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Financial Performance— Based Utility Bonuses: Unnecessary Exposure

A series of derivative lawsuits has recently been filed against the officers and directors of Pacific Gas and Electric Co. (PG&E) based on the explosion of a PG&E gas transmission line in San Bruno, Calif., in September 2010. The incident caused eight deaths and destroyed approximately 35 homes.

Derivative lawsuits are brought on behalf of a company's shareholders. They assert that management's breaches of their fiduciary duties and other misdeeds have financially harmed the company's owners (the shareholders) and request that the court order the defendant management to alter their ways.

Misdirected Incentives Expose Utilities

The allegations highlight important utility industry issues that transcend the San Bruno explosion—to what extent should bonuses for utility management be based on financial performance? In economic theory, correlating bonuses on financial performance should incent utility managers to benefit ratepayers by increasing operating efficiencies and implementing cost-saving measures. Conversely, rewarding financial performance exposes utility managers to claims of sacrificing safety.

The plaintiffs argue that the tragedy at San Bruno was precipitated by the emphasis on financial performance that the PG&E Short-Term Incentive Plan (STIP) offers management. Prior to San Bruno, PG&E based 50% of STIP bonuses on financial performance (the remainder reflected safety and customer satisfaction criteria). The lawsuits contend that PG&E inappropriately reduced maintenance and other infrastructure expenditures to meet financial performance criteria.

Plaintiffs allege that PG&E "diverted" more than \$100 million intended for natural gas pipeline maintenance to other purposes, including bonuses. Bluntly stated, plaintiffs accuse PG&E management of intentionally sacrificing public safety for company profit and personal gain. Plaintiffs contend that linking company financial achievement and personal compensation made a San Bruno-magnitude catastrophe inevitable: "It was not a question of if there would be an explosion, it was only a question of when and where."

The lawsuits accuse PG&E management of promoting "an atmosphere and culture in which short term profits, cost cutting, and personal profiteering was put ahead of the proper management." Plaintiffs ridicule a particular PG&E "backwards" incentive program, alleging it rewarded employees for electing not to "report or fix leaks, or otherwise report any dangerous conditions that would cost PG&E money to fix."

This article does not comment on the possible (or lack of) merits of these allegations; the objective is to alert the utility industry that it must extricate itself from the untenable position of defending against accusations that senior executives sacrificed safety for personal profit.

Utilities Are Different

The economic theories that cost cutting should increase profits and that shareholders should correspondingly reward management

for increasing profits makes sense for most unregulated industries. However, an initiative by Apple or Ford to cut costs to increase profits is constrained by the reality that any resulting decline in product quality risks a decrease in sales and revenues, and correspondingly, profits. Thus, economically rational entities cut costs only if they can produce the same product at a lower cost or believe that consumers will continue to purchase a lesser product.

In contrast, the captive customer base within its exclusive service territory enables a utility to reduce operating costs, essentially without risk of customer loss due to product decline—customers cannot forsake electricity and have extremely limited alternative purchase options. Moreover, when expenditures are cut on maintenance of infrastructure, the utility customer has no notice of the resulting deterioration of service.

Zero Tolerance for Financial Performance-Based Bonuses

Over the last several decades, utility compensation has tended to mimic financial and technology companies, transitioning pay from almost all salaries and benefits to appreciable percentages of total compensation being bonus-based and the bonus in part being based on financial performance. For instance, even after San Bruno, PG&E's STIP remains based at 30% on financial performance.

The best industry practices and stringent regulatory oversight should reduce the occurrence of accidents such as San Bruno. However, the combination of aging infrastructure, population growth, and increased demands on existing facilities renders it statistically likely that a tragedy of the magnitude of the San Bruno explosion will again occur.

In the wake of the San Bruno event, utilities must appreciate that even the slightest nexus between "cost cutting" and executive bonuses poses undue risk. The California Public Utilities Commission and likely the courts will ultimately determine liability for San Bruno. Regardless of the outcomes, plaintiffs' arguments that PG&E's management sacrificed safety for personal gain will continue to attract disparaging headlines, incite critical political rhetoric, and encourage additional legal actions, whether the financial performance component in the incentive program is 50%, 30%, 10%, or even less.

Utilities would best serve their customers, employees, and shareholders by eliminating company financial performance as a criterion for bonuses altogether. Financial incentives for utility management and employees should be based on safety, reliability, and customer satisfaction. The public relations and legal nightmare PG&E confronts daily in the media, legislature, regulatory agencies, and the courts should persuade utility executives to demand "zero tolerance" and totally delink financial performance from incentive compensation programs. ■

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