Response Form – "Rules on Remuneration and Governance" consultation

Please send your responses to: RemunerationGovernanceRules@ofwat.gov.uk by 19 November 2024

Name / Organisation: InfraRed Capital Partners

Sector: Investment Management

Date: 13 November 2024

Rule: Performance related executive pay (PRP) prohibition
Question 1: Do you agree with our proposal in terms of which individuals the Rule would apply to? And what considerations do you think should be taken into account in designing the application of the Rule to different types of performance related pay?
Response: We agree with which individuals should be affected. We agree it should relate to annual bonus and any payment from a long term incentive plan that would otherwise be payable in that year. More broadly in relation to this consultation, while we do not disagree with the objectives of the consultation or the Bill that drives it, we believe that the risk of unintended adverse consequences is high in these areas, and that miscalibrated rules could easily undermine the stated objectives rather than reinforce them. In this response, we have sought to propose amendments to the rules that we believe would make them better deliver the stated policy objectives. As a general point in relation to this rule in particular, we suggest that Ofwat assess the impact of this rule after three years. In the event that there has been an increase in senior executive turnover, challenged recruitment processes and/or other unintended adverse consequences, the rule should be revised.
Question 2: Do you agree that PRP should be prohibited if a company has been fined by Ofwat for a breach of a principal duty? Are there any alternatives or additions you would suggest for the "consumer matters" standard?

Response: Yes this seems appropriate: there should be a very high bar to zeroing a large component of someone's pay, and we also agree that it should be a clear and objective standard. Breach of the principal duties under sections 37 or 94 meets those criteria.
Question 3: Do you agree that PRP in any given year should be prohibited where the company has had a serious pollution incident in the previous calendar year? Are there any alternatives or additions you would suggest for the "environment" standard?
Response: This is unfortunately quite a low bar to prohibition. The numbers of incidents occurring in the industry suggest that companies are not able to reduce the risk of incidents to a low level on the cost allowances available. Where such risks of incidents remain substantial, executives are likely to see this clause as substantially devaluing any PRP package. That would lead to executives to demand higher base salaries and a smaller proportion of PRP for the same total compensation (as happened at investment banks when the EU capped bonuses). If the industry expects that these restrictions mean that any PRP will pay out only rarely, then it is likely the industry would only be able to recruit and retain executives by moving to a model of no PRP and executives receiving materially higher fixed salaries instead. Hence setting the bar too low could lead to executives <u>becoming less incentivised</u> to these factors not more. We would also suggest that binary 'all-or-nothing' thresholds can be counterproductive. For example, as proposed, if there were to be a Cat 2 incident on the first day of the year, the executive could no longer earn any PRP for that year and will be working with no effective incentivisation for that time. We would suggest that a Cat 1 incident lead to a 25% cut to any bonus or LTIP payments. We suggest that Cat 2 incidents not be covered by a mandatory regime. In addition, the restriction should apply where there has been demonstrable management failure, e.g. an incident caused by third party action should be treated differently to a company operating failure where mitigating action is not taken promptly. This qualification is especially important if all restrictions are applied as 100% payment reductions instead of a more gradated approach.
Question 4: Do you agree that the standard for financial resilience should be a minimum required credit rating and if so, at what level? Are there any alternatives or additions you would suggest for the financial resilience standard?

Response: Ruling out PRP payment on the basis of financial resilience is problematic because financial reliance can be compromised by external factors. However, if the Bill is passed unamended then we agree that certain ratings are likely the best measure. However, it should be recognised that a company may be downgraded due to factors outside of its control: e.g. Moody's has suggested that it may downgrade the regulatory framework as a whole due to the direction of the PR24 settlement, which would likely lead to downgrades to most or all companies, potentially causing executives to forfeit pay due to the actions of the regulator. We also note that, in troubled companies, executives (who may be new executives who did not preside over the underlying issues) need to be incentivised to turn the situation around. In addition, if there were to be a rating trigger, it is also important that it should not be too low a bar to zeroing pay, as noted above under Q3. We suggest that the following amendments should be made: i) the threshold should be below investment grade (i.e. to worse than Baa3 / BBB-), ii) the sanction should apply only in the period in which the relevant rating transition occurred, iii) the sanction should be 25% of PRP otherwise payable not 100%. The restriction should apply only where there has been demonstrable management failure, including failure to take mitigating action. For example, where the trigger for a downgrade is a regulatory determination, then the restriction should not apply until management has had an opportunity to take mitigating action, e.g. to appeal an adverse determination to the CMA and/or to implement changes in capital structure.
Question 5: Do you agree that this Rule standard should cover all criminal convictions? Please explain the reasons for your view.
Response: This clause is problematic. Firstly we suggest this rule apply only to convictions under specified laws relating to environment and safety. The legal framework within which large corporates operate is increasingly complex and there are more and more areas in which criminal breaches are possible, some of which may be relatively minor matters that are nonetheless classified as criminal. Within environmental law, as noted above in the context of pollution incidents, the law allows a wide range of incidents to be classified as criminal offences, and we observe that the Environment Agency tends to prefer pressing criminal charges whenever possible, even where civil sanctions are available as an alternative. The number of convictions that Ofwat quotes suggests companies have not been able to reduce these risks to a low level for the cost allowances available.

In addition, these incidents often take several years from occurrence to sentencing. Executives would therefore i) be subject to uncertainty for a sustained period (and hence unable to spend their pay), and ii) if they leave in that period they would be reliant on their successors continuing to fight the case. In both respects, executives are likely to see this clause as substantially reducing the value of PRP schemes.

Meanwhile, executives that do stay on through the process would be heavily incentivised to contest any convictions through all available appeal mechanisms. Similarly, we would also expect a sharp reduction in companies pleading guilty to offences.

We do not see a workable application of this rule that can apply absolutely across any and all convictions unless the Environment Agency agrees to fundamentally change its approach and pursue criminal sanctions only in the most serious cases. Alternatively, we understand that, for breaches of environmental law, the courts make an assessment of management culpability: it would be more reasonable if the payment restriction were to apply only where there is assessed to be a high level of culpability , e.g. an assessment management have been “reckless”.

Question 6: How can Ofwat best address the risk of the time lag between an incident and conviction?

Response: We do not believe that this risk is readily addressable. If there is to be certainty of PRP recovery for a protracted period following the original event, then there is inevitably a significant de-valuing of PRP schemes.

We suggest that any penalty be time limited to 3 years. We also believe that clawback is an unwieldy and undesirable mechanism to employ except in very narrow circumstances (principally fraud) and that delayed sanctions should only therefore apply to unvested LTIP payments as at the date of conviction that relate to the date of the original offence.

Question 7: What type of arrangements (e.g. clawback) should companies be required to have to recover PRP payments when a Rule breach occurs?

Response: It is far preferable to set conditions that can be assessed in-year, i.e. before payment is made, than to rely on clawback mechanisms.

A substantial risk of clawback means an executive can’t spend their pay. That essentially delays payment, making it less valuable to them.

There is also a tax aspect. HMRC does not refund tax paid on pay that is subsequently clawed back. If Ofwat claws back the gross amount, then the affected executive may have to pay back more than they received. This potentially makes PRP schemes more of a liability than an asset to executives.

We suggest that clawback is avoided, except in cases of fraud. Instead, we suggest that this rule apply only to LTIP payments, i.e. a payment relating to the year of the offence which would be payable in the year of sentencing.

Question 8: What do you think should be considered an exceptional circumstance for when PRP could still be paid despite the company appearing to breach one or more of the Rule's standards?

Response: Exceptions should be granted where the event in question was not demonstrably the result of management action or inaction.

Rule: Fitness and propriety

Question 9: Do you agree that the types of standards proposed above (under Standards for Consideration) could be suitable for the proposed fit and proper persons test? What other (if any) criteria should be considered?

Response: These are largely suitable with three important amendments required.

1) An individual should not have been the subject of adverse findings in a regulatory investigation or disciplinary proceedings.
2) Adverse findings in civil proceedings should be excluded. This is otherwise very broad and could be triggered by any number of proceedings that have no bearing on fitness and propriety, e.g. losing a boundary dispute with a neighbour.
3) A prohibition on directors who have been involved with an insolvency / administration is too broad. Sometimes businesses fail – that is enterprise. This is especially the case for small, young and/or innovative companies. Many of our INEDs and investor NEDs are involved in such companies. Often these are people with more experience of technology and innovation. The water industry should welcome such people. In addition, businesses occasionally fail due to exogenous factors beyond management control, e.g. change of law or geopolitical factors. We suggest the prohibition apply only to a special administrationof a regulated utility.
4) In addition, directors who join when problems are already apparent should not be sanctioned. We suggest the sanction should only apply if an individual had

been a director for at least 12 months prior to a regulated utility administration / insolvency.

Under management and technical competency, we suggest that Ofwat assesses this outside of the fitness and propriety rule. Instead Ofwat should continue to use its pre-appointment meetings to advise on potential areas of training and induction for incoming directors. Otherwise prospective non-executives from most backgrounds are unlikely to have detailed knowledge of water regulation before joining, but may bring valuable knowledge and experience from other sectors. The same is often true for executives: some of the most successful water CEOs did not work in the sector prior to their appointment.

Question 10: Do you agree with the proposal that the fit and proper persons test should be applied at this stage to chief executives and other individuals who are appointed as directors to the board, including both executive directors and non-executive directors? If not, please explain why.

Response: Yes.

However, Ofwat should ensure that there are no events in relating to the company that could cause the entire board to be deemed no longer fit and proper and have to resign simultaneously. It is rarely positive for an entire board to be removed at the same time.

Question 11: Do you agree with the approach that companies should as a minimum provide assurance to Ofwat through their annual reporting process? What other mechanisms of assurance and information provision could be considered for monitoring compliance of the rule?

Response: Yes. This would seem entirely adequate.

Rule: Consumer involvement in decision-making

Question 12: Do you agree with the core principles proposed for effective consumer representation? Please explain the reasons for your view and tell us if you consider there are any other core principles that should be included.

Response: We welcome clear channels for consumer involvement, which we believe can help build legitimacy for decisions. However there are certain caveats:

1) The input needs to be advisory

2) The framework should allow companies to take into account wider interests and government policy. (For example in relation to potential local resistance to a reservoir that may be required for the region's supply resilience.)
3) The processes must not slow up decisions, especially during operational incidents
4) The mechanisms should not be too onerous, both from the perspective of the company and also for the consumer representatives

Question 13: Do you agree the consumer rule should require companies to take appropriate account of consumer views in these areas, or if any of them should be limited or otherwise defined? Please explain the reasons for your view and tell us if there are any other areas that should be included.

Response: During a major incident, it is essential that decisions can be taken quickly. There may well be circumstances where consulting with consumer representation is useful, e.g. in terms of managing consumer expectations of a fix. However there should not be a hard requirement for this to occur before any given action. Not least because a customer representative would then need to be available 24/7/365.

However, we note that the language currently contemplates decisions taken at board level, i.e. not immediate responses by operational teams. The board level stipulation would largely mitigate the risks raised above.

Question 14: Do you agree with our proposal to take an outcomes-based approach to this element of this Rule? If not, please explain why.

Response: The approach as laid out makes sense.

Question 15: Are there any other mechanisms or channels for the consumer voice that should be considered? Please explain the reasons for your view and tell us whether there are any consumers under our definition who may need a different type of approach.

Response: The channels laid out are adequate.

Question 16: What are the most effective ways for ensuring these mechanisms or channels are sufficiently independent from the company?

Response: On the obverse of this question, mechanisms should not be too onerous or exclusionary, such that it becomes difficult to find people willing to undertake these roles. Similarly, a degree of tenure should be actively encouraged as the issues are complex and representatives are likely to become more knowledgeable and effective with time.
Question 17: Do you agree that the Rule should provide options for water companies in terms of how they establish appropriate arrangements? And do you agree with these proposed mechanisms? If not, please explain why and if are there alternative mechanisms that should be considered.
Response: Yes we agree the proposed approach makes sense.
Question 18: Do you agree with the proposed assurance mechanisms described? Do you have any other suggestions on assurance mechanisms for monitoring compliance?
Response: Yes.
Question 19: Do you agree with the proposed means of raising concerns on behalf of consumers who do not consider the Rule is being adequately followed?
Response: This appears reasonable, subject to the caveats given at the start of this section. Companies will not be able to deliver every output customers want. Assets will have to built next to customers who would prefer that they weren't. Ofwat and CCW will need to take this into account when assessing whether companies have nonetheless taken customer views into account appropriately.
New appointees
Question 20: Do you have any views on whether the rules should apply to new appointees, and if so, whether the same or different rules should apply?
Response: We query whether these provisions may be excessive for a SIPR project, which does not have the broad operational remit of the network utilities.

Responding to this consultation

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

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