

USA Utilities Proxy Statement Review



Achieving the Cleaner Energy Future

Aligning Accountability, Performance Measurement & Executive Incentive Design

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Executive Summary

The need to provide safe, reliable, low cost and cleaner energy is the leadership challenge for the electric power industry, the Boards, and executive management for over 3500 utilities and independent system operators in USA and Canada.

Recent reports from the Edison Institute and EPRI (Electric Power Research Institute) identify the magnitude of the industry transformation and level of capital investment in a cleaner energy future that is required. The Edison Institute identifies in their 2008 “Transforming America’s Power Industry” report the need for the industry to invest \$ 1.5 to \$ 2 trillion dollars by 2030.

The well recognized EPRI PRISM outlines that a 41 % reduction in CO₂ emission by 2030 is technically feasible, but will require a portfolio of innovation and investment solutions to achieve a secure, reliable lower carbon future. The types of projects that are part of this multi-faceted solution include:

- Energy Efficiency and Demand Side Management (including Smart Grid)
- Transmission & Delivery efficiencies (including Smart Grid)
- Renewable Energy power generation (solar, wind, geothermal, bioenergy, hydrogen)
- New nuclear power generation
- Fossil fuel efficiency (including natural gas combined cycle)
- Carbon Capture & storage
- PEV – Plug In Electric Vehicles
- CO₂ reduction

In fact, many electric utilities already have such strategic initiatives under way and/or have budgeted for them. Since these projects are currently in progress or capital budgets have been approved and set aside, investors, Board members, and other stakeholders should expect to see executive performance measurement and incentive design, aligned to these large capital-intensive strategic initiatives. Senior utility management should be held to account for the successful deployment of these new clean energy technologies, emerging business models, sustained return for shareholders and broader impact on society.

What would aligned management accountability and executive incentive design look like?

- Performance scorecards for senior executive roles would have specific metrics & specific targets tied to these critical initiatives and a cleaner energy future
- Performance periods would be aligned to the risk horizon of the enterprise and major capital investments and their key milestones
- Key milestones and indicators of progress would be disclosed to shareholders in their US Securities Exchange Commission (SEC) filings including both MD&A and CD&A documents
- Specific metrics, specific targets, Pay for Performance payout levels all demonstrating line-of sight accountability would be disclosed in the CD&A and demonstrate executive incentive design and enterprise risk management that align to the business strategy of the utility and the strategic capital investment programs
- Incentive design would be aligned to ensure executives are taking proper action to address climate change and related regulatory risks that ensure long-term financial viability of the business model for shareholders

However, our Electric Utility Industry benchmarking analysis, based on Proxy Statement disclosures with the US Securities and Exchange Commission (SEC), indicates that a significant “accountability and incentive design gap” exists today. While many utilities are making large strategic investments in cleaner energy technologies and the transformation of their business model, there is NOT an equivalent set of performance metrics, targets and incentives that align senior management to these outcomes.

We believe setting specific metrics, targets, performance periods and incentive design for Named Executive Officers sets the “Tone at the Top” for the enterprise and is fundamental to the successful transformation of the industry and effective enterprise risk management. In addition, executive pay delivery design (including base salary, STIP, and LTIP) must be aligned with business strategy, key performance metrics and the risk horizon of the enterprise.

To briefly summarize, our review of the 2009 proxy statements of 32 of the larger US utilities identified:

- Only 11 of the 32 utilities demonstrated any level of alignment between performance measurement, pay-for performance and incentive design and a cleaner energy future based on their proxy statement and Compensation Discussion & Analysis (CD&A) section.
- 10 of 32 utilities reviewed did include a disclosure in their Compensation Discussion & Analysis (CD&A) section of their proxy identifying enterprise performance measurement and executive compensation, to broadly align to some of the required cleaner energy transformation.
- These same 10 utilities did not provide disclosure of specific performance metrics, specific targets or incentive payout levels that demonstrate direct line of sight accountability, pay-for-performance and executive compensation alignment to a cleaner energy future.

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- Only one utility disclosed multiple performance metrics, specific targets and incentive design for Named Officers that directly aligned accountability and pay-for-performance with the need for utility transformation to a cleaner energy future.

We conclude that the majority of the industry and their corporate governance, performance measurement, executive incentive design, and required SEC disclosure practices have yet to catch up to the new regulatory and societal realities and expectations. The size of this gap and opportunity for improved corporate governance and better alignment between performance metrics and executive incentive design and a cleaner energy future, is the subject of this report.

Electric Power Industry Transformation

The electric utility industry worldwide and in the USA in particular is facing the greatest challenge in its history. The intersection of a growing power demand from an increasing digital economy, buying back distributed energy resources from customers, increasing customer use of electric vehicles, a changing regulatory environment related to global climate change and CO₂ emissions, and the evolution of new cleaner energy technologies, together set the stage for the transformation of the industry and individual utilities.

While this evolution unfolds, utilities will also have to ensure system reliability and pre-empt the erosion of revenues. The disruption of the current business model through the emerging energy efficiency, dynamic pricing, and distributed energy business drivers will require utilities to be structured for a higher level of innovation than in the past. This type of business model disruption, innovation shift, and its risk for shareholders is very similar to that which took place in the telecommunications utility industry over the last 25 years.

In the context of this emerging industry transformation, and as part of our work for boards and management in the utility industry in designing executive scorecards and executive compensation, we were asked to benchmark the current state of performance metrics and incentive design and alignment to this dynamic future.

Our Analysis of 2009 Electric Utility Proxy Statements: Accountabilities and Executive Incentive Design

The following analysis is based on a detailed review of the Proxy Statements filed with the US Securities and Exchange Commission (SEC) for 32 companies across the US utilities industry sector.

Most of these 32 utilities have been identified as those SEC filing utilities at greatest risk for shareholders and broader society resulting from a material change to regulation of Green House Gas emissions and/or a Carbon Tax. These utilities have a larger portion of their future revenues at risk given a possible carbon tax that would impact profits and dividends for shareholders. Please see appendix for the complete list of all 32 utilities reviewed.

The analysis focused primarily on the Compensation Discussion & Analysis (CD&A) section of the proxy statement, which outlines in detail the performance metrics, performance periods, and specific performance targets to which executive compensation and incentive design are tied and disclosed to shareholders.

Our review of the Investor Owned (IOU) and Independent Power Producer (IPP) utility proxy statements included:

- the longest performance period aligned to incentive design and enterprise risk management
- specific metrics and targets to which accountability design, performance measurement, and incentive based executive compensation was designed
- executive incentive design that was performance based
- information disclosed to shareholders and filed with the SEC in 2009

The disclosed metrics, targets and incentive design are the same performance metrics, targets and executive incentive design which shareholders have implicitly or explicitly approved through their proxy voting process.

The move to “Say on Pay” legislation in the USA will make these metrics, targets and incentive design approval more explicit by shareholders. Directors who oversee performance metrics, targets and incentive design for utilities that have NO alignment to a cleaner energy future may find themselves at risk from activist shareholders, proxy voting services and the media regarding their corporate governance.

Detailed Proxy Analysis & Findings

Only 1 of 32 (3 %) of USA based utilities reviewed that files with the SEC had specific metrics, specific targets and pay-for-performance incentive design aligned to longer-term performance and investments and corresponding to the need for innovation regarding new clean energy technologies, new distributed energy business models and climate change risk.

Our analysis also identified the following performance metrics and incentive design components and to what extent they align to many of the EPRI PRISM components required for a lower carbon future:

- 7 of the 32 utilities (21 %) did mention energy efficiency strategies and programs for customers as a broad goal but provided no detailed CD&A disclosures related to specific metrics, targets or incentive design for Named Executive Officers.
- 3 of the 32 utilities (9 %) did mention increasing renewable energy as a broad goal but provided no detailed CD&A disclosures related to specific metrics, targets or incentive design for Named Executive Officers.
- 1 of the 32 utilities (3 %) did mention investments in SMART Grid and Distributed energy as a broad goal AND was the model in providing detailed disclosure of specific metrics, specific targets and incentive design for Named Executive Officers. This was Xcel Energy.
- 1 of the 32 utilities (6 %) did mention increasing investments in clean energy technology and related Research & Development as a broad goal but provided no CD&A disclosures related to specific metrics, targets or incentive design for Named Executive Officers.
- 2 of the 32 utilities (6 %) did mention Green House Gas reduction as a broad goal but provided no detailed CD&A disclosures related to specific metrics, targets or incentive design for Named Executive Officers.

Xcel Energy was the ONLY Investor Owned utility (1 of 32 or 3 %) that was an exemplar model for strategic alignment of performance measurement, incentive design with a new cleaner energy business model, climate change and regulatory risks.

Other exemplar cleaner energy business models are found in the Municipal Utility Sector in the USA with such companies as CPS Energy and Austin Energy. We did not analyze the larger municipal utilities, as they are not required to file with the SEC regarding their executive performance measurement and executive compensation design.

The following table summarizes our key findings and analysis from the proxy statement review.

32 USA Electric Utilities

Analysis & Statistical Summary	Longest Disclosed Performance Period	Energy Efficiency	Renewable Energy or Renewable Portfolio Standard	SMART Grid & or Distributed Energy	New Clean Energy Technology Investment & or related Research & Development	Green House Gas Reduction
	3 years (Average Risk Horizon & Capital Cycle of 10 to 20 yrs peak to trough)					
Mentioned in CD&A but NO specific metrics or targets disclosed		7 of 32 or 21 %	3 of 32 or 9 %	0 of 32 or 0 %	1 of 32 or 3 %	2 of 32 or 6 %
Specific utilities identified with general CD&A disclosures		<ul style="list-style-type: none"> • Exelon • Progress Energy • First Energy • Edison International • PSEG • Allegheny • Scana 	<ul style="list-style-type: none"> • PSEG • PPL • Hawaiian Electric 		<ul style="list-style-type: none"> • Hawaiian Electric 	<ul style="list-style-type: none"> • NRG • PSEG
Disclosed Specific Metrics, Targets & Incentive Design		1 of 32 or 3 %	1 of 32 or 3 %	1 of 32 or 3 %	1 of 32 or 3 %	1 of 32 or 3 %
Specific utilities identified with detailed disclosures		<ul style="list-style-type: none"> • Xcel 	<ul style="list-style-type: none"> • Xcel 	<ul style="list-style-type: none"> • Xcel 	<ul style="list-style-type: none"> • Xcel 	<ul style="list-style-type: none"> • Xcel

Detailed Financial & Valuation Analysis

We also undertook a financial performance analysis of the USA electric utility sector including 70 of the largest SEC filing utilities. In total, these 70 utilities generate over \$ 414 Billion in revenues, \$ 66 Billion in Net Operating Profit After Tax, and have a median dividend payout of over 4 % or \$ 1.22 per share.

The following table outlines the results segmenting the industry into two groups. The 11 Cleaner utilities based on their SEC disclosures related to metrics and incentive design (CD&A) and the other 59 more Traditional Utilities with no CD&A disclosures aligned to cleaner energy.

It appears that the Cleaner utilities are a segment of utilities that are higher performing today in their business operations, and their 5 year average total shareholder return. It may be they are using their current higher performance and operational and capital efficiency to partly fund their transformation towards a cleaner energy utility and to sustain their success and sustainability longer-term. Clearly the Cleaner energy utility segment will be of interest to long-term institutional investors.

	5 yr Avg Total Shareholder Return		4 yr Y/Y Dividend Growth		5 yr Avg Return On Invested Capital		2 yr Increase in Economic Profit	
	Cleaner	Traditional	Cleaner	Traditional	Cleaner	Traditional	Cleaner	Traditional
Median	11.76 %	7.8%	5.06 %	4.08%	7.55 %	6.64 %	1.34 %	0.79 %

NOTE: The financial performance analysis was for the trailing 1, 2 and 5 years ending in September 2009, using financial and valuation data supplied from Stockpointer. This includes Stockpointers' raw financial data feed from S&P Compustat.

Recommendations for Boards of Directors, Executive Management & Institutional Investors

- Directors and Officers will want to get out in front of this industry transformation to ensure their utility is strategically positioned for longer-term financial viability and enterprise sustainability.
- A tremendous opportunity for improved corporate governance and disclosure to shareholders exists for those utilities already undertaking significant investments in creating a cleaner energy future but have yet to align these strategic initiatives with enterprise performance, enterprise risk management and executive pay.
- The need for utilities, their boards and management to embrace a Triple Bottom Line (TBL) approach to performance measurement and executive incentive design is at the core of our findings. A Triple Bottom Line measurement approach that balances the needs of customers / society, environment and shareholders and creates a truly sustainable and viable electric utility for the longer-term.
- Utilities have different costs of generating electricity and reducing CO₂ emissions at least in part because they face different regulatory environments. Necessarily then, the proper choice of performance targets and weights will differ from utility to utility. The best approach for accountability design may also involve the establishment of metrics, targets and weighting on a business unit and geographic basis.
- Directors and Officers will need to ensure that their management structure, executive talent pipeline for succession, and enterprise incentive design are engineered for a higher level of innovation, including introducing new cleaner energy products, new related services, and possibly launching new lines of business all to protect revenues and shareholder returns longer-term.
- The SEC's recent release regarding new shareholder disclosure requirements for "risk taking incentives" will find those utilities facing "reasonably material adverse effect" from regulatory and business model risks, needing to enhance their disclosures for shareholders.
- For institutional investors, they will want to review their investments and proxy voting policies and processes related to the electric utility sector, and in particular the Performance Measurement and Incentives design of their investee companies. This analysis suggests that utilities moving towards a cleaner energy future with clear accountability and incentive design alignment are likely to generate top quartile investment performance for the long-term.

To learn more about how to better align a utility's performance measurement, executive compensation, CEO succession & selection, and management structure design with the new cleaner energy future, please call MVC Associates International at 813-600-5259

Appendix

USA Utilities Analyzed

(In decreasing order of Revenue)

Company	Ticker	Revenue – TTM Sept 2009 In millions	Net Operating Profit After Tax (NOPAT) TTM Sept 2009 in millions	NOPAT / FTE
Exelon Corp	EXC	\$17,695	\$4,934	\$251,589
Constellation Energy Grp Inc	CEG	\$17,122	\$280	\$27,424
Dominion Resources Inc	D	\$16,049	\$3,052	\$169,573
Southern Co	SO	\$16,035	\$2,963	\$108,632
FPL Group Inc	FPL	\$15,991	\$3,181	\$297,311
AES Corp	AES	\$14,257	\$2,612	\$104,496
PG&E Corp	PCG	\$13,503	\$2,531	\$172,801
American Electric Power Co	AEP	\$13,443	\$2,655	\$121,185
FirstEnergy Corp	FE	\$12,960	\$2,441	\$166,061
Public Service Entrp Grp Inc	PEG	\$12,785	\$2,351	\$387,297
Consolidated Edison Inc	ED	\$12,757	\$1,872	\$119,768
Duke Energy Corp	DUK	\$12,754	\$2,277	\$124,742
Edison International	EIX	\$12,538	\$2,400	\$131,204
Entergy Corp	ETR	\$11,248	\$2,109	\$143,768
Progress Energy Inc	PGN	\$9,739	\$2,002	\$95,342
Xcel Energy Inc	XEL	\$9,734	\$1,376	\$122,638
Pepco Holdings Inc	POM	\$9,605	\$729	\$133,265
NRG Energy Inc	NRG	\$8,466	\$2,007	\$569,283
PPLCorp	PPL	\$8,342	\$1,163	\$110,162
DTE Energy Co	DTE	\$8,074	\$1,456	\$139,090

Company	Ticker	Revenue – TTM Sept 2009 In millions	Net Operating Profit After Tax (NOPAT) TTM Sept 2009 in millions	NOPAT / FTE
Ameren Corp	AEE	\$7,323	\$1,331	\$139,734
Calpine Corp	CPN	\$6,963	\$878	\$428,479
Scana Corp	SCG	\$4,444	\$712	\$122,981
Wisconsin Energy Corp	WEC	\$4,261	\$686	\$139,092
RRI Energy Inc	RRI	\$3,939	-\$304	-\$79,583
Teco Energy Inc	TE	\$3,316	\$486	\$110,438
Pinnacle West Capital Corp	PNW	\$3,296	\$580	\$77,318
Allegheny Energy Inc	AYE	\$3,274	\$600	\$80,018
Dynegy Inc	DYN	\$2,822	\$299	\$149,734
Hawaiian Electric Inds	HE	\$2,490	\$209	\$58,712
Great Plains Energy Inc	GXP	\$1,931	\$399	\$122,361
Westar Energy Inc	WR	\$1,824	\$368	\$152,411
25th percentile		\$4,181	\$595	\$109,779
Median		\$9,670	\$1,416	\$127,973
75th percentile		\$13,081	\$2,410	\$155,824

Source: Stockpointer / S&P Compustat and Hoovers and MVC Associates analysis

Contact Info:



Consultants in
Organization Effectiveness,
Leadership &
Pay for Performance

www.mvcinternational.com

Mark Van Cleef

Mark@mvcinternational.com
813 - 600- 5259

Michael Friedman

MichaelF@mvcinternational.com
713- 874 -1557

Dan Smith

Dans@mvcinternational.com
484 - 927 - 6075



Executive Compensation,
Enterprise Performance &
CEO Succession

www.board-advisory.com

Mark Van Cleef

mvancleef@board-advisory.com
813 - 600- 5259

Bill White

wlwhite@board-advisory.com
505 - 984 - 9910

Jeff McCutcheon

jmccutcheon@board-advisory.com
904-306-0907