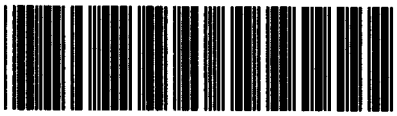

Control Number: 37744

Item Number: 1011

Addendum StartPage: 0

SOAH DOCKET NO. 473-10-1962
PUC DOCKET NO. 37744

APPLICATION OF ENTERGY TEXAS, INC. FOR AUTHORITY TO CHANGE RATES AND RECONCILE FUEL COSTS	§ § § §	PUBLIC UTILITY COMMISSION OF TEXAS

WORKPAPERS

TO THE

DIRECT TESTIMONY

OF

WILLIAM B. MARCUS

ON BEHALF OF THE

OFFICE OF PUBLIC UTILITY COUNSEL

REDACTED

June 9, 2010

1011

ENTERGY TEXAS, INC.
PUBLIC UTILITY COMMISSION OF TEXAS
Docket No. 37744 - 2009 ETI Rate Case

Response of: Entergy Texas, Inc.
to the Seventeenth Set of Data Requests
of Requesting Party: Office of Public Utility Counsel

Prepared By: Steve Bridges
Sponsoring Witness: J. David Wright
Beginning Sequence No. 16329

Ending Sequence No. 16349

Question No.: OPUC 17-2 Part No.: Addendum:

Question:

For each incentive compensation and/or bonus plan, please provide the amount of expense by account recorded on ETI's books for each year 2004-2008, for the test year, and for the 12 months ending September 30, 2009; divide into ETI direct, ESI billed to ETI, and nuclear. Provide figures for each program by FERC Account.

Response:

Please see the attached incentive schedules for 2004 – 2009, the test year ended June 30, 2009 and the year ended September 30, 2009. The 2004 – 2007 schedules pertain to EGSI, while the other schedules pertain to ETI.

ENTERGY TEXAS, INC.
DOCKET NO. 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ESI TO ETI INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
2009	107	243,988	411,475	942,746	29,461				1,627,670
2009	108	398	671	1,537	48				2,654
2009	163	19,948	33,642	77,079	2,409				133,078
2009	174	16,858	28,430	65,138	2,036				112,462
2009	181	2,450	4,132	9,467	296				16,345
2009	182	(7)	(11)	(26)	(1)				(45)
2009	184	4,335	7,311	16,749	523				28,918
2009	186	19,587	33,032	75,681	2,365				130,665
2009	228_1	21,881	36,901	84,545	2,642				145,969
2009	421	29	50	113	4				196
2009	426_1	1,545	2,605	5,968	187				10,305
2009	426_4	4,926	8,308	19,034	595				32,863
2009	426_5	346	583	1,335	42				2,306
	NON O&M	336,284	567,129	1,299,366	40,607	-	-	-	2,243,386
2009	500	66,686	112,464	257,670	8,052				444,872
2009	506	32,436	54,701	125,328	3,917				216,382
2009	510	15,058	25,394	58,182	1,818				100,452
2009	512	661	1,115	2,556	80				4,412
2009	513	690	1,164	2,667	83				4,604
2009	514	19,678	33,186	76,033	2,376				131,273
2009	517	37	62	143	4				246
2009	535	151	255	584	18				1,008
2009	539	40	68	156	5				269
2009	541	86	145	333	10				574
2009	546	48	81	187	6				322
2009	548	17	29	67	2				115
2009	551	4	7	16	1				28
2009	553	7	11	26	1				45
2009	556	17,834	30,076	68,909	2,153				118,972
2009	557	8,442	14,237	32,619	1,019				56,317
2009	560	21,118	35,615	81,598	2,550				140,881
2009	561	70,638	119,129	272,940	8,529				471,236
2009	566	9,186	15,493	35,496	1,109				61,284
2009	568	5,868	9,896	22,674	709				39,147
2009	569	5,692	9,599	21,992	687				37,970
2009	570	47	79	181	6				313
2009	571	16	26	60	2				104
2009	580	15,233	25,690	58,860	1,839				101,622
2009	586	203	342	783	24				1,352
2009	587	6	10	23	1				40
2009	588	10,017	16,893	38,704	1,210				66,824
2009	590	893	1,505	3,449	108				5,955
2009	592	901	1,519	3,480	109				6,009
2009	593	341	576	1,319	41				2,277
2009	595	24	41	93	3				161
2009	598	604	1,019	2,335	73				4,031
2009	901	5,136	8,662	19,845	620				34,263
2009	902	7,203	12,148	27,833	870				48,054
2009	903	63,622	107,296	245,829	7,682				424,429
2009	905	408	689	1,578	49				2,724
2009	907	262	442	1,012	32				1,748
2009	908	23	38	88	3				152
2009	909	463	781	1,790	56				3,090
2009	911	7	12	27	1				47
2009	912	17,350	29,261	67,041	2,095				115,747
2009	916	1,007	1,698	3,891	122				6,718
2009	920	342,748	578,030	1,324,348	41,386	332,505	210,006	159,723	2,988,746
2009	923	2	4	9	-				15
2009	924	1,073	1,810	4,146	130				7,159
2009	925	5,977	10,080	23,095	722				39,874
2009	928	17,679	29,815	68,311	2,135				117,940
2009	930_1	23	39	90	3				155
2009	930_2	12,231	20,628	47,261	1,477				81,597
2009	935	1,298	2,189	5,016	157				8,660
	O&M	779,174	1,314,049	3,010,673	94,085	332,505	210,006	159,723	5,900,215
	TOTAL	1,115,458	1,881,178	4,310,039	134,692	332,505	210,006	159,723	8,143,601

ENTERGY TEXAS, INC
DOCKET NO 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ESI TO ETI INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
10/1/08-9/30/09	107	194,986	328,836	753,409	23,544				1,300,775
10/1/08-9/30/09	108	409	690	1,581	49				2,729
10/1/08-9/30/09	163	14,777	24,921	57,098	1,784				98,580
10/1/08-9/30/09	174	24,216	40,839	93,568	2,924				161,547
10/1/08-9/30/09	181	2,864	4,830	11,066	346				19,106
10/1/08-9/30/09	182	(27)	(46)	(105)	(3)				(181)
10/1/08-9/30/09	184	3,441	5,803	13,295	415				22,954
10/1/08-9/30/09	186	4,817	8,124	18,612	582				32,135
10/1/08-9/30/09	228_1	41,590	70,139	160,698	5,022				277,449
10/1/08-9/30/09	421	29	50	113	4				196
10/1/08-9/30/09	426_1	1,299	2,190	5,018	157				8,664
10/1/08-9/30/09	426_4	4,136	6,974	15,979	499				27,588
10/1/08-9/30/09	426_5	309	521	1,195	37				2,062
	NON O&M	292,846	493,871	1,131,527	35,360	-	-	-	1,953,604
10/1/08-9/30/09	500	44,277	74,671	171,082	5,346				295,376
10/1/08-9/30/09	506	21,174	35,710	81,816	2,557				141,257
10/1/08-9/30/09	510	11,611	19,581	44,863	1,402				77,457
10/1/08-9/30/09	512	736	1,241	2,844	89				4,910
10/1/08-9/30/09	513	249	420	963	30				1,662
10/1/08-9/30/09	514	74	125	286	9				494
10/1/08-9/30/09	517	45	77	176	5				303
10/1/08-9/30/09	524	8	14	32	1				55
10/1/08-9/30/09	535	115	194	445	14				768
10/1/08-9/30/09	539	40	68	156	5				269
10/1/08-9/30/09	541	86	145	333	10				574
10/1/08-9/30/09	546	50	85	194	6				335
10/1/08-9/30/09	548	21	35	80	3				139
10/1/08-9/30/09	551	4	7	16	1				28
10/1/08-9/30/09	553	7	11	26	1				45
10/1/08-9/30/09	556	14,608	24,635	56,443	1,764				97,450
10/1/08-9/30/09	557	6,810	11,485	26,315	822				45,432
10/1/08-9/30/09	560	15,779	26,611	60,969	1,905				105,264
10/1/08-9/30/09	561	58,590	98,810	226,388	7,075				390,863
10/1/08-9/30/09	566	8,561	14,438	33,080	1,034				57,113
10/1/08-9/30/09	568	5,207	8,781	20,118	629				34,735
10/1/08-9/30/09	569	4,974	8,388	19,218	601				33,181
10/1/08-9/30/09	570	47	79	181	6				313
10/1/08-9/30/09	571	16	26	60	2				104
10/1/08-9/30/09	580	12,779	21,551	49,377	1,543				85,250
10/1/08-9/30/09	586	193	325	745	23				1,286
10/1/08-9/30/09	587	6	10	23	1				40
10/1/08-9/30/09	588	8,598	14,499	33,220	1,038				57,355
10/1/08-9/30/09	590	731	1,233	2,824	88				4,876
10/1/08-9/30/09	592	748	1,262	2,891	90				4,991
10/1/08-9/30/09	593	283	477	1,093	34				1,887
10/1/08-9/30/09	595	23	38	88	3				152
10/1/08-9/30/09	598	424	714	1,637	51				2,826
10/1/08-9/30/09	901	4,231	7,135	16,347	511				28,224
10/1/08-9/30/09	902	5,586	9,420	21,583	674				37,263
10/1/08-9/30/09	903	43,916	74,063	169,688	5,303				292,970
10/1/08-9/30/09	905	284	478	1,095	34				1,891
10/1/08-9/30/09	907	208	351	803	25				1,387
10/1/08-9/30/09	908	23	39	89	3				154
10/1/08-9/30/09	909	419	706	1,617	51				2,793
10/1/08-9/30/09	911	7	12	27	1				47
10/1/08-9/30/09	912	14,561	24,557	56,264	1,758				97,140
10/1/08-9/30/09	916	847	1,429	3,273	102				5,651
10/1/08-9/30/09	920	218,325	368,195	843,587	26,362	1,074,235	273,386	172,108	2,976,198
10/1/08-9/30/09	923	8	14	32	1				55
10/1/08-9/30/09	924	788	1,329	3,046	95				5,258
10/1/08-9/30/09	925	5,007	8,444	19,345	605				33,401
10/1/08-9/30/09	928	15,019	25,328	58,031	1,813				100,191
10/1/08-9/30/09	930_1	25	42	97	3				167
10/1/08-9/30/09	930_2	10,992	18,537	42,471	1,327				73,327
10/1/08-9/30/09	935	1,082	1,825	4,182	131				7,220
	O&M	538,202	907,650	2,079,559	64,987	1,074,235	273,386	172,108	5,110,127
	TOTAL	831,048	1,401,521	3,211,086	100,347	1,074,235	273,386	172,108	7,063,731

ENTERGY TEXAS, INC.
DOCKET NO. 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ESI TO ETI INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
7/1/08-6/30/09	107	202,647	341,755	783,008	24,469				1,351,879
7/1/08-6/30/09	108	33	56	128	4				221
7/1/08-6/30/09	163	14,426	24,329	55,742	1,742				96,239
7/1/08-6/30/09	174	34,961	58,961	135,087	4,221				233,230
7/1/08-6/30/09	181	1,750	2,952	6,762	211				11,675
7/1/08-6/30/09	182	(100)	(169)	(386)	(12)				(667)
7/1/08-6/30/09	184	3,870	6,526	14,952	467				25,815
7/1/08-6/30/09	186	7,590	12,800	29,326	916				50,632
7/1/08-6/30/09	228_1	58,351	98,407	225,464	7,046				389,268
7/1/08-6/30/09	421	29	50	113	4				196
7/1/08-6/30/09	426_1	1,554	2,620	6,003	188				10,365
7/1/08-6/30/09	426_4	4,943	8,336	19,099	597				32,975
7/1/08-6/30/09	426_5	343	579	1,326	41				2,289
	NON O&M	330,397	557,202	1,276,624	39,894	-	-	-	2,204,117
7/1/08-6/30/09	500	51,250	86,430	198,024	6,188				341,892
7/1/08-6/30/09	506	24,742	41,727	95,602	2,988				165,059
7/1/08-6/30/09	510	13,976	23,570	54,003	1,688				93,237
7/1/08-6/30/09	512	646	1,090	2,498	78				4,312
7/1/08-6/30/09	513	311	524	1,201	38				2,074
7/1/08-6/30/09	535	114	193	442	14				763
7/1/08-6/30/09	539	31	52	119	4				206
7/1/08-6/30/09	541	86	145	333	10				574
7/1/08-6/30/09	546	82	138	316	10				546
7/1/08-6/30/09	548	22	38	87	3				150
7/1/08-6/30/09	551	4	7	16	1				28
7/1/08-6/30/09	553	7	11	26	1				45
7/1/08-6/30/09	556	16,915	28,527	65,359	2,042				112,843
7/1/08-6/30/09	557	8,576	14,463	33,136	1,035				57,210
7/1/08-6/30/09	560	17,937	30,250	69,307	2,166				119,660
7/1/08-6/30/09	561	68,449	115,437	264,483	8,265				456,634
7/1/08-6/30/09	566	10,385	17,515	40,128	1,254				69,282
7/1/08-6/30/09	568	5,430	9,158	20,981	656				36,225
7/1/08-6/30/09	569	5,982	10,088	23,112	722				39,904
7/1/08-6/30/09	570	27	46	106	3				182
7/1/08-6/30/09	571	16	26	60	2				104
7/1/08-6/30/09	580	13,833	23,329	53,449	1,670				92,281
7/1/08-6/30/09	586	246	415	952	30				1,643
7/1/08-6/30/09	587	21	35	79	2				137
7/1/08-6/30/09	588	10,014	16,888	38,694	1,209				66,805
7/1/08-6/30/09	590	814	1,373	3,145	98				5,430
7/1/08-6/30/09	592	811	1,368	3,134	98				5,411
7/1/08-6/30/09	593	332	560	1,283	40				2,215
7/1/08-6/30/09	595	15	26	59	2				102
7/1/08-6/30/09	598	493	831	1,905	60				3,289
7/1/08-6/30/09	901	4,922	8,301	19,019	594				32,836
7/1/08-6/30/09	902	6,384	10,766	24,666	771				42,587
7/1/08-6/30/09	903	51,889	87,509	200,496	6,265				346,159
7/1/08-6/30/09	905	300	506	1,160	36				2,002
7/1/08-6/30/09	907	228	385	882	28				1,523
7/1/08-6/30/09	908	27	45	103	3				178
7/1/08-6/30/09	909	456	768	1,760	55				3,039
7/1/08-6/30/09	911	7	11	26	1				45
7/1/08-6/30/09	912	16,960	28,602	65,532	2,048				113,142
7/1/08-6/30/09	916	1,029	1,735	3,975	124				6,863
7/1/08-6/30/09	920	245,455	413,950	948,416	29,638				1,637,459
7/1/08-6/30/09	923	8	14	32	1				55
7/1/08-6/30/09	924	826	1,393	3,191	100	954,647	(270,471)	(14,711)	674,976
7/1/08-6/30/09	925	5,812	9,802	22,459	702				38,775
7/1/08-6/30/09	928	15,832	26,701	61,175	1,912				105,620
7/1/08-6/30/09	930_1	18	31	70	2				121
7/1/08-6/30/09	930_2	11,209	18,903	43,309	1,353				74,774
7/1/08-6/30/09	935	1,105	1,863	4,269	133				7,370
	O&M	614,034	1,035,545	2,372,579	74,143	954,647	(270,471)	(14,711)	4,765,767
	TOTAL	944,431	1,592,747	3,649,203	114,037	954,647	(270,471)	(14,711)	6,969,884

ENTERGY TEXAS, INC.
DOCKET NO. 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ETI DIRECT INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
2009	107	108,466	18,378	107,847	60,295				294,986
2009	108	7,656	1,297	7,612	4,256				20,821
2009	146	42,876	7,265	42,631	23,834				116,606
2009	163	39,754	6,736	39,527	22,099				108,116
2009	174	3,319	562	3,300	1,845				9,026
2009	182	(50,822)	(8,611)	(50,532)	(28,252)				(138,217)
2009	184	45,661	7,736	45,401	25,383				124,181
2009	186	53,676	9,094	53,369	29,838				145,977
2009	228_1	149,479	25,327	148,626	83,094				406,526
2009	234	(14,103)	(2,390)	(14,023)	(7,840)				(38,356)
2009	426_4	14,949	2,533	14,864	8,310				40,656
2009	426_5	754	128	749	419				2,050
	NON O&M	401,665	68,055	399,371	223,281	-	-	-	1,092,372
									-
2009	500	3,436	582	3,416	1,910				9,344
2009	502	40,129	6,799	39,900	22,307				109,135
2009	505	1,658	281	1,649	922				4,510
2009	506	31,178	5,282	31,000	17,331				84,791
2009	510	7,882	1,335	7,837	4,381				21,435
2009	511	2,585	438	2,570	1,437				7,030
2009	512	6,132	1,039	6,097	3,409				16,677
2009	513	8,183	1,386	8,136	4,549				22,254
2009	514	1,622	275	1,613	902				4,412
2009	560	6,968	1,181	6,928	3,874				18,951
2009	561	(18,852)	(3,194)	(18,744)	(10,479)				(51,269)
2009	562	563	95	560	313				1,531
2009	563	111	19	111	62				303
2009	566	190	32	189	106				517
2009	568	29,099	4,930	28,933	16,176				79,138
2009	569	354	60	352	197				963
2009	570	7,842	1,329	7,797	4,359				21,327
2009	571	71	12	71	39				193
2009	580	40,658	6,889	40,426	22,601				110,574
2009	581	13,679	2,318	13,601	7,604				37,202
2009	582	5,775	978	5,742	3,210				15,705
2009	583	5,206	882	5,177	2,894				14,159
2009	584	3,371	571	3,352	1,874				9,168
2009	585	3,326	563	3,307	1,849				9,045
2009	586	14,980	2,538	14,894	8,327				40,739
2009	587	6,255	1,060	6,219	3,477				17,011
2009	588	16,314	2,764	16,221	9,069				44,368
2009	590	34,593	5,861	34,395	19,230				94,079
2009	591	2	-	2	1				5
2009	592	6,482	1,098	6,445	3,603				17,628
2009	593	28,227	4,783	28,066	15,691				76,767
2009	594	9,046	1,533	8,994	5,029				24,602
2009	596	3,995	677	3,972	2,221				10,865
2009	597	2,491	422	2,477	1,385				6,775
2009	598	1,349	229	1,342	750				3,670
2009	901	160	27	159	89				435
2009	902	728	123	723	404				1,978
2009	903	8,983	1,522	8,932	4,994				24,431
2009	905	162	27	161	90				440
2009	907	6,512	1,103	6,474	3,620				17,709
2009	908	49,315	8,356	49,033	27,414				134,118
2009	909	3,046	516	3,029	1,693				8,284
2009	910	26,186	4,437	26,037	14,557				71,217
2009	920	(281,653)	(47,721)	(280,044)	(156,567)	27,127	4,198	-	(734,660)
2009	925	150	25	150	84				409
2009	928	6,935	1,175	6,895	3,855				18,860
2009	930_1	365	62	363	203				993
2009	930_2	(32,956)	(5,584)	(32,768)	(18,320)				(89,628)
2009	935	1,695	287	1,685	942				4,609
	O&M	114,528	19,402	113,876	63,668	27,127	4,198	-	342,799
	TOTAL	516,193	87,457	513,247	286,949	27,127	4,198	-	1,435,171

ENTERGY TEXAS, INC.
DOCKET NO. 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ETI DIRECT INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
10/1/08-9/30/09	107	401,523	68,031	399,230	223,202				1,091,986
10/1/08-9/30/09	108	4,268	723	4,243	2,372				11,606
10/1/08-9/30/09	163	31,705	5,372	31,524	17,624				86,225
10/1/08-9/30/09	174	36,991	6,267	36,780	20,563				100,601
10/1/08-9/30/09	184	41,599	7,048	41,361	23,124				113,132
10/1/08-9/30/09	186	955	162	950	531				2,598
10/1/08-9/30/09	228_1	134,580	22,802	133,812	74,812				366,006
10/1/08-9/30/09	426_4	14,033	2,378	13,953	7,801				38,165
10/1/08-9/30/09	426_5	705	119	701	392				1,917
	NON-O&M	702,531	119,031	698,519	390,528	-	-	-	1,812,236
									-
10/1/08-9/30/09	500	41,328	7,002	41,092	22,973				112,395
10/1/08-9/30/09	502	22,261	3,772	22,134	12,375				60,542
10/1/08-9/30/09	505	1,145	194	1,138	636				3,113
10/1/08-9/30/09	506	36,311	6,152	36,104	20,185				98,752
10/1/08-9/30/09	510	6,573	1,114	6,536	3,654				17,877
10/1/08-9/30/09	511	2,293	389	2,280	1,275				6,237
10/1/08-9/30/09	512	5,359	908	5,328	2,979				14,574
10/1/08-9/30/09	513	6,809	1,154	6,770	3,785				18,518
10/1/08-9/30/09	514	1,292	219	1,285	718				3,514
10/1/08-9/30/09	560	5,797	982	5,764	3,222				15,765
10/1/08-9/30/09	561	466	79	463	259				1,267
10/1/08-9/30/09	562	542	92	539	301				1,474
10/1/08-9/30/09	563	111	19	110	62				302
10/1/08-9/30/09	566	176	30	175	98				479
10/1/08-9/30/09	568	21,576	3,656	21,453	11,994				58,679
10/1/08-9/30/09	569	352	60	350	196				958
10/1/08-9/30/09	570	7,968	1,350	7,922	4,429				21,669
10/1/08-9/30/09	571	57	10	57	32				156
10/1/08-9/30/09	580	45,770	7,755	45,508	25,443				124,476
10/1/08-9/30/09	581	13,004	2,203	12,930	7,229				35,366
10/1/08-9/30/09	582	5,578	945	5,546	3,101				15,170
10/1/08-9/30/09	583	4,028	683	4,005	2,239				10,955
10/1/08-9/30/09	584	3,379	572	3,359	1,878				9,188
10/1/08-9/30/09	585	2,085	353	2,073	1,159				5,670
10/1/08-9/30/09	586	13,858	2,348	13,779	7,703				37,688
10/1/08-9/30/09	587	5,491	930	5,459	3,052				14,932
10/1/08-9/30/09	588	15,400	2,609	15,312	8,560				41,881
10/1/08-9/30/09	590	24,323	4,121	24,184	13,521				66,149
10/1/08-9/30/09	592	6,659	1,128	6,621	3,702				18,110
10/1/08-9/30/09	593	27,878	4,723	27,718	15,497				75,816
10/1/08-9/30/09	594	9,134	1,548	9,081	5,077				24,840
10/1/08-9/30/09	596	3,752	636	3,731	2,086				10,205
10/1/08-9/30/09	597	2,458	417	2,444	1,367				6,686
10/1/08-9/30/09	598	1,351	229	1,343	751				3,674
10/1/08-9/30/09	870	7,437	1,260	7,394	4,134				20,225
10/1/08-9/30/09	901	167	28	166	93				454
10/1/08-9/30/09	902	791	134	787	440				2,152
10/1/08-9/30/09	903	50,231	8,511	49,944	27,923				136,609
10/1/08-9/30/09	905	131	22	130	73				356
10/1/08-9/30/09	907	5,751	974	5,718	3,197				15,640
10/1/08-9/30/09	908	52,942	8,970	52,639	29,430				143,981
10/1/08-9/30/09	909	2,555	433	2,541	1,420				6,949
10/1/08-9/30/09	910	28,797	4,879	28,633	16,008				78,317
10/1/08-9/30/09	920	64,527	10,933	64,158	35,870	77,461	4,198	-	257,147
10/1/08-9/30/09	925	150	25	150	84				409
10/1/08-9/30/09	928	6,209	1,052	6,174	3,452				16,887
10/1/08-9/30/09	930_1	326	55	324	181				886
10/1/08-9/30/09	930_2	9,757	1,653	9,702	5,424				26,536
10/1/08-9/30/09	935	1,536	260	1,527	854				4,177
	O&M	575,871	97,571	572,580	320,121	77,461	4,198	-	1,647,802
	TOTAL	1,278,402	216,602	1,271,099	710,649	77,461	4,198	-	3,460,038

ENTERGY TEXAS, INC.
DOCKET NO. 37744 ETI COS 6/30/09
OPUC 17TH SET QUESTION 2
ETI DIRECT INCENTIVE COMPENSATION

YEAR	ACCOUNT	EXIP	EAIP	SMIP	TSIP	LONG-TERM	EQUITY AWARDS	RESTRICTED SHARE	TOTAL
7/1/08-6/30/09	107	459,101	77,786	456,479	255,209				1,248,575
7/1/08-6/30/09	108	(441)	(75)	(439)	(245)				(1,200)
7/1/08-6/30/09	163	21,972	3,723	21,847	12,214				59,756
7/1/08-6/30/09	174	(29,809)	(5,051)	(29,639)	(16,570)				(81,069)
7/1/08-6/30/09	184	34,985	5,928	34,785	19,448				95,146
7/1/08-6/30/09	186	2,200	373	2,188	1,223				5,984
7/1/08-6/30/09	228_1	164,632	27,894	163,692	91,517				447,735
7/1/08-6/30/09	426_4	16,503	2,796	16,409	9,174				44,882
7/1/08-6/30/09	426_5	966	164	961	537				2,628
	NON O&M	670,109	113,538	666,283	372,507	-	-	-	1,822,437
7/1/08-6/30/09	500	40,714	6,898	40,482	22,633				110,727
7/1/08-6/30/09	502	19,705	3,339	19,592	10,954				53,590
7/1/08-6/30/09	505	1,127	191	1,120	626				3,064
7/1/08-6/30/09	506	43,100	7,302	42,854	23,959				117,215
7/1/08-6/30/09	510	6,261	1,061	6,225	3,480				17,027
7/1/08-6/30/09	511	1,940	329	1,929	1,078				5,276
7/1/08-6/30/09	512	5,165	875	5,135	2,871				14,046
7/1/08-6/30/09	513	6,601	1,118	6,563	3,669				17,951
7/1/08-6/30/09	514	1,000	169	994	556				2,719
7/1/08-6/30/09	560	6,831	1,157	6,792	3,797				18,577
7/1/08-6/30/09	561	406	69	403	225				1,103
7/1/08-6/30/09	562	546	92	543	303				1,484
7/1/08-6/30/09	563	100	17	99	55				271
7/1/08-6/30/09	566	178	30	177	99				484
7/1/08-6/30/09	568	21,360	3,619	21,238	11,874				58,091
7/1/08-6/30/09	569	403	68	401	224				1,096
7/1/08-6/30/09	570	7,870	1,333	7,825	4,375				21,403
7/1/08-6/30/09	571	57	10	57	32				156
7/1/08-6/30/09	580	43,416	7,356	43,168	24,134				118,074
7/1/08-6/30/09	581	12,775	2,164	12,702	7,101				34,742
7/1/08-6/30/09	582	5,329	903	5,298	2,962				14,492
7/1/08-6/30/09	583	3,605	611	3,584	2,004				9,804
7/1/08-6/30/09	584	3,857	653	3,835	2,144				10,489
7/1/08-6/30/09	585	2,405	408	2,392	1,337				6,542
7/1/08-6/30/09	586	12,664	2,146	12,592	7,040				34,442
7/1/08-6/30/09	587	5,700	966	5,668	3,169				15,503
7/1/08-6/30/09	588	15,655	2,653	15,566	8,703				42,577
7/1/08-6/30/09	590	22,949	3,888	22,818	12,757				62,412
7/1/08-6/30/09	592	6,139	1,040	6,103	3,412				16,694
7/1/08-6/30/09	593	31,253	5,295	31,074	17,373				84,995
7/1/08-6/30/09	594	9,322	1,579	9,269	5,182				25,352
7/1/08-6/30/09	596	4,243	719	4,218	2,358				11,538
7/1/08-6/30/09	597	2,399	406	2,385	1,334				6,524
7/1/08-6/30/09	598	1,628	276	1,619	905				4,428
7/1/08-6/30/09	901	183	31	182	102				498
7/1/08-6/30/09	902	786	133	782	437				2,138
7/1/08-6/30/09	903	48,769	8,263	48,490	27,110				132,632
7/1/08-6/30/09	905	192	32	191	107				522
7/1/08-6/30/09	907	5,282	895	5,252	2,936				14,365
7/1/08-6/30/09	908	49,319	8,356	49,037	27,416				134,128
7/1/08-6/30/09	909	2,592	439	2,577	1,441				7,049
7/1/08-6/30/09	910	26,671	4,519	26,518	14,826				72,534
7/1/08-6/30/09	920	165,449	28,032	164,504	91,971	62,677	4,198	-	516,831
7/1/08-6/30/09	928	6,900	1,169	6,861	3,836				18,766
7/1/08-6/30/09	930_1	268	45	267	149				729
7/1/08-6/30/09	930_2	9,246	1,566	9,193	5,139				25,144
7/1/08-6/30/09	935	1,831	310	1,821	1,018				4,980
	O&M	664,191	112,530	660,395	369,213	62,677	4,198	-	1,873,204
	TOTAL	1,334,300	226,068	1,326,678	741,720	62,677	4,198	-	3,695,641

ENTERGY TEXAS, INC.
PUBLIC UTILITY COMMISSION OF TEXAS
Docket No. 37744 - 2009 ETI Rate Case

Response of: Entergy Texas, Inc.
to the Seventeenth Set of Data Requests
of Requesting Party: Office of Public Utility Counsel

Prepared By: Steve Bridges
Sponsoring Witness: J. David Wright
Beginning Sequence No. LL6352

Ending Sequence No. LL6358

Question No.: OPUC 17-6 Part No.: Addendum:

Question:

Is ratepayer funding requested for any long-term incentives such as stock options, performance stock, or similar items (collectively "stock-based compensation")? If so, please answer the following questions:

a. What percentage of each type of long-term incentives are requested in rates? If any type is not 100%, provide the rationale for a lower percentage for each that is not.

b. What is the amount of long-term incentives requested in rates, divided between ETI employees and costs of Entergy Corporation employees allocated to ETI (provide total amount of stock-based compensation, by type, and amount allocated to ETI).

c. Please provide the latest documentation showing the valuation of long-term incentives requested in rates.

d. Please provide a narrative explanation of how the 2008-09 decline in the stock market has affected the valuation of long-term incentives issued prior to the decline. Explain how this change in valuation affects the income statement and balance sheet of the company.

Response:

a. Yes, 100% is requested.

b. Please see the Company's response to OPUC 17-2 and Rose City 7-20 for Long-Term Incentives, Restricted Share and Equity awards requested in this case. Please also see the Company's response to Rose City 6-9 for test year stock option expense.

c. Please see the attached plan document for the Long-Term Incentive program and a description of Equity Awards and Restricted Share Awards.

Question No.: OPUC 17-6

d. Share-based incentives such as the Long-Term Incentive Plan and Restricted Units Program are accrued quarterly over a defined time period and are based on equivalent share units times the current market value of Entergy stock. The quarterly accrual recognizes another portion of the overall expected liability to be incurred at the end of the programs. In a market where Entergy's stock price remained constant, these accruals would be the same amount each quarter. However, in the situation where Entergy's stock price has declined (as was the case from 2008 to 2009), the quarterly accrual is reduced to reflect the lower liability expected as a result of this decline in Entergy stock price.

Stock option expense is accrued over a three-year period for each respective grant and is based on a fair value determination resulting from several stock option weighted-average assumptions. This fair value determination is assigned at the date of the grant and remains unaffected by any future decline in Entergy market value. However, future stock option grant valuations could be affected by a decline in Entergy stock price as stock price volatility is one of the several assumptions used in determining fair value.

ENTERGY TEXAS, INC.
6/30/09 COST OF SERVICE
DOCKET 37744
ATTACHMENT - OPUC DATA REQUEST 17-6 Part C
DESCRIPTION OF EQUITY AWARDS AND RESTRICTED SHARE AWARDS

EQUITY AWARDS

The program is used to record the market value fluctuation for executive incentive compensation (EAIP, LTIP, Restricted Units) for which participants have elected to defer collection. The initial principal amount of deferred incentive is retained as a liability on the books as Entergy has not yet funded this obligation. Participants elect to have their deferred compensation invested as "book" accounts managed by TRowePrice. Every quarter TRowe provides accounting with the current market value of these book investments and the liability is adjusted accordingly. The offset account charged for the change in this liability is expense account 920000.

RESTRICTED SHARE AWARDS

Restricted units granted under our equity ownership plans represent phantom shares of Company common stock (i.e., non-stock interests that have an economic value equivalent to a share of our common stock). We occasionally grant restricted units to Named Executive Officers for retention purposes or to offset forfeited compensation from a previous employer or to existing employees for retention or other limited purposes. If all conditions of the grant are satisfied, restrictions on the restricted units lift at the end of the restricted period, and a cash equivalent value of the restricted units is paid. The settlement price is equal to the number of restricted units multiplied by the closing price of Company common stock on the date restrictions lift. Restricted units are not entitled to dividends or voting rights. Restricted units are generally time-based awards for which restrictions lift, subject to continued employment, over a two- to five-year period.

2007 – 2009 PERFORMANCE UNIT PROGRAM SUMMARY

1. *OBJECTIVES*

- The Performance Unit Program is designed to strengthen the link between executive compensation and long term shareholder value.
- The Performance Unit Program complements the Executive Annual Incentive Plan by tying payouts to the total return to shareholders over a three-year performance period.

2. *WHAT ARE PERFORMANCE UNITS?*

- Performance Units are phantom shares of Entergy Corporation common stock. Each Performance Unit equals the cash value of one share of Entergy common stock. Each Unit also earns the cash equivalent of the dividends paid during the three-year performance period.
- Participants earn Performance Units based on their performance relative to corporate performance measures and goals.
- At the end of the performance period, restrictions are lifted on Units earned and their corresponding cash dividends, as determined by the performance measures. The cash value of those earned Units plus accrued dividends is either paid to participants in early 2009 or deferred in that same time period, if so elected.

3. *KEY DESIGN FEATURES*

- Participants will earn Performance Units as follows:
  - 0% of "Target" for achieving less than "Minimum" performance.
  - 10% of "Target" for achieving "Minimum" performance.
  - 100% of "Target" for achieving "Target" performance.
  - 250% of "Target" for achieving "Maximum" performance.
- Performance Units earned will be calculated by using the actual performance level achieved between "Minimum" (10%), "Target" (100%) and "Maximum" (250%) performance – rounded to the nearest whole Unit. In no case, however, may a participant payout exceed 250% of the target.
- The value associated with the Units earned and their accrued dividends will be paid in early 2010 (following the three-year performance period) or deferred -- based upon each participant's election.
- Dividends will be accrued only on the Performance Units earned during the 2007 -2009 performance period.
- Executives may elect to defer up to 100% of the value associated with the Units earned including accrued dividends under either the Executive Deferred Compensation Plan (EDCP) or the Equity Ownership Plan (EOP). The plan selected will determine how the executive's deferral is invested.

2007 – 2009 PERFORMANCE UNIT PROGRAM SUMMARY

- Each participant must provide his/her irrevocable deferral election (to either receive the earned Units and dividends in early 2010 or to defer payment) in accordance with Entergy's deferral process. Otherwise, the value of the accrued Performance Units and dividends will be paid in cash in early 2010.
- To earn Performance Units, participants must be active employees at the end of the Performance Period (12/31/09) unless retirement, death or disability occurs.
  - Participants include all Entergy System management level 1-4 employees.
  - Retirement, death or disability will cause the Performance Units earned to be prorated for the number of full months of participation.
  - Participants added to the Program after the beginning of the performance period will have their Performance Units prorated to reflect the number of full months as a participant. To receive an award, participation must commence no later than January 1, 2009.
  - Participants whose Management Level changes during the performance period will have their Performance Units prorated to reflect the number of full months as a participant in each of those levels.
  - Participants demoted below an eligible System Management Level during the performance period will have their Performance Units prorated to reflect the number of full months at an eligible System Management Level.
- No single participant may be granted Performance Units whose total value exceeds .5% of Entergy's operating cash flow, and the total value of performance units granted to all of the named executive officers in Entergy's proxy statement may not exceed 1% of operating cash flow.

4. *2007 - 2009 PERFORMANCE UNIT PROGRAM GOALS AND PEER GROUP*

As the following chart illustrates, performance is measured by Entergy's Total Shareholder Return (TSR) relative to the other companies that comprise the Philadelphia Utilities Index over the three-year performance period. Minimum, Target and Maximum performance levels are set in terms of Entergy's TSR performance against the Philadelphia Utilities Index quartiles.

Quartiles:	4	3	2	1
Performance Levels:	Zero	Minimum	Target	Maximum
TSR Ranges:	25th percentile and below	25th to 50th percentiles	50th to 75th percentiles	75th percentile and above
Payouts:	No Payout	Interpolate between Minimum and Target (10% to 100% of Target)	Interpolate between Target and Maximum (100% to 250% of Target)	Maximum Payout (250% of Target)

2007 – 2009 PERFORMANCE UNIT PROGRAM SUMMARY

- A TSR ranking anywhere in the first quartile gains a maximum award of 250% of Target.
- A TSR ranking in the fourth quartile (bottom) quartile is below the minimum performance level resulting in no award (zero pay out).
- A TSR ranking in the second and third quartiles is calculated linearly based on where Entergy ranks between the minimum and the median (target), or the median (target) and the maximum.
  - The company ranking last in the 3rd quartile defines minimum performance.
  - Target performance is defined as the median TSR
  - The company ranking last in the 1st quartile defines maximum performance.
- The current listing of companies in the Philadelphia Utilities Index includes the following 20 companies:*

Ameren Corp.	Exelon Corp.
American Electric Power	Firstenergy Corp.
AES Corp.	FPL Group, Inc.
CenterPoint Energy	Northeast Utilities
Dominion Resources	PG&E Corp.
DTE Energy Holding Co.	Public Service Enterprise
Duke Energy Corp.	Progress Energy, Inc.
Consolidated Edison	Southern Co.
Edison International	TXU Corp.
Entergy Corp.	XCEL Energy, Inc.

* as of February 5, 2007

- **Total shareholder return** is the difference between the market price of Entergy Corporation common stock at the beginning from the market price at the end of the performance period, plus the dividends received during the same period, plus the investment return on those reinvested dividends divided by the share price at the beginning of the performance period.
- **Example:**

Date	Closing Stock Price	
12/29/06 (Beginning of Period)	$92.32	(actual)
12/31/09 (End of Period)	$102.32	(estimated)
Difference in Market Price	$10.00	(estimated)

Assume also that dividends paid to shareholders during the three-year performance period are $0.54 per quarter or $6.48 for the three-year period. For the purposes of the Total Return calculation, we further assume that dividends are immediately reinvested in Entergy

2007 – 2009 PERFORMANCE UNIT PROGRAM SUMMARY

Corporation common stock, as they are paid, producing a reinvestment return of $0.74 per share.

Total Return during the three-year Performance Period = (Difference in Market Price + Dividends Paid + Reinvestment Return on Dividends) divided by the Beginning Stock Price and would be calculated as follows:

- ➡ Total Return = ($10.00 + $6.48 + $0.74) divided by $68.65
- ➡ Total Return = 25.08%

5. *TAX TREATMENT EXAMPLE (Please consult your tax advisor)*

- The Company is obligated to withhold taxes on the value of the Performance Units and dividends earned by participants. The following is an example of a typical situation encountered by a participant. Individual tax circumstance may vary.
  - ➢ The participant's "taxable event" should occur at the time of payment; i.e. either in early 2010, following the three-year performance period, or at the end of the deferral period, if so elected.
- If immediate distribution is elected, then a Participant's tax withholding requirements are satisfied as described in the following example:

Restrictions lifted on 1,000 Units Market value (at a price of $102.32 per Unit)	$102,320.00
Dividend equivalent cash on 1,000 Units ($6.48 per share per year for 3 years)	6,480.00
Total reportable W-2 taxable income	$108,800.00
Tax Withholding Applied to Reportable Income	
Federal income tax (at the supplemental 25% rate)	$ 27,200.00
State income tax (e.g., Arkansas @ 7%)	7,616.00
FICA tax (6.20%)	6,745.60
Medicare tax (1.45%)	1,577.60
Total tax withholding	$ 43,139.20

Participant receives net cash payment of	**$65,660.80**

- If deferral is elected, then the FICA and Medicare tax amounts indicated above are withheld in early 2010. Federal and state income taxes are deferred until the payment is made.

ENTERGY TEXAS, INC.
PUBLIC UTILITY COMMISSION OF TEXAS
Docket No. 37744 - 2009 ETI Rate Case

Response of: Entergy Texas, Inc.
to the Seventeenth Set of Data Requests

of Requesting Party: Office of Public Utility Counsel

Prepared By: Steve Bridges/Liz Landry
Sponsoring Witness: J. David Wright/Kevin G. Gardner
Beginning Sequence No. LR7362

Ending Sequence No. LR7364

Question No.: OPUC 17-7 Part No.: Addendum:

Question:

Please identify each ETI position and each Entergy Corporation (defined to include Entergy Services Inc., Entergy Operations, Inc. or any other company allocating costs to ETI) position allocated to ETI with a base salary in excess of $200,000 per year in the test year and provide the following information on each position for the period from 2002-2008. You may exclude positions for which no costs are charged to ETI ratepayers in this rate case.

a. Percentage of salary allocated to ETI (if Entergy Corporation)
b. Period of employment during the year (full year or whether the employee started or ended employment during the year).
c. Base salary
d. Short-Term Incentive Plan payments or other bonuses
e. Value of Restricted stock, performance stock, or other long-term incentives, excluding stock options
f. Value of stock options received
g. Costs of financial planning, personal or family use of corporate aircraft, club dues, or other perquisites (e.g., home security systems, tickets for sporting events and concerts, etc.) and tax gross-ups for other costs for which costs are charged to ratepayers.
h. Other compensation that appears on W-2

Response:

a. Positions were identified where incumbent ETI & ESI employees as of June 30, 2009 have an annual salary exceeding or equal to $200,000. Worksheets in the attached schedules identify employees who were in each of these positions for years 2004-2009 and the Test Year ended June 30, 2009 and provide the employee base salary and job title. Other worksheets list the earnings received by these employees. The information in the attached schedules tracks the information on the basis of position rather than by employee ID; however, employee ID is included because earnings and base salary are specific to an employee. Additionally, Entergy uses positions to demonstrate and track reporting relationships and they may not always relate to a specific job title (e.g. position number H11675 may not always be filled by the Assoc Gen Counsel-Labr/Emp Ben). In instances where two employees occupied the same position during a calendar year, earnings included in the schedule reflect each employee's earnings for the entire year and are not limited to the time that the employee occupied the specified position.

Question No.: OPUC 17-7

This information is not readily available within Entergy's accounting system because earnings are tied to employee ID rather than position. Payroll costs are billed to ETI from ESI based on the project codes charged by the employee. The employee ID field is not carried forward in the billing process (ESI billings to ETI), therefore payroll billed to ETI is not recorded on ETI's books at the individual employee ID level. Because employee ID is not a field that is carried forward in the billing process, actual billed payroll to ETI by employee is not captured in Entergy's accounting systems.

b-h. The Company objects to this request on grounds that the responsive materials are highly sensitive protected ("highly sensitive") materials. Specifically, the responsive materials are protected pursuant to Texas Government Code Sections 552.101, 552.104 and/or 552.110. Highly sensitive materials will be provided pursuant to the terms of the Protective Order in this docket.

Please see the attached highly sensitive CD.

ENTERGY TEXAS, INC.
PUBLIC UTILITY COMMISSION OF TEXAS
Docket No. 37744 - 2009 ETI Rate Case

Response of: Entergy Texas, Inc.
to the Seventeenth Set of Data Requests

of Requesting Party: Office of Public Utility Counsel

Prepared By: Steve Bridges/Liz Landry
Sponsoring Witness: J. David Wright/Kevin G. Gardner
Beginning Sequence No. LR7362

Ending Sequence No. LR7364

Question No.: OPUC 17-7 Part No.: Addendum:

Question:

Please identify each ETI position and each Entergy Corporation (defined to include Entergy Services Inc., Entergy Operations, Inc. or any other company allocating costs to ETI) position allocated to ETI with a base salary in excess of $200,000 per year in the test year and provide the following information on each position for the period from 2002-2008. You may exclude positions for which no costs are charged to ETI ratepayers in this rate case.

a. Percentage of salary allocated to ETI (if Entergy Corporation)
b. Period of employment during the year (full year or whether the employee started or ended employment during the year).
c. Base salary
d. Short-Term Incentive Plan payments or other bonuses
e. Value of Restricted stock, performance stock, or other long-term incentives, excluding stock options
f. Value of stock options received
g. Costs of financial planning, personal or family use of corporate aircraft, club dues, or other perquisites (e.g., home security systems, tickets for sporting events and concerts, etc.) and tax gross-ups for other costs for which costs are charged to ratepayers.
h. Other compensation that appears on W-2

Response:

a. Positions were identified where incumbent ETI & ESI employees as of June 30, 2009 have an annual salary exceeding or equal to $200,000. Worksheets in the attached schedules identify employees who were in each of these positions for years 2004-2009 and the Test Year ended June 30, 2009 and provide the employee base salary and job title. Other worksheets list the earnings received by these employees. The information in the attached schedules tracks the information on the basis of position rather than by employee ID; however, employee ID is included because earnings and base salary are specific to an employee. Additionally, Entergy uses positions to demonstrate and track reporting relationships and they may not always relate to a specific job title (e.g. position number H11675 may not always be filled by the Assoc Gen Counsel-Labr/Emp Ben). In instances where two employees occupied the same position during a calendar year, earnings included in the schedule reflect each employee's earnings for the entire year and are not limited to the time that the employee occupied the specified position.

Question No.: OPUC 17-7

This information is not readily available within Entergy's accounting system because earnings are tied to employee ID rather than position. Payroll costs are billed to ETI from ESI based on the project codes charged by the employee. The employee ID field is not carried forward in the billing process (ESI billings to ETI), therefore payroll billed to ETI is not recorded on ETI's books at the individual employee ID level. Because employee ID is not a field that is carried forward in the billing process, actual billed payroll to ETI by employee is not captured in Entergy's accounting systems.

b-h. The Company objects to this request on grounds that the responsive materials are highly sensitive protected ("highly sensitive") materials. Specifically, the responsive materials are protected pursuant to Texas Government Code Sections 552.101, 552.104 and/or 552.110. Highly sensitive materials will be provided pursuant to the terms of the Protective Order in this docket.

Please see the attached highly sensitive CD.

The remainder of the response to DR 17-7 is highly sensitive. It is included in the highly sensitive workpapers used to develop aggregate compensation trends.

ENTERGY TEXAS, INC.
PUBLIC UTILITY COMMISSION OF TEXAS
Docket No. 37744 - 2009 ETI Rate Case

Response of: Entergy Texas, Inc.
to the Fifth Set of Data Requests
of Requesting Party: Staff

Prepared By: Steve Bridges
Sponsoring Witness: J. David Wright
Beginning Sequence No. TH2267
Ending Sequence No. TH2268

Question No.: Staff AG 5-31 Part No.: Addendum:

Question:

Compensation

Does the Company's requested cost of service include amounts for executive perquisites such as financial planning and tax gross-ups? If so, please provide an explanation of the types of perquisites included, a copy of the Company's policies regarding the payment of such perquisites, and the amount of such payments included in cost of service by FERC account. Indicate which amounts are directly incurred by ETI and which amounts are allocated.

Response:

Please see the attached summary of the Financial Counseling Plan. Below are the amounts for financial counseling and the tax gross-up included in the cost of service.

	FINANCIAL COUNSELING	TAX GROSS-UP	ACCOUNT
ETI	10,030	6,855	923000
ESI	45,406	31,031	923000
	55,436	37,886	

[redacted]

The Financial Counseling Plan promotes maximizing investment growth opportunities for the System Officers. This program encourages executives to prepare a strategy for their future by assisting in achieving financial peace of mind, thus increasing their productivity. This program allows reimbursement for certain expenses incurred for personal financial counseling services.

All Management Level 1-4 executives are entitled to participate. Participants may select AYCO or Pricewaterhouse Cooper (PWC) at the pre-set service and price level or any other provider at a maximum amount of $5,000 per year.

"Covered Expenses" shall mean any costs related to the following services which are incurred by an Eligible Executive (A) during a Program Year while employed by a System Company or (B) during the Continuation Period, if applicable:

- risk management (i.e. the assessment of personal financial risks to determine whether sufficient insurance coverage exists);
- tax planning assistance (including preparation of tax returns);
- investment planning and portfolio management;
- retirement planning;
- estate planning (including trustee and legal fees associated with the establishment, maintenance and revision of trusts and wills);

Your financial counselor will also help you to track and maintain your stock option ownership levels as established under the stock ownership guidelines.

Covered Expenses shall not include any of the following items: appraisal fees; commissions, brokerage fees or premiums on the sale or purchase of securities or insurance of any kind; computer hardware or software; the cost of tax return preparation manuals; custodial or legal fees relating to rental property; fees associated with the opening and administration of a succession; fines or penalties; expenses attributable to a "hobby" of the Participant; legal fees with respect to any criminal or civil litigation (including, but not limited to contract disputes, tort and divorce cases); expenses relating to home offices; real estate transaction fees; rental cost of safety deposit box; subscriptions to investment magazines, newsletters or other publications; tax, accounting or legal fees associated with any business venture other than the Participant's employment with the System (including, but not limited to, with respect to such business venture of the Participant's spouse); or travel, transportation, meals, or entertainment expenses of any kind.

If an Eligible Executive retires from the Company, they will be eligible to continue financial counseling for 12 months following their last day of employment. Financial counseling benefits cease on the date of termination for all Eligible Executives who leave the Company for reasons other than retirement.

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Executive Compensation as an Agency Problem

Lucian Arye Bebchuk and Jesse M. Fried

Executive compensation has long attracted a great deal of attention from financial economists. Indeed, the increase in academic papers on the subject of CEO compensation during the 1990s seems to have outpaced even the remarkable increase in CEO pay itself during this period (Murphy, 1999). Much research has focused on how executive compensation schemes can help alleviate the agency problem in publicly traded companies. To understand adequately the landscape of executive compensation, however, one must recognize that the design of compensation arrangements is also partly a product of this same agency problem.

Alternative Approaches to Executive Compensation

Our focus in this paper is on publicly traded companies without a controlling shareholder. When ownership and management are separated in this way, managers might have substantial power. This recognition goes back, of course, to Berle and Means (1932, p. 139) who observed that top corporate executives, "while in office, have almost complete discretion in management." Since Jensen and Meckling (1976), the problem of managerial power and discretion has been analyzed in modern finance as an "agency problem."

Managers may use their discretion to benefit themselves personally in a variety

■ *Lucian Arye Bebchuk is the William J. Friedman Professor of Law, Economics and Finance, Harvard Law School, and Research Associate, National Bureau of Economic Research, both in Cambridge, Massachusetts. Jesse M. Fried is a Professor of Law at Boalt Hall School of Law, University of California at Berkeley, Berkeley, California. Their e-mail addresses are ⟨bebchuk@law.havard.edu⟩ and ⟨friedj@law.berkeley.edu⟩, respectively.*

of ways (Shleifer and Vishny, 1997). For example, managers may engage in empire building (Jensen, 1974; Williamson, 1964). They may fail to distribute excess cash when the firm does not have profitable investment opportunities (Jensen, 1986). Managers also may entrench themselves in their positions, making it difficult to oust them when they perform poorly (Shleifer and Vishny, 1989). Any discussion of executive compensation must proceed against the background of the fundamental agency problem afflicting management decision-making. There are two different views, however, on how the agency problem and executive compensation are linked.

Among financial economists, the dominant approach to the study of executive compensation views managers' pay arrangements as a (partial) *remedy* to the agency problem. Under this approach, which we label the "optimal contracting approach," boards are assumed to design compensation schemes to provide managers with efficient incentives to maximize shareholder value. Financial economists have done substantial work within this optimal contracting model in an effort to understand executive compensation practices; recent surveys of this work include Murphy (1999) and Core, Guay and Larcker (2001). To some researchers working within the optimal contracting model, the main flaw with existing practices seems to be that, due to political limitations on how generously executives can be treated, compensation schemes are not sufficiently high-powered (Jensen and Murphy, 1990).

Another approach to studying executive compensation focuses on a different link between the agency problem and executive compensation. Under this approach, which we label the "managerial power approach," executive compensation is viewed not only as a potential instrument for addressing the agency problem but also as *part* of the agency problem itself. As a number of researchers have recognized, some features of pay arrangements seem to reflect managerial rent-seeking rather than the provision of efficient incentives (for example, Blanchard, Lopez-de-Silanes and Shleifer, 1994; Yermack, 1997; and Bertrand and Mullainathan, 2001). We seek to develop a full account of how managerial influence shapes the executive compensation landscape in a forthcoming book (Bebchuk and Fried, 2004) that builds substantially on a long article written jointly with David Walker (Bebchuk, Fried and Walker, 2002).

Drawing on this work, we argue below that managerial power and rent extraction are likely to have an important influence on the design of compensation arrangements. Indeed, the managerial power approach can shed light on many significant features of the executive compensation landscape that have long been seen as puzzling by researchers working within the optimal contracting model. We also explain that managers' influence over their own pay might impose substantial costs on shareholders—beyond the excess pay executives receive—by diluting and distorting managers' incentives and thereby hurting corporate performance.

Although the managerial power approach is conceptually quite different from the optimal contracting approach, we do not propose the former as a complete

replacement for the latter. Compensation arrangements are likely to be shaped both by market forces that push toward value-maximizing outcomes, and by managerial influence, which leads to departures from these outcomes in directions favorable to managers. The managerial power approach simply claims that these departures are substantial and that optimal contracting alone cannot adequately explain compensation practices.

The Limitations of Optimal Contracting

The optimal contracting view recognizes that managers suffer from an agency problem and do not automatically seek to maximize shareholder value. Thus, providing managers with adequate incentives is important. Under the optimal contracting view, the board, working in shareholders' interest, attempts to provide cost-effectively such incentives to managers through their compensation packages.

Optimal compensation contracts could result either from effective arm's length bargaining between the board and the executives or from market constraints that induce these parties to adopt such contracts even in the absence of arm's length bargaining. However, neither of these forces can be expected to prevent significant departures from arm's length outcomes.[1]

Just as there is no reason to presume that managers automatically seek to maximize shareholder value, there is no reason to expect *a priori* that directors will either. Indeed, directors' behavior is also subject to an agency problem, which in turn undermines their ability to address effectively the agency problems in the relationship between managers and shareholders.

Directors generally wish to be re-appointed to the board. Average director compensation in the 200 largest U.S. corporations was $152,626 in 2001 (Pearl Meyers and Partners, 2002). In the notorious Enron case, the directors were each paid $380,000 annually (Abelson, 2001). Besides an attractive salary, a directorship is also likely to provide prestige and valuable business and social connections. CEOs play an important role in renominating directors to the board. Thus, directors usually have an incentive to favor the CEO.

To be sure, in a world in which shareholders selected individual directors, directors might have an incentive to develop reputations as shareholder-serving. However, board elections are by slate, dissidents putting forward their own director slate confront substantial impediments, and such challenges are therefore exceedingly rare (Bebchuk and Kahan, 1990). Typically, the director slate proposed by management is the only one offered.

The key to a board position is thus being placed on the company's slate.

[1] Shareholders could try to challenge undesirable pay arrangements in court. However, corporate law rules effectively prevent courts from reviewing compensation decisions (Bebchuk, Fried and Walker, 2002, pp. 779–781).

Because the CEO's influence over the board gives her significant influence over the nomination process, directors have an incentive to "go along" with the CEO's pay arrangement, a matter dear to the CEO's heart—at least as long as the compensation package remains within the range of what can plausibly be defended and justified. In addition, because being on the company's slate is the key to being appointed, developing a reputation for haggling with the CEO over compensation would hurt rather than help a director's chances of being invited to join other companies' boards. Yet another reason to favor the CEO is that the CEO can affect directors' compensation and perks.

Directors typically have only nominal equity interests in the firm (Baker, Jensen and Murphy, 1988; Core, Holthausen and Larcker, 1999). Thus, even a director who did not place much value on a board seat would still have little personal motivation to fight the CEO and her friends on the board on compensation matters. Moreover, directors usually lack easy access to independent information and advice on compensation practices necessary to effectively challenge the CEO's pay.

Finally, market forces are not sufficiently strong and fine-tuned to assure optimal contracting outcomes. Markets—including the market for corporate control, the market for capital and the labor market for executives—impose *some* constraints on what directors will agree to and what managers will ask them to approve. An analysis of these markets, however, indicates that the constraints they impose are far from tight and permit substantial deviations from optimal contracting (Bebchuk, Fried and Walker, 2002).

Consider, for example, the market for corporate control—the threat of a takeover. Firms frequently have substantial defenses against takeovers. For example, a majority of companies have a staggered board, which prevents a hostile acquirer from gaining control before two annual elections pass, and often enables incumbent managers to block hostile bids that are attractive to shareholders. To overcome incumbent opposition, a hostile bidder must be prepared to pay a substantial premium; during the second half of the 1990s, the average premium in hostile acquisitions was 40 percent (Bebchuk, Coates and Subramanian, 2002). The disciplinary force of the market for corporate control is further weakened by the prevalence of "golden parachute" provisions, as well as acquisition-related benefits that target managers often receive when an acquisition takes place. The market for corporate control thus leaves managers with considerable slack and ability to extract private benefits.

To be sure, the market for control might impose some costs on managers who are especially aggressive in extracting rents; we later note evidence that CEOs of firms with stronger takeover protection get pay packages that are both larger and less sensitive to performance. The important point is that the market for corporate control fails to impose tight constraints on executive compensation.

Some responses to our earlier work assumed that our analysis of the absence of arm's length bargaining did not apply to cases in which boards negotiate pay with a CEO candidate from outside the firm (for example, Murphy, 2002). However,

while such negotiations might be closer to the arm's length model than negotiations with an incumbent CEO, they still fall quite short of this benchmark. Among other things, directors negotiating with an outside CEO candidate know that after the candidate becomes CEO, she will have influence over their renomination to the board and over their compensation and perks. The directors will also wish to have good personal and working relationships with the person who is expected to become the firm's leader and a fellow board member. And while agreeing to a pay package that favors the outside CEO hire imposes little financial cost on the directors, any breakdown in the hiring negotiations, which might embarrass the directors and in any event force them to reopen the CEO selection process, would be personally costly to them. Finally, directors' limited time forces them to rely on information shaped and presented by the company's human resources staff and compensation consultants, all of whom have incentives to please the incoming CEO.

The Managerial Power Approach

The very reasons for questioning the ability of optimal contracting to explain compensation practices adequately also suggest that executives have substantial influence over their own pay. In addition, these reasons suggest that the greater is managers' power, the greater is their ability to extract rents. There are limits to what directors will accept and what markets will permit, but these constraints do not prevent managers from obtaining arrangements that are substantially more favorable than those they could obtain by bargaining at arm's length.

One important building block of the managerial power approach is "outrage" costs and constraints. The tightness of the constraints managers and directors confront depends, in part, on how much "outrage" a proposed arrangement is expected to generate among relevant outsiders. Outrage might cause embarrassment or reputational harm to directors and managers, and it might reduce shareholders' willingness to support incumbents in proxy contests or takeover bids. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve the arrangement and the more hesitant managers will be to propose it in the first instance. Thus, whether a compensation arrangement that is favorable to executives but suboptimal for shareholders is adopted will depend on how it is perceived by outsiders.

There is evidence that the design of compensation arrangements is indeed influenced by how outsiders perceive them. Johnson, Porter and Shackell (1997) find that CEOs of firms receiving negative media coverage of their compensation arrangements during 1992–1994 subsequently received relatively small pay increases and had the pay-performance sensitivity of their compensation arrangements increased. Thomas and Martin (1999) find that, during the 1990s, CEOs of firms that were the target of shareholder resolutions criticizing executive pay had

their annual compensation reduced over the following two years by an average of $2.7 million.

The potential significance of outsiders' perception of a CEO's compensation and of outrage costs explains the importance of yet another building block of the managerial power approach—"camouflage." To avoid or minimize the outrage that results from outsiders' recognition of rent extraction, managers have a substantial incentive to obscure and try to legitimize—or, more generally, to camouflage—their extraction of rents. The strong desire to camouflage might lead to the adoption of inefficient compensation structures that hurt managerial incentives and firm performance. This concept of camouflage turns out to be quite useful in explaining many otherwise puzzling features of the executive compensation landscape.

The importance of how compensation arrangements are perceived means that, in the executive compensation area, the transparency of disclosure matters. Financial economists often focus on the role of disclosure in getting information incorporated into market pricing. It is widely believed that information can become reflected in stock prices as long as it is known and fully understood by a limited number of market professionals. In the executive compensation context, however, the ability of plan designers to choose arrangements that favor managers depends on how these arrangements are perceived by a much wider group of outsiders. As a result, the transparency and salience of disclosure can have a significant effect on CEO compensation.

Murphy (2002) and Hall and Murphy (this issue) argue that our approach cannot explain increases in managerial pay during the 1990s. In their view, CEO power declined during this period. Given the strengthening of takeover defenses during the 1990s, however, it is unclear whether CEO power diminished during this period. In any event, executive pay increases during the 1990s resulted not from changes in managerial power but rather from other factors, none of which is inconsistent with the managerial power approach.

First, seeking to make pay more sensitive to performance, regulators and shareholders encouraged the use of equity-based compensation. Taking advantage of this enthusiasm, executives used their influence to obtain substantial option pay without giving up corresponding amounts of their cash compensation. Furthermore, the options they received did not link pay tightly to the managers' own performance, but rather enabled managers to reap windfalls from that part of the stock price increase that was due solely to market and sector trends beyond their control. As a result, managers were able to capture much larger gains than more cost-effective and efficient option plans would have provided. Second, because executive compensation has historically been correlated with market capitalization, the rising stock markets of the 1990s, which carried along with them even many poorly performing companies, provided a convenient justification at most firms for substantial pay increases. Third, market booms weaken outrage constraints; exuberant shareholders are less likely to scrutinize and resent generous pay arrangements, in the same way that the recent market declines have made shareholders more prone to do so.

Power and Camouflage at Work

We illustrate below the potential value of the managerial power approach by discussing four patterns and practices that can be at least partly explained by power and camouflage: the relationship between power and pay; the use of compensation consultants; stealth compensation; and gratuitous goodbye payments to departing executives.

Power-Pay Relationships

The managerial power approach predicts that pay will be higher and/or less sensitive to performance in firms in which managers have relatively more power. Other things being equal, managers would tend to have more power when i) the board is relatively weak or ineffectual; ii) there is no large outside shareholder; iii) there are fewer institutional shareholders; or iv) managers are protected by antitakeover arrangements. There is evidence indicating that each of these factors affects pay arrangements in the way predicted by the managerial power approach.

Executive compensation is higher *when the board is relatively weak or ineffectual* vis-à-vis the CEO. Core, Holthausen and Larcker (1999) find that CEO compensation is higher under the following conditions: when the board is large, which makes it more difficult for directors to organize in opposition to the CEO; when more of the outside directors have been appointed by the CEO, which could cause them to feel a sense of gratitude or obligation to the CEO; and when outside directors serve on three or more boards, and thus are more likely to be distracted. Also, CEO pay is 20–40 percent higher if the CEO is the chairman of the board (Cyert, Kang and Kumar, 2002; Core, Holthausen and Larcker, 1999). Finally, CEO pay is negatively related to the share ownership of the board's compensation committee; doubling compensation committee ownership reduces nonsalary compensation by 4–5 percent (Cyert, Kang and Kumar, 2002).

The *presence of a large outside shareholder* is likely to result in closer monitoring (Shleifer and Vishny, 1986), and it can be expected to reduce top managers' influence over their compensation. Consistent with this observation, Cyert, Kang and Kumar (2002) find a negative correlation between the equity ownership of the largest shareholder and the amount of CEO compensation: doubling the percentage ownership of the outside shareholder reduces nonsalary compensation by 12–14 percent. Bertrand and Mullainathan (2000) find that CEOs in firms that lack a 5 percent (or larger) external shareholder tend to receive more "luck-based" pay—pay associated with profit increases that are entirely generated by external factors (such as changes in oil prices and exchange rates) rather than by managers' efforts. They also find that in firms lacking large external shareholders, the cash compensation of CEOs is reduced less when their option-based compensation is increased. Relatedly, in an examination of Standard & Poor's 500 firms during the period 1992–1997, Benz, Kucher and Stutzer (2001) find that a higher concentration of shareholders results in a significantly smaller amount of options grants to top executives.

A *larger concentration of institutional shareholders* might result in greater monitoring and scrutiny of the CEO and the board. Examining CEO pay in almost 2000 firms during the period 1991–1997, Hartzell and Starks (2002) find that the more concentrated is institutional ownership, the lower is executive compensation. They also find that a larger institutional presence results in more performance-sensitive compensation. Examining CEO compensation in the 200 largest companies during 1990–1994, David, Kochar and Levitas (1998) find that the effect of institutional shareholders on CEO pay depends on the types of relationships they have with the firm. They divide institutional shareholders into 1) those that have no other business relationship with the firm and are thus concerned only with the firm's share value ("pressure-resistant" institutions); and 2) those that have other business relationships with the firm (like managing a pension fund) and are thus vulnerable to management pressure ("pressure-sensitive" institutions). As the managerial power approach predicts, CEO pay is negatively correlated with the presence of pressure-resistant institutional investors and positively correlated with the presence of pressure-sensitive ones.

The adoption of *antitakeover provisions* makes CEOs less vulnerable to a hostile takeover. Borokhovich, Brunarski and Parrino (1997), examining 129 firms that adopted antitakeover provisions (such as a supermajority rule) during the period 1979–1987, find that CEOs of firms adopting such provisions enjoy above-market compensation before adoption of the antitakeover provisions and that adoption of these provisions increases their excess compensation significantly. This pattern is not readily explainable by optimal contracting; indeed, if managers' jobs are more secure, shareholders should be able to pay managers a lower risk premium (Agrawal and Knoeber, 1998). In another study, Cheng, Nagar and Rajan (2001) find that CEOs of Forbes 500 firms that became protected by state antitakeover legislation enacted during the period 1984–1991 reduced their holdings of shares by an average of 15 percent, apparently because the shares were not as necessary for maintaining control. Optimal contracting might predict that a CEO protected by antitakeover legislation would be required to buy more shares to restore the CEO's incentive to increase shareholder value.

Compensation Consultants

U.S. public companies typically employ outside consultants to provide input into the executive compensation process (Bizjack, Lemmon and Naveen, 2000). The use of consultants can be explained within the optimal contracting framework on grounds that they supply useful information and contribute expertise on the design of compensation packages. But although compensation consultants might play a useful role, they also can help in camouflaging rents. The incentives of compensation consultants—and the evidence regarding their use—suggest that these consultants are often used to justify executive pay rather than to optimize it.

Compensation consultants have strong incentives to use their discretion to benefit the CEO. Even if the CEO is not formally involved in the selection of the compensation consultant, the consultant is usually hired by the firm's human

resources department, which is subordinate to the CEO. Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firms. Moreover, executive pay specialists often work for consulting firms that have other, larger assignments with the hiring company, which further distorts their incentives (Crystal, 1991).

Pay consultants can favor the CEO by providing the compensation data that are most useful for justifying a high level of pay. For example, when firms do well, consultants argue that pay should reflect performance and should be higher than the average in the industry—and certainly higher than that of CEOs who are doing poorly. In contrast, when firms do poorly, the consultants focus not on performance data but rather on peer group pay to argue that CEO compensation should be higher to reflect prevailing industry levels (Gillan, 2001).

After the compensation consultant has collected and presented the "relevant" comparative data, the board generally sets pay equal to or higher than the median CEO pay in the comparison group. Reviewing the reports of compensation committees in 100 large companies, Bizjack, Lemmon and Naveen (2000) report that 96 used peer groups in determining management compensation and that a large majority of firms that use peer groups set compensation at or above the fiftieth percentile of the peer group. The combination of helpful compensation consultants and sympathetic boards is partly responsible for the widely recognized "ratcheting up" of executive salaries (Murphy, 1999, p. 2525).

After the board approves the compensation package, firms use compensation consultants and their reports to justify executive compensation to shareholders. Examining Standard & Poor's 500 companies during the period 1987–1992, Wade, Porac and Pollack (1997) find that companies that pay their CEOs larger base salaries, and firms with more concentrated and active outside ownership, are more likely to cite the use of surveys and consultants in justifying executive pay in their proxy reports to shareholders. This study also finds that, when accounting returns are high, firms emphasize the accounting returns and downplay market returns.

Stealth Compensation

As we document in Bebchuk and Fried (2003), firms use pay practices that make less transparent the total amount of executive compensation and the extent to which compensation is decoupled from managers' own performance. Among the arrangements used by firms that camouflage the amount and the performance-insensitivity of compensation are pension plans, deferred compensation, post-retirement perks, and consulting contracts.

Most of the pension and deferred compensation benefits given to executives do not enjoy the large tax subsidy that applies to the standard retirement arrangements provided to other employees. In the case of executives, such arrangements largely shift tax liability from the executive to the firm in ways that sometimes even increase the joint tax liability of the two parties. The efficiency grounds for providing compensation through in-kind retirement perks and guaranteed postre-

tirement consulting fees are also far from clear. All of these arrangements, however, make pay less salient.

Among other things, under existing disclosure rules, firms do not have to place a dollar value on—and include in the firm's publicly filed compensation tables—compensation provided to executives after they retire. Although the existence of executives' retirement arrangements must be noted in certain places in the firm's public filings, this disclosure is less salient, because outsiders focus on the dollar amounts reported in the compensation tables. Indeed, the compensation table numbers are used by the ExecuComp database, which is the basis for much of the empirical work on executive compensation.

Another practice with camouflage benefits was the use of executive loans. While the Sarbanes-Oxley Act of 2002 now prohibits such loans, prior to the Act's adoption more than 75 percent of the 1,500 largest U.S. firms lent money to executives (King, 2002). It is not readily apparent that having firms (rather than banks) lend to executives—or that providing compensation in the form of favorable interest rates—is efficient. But loans are useful for reducing the salience of managers' compensation.

To begin with, the implicit compensation provided by below-market-rate loans often does not appear in the compensation tables in the firm's annual filing. The SEC ruled that firms must disclose in the category of "other annual compensation" the difference between the interest actually paid on executive loans and the "market rate." However, the SEC did not define "market rate," and firms have interpreted the term in a manner that enabled them to exclude the value of large interest rate subsidies from the compensation tables.

For example, WorldCom did not report in its compensation tables any income to CEO Bernard Ebbers from the over $400 million of loans he received from WorldCom at an interest rate of 2.15 percent; it later justified the omission on the grounds that 2.15 percent was the "market rate" at which WorldCom was borrowing under one of its credit facilities. However, 2.15 percent was far below the more than 5 percent rate that Ebbers would have paid at that time in the market to borrow funds. To be sure, the existence and terms of the loans (although not an estimate of the conferred benefits) had to be noted elsewhere in the firm's public filings as a related party transaction. However, this disclosure is much less salient because outsiders interested in executives' compensation commonly focus on the compensation tables. Indeed, in Ebbers's case, despite the large financial benefit provided by the extremely low interest rate on his loans, the loans received no media attention and no outside scrutiny until WorldCom became involved in an accounting scandal.

Another manner in which loans provided camouflage was through the practice of loan forgiveness. A firm that gave an executive a loan to buy a large amount of stock would often not demand full repayment of the loan if the stock value fell below the amount due on the loan. As a result, the arrangement was similar to (but, it can be shown, often less tax efficient than) granting the executive an option to buy shares at a price equal to the amount owed on the loan. However, option grants

must be reported the year they are made in the firm's publicly filed compensation tables. In contrast, when granting a loan that likely will be forgiven if the stock price drops, the firm did not need to include the option value of the arrangement in the compensation tables in the year the loan was made. Indeed, if the stock price fell, the loan would often be forgiven at the time that the executive left the company, when any resulting outrage is likely to have little impact on the executive personally. For example, George Shaheen, the Webvan CEO who resigned shortly before Webvan went bankrupt, had a $6.7 million loan forgiven in exchange for $150,000 of Webvan stock (Lublin, 2002).

Gratuitous Goodbye Payments

In many cases, boards give departing CEOs payments and benefits that are gratuitous—not required under the terms of the CEO's compensation contract. Such gratuitous goodbye payments are common even when CEOs perform so poorly that the board feels compelled to replace them.

Compensation contracts usually provide executives with generous severance arrangements even when they depart following very dismal performance. Such "soft landing" provisions provide executives with insurance against being fired due to poor performance. It is far from clear that these arrangements reflect optimal contracting; after all, such provisions reduce the difference in managerial payoffs between good and poor performance that firms spend so much money trying to create. Our focus here, however, is on payments that go beyond the severance arrangements that are contractually specified.

For example, when Mattel CEO Jill Barad resigned under fire, the board forgave a $4.2 million loan, gave her an additional $3.3 million in cash to cover the taxes for forgiveness of another loan and allowed her unvested options to vest automatically. These gratuitous benefits were in addition to the considerable benefits that she received under her employment agreement, which included a termination payment of $26.4 million and a stream of retirement benefits exceeding $700,000 per year.

It is not easy to reconcile such gratuitous payments with the arm's length, optimal contracting model. The board has the authority to fire the CEO and pay the CEO her contractual severance benefits. Thus, there is no need to "bribe" a poorly performing CEO to step down. In addition, the signal sent by the goodbye payment will, if anything, only weaken the incentive of the next CEO to perform.

The making of such gratuitous payments, however, is quite consistent with the existence of managerial influence over the board. Because of their relationship with the CEO, some directors might be unwilling to replace the CEO unless she is treated very generously. Other directors might be willing to replace the CEO in any event, but prefer to accompany the move with a goodbye payment to reduce the discomfort they feel firing the CEO or to make the difficult separation process more pleasant and less contentious. In all of these cases, directors' willingness to make gratuitous payments to the (poorly performing) CEO results from the CEO's relationship with the directors.

It is important to note that, taking managerial power *as given*, providing gratuitous payments to fired CEOs might be beneficial to shareholders in some instances. If many directors are loyal to the CEO, such payments might be necessary to assemble a board majority in favor of replacing him. In such a case, the practice would help shareholders when the CEO's departure is more beneficial to shareholders than the cost to them of the goodbye payment. For our purposes, however, what is important is that these gratuitous payments, whether they are beneficial to shareholders or not, reflect the existence and significance of managerial influence.

Suboptimal Pay Structures

Pay Without Performance

Optimal contracting arrangements might call for very large amounts of compensation for executives, if such compensation is needed to provide managers with powerful incentives to enhance shareholder value (Jensen and Murphy, 1990). The problem with current arrangements, however, is that the generous compensation provided executives is linked only weakly to managerial performance. This pay-performance disconnect is puzzling from an optimal contracting view.

The substantial part of compensation that is not equity based has long been criticized as weakly linked to managerial performance. During the 1990s, there was no significant correlation between a CEO's salary and bonus and her firm's industry-adjusted performance (Murphy, 1999). In addition, there is evidence that cash compensation increases when firm profits rise for reasons that clearly have nothing to do with managers' efforts (Blanchard, Lopez-de-Silanes and Shleifer, 1994; Bertrand and Mullainathan, 2001). Furthermore, managers receive substantial non-equity compensation through arrangements that have received little attention from financial economists—such as pensions, deferred pay and loans—and this compensation is also relatively insensitive to managers' own performance.

In light of the historically weak link between managers' performance and their non-equity compensation, shareholders and regulators have increasingly looked to equity-based compensation to provide the desired link between pay and performance. In the early 1990s, institutional investors and federal regulators sought to encourage the use of such compensation, and the last decade has witnessed a dramatic growth in the use of stock options. Unfortunately, however, managers have been able to use their influence to obtain option plans that appear to deviate substantially from optimal contracting in ways that favor managers.

We wish to emphasize our strong support for the concept of equity-based compensation which, if well designed, could provide managers with very desirable incentives. The devil, however, is in the details. Below, we discuss several important features of existing option compensation plans that are difficult to justify from an optimal contracting perspective, but can readily be explained by the managerial

power approach: the failure of option plans to filter out windfalls, the almost uniform use of at-the-money options and the broad freedom given to managers to unload options and shares.

It might be asked why risk-averse managers would not use their influence to get higher cash salaries rather than options. Holding the expected value of additional compensation constant, managers would indeed prefer to take the cash. But managers seeking to increase their pay during the 1990s did not have a choice between additional compensation in the form of cash and additional compensation in the form of options with the same expected value. Rather, outsiders' enthusiasm about equity-based compensation enabled managers to obtain additional compensation in the form of options without offsetting reduction in cash compensation. Furthermore, the possible benefits from improved incentives provided defensible reasons for very large amounts of additional compensation. While Apple CEO Steve Jobs was recently able to obtain an option package worth over half a billion dollars, albeit with some outcry, cash compensation of this order of magnitude is (still) quite inconceivable. The fact that better designed options could have provided much more cheaply the same incentives has not been sufficiently salient to make conventional plans patently unjustifiable.

Option Plans that Fail to Filter Out "Windfalls"

One widespread and persistent feature of stock option plans is that they fail to filter out stock price rises that are due to industry and general market trends and thus completely unrelated to managers' own performance. Under conventional option plans, when the market or sector rises substantially, even executives whose companies perform poorly relative to the market or sector average can make large profits. Paying managers substantial compensation for stock price increases that have nothing to do with their own performance is difficult to explain under optimal contracting. The substantial amount currently spent on rewarding managers for market or sector rises could either be used to enhance incentives (for example, by giving managers a large number of options linked more tightly to managers' own performance) or be saved with little weakening of incentives.

There are many different ways of designing what we call "reduced-windfall" option plans—plans that filter out all or some of the part of the stock price increase that is unrelated to managers' own performance. One approach discussed frequently by academics is linking the exercise price of options to a market-wide index or a sector index (for example, Rappaport, 1999). Another strategy is to condition the "vesting" of options on the firm meeting specified performance targets. These targets can be linked to the stock price, earnings per share or any other measure of firm performance.

When the exercise price of an indexed option is linked to market or sector averages, there is a substantial possibility that the manager will receive no payoff from the option plan. If this possibility were regarded as undesirable, reduced-windfall options could easily be designed to produce a high likelihood of payout. For example, the exercise price could be indexed not to changes in the

industry or market average, but rather to changes in a somewhat lower benchmark—say, the stock price of the firm that is at the bottom 20th percentile of the industry or market. Under such an option plan, executives would have, on average, an 80 percent probability of outperforming the benchmark and receiving a payout. But executives would not profit, as they could under conventional plans, when their performance places them at or below the 20th percentile.

Given the wide variety of reduced-windfall options available and their potential benefits, it would probably be optimal in many firms to filter out at least some of the increase in the stock price that has nothing to do with managers' own performance. Yet almost all U.S. firms use conventional stock options under which managers capture the full increase in stock price. In 2001, only about 5 percent of the 250 largest U.S. public firms used some form of reduced-windfall options (Levinsohn, 2001).

Financial economists have made substantial efforts to develop optimal-contracting explanations for why firms do not use reduced-windfall options. We survey the various explanations in our earlier work (Bebchuk, Fried and Walker, 2002, pp. 803–809) and conclude that none of them can adequately explain the widespread failure to screen out windfalls. From the perspective of managerial power, however, the failure to filter out general market or industry effects is not at all puzzling. Under this approach, compensation schemes are designed to benefit executives without being perceived as clearly unreasonable. Given that using conventional options will be legitimate and acceptable (after all, most firms use them) and that moving to indexing or any other form of reduced-windfall options is likely to be costly or inconvenient for managers, the lack of any real movement toward such options is consistent with the managerial power approach.

At-the-Money Options

Almost all of the stock options used to compensate executives are "at-the-money"—that is, their exercise price is set to the grant-date market price (Murphy, 1999, p. 2509). An optimally designed scheme would seek to provide risk averse managers with cost-effective incentives to exert effort and make value-maximizing decisions. The optimal exercise price under such a scheme would depend on a multitude of factors that are likely to vary from executive to executive, from company to company, from industry to industry and from time to time. Such factors might include the degree of managerial risk aversion (which in turn might be affected by the manager's age and wealth), the project choices available to the company, the volatility of the company's stock, the expected rate of inflation and the length of the manager's contract, among other things. There is no reason to expect that "one size fits all"—that the same exercise price is optimal for all executives at all firms, in all industries and at all times.

It is therefore highly unlikely that out-of-the-money options—options whose exercise price is above the current market price—are *never* optimal. Out-of-the-money options have a lower expected value than at-the-money options because they

are less likely to pay off than at-the-money options, and when they do pay off the holder receives less value. Thus, for every dollar of expected value, a firm can give an executive more out-of-the money options than at-the-money options. By giving more out-of-the money options, the firm can increase the reward to the manager for doing particularly well. Out-of-the-money options thus can offer much higher pay-for-performance sensitivity per dollar of expected value than conventional options (Hall, 1999). There is even evidence suggesting that giving managers out-of-the-money options rather than at-the-money-options would, on average, boost firm value (Habib and Ljungqvist, 2000). The almost uniform use of at-the-money options is thus difficult to explain from an optimal contracting perspective. Indeed, economists working within optimal contracting have called this practice a "puzzle" (Hall, 1999, p. 43).

The near uniform use of at-the-money options is not puzzling, however, when examined under the managerial power approach. Everything else equal, executives prefer a lower exercise price. Because at-the-money options might sometimes be optimal and are employed by almost all other firms, their use in any given case will not generate outrage. Therefore, compensation plan designers have little reason to increase the exercise price above the grant-date market price.

Executives would be even better off, of course, if stock options were issued with an exercise price below the grant-date market price. However, such in-the-money options would create a salient windfall and might generate some outrage costs. Furthermore, in-the-money options would trigger a charge to accounting earnings, which might undermine a main excuse for not using indexed options or other reduced-windfall options—that the use of such options would hurt reported earnings (Bebchuk, Fried and Walker, 2002). Because in-the-money options would thus be difficult or costly for plan designers to use, and at-the-money options are the most favorable to managers within the remaining range of possibilities, a uniform use of at-the-money options is consistent with the managerial power approach.

Managers' Freedom to Unwind Equity Incentives

Another problem for the optimal contracting approach is managers' broad freedom to unload their options and shares. When managers unwind their equity incentives, restoring pay-performance sensitivity requires giving them new options or shares. Thus, such unwinding either (1) weakens managers' incentives or (2) forces the firm to give managers new equity incentives to restore incentives to the pre-unwinding level.

Although an executive becomes entitled to options once they have vested, the compensation contract could preclude the executive from "cashing out" the vested options—that is, from exercising the options and then selling the acquired shares—for a specified period after the vesting date. Such a limitation would maintain incentives for that additional period without requiring the firm to grant new options to replace the ones cashed out.

To be sure, restrictions on executives' ability to cash out vested equity instruments impose liquidity and diversification costs that must be balanced against the

incentive benefits of restricting unwinding. The efficient arrangement is thus likely to vary from case to case, depending on the executive's and the firm's characteristics. But there is no reason to expect that optimal contracts would generally make the vesting date and the cash-out date identical.

In practice, however, the date on which options vest and the date on which they are exercisable are almost always the same. A minority of firms have created "target ownership plans" that require managers to hold a certain amount of shares (Core and Larcker, 2002). But the targets tend to be rather low, and there often appears to be no penalty imposed for missing them. As a result of weak restrictions on unwinding, managers exercise many of their options well before the options expire and sell almost all of the shares thereby acquired (Carpenter, 1998; Ofek and Yermack, 2000). Shares that are not sold after option exercise are often hedged or partially hedged in transactions that are not reported to the Securities and Exchange Commission (Bettis, Bizjack and Lemmon, 2001).

Managers also typically have freedom to determine the precise time of unwinding, a practice that is also difficult to explain under optimal contracting. Although trading on "material" inside information is illegal, the definition of "materiality" and the difficulties of enforcement are such that managers making selling decisions can use their superior knowledge about the firm with little fear of liability (Fried, 1998). As a result, managers are able to obtain abnormal returns trading in their firm's shares (Seyhun, 1998). It is far from clear, however, that enabling managers to make such profits is an efficient form of compensation.

Even assuming it were desirable to permit managers to unload shares at a certain stage in their contracts, it does not follow that executives should have absolute control over the exact timing of their sales. After all, liquidity or diversification needs are unlikely to arise unexpectedly one morning. Firms could require that sales be carried out gradually over a specified period, perhaps pursuant to a pre-arranged plan. Alternatively, firms could require executives to disclose publicly in advance their intended trades, which would reduce executives' ability to profit from their informational advantage (Fried, 1998). Yet firms generally do not impose any such restrictions.

Because a firm can be held liable if it fails to take reasonable steps to prevent insider trading by its employees, a number of firms have adopted "trading windows" and "blackout periods" to restrict the times during the year when a manager can sell or buy shares (Bettis, Coles and Lemmon, 2000). However, many firms have not put such restrictions in place. And even in firms that have imposed such restrictions, managers who know undisclosed bad news during a trading window may use that trading opportunity to unwind a substantial amount of their holdings. Thus, executives retain the ability to dump shares before bad news becomes public. In one notorious case, Enron insiders sold hundreds of millions of shares before information about Enron's actual financial condition was released and the stock price collapsed.

Although managers' ability to unwind equity incentives early and to control

the time of such unwinding cannot easily be explained under optimal contracting, it is quite consistent with the managerial power approach. Broad freedom to unload equity instruments provides managers with substantial benefits that are not particularly conspicuous. The corresponding costs to shareholders from diluted incentives are also not salient. Furthermore, and perhaps most importantly, managers' unwinding of options and shares provides a convenient justification for frequently granting managers new equity-based incentives, thereby boosting their total compensation. Although a system of constant unwinding and replenishing incentives is more costly to shareholders than one that requires managers to hold options and shares for longer periods, it is obviously much better for managers.

The "Perceived Cost" Explanation

Murphy (2002) and Hall and Murphy (this issue) put forward a "perceived cost" explanation for the use of conventional, at-the-money options. According to their explanation, executives and directors erroneously perceive conventional options to be "cheap" or even "nearly free to grant" because such options can be granted without any cash outlay and without reducing reported earnings.

We doubt that executives and their advisers cannot grasp the costs of conventional options to shareholders. Assuming that Hall and Murphy are correct in suggesting that managers believe that the stock market is influenced by accounting numbers rather than underlying economic reality, this would at most mean that executives believe that investors underestimate or ignore the costs of options that are not expensed for accounting purposes—not that executives themselves fail to see the significant economic costs that conventional options impose on shareholders (whose ownership interest the options dilute).

One might even be skeptical that directors, many of whom are executives themselves, fail to understand the costs of options to shareholders. Indeed, if directors had so little financial sophistication, then the board-monitoring model of corporate governance is in even worse shape than our analysis suggests. Let us suppose, however, that directors have been oblivious to the true cost of conventional options. If so, such a misperception on the part of directors is best seen not as an alternative to the managerial power explanation, but rather as one of the factors contributing to managers' ability to exert considerable influence over the terms of their pay.

As we discussed earlier, there are several reasons why boards cannot be expected to engage in arm's length negotiations with the CEO over executive compensation; one of them is directors' lack of easy access to accurate, unbiased information. To the extent directors in fact did misperceive the cost of options, such a misperception would simply be part of the informational problem that contributes to directors' willingness to approve suboptimal arrangements. If directors were ignorant about such an important and widely discussed issue as the actual cost of options, they would likely be inadequately informed about other features of compensation arrangements.

In our view, inadequate information is only one of the factors, alongside

inadequate incentives and others, that might lead directors to agree to pay arrangements that favor managers. For one thing, directors' confusion over the cost of options cannot explain the systematic relationship between power and pay and managers' efforts to make compensation less salient that we discussed earlier. For many purposes, however, it does not matter whether directors' willingness to accept arrangements that favor executives is the result of conscious favoritism, honest misperceptions, inadequate incentives to exert effort, or some combination of these factors. The important thing is that directors do not adequately represent shareholders' interests in bargaining with managers over their pay and that these pay arrangements consequently depart from the arm's length model in directions favorable to executives.

Costs to Shareholders

What are the costs imposed on shareholders by managers' influence over their own pay? To begin with, there is the excess pay managers receive as a result of their power—the difference between what managers' influence enables them to obtain and what they would receive under an arm's length arrangement. Some might think that this problem is only symbolic, and that these rents have little effect on shareholders' bottom line. But a close look at the amounts involved indicates that they add up to much more than small change. In 2000, CEO compensation was on average 7.89 percent of corporate profits in the firms making up the 1500-company ExecuComp dataset (Balsam, 2002, p. 262).

Furthermore, and perhaps more importantly, managers' ability to influence their pay leads to compensation arrangements that generate worse incentives than those that arm's length contracts would provide. Managers have an interest in compensation schemes that camouflage the extent of their rent extraction or that put less pressure on them to reduce slack. As a result, managerial influence might lead to the adoption of compensation arrangements that provide weak or even perverse incentives. In our view, the reduction in shareholder value caused by these inefficiencies, rather than the excess rents captured by managers, could be the largest cost arising from managers' ability to influence their compensation.

To begin, compensation arrangements currently provide weaker incentives to reduce managerial slack and increase shareholder value than likely would be provided by arm's length arrangements. As explained, both the non-equity and equity components of managers' compensation are substantially more decoupled from managers' own performance than appearances might suggest. Shareholders thus might benefit substantially from the improved performance that a move toward optimal contracting arrangements could generate.

Prevailing practices not only fail to provide cost-effective incentives to reduce slack, but also create perverse incentives. For one thing, they provide managers' incentives to change firm parameters in a way that would justify increases in pay.

Consider, for example, the familiar problem of empire building. It is commonly believed that the practice of granting options provides managers with incentives not to undertake acquisitions that are value-decreasing for shareholders. This is clearly the case, however, only in a static model in which all option grants are made before managers make acquisition decisions. In a dynamic model, managers considering an expansion decision that is somewhat value decreasing for shareholders would have different incentives: While such an expansion would reduce the value of their current options, it may raise their aggregate future compensation by an even greater amount because a larger firm size can be used to justify higher pay.

Furthermore, managers' broad freedom to unload equity incentives can produce substantial inefficiencies. Executives who expect to unload their shares or options have weaker incentives to exert effort when the payoff is not going to be recognized by the market at the time they unwind their equity positions (Bar-Gill and Bebchuk, 2003a). Such executives also have incentives to misreport corporate performance and suppress bad news (Bar-Gill and Bebchuk, 2002). Indeed, such executives also have an incentive to choose projects that are less transparent or to reduce the transparency of existing projects (Bar-Gill and Bebchuk, 2003b). The efficiency costs of such distortions might exceed, possibly by a large margin, whatever liquidity or risk bearing benefits executives obtain from being able to unload their options and shares at will.

Conclusion

There are good theoretical and empirical reasons for concluding that managerial power substantially affects the design of executive compensation in companies with a separation of ownership and control. Executive compensation can thus be fruitfully analyzed not only as an instrument for addressing the agency problem arising from the separation of ownership and control—but also as part of the agency problem itself.

The conclusion that managerial power and rent extraction play an important role in executive compensation has significant implications for corporate governance, which we explore in our forthcoming book (Bebchuk and Fried, 2004). It is important to note, however, that this is an area in which widespread recognition of the problem might contribute to alleviating it. The extent to which managerial influence can move compensation arrangements away from optimal contracting outcomes depends on the extent to which market participants, especially institutional investors, recognize the problems we have discussed. Financial economists can thus make an important contribution to improving compensation arrangements by analyzing how current practices deviate from those suggested by optimal contracting. We hope that future studies of executive compensation will devote to the role of managerial power as much attention as the optimal contracting model has received.

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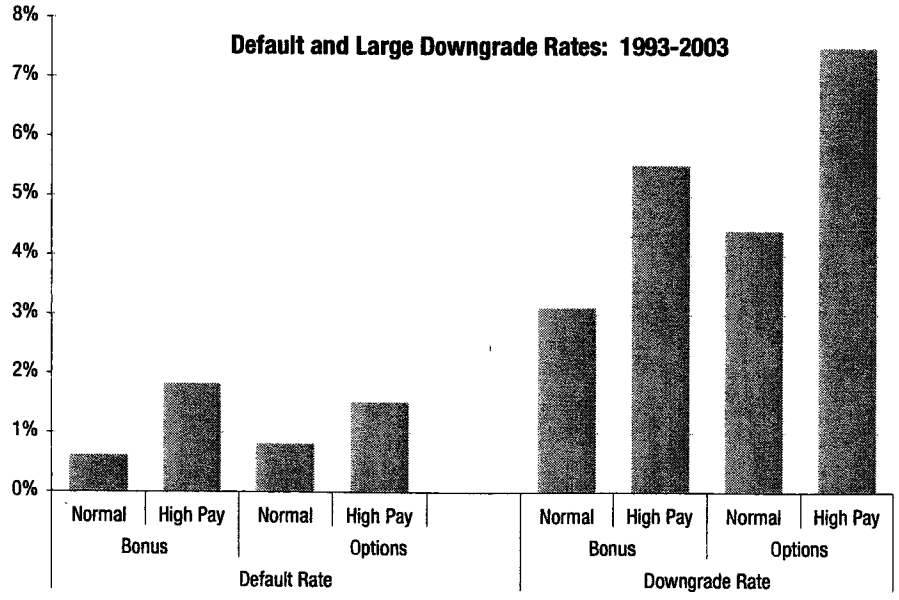
Contact	Phone
New York	
Kenneth Bertsch	1.212.553.1653
Chris Mann	

CEO Compensation and Credit Risk

Contents:



Summary

We examine the empirical relationship between executive compensation and credit risk. For each of the three major components of CEO compensation – salary, bonus, and stock option awards – we derive estimates of "unexplained" compensation as pay that deviates substantially from expected pay based on firm size, past performance, and other variables. We then relate these measures of unexplained compensation to the risk of default and large rating downgrades between 1993 and 2003.

After controlling for a variety of firm characteristics, including industry effects and long-term ratings, we find that large, positive, unexplained bonus and option awards are predictive of both default and large rating downgrades. Variations in salaries, however, do not appear to be predictive of credit risk.

Although the analysis does not directly address the reasons why large bonuses or option grants are associated with greater credit risk, possible explanations can be inferred from the academic literature on CEO compensation, managerial incentives, and board control.

High levels of unexplained compensation may indicate that board oversight is lax and, as a result, management has insufficient pressure to deliver good financial performance.

Large performance-based compensation packages, in particular, may induce managers to:

- Deliver strong short-term financial results and obscure longer-term structural problems.
- Pursue high risk strategies with very strong positive, but also very adverse, potential payoffs.

The Link Between CEO Compensation And Credit Risk

This *Special Comment* investigates the empirical relationship between the size of a CEO's pay package – compared to its expected value as determined by a simple compensation prediction model – and credit risk, as measured by default rates and the frequency of large rating downgrades. To our knowledge, this is the first empirical research to focus on CEO compensation and realized credit risk, although there is an extensive theoretical literature that relates compensation to managerial incentives and a large empirical literature that relates compensation to realized equity returns.

CEO compensation schemes are designed to provide incentives to induce superior managerial performance, consistent with shareholder objectives. Although base salaries tend to be fairly insensitive to firm performance, bonus payments are often tied directly to operating performance through specific formulas, and option grants reward strong expected future operating performance that leads to higher stock prices.

Large compensation packages may be a signal, however, that a CEO has undue influence over his or her board of directors. As a result, the expected incentive effects of the compensation package may be ineffective because the CEO can obtain high compensation despite mediocre performance. Evidence that compensation is larger than expected may, therefore, be predictive of poor performance, both from the perspective of equityholders and debtholders.

It is also possible that equityholders and debtholders may view large levels of incentive-based bonus and options differently. Stockholders generally want firm managers to pursue all positive expected value projects – even if they are risky – because stockholders benefit from limited liability and a residual claim on the firm's assets and they can diversify their holdings across firms. Debtholders, on the other hand, would generally prefer managers to pursue less risky strategies. Since incentive compensation is intended to align manager incentives with stockholder interests, it is reasonable to expect that higher levels of incentive pay (at least based on shareholder-oriented metrics) would be correlated with greater credit risk.

Compensation that is highly sensitive to short-term financial performance may also create incentives for CEOs to manipulate short-term measures of firm's performance – even if such manipulation adversely affects the firm's long-term performance. For example, if the CEO's bonus depends entirely on operating income, the individual has an incentive to adopt aggressive accounting practices to maximize short-term financial results, even if in so doing, long-term financial performance is compromised.[1] It is also possible that managers alter actual operations in ways that hurt the firm in the long term or increase event risk. Examples of this could include cutbacks, by a utility with nuclear

1. *Prior academic research has shown that large executive stock option grants have been associated with accounting restatements and fraud. Specifically, the research showed that there was little relationship between salary and the announcement of an SEC forced restatement, including those related to fraud, or the announcement of a class action law suit proclaiming securities fraud. The relationship between these events and the size of the bonus is always positive but rarely significant. Only stock-based incentives were found to be significantly and positively related to the occurrence of a negative event. (For accounting restatements and fraud, see the papers by Erickson et al or by Johnson, et al. For class action lawsuits, see the paper by Denis, et al.)*
While previous research shows a relationship between option incentives and certain negative events, the focus on these negative events makes it difficult to determine whether option incentives only increase the likelihood of fraud or also increase the overall risk of the firm. It is quite possible that the accounting fraud comes about due to managers attempts to cover up randomly bad results from good but risky projects. Some previous research shows that higher option incentives are related to better firm performance on average lending some credence to this hypothesis. (See, for example, the paper by Hillegeist and Penalva.)

power plants or by an airline, of the ordinary maintenance and repair budget to the bone, or bank cutbacks on internal audit. Larger than expected compensation may also be correlated with higher levels of credit risk if it signals weak oversight from the board of directors. Strong board oversight may be an important safeguard against the risk that management will pursue uneconomic projects that might endanger the firm's future.

The Data Set

We focus exclusively on non-financial corporations in the United States with senior unsecured bond ratings of B3 or higher, from 1993 through 2003. An "observation" for each firm in a year includes its rating at the beginning of the year, a dummy variable indicating whether the firm defaulted within the next twelve months, and another dummy variable indicating whether the firm experienced a "large" rating downgrade of three or more refined rating notches during the subsequent year.

Each observation also includes the three major components of the prior year's CEO compensation – salary, bonus, and stock-based incentive compensation. Stock-based compensation includes both restricted stock grants and executive stock options. However, due to the preponderance of options versus stocks within our sample period, we will refer to this component of compensation as simply "option" compensation throughout the remainder paper. While we expect there could be differences in the incentives caused by stocks and options, we do not test for these in this study. In addition, we track firm revenues and operating income during the prior year, market capitalization at the beginning of the year, CEO tenure in years, and a number of other firm financial performance measures. The financial data is drawn from Compustat, and the compensation data comes from Execucomp.

Altogether, we have 4,485 annual observations on a total of 865 unique firms, with an average of 5.2 annual observations on each firm.[2] Among these firms, 43 or 1.0% defaulted during the sample period, and 214 or 4.8% incurred "large downgrades," which we define as a change in three or more refined rating notches within any twelve-month period. (Firms can experience more than one large rating change within the twelve-year sample period.)

Modeling Compensation

To determine unexplained compensation, we develop a model that predicts expected salary, expected bonus, and expected option grants based on firm size, past operating performance, CEO tenure, and industry – variables selected from the academic literature on CEO compensation.[3] We also include annual dummies to account for the fact that compensation levels rose steadily through the sample period. We estimate three related regression models – one for each of the three major components of compensation. However, we use a regression technique that takes into account the fact that the determinants (both included in and excluded from the model) of compensation are likely to be correlated across the components.[4]

Selecting the timing relationships between the explanatory and dependent variables requires some care. Once executive compensation data are made publicly available, in most cases the actual compensation decisions have been set for over a year. For example, the most recent proxy statement for Moody's Corporation was publicly released on March 23, 2005, and reported CEO salary, option grant, and bonus data for 2004. The salary was determined based on fiscal year 2003 performance and was paid out over fiscal year 2004. The option grant was also based on fiscal year 2003 performance and was awarded in February of 2004. The targets for the 2004 bonus were set in light of the fiscal year 2003's performance, but the actual payout was based on fiscal year 2004's performance. Our models for salaries and options are, therefore, based on data lagged by one year; however, our model for determining bonuses requires data spanning two years – the year for which the targets were set and the year over which performance was measured.[5] This will likely bias the results of our studies against finding any results because we will be predicting performance

2. *Observations pertaining to CEOs with tenures of less than one year were removed from the sample because firms in distress often pay larger amounts to new CEOs as an incentive to turn the firms around. If we had included these observations in the sample, we might have concluded that high compensation predicted credit risk, when the relevant compensation for predicting credit risk was really the package received by the prior CEO.*
3. *See, for example, the survey on executive compensation by Murphy (1998).*
4. *In particular, we obtain our coefficient estimates results using a seemingly unrelated regression ("SUR") model that adjusts for correlation between the variables. The appropriateness of the SUR approach was confirmed by the correlation matrix of the residuals from the first-stage regression which indicated positive correlations – salaries and bonuses at 20.7%, salaries and options at 3.5%, and bonuses and options at 7.5%. The regressions were estimated on a weighted basis, where the reciprocal of the natural log of revenues was used as the weight, because compensation shocks to firms with large revenues are likely to be larger than those of other firms. The regressions were run as panels. Since the standard t-statistics associated with panel regression coefficient estimates are likely to be biased upward due to persistent shocks to individual firms, we calculated the t-statistics reported in Table 1 using regression residuals each year and averaging. Calculating the t-statistics in this way is biased downward – rather than upwardly biased as in the standard model.*
5. *There are complications here, for example that in many cases the bonus award will be based less on a pre-set formula and more on subjective determinants. There are other variations from the standard pattern assumed here, creating some noise around the results. However, we believe our timing assumptions are true for most companies included in the study. The likely effect of firms using different timing patterns on our results will be to create a bias against finding any relationship between pay and credit risk.*

over the next year using year-old data.[6] For simplicity, the fiscal year immediately prior to the proxy report will be called the "current" year, the year prior to that will be called "previous" year, and the following year for which we are forecasting credit behavior will be called "next" year.

Exhibit 1 presents the estimated empirical determinants of the components of compensation. The estimates are consistent with our expectations. Larger firms – measured either by revenues or market capitalization – pay more. Firms with higher operating income pay more. CEOs with longer tenures receive more pay. Variations in CEO salaries are well explained by our model, as evidenced by the high adjusted-R^2 of 47.4%. Firms tend to be less uniform in their methods for assigning bonuses (adjusted-R^2 of 21.1%) and even less predictable with their assignment of stock option grants (adjusted-R^2 of 5.3%). While the model may not perform well in predicting any individual firm's assignment of options for a given year, the model does appear to correctly flag companies whose option payouts exceed expectations based on firm size, past performance, and industry.

Exhibit 1
Determinants of the CEO Compensation

	Dependent Variables		
Explanatory Variables	Salary	Bonus	Options
variables from the previous year			
Log of Sales	83.51	114.23	(249.37)
	(4.95)	(2.04)	(0.64)
Log of Market Capitalization	27.65	47.99	1193.41
	(1.87)	(1.02)	(3.37)
Operating Income	0.08	0.22	1.65
	(7.45)	(6.39)	(6.30)
variables from the current year			
Log of Sales		243.55	
		(0.70)	
Log of Market Capitalization		231.52	
		(1.02)	
Operating Income		0.59	
		(4.37)	
CEO Tenure (in years)	5.98	3.74	4.25
	(3.16)	(0.62)	(0.10)
Adjusted - R^2	47.4%	21.1%	5.3%

Notes:
1. Sample consists of 4,485 annual observations covering 865 unique firms.
2. Regressions were estimated using a seemingly unrelated regression model, and residuals were weighted by inverse of firm revenues.
3. Absolute t-statistics in parentheses indicate significance of estimated coefficients for the panel data but is derived by averaging across annual t-stat estimates derived using the residuals from the SUR for each annual cohort.
4. Regressions include year, industry, and ratings dummies (not reported).

CEO salaries are typically benchmarked to the logarithm of firm size, usually measured by sales. Bonuses and stock incentives are typically benchmarked to salary and other performance measures. In our model, the logarithm of sales is highly significant for salary but not statistically significant for bonus or option incentives. The negative coefficient for option incentives might indicate that many smaller firms issue large amounts of options.

Market capitalization is statistically and economically significant for salaries and stock-based incentives. The positive result for salaries may indicate that some firms use the stock market in their assessment of firm size. The size of the coefficient for options is many times larger for stock-based incentives than it is for salaries and bonuses. This might indicate that firms that issue executive stock options focus more on stock performance and therefore have high market capitalizations given their revenue size.

Last year's operating income is statistically and economically significant for all compensation components. While firms that have performed well may give their employees large one-time bonuses, they will often also reset overall levels of future compensation. This is demonstrated by the increase in salaries and the very large increase in stock option grants.

We also considered other potential explanatory variables, such as changes in working capital, leverage, total assets, cash, quick ratio, net income, return on assets, and the previous year's rating actions. None was found to be significant when included with those listed in Exhibit 1. Industry dummies were included in the regression but are not presented.

6. *The variables for the second year are measured as the positive increase over the previous year because we envision that firms do not set negative bonus targets. CEOs that do not create a positive performance in the second year are expected to get no bonus.*

With a model now in hand that explains variations in CEO compensation, it is possible to identify the gap between actual compensation and predicted compensation as "unexplained" compensation (which when negative, should be interpreted as "unexpectedly" low compensation). Because this is a model-based measure of unexplained compensation, many of the compensation packages identified as unexplained can presumably be explained in a straightforward manner by analysts who are well acquainted with the circumstances. Nevertheless, we believe that these models are successful in identifying many of the cases of unusually large and unusually low levels of executive compensation.

Examples of firms caught by the model that ultimately defaulted include Covanta Energy and Enron, both of which defaulted in 2001. Covanta Energy was marked by the model as having high unexplained compensation in six of the seven years prior to its default. Enron was also marked as providing high unexplained compensation in six of the seven years prior to its default.

While a higher number of firms with larger than expected compensation experienced a credit event than would otherwise have been expected, not every firm with larger than expected compensation is necessarily a higher credit risk. The vast majority of these firms never experienced a default or a large downgrade during our sample period. Instead, using compensation as a signal judiciously with other factors may help to highlight the effectiveness of a firm's governance practices.

Default Rates, Downgrade Rates, And Unexplained Compensation

In order to compare the degree of deviations from expectation across firms, we normalized unexplained compensation by its predicted value; i.e., unexplained compensation is expressed as a percentage deviation from the predicted level of compensation.[7] We then measure annual default rates and downgrade rates for various subgroups of the population. We focus on "large" downgrade rates, defined as a downgrade of three or more refined rating notches with a year, with the particular objective of measuring financial distress at investment-grade firms, which are less likely than speculative-grade firms to default.[8]

The results for various percentile stratifications of the compensation distributions for the full dataset (including both investment-grade and speculative-grade firms) are presented in Exhibit 2. To determine a firm's position in the distribution of unexplained compensation, the firms are sorted by the appropriate unexplained compensation each year and their position is marked. This is done for all three compensation variables. The sorting is done each year so as to avoid a situation where all of the outliers fall into one year. This maximizes the model's ability to determine whether it is possible to differentiate between firms in any given year.

Exhibit 2
Variation in Annual Default and Downgrade Rates across the Compensation Distribution

	Defaults Rates			Downgrade Rates		
Position in the Unexplained Compensation Distribution	Salary	Bonus	Options	Salary	Bonus	Options
0% - 20%	1.0%	1.8%	1.1%	4.9%	10.3%	4.7%
20% - 40%	0.7%	1.2%	0.8%	6.0%	3.8%	4.5%
40% - 60%	1.1%	0.1%	0.7%	3.3%	3.0%	4.0%
60% - 80%	0.7%	0.6%	0.8%	4.5%	2.5%	4.9%
80% - 100%	1.3%	1.1%	1.4%	5.1%	4.3%	5.8%
20% - 90%	1.0%	0.6%	0.8%	4.7%	3.1%	4.4%
90% - 100%	0.9%	1.8%	1.5%	4.6%	5.5%	7.5%
Full sample		0.7%			4.8%	

The first point to notice is that there are no consistent patterns in the middle 60% of the distribution. All of the action appears in the bottom and top quintiles. Interestingly, companies that paid their CEOs the least in bonus compensation (the bottom 20%) experienced the highest default and downgrade rates. This perhaps initially surprising result is easily explained by reverse causality: poor prior performance probably led to low bonus compensation, rather

7. *In order to ensure that the excess compensation measured on a percentage makes economic sense even when the model-derived measure of expected compensation is negative and or positive but close to zero, we truncated expected compensation used in the denominator of this measure at a small but positive number. In particular, we assumed in these cases that the denominator took the value of compensation observed by the highest earning CEO within the bottom decile of the population, i.e., $400,000, $200,000, and $40,000 for salaries, bonuses, and stock-based incentives, respectively.*

8. *Although not reported, we also correlated excess compensation with upgrade rates and generally found no systematic relationship. This finding is unsurprising because upgrades for improved financial performance are normally gradual over time, with at most two rating notch increases per year. Large rating upgrades typically occur when a weaker company is acquired by a stronger company, which often follow (ironically) from deterioration in weaker company's stand-alone credit risk.*