Remuneration Benchmarking in the Utilities Sector

Utilities benchmark

A newsletter with focus on Executive and Board Remuneration in the Utilities Sector

Special Issue January 2022

2021 - A Year of Consolidation & Structural Review

Each year we undertake a benchmark analysis of board and executive remuneration in the Utilities Sector across Australia and New Zealand. This year we analysed remuneration practice for sixty-one utility companies involved in electricity generation, transmission, distribution and retail, gas production, distribution and retail, water supply, wastewater treatment, recycling and retail.

A number of observations are relevant:

Remuneration Strategy

Some companies, particularly energy based utilities, have taken the opportunity to review and re-align their executive remuneration strategy in 2021. Some have reduced STI opportunity and at the same time increased the LTI ceiling to focus on long term sustainability. The effectiveness of this change remains in question with heightened risk across a range of factors.

Remuneration Reviews

We've seen Fixed Annual Remuneration (FAR) remain relatively stable during the year with some awarding modest increases and others not proceeding with annual executive reviews. In some instances those that did not make upward adjustments to FAR experienced financial pressures on revenue, NPAT and ROE.

STI Payments

Some utilities did not pay an STI in 2021. Financial results were down, particularly for retailers. Safety performance generally remained sound as did customer outcomes. Employee engagement slipped for some as the impact of work from home tested endurance. However results on this measure perhaps mask a deeper level of commitment and resilience displayed by employees across the Sector in unprecedented circumstances.

So let's have a look at some macro indicators of the state of board and executive remuneration across the Utilities Sector.

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In this Newsletter we discuss the challenge of formulating executive remuneration strategy in 2022. A moderate market correction is underway with Boards and Remuneration Committees applying the brakes to increases in Fixed Annual Remuneration. Some state governments froze FAR increases and STI payments for their utility companies in 2021. Many private sector utilities followed a similar policy particularly those with significant retail exposure.

Geoff Nunn & Associates

Geoff Nunn & Associates was established in 1993 as an independent provider of remuneration and governance services to the government and corporate sectors. We specialise in working with Boards and CEOs in the areas of board and executive remuneration strategy, corporate governance, board dynamics and renewal, and governance structures.

Our Services

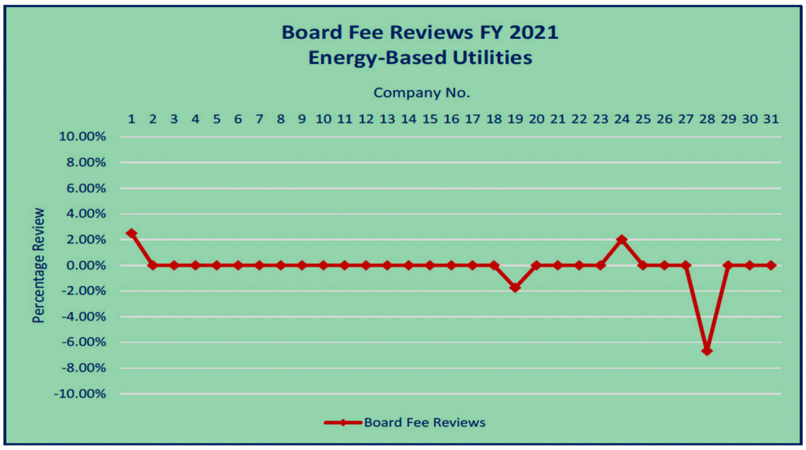
- Board & Executive Remuneration Strategy
- Innovative Remuneration Solutions
- Board Advisory Services
- Board Governance Advice
- Facilitated Boardroom Dialogue
- Focused Board Renewal
- Board Charter Drafting

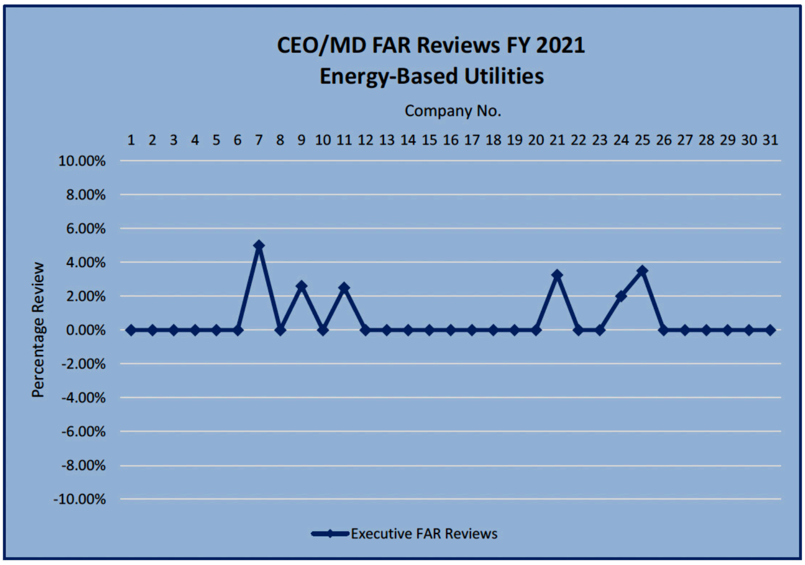
The Annual Review Question

FY 2021 & 2022

Has the Market Flatlined or Entered a Period of Correction?

It is illustrative to have a look at what's happening in terms of annual reviews of board fees and executive fixed annual remuneration. Most of the energy based utilities in our benchmark took the opportunity to place board fees on hold for FY 2021. Two utilities reduced fees during the year and only two awarded a modest increase (2.5%). The consensus was that board fees were appropriate at their current level and no adjustment required. The following graph illustrates:





Remuneration Committees also took a conservative view when it came to reviews of CEO Fixed Annual Remuneration. Most kept FAR on hold although a small number made adjustments in the range of 2.5% to 5.0%. We expect restraint to continue in 2022 although pressure will continue to mount for specialist executive roles such as CIOs and GMs Regulation.

What's Happening in the Water Industry?

All but one of the 30 water companies in our benchmark analysis is in government ownership. The one private sector company provides outsourced operational services to a government entity. So we would expect a relatively conservative approach to remuneration reviews in this Sector. And this has indeed been the case. Executive increases in FAR have been muted and generally in the range of 1.0% to 2.5%. Of particular note has been the Water Industry's move away from variable "at risk" remuneration.

In Victoria the move to exit STI or bonus plans in Water Utilities accelerated in 2020 with an offer to "buy-out" existing executive contractual arrangements. An adjustment to Fixed Annual Remuneration was made to those who accepted the offer. We understand that most did.

The Victoria State Government Remuneration Tribunal also mandated an upper limit of 1.2% for annual remuneration reviews for 2021 for government owned entities. This covered the 18 Victorian water utilities. Other state governments and boards approved increases of up to 2.5%.

From an overall remuneration perspective the Water Industry tends to be more conservative than Energy- Based Utilities. To the best of our knowledge no water based utility offers and LTI Plan. Some still offer STIs. NSW, Victoria, SA, SA, ACT and NT do not generally offer STIs to executives. Queensland water utilities offer bonuses capped at 15.0% to 20.0%.

In contrast energy-based utilities, particularly those listed on the ASX or NZX, or in private ownership, offer considerable variable reward packages. STIs ceilings range from 15.0% to 175.0% and LTIs 25.0% to 150.0% of FAR.

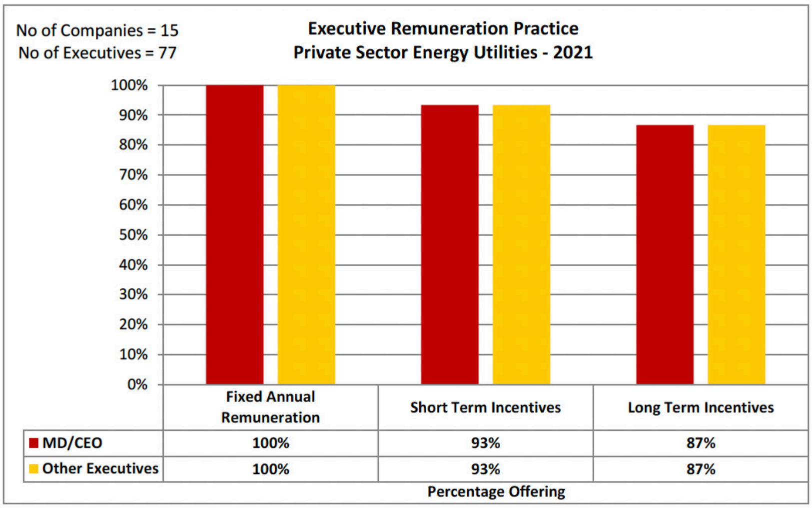
Government vs Private Sector:

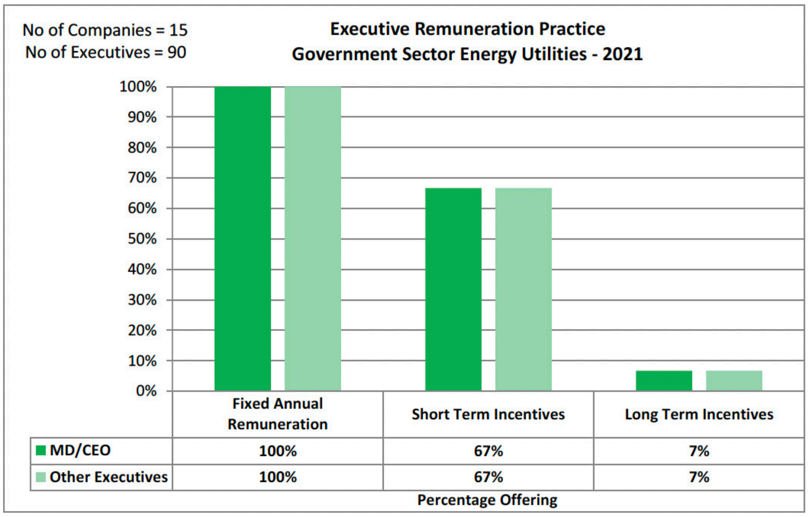
The Strategic Difference

The Differences Explained:

Perhaps the most striking differences between government and private sector utilities, in terms of executive remuneration, is that government organisations, do not offer long term incentive plans as part of their remuneration mix. There is one exception; Snowy Hydro, which offers a non-equity based LTI to its CEO and other executives.

Two-thirds of government-owned energy utilities offer executives participation in some form of STI plan although caps tend to be modest (15.0% to 30.0% of FAR). The following graphs illustrate the contrasting position in energy based utilities:





One private/public energy based utility in our benchmark analysis did not offer an LTI. Two thirds continue to offer an STI.

Low Carbon Remains Centre Stage in New Zealand

Late 2019 the New Zealand Parliament passed the Climate Change Response (Zero Carbon) Amendment Act which sets some ambitious carbon reduction targets. The primary target is for net zero emissions by 2050 in line with the Paris 2015 Accord and COP 26. All utilities in New Zealand have taken this on board and developed comprehensive emissions reduction programs. To support these targets the New Zealand Government established the Climate Change Commission.

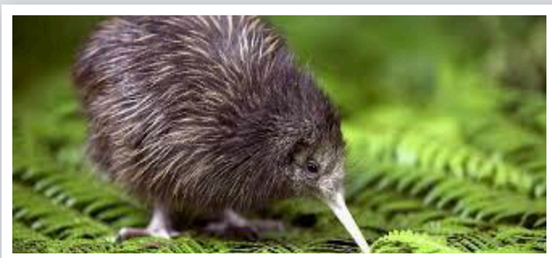
This is its mandate:

"We are an independent Crown entity set up to provide expert, evidence-based advice to successive governments to help Aotearoa (New Zealand) transition to a thriving, climate-resilient and low emissions future. We monitor and review the Government's progress towards its emissions reduction and adaptation goals and their effectiveness.

Our independence means we can provide impartial advice, challenge and hold the Government to account for action on climate change.

We are a small team dedicated to ensuring we can pass a better Aotearoa on to future generations. We have a range of expertise, including economics, public policy, land and resource management, Māori sector, climate science, behavioural sciences, forestry, agriculture and energy. We are supported by a board of seven commissioners from different fields. "

Energy based utilities and water companies in New Zealand have embraced the country's net zero 2050 strategy and established ambitious targets. Australia is rapidly catching up with new developments such as Sun Cable, and initiative of David Griffin, Mac Thompson and Fraser Thompson which will deliver solar power, via undersee cable, to Singapore.



The Macro Agenda

APRA CPS511 & Remuneration Governance

Executive Remuneration Compliance Tightens in APRA Regulated Entities

In the wake of the Banking Royal Commission APRA has tightened governance requirements for executive remuneration in APRA regulated financial institutions. Evidence presented at the Royal Commission strongly implicated executive remuneration practices with corporate misconduct. CPS511 is due to come into effect on 1 January 2023 and applies to organisations in the following categories:

- Authorised Deposit Taking Institutions (ADIs).
- General Insurers.
- Life Insurers and Friendly Societies.
- Private Health Insurers.
- Registrable Superannuation Entity Licensees (RSEs).

The main features of CPS511 are summarised below:

1. Companies must maintain a prudent and documented remuneration policy which provides clear lines of accountability and does not reward executives for failures of risk management.
2. Companies must ensure the remuneration framework aligns with business plans, strategic objectives and the company's approach to risk management.
3. The Prudential Practice Guide (PPG) is intended to support and not be perscriptive of entities in their management of executive remuneration. CPS511 aims to increase the focus on non-financial metrics.
4. CPS511 emphasises the Board's role in remuneration governance oversight across the total organisation. The focus is on CEO and Executive remuneration however, the Board must adopt a watching and governance brief across all organisational levels including certain outsourced provider arrangements.
5. For the CEO 60.0% of variable reward must be deferred for a minimum of 6 years with pro-rata vesting after 4 years. For other executives 60.0% must be deferred for a minimum of 5 years with pro-rata vesting after 4 years.

CPS511 itself contains some 77 points of regulation and the Prudential Practice Guide 81 points of guidance. Whilst well intentioned the framework further embeds the existing remuneration paradigm in financial institutions, with its inherent shortcomings. It will prove to be yet another prodigious compliance task for boards and remuneration committees and keep the major accounting, legal and remuneration advisory firms busy for years to come.

Wayne Bryes - APRA - Source Lawyers Weekly

What Does CPS511 Mean for Utility Company Remuneration Committees?

Most of the major listed and private sector utility companies follow executive remuneration strategies that are similar in structure to listed financial institutions. All have deferral periods on LTIs of 3-4 years, which is more than adequate.

In the financial services sector many super funds do not have LTIs as part of their executive remuneration strategy although some have modest STIs. Many government owned utilities follow a similar executive remuneration model. As mentioned on Page 3, the Water Industry, in particular, has been moving away from STIs for some time. Victoria has 18 water corporations. Effective 1 July 2020 these corporations made a once only offer to but out bonus opportunities from executives with an amount rolled into FAR. No future contracts are to include STIs. This brings Victoria into line with WA, SA, Tasmania, NSW, ACT and NT. Qld water corporations still offer STIs to executives.

CPS511 will impact listed and private sector utility companies. Remuneration Committee oversight of all remuneration processes will increase. Focus on managing risk and compliance will strengthen and some will consider lengthening the vesting periods on LTIs.

Some utility companies do not currently have documented board and executive remuneration policies in place. Rather they rely on employment contracts and mix special purpose documents (STI and LTI guidelines). CPS511 will increase the pressure on remuneration committees to ensure that they have fully documented board and executive remuneration strategies and policies which reflect their operating environment and governance requirements.