policy for 2023 has been recommended by the Remuneration Committee, which has a majority of INEDs as members and representatives from our three largest shareholders.
- 2.4 Given the protections already in place, and how those protections have been applied with careful consideration in recent years, we are concerned that Ofwat considers that the PRP recovery mechanism it has suggested is necessary:
 - (a) First, our existing performance measures and those specific measures contained within our EIP scheme provide more detail, more clarity and therefore more certainty of consistency in application than would be the case with the broader, and more subjective criteria set out in the consultation document. If one of the concerns which prompted this consultation is that there should be more consistency across the sector in relation to the measures applied in relation to PRP, we would suggest that the Guidance should be more explicit in this regard than what is currently proposed.
 - (b) Second, the introduction of a recovery mechanism for use when Ofwat considers post-fact that water companies' remuneration committees have not properly applied the appropriate criteria in determining the payments of executive PRPs in particular, could call into question the trust that is currently placed in the hands of the members of our Remuneration Committee in discharging their obligations in circumstances in which we seriously question whether there is good reason to do so.
- 2.5 To the extent that Ofwat has concerns about the proper discharge of remuneration committees' functions with regard to the assessment and award of executive PRP, it would seem to us to be a more appropriate mechanism for improving remuneration committee decision-making to encourage or indeed require water companies to improve their policies relating to executive PRP, including the imposition of more objective criteria against which to make their decisions, rather than Ofwat scrutinising remuneration committees' executive PRP decisions once they have already been made. To this extent, we would suggest any such improvements are clarified and notified to each company to align with the requirements proposed in this consultation.

3. Further clarity of Ofwat's PRP recovery mechanism is necessary to avoid divergent outcomes.

- 3.1 Without prejudice to our view generally in respect of the proposals, a specific concern is that Ofwat has the potential to introduce an additional extra layer of external governance to that which is already applied by the company which in our view is unnecessary and disproportionate and has the potential to create a conflict with those governance duties already in place. To the extent that Ofwat wishes to continue consulting on this issue, we would request that Ofwat publishes its detailed proposals of how the proposed recovery mechanism would function in practice, including setting out more detailed criteria for its decision-making and how it envisages the PRP recovery mechanism to be sequenced.

- 3.2 On Ofwat’s decision-making criteria on pages 5-6 of the consultation document, Yorkshire Water agrees that with one exception (explained below), the points raised there are appropriate for consideration in PRP decision-making, and indeed they are already reflected in Yorkshire Water’s own Remuneration Policy and performance measures for both short- and long-term variable pay elements. The exception is in respect of the treatment of financial measures. The consultation states “*Financial measures which are solely for the benefit of investors cannot be considered as relating to delivery for customers*”. Yorkshire Water considers that many financial measures undertaken by water companies that benefit investors are vital to the financial resilience of that water company. This is particularly the case when considering the investability limb of financial resilience; financial measures undertaken for the benefit of investors in water companies increase the long-term investability in the water company, which assists in increasing the long-term financial resilience of the water company. Yorkshire Water encourages Ofwat to provide more details on what it considers to be financial measures which are solely for the benefit of investors, but which do not aid the financial resilience of that water company. Indeed, the regulatory framework more broadly is designed to seek alignment between the interests of investors and customers – for instance, water companies are incentivised through price controls to operate efficiently to improve their performance, and there are also specific mechanisms in place to ensure that customers share the benefit of outperformance (such as through cost sharing rates whereby any under-spend against efficient cost allowances is shared between customers and companies¹).
- 3.3 Based on our understanding of the consultation document, it seems that remuneration committees would be obliged to make their decision on executive PRP, after which Ofwat will have the opportunity, retrospectively, to make its own, separate decision based on the factors set out on pages 5-6 of the consultation document. If that understanding is correct, Yorkshire Water has concerns:
- (a) As mentioned above, the factors listed at pages 5-6 of the consultation document are drafted widely and are open to subjective interpretation. The result may therefore be that two separate decision-makers (our Remuneration Committee and Ofwat) reach two different, but equally legitimate, decisions based on the factors listed therein. If Ofwat continues with the sequencing of the PRP mechanism in this way, it would be critically important for Ofwat to provide a much more detailed (and objective) set of criteria that can be applied to executive PRP decision-making.
 - (b) Relatedly, we are concerned that in its current form, the sequencing of the proposed recovery mechanism could make the decision-making of remuneration committees practically impossible. A remuneration committee is obliged to reach firm decisions on executive PRP in accordance with the Remuneration Policy before it, and to do so, the remuneration committee must be able to reach a sufficient level of comfort that its decision is in the best interests of the company. The remuneration committee could find itself in a position where its decision-making is in line with its company law obligations and with the water company’s own

¹ PR24 Final Methodology (December 2022), Appendix 9, section 2.4.5 Cost sharing mechanism.

Directors' Remuneration Policy and other relevant codes, but its decisions are then subject to further post-award scrutiny by Ofwat under a broad and subjective set of guidelines. This raises a number of questions: should the remuneration committee take into account the range of plausible decisions that Ofwat could potentially make under those subjective criteria? And what should it communicate to its executives? The only way that a remuneration committee could reach a sufficient degree of comfort that its decision-making will not be overturned by Ofwat would be to reach the most conservative conclusions possible under the possible range of outcomes. That is required neither under company law nor under water company policies relating to executive director PRP. Indeed, reaching the most conservative decision possible is likely not to be in the best interests of the water company over the long-term (acting in the best interests of the company being a directors' duty under the Companies Act 2006), given the disincentive for high quality executives to work for the water company in that scenario – and therefore could, over time, be at odds with company law obligations

- (c) It would also be important for remuneration committees to have the opportunity to receive comfort from Ofwat with respect to their particular interpretations of the application of the guidance prior to remuneration committees making awards where there are genuine uncertainties about Ofwat's interpretation in those circumstances. Certainly there would be a strong disincentive to sit on remuneration committees if their decision-making could be overturned after PRP awards have been made and whose members, who are likely to be highly qualified and experienced individuals, would thereby be the subject of potential public criticism, in particular where remuneration committees have reached decisions in accordance with the relevant codes and policies (as discussed elsewhere in this response) with the overarching aim of supporting strategy and promoting the long-term sustainable success of the company, whilst remaining aligned to the company's purpose and values.

4. Conclusion

- 4.1 We recognise the issue of executive PRP can be contentious. We take extremely seriously our obligations to ensure that executives at Yorkshire Water receive PRP only to the extent that their contribution is consistent with a range of important parameters, including those that are the subject of this consultation, and that awards are subject to appropriate adjustment mechanisms where appropriate. We consider that we are already applying strict rules on this as set out in our Remuneration Policy and in the Code, and we are concerned that the proposed guidance reduces rather than enhances the clarity around what is already being done. Our strong preference is therefore to work with Ofwat to identify and remedy any perceived deficiencies in the content and application of companies' existing applicable codes and policies.
- 4.2 We would be happy to meet with you to discuss any aspects of this response that you might find helpful to discuss in more detail.