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A Tale of Two Organizations

Much has been written in the press over the past 12 months about the $6 million compensation of the former Chief Executive Officer of Hydro One Limited, Mr. Mayo Schmidt. The Government of Ontario recently imposed a cap of $1,500,000 on the compensation of the CEO of Hydro One, to be in line with the compensation of the CEO of Ontario Power Generation (OPG).

How did we get to this point? To find the answer, this article examines:

- the process these two organizations have used to determine the compensation of their CEOs over the past 20 years since they were spun off from Ontario Hydro,
- how changes in the Government at Queens Park and political reaction to certain key events have affected the compensation of the two companies' CEOs,
- how much the CEOs actually earned over the period, and
- the potential implications of the new Government's recent decisions going forward for broader public sector organizations in Ontario.

Background

Hydro One and Ontario Power Generation were created twenty years ago when Ontario Hydro was separated in April 1999 into five organizations by Mike Harris' Progressive Conservative Government. The following is a high-level current comparison of the two organizations:

	Hydro One	**Ontario Power Generation**
Regulated Business	Electricity transmission	Electricity generation
Assets	$26.4 billion	$48.8 billion
Annual revenues	$6.2 billion	$5.2 billion
Employees	8,600	9,200
Key Differentiators	• 1.4 million customers • 47.4% owned by the Province of Ontario, 1.5% by OPG and 51.1 % publicly traded	• Nuclear operations • 100% owned by the Province of Ontario

Hydro One's transition from being a part of Ontario Hydro to becoming a Crown Corporation in 1999 and then subsequently to a publicly-traded organization in 2015 has been somewhat of a roller coaster ride, especially for Hydro One's CEOs, as the following time line demonstrates:

Dates	**Hydro One Time Line**
April 1, 1999	Ontario Hydro Services (OHSC) is formed Former Deputy Minister of Finance and former Ontario Hydro Vice President Ms. Eleanor Clitheroe is appointed CEO
May 1, 2000	OHSC is renamed "Hydro One"
July 19, 2002	Ms. Clitheroe is terminated due to an expense controversy Tom Parkinson becomes CEO
December 8, 2006	Tom Parkinson resigns over an expense controversy He receives almost $3.0 million in severance, creating a political uproar
Early 2007	Ms. Laura Formusa is promoted to CEO of Hydro One
June 2007	Hydro One changes its approach to executive compensation in order to conform with the recommendation of an independent panel
March 31, 2012	Executive compensation is frozen in the broader public sector
September 19, 2012	Ms. Formusa announces she is stepping down as CEO
January 2013	Mr. Carmine Marcello is promoted to CEO of Hydro One
June 2015	Hydro One's executive compensation freeze is lifted by the Province
September 3, 2015	Mr. Mayo Schmidt is appointed CEO of Hydro One two months prior to the November Initial Public Offering
March 19, 2018	Hydro One's annual management proxy circular is released Mr. Schmidt's target compensation has been increased by 62%
April 11, 2018	Doug Ford takes aim at Hydro One's "$6 million-dollar man"
June 7, 2018	The Progressive Conservative Party wins the Ontario election
July 11, 2018	Mr. Schmidt retires from Hydro One. He receives no severance, his stock options are cancelled, but his share units continue to vest at target. Hydro One's CFO, Mr. Paul Dobson, is appointed Acting CEO
July 15, 2018	*The Hydro Accountability Act, 2018* gives Management Board of Cabinet final say over Hydro One's executive compensation

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February 14, 2019	Hydro One submits a New Compensation Framework with a proposed CEO total compensation cap of $2,775,000
February 21, 2019	Management Board of Cabinet issues directive to Hydro One's Board of Directors capping CEO total compensation at $1,500,000
March 8, 2019	Hydro One's Board agrees to limit the CEO's salary to $500,000 and the CEO's incentives to $1,000,000
March 28, 2019	Hydro One announces it has hired BC Hydro's EVP Operations, Mark Poweska, as its new CEO

Meanwhile, apart from the first four years, OPG's CEO situation has been relatively stable:

Dates	**OPG Time Line**
April 1, 1999	Ontario Power Generation is formed Mr. Ron Osborne, former Ontario Hydro CEO, is appointed CEO
October 2, 2003	The Liberal Party wins the Ontario election
December 4, 2003	Mr. Osborne is asked to resign by the new Government Mr. Richard Dicerni is appointed Acting CEO
May 2, 2005	Mr. Jim Hankinson from New Brunswick Power is appointed CEO
July 1, 2009	Mr. Hankinson retires Mr. Thomas Mitchell is promoted from Chief Nuclear Officer to CEO
March 31, 2012	Executive compensation is frozen in the broader public sector
August 21, 2015	Mr. Mitchell retires Mr. Jeffrey Lyash is recruited from the US as CEO of OPG
September 7, 2016	Regulation 304/16 introduces new procedures for determining executive compensation within the broader public sector in Ontario
January 1, 2017	OPG's Executive Compensation Program under the Regulation produces $3,800,000 potential CEO total direct compensation OPG's Board caps the CEO's total direct compensation at $1,937,500, with a target of $1,500,000
February 13, 2019	Mr. Lyash announces he is returning to the US as CEO of the Tennessee Valley Authority Mr. Ken Hartwick, OPG's CFO, is appointed CEO effective April 1

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Peer Groups

Key first steps in developing any executive compensation policy include defining an appropriate group of peer organizations for comparison purposes, and then determining how competitive the organization wants to be with the peer group, typically focusing on the 50th percentile.

Hydro One CEO Compensation Peer Groups

Hydro One's peer group and competitive executive compensation strategy has changed a number of times over the past 20 years.

From 1999 to mid-2007, Hydro One's executive compensation comparator group consisted of a group of Canadian utility, energy companies and industrial organizations, weighted 80% private sector and 20% public sector. Total compensation at Hydro One was to be targeted at the 75th percentile of the total cash compensation (i.e. salary plus target bonus, but *not* including long-term incentive compensation) of the comparator group. As of 2007, this group had consisted of 35 private sector companies and 9 public sector organizations.

The political outcry following the almost $3.0 million severance paid to ex-Hydro One CEO Tom Parkinson in late 2006, in part, led the incumbent Liberal Government to establish an Agency Review Panel in January 2007 led by former Molson's CEO Mr. James Arnett. In May 2007, the Panel submitted its report on Phase I of its review of Ontario's provincially-owned electricity agencies. Based on the Panel's executive compensation recommendations, Hydro One implemented the following guidelines for all new executives and new senior management:

- Use comparative market data based on a 50/50 blend of public and private sector companies in determining total compensation.
- Establish Hydro One's total compensation relative to the 50th percentile of the blended market total compensation data (i.e. salary, target bonus, annualized net present value of long-term incentives (new), benefits and pension)

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The resulting comparator group consisted of 30 Canadian-based companies (15 public and 15 private) each year, approximately 2/3rds of which were utilities. In 2014, for example, the comparator group included the following companies:

Public Sector	**Private Sector**
Atomic Energy of Canada	ArcelorMittal Canada
Business Development Bank	Amec Americas
Canada Mortgage and Housing	Barrick Gold
Canadian Standards Association	Bombardier Transportation Canada
Enersource Hydro Mississauga	Bruce Power
Farm Credit Canada	Canadian National Railway
Government of Ontario	Fortis
Hydro Ottawa	FortisBC Energy
NB Power	Glencore
Ontario Power Authority	Goldcorp
Ontario Power Generation	Newfoundland Power
Royal Canadian Mint	Siemens Canada
SaskEnergy	Suncor Energy
SaskTel	Ultramar
Toronto Hydro	Vale Canada

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In anticipation of Hydro One's November 2015 initial public offering, the company developed a new primary reference group for its incoming CEO and CFO consisting of the four largest utilities listed on the Toronto Stock Exchange, plus four other TSX-listed companies within the broader energy industry that were deemed to be of comparable size and scope of operations to Hydro One, as follows:

2015 Reference Group

Utility Peers	**Broader Energy Peers**
AltaGas Ltd.	ATCO Ltd.
Emera Incorporated	Inter Pipeline
Fortis Inc.	Keyera Corp.
Pembina Pipeline	TransAlta

Based on this peer group, Mr. Mayo Schmidt was hired with target compensation of $4.0 million.

In 2017, a broader peer group of 19 organizations was used for all Hydro One's senior executives, including the CEO and CFO, as follows:

2017 Reference Group

Utility Peers	**Asset Intensive Companies**
AltaGas	Agrium
ATCO	Air Canada
Emera	Canadian National Railway
Fortis	Canadian Pacific Railway
Inter Pipeline	Canadian Tire
Keyera	CGI Group
Pembina Pipeline	National Bank
TransAlta	Rogers Communications
TransCanada	SNC-Lavalin
	Telus

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The CEO's target compensation increased by 62% to $6.5 million as a result of this change.

Even further changes to the peer group were anticipated following the close of Hydro One's proposed purchase of US-based Avista Corporation in the second half of 2018. Had this takeover gone through, Mr. Schmidt's target compensation would have increased once again, as US companies typically pay their CEOs more than Canadian companies.

Following the June 2018 election, the new Government implemented the *Hydro Accountability Act* which required Hydro One's Board to develop a new Executive Compensation Program for Cabinet approval.

In February 2019, Hydro One's Board developed the following revised peer group of 12 Canadian organizations for this purpose:

2019 Revised Reference Group

Utility and Energy Peers	**Public Sector Peers**
AltaGas	Hydro Quebec
ATCO	BC Hydro
Emera	Ontario Power Generation
Fortis	Toronto Hydro
Inter Pipeline	
Keyera	
Pembina Pipeline	
TransAlta	

It should be noted that the 8 utility and energy peers in this group are the same private sector companies that were in the 2017 peer group, with the sole exception of TransCanada which was removed. Meanwhile, the 4 public sector peers replaced the 10 asset intensive companies.

The Government of Ontario subsequently imposed the following peer group on Hydro One.

Ontario Power Generation

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OPG Comparator Groups

The publicly available information on OPG's comparator groups only goes back to 2008 when OPG issued its first annual "Statement of Executive Compensation" as required by the Canadian Securities Administrators.

From 2008 to 2013 the OPG peer group included the following equally-weighted private sector and public sector peer group:

Private Sector	Public Sector
Air Canada	Atomic Energy of Canada
Atco Ltd	BC Hydro
Canadian Natural Resources	Canada Post
Canadian Pacific Railway	Canadian Broadcasting Corporation
CN Rail	Hydro One
Enbridge	Hydro Quebec
Husky Energy	London Health Sciences
Nexen	Mount Sinai Hospital
NOVA Chemicals	Sunnybrook Health Sciences Centre
Talisman Energy	The Hospital for Sick Children
TransAlta Corp	Trillium Health Centre TransCanada
TransCanada	University Health Network

From 2014 to 2016, OPG no longer listed the companies in its peer group. No changes were made to the CEO's compensation during this period. However, OPG did state that it benchmarked executive compensation against the 50th percentile of the comparator group's compensation.

In the fall of 2016, OPG became one of the first Ontario broader public sector organizations to issue a formal executive compensation program pursuant to Regulation 304/16 under the BPSEC Act[1]. The company was given permission by the Province to include both private sector and US organizations for this purpose.

[1] Broader Public Sector Executive Compensation Act, 2014

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The peer group for the CEO position included the CEOs of the 9 largest nuclear power generation companies in the U.S., plus Bruce Power and 2 Canadian public sector utilities with revenues greater than $4 billion, as follows:

Private Sector		**Public Sector**
Bruce Power	FirstEnergy	Hydro Quebec
Dominion Resources	NextEra Energy	BC Hydro
Duke Energy	PSEG	
Entergy	Southern Company Services	
Exelon	Tennessee Valley Authority	

The maximum allowable CEO compensation as of January 1, 2017 based on this peer group was $3.8 million, largely due to the impact of the nine US companies. Nevertheless, OPG's Board decided to target the CEO's compensation under the program at $1,500,000 with an annual cap of $1,937,500. Mr. Lyash's 2017 target compensation as OPG's CEO was not increased as a result of this Board decision.

CEO Compensation Histories

How much were the CEOs of the two companies actually paid over the past 20 years?

The publicly available information on Hydro One's CEO and OPG's CEO cash compensation for the initial 1999 to 2007 period is limited to their "Sunshine List" disclosures (see Table 1). Over this time period, their average CEO cash compensation was similar, approximately $1.2 million at Hydro One and $1.4 million at OPG.

During the following period from 2008 to 2017 prior to Hydro One becoming a publicly traded company in November 2015, the total cash compensation of Hydro One's CEOs declined by about 30% to around $850,000. Meanwhile, the total cash compensation paid to OPG's CEOs increased by about 15% to an average of around $1,600,000 (see Table 1).

The disparity between the two organizations reversed in 2015 when Hydro One went public and gave Mr. Schmidt a total direct compensation package of $4.0 million and was increased even further in 2017 to $6.5 million, primarily as a result of the updated peer group, making Mr. Schmidt the "$6 million-dollar man". Table 2 summarizes the total CEO compensation program of the two organizations from 2015 to 2017.

Hydro One's new CEO will have an annual salary of $500,000 cap and maximum annual and long-term incentives totaling $1,000,000 as mandated by Management Board.

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Implications for the Broad Public Sector

When the new Government rescinded Regulation 304/16 in August 2018, it froze all executive compensation within the broader public sector in Ontario and indicated that it would develop a new approach to executive compensation by June 2019.

Based on the Hydro One decisions and other situations we are aware of, we are not expecting the Ontario Government to be more lenient when it comes to executive compensation within the broader public sector. In fact, we expect them to be tougher than the former Government.

Conclusion

CEO compensation continues to be a lightning rod in both the public and private sectors, as the Hydro One story illustrates.

What are the Boards of Directors to do? On the one hand, all Boards are required by the Supreme Court in the BCE decision[2] to "act in the best interests of the corporation" when making their decisions, not just for the sole benefit of shareholders, employees, suppliers, or customers.

The voice of the shareholder has become increasingly louder in recent years, however.

- At Hydro One, the role of the largest shareholder changed over time from general oversight in 1999, to more arm's length in 2015, and then back to greater control in mid-2018. The executive compensation program has had to respond to the wishes of its largest shareholder, the Province of Ontario.

A good executive compensation program and philosophy should always support the organization's business strategy and be updated regularly.

- The Hydro One strategy changed from a primary focus on more effective Ontario energy transmission as a separate Crown Corporation, to growth through acquisitions as a publicly-traded Ontario-based corporation, and now to reducing Ontario electricity rates. Hydro One's executive compensation program seems to reflect these changes in strategy.

No doubt the executive compensation story at Hydro One and OPG will continue to make headlines as well as others, as companies attempt to balance governance, business strategy, talent attraction and retention at the top.

2 BCE Inc. v. 1976 Debentureholders, 2008 SCC 69

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Tables

Table 1: Hydro One and OPG CEO Total Cash Compensation from 1999 to 2014 [3]

Year	Hydro One CEO		OPG CEO	
1999	E. Clitheroe	$723,203	R. Osborne	$1,351,304
2000	E. Clitheroe	$1,249,598	R. Osborne	$1,767,870
2001	E. Clitheroe	$1,622,228	R. Osborne	$1,874,103
2002	E. Clitheroe T. Parkinson	$1,470,041 $557,201	R. Osborne	$2,264,311
2003	T. Parkinson	$999,042	R. Osborne R. Dicerni	$925,998 $579,100
2004	T. Parkinson	$1,069,442	R. Osborne R. Dicerni	$676,541 $885,217
2005	T. Parkinson	$1,563,222	R. Dicerni J. Hankinson	$866,562 $593,010
2006	T. Parkinson	$1,560,901	J. Hankinson	$1,480,804
2007	L. Formusa	$794,299	J. Hankinson	$1,788,719
2008	L. Formusa	$924,437	J. Hankinson	$2,475,800 [4]
2009	L. Formusa	$975,176	J. Hankinson T. Mitchell	$2,150,116 $1,011,334
2010	L. Formusa	$953,844	T. Mitchell	$1,325,119
2011	L. Formusa	$961,963	T. Mitchell	$1,824,000
2012	L. Formusa	$1,036,740	T. Mitchell	$1,720,000
2013	C. Marcello	$724,917	T. Mitchell	$1,714,000
2014	C. Marcello	$741,554	T. Mitchell	$1,555,200

[3] Source: The Sunshine List
[4] Includes $600,000 retention bonus

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Table 2: 2015 to 2018 Hydro One and OPG CEO Compensation Programs [5]

	CEO	Annual Salary	Annual Incentive (% of Salary)	Long Term Incentives (% of Salary)	Target Total Direct Compensation	Total Direct Compensation for the Year
Hydro One						
2015	C. Marcello M. Schmidt	$525,000 $850,000	65% 90%	0% 280%	$866,250 $3,995,000	$1,222,500 [6] $1,321,423 [7]
2016	M. Schmidt	$850,000	90%	280%	$3,995,000	$4,399,948
2017	M. Schmidt	$1,200,000	110%	330%	$6,480,000 [8]	$6,074,319
Ontario Power Generation						
2015	T. Mitchell J. Lyash	$800,000 $775,000	100% 100%	0% 0%	$1,600,000 $1,550,000	$1,096,290 [9] $1,122,406 [10]
2016	J. Lyash	$775,000	100%	0%	$1,550,000	$1,530,459
2017	J. Lyash	$775,000	100%	0%	$1,550,000	$1,722,825

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[5] Source: Hydro One Management Information Circulars and OPG annual "Statements of Executive Compensation"
[6] Includes $407,500 "transition bonus"
[7] Pro-rated for 4 months' service
[8] Increased by 62% effective May 4, 2017
[9] Pro-rated to August 21, 2015
[10] Pro-rated from August 4, 2015. Includes $450,000 signing bonus

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