

CEO & Enterprise Internal Pay Equity Multiplier & Optimal Management Structure Analysis

**Compensation Standards.com
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Steve Hennigan, CPA
Board Chair CPS Energy

Mark Van Clieaf

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

Original Internal Pay Equity Research

Felt Fair Pay - “FFP” = 2 X

- 13 research studies over 15 years with 1000+ managers from CEO to front line in USA, Canada, UK
(see MVC Associates International published articles)
- Differential Work justifies Differential Pay & data shows a consistent Felt Fair Pay multiplier / differential
- Each TRUE differential Level of Work *(see Appendix)* was identified as worth 2X more in Total Direct Compensation than the level directly below it
- MVC Associates has effectively applied 2X to 2.5X differential to its 5 Levels of CEO Work analysis for clients worldwide

Jeff Immelt, CEO of GE Validates 2X to 3X CEO Pay Differential as Felt Fair Pay - FFP

- Winter Issue of *Compensation Standards*:
“CEO role should be paid within a small range of the top 20+ executive team members”
- Immelt points out that his pay is within 2 to 3 times his top executive team members

Moody's Multi-Dimensional Credit & Governance Risk Analysis including Red Flag > 3X CEO Pay Differential

June 2006 Comment on CEO Pay Structures

- Board Picks & Pays the CEO
- RED FLAG > 3X CEO to any NEO pay differential
- > 3X CEO pay differential is a possible indicator of weak board & poor corporate governance
- > 3X CEO pay differential is a possible indicator of key person risk & CEO succession problem
- Outsized CEO pay to peers also a key warning flag for other potential governance & credit risks

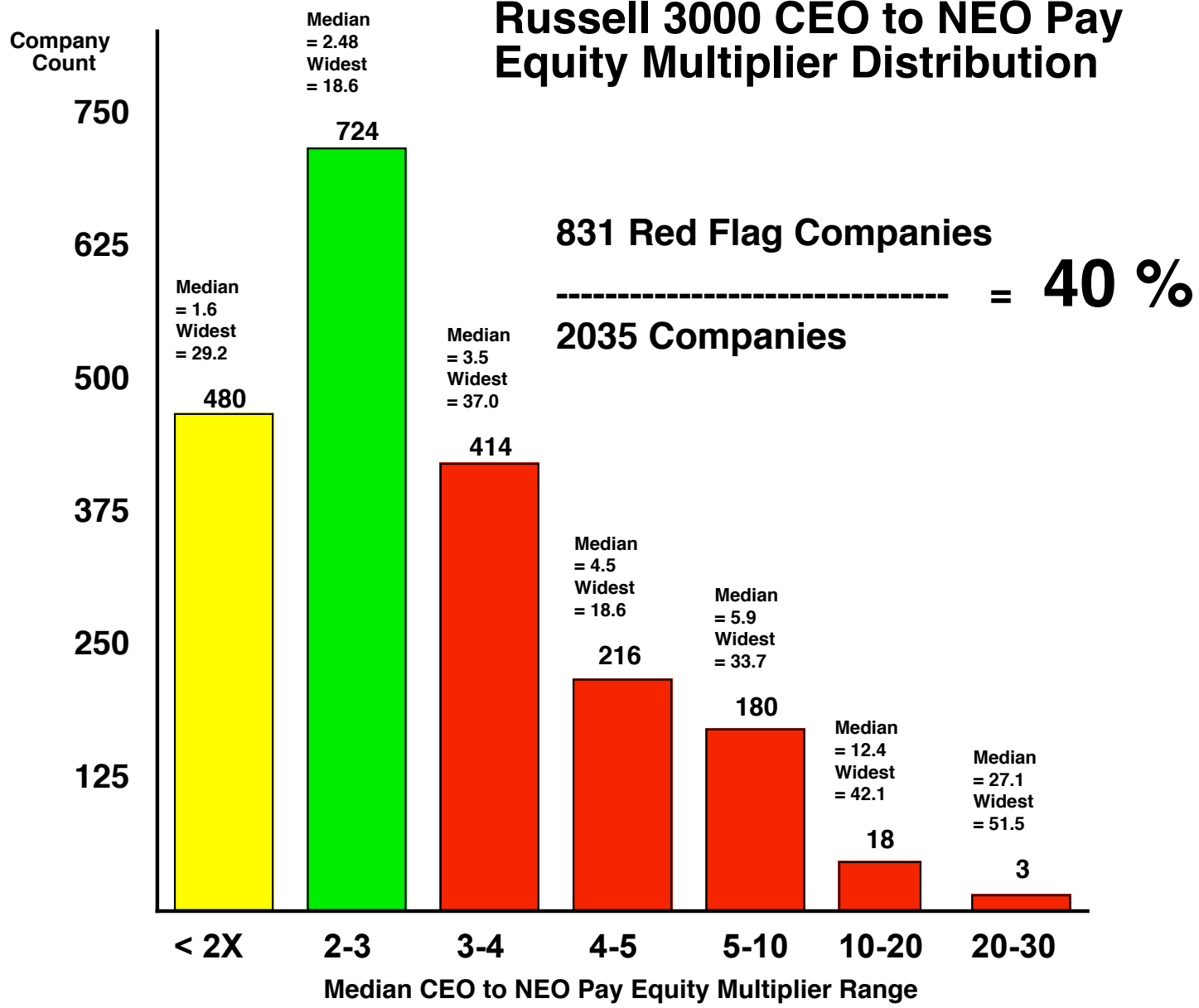
High CEO to NEO PEM May Indicate

- CEO pay not justified by CEO Level of Work (5 CEO LEVELS) nor validated by Truly Comparable Peer Group & Pay-for-Performance links
- NEO Group may lack appropriate delegated decision authority relative to CEO Role
 - Management structure risk / overly dominant CEO
- Poorly structured performance metrics & poor delegation of truly Differential Work cascading throughout the Organization
 - Failure of executive team to be accountable for Future Value, growth & innovation already built into enterprise valuation
 - May foster drive for acquisition vs. organic growth, high balance sheet leverage at the risk of LONG TERM sustainable value creation
- Weakness in Internal Succession Planning in the natural talent pool – the NEO's & 3rd tier of Management
- Weakness in Board processes, Director Independence & Execution of Fiduciary Duty
- Broader systemic & governance risks

NEW MVC Assoc RESEARCH SAYS CEO Internal Pay Equity Multiplier (PEM) is in 2X to 3X Range

- MVC Associates Board clients ask: What is a standard for CEO Pay Fairness / Equitable CEO Pay Differential?
- MVC Associates conducted research across the Russell 3000 (2000 companies for 2003 to 2005)
- Setting aside the extreme outliers, our analysis shows the median value of the CEO to Median NEO Pay Differential for 1600 companies for 2003 to 2005 is 2.45X – within the 2X to 3X range

Russell 3000 CEO to NEO Pay Equity Multiplier Distribution



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Model Internal Pay Equity Table

Internal Pay Equity Multiplier
for each Work Level **2.52**

Starting "X" Total Compensation
\$ for Senior Manager / Entry Level
Director **\$118,000**

4000 compensation data points - TOTAL COMPENSATION

Work Level	Work Level 7	Work Level 6	Work Level 5	Work Level 4	Work Level 3	
Management Layer Down From Board	1	2	3	4	5	
	Global CEO Pay Band \$	COO / Sector CEO or Sector President Pay Band \$	Business Unit President Pay Band \$	Business Unit SVP or VP Pay Band \$	Snr Mgr / Director Pay Band \$	
Cumulative Pay Multiplier from "X" from Senior Manager or Entry Level Director	101.63	40.33	16.00	6.35	2.52	1.00
Top of Total Equitable Compensation Band by Work Level	HIGH	\$ 11,391,599	\$ 4,520,476	\$ 1,793,840	\$ 711,841	\$ 282,477
Middle of Total Equitable Compensation Band by Work Level	MEDIUM	\$ 7,176,033	\$ 2,847,632	\$ 1,130,013	\$ 448,418	\$ 177,944
Bottom of Total Equitable Compensation Band by Work Level	LOW	\$ 4,758,654	\$ 1,888,355	\$ 749,347	\$ 297,360	\$ 118,000

MVC Associates International Internal Pay Equity Benchmark Analysis

Highlighted Areas
Fit Internal Pay
Equity Model

Company	Assets - \$ Millions	ROIC %	Net Income \$ Millions	Revenue \$ Millions	Total Compensation \$ = Base + Bonus + Non-Equity Incentive + GrantDFVSO		Internal Pay Equity Multipliers		
					Global CEO Total Comp \$	Global COO or Sector CEO / President \$	CEO TO COO / President Multiplier	COO / Sector Pres TO Mid Mgmt Pay Multiplier - Layer 5 - Snr Mgr / Director = \$ 118,000	CEO TO Mid Mgmt Pay Multiplier - Layer 5 - Snr Mgr / Director = \$ 118,000
Work Level					Work Level 7	Work Level 6			
Exxon	\$ 138,014	23.2	\$ 39,500	\$ 377,635	\$ 17,891,025	\$ 8,015,898	2.23	68	152
GE	\$ 697,239	3.3	\$ 20,829	\$ 163,391	\$ 14,605,125	\$ 8,684,189	1.68	74	124
ConocoPhillips	\$ 164,781	7.6	\$ 15,550	\$ 188,523	\$ 14,586,778	\$ 6,072,118	2.40	51	124
J&J Corp	\$ 70,556 \$ 30,831	19.3 21	\$ 11,053 \$ 5,234	\$ 53,324 \$ 85,449	\$ 14,649,560 \$ 8,237,430	\$ 4,713,801 \$ 3,707,453	3.11 2.22	40 31	124 70
Merck	\$ 44,569	13.6	\$ 4,433	\$ 22,630	\$ 7,828,634	\$ 5,991,836	1.31	51	66
UPS	\$ 33,210	14.5	\$ 4,202	\$ 47,547	\$ 4,097,520	\$ 1,357,820	3.02	12	35
3M	\$ 21,294	24	\$ 3,851	\$ 22,923	\$ 14,735,623	\$ 4,235,721	3.48	36	125
McDonalds	\$ 29,023	8.1	\$ 3,544	\$ 21,586	\$ 12,775,092	\$ 3,585,555	3.56	30	108
Caterpillar	\$ 50,879	6.4	\$ 3,537	\$ 41,517	\$ 12,403,552	\$ 4,716,220	2.63	40	105
Dupont	\$ 31,777	11.7	\$ 3,148	\$ 28,982	\$ 10,139,960	\$ 4,795,305	2.11	41	86
Aloca	\$ 37,183	7.1	\$ 2,248	\$ 30,379	\$ 9,433,601	\$ 3,940,986	2.39	33	80
Honeywell	\$ 30,941	9.7	\$ 2,083	\$ 31,367	\$ 9,576,192	\$ 5,156,577	1.86	44	81
Kimberly Clark	\$ 17,067	12.9	\$ 1,499	\$ 16,746	\$ 9,486,469	\$ 2,294,334	4.13	19	80
Xerox	\$ 21,709	6.4	\$ 1,210	\$ 15,895	\$ 10,235,700	\$ 3,915,015	2.61	33	87
General Mills	\$ 18,184	8.1	\$ 1,144	\$ 12,442	\$ 11,606,405	\$ 4,613,194	2.52	39	98
Whirlpool	\$ 13,878	6	\$ 433	\$ 18,080	\$ 9,411,446	\$ 3,258,221	2.89	28	80
Goodyear	\$ 17,029	-4.6	\$ (330)	\$ 20,258	\$ 11,741,653	\$ 3,586,688	3.27	30	100
Median	\$31,359	8.1	\$ 3,541	\$ 29,681	\$ 10,921,053	\$ 4,424,458	2.47	37.50	92.55
Internal Pay Equity Multiplier Model							2.52	40.33	101.63
Minimum	\$ 13,878	-4.6	\$ (330)	\$ 12,442	\$ 4,097,520	\$ 1,357,820	1.31		
Maximum	\$ 697,239	24	\$ 39,500	\$ 377,635	\$ 17,891,025	\$ 8,684,189	4.13		

CPS Energy Board

Ensures Management Structure & Pay Alignment

- Fiduciary Duty of Directors to ensure social well being, corporate health & sustainability of the Enterprise
- Want to ensure commitment of the workforce to carrying out the enterprise mission
- Concern about rising pay differentials between CEO & other senior officers vs. the rest of the workforce (4000 employees)
- Concern that executive compensation surveys driving wider CEO pay differential & looking for alternative process to help benchmark equitable pay
 - **Work Levels & Internal Pay Equity (pay multipliers) as an alternative**

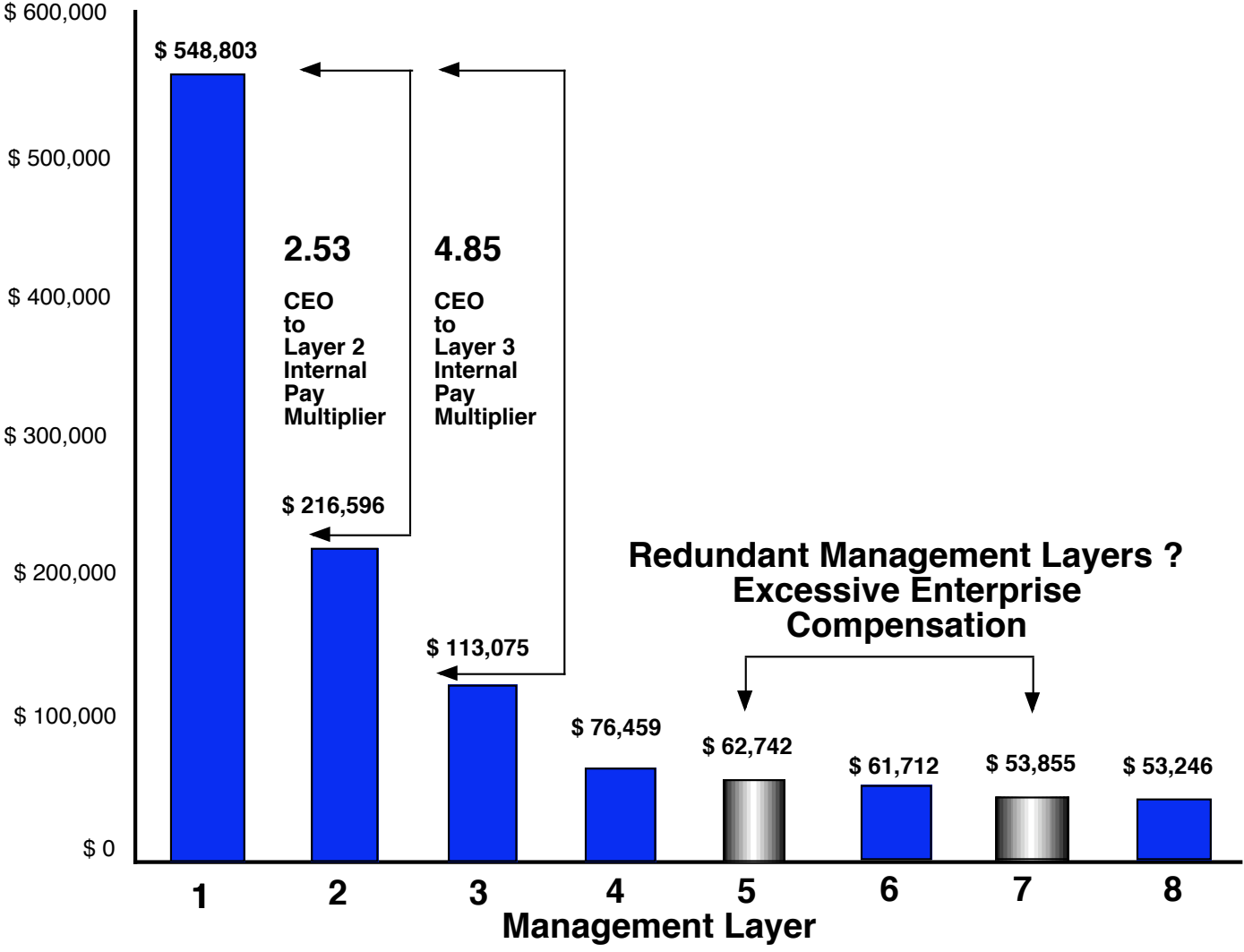
CPS Energy Board

Asks Key Questions of Management about Organization Structure & Pay

- How many layers of management do you have ?
- How many layers of management do you really need ?
 - (what the are the performance metrics for each mgmt layer that are differential & validate the value-add of each management layer ?)
- What is the internal pay differential between each management layer that justifies the differential pay / work relationship ?
- What is the headcount and total cost of management at each management layer?

CPS Energy Structure / Pay Analysis 2005

Average
Total Compensation \$\$
by Management Layer



CPS Energy 2005

Enterprise Structure & Internal Pay Analysis

Layer Down From Board	# of FTE's	Average Annual Total Compensation & Benefits by Layer	Layer To Layer Pay Multiplier	Cumulative Pay Multiplier To Front Line	Total Annual Comp & Benefits Cost \$
1 CEO	1	\$ 548,803	2.53	10.31	\$ 548,803
2 SVP	13	\$ 216,596	1.92	4.07	\$ 2,815,743
3 VP	71	\$ 113,075	1.48	2.12	\$ 8,028,321
4 Dir	237	\$ 76,459	1.22	1.44	\$ 18,120,834
5 Manager	638	\$ 62,742	1.02	1.18	\$ 40,029,526
6 Superintendent Engineer	1693	\$ 61,712	1.15	1.16	\$ 104,478,807
7 Supervisor	946	\$ 53,855	1.01	1.01	\$ 50,947,025
8 Analyst	181	\$ 53,246			\$ 9,637,591
TOTAL	3780				\$ 234,606,651

CPS Energy 2005

Mgmt Structure / Internal Pay Analysis

- CEO to NEO Pay differential at 2.5 X is reasonable as long as CEO role is doing differential work - pay multiplier needs to be monitored - challenge executive compensation survey bias to ratchet up CEO pay
- CEO (Work Level 5) to Director (Work Level 3 entry role) pay differential should be in the 4 to 5 times pay multiplier range & should be monitored regarding setting CEO pay levels
 - Consider implementing a Work Level based organization design and pay structure including internal pay equity and equitable pay differentials for each value added mgmt layer (Work Level)
- Ask CEO about the # of Management Layers knowing the organization probably needs 5 Work Levels (CEO to Front Line) not 8 organizational layers
- Analyze & Re-design Management Structure including removing non-value added management layers and excess enterprise compensation costs highlighted by small internal pay differentials

Work Levels / Internal Pay Equity Multipliers

Aligning differential work & differential pay

- Works Levels for Management Structure Design & Internal Pay Equity Multipliers for Differential Compensation
 - Can keep CEO / NEO pay levels and pay differentials in check & balance to the rest of the organization
 - Minimize the risk of being challenged on CEO pay by Institutional Investors, Moody's, media
 - Provide a framework for the design of optimal management structure & removal of excess enterprise compensation costs due to over-layering & over-titling
 - Ensure organization alignment between differential work justifying differential pay at all levels in the enterprise

Guiding Principles For The Board & Executive Management

Executive Job Design & Executive Pay

Only Differential Executive Work Justifies Differential Executive Pay

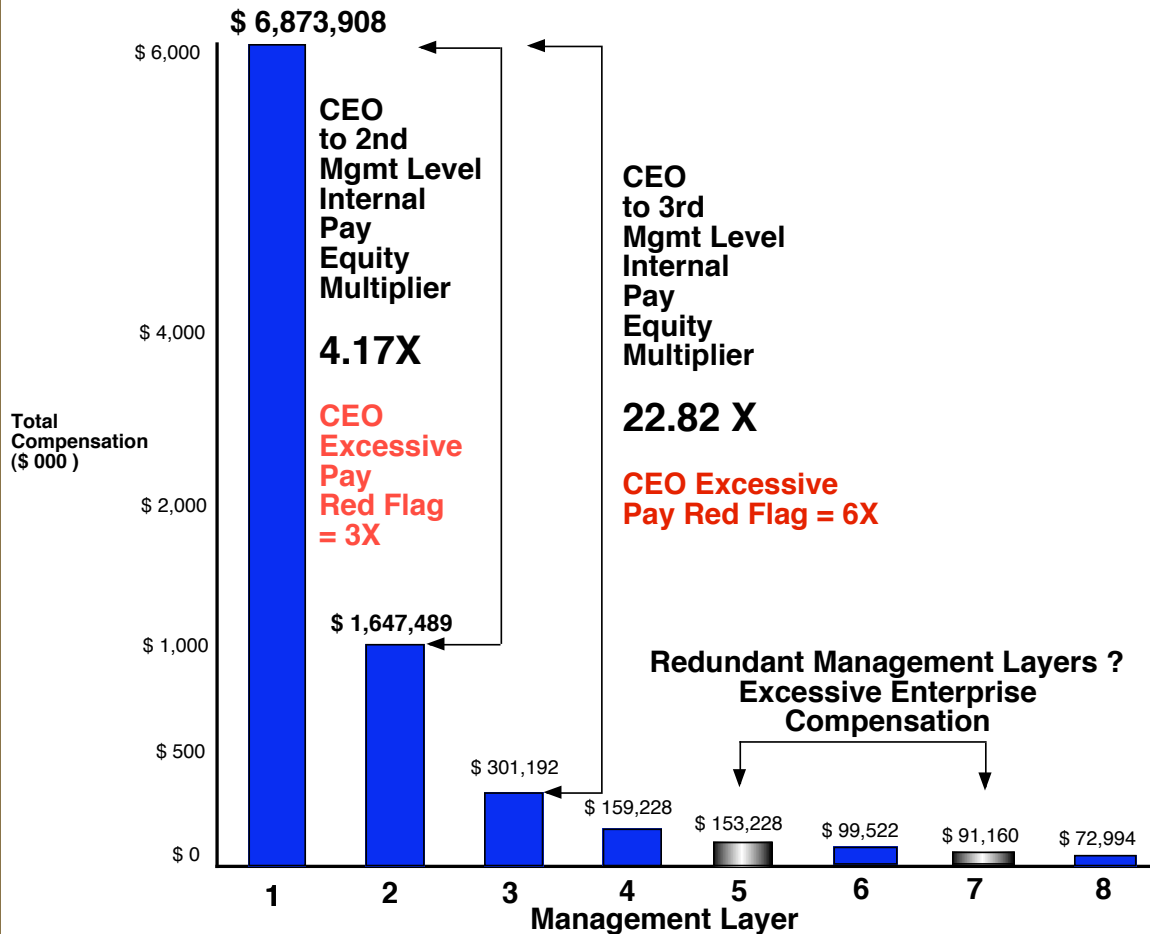
If the Top 3 layers of senior management are doing the same work including:

- Accountabilities
- Performance metrics
- Performance periods

Then what is the unique value-add that justifies current CEO / NEO compensation levels?

**Differential Executive Work is the necessary justification for
Internal Pay Equity Multipliers between Levels of Management**

MVC Board & CEO Clients Check For Wasted & Excessive Enterprise Compensation



How many management layers are truly needed?

- What is the Internal Pay Equity Multiplier between each management layer?
- Pay Multiplier Red Flags !
- Organization Re-Design undertaken to remove \$ 30+ million in wasted compensation – from over-layering & over-titling

Sample Summary
**Management Structure, Enterprise Cost of Management
 & Internal Pay Equity Multiplier Analysis**

Company \$ 4 Billion Revenues and 4000 Employees

Mgmt Layer Down From Board	# of Mgmt FTE's	Median Annual Total Management Compensation & Benefits by Mgmt Layer	Mgmt Layer to Mgmt Layer Pay Multiplier	Cumulative Pay Multiplier To Front Line Mgmt	3 year Fully Loaded Mgmt Costs Total Comp & Benefits by Layer	Mgmt Layer % of 3 yr Total Cost of Mgmt
1 CEO	1	\$ 6,873,908	4.17	94.17	\$ 20,621,724	10 %
2 EVP	7	\$ 1,647,489	5.47	22.57	\$ 37,597,269	18 %
3 VP & SVP	6	\$ 301,192	1.88	<u>4.13</u>	\$ 5,960,435	3 %
4 Snr Dir	48	\$ 159,841	1.04	2.19	\$ 29,547,779	14 %
5 Directors	35	\$ 153,228	1.54	<u>2.10</u>	\$ 15,790,520	7 %
6 Senior Mgr	135	\$ 99,522	1.09	1.36	\$ 45,826,178	22 %
7 Manager	50	\$ 91,160	1.25	1.25	\$ 17,897,343	8 %
8 Supervisor	141	\$ 72,994			\$ 38,489,693	18 %
TOTAL	423				\$ 211,730,941	100%

Executive Pay Needs

A Balanced Decision Making Process

- **Can't Determine Equitable vs. Excessive Compensation unless Board of Directors have analysis / insight on 4 tests:**
 - **External Pay Equity** = Pay Relative to Truly Comparable Work across companies with compensation calibrated to reflect the level of role complexity & job worth differences
 - **Internal Pay Equity** = Differential Work across levels in the managerial hierarchy – *see Moody's & ISS Red Flags*
 - **Pay Relative to TOTAL Wealth** = Already granted or earned over 5 to 10 yrs – a tally sheet fully loaded
 - **Pay Relative to 3 to 5 yr Performance** = Absolute & relative to proper industry sector or appropriate peer groups:
 - Revenue Growth, NOPAT & Economic Profit Growth (real earnings), Free Cash Flow
 - Return on Invested Capital and or Return on Equity
 - Total Shareholder Return &/or Market Value Added relative to a proper peer group