24 August 2010

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

**By email:** john.kluver@camac.gov.au

Dear Mr Kluver

**CAMAC REVIEW - EXECUTIVE REMUNERATION (SIMPLIFICATION OF REPORTING AND OF INCENTIVE STRUCTURES)**

On behalf of the Board of Directors of Origin Energy I welcome the opportunity to provide a submission to the review on executive remuneration matters that your Committee is undertaking at the request of the Minister for Financial Services, Superannuation and Corporate Law.

The Minister has requested CAMAC to advise on two separate matters:

(1) Appropriate changes that would reduce the regulatory complexity applying to remuneration reporting and to make that reporting more effective in meeting stakeholder requirements; and

(2) Legislative changes that would simplify the incentive components of executive remuneration.

Our submission will address the matters in that order.

However, by way of preface, we refer to the final report of the Productivity Commission's 2009 Inquiry into Executive Remuneration (as identified in your July 2010 Information Paper). This landmark review concluded that it was a key function of Boards to set appropriate executive remuneration for their corporations and noted that, in a global context, Australian boards and Australian corporations have managed executive remuneration relatively well.

The Commission's Recommendation 8, which has led to the Minister's first reference above, identified the need for an expert panel to formulate guidelines for the simplification of remuneration reporting.

The Commission, soundly, did not make a recommendation for legislation to simplify or regulate incentive structures themselves. For the reasons provided below, we have significant concern that regulation in this area will be counterproductive and will hamper boards from devising appropriate

remuneration for their particular circumstances and time. We do, however, see some areas in which the Corporations Act and related regulation should be amended so that incentive structures can be simpler and more effective and lead to greater linkage between pay and performance, in turn making reporting of that remuneration more meaningful.

Also by way of preface, a key principle underpinning our submission is that different industries, different sectors, companies with different levels of complexity, and companies at different points in their evolution, all have different requirements to exact from their remuneration systems and strategies. There are risks to Australian productivity and competitiveness if companies are to be constrained by excessive regulation into a "one-size-fits-all" approach to remuneration. This could result, for example, if regulatory thrusts are designed around features observed in the finance sector, and then applied to other sectors without an understanding of their different operational and strategic circumstances and requirements.

# 1 Reducing remuneration reporting complexity and making it more effective

The guiding principles around the disclosure arrangements for remuneration reports should be:

- Disclosures are designed to enable stakeholders to assess the remuneration strategy and outcome in the context of the company's operational situation and its performance. Rather than a goal of simplification for its own sake, the goals should be defined in terms of three fundamental aims - relevance, understandability and transparency (a "true and fair view").
- The disclosures be regulated from one source (Corporations Act) rather than the multiplicity of accounting standards regulations that currently affect it.
- Given that the government has accepted the Productivity Commission's Recommendation 15 (boards will ultimately stand or fall on the voting of their Remuneration Reports) a guiding principle should be that boards should have sufficient flexibility to present their reports in the manner that allows them to best explain the way they have designed and managed remuneration arrangements and linked them to strategy. There is a need to reduce the current level of rigidity and prescription applying to Remuneration Reports.

It is important to note that remuneration matters are complex and that reporting of them has been subject to increasingly overlapping and complex regulation over time. The starting point for simplification should be the removal of irrelevant and overlapping regulation, including the removal of remuneration data based on accounting standards (such data should be in the Financial Statements rather than the Remuneration Report). In particular:

- We note that the Productivity Commission's Recommendation 9 (removing the requirement for 'Top 5' disclosure) has commenced this process. The 'Top 5' is an example of duplicative and unnecessary reporting and the Recommendation should be implemented.

- The tabular requirements for detailed disclosure of Key Management Personnel should be made more flexible so that the disclosures relate to the way the company manages remuneration. Current requirements create a disconnect between the data presented and with the aims of the report itself (which are to explain the connection between remuneration and performance). For example, the current framework leads to companies separating out post employment benefits such as superannuation, or specific components such as employee benefits, when many companies in fact manage their remuneration on a fixed package basis (where the executive can adjust components such as superannuation, cash or benefits provided that the total cost to the company remains the same). The remuneration table is currently needlessly complicated because it reflects changing decisions that individuals have made within their packages rather than focusing on the total that is being managed.

- Incentive payments may be unrelated to the performance period being reported because of the requirement to use accounting standards. The use of accounting standards mask the lags between the performance that created the reward and the deferred receipt thereof. In response to the desire to report "actual" remuneration, the challenge is to recognise that the actual payment received in one financial year from equity plans may include deferred remuneration from prior years. The best way of presenting the board's award of remuneration to an executive during a year is to disclose the value of all pay **awarded** that year. For equity this means the fair value of allocated value in that year. This is the number by which both the board and the executive value annual remuneration. Any disclosure of the "full picture" of delivered results from deferred pay arrangements over multi-year periods, if disclosed at all, should be separately tabulated to make it clear that it includes deferred remuneration from prior years and that it may represent double-counting with the annual disclosure described above. The value reported to the ATO on vesting is the obvious choice to disclose in the "vested value and deferred remuneration" context, though our submission is that the annual award value is the only necessary disclosure.

- The requirement to provide a section on corporate performance within the remuneration report itself is duplicative and unnecessary. The requirements to discuss the relationship between corporate performance and the remuneration policy are sufficient.

By way of concluding comments on the Reporting issue, it is important that the desire to strive for brief and "plain English" does not leads to a "plain vanilla" approach to remuneration. This could lead to ever greater homogeneity of executive pay, and less willingness by boards to adopt innovative approaches to create the best arrangements to suit the individual organization. Boards must be and feel free to manage remuneration without fear of having to conform to short term fashion or trends, or without fear of experimentation with new approaches that may take more than one cycle to demonstrate value.

While some organisations may find it helpful to produce short or concise versions of their remuneration reports, designed perhaps for retail investors, and keep the fuller versions for reference to suit institutional investors, such separation should not be mandated. It is again a matter for what suits the organisation best, and a judgement of the board as to how to make communications with shareholders most effective.

## 2 Simplifying incentive arrangements through legislative change

In approaching the issue of whether legislative changes are appropriate in terms of regulating incentive arrangements themselves, the concluding comments above are repeated. It is important that regulatory constraint does not prevent boards from designing arrangements that best suit the circumstances of their corporations.

There is a distinct risk that over-regulation of remuneration simply puts pressure on replacing incentive or variable pay with fixed or guaranteed pay, and pressure on replacing deferred pay with advance or up-front pay. Both trends are counter to the direction of remuneration governance.

We are already seeing these trends emerge in response to the 2009 changes by the government on employee equity schemes and termination payments legislation.

In a short-skilled competitive market, especially where corporations need to look overseas for specialist talent, prospective candidates are less inclined to accept variable pay arrangements because of the additional risks they now carry. Increasingly they seek to substitute variable or deferred pay with lower-risk fixed or up-front pay. There is less willingness to have 'skin in the game' and the pressures serve to escalate (fixed) salaries generally. The fixed cost of employment rises and the ability of corporations to incentivate is diminished.

Direct regulation around the incentive arrangements reduces the capacity for boards to design remuneration that is tailored to their industry and circumstances. It inevitably leads to a one-size-fits-all approach. Boards will become increasingly risk-averse to experimentation to find solutions that work best to align their remuneration strategy with their corporate strategy.

In terms of regulation, there is also a risk that those entities governed by the regulation will be disadvantaged in the highly competitive international market by the adoption of standardised remuneration policies developed to meet the requirements of minority and unsophisticated shareholders rather than developed to create value through alignment with the corporations's strategic direction and requirements. Working for a large listed Australian company should not require employees to accept disadvantage or sacrifice compared to comparable positions with unlisted, overseas or private competitors. It is not in the interests of the Australian investor base or the economy as a whole for listed employers to be handicapped in attracting and retaining talent.

It is important to acknowledge that the complexity of incentive arrangements is partly a response to the complexity of the taxation arrangements that govern them. Genuine reform and simplification of incentive arrangements requires that the taxation arrangements be simplified.

For example, the Productivity Commission's Recommendation 13 was to remove cessation of employment as a taxing point for equities or rights that qualify for tax deferral and are subject to risk of forfeiture. This recommendation should be implemented as a matter of priority. In its initial response to this recommendation the government advocated addressing the problems associated with this provision by accelerated or partial vesting or other special

compensation in Plan Rules. The result of this approach is to encourage short-term behaviours and short-term focus, which is at odds with the direction of corporate governance. Further, it drives complexity in incentive structures and it diminishes the attractiveness of them to executives. It is another feature of the regulatory framework that puts additional pressure on the provision of guaranteed or fixed pay. The government's suggestion of using partial or accelerated vesting to address a widely acknowledged problem is inconsistent with the punitive stance it has taken on accelerated vesting in the Termination Payments legislation that it introduced during 2009.

The Australian Prudential and Supervision Authority has made similar recommendations concerning the removal of cessation of employment as a taxing point.

Action on Recommendation 13 is the single most important reform that should be made in order to simplify and make incentive arrangements more effective.

Another area for priority is the current Termination Payments legislation. In particular the limit of one times base salary, excluding variable pay altogether, is so low that it acts as a powerful driver in pushing up the level of fixed pay and complicating the structure of overall remuneration arrangements. The limit should be raised and it should take into account the annual remuneration amount rather than the fixed base salary component.

## Conclusion

The focus of review on legislative arrangements affecting executive remuneration should be to remove constraints (such as cessation of employment as a taxing point, and the excessively low cap in Termination Payments legislation) and to remove duplication, rather than to attempt to regulate the arrangements themselves.

Increased or prescriptive regulation of incentive arrangements is likely to continue the trends that are already occurring to increasing pressure on fixed pay at the expense of deferred pay, and it will reduce the flexibility of boards to determine the remuneration arrangements that would maximise their corporations' performance. The risks created and unintended consequences that flow from excessive regulation have the potential to diminish not just the performance of individual corporations, but the Australian economy and its productivity overall.

Please do not hesitate to contact me if you wish to discuss any of these matters in more detail.

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Remuneration Committee
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