Executive Compensation Linked to Good Corporate Governance

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Richard Kinder, chairman and CEO of Kinder Morgan Inc., has something in common with the chief executives of several of the largest and most successful corporations in North America - Google, Capital One Financial, Apple Computer, and Pixar Studios. For the past six years, he has taken only $1 per year in salary to run a multi-billion dollar company.

Kinder, a founder of the Houston-based midstream developer and operator when the company was created in 1997, has built KMI into one of the largest energy companies in North America with about 40,000 miles of natural gas and products pipelines, 150 terminals, more than 9,000 employees, and 1.1 million gas distribution customers.

Don't shed any tears for the boss at Kinder Morgan though. He owns 18% of the company's shares, which last year paid $3/share in dividends, providing him with $72 million in income, still modest by today's CEO standards. Online business columnist Michael Brush earlier this year profiled some high-profile executives taking the $1/year salary.

In contrast, the two founders and the CEO at Google, according to Brush, took the $1 annual pay with great fanfare, but said little about their total compensation, which was about $1.5 billion each for the two founders, Sergey Brin and Larry Page, based on Google stock they sold since the start of 2005. CEO Eric Schmidt made $387 million, meaning the three top executives made more than $3 billion last year, more than most S&P 500 companies reported in net income for the year.

Morningstar, the Wall Street investment analysis firm, named Kinder its 2005 CEO of the Year,in part because of how his compensation appears to be more aligned with the interests of his shareholders. The question then is how do other petroleum industry CEOs and CFOs stack up - with Kinder and with their counterparts in other industries?

Richard Kinder, chairman and CEO of Kinder Morgan Inc., famously takes only $1 per year in salary. However, his stock dividends in the company earned him $72 million last year, considered by some to be modest compensation for a company with an enterprise value of $35 billion.

"The oil and gas sector is probably better compensated than most other industries, [and executive] pay tends to be higher for companies in this sector than in other industries," according to Steve Cross, business leader for executive remuneration in the Houston office of Mercer Human Resource Consulting. (See April 2005 Mercer report, "The Wall Street Journal/Mercer

Human Resource Consulting CEO Compensation Survey.")

For CEO total direct compensation (TDC) in 2004, oil and gas industry top executives exceeded their counterparts in every other industry except telecommunications, with a $10.5 million average TDC, nearly a 30% jump in a year when average net income for the industry was up 78%, according to the Journal/Mercer report. In contrast, telecom CEOs averaged TDC of $16.3 million which was a 3.6% drop in a year in which average net income grew at less than a half-of-one-percent (0.3%).

Mercer's data over the last five years ending Dec. 31, 2004 shows the overall CEO pay mix has produced the following ranges: salary has varied from 15% to 18% of TDC; bonuses have been 13% to 23%, and long-term incentives have ranged from 62% to 71%. For the most recently completed year (2004), the mix has been 15% for salary, 23% for bonuses, and 62% for long-term incentives, according to the Mercer statistics.

"The median TDC (base salary, annual bonus, and present value of long-term incentives) for CEOs generally rose 17.1% to $7 million in 2004, mirroring the median 17.4% increase in total shareholder return in 2004," the Journal/Mercer report said.

In a preview of this year's updated survey out later in 2006, Mercer concludes that a "new normal" has now settled over the executive compensation space across industries, and two major trends are the growing attention board compensation committees are receiving from shareholders and news media, while the watchword surrounding everything is "transparency,"as shareholders demand greater disclosure.

Emphasizing that under total cash compensation the oil and gas industry (O&G) is among the top industries with total compensation in the upper quartile, Cross reminds his questioner that the O&G business is cyclical, and in good times, it will be at the top of the market, and should be. In down years, the rank-order will change. This is talking strictly about public companies.

With record revenues and profits the past two years in the sector, the CEO and CFO compensation relative to other industries has vaulted to the top. It is a function of the industry's sheer growth recently and the equity position of the officers at the top, according to Alex Preston, president of The Energists, a Houston-based executive search firm in the industry. "Their options and stock grants have risen a lot faster than other industries, and thus, their overall compensation has been higher,"he says.

While there are many similarities with CEOs and CFOs in other industries, some of the trends may be unique to the oil and gas industry, such as the penchant for rising through the ranks in the industry and the increasing shortening of the average tenure of the CEOs. In terms of total compensation in a highly cyclical business, O&G executives take smaller portions in salary during the good years, such as the last two. The reverse is true during the lean times.

In addition, the compensation packages for CEOs and CFOs can vary among four or five segments within the broader O&G industry - major exploration/production companies, independents, service/drilling, downstream refineries/marketers, and the regulated pipeline sector.

In 2005, 48 CEO positions changed in the energy sector (including utilities), according to Chicago-based Challenger, Gray & Christmas, a human resources consulting and research firm. Twenty-one of the CEOs retired; 12 resigned or stepped down; and 15 moved on to other companies or pursuits.

While each company is slightly different in its approach and philosophy toward senior executive compensation - and the CEOs themselves put their own signatures on the program - all of the oil industry segments are similar broadly in being cyclical, global in scope, and complex businesses. The skill sets can be very different in the industry, according to some of the leading energy executive recruiters.

Against the micro differences, there is a current backdrop of macro efforts to bring more uniformity, clarity, and transparency to top executive compensation at the major publicly held companies. Early this year, the Securities and Exchange Commission, under its new chairman Christopher Cox, the former California congressman, proposed significant changes in the way public companies report executive pay.

The latest push is an outgrowth generally from the corporate governance, legal, accounting, and regulatory changes in the wake of Enron Corp. and other industry giantsalleged accounting misdeeds and senior executive abuses of power to enrich themselves at the expense of their company's shareholders. Thus, more pay-for-performance, disclosure of future compensation, gold-plated retirement-benefits-for-life, and hidden rewards are all being cited by the SEC in its proposed overhaul of what companies may be required to report regularly in the future.

Writing in the Wall Street Journal in mid-January when the SEC was taking its initial action to require more information, the head of the Harvard Law Schools corporate governance program, Lucian Bebchuk noted billionaire Warren Buffett's observation that executive compensation is the acid testof corporate governance. Then, Bebchuk concluded in a column lauding the SEC's latest efforts that more disclosure will only emphasize that much work remains to be done to fix executive compensation.

Critics such as Nell Minow, editor, founder, and chair of the Portland, Maine-based Corporate Library, a research group, lament that corporate boards still have not stepped up to their biggest corporate governance challenge, which is reining in CEO pay, according to an interview she did with the New York Times in late January. "If they can't get that right, then something is still wrong," Minow told a Times' business columnist.

Houston-based Eric Nielsen, senior client partner, managing director, with Korn/Ferry International, thinks the push for more transparency is going to result in changes in executive perks and allowances, including the oil and gas industry, which he says for the most part has not had a lot of exposure for excessive CEO compensation packages.

Generally, Nielsen sees the energy industry's CEOs as "high quality people who care about their employees. They worked incredibly hard to get where they are, and they are paid exceptionally well, there is no doubt about it."

Noting it can always be argued that packages CEOs get are excessive, Nielsen still thinks for the most part in the O&G industry they earn it. "From the perspective of a person like myself who does CEO searches, I can tell you, not many people want those jobs. They're tough, and these people earn what they get."

Nielsen thinks there is a big gap in understanding what CEOs do. "So few people are capable of doing the job, and appreciating the full aspects of the position," he says. "For a CEO's job, everything begins and ends with leadership. You can define that a million different ways and a million different situations."

The Energists' Alex Preston puts the petroleum sector on a higher plain, saying, "Generally speaking, the officers and CEOs in the oil and gas industry probably have a higher level of ethics and morals than other industries. Mainly, their educations as geologists and engineers tend to give them a steadier moral compass. You have some that waver because of the power and pay, but generally speaking when you come up through the sciences, you tend to have a better moral compass."

Regardless of their backgrounds and the industry involved, CEOs generally with the help of outside consultants, such as Towers Perrin, Hewitt, or others, present a recommendation to the board compensation committee, wrapped in that particular senior executive's own perspectives regarding compensation philosophy. With the board's approval, this will lead to pay programs and tools that the CEO and his executive staff will put in place, with a combination of stock options, restricted shares, defined benefits, and other tools. The mix is constantly changing with each industry and CEO.

Although recent statistics are skewed somewhat by the large bonuses across the industry the past two years, Mercer's Cross says, "The long-term incentive portion of CEO pay is very highly emphasized in this industry, so that for CEOS and CFOs it makes up somewhere between 60 to 65% of their total pay package."

In terms of lucrative retirement packages, so-called golden parachute severance packages, and perks, the oil industry runs mostly the same as large industries generally, although there are

distinct differences depending on the risk profile of the sector. Integrated major E&P companies usually provide more valuable, larger defined benefit packages, while the mid-cap and independent firms would have much less in the way of these benefits.

"They tend to be leaner and meaner, and put more pay at risk," Cross says. "In contrast, the service sector for large-cap companies would tend to have larger retirements like the integrated majors."

Consultants and search firm professionals are reluctant to put a blanket characterization on the severance arrangements for top executives in the industry. Korn/Ferry's Nielsen says each history of the CEO or CFO getting one of these packages is different and has to be taken into consideration. Along with what the executive is leaving with, Nielsen cautions that an assessment of what the individual is giving up must also be considered.

"If someone is losing a lot of equity because of restricted shares, the severance package may be what was needed to recruit them in the first place," he says. "I don't know if that is what I would call a "golden parachute." But people generally don't have a lot of sympathy for people making the kind of money CEOs and CFOs make."

The people doing the grooming and recruiting of CEOs and CFOs don't see corporate governance problems or disconnects between the industry top executives' current historically high total pay packages and the performance of the companies. They are in sync, and tend to be in both good and bad times, the professional recruiters say.

Stepping back 10 or 15 years to an earlier cross-industry survey, there was a wide gap between compensation levels and performance of organizations, says Mercer's Cross, who now thinks the relationship between pay and performance "is so tight you could set your watch by it"- at least in the petroleum industry.

"These guys have to perform, and the things they have to do to perform, that they get rewarded for, fall into (a) finding oil and gas reserves, (b) growing those reserves, and (c) increasing production volumes, so they generate bigger cash flows. If they do that, they really do earn their money."

Cross concluded: "If you watch [executive] pay over time, it really cycles with their performance against earnings and cash flows much more tightly than it did 15 years ago."OGFJ

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