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PR19 Putting the sector back in balance: Dividend policy and performance related pay

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1. Introduction

- 1.1. Strong corporate governance reflects the values set by the Board of Welsh Water and supports decision making at every level within the business. We have made a voluntary undertaking to comply with the UK Corporate Governance Code, as if we were a listed company. Good governance includes transparency around decision making and strategy, including concerning dividends, gearing and our executive remuneration policy. We consider that we fully meet the principles that Ofwat set out in its consultation: “Putting the sector in balance: position statement on PR19 business plans” (July 2018).

2. Dividends

- 2.1. Ofwat expects companies to set out details underpinning their approach to dividends in their business plans. Uniquely in the sector, as a non-shareholder company, we do not pay dividends outside of our Group. We nevertheless provide a summary of our relevant policies below.
- 2.2. Welsh Water’s ultimate parent undertaking is Glas Cymru Holdings Cyfyngedig, a company formed with the single purpose to manage Dŵr Cymru. As a company limited by guarantee, and having no shareholders, all financial surpluses are reinvested for the benefit of customers. The reserves built up from retained profits help to secure the long-term financial viability of the business, providing reassurance to customers that we can maintain a resilient service to them even in the face of severe financial shocks. This secure financial position also improves our credit quality, helping to keep the cost of finance and thereby bills to customers as low as possible.
- 2.3. A new dividend policy for the appointed business (Dŵr Cymru Cyf.) was approved by Ofwat in December 2015 and formally adopted by the Welsh Water Board in March 2016. This dividend policy is reported in our Annual Report and Accounts (for example, on page 86 of the 2017-18 Glas Cymru Report and Accounts). No monies are transferred out of the Glas Cymru group of companies under this policy and all financial surpluses are retained for the benefit of customers. The policy allows for dividends of up to £100 million (indexed) to be paid within the group to enable the funding of closely related commercial activities, such as in the wider bioresources market, the profits from which would ultimately be used to finance improved value for Welsh Water’s customers. Our dividend policy expressly provides that dividends will not be paid unless the Directors are satisfied that this would not impair Welsh Water’s ability to finance its regulatory activities. To date, a £30 million dividend has been paid in this way, part of which was used to purchase the advanced anaerobic digester plant for local council food waste, which is sited adjacent to Welsh Water’s main wastewater treatment works in Cardiff.
- 2.4. The Welsh Water Board intends to continue with the published dividend policy set out above throughout AMP7 and beyond, this being central to our not-for-shareholder structure where all gains are used for the benefit of our customers.
- 2.5. We also publish each year a statement of our policy for the Return of Value to our customers (‘Customer Dividends’) and the amount of money returned to customers in the year (for example, see pages 15 and 86 of the 2017-18 Glas Cymru Report and Accounts). Board decisions on how to make ‘customer dividends’ in the best interests of customers

have been informed by a wide-ranging programme of customer involvement activities on this question, through the 2016 Have Your Say campaign.

- 2.6. Since 2001, Welsh Water has applied £353 million in total for the benefit of its customers, through 'customer dividends'. These 'customer dividends' abide by the same restrictions which would apply to payment of dividends in a shareholder owned company. Accordingly, Return of Value in 2017-18 was set by the Board at £34 million in total. This ensured that the gearing target of just below 60% in 2020 could be maintained (see below), to preserve a strong credit rating and financial resilience for the longer-term benefit of customers. The decision took account of known and expected costs and the Group's pension funding position (including commitments to contribute to deficit payments).

3. Linking performance related pay with delivery for customers

- 3.1. Ofwat expects companies to be transparent about how executives are remunerated and specifically how any performance related element of executive pay is linked to the underlying performance of the company. We comply with the UK Corporate Governance Code provisions for remuneration, which also cover Ofwat guidance on transparency set out in Regulatory Accounting Guidance 3.09. Our approach is summarised below, with full details being provided in our published annual Remuneration Report (see pages 69 to 82 of the 2017-18 Glas Cymru Report and Accounts).
- 3.2. The principles and framework of the current Remuneration Policy were approved by Glas Members at the AGM on 3 July 2015 and were effective from that date. The policy is set out each year for customers and stakeholders in the Annual Performance Report, as well as the Annual Report.
- 3.3. The Policy aligns executive remuneration with the implementation of Welsh Water's strategy to deliver the best possible outcomes and value for money for our customers and to protect the environment. Under the policy, remuneration is linked to performance both annually and over the five year regulatory period that commenced in April 2015.
- 3.4. The Policy is implemented to ensure that certain principles are delivered:
- Levels of base salary and total remuneration (when assessed periodically against the market) are considered to be fair and competitive having regard to an individual's experience and responsibility;
 - Performance improvement is encouraged by ensuring that a significant proportion of the total remuneration opportunity is linked to performance, while balancing this with base salary to ensure that excessive risk-taking is not incentivised;
 - Incentives are focused on the outcomes which are considered important for customers and calibrated against the prior year's performance and against the performance of other companies as assessed by Ofwat and other regulators, in order to incentivise sector-leading performance in a transparent and accountable way; and
 - The Long Term Variable Pay Scheme (LTVPS) rewards sustained, sector leading customer service performance and the creation of long-term customer value through the cumulative financial performance of Welsh Water.

3.5. Because we have no external shareholders, our Annual Variable Pay Scheme (AVPS) and LTVPS do not contain any traditional “shareholder” measures, such as Earnings per Share, dividend growth or the increase in the share price. Instead, all performance measures are directly relevant to customers in terms of the service levels they receive, future levels of bills and environmental performance. Current performance measures in the AVPS include:

- Drinking water quality
- Environmental compliance
- Customer satisfaction and complaints
- Reliability of customer service, and
- Cost reduction.

The two measures in the LTVPS are currently:

- Three year average customer service performance (SIM), and
- Customer value creation (measured by the ‘customer dividends’ made and the growth in the Customers’ Reserves – RCV less net debt.)

3.6. The Measures of Success and cost elements which form the basis of the AVPS for Executive Directors and the wider Executive team are also the basis of variable pay arrangements across the organisation, including an annual company performance bonus scheme which applies to all employees. The Committee does not formally consult with employees on Executive pay, but does regularly seek the views of the Director of Human Resources and takes into account views expressed in dialogue with Glas Members as well as bench-marking and best practice. We also voluntarily disclose the ratio of the Chief Executive’s total remuneration to that of the average employee, which in 2017-18 was some 14:1.

3.7. The Remuneration Committee will operate the AVPS and LTVPS according to their respective scheme policies and in accordance with the Listing Rules, UK Corporate Governance Code, and IA/ISS Guidelines where appropriate.

3.8. The Committee retains discretion, consistent with market practice, in relation to the operation and administration of these schemes. These include, but are not limited to, taking into account significant safety or reputational issues, or significant deterioration of performance.

3.9. The scheme rules allow for clawback of variable pay from directors, whether before or after awards have vested.

3.10. The Members of Glas Cymru will be asked to approve the remuneration policy for the period 2020 – 2025 at the 2019 AGM. The Committee is still considering the detail of the AMP7 Remuneration Policy which it will propose to Members, but has indicated to Members that the key element of the structure of pay and reward will remain as set out above.

4. Outperformance sharing – Gearing and cost of debt

Ofwat expects companies with gearing levels materially above their notional assumption, to propose, in their business plans, outperformance sharing mechanisms that allow customers to share in the returns equity investors achieve from high gearing.

- 4.1. In the case of Welsh Water, as a not-shareholder company, any and all financial outperformance is returned to customers.
- 4.2. The Board has set a gearing policy to keep gearing at or around 60% and gearing is forecast to be just below this at around 59 % by the end of the AMP6 period. This threshold has been carefully set by the Board to balance financial resilience with returning value to our customers, either through additional investments in service improvements or resilience, through funding social tariffs, or through reductions in bills ('customer dividends'). We publish our Gearing Policy each year (see page 86 of the 2017-18 Glas Cymru Annual Report and Accounts).
- 4.3. As set out in our Business Plans, we plan to maintain gearing at around the 60% level throughout AMP7 and AMP8. As such, Ofwat's proposed outperformance sharing mechanism is not expected to apply.
- 4.4. It is possible that the interest cost of new debt raised during the AMP7 period could be lower than that assumed by Ofwat in making its Final Determination in December 2019. In those circumstances, the Board would consider in the round whether it should preempt the clawing back of a proportion of this cost of debt outperformance at PR24 by passing the benefits immediately to customers in the form of lower bills. This would be judged based on the overall financial position of the company at the time, as the lower than expected interest costs could be the result of adverse economic conditions such as prolonged deflation, which would be having a wider negative impact on the company's financial position. The Board would take this decision in the best interests of customers, having taken account of the views of the CCG, customers and other stakeholders.
- 4.5. Because we have no external shareholders, all of the benefit of unexpectedly low interest costs will ultimately be applied for the benefit of our customers through Return of Value, not just a proportion.

5. Outperformance sharing - WaterShare

- 5.1. We have proposed an innovative new outperformance sharing mechanism called "WaterShare", which reflects the views of our customers on the role of potential ODI rewards that could be earned during the AMP7 period.
- 5.2. Under the WaterShare scheme, any net rewards earned would be shared 50:50, with half automatically being applied to reduce customer bills in the period. For the other half, we would consult widely with customers, the CCG, regulators and other stakeholders before the Board came to a decision as to how best to use this funding in the best interests of customers. This could involve additional Return of Value to customers in the period, through lower bills, more funding for social tariffs or increased investment in service or resilience improvements. This consultation exercise would build on the success of the

similar Have Your Say campaign in 2016, in which we sought customers' views on the Return of Value in the AMP6 period.

6. Other transparency and trust issues

- 6.1. Through our commitment to comply with the UK Corporate Governance Code, as if we were a listed company, we fully meet the principles that Ofwat set out in its consultation: "Putting the sector in balance: position statement on PR19 business plans" (July 2018).
- 6.2. In our Annual Report, we describe the Group Tax Strategy, together with our approach to tax planning and tax risk. (See page 85 of the 2017-18 Glas Cymru Annual Report and Accounts.) All of our group companies are UK tax resident and subject to UK corporation tax on their profits. Our focus is on compliance; ensuring that all taxes are correctly calculated, accurately reported and paid when due. We do not engage in artificial arrangements with no commercial purpose, or transactions which are directed at exploiting tax legislation in order to reduce the tax we pay. We comply with the spirit of the law, as well as the letter of the law.
- 6.3. We also make a full disclosure of our corporate structure each year to customers and investors (see page 53 of the 2017-18 Glas Cymru Annual Report and Accounts). This section reported that Dŵr Cymru (Financing) Limited is the 'issuer' company for Welsh Water's bonds, which are listed currently on the Luxembourg Bourse. Dŵr Cymru (Financing) Limited was established prior to the acquisition of Welsh Water by Glas Cymru in 2001 and is registered both in the Cayman Islands and in England and Wales. It is managed, controlled and resident in the UK for tax purposes. The company on-lends the proceeds of any bond issuance to Dŵr Cymru Cyfyngedig. We expect to transfer the debt held in this company to a new company registered solely in England and Wales by the end of December 2018. These arrangements, including the joint registration of Dŵr Cymru (Financing) Limited, have not been the cause of any adverse comment by customers or other interested parties.
- 6.4. In summary, we make a full, public disclosure each year of all "transparency" issues of potential concern to customers and other interested parties, including:
 - Our gearing policy
 - Our dividend policy
 - Our Return of Value to customers
 - Our executive pay policy and principles
 - Our corporate structure
 - Our tax strategy and tax affairs.
- 6.5. We believe that this open and transparent approach provides reassurance to our customers, regulators and industry commentators that, in all these respects, we are seeking to work in the best, long-term interests of the customers of the essential public service that we provide. This in turn supports high levels of customer trust in Welsh Water – as reflected by the fact that we were (by some distance) the most trusted water

and wastewater company in the annual CCWater “Water Matters” report for 2017, with a trust score of 8.15 (compared to a sector average of 7.67).