GEOFF NUNN & ASSOCIATES

Governance and Board Advisors

Governance Update: Executive and Board Remuneration in the Utilities Sector

May 2022

Remuneration Strategy in the Utilities Sector

Balancing Risk and Reward

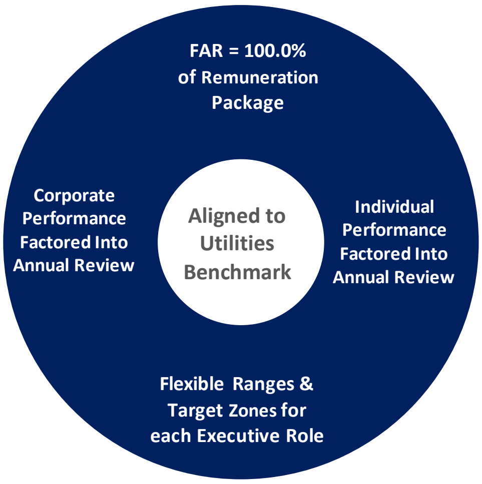
We often get asked the question: "What's the best executive remuneration framework for our organisation?" There is no one-size fits all. Each company's executive remuneration framework needs to be specifically designed for its governance and operating environment. There are a range of factors to take into account:

1) The company's ownership and governance structure.
2) The degree to which the company has a market monopoly.
3) The applicable regulatory framework.
4) The company's operating and risk environment.
5) The company's commercial orientation and focus.
6) The company's geographic scope of operations.

In this Newsletter we are going to discuss three base executive remuneration frameworks and the environments in which they might be appropriate.

The Zero "At Risk" Model

With this model the executive package is comprised entirely of Fixed Annual Remuneration (FAR). This is no variable "at risk" remuneration. The following diagram illustrates:



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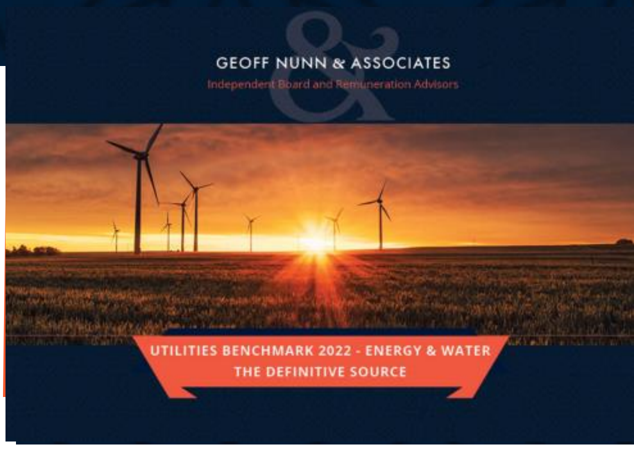

Utilities Benchmark 2022 Report

Now Available

The Utilities Benchmark 2022 is the most comprehensive analysis of board, CEO and executive remuneration in the Utilities Sector that has ever been undertake in Australia and New Zealand.

See: https://www.gna.net.au/utilities-benchmark

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
- Innovative Remuneration Solutions
- Utilities Benchmark
- Remuneration Governance
- Board Governance Advice
- Facilitated Boardroom Dialogue
- Focused Board Renewal
- Board Charter Drafting

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The Zero "At Risk" Model (Continued)

This model is typically used in government owned utilities which operate in a monopoly, or near monopoly, environment. The risk of losing market share to competitors is non-existent or relatively low. Therefore revenue may not be subject to large fluctuations, although the pandemic has placed pressure on revenue for some utilities where an increase in distressed customers has been the result.

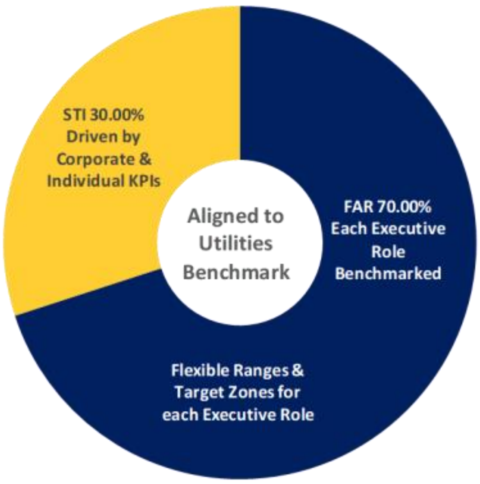
Pricing may be regulated through the Australian Energy Regulator or various state and territory regulators for water companies. This process again contributes to stability of revenue.

Governments generally do not favour "At Risk" remuneration plans such as STIs and LTIs in water utilities. Very few water utilities continue to offer STI plans. Queensland if the exception where state and council owned water companies offer modest STIs. Most energy-based utilities, whether government or privately owned, offer STIs.

The real innovation that we are able to offer in terms of the Zero "At Risk" Model is the corporate performance into the annual review process via a performance multiplier. This ensures that the collective focus of the executive team remains on corporate performance.

Moderate "At Risk" Model (Example Only)

In a market driven environment where the organisational risk profile is somewhat more elevated than those organisations in a monopoly situation it may be appropriate to place some executive remuneration "at risk" via a Short Term Incentive (STI) plan.



The level of variable at risk remuneration is dependent on a number of factors:

Moderate "At Risk" Model (Continued)

- The organisation's ownership structure with government owned energy utilities generally favouring a lower STI configuration.
- The nature of the competitive environment in which the organisation operates.
- The regulatory regime under which the utility operates. Where pricing is regulated and volumes relatively predictable a lower level of variable remuneration might be appropriate. If the pricing is unregulated greater variability would suggest a higher at risk.
- The view of key stakeholders.. Some boards are prepared to go against market trends and embrace innovative models which broaden the base and weighting of STI KPIs.

Market practice data is available in our **Utilities Benchmark 2022.** It covers the incidence and level of at risk remuneration for those companies which have adopted the Moderate "At Risk" model. Perhaps the greatest challenge is striking the right balance of financial versus non-financial KPIs and ensuring the appropriate weighting is applied. Over the last three years targets associated with lowering green house gas (GHG) emissions and other environmental KPIs have begun to appear in STI and LTI plans. This is a positive development and places climate change firmly on the agenda for utility companies.

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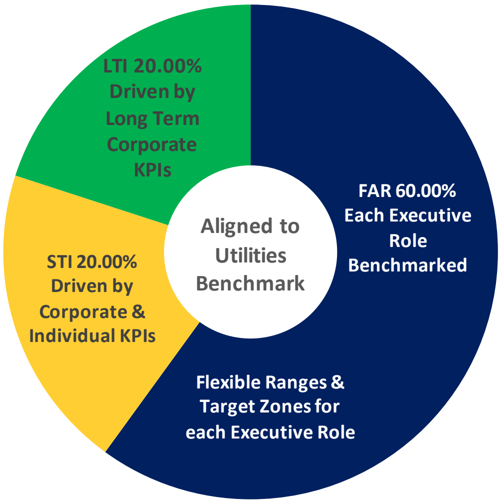
High "At Risk" Model (Example Only)

For utility organisations in a highly competitive, market driven environment the High "At Risk" Model might be the best fit.



This model tends to be favoured by privately owned and listed companies where the emphasis is both the immediate short term financial and operational performance and on the creation of longer term shareholder value and returns. To the best of our knowledge only one energy based utility in government ownership (Snowy Hydro) offers both an STI and an LTI plan to its executive team.

Listed utilities tend to defer part of the STI. That is, only part is paid in cash in the year that it is earned. Percentages vary but in the case of AGL Energy 25.0% to 50.0% is payable in restricted shares which must be held for a minimum of 2 years. In this case 60.0% of the STI is driven by financial performance and the other 40.0% by a range of KPIs linked to business strategy.

LTIs are almost always driven by shareholder metrics such as Total Shareholder Return (TSR) and Return on Equity (ROE). Again using AGL Energy as an example this company uses these measure at 33.3% weighting each and in 2020 introduced carbon transition metrics into their LTI with a weighting of 33.3%. All LTIs in listed companies vest over a 3-4 year period.

Many privately owned utilities also offer executive participation in a cash based LTI which vest over a 3-4 year period.

Determining the appropriate proportions for the FAR/STI/LTI mix with this model presents its own challenges with owner and regulator stakeholders having a major input on decision making.

A Word of Caution About the High "At Risk" Model

The Banking Royal Commission of 2018 and 2019 clearly highlighted problems associated with high levels of variable "at risk" remuneration driven primarily by financial metrics, particularly short term profitability and shareholder returns.

The Royal Commission determined that the structure of executive remuneration in the major banks and other financial service organisations which follow a similar model was implicated in the very serious corporate misconduct that was uncovered.

APRA has developed a framework to regulate executive remuneration (CPS511) in the financial services sector. This additional level of regulation comes into effect on 1.1.2023 and is certain to place an increased compliance burden on Boards and Remuneration Committees in this sector.

The key imperative for utility companies which choose to implement the High "At Risk" Model is to ensure that the balance the interests of all key stakeholder groups including shareholders, customers, employees, suppliers, regulators and governments in setting KPIs.

A Final Word

As mentioned in the introduction there is "no one size fits all". Executive remuneration strategy development is a major undertaking. Not an accounting exercise. We have worked with a diverse range of utility companies. Give Geoff Nunn a call or send an email . Contact details are below.

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