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By email

Llyr Gruffydd MS  
Chair of the Climate Change, Environment, and Infrastructure Committee  
Welsh Parliament  
Cardiff Bay  
Cardiff  
CF99 1SN

08 November 2023

Dear Mr Gruffydd,

I am writing to inform you about a [report](#) published by Ofwat today, setting out our assessment of 2022-23 performance related executive pay, as part of our effort to drive up standards of governance in the water industry.

Six companies set out in their annual reports that their CEO and, in some cases other executive directors, decided to waive their entitlement to PRP payments for that year. Five other companies set out that shareholders rather than customers would fund all or part of PRP payments for 2022-23. We do acknowledge Dŵr Cymru for the leading edge 80% alignment of their bonus to delivery for customers and the environment.

Today we've published our assessment of how performance related pay (PRP) awarded to water company executives during 2022-23 was aligned to delivery for customers and the environment, and overall company performance. The report looks at the 16 largest companies in England and Wales and is the latest step we have taken as we crack down on inappropriate pay outs in the sector. We have introduced a performance related pay recovery mechanism, in relation to 2023-24 pay onwards, to ensure that shareholders, not customers, will pay for water company executive bonuses where they do not meet expectations. The report highlights progress made in this last year before our new mechanism applies, and outlines further steps which companies should take before remuneration committees make pay decisions for 2023-24 onwards.

Our assessment revealed that improvement is needed across all companies:

- Companies need to do more to explain how the targets they have used for the measures which determine PRP decisions are stretching.
- Companies need to go further in explaining how overall performance has been taken into account when making PRP decisions.
- PRP frameworks at most companies meet our current expectations regarding alignment to delivery for customers and the environment. Our assessment of 2022-23 PRP

decisions has revealed a small number of companies where this is not the case but the companies concerned have committed to changes from next year.

In the report, we are clear that it is important stakeholders are able to see the standards to which executive directors are being held in relation to performance related pay, and how remuneration committees have taken account of the overall performance of the company. If they do not do this, it will be difficult for us to conclude that a company has met our expectations in future years.

More details about the report are [here](#).

Ahead of Ofwat's evidence session tomorrow, I wanted to draw this update to your attention, and I look forward to answering further questions about it then. We'd be grateful if you could share this update with the wider committee.

Yours sincerely,

**David Black**  
**Chief Executive, Ofwat**

November 2023

# Protecting customer interests on performance-related executive pay: 2022-23 assessment

## About this document

In June 2023 we published the [final guidance](#) for our performance related executive pay (PRP) recovery mechanism. This mechanism allows us to intervene to ensure customers are protected and do not fund executive directors' PRP where a company does not meet the expectations we have set out.

As noted in our [consultation response](#) document, these provisions will apply from the 2023-24 reporting year onwards. This report sets out our assessment for 2022-23 to help companies and other stakeholders better understand our approach and to help companies improve their alignment to our guidance from 2023-24 onwards.

In future years, the financial adjustments which we identify need to be made as a result of this mechanism will be implemented through the cost reconciliation mechanism. Details of this can be found in our [Reconciliation Rulebook](#).

## Introduction

Performance related executive pay (PRP) should be aligned to the delivery of stretching performance for customers and the environment and reflect overall performance. This link is key to ensuring that executive directors are properly incentivised to deliver the right outcomes for customers and the environment.

This report sets out our assessment of companies' 2022-23 PRP decisions against the expectations set out in our guidance. These include that:

- the criteria for awarding both the short- and long- term elements of PRP in the year should demonstrate a substantial link to stretching delivery for customers and the environment;
- PRP decisions for the year should be based on stretching targets; and
- PRP decisions for the year 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.

In line with our guidance, we also considered how discretion has been exercised in appropriate cases, through mechanisms such as deferral, malus, and clawback.

This report considers the 16 largest companies in England and Wales. One company (Hafren Dyfrdwy) did not provide sufficient information on the remuneration of its executives for us to be able to assess its PRP decisions against our guidance. As such, we have not included it in this report. We will engage directly with the company with respect to its 2022-23 reporting.

In the context of increased scrutiny and stakeholder pressure surrounding PRP, in 2022-23, six companies set out in their annual reports that their CEO and, in some cases other executive directors, decided to waive their entitlement to PRP payments for that year. Five other companies set out that shareholders rather than customers would fund all or part of PRP payments for 2022-23.

## Key messages

### **Companies need to do more to explain how the targets they have used for the measures which determine PRP decisions are stretching.**

Our analysis revealed that improvement is needed across all companies. In some cases, bonus targets were set below the level of the performance commitment levels set at PR19 final determinations with no explanation as to why this was appropriate. In a small number of other cases no target was stated at all for particular metrics.

It is important that stakeholders are able to see the standards to which executive directors are being held in relation to PRP and therefore companies should ensure that targets are provided for each metric used.

No company provided a metric-by-metric explanation setting out why each target was used and how it was stretching. If a company does not explain this in future years, it will be difficult for them to demonstrate that our expectations regarding stretching targets are being met.

### **Companies need to go further in explaining how overall performance has been taken into account when making PRP decisions.**

Six companies set out in their annual reports that their CEO and, in some cases other executive directors, have decided to waive their entitlement to PRP payments for 2022-23. Five other companies set out that shareholders rather than customers would fund all or part of PRP payments for 2022-23.

We welcome this acknowledgement of the expectations we have put in place and of the need for company remuneration committees, executive directors and investors to demonstrate accountability for customer and environmental outcomes overall.

While these are welcome steps in terms of moving PRP decisions in the right direction, we are clear that remuneration committees, executives and investors should continue to reflect on our and other stakeholders' concerns ahead of decisions for 2023-24.

### **PRP frameworks at most companies meet our current expectations regarding alignment to delivery for customers and the environment.**

Well-designed pay policies should create incentives that are aligned with the outcomes stakeholders expect to be delivered. We identified 60% alignment to delivery for customers and the environment as good practice among the companies we regulate at PR19 and most companies currently meet or exceed this level, with some exceeding 80%.

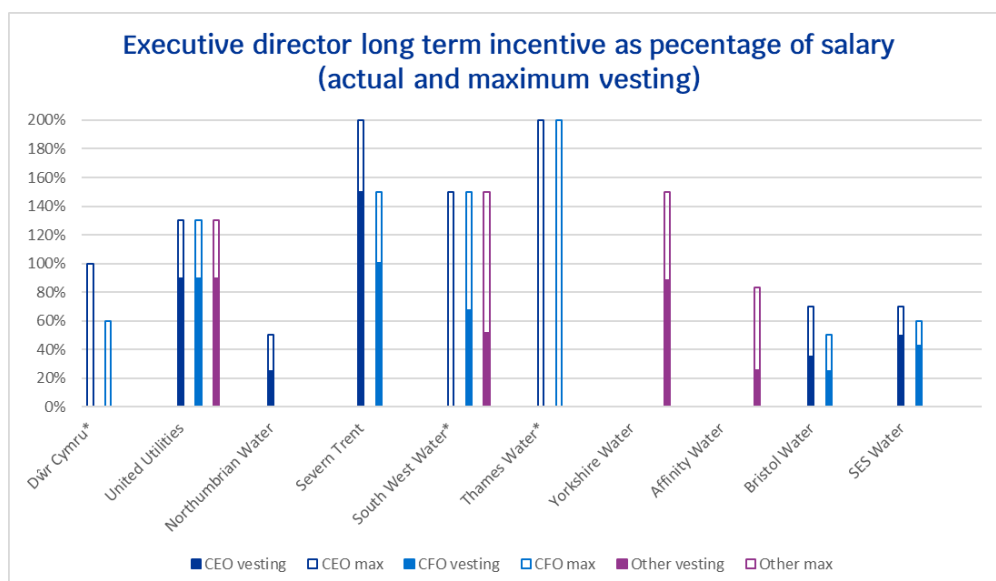
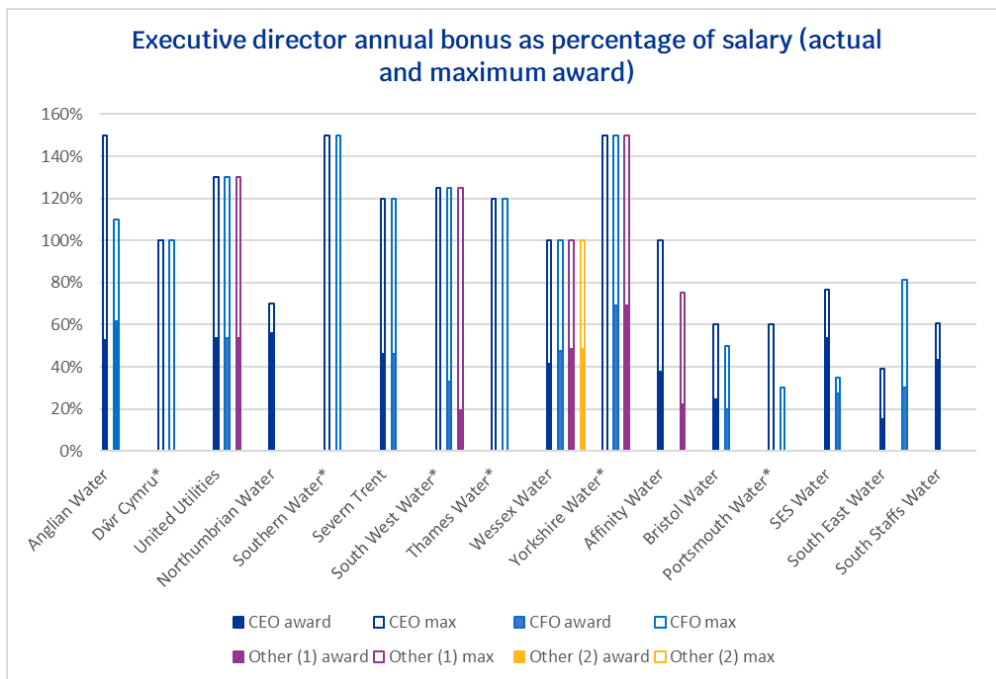
As set out at PR19, and in subsequent guidance, this alignment is equally important for long-term incentive plans (where these are used) as it is for annual bonuses.

Our assessment of 2022-23 PRP decisions has revealed a small number of companies where the structure of pay awards does not meet our expectations in this respect, although all have committed to changes.

## Overview of 2022-23 PRP decisions

The charts below set out an overview of pay outcomes across the sector, detailing the actual award and the maximum award possible, as a percentage of salary. This has been calculated for both the short- and, where applicable, long-term elements of performance related pay for 2022-23. The outcomes shown below are for all measures – both those aligned to delivery for customers and the environment, and other measures.

**Company names with an asterisk are those at which one or more of the executive directors have decided to forgo PRP payments for 2022-23.** The outcomes are shown after the application of discretion by the remuneration committee, where applicable.



## Our expectations

### Alignment to delivery for customers and the environment

**We expect the criteria for awarding both the short- and long- term elements of PRP in the year to demonstrate a substantial link to delivery for customers and the environment. Where this is not the case going forward, we will intervene to ensure that customers do not pay for executive bonuses.**

Each company uses a basket of weighted metrics to determine both the short- and, where applicable, long-term elements of PRP. We assessed each metric used to calculate awards in 2022-23 to determine whether a substantial proportion of metrics, by weighting, was related to delivery for customers and/or the environment. Examples of specific measures which we consider relate to delivery for customers and/or the environment include those which cover customer service, water quality or pollution incidents. Financial measures may be considered as relating to delivery for customers where the achievement of targets will benefit customers. However, where financial measures are solely for the benefit of investors, these will not be considered as relating to delivery for customers.

Most companies achieved a 50% alignment of metrics to delivery for customers and the environment for calculating the award of the short-term element of PRP (generally referred to as annual bonuses), which we regard as a minimum expectation. We note that two (Portsmouth Water and South West Water) did not. In the case of the longer-term element of PRP (often in the form of a long-term incentive plan), again the outcomes of two companies for 2022-23 (Severn Trent and South West Water) did not meet our expectations.

In these cases, most of the company's metrics related to financial measures, which did not directly benefit customers, or measures which related to personal outcomes for individual directors. We identified 60% alignment to delivery for customers and the environment as good practice among the companies we regulate at PR19 and most companies meet or exceed this level. Four companies (Dŵr Cymru, Bristol Water, Thames Water and Southern Water) met or exceeded 80% alignment to delivery for customers and the environment in their 2022-23 annual bonus awards which we welcome, and we would like to see more companies aspire to a higher weighting.

**We expect those companies where there was not a substantial alignment of metrics in 2022-23 to address this issue.** We are aware that all the above companies have already made or are committed to making changes for 2023-24 and we will consider whether their amended approach for 2023-24 meets our expectations based on next year's annual reporting.



## Stretching targets

**We expect the targets applied to performance related executive pay metrics to be stretching so that executive directors are not rewarded for meeting targets which could be construed as reflecting poor performance, save in exceptional circumstances (such as to provide appropriate incentives where companies are in turnaround).**

We set out the reporting requirements which each company must follow when explaining its executive PRP arrangements and outcomes in Regulatory Accounting Guideline 3 ([Guideline for the format and disclosures for the annual performance report](#)) including an explanation of how targets used are stretching.

While it is for each remuneration committee to determine which metrics are most appropriate, we expect each company to provide a clear explanation of how the targets used are stretching. We looked at the target for each metric used to make 2022-23 PRP decisions to assess if we could find evidence of this.

Often companies provided only high-level statements about the targets used and in a small number of cases no target was stated at all for particular metrics. In cases where a company used targets which were set as part of its final determination for the 2019 price review, we considered these as being stretching. However, in some cases companies used the same measures as those used at its final determination, but with less stretching targets and without explaining why those targets should nevertheless be considered stretching. In many other cases, companies used measures different to those used at its final determination, again without providing any explanation of why the targets were used and how they could be considered stretching.

**It is important that stakeholders are able to see the standards to which executive directors are being held in relation to PRP and therefore each company should ensure that targets are provided for each metric used and that they demonstrate why they are stretching.** Where this is not the case going forward, it will be difficult for us to conclude that stretching targets are being used and therefore that our expectations are being met.

## Taking into account overall performance

**We expect that in addition to reflecting performance against individual metrics, PRP decisions also reflect overall performance delivered for customers and the environment.**

PRP metrics may not capture all elements of a company's performance and so it is relevant for companies and remuneration committees to consider overall performance (or

performance in the round) when making PRP decisions. We have been clear that we attach importance to the ability of remuneration committees to override any formulaic outcomes and exercise appropriate discretion. We set out factors in our final guidance which, when taken together or individually, may provide an indication of company overall performance.

We looked at pay outcomes to determine to what extent, if any, remuneration committees had taken into account overall performance of the company when making final PRP decisions for 2022-23.

We saw a very small number of examples of remuneration committees using their discretion to reduce payouts against individual metrics (Anglian Water and Thames Water)<sup>1</sup>. We welcome these interventions as evidence that remuneration committees are using their discretion to override formulaic outcomes where these may not appear justified in the circumstances. However, we note that these interventions were generally made to reflect specific issues, rather than reducing total PRP to take account of the overall performance of the company.

Around half of companies stated in their annual reporting that the PRP decisions for the year fairly reflected the overall performance of the company for the year. However, in many cases it was not clear if and how the remuneration committee had considered overall performance of the company when determining the need to use discretion in relation to PRP decisions. Even where high level statements were provided that overall performance had been considered, there was generally little detail on the factors which remuneration committees had considered.

In future years' reporting, each company should provide greater detail on how its remuneration committee has considered overall performance in making PRP decisions. The reporting requirements set out in Regulatory Accounting Guideline 3 are clear that each company should explain how PRP decisions are justified in the context of overall performance. The requirements also set out that each company should explain what factors its remuneration committee has taken into account in reaching its decisions on overall performance in this context.

**If a company does not demonstrate how it has taken account of overall performance in future years, it will be difficult for us to conclude that a company has met our expectations.**

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<sup>1</sup> We also note in this context that directors at United Utilities waived part of their annual bonus for 2022-23 and that "noting the effect of the voluntary waivers, the [remuneration] committee has not applied any discretion in respect of annual bonus outcomes for 2022-23".

## Next steps

We will engage with all companies to address the issues highlighted in this report and to raise any other areas of improvement for future years.

We will review companies' 2023-24 annual reporting to assess their PRP decisions against our expectations and will report on our findings. As we explained in our [consultation response](#) document, where a company falls short we will consider the need to calculate a provisional adjustment using our 'performance related executive pay recovery mechanism' to ensure that customers do not pay where PRP decisions do not meet our expectations.

We are assessing the remuneration policies which companies have included in their PR24 business plans and which will apply from 2025-26 onwards. We are considering whether those policies meet the expectations set out in our final methodology, including on the alignment of the PRP framework to delivery for customers and the environment, the use of stretching targets and consideration of overall performance. Our view of these plans will also form part of our quality and ambition assessment of companies' business plans.

**Ofwat (The Water Services Regulation Authority)  
is a non-ministerial government department.  
We regulate the water sector in England and Wales.**

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