Scottish Water
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Richard Leonard MSP
Convenor of the Public Audit Committee
The Scottish Parliament
Edinburgh
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***Emailed to: publicaudit.committee@parliament.scot***

Dear Convenor,

**Information on Scottish Water's Annual Outperformance Incentive Plan (AOIP), Long Term Incentive Plan (LTIP) and Manager Reward Review**

At the Public Audit Committee on 19 February 2025, Roy Brannen suggested he could ask Scottish Water to write to you with details on the above matters. This letter discharges that request.

**Annual Outperformance Incentive Plan (AOIP)**

AOIP allows a portion of remuneration to be placed at risk, dependent upon the performance of the organisation. Scottish Water introduced a single annual outperformance incentive scheme for employees at all levels in 2004/05, as part of integrating terms and conditions of the former regional water authorities. Payment depends on generation of sufficient financial surplus in operating costs, so that the bonus can be funded. Beyond that, targets are set across a range of business measures requiring annual outperformance of standards contained within our regulatory contract. These measures link to our strategic ambitions as an organisation (Service Excellence, Net Zero Emissions and Great Value and Financial Sustainability) and are published each year in our Members' Remuneration Report, which forms part of our annual report and accounts.

The measures are weighted so that the degree of outperformance against any one of them drives payment of that part of the bonus. These are corporate measures and targets against which Scottish Water is assessed for performance. They incorporate measures of customer service and experience ratings, sound financial management, delivery of capital programme outputs, and delivery of carbon emissions reductions.

Once performance levels for any given year have been confirmed, our Board and Remuneration Committee of independent Non-executive Directors then determines the degree to which bonuses should be payable, based on the scheme rules.

Members of the Executive Leadership Team have bonus potential of up to 40% of salary each year. Managers on individual contracts have bonus potentials between 15% and 30% of salary, dependent on management grade. All collectively bargained employees have the same annual bonus potential regardless of job grade, currently set at £1,145 for a full time employee with a full year of service.

The AOIP (bonus) measures and targets for 2024/25, which will generate payments in July 2025 are as follows:

| **Gateways** |
|---|
| • Tier 1 costs (broadly, operating costs rather than capital investment) to be sufficiently lower than the Final Determination (updated for out-turn inflation) to fund AOIP payments; and<br>• Progress to the Committed List (PCL – a measure of capital investment projects that are “green-lit” from the larger programme of potential work) to be equal to or greater than 97.5%.<br>• If either Gateway is not achieved, no AOIP is payable to any employee group. |

| Ambition | Weight | Measure | Weight | Target Type |
|---|---|---|---|---|
| Great Value & Financial Stability | 34% | Tier 1 costs (before LTNC items) (relative to Final Determination updated for inflation) | 20% | Target Zone of zero to £30m lower than FD |
| | | IPOD (Indicator of Progress of Delivery) | 8% | Tramline +/-3 months to within +/-1 month |
| | | IFAC (Indicator of Forecast Accuracy at Commitment) | 6% | Tramline +/- 5% i.e. 95% or 105%, to +/-1.7% i.e. 98.3% to 101.7% |
| Service Excellence | 33% | Overall Performance Assessment (OPA) | 20% | Target Zone 395 to 410 points |
| | | Household Customer Experience (hCEM) | 5% | Target Zone 85.0 to 87.8 points |
| | | Non household Customer Experience Measure (nhCEM) | 5% | Target Zone 86.0 to 90.0 points |
| | | Revised Developer Customer Experience Measure (dCEM) | 3% | Target Zone 78.3 to 80.5 points |
| Net Zero | 33% | Operational emissions route map reductions | 33% | Target Zone 36,000 – 42,000 tCO2e reduction cumulative in SR21 |

Target zone – half pay out if the bottom of the target zone is delivered with straight line increase to full pay out if top of target zone is achieved. Tramline – half pay out if within tramlines, with straight line increase to full payout if within the middle 1/3 of the tramlines.

## Long Term Incentive Plan (LTIP)

The LTIP links the reward of Directors and other senior members of the leadership team to the longer term and sustainable performance of the company. It also creates a retention incentive for key, senior employees in roles that can often command higher remuneration elsewhere. Payments are earned and made in a series of Performance and Vesting periods and the scheme operates alongside the Annual Out-performance Incentive Plan which rewards performance in excess of regulatory targets year on year.

Before any payment can be made, the LTIP requires consistent and sustained outperformance against the specified measures, including financial out-performance at an organisation level sufficient to fund any payments.

The LTIP structure for SR21 onwards has been designed to address two key elements:

1. Our Strategic Outcome of Beyond Net Zero Emissions stretches across multiple regulatory contracts and so the LTIP must reflect that longer-term commitment.

2. Since first application of an LTIP scheme in 2006-10, the per-year equivalent payment potential has reduced steadily for participants, as plan and regulatory period durations have lengthened. The new scheme has provided an opportunity to address the annual equivalent value and thus the financial impact of the LTIP within the overall reward package of participants.

Targets 2024-27

**Gateways/Cross-checks**

- Tier 1 costs (broadly, operating costs rather than capital investment) to be sufficiently lower than the Final Determination (updated for outturn inflation) to fund LTIP payments; and
- Progress to the Committed List (PCL – a measure of capital investment projects that are "green-lit" from the larger programme of potential work) to be equal to or greater than 97.5%.
- Transformation plan has delivered on planned activities for the performance period. Assessment informed by stakeholder views on the extent of progress being made to transform Scottish Water. Yes/Partial/No decision by Rem Com on the extent of LTIP payable.

| Ambition | Weight | Measure | Basis |
|---|---|---|---|
| Great Value & Financial Stability | 34% | Tier 1 costs (before LTNC items) (relative to Final Determination updated for inflation) | Sliding scale of £0m to £100m outperformance over 24-27 period |
| Service Excellence | 33% | Overall Performance Assessment (OPA) | Sliding scale of performance in target zones over 24-27 period (50% for achieving bottom of the target zones, 100% for top) [1] |
| Net Zero | 33% | Operational emissions route map reductions | Sliding scale from 45,000 $tCO_2e$ reduction to 60,000 $tCO_2e$ reduction |

Duration & Payments

Scottish Water's LTIP operates through a Performance period (during which the incentive is assessed by reference to the performance criteria); and a Vesting period (during which the amount identified in the performance period is held for payment at the end of vesting).

Each of these periods lasts three years and allows the LTIP to reflect the rolling nature of truly long-term performance measures, such as Net Zero Emissions. The Vesting period allows

[1] Current OPA target zone is 395 to 410 points, although this can be adjusted annually. Therefore performance across 2024-27 would be an aggregate against the target zones defined for each year.

Remuneration Committee to verify that payments earned over a three-year Performance period are not based on short-term decisions that later prove unsupportive of longer-term performance. This means that the Remuneration Committee can, if necessary, intervene and moderate the level of incentives actually paid out.

| Year | 2021 | 2024 | 2027 | 2030 | 2033 | 2036 |
|---|---|---|---|---|---|---|
| Performance Period | LTIP1 start | LTIP1 end; LTIP2 start | LTIP2 end; LTIP3 start | LTIP3 end; LTIP4 start | LTIP4 end; LTIP5 start | LTIP5 end; etc. |
| Vesting Period | | LTIP1 start | LTIP1 end; LTIP2 start | LTIP2 end; LTIP3 start | LTIP3 end; LTIP4 start | LTIP4 end; etc. |
| Payment | | | LTIP1 | LTIP2 | LTIP3 | LTIP4 |

Potential payment for LTIP period 2024-27 (LTIP 2 in the above table) would be made in 2030. The maximum potential LTIP payment for Directors is the equivalent of 15% of base salary per annum, 45% over each 3-year Performance Period.

**Manager Reward Review (MRR)**

In April 2024, following extensive negotiations with our unions, we implemented a reformed pay and grading structure for collectively bargained employees, who comprise around 96% of our direct workforce. This addressed concerns colleagues had raised with the previous pay and grading structure, where salary ranges had become too broad and overlapped excessively between grades, and where there was poor visibility of how salaries could progress through time. The previous structure had been in place for almost two decades.

Following the implementation of this new framework, we then undertook a comparable exercise for our management grades. This was implemented following consultation with our sponsor team and review by the Scottish Government Remuneration Group.

Both projects took an approach where roles were sized against new job grades with clear, externally benchmarked salary ranges. Both projects also introduced pay progression, allowing people to see where their salary could go over time (although this will only be implemented for our managers once the employee pay dispute for 2024/25 is settled).

In both cases, the changes generate greater transparency and consistency, and a fairer approach to reward.

I trust the above information is helpful.

Yours sincerely,

**Deirdre Michie OBE**
**Chair**
**Scottish Water**

**Alex Plant**
**Chief Executive**
**Scottish Water**