Compensation Survey and Peer Group Data Integrity & Analysis Problems

Steve Hennigan, CPA
CPS Energy Board Chair

Mark Van Clieaf
Ken Stewart, FSA, FCIA, MAAA

MVC Associates International
Consultants In Organization Design, Leadership & Shareholder Value
www.mvcinternational.com
Mark@mvcinternational.com
Tampa • Houston • Toronto • London

Data Integrity & Analysis Problems With Industry Compensation Surveys
(Business & Top Jobs NOT Comparable)

- Major Compensation Surveys Mixing together compensation data from:
  - Utility sectors including Telephone, Wireless, Internet & Electricity where business models very different and not comparable directly
  - Power Electric Utilities:
    - International vs. USA Only
    - Generation (major assets), Transmission & Distribution vs. ONLY Transmission & Distribution
    - Coal, Gas generation vs. Coal, Gas, Nuclear, Wind generation
  - Surveys state CPS top jobs at the avg of 42nd percentile - but data & analysis questionable
  - Regression on Revenue (accepted compensation industry standard) does NOT fix data integrity, survey peer and Top Job comparability problems & misleading pay percentiles
  - NO business Performance data on companies in surveys - high vs. low performance companies relative to pay levels
  - Mixing apples, oranges & pears, leads to compensation ratcheting effect - Executive Pay chasing Executive Pay
  - Similar challenges in other industry sectors

Problematic Industry Compensation Surveys

(Business Complexity & Top Jobs NOT Comparable)

Company	Revenue $ Millions	Business Complexity	Geographic & Regulatory Complexity
AES Company	$ 11,564	• Power Generation & Wholesale • Electric Distribution & Retail • Alternative Energy Wind & LNG	• 26 Counties including North America, Europe & Africa, Latin America, Asia, Middle East
Sempra Energy	$ 11,761	• Power Generation & Wholesale • Electric Distribution & Retail • Gas Pipeline & Storage • LNG Terminals • Commodities Mgmt	• USA, Europe, Canada, Mexico, South America, & Asia
Reliant Energy	$ 10,877	• Power Generation & Wholesale • Electric Distribution & Retail	• USA only - 4 states

Compensation Committee Needs Quality Assurance Check

Pay Reports, Peer Groups & Pay Percentiles

Based on recent MVC Associates experience for numerous clients (board & management) in reviewing the work / reports of major compensation consulting firms & executive compensation surveys used:

- Directors & management can't just "check the box" with current compensation reports & accept peer groups & pay percentiles at face value
- Nor can Directors solely rely on reputable compensation consulting firm to check another firm's work to provide a defensible QA check for Board
  - Directors must exercise their own judgment on a meaningful process for developing peer groups, pay analysis & pay percentiles that will be certified as valid & accurate
  - Risk that new certified SEC Compensation Report / CD&A could contain materially misleading statements to shareholders

Check for Quality Assurance & Data Integrity Problems with Compensation Reports ➔➔ Jobs & Pay Not Truly Comparable

- Mixing executive roles at fundamentally different Levels of Work & role complexity across industries & sectors
  - *see MVC Research on CEO Levels of Work*
- This leads to faulty peer groups, compensation surveys & reports:
  - Mixing industry sub-sectors = unreliable pay percentiles
  - Regression on Revenues NOT a defensible process for developing pay comparables
  - Proxy Peer groups targeting 0.5X to 3X revenue size fosters a pay spiral
  - Mixing companies with different pay philosophies (target 50th, 75th percentile)
- Faulty job matching / compensation calibration applied to public filings data & compensation surveys may lead to compensation data integrity problems for pay analysis & MATERIALLY unreliable pay percentiles & disclosures
  - Mixing USA Only & Global companies - e.g. 49 % TDC pay level difference at median CEO pay
- Not all CEO, COO, CFO, Top C-Level roles are created equal - but too many compensation consultants & surveys treat roles with the same titles as equal:
  - Campbell's Soup vs. P&G
  - Eli Lilly vs. J&J
  - Gateway vs. Dell

Compensation Analysis / Report Quality Assurance For Directors

- Telecom company compensation report
  - Different complexity of businesses, peer group not truly comparable and NO business performance data in compensation report analysis
  - In the end board disregards primary consultant report, exercises judgment & sets targeted TDC compensation at 25 % of existing peer group
  - CEO could not disagree with logic, bought in and no one from management left
- Software company compensation report
  - used peer group from $ 500 Million to $ 10 Billion for a $ 700M North American company
  - Used a mix of hardware & software companies many not comparable
  - Used a mix of Global & US Only peer companies
  - NO business performance data / analysis on any of the peer companies
  - Avg positioning for NEO's in primary consultant report at 36 % below the median
  - Board chose to agree to 10 % increase in TDC BUT NOT too median due to concerns with faulty peer group and pay percentiles analysis
- Directors educated about data integrity & analysis problems, get second expert opinion, & exercise their judgment on CEO / NEO final pay decisions