Getting what you pay for:

Linking executive remuneration to responsible long-term corporate success

A Discussion Paper

February 2005

Henderson Global Investors, founded in 1934, is a leading investment manager, providing a wide range of investment products and services to institutions and individuals in Asia, Europe and North America. Henderson manages over £68.4 billion (as at 30 June 2004) in assets and employs more than 800 people around the world. We take an active interest in corporate governance and corporate responsibility and believe that excellence in these areas by the companies in which we invest contributes significantly to long-term shareholder value. Our Responsible Investment Policy, setting out our overall approach to corporate governance, remuneration and corporate responsibility, can be found at www.henderson.com

Universities Superannuation Scheme is a global pension fund principally for academic and senior administrative staff in UK universities and other higher education and research institutions. With nearly 200,000 members and assets of approximately £20 billion, USS is one of the largest pension funds in the UK and Europe. USS aims to be an active and responsible long-term shareholder of companies and markets in which it invests. The Fund has a commitment to encourage responsible corporate behaviour which is based upon

i) the view that management of such issues is good for long term corporate performance and

ii) a duty to protect and enhance the value of the fund's investments. This approach is indeed widely recognised as one that greatly increases the likelihood of long-term value delivery and therefore to be in the interests of pension fund beneficiaries. USS's recently revised voting and engagement policy can be found at www.usshq.co.uk/policystatement

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BG Group	Cathy Aldwinckle, Head of Compensation and Benefits Helen Parris, Investor Relations Manager
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Shell	Stephanie Boyde, Manager, Executive Remuneration Mike Reiff, Head of Remuneration and Benefits John Hofmeister, Director of Human Resources
Scottish & Southern Energy	Vincent Donnelly, Company Secretary
United Utilities	Reg Unsworth, Compensation and Benefits Manager
Vodafone	Derek Steptoe, Compensation and Benefits Director Phil Williams, Group Human Resources Director
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Shade Duffy of Henderson Global Investors also contributed valuable insights to this paper.
Statements of fact about individual companies' approach to remuneration have been reviewed for accuracy by the companies concerned. The conclusions drawn, the views expressed and the recommendations made are those of Henderson Global Investors and the Universities Superannuation Scheme alone.

We would welcome feedback on this paper. Please send comments to:
Rob Lake, Head of Corporate Engagement, Henderson Global Investors – rob.lake@henderson.com, and Daniel Summerfield, Responsible Investment Adviser, USS – dsummerfield@uss.co.uk

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Executive Summary

Investors expect companies to structure their remuneration in ways that support the delivery of durable long-term value growth. The companies reviewed here recognise that in order to do this, remuneration systems need to provide incentives focused not just on their ultimate financial goals, but also on the means by which those goals will be achieved. They are therefore integrating areas such as customer satisfaction, employee issues, the environment and health and safety into executive remuneration schemes, alongside financial performance measures. These approaches are also focusing executives' attention on key dimensions of corporate responsibility for these companies.

The innovations described here stand out against a background of remuneration schemes and structures that generally display little diversity, particularly with regard to the narrow range of performance measures they use, which are usually financial. The companies reviewed are at the forefront of initiatives to tailor their remuneration arrangements more closely to the operational requirements of implementing their strategies.

Extra-financial factors are being linked almost exclusively to short-term incentive schemes (STI). Extra-financial performance accounts for between 10% and one third of the annual bonus award at the companies reviewed. The number of extra-financial measures used ranges from one to ten; all companies agree that the system used needs to be clear and readily understandable to employees. Some companies link bonuses to personal performance, some to group performance, and some to a mixture of the two. Rewards for extra-financial performance can be made independently of the company's financial performance, or they can be conditional on it. Measurement of extra-financial performance needs to be transparent, trustworthy and practical, and to reflect real performance.

Share-based incentives offer the potential for significantly higher levels of reward than annual cash bonuses and are based on performance over longer periods. They thus provide stronger incentives for the performance areas they target. It is therefore surprising that few companies link extra-financial performance to share-based remuneration. The only examples among the companies reviewed here are deferred bonus schemes in which the initial value of awards is based in part on annual extra-financial performance. Some companies are starting to consider linking extra-financial performance to long-term incentive plans (LTIPs).

The ABI Guidelines on Executive Remuneration have for some time stressed the importance of individual and corporate performance targets tailored to the requirements of the business, and called on companies to disclose the performance parameters being used.[1] The ABI Guidelines on Social Responsibility, introduced in late 2001, also call for such disclosure in relation to performance measures linked to social, environmental and ethical issues.[2] Despite this there is currently little disclosure to investors on what companies are doing in this area.

Companies should disclose more fully to investors how their approach to remuneration supports the achievement of their strategy. The Operating and Financial Review (OFR) should provide an overall account of remuneration policy across the company and how it supports the corporate strategy, including the way that extra-financial issues are addressed. Executive remuneration should be described in greater detail in the Directors' Remuneration Report. KPIs used should be consistent with those set out in the OFR.

[1] ABI Guidelines on Executive Remuneration, para 4. Available at www.abi.org.uk
[2] ABI Guidelines on Social Responsibility, Appendix 1. Available at www.abi.org.uk

Extra-financial measures should certainly not be used to the exclusion of financial performance to determine executive remuneration, or to justify pay-outs when a company has not met its earnings per share (EPS) or total shareholder return (TSR) targets but has, for example, met its health and safety targets or environmental key performance indicators (KPIs). But companies should consider incorporating (and disclosing) these additional targets alongside the financial measures used in traditional incentive schemes.

Henderson and USS now intend to incorporate these themes into their ongoing discussions with companies on their remuneration arrangements. We will seek to understand fully the link between companies' strategy and the specific design of their remuneration arrangements. We will aim to ensure that appropriate rewards and incentives are provided for taking the operational steps needed for the achievement of companies' ultimate financial objectives. We also hope to discuss this paper widely with fellow investors, remuneration consultants and other interested parties.

1 What this paper is about

'We certainly cannot claim to be achieving operational excellence without first-rate health, safety and environment (HSE) performance across the board. And, in my experience, meeting HSE targets is a good guide to management's ability to meet other business goals.'

Jeroen van der Veer, Chief Executive, Shell

From the investor's perspective the primary role of a company's senior management is to direct the company's affairs in such a way as to deliver durable long-term value growth for shareholders. Companies concentrate their senior executives' attention on the desired goals through remuneration schemes that usually specify performance primarily in financial terms. Total shareholder return (TSR) and earnings per share (EPS) are the most common performance metrics for share-based incentive schemes. But these give executives little or no guidance as to how these goals should be achieved. Focusing just on financial objectives may sometimes mean that underlying extra-financial factors that are essential for long-term success do not receive adequate attention.

For example, after Sir Clive Thompson stepped down as Chairman of Rentokil in May 2004 the Senior Independent Director of the company said Thompson had become too obsessed with meeting short-term targets and had failed to invest in long-term top line growth, a shortfall particularly evident in staff recruitment and training. Executive directors' annual bonuses were based on annual growth in EPS, providing a clear incentive for this short-term focus. Analysts had also been concerned for some time that the company was managed almost exclusively on the basis of these EPS targets.

The first challenge in designing remuneration strategies is therefore to identify the range of operational factors that will create long-term value growth for the company. These are the 'means' that will enable the company's ultimate 'ends' of financial performance in terms of earnings and the share price to be met. Some of these 'means' will be formulated in financial terms – e.g. sales growth. But many will be extra-financial – in areas such as customer and employee satisfaction, corporate reputation, health and safety or the environment.

The precise mix of metrics that best links strategy and remuneration will of course be specific to each individual company. But linking remuneration to a more balanced range of measures than is currently common helps to ensure that a focus on 'ends' (financial performance) does not cause the 'means' (management of a range of tangible and intangible assets) to be eclipsed.

These extra-financial measures are often also closely linked to issues that are frequently defined as matters of 'corporate responsibility'. As companies grapple with changing regulation, customer expectations, media scrutiny and other pressures, many are finding that being 'responsible' often makes good business sense. Incorporating strategically significant aspects of the 'responsibility' agenda into performance measurement and remuneration frameworks should provide incentives for actions that are both responsible and deliver long-term business benefits.

This concept is familiar to many companies. But it seldom if ever looms large in discussions between companies and investors about remuneration. The debate about financial performance metrics in remuneration schemes is itself broadening. Investors are encouraging companies to utilise financial measures such as cash flow return on investment, gross investment growth, return on capital employed where these represent the appropriate focus for long-term value creation.

Henderson and USS have decided to focus specifically on extra-financial measures for two key reasons:

- they provide an indication of the extent to which key drivers of long-term value creation have been incorporated into the objectives set for both individuals and the organisation through the linkage to executive remuneration

- this important area of executive remuneration has not traditionally been addressed by investors, who have tended to focus instead on the wider debate on directors' pay and the link to traditional financial measures.

It is important to stress that this paper is not advocating that extra-financial measures be used to the exclusion of financial performance to determine executive remuneration, or to justify pay-outs when a company has not met its EPS or TSR targets but has, for example, met its health and safety targets or environmental KPIs. Instead, the aim is to encourage companies to consider incorporating (and disclosing) these additional targets alongside the financial measures used in traditional incentive schemes. We hope this paper will help to promote greater dialogue in this area, and foster understanding of how extra-financial performance conditions in remuneration schemes can best be used to achieve long-term responsible business success.

We have taken an empirical approach, aiming to understand emerging practices and note trends. We indicate our views on these, but do not seek to prescribe specific solutions for individual companies. Remuneration at all levels in a company is important for overall success. But we concentrate here primarily on directors' remuneration. This is a natural focus for investors, given the requirement for companies to put the Directors' Remuneration Report to the vote at the AGM and to gain shareholder approval for share-based incentive schemes.

We started by reviewing Remuneration Reports from the companies in the FTSE100 and a small number of others to identify examples of links between directors' pay and extra-financial performance. From these we selected a small sample for further investigation through discussion with the companies individually, aiming to explore experience across a range of sectors. We then held a seminar to discuss our initial conclusions with the companies.

Section 2 summarises what the sample companies are doing; Section 3 draws out some conclusions, highlights emerging good practice and makes recommendations. The Annex provides more detailed descriptions of individual companies' remuneration arrangements.

2 What companies are doing

2.1 Extra-financials in the overall remuneration package

Experience with links to STI growing. No links yet to LTI

Experience in linking extra-financial factors to short-term incentive schemes (STI) is growing. Extra-financial performance determining varying percentages of annual cash bonus at the companies reviewed here. Three of them – BHP Billiton, BT and Scottish and Southern Energy (SSE) – increase the potential reward for annual extra-financial performance through share-based deferred bonus schemes. However, none of the companies studied here links extra-financial performance to long-term incentive schemes (LTI) that are not tied to the annual bonus.

Table 1 provides an overview of company practice in some of the key areas that are discussed in more detail below. Detailed company case studies can be found in the Annex.

2.2 Number of extra-financial measures used

One KPI or many

Most of the companies reviewed include a range of extra-financial key performance indicators (KPIs) in implementing the corporate strategy (e.g. in the corporate scorecard and assessment frameworks for individuals and parts of the business). All the companies agree on the need for the KPIs selected to be clearly understood by those whose performance is assessed in this way. But the number of such KPIs used for remuneration varies widely. Some companies use only one: customer satisfaction at BT and Vodafone. BHP Billiton and Shell use four corporate measures (as distinct from measures of personal performance). Each of Shell's four measures in turn breaks down into sub-measures. At the time of writing, in November 2004, Shell is reviewing its system. Rio Tinto uses corporate safety performance, as well as a number of extra-financial personal performance measures.

Clearly there is no 'one size fits all' approach. Even companies in the same industry differ substantially – as in the case of Rio Tinto and BHP Billiton.

2.3 Weighting of extra-financial measures

Weighting from 10% to one third

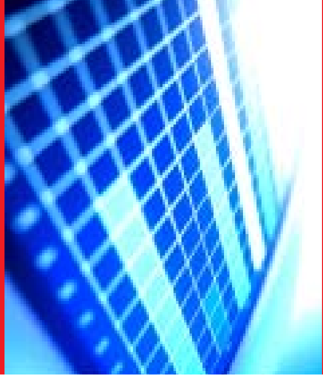
The proportion of annual cash bonus determined by extra-financial factors can be a specified percentage laid down in advance, or it can be left to the discretion of the Remuneration Committee. Pre-determined percentage levels range from a specified minimum of 10% at BHP Billiton to one third at SSE. At BG there is no specified percentage, but the Remuneration Committee makes a judgement on the weighting to be attached to health, safety, security and environment factors on the basis of an annual performance report it receives. United Utilities is currently considering increasing the weighting of extra-financial factors, having found it difficult to provide a meaningful incentive with the relatively low weighting now given to individual extra-financial factors.

Linking remuneration to group/company performance or individual performance only.

Personal pay linked to group performance

All the companies reviewed except SSE link the remuneration of directors and other executives with group responsibilities to the group's extra-financial performance. In other words, bonus levels are affected by performance in areas for which the individual does not have line management responsibility. In some cases performance on personal objectives also contributes to bonus levels. SSE links the annual cash bonus to personal rather than group extra-financial measures – but weights grant levels for all deferred share awards by aspects of group extra-financial performance.

A number of the companies reviewed expressed the concern that using personal KPIs could be counterproductive if it focused individuals' attention on their own performance to the exclusion of



that of the group as a whole. Others, by contrast, stressed the need for individual executives to see a clear connection between their remuneration and their own actions and areas of management responsibility. Rio Tinto addresses this by requiring specified minimum levels of both group and personal performance (financial and extra-financial in both cases) before any bonus is achieved.

2.4 Link between financial and extra-financial KPIs

Pay for what is important…

This review identified four different models for the link between financial and non-KPIs in calculating annual bonus levels:

- At BG there is no formally specified mechanism. The Remuneration Committee considers overall Group performance, including financial performance, extra-financial performance and health, safety and environmental performance, as well as individual performance.
- BHP Billiton, BT, SSE, United Utilities and Vodafone assess financial and extra-financial factors independently in calculating STI.
- Shell has a 'hurdle' or 'light switch' approach, in which group financial performance has to reach a specified level before any reward determined by extra-financial performance will be paid.
- At Rio Tinto both group and personal objectives have financial and extra-financial components. Both and group and personal performance have to reach specified minimum levels before any bonus is achieved. Thus group safety performance can affect the bonus payable for performance on personal financial KPIs. (In practice the Remuneration Committee can exercise discretion, and performance has never been such that a zero bonus has been paid.)

…but avoid unwanted side-effects

Assessing financial and extra-financial performance independently may allow good performance in one area of benefit to the company to be rewarded regardless of short-term poor performance in another. Requiring minimum levels of financial performance before rewarding extra-financial performance may potentially disincentivise extra-financial efforts that contribute to longer-term financial performance. Requiring minimum performance levels on both financial and extra-financial fronts before any bonus is paid sends a clear signal that the two cannot be seen in isolation – but may also disincentivise one or the other, depending on circumstances.

2.5 Measurement, verification and benchmarking

Make measurement transparent, trustworthy and practical…

Measurement, verification and benchmarking of commonly used financial performance metrics – such as EPS or TSR - are well established (though these measures themselves are subject to criticism in some quarters). Auditors and remuneration consultants provide assurance to both beneficiaries of remuneration schemes and investors that these figures have been calculated appropriately. Approaches for extra-financial performance are inevitably more diverse.

- Many of the companies reviewed subject environmental and safety performance data to external verification.
- Customer satisfaction surveys are conducted by independent market research agencies for BT and Vodafone.
- SSE uses publicly reported complaints to the industry regulator energywatch to monitor customer satisfaction.
- United Utilities links a proportion of remuneration to its score in the Business in the Environment (BiE) index. This has proved problematic, as the criteria of the index have been altered, making it difficult for the company to assess its performance against the target it originally set.

For both executives and investors, systems used to measure extra-financial performance need to be transparent, trustworthy and practical, and to reflect real performance. Data provided or verified by

…and make sure you pay for real-world performance

parties external to the company can satisfy this requirement. A number of companies use indicators reflecting the way customers or others view the company – such as BT's and Vodafone's customer satisfaction measures, Shell's Reputation Tracker survey and United Utilities' use of the BiE index. However, companies need to ensure that the use of such perception measures and the achievement of associated targets do drive and reflect actual extra-financial performance which delivers long term business benefits. For example, external evaluations based solely on the existence and quality of policies and management systems may overlook poor performance in terms of environmental pollution or health and safety.

2.6 Extra-financials and long-term incentives

If it really matters, link it to share-based pay…

IInvestors expect remuneration to be structured to provide a significantly higher proportion of the total reward through long-term performance-related schemes than through basic salary and annual cash bonuses paid out immediately. These LTIs should be share-based in order to align executives' interests with those of shareholders. Given that the levels of pay-out can be very considerable if high performance is achieved, the design of LTIs sends clear signals to executives as to the performance areas that matter most to the company. It is therefore surprising that only three of the companies reviewed here (BHP Billiton, BT and SSE) incorporate extra-financial factors formally into the operation of any share-based incentives – and in each case these are deferred bonus schemes that are in fact part of the short-term incentive rather than free-standing long-term schemes. One company, United Utilities, is currently considering whether to introduce extra-financial performance factors into long-term incentives in some way.

2.6.1 Deferred bonus

…in deferred bonus schemes…

SSE links levels of deferred share awards to personal extra-financial performance, group safety figures and customer complaints (as well as group financial performance). Awards vest after three years, with no further performance conditions. It is worth noting that utility regulators often use measures such as customer satisfaction when making regulatory assessments that have direct financial implications for the companies concerned. At BHP Billiton, health, safety, environment and community performance influences the scale of awards of deferred shares or options that vest after two years. At BT, awards of shares under the Deferred Bonus Plan are linked to the value of annual bonuses – and therefore to performance on customer satisfaction. Awards are generally 50% of the executive's gross annual bonus and vest after three years if the executive is still employed by the company and with no further performance conditions.

These mechanisms focus attention on longer-term performance and provide stronger incentives than cash alone for the performance areas measured under STIs, as they offer the potential for higher pay-outs if the share price rises. They also in effect test the contribution of the STI performance areas to improving the company's overall business performance: if these do indeed contribute strongly to financial objectives pay-outs will be correspondingly higher.

Henderson and USS strongly support this approach.

2.6.2 Long-term incentive plans

…and even LTIPs.

No company studied here formally relates extra-financial performance in any way to long-term incentive plans (LTIPs) that are not tied to annual bonus levels. In principle such a link could further strengthen the focus on desired operational activities. it would be possible to do this in various ways.

- Some LTIPs already adjust award levels to take account of an executive's prior performance, rather than simply making grants worth a pre-determined percentage of salary. This helps to ensure that large share-based grants do not follow poor company performance. Performance in key extra-financial areas could be included in the determination of grant levels.

- Some companies already link different tranches of vesting to different performance conditions. Appropriate extra-financial performance conditions clearly linked to the company's strategic objectives could be used to determine a proportion of vesting.
- Under the rules of many LTIPs the Remuneration Committee has a general discretion to adjust vesting levels if corporate or personal performance is inadequate despite financial performance targets having been met. These 'reasonableness tests' could be extended to cover key aspects of extra-financial performance.

Henderson and USS would welcome discussion with companies on these options.

2.7 Disclosure and the OFR

Disclosure is currently poor

The review of Remuneration Reports conducted as part of the research for this paper showed there is currently little detailed disclosure on the performance measures used for short-term incentives – whether those measures are financial or extra-financial.[3] The frequent references to 'personal objectives' or 'other corporate objectives' do not allow investors to judge whether the factors used are appropriate in the light of the company's strategy and the investors' expectations of its performance. Our detailed discussions with companies showed that in some cases where appropriate measures are indeed used, their detailed application is a matter for the discretion of the Remuneration Committee, rather than being transparent to investors.

Remuneration Committee discretion can work against investors' interests

It is an important principle that investors should be given enough information on directors' remuneration to enable them to understand its appropriateness. This includes, crucially, information that demonstrates clearly how performance is linked to the actual pay received. Recent examples – notably J Sainsbury in summer 2004 – demonstrate that a lack of transparency on performance conditions can allow Remuneration Committees to exercise their discretion in ways that are not in shareholders' interests.[4] The rising upper limit on annual bonuses as a percentage of basic salary, leading to larger bonus payments,[5] makes this even more important.

Link the Remuneration Report and the OFR…

The relationship between the Directors' Remuneration Report and the future Operating and Financial Review (OFR) will be important in this context. The purpose of the OFR is 'to enable the members of the company to assess the strategies adopted by the company and its subsidiary undertakings and the potential for those strategies to succeed.'[6] Any information the directors judge to be necessary to achieve this objective will have to be included. The OFR regulations refer in particular to information on '(a) the employees of the company and its subsidiary undertakings; (b) environmental matters; and (c) social and community issues.' The OFR will therefore set out the company's approach to these and if appropriate other extra-financial issues it considers important to the achievement of its strategy. Given the requirement to include relevant information on employees, it would be appropriate for the OFR to provide an overall account of the approach to remuneration across the company as a whole, as an important part of human capital management. The Directors' Remuneration Report should then set out – in greater detail than at present – how the company's policy on directors' remuneration specifically supports the delivery of the strategy. It would clearly be logical to see that at least some of the strategic priorities discussed in the OFR – including extra-financial areas – are used as KPIs or performance conditions for directors' remuneration purposes.

…to show how remuneration supports the company strategy.

[3] The Directors' Remuneration Report Regulations only require performance conditions to be disclosed for share-based remuneration.
[4] Conditional shares awarded to the former Chief Executive, Sir Peter Davis, were based partly on the achievement of business transformation targets and profits measured against levels set by the Board. Shareholders were unable to ascertain what the precise transformation targets were or whether the profits targets set by the Board were challenging.
[5] Executive Remuneration – Trends in executive pay and share-based reward 2004. RREV
[6] Draft Regulations on the Operating and Financial Review and Directors' Report – A consultative document. Department of Trade and Industry, May 2004.

Table 1: Summary of company practice on key issues

	KPIs used and weighting for calculating annual bonus/short-term incentive	Annual bonus linked to group or personal extra-financial performance?	Link between financial and extra-financial measures in determining bonus level	Extra-financials linked to long-term share-based remuneration?
BG	Health, safety, security, environment No formal weighting: RemCo discretion	Both	RemCo discretion	RemCo discretion
BHP Billiton	Health, safety, environment, people 10% minimum; higher if individual has direct responsibility	Both	Factors assessed independently	Yes. 50% of annual bonus deferred into shares or options. No link to LTIP.
BT	Customer satisfaction Maximum of 20% of Corporate Scorecard	Group	Factors assessed independently	Yes. Deferred Bonus Plan linked to annual bonus calculation. No link to other LTIs.
Rio Tinto	• Safety 25% • Various personal objectives: weighting determined by manager (Chairman for CEO)	Both	Minimum performance on both required for any bonus, with RemCo discretion	No (though general RemCo discretion to adjust vesting according to underlying personal or corporate performance)
Scottish and Southern Energy	Various – personal objectives One third	Personal	Factors assessed independently	Yes – formal link to the single long-term scheme
Shell	• Health and Safety 5% (2 sub-measures) • Environment 5% (3 sub-measures) • People 5% (3 sub-measures) • Reputation 5% (2 sub-measures)	Group	Financials must be on target before extra-financials considered	No
United Utilities	Environment 3% People 3% Personal objectives 6%	Both	Factors assessed independently	Under consideration
Vodafone	Customer satisfaction 15%	Group	Factors assessed independently	No

3 What seems to work

The case studies in this paper show how widely companies differ in their remuneration approaches – even within the same sector. Yet the innovations described here stand out against a background of remuneration schemes and structures that generally display little diversity, particularly with regard to the narrow range of usually financial performance measures they use. Remuneration linked closely to strategy and to each company's individual circumstances needs to reward and incentivise performance in important extra-financial areas as well as utilising a wider range of financial metrics. It is not possible to prescribe a single approach valid for all companies. However, we set out below a number of conclusions and recommendations on the emerging good practice we have identified in this research in the specific area of extra-financial corporate performance and executive pay.

Design of remuneration

1. **Linking remuneration to extra-financial performance measures clearly aligned with a company's strategy can reward and incentivise performance in key areas important for short-term and long-term success. These can include areas such as customer satisfaction, employee issues, the environment and health and safety. These measures can help to ensure that executives' attention is focused on the range of extra-financial actions needed to ensure the company's financial goals are achieved.**

2. **A single extra-financial measure or a range of measures can be used successfully. Using a small number of measures has the advantage of clarity and simplicity. Using more may reflect a company's broader range of strategic priorities. However, high levels of complexity – e.g. breaking down measures into sub-elements that each contribute only a small percentage to the reward received – can reduce incentives by diluting the 'signal strength' of each individual performance area.**

3. **Strong links between individual reward and company-wide performance (financial and extra-financial) foster collective motivation and responsibility amongst the directors. This needs to be balanced with the need for individuals to see a clear link between their own actions and the rewards earned.**

4. **The links among performance measures are important. Bonuses can be paid for each performance area independently, or payment for performance on one area can be conditional on performance in another. If rewards for extra-financial performance depend on financial targets also being met, important actions that will contribute to longer term financial performance may be discouraged. Nonetheless, it is important not to lose a focus on financial performance.**

5. **Systems used to measure extra-financial performance need to be transparent, trustworthy and practical, and to reflect real performance. Key performance indicators (KPIs) that are verifiable by appropriate third-party specialists should be used wherever possible.**

6. **Deferred bonus schemes in which a proportion of the annual bonus is deferred into shares that vest after a number of years (usually two or three) encourage a focus on performance over a longer term and offer the potential for higher levels of reward for the performance areas on which the annual bonus is based. These schemes can thus increase incentives for strong performance in key extra-financial as well as financial areas.**

7. None of the companies studied here links extra-financial performance formally to long-term incentive plans (LTIPs). Such a link could in principle help to ensure adequate long-term attention is given to the underlying operational performance required to achieve financial objectives. This could be done in various ways: for example by adjusting award levels in LTIPs according to prior extra-financial operational performance; by linking a tranche of vesting to strategically important extra-financial performance; or by reducing vesting levels if performance in these areas had been unsatisfactory despite financial targets being met. Henderson and USS would welcome discussion with companies on these options.

Disclosure

8. The precise relationship between performance and reward should be made clear to investors and should not be left to the discretion of the Remuneration Committee.

9. Companies should disclose more fully to investors how their approach to remuneration supports the achievement of their strategy. The Operating and Financial Review should in future give an overall account of remuneration policy across the company, as well as setting out how other key extra-financial issues – such as the environment, and social and community matters – are addressed. KPIs and performance conditions used for directors' remuneration should be consistent with the priorities reported in the OFR.

4. What Henderson and USS intend to do next

Henderson and USS now intend to incorporate these findings into their ongoing discussions with companies on their remuneration arrangements. We will seek to understand fully the link between companies' strategy and the specific design of their remuneration arrangements. We will aim to ensure that appropriate rewards and incentives are provided for taking the operational steps needed for the achievement of companies' ultimate financial objectives.

We also hope to discuss this paper widely with fellow investors, remuneration consultants and other interested parties.

Annex: Company case studies

These case studies have been reviewed for factual accuracy by the companies concerned.

BG

When determining annual incentive payments, the Remuneration Committee considers overall Group performance, including financial performance and health, safety and environmental performance, as well as individual performance.

The Committee is provided with a detailed report covering key aspects of BG's business performance including performance against financial measures, relative to peers and against work programme.

The report includes comprehensive information about all aspects of Health, Safety, Security and Environment (HSSE) performance. Performance against both proactive and reactive indicators is included:

- **Fatalities in the Group's operations**
- **Lost Time Injury Frequency**
- **New HSSE initiatives (e.g. progress with the Behavioural Based Safety process, health risk assessments and mitigation plans, etc)**
- **Asset performance against BG's 14 Point Profile. This is a self-assessment tool which enables businesses to analyse HSSE performance against 14 criteria including: Leadership and commitment, Competency and training, Contractor performance and Incident investigation.**

All this HSSE information, together with the other business performance indicators, is taken into account by the Remuneration Committee when determining the Directors' payments. However, the HSSE metrics are not built into the incentive formula in a formal sense. Rather, the Committee applies judgement in determining how to take account of these metrics in making annual incentive awards.

Grant levels under the Company Share Option Scheme and Long-Term Incentive Scheme partly reflect an individual's overall performance, with HSSE taken into consideration. As with annual incentives, this is a matter of judgement rather than a mechanical formula.

BHP Billiton

The Group Scorecard that applies to all Executive Committee members incorporates specific health, safety, environment and people KPIs, including a specified classified injury frequency rate. These measures account for a minimum of 10% of the Scorecard. The figure is higher for individuals with specific responsibilities in these areas at Group level and within individual businesses. A combination of lagging and leading indicators is used. The level of environmental incidents and safety figures are used as lagging indicators, and implementation of action plans to improve performance as leading indicators. The RemCo reviews performance metrics annually.

The financial KPIs in 2003 were: reduction in operating costs; realisation of merger synergies; ROCE; EBIT Shareholder Value Added, free cash flow; and shareholder value added. Individual business measures and personal measures are also used.

The Scorecard determines the annual bonus level. Financial and extra-financial performance are treated independently; there is no formal requirement to achieve a specified level of financial

performance before extra-financials can be taken into account in the bonus calculation. However, the Remuneration Committee has the discretion to reduce overall awards if financial targets have not been achieved.

50% of the actual annual bonus achieved is paid out in cash immediately. The other 50% is converted into deferred shares and/or options. These vest after two years.

The extra-financial KPIs therefore play a direct part in determining the scale of awards under long-term incentive schemes, and thus the level of ultimate variable reward.

BT

BT includes reduction in customer dissatisfaction in the Corporate Scorecard that is used to determine senior executives' annual bonus. Improving customer satisfaction is one of the company's eight strategic priorities. The weighting allocated to this area is 20% (as mentioned earlier). The other factors used are EPS (40%) and free cash flow (40%).

Customer satisfaction is measured through independent monthly surveys by four major independent research agencies of residential, small business and large corporate customers. This reflects customer perceptions of BT over the preceding 12-24 months. BT has conducted research which shows a correlation between customer satisfaction, employee satisfaction and the company's image and reputation on corporate social responsibility issues.

BT has a number of other extra-financial KPIs that are used to manage the business, but these are not currently included in the Corporate Scorecard.

Awards of BT shares under the Deferred Bonus Plan are linked to the value of annual bonuses – and therefore to performance on customer satisfaction. Awards are generally 50% of the executive's gross annual bonus (except in the case of the Chief Executive, whose award was 100% of bonus in 2003), and vest after three years if the executive is still employed by the company and with no further performance conditions.

There is no formal link between annual bonus and performance and awards under other share-based long-term incentive schemes.

Rio Tinto

The company moved in 2004 from an 'additive' to a 'multiplicative' relationship between Group and personal objectives in the calculation of short-term incentives. This provides a closer link between the incentive payment and the individual's personal performance and offsets (to some extent) factors outside the individual's control, such as commodity prices. Performance on both financial and extra-financial performance measures has to be satisfactory in order for the minimum bonus to be achieved (e.g. as the system is multiplicative an "unsatisfactory" score for the combination of measures under either the financial or personal components will result in zero overall bonus)

For Group-level executives, Group safety performance determines 25% of the Corporate / business performance component of the short-term incentive payment. This is based on an overall assessment by the Remuneration Committee rather than the use of a single metric, which would not be appropriate given the diversity of the Group's operations. In making this assessment the Committee takes account of absolute performance relating to total Group (managed operations) Lost Time Injury Frequency Rate (LTIFR), All Injury Frequency Rate (AIFR) and incidence of fatalities, as well as short and medium term trends in improving overall safety performance against these measures. The safety performance of each Product Group is also considered.

The Corporate / business performance component for Group-level executives also comprises business financial measures determined by the Remuneration Committee. The individual's overall personal contribution to the Group over the year is also considered, alongside group financial performance. This personal contribution accounts for approximately 50% of the short-term incentive and can include aspects of sustainable development, as appropriate to the individual's role.

Delivered performance against the Corporate/business measures and the personal measures are each scored relative to target performance (indexed at 100%), and these results are multiplied together to arrive at a total bonus score relative to target. This process means that underperformance or above target performance leverages the bonus up or down.

The Group does not mandate the specific performance measures for individual businesses other than to require that there be a mix of business/financial measures and personal measures, and that safety performance must comprise 25% of either the relevant business/financial component or the personal component depending on the nature of the role. Different measures are relevant for different businesses.

Performance agreements between the Group CEO and Product Group CEOs (i.e. below board level) include measures such as overall business financial and operational performance, occupational health and safety, environmental performance and community relations as appropriate to the business. Safety accounts for 25% of the personal component of the short-term incentive for the Product Group Chief Executives, and the other extra-financial metrics account for the balance of this component. The system for these executives is also multiplicative so that under or above target performance is leveraged.

Grants of share options and conditional rights to receive shares under the two long-term incentive plans are not linked to extra-financial performance – though the Remuneration Committee may exercise its discretion to adjust grant sizes or vesting of awards in exceptional circumstances where performance (other than against the specific performance condition applicable to vesting) is not satisfactory. The performance conditions under these schemes compare Rio Tinto TSR performance relative to comparator companies for both share options and conditional shares.

Scottish and Southern Energy

Two thirds of annual bonus for Executive Directors is attributable to corporate financial performance (profit targets) and one third to personal objectives. The personal objectives depend on the individual's own area of responsibility and can include: reducing power station shutdowns; improving efficiency and reducing costs; improving safety standards; improving customer supply standards; and new business development - e.g. renewable energy.

Some of these targets are chosen because they are measurable against independently verifiable competitor company data – e.g. customer complaints to energywatch, the industry regulator.

The corporate financial performance is linked to budgeted PBT performance for the year.

Under the company's Deferred Bonus Scheme, participants are granted awards equivalent to a value equal to their actual short-term bonus. The value of the award is then adjusted by reference to three factors: the company's relative performance in terms of TSR over a three-year period (compared to the FTSE 100); safety (which is externally verified and compared to other energy companies); and relative performance in terms of customer complaints, as recorded by the independent regulatory body, energywatch. Dependent on actual performance each factor gives a multiplier of between 0.7 and 1.35. A weighted average is then taken using TSR (40%), safety (40%) and customer complaints (20%), to create a single factor which is applied to the award. The resultant amount is then used to determine the number of shares to be awarded to the employee based on the market value of the shares at the time of the award.

Extra-financial factors therefore determine deferred bonus awards for all recipients – not just those with direct personal responsibility for the areas concerned.

Deferred shares vest after three years, with no further performance conditions.

Shell

Every individual and business in the Group has a Scorecard for performance measurement. Business Scorecards have a 'common architecture'. Scorecards 'nest' from Group to individual employee level to reflect the integrated implementation of strategic objectives. Business Scorecards are approved by the Committee of Managing Directors and the Group Scorecard by the board Remuneration Committee.

For approximately the top 225 executives in the Group, 50% of annual bonus is based on the Group Scorecard and 50% on their own business' Scorecard. All executives at the corporate centre are measured 100% against the Group Scorecard.

Until 2003, 60% of the Scorecard was determined by financial results (TSR, Absolute ROACE and Relative ROACE) and 40% by extra-financial factors under the heading of sustainable development (SD). The weightings are now 60% financial and 20% sustainable development, with 20% being linked to a Portfolio Value Growth (PVG) measure (a key initiative for the business in the year).

If financial results are not at least On Target, PVG and SD are not taken into account.

The SD Measure represents those areas of sustainable development that are not specifically covered elsewhere in the Scorecard through selection of components reflecting areas of particular focus. These are health and safety, environment, people and reputation. Each component is of equal weighting, and therefore accounts for 5% of the overall Scorecard. Each area consists in turn of various elements, each with an individual measurement method:

- Health and Safety – implementation of the Shell Minimum Health Management Standards and Total Recordable Case Frequency for accidents. These are weighted equally.
- Environment – Spills, Energy Efficiency, Flaring and Global Warming Potential. These are weighted equally.

For Health and Safety and Environment, performance against target has a 75% weighting for each component and peer group benchmarking has a 25% weighting for each component. An overall reality check is also applied to ensure that the assessments are in line with external assessments of the Group's performance.

- People – Talent, Leadership Development and Diversity and Inclusiveness
- Reputation – Shell Reputation Tracker and quarterly reviews.

A score of Outstanding, Above Target, On Target, Threshold or Below is given to each area, and this then translates into a score in the Scorecard. A judgement override can be applied in each area – e.g. the total score for the Scorecard could be reduced if fatalities were high in a given year.

Share option awards have performance conditions on grant. Grant levels are linked to average financial performance over the preceding three years. No formal account is taken of extra-financial performance – though the overall financial performance score on which awards are based may have been adjusted by the Remuneration Committee if sustainable development performance has been particularly unsatisfactory.

United Utilities

Annual bonus can be up to 60% of basic salary. 48% is determined by group financial performance and 12% by extra-financial factors. To avoid the risk of spreading this relatively low percentage too thinly across too wide a range of measures, the company focuses on three areas: environment, employees and personal objectives. All senior executives are measured on corporate performance on environment and employees.

The Environment metric – accounting for 3% - is the company's score in the Business in the Environment index.

The Employees measure – also accounting for 3% - is linked to the responses to two specific questions in the group's employee opinion survey. The results are externally measured and verified and both targets (attainment of which reflects improved performance) have to be achieved for any of this element of bonus to be paid.

Personal objectives account for the remaining 6% of the 12% of bonus allocated to extra-financial performance.

There is no conditionality between financial and extra-financial performance areas – i.e. the individual does not have to achieve financial targets before a bonus can be achieved for extra-financial performance.

The company is currently considering replacing the environment metric with a corporate social responsibility (CSR) measure – for example the company's rank in the Business in the Community Corporate Responsibility Index. It will be important to ensure that the measure chosen captures aspects of CSR that are relevant to the business.

There is no link between extra-financial performance and levels of awards under share-based schemes at present. This might be reviewed in the future – e.g. by making a link between annual bonus and the existing LTIP or a new LTIP.

Vodafone

Performance on customer satisfaction represents 15% of the short-term incentive. This is important for the business strategy in that customer retention and increased revenue per customer are now crucial for business growth given the high level of market penetration Vodafone has already achieved. Customer satisfaction is measured by a system developed by Vodafone with consultants.

The short-term incentive programme comprises two elements: a base award earned by achievement of one-year performance targets and an enhancement award. The base award is delivered in the form of shares, receipt of which is deferred for a further two years. An enhancement award of 50% of the number of shares comprised in the base award may be payable, subject to the achievement of a subsequent two-year performance target following the initial twelve-month period. Release of the base award and the enhancement award after the total three-year period is dependent upon the continued employment of the participant.

Long-term incentive awards are not linked to the short-term incentive calculation. Taking short and long-term incentives together, customer satisfaction accounts for 3% of the CEO's total expected incentive opportunity.

Other extra-financial performance measures used by the company at the strategic level – employee satisfaction and corporate and social responsibility – are not linked to remuneration. This may be reviewed in the future as the company's overall strategic priorities are adjusted.

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4 Broadgate, London EC2M 2DA. Tel 020 7818 4100.

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