

PAY FOR PERFORMANCE

New Trends in
Executive
Compensation

By Gary M. Stern

Illustration by Jürgen Mantzke

A year ago, *The Associated Press* reported that the salaries of CEOs of the Standard & Poor's 500 had "skyrocketed and reached stratospheric heights so that half were making \$8.3 million a year and more." Almost one year later, *The Wall Street Journal* noted, "Directors, facing unprecedented pressure from investors, lawmakers and regulators, are increasingly cutting back the pay-setting power of CEOs." Are the compensation packages of utility CEOs also being reduced by directors, or is utility CEO pay rising?

A year ago, pay packages for utility executives had escalated due to deregulation, which made the profits of utilities as competitive as most other companies. Compensation packages including stock options and deferred payments had risen to \$12 million to \$20 million annually for CEOs at Constellation Energy, Exelon, Entergy, AEP and Duke Energy.

In 2008, utility CEOs are facing two contradictory trends

in compensation. An SNL Energy survey reveals that CEO compensation at most utilities has been rising. At the same time that pay packages are expanding, many boards are linking compensation to performance and not just rubber-stamping bonuses and stock options. Nonetheless, many boards seem reluctant to crack down on rising CEO bonuses, continue to offer more stock options and sometimes yield to CEO demands even when the stock price is lagging.





“The definite, overarching theme is pay is up for executives in the energy business,” noted Chris Crawford, executive director at Longnecker & Associates, a Houston-based executive compensation company that consults for energy and utility companies. He attributed the rise in CEO compensation to the limited supply of seasoned energy talent and the increasing demand for their services.

“In a super-regulated environment it takes a sophisticated individual to run an energy company,” Crawford said. A number of baby boomer executives are reaching retirement age, and there’ll be fewer seasoned CEOs in the marketplace. Hence, utilities have to keep CEO compensation packages competitive or face losing their talent.

After the oil boom crashed in the 1980s, which also affected utilities, many business people avoided entering the energy field, causing a dearth of executive talent who were in their thirties and forties. “Everyone is going after the same people, exacerbated by companies starting up and investors looking at energy as a good business. Money is flowing in but there aren’t that many Michael Jordans of business that create shareholder value and jobs,” Crawford stated.

In fact, SNL Energy’s 2008 survey of the top 100 utility CEOs confirms that compensation packages are on the rise. The top five earners for 2008 were: J. Wayne Leonard, CEO of Entergy Co., whose entire compensation package was \$26.2 million, including \$15.7 million in stock options; followed by \$21.3 million for Murry Steven Gerber, CEO of Equitable Resources, a natural gas company; \$19.7 million for Michael G. Morris, CEO of AEP; \$19.5 million for John W. Rowe, CEO of Exelon Corp.; and \$15.6 million for Anthony J. Alexander, CEO of First Energy Corp.

CEOs of 16 utility companies earned upward of \$10 million in compensation, and 44 CEOs earned more than \$5 million. Pay for performance has not been inhibiting the rise of CEO compensation. “Just because a board scrutinizes CEO pay doesn’t mean it’s reducing compensation. It’s trying to make sure compensation is aligned with shareholder interest and stock performance,” Crawford added.

How can CEO pay packages rise when boards are tying pay to performance? Ed Metz, director of SNL Energy,

UTILITY EXECUTIVE COMPENSATION [year ending Dec. 31, 2007]

COMPANY	INDUSTRY	EXECUTIVE	AGE	TOTAL COMP.	DEFERRED COMP.
Entergy	Power	J. Wayne Leonard	57	26,187,510	20,024,698
Equitable Resources	Natural Gas	Murry Steven Gerber	54	21,319,134	--
American Electric Power	Power	Michael G. Morris	61	19,659,476	9,335,744
Exelon	Power	John W. Rowe	61	19,491,556	120,077
FirstEnergy	Power	Anthony J. Alexander	56	15,583,672	5,940,674
Dominion Resources	Power	Thomas F. Farrell II	53	15,118,207	130,134
Sempra Energy	Power	Donald E. Felsing	60	14,152,180	16,167,695
Williams Cos.	Natural Gas	Steven J. Malcolm	59	13,939,210	--
Constellation Energy Group	Power	Mayo A. Shattuck III	53	13,903,696	6,909,068
Wisconsin Energy	Power	Gale E. Klappa	57	11,761,866	1,457,322
Cheniere Energy	Natural Gas	Charif Souki	55	11,749,571	--
Edison International	Power	John E. Bryson	64	11,733,648	22,948,717
Southern Company	Power	David M. Ratcliffe	59	10,957,921	9,232,125
Atlas America	Natural Gas	Edward E. Cohen	69	10,823,317	--
FPL Group	Power	Lewis Hay III	52	10,525,923	23,099,014
Energy East	Power	Wesley W. von Schack	64	10,243,787	--
Duke Energy	Power	James E. Rogers	60	9,914,319	68,577,086
PPL	Power	James H. Miller	59	9,674,133	141,463
Mirant	Power	Edward R. Muller	56	8,569,571	394,295
Pepco Holdings	Power	Dennis R. Wraase	64	8,434,769	2,234,889
Alliant Energy	Power	William D. Harvey	58	8,354,512	3,135,671
Xcel Energy	Power	Richard C. Kelly	61	8,033,106	703,698
PG&E	Power	Peter A. Darbee	55	7,821,073	2,493,777
Dynegy	Power	Bruce A. Williamson	48	7,757,804	--
Progress Energy	Power	William D. Johnson	54	7,744,448	611,134

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said, "Boards feel a lot of competitive pressure from investors to hire the best CEOs. From an investor perspective, a good CEO will help drive a stock's value many times what his package costs." Moreover, boards employ pay for performance as a default by linking a sizeable chunk of overall compensation to stock-based incentives, but bonuses are only a percentage of the base salary.

Too many boards are not independent of the CEO, which can create problems, explained Paul Hodgson, the Camden, Maine-based senior research associate at the Corporate Library, a governance research firm. At many companies, "the board is either enthralled with the CEO or the CEO is in control," he said. In those situations, when the utility's performance and stock price falter, the CEO comes to the board, explains why targets weren't hit and that the economic situation was challenging, and convinces the board to pay the bonus.

An increasing number of energy companies are linking compensation to "earnings per share growth, return on equity and other customer satisfaction metrics," explained Ira Kay, a New York-based executive compensation consultant with Watson Wyatt Worldwide. Kay said that boards are showing increased sensitivity in the energy sector to the full compensation package of CEOs, which includes "supplemental

pensions, perquisites and severance. They have become the biggest irritants to shareholders."

Despite this crackdown, Kay declared that "boards haven't been lax" about CEO compensation. Energy CEOs "have alternatives." He continued, "They can go to private equity or another energy firm. They have labor market power, and boards are, in fact, concerned, if not alarmed, that if CEOs leave, they can cause considerable damage if the company's market cap goes down."

Some boards have been stringent about cutting CEO compensation due to poor performance. "If the stock price goes from 30 to 15, compensation is going down. Make no mistake about it," Crawford stated. Boards are increasingly holding CEOs accountable for the company's performance value and adjusting the compensation package to ensure CEOs aren't overpaid.

Indeed, Peter Lupo, managing director of the New York office of Pearl Meyer & Partners, which specializes in executive compensation, has consulted for several utilities whose CEO's compensation has been reduced. "When management doesn't hit their financial goals, pay packages are cut down," he said, though because of confidentiality agreements he can't name names. Most of this reduced compensation takes the form of restricted stock options, which do not vest in two to



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three years if these financial goals aren't met. Because a considerable percentage of executive payment stems from stock options, CEO compensation is taking a hit when options are denied.

In this new environment of pay for performance for utility CEOs, the trick for most boards is setting target goals that can be met, explained Lupo. Because the utility business is very complex, boards must set "stretch" goals in either stock price or cash flow that are attainable. "Boards don't want to set goals that can't be met. That destroys motivation," Lupo noted.

"The real question to ask about CEO pay is what is the peer group earning they're being assessed against?" explained Suzanne Hopgood, who heads the boardroom education

This intensified board scrutiny is also changing how boards operate, Peck added. In the past, CEOs often served as chairmen of their own boards. "That is being viewed as contradictory. When the chairman is independent, you get true board oversight," Peck asserted.

Hodgson concluded, "Although we've seen improvement in the link between pay and performance, we're a long way from the optimal level." He thinks that if the company hasn't met its targets that the CEO should receive only base salary and basic benefits but relinquish much of their bonus and stock options. "Too often, there's a mindset

that if we don't pay them this year, they'll leave and go elsewhere," Hodgson said. But isn't that like the owner of a last-place baseball team refusing to fire the manager because the skipper will find another job? Failure is often rewarded, Hodgson surmised.

But Hopgood says, "If you want to destroy the value of a company, change CEOs every year." Issues are never

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program at the National Association of Corporate Directors and runs the consulting agency, the Hopgood Group. Hopgood said that most boards tie performance to meeting long-range goals of five years. Often, it takes a new CEO at least a year to become familiar with the company. Even if a company's stock price declines 10 percent in one year, the company's stock may have risen 40 percent over the last four years, and the CEO will still be entitled to a bonus.

CEO bonuses though have been slashed. Charles Peck, a senior advisor to the Conference Board, a New York-based nonprofit business research firm that compiles an annual CEO compensation report, noted that if performance goals aren't met, some CEOs "are getting zero bonuses." And since most bonuses begin at a million dollars and zoom upward, CEOs consider this setback as lost income.

Moreover, boards are reviewing any perquisites that seem excessive or could damage a company's reputation if they were revealed in the daily newspaper or online. Outside of basic entitlements such as automobile use and financial planning, any extra perquisites such as jet use and country club memberships are being questioned, Crawford suggested. Furthermore, SEC rules dictate that boards must disclose the dollar amount of these perquisites, which discourage the kind of extras that were lavished on ex-General Electric CEO Jack Welch.

black and white. If a company has had four CEOs in four years, the board may want to give the CEO more time to improve the valuation and stock price before dismissing him in order to create some stability. Furthermore, changes occur industry-wide. A board at an airline company might not fire a CEO because the stock price declined if fuel prices rose from \$60 to \$125 a barrel, she says.

Utilities themselves are tight-lipped about discussing how their compensation board operates and whether they are taking a harder line on CEO pay packages. Several utilities declined to make their director of the compensation board available for interviews, suggesting that these were internal matters, not something they wanted to disclose to the public.

Looking into his crystal ball, Peck of the Conference Board envisions that utility CEO compensation will reflect the prevailing economy. "If we indeed go into a recession, CEO compensation won't be increasing at the same rate," he said. Yet he noted that even in recessionary times, utilities can prosper because people can cut back on buying sweaters and new refrigerators but won't turn off their lights or air-conditioners. "If the energy business is sustained and companies meet performance goals, CEO compensation will boom along," he concluded. ☺

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