

## 5. Bonus Design 2017

The question of bonus design has been under review for some time and notwithstanding recent modifications to the design, the Committee has expressed concern that the bonus is fragmented, does not generate significant reward at budgeted performance levels and is complex to disclose.

### Background

The original approach to bonus design was to provide for around half of the likely pay out – £9.3m for the entire population (c. 2,138 people) in scope at the time. The bonus was driven off EPS performance and personal objectives. (EPS being management's preferred financial measure as it is aligned to shareholder expectations on annual performance), This accrual allowed for an element of the financial payment to be made at budgeted performance levels. However it was released in full some time ago for financial reasons and for a number of years no provision was made and no bonus paid. A significant event or change in corporate activity would have been required to allow the £10m accrual to be provided for again and therefore earning a bonus became in practice very difficult. In an effort to generate some reward for the efforts of management, the design was changed in two stages:

1. The financial gateway of budgeted EPS was removed from the personal element of the bonus
2. For participants in the LEAP scheme, part of the financial element previously measured against EPS was converted to be payable against strategic or individual stretch targets. As for the personal performance element, payment for these additional objectives did not depend on the EPS gateway being met. Investors were consulted on this approach and approved it although subsequently there has been less enthusiasm given the potential overlap between the stretch targets and either the financial or personal measures and there have been some questions around disclosure.

The net effect of these changes has been to bring more of the bonus into payment which was the intended outcome. However, like anything designed in stages, the resultant bonus plan looks complex. Furthermore, there is an increasing requirement for clarity around disclosure which means we need to rethink the bonus at least from a presentational perspective as a minimum.

The Committee's aim is to have a bonus arrangement that delivers a percentage of the award at budgeted performance levels. The existing, albeit complicated arrangements do achieve this but through a combination of elements that are not tested against EPS performance.

### Altering the bonus structure

The Committee has discussed changing the current approach to address some of these concerns and asked us to specifically consider:

1. Being able to structure a bonus which pays out for budgeted EPS;
2. the use of EPS as the primary profit measure; and
3. the definition of Cash in the bonus which is defined as "cash conversion"
4. the weightings of the metrics which are currently 30% EPS, 20% Cash, 25% Stretch objectives and 25% Personal objectives

The issue of affordability remains a challenge in practical terms. Without providing for the bonus payment at least in part within the profit number, any payment at budget would erode the financial performance to below budget levels. We have looked at reducing the population in scope of bonus overall by buying out those at lower levels

thereby making it more practical to provide for a payment at target EPS. The timing around this is sensitive particularly in the light of potential corporate activity which may produce exceptional financial performance in the very year we will have changed the scope

With regards to the appropriate profit and/or other financial measures, we have a new CFO in post from January who will want to take his own view of the business financials and propose appropriate measures to drive the business outcomes he envisages and we would propose to work with him on a review of the bonus in 2017.

The current definition of Cash Conversion is used as the primary cash management tool within the business and current thinking is that this should not be changed but again we would recommend working with Zafar in 2017 to ensure he is comfortable that this is the right lever to include within the business going forward and therefore the right definition for the bonus.

There are other factors that impact on the timing of a fundamental change to bonus:

- We are in the final year of the current policy period with bonus 2018 being covered by the new policy which also allows for a maximum opportunity of 150% should that be required
- We introduced a change in 2016 (the introduction of a cash measure) which we have not seen through to delivery in terms of bonus performance and the resultant reward. Current forecast numbers suggest that around half of the 20% Cash element of the bonus will be delivered in 2016.

It is therefore recommended that no substantial change is made for 2017 but that working with Zafar in 2017 and making the right budgetary provision we redesign bonus 2018.

## Bonus 2017

We have identified the need to design the measures and personal objectives with one eye on disclosure as well as providing a focus for the right business outcomes since investors have made it clear that they are not prepared to accept significant payment for less tangible objectives which don't have hard measures. There were investor concerns expressed this year regarding the fact that whilst no bonus was paid under the EPS element, the personal and stretch objectives paid out almost in full. With this in mind, the following design is proposed for 2017:

- EPS remains the prime financial measure, supplemented by the cash conversion measure introduced in 2016
- The “stretch” objectives are replaced by Corporate KPIs which link into the front end of the Report and Accounts and which are hard measures e.g. safety, cost and work winning and based on audited metrics
- Personal objectives to be limited to a maximum of three for bonus purposes with wording which clarifies that the objectives are more than “business as usual”
- Participants will have an EPS target and a cash conversion target for 2017
- The payment of the personal objectives and Corporate KPIs are not dependent on EPS levels being achieved
- If EPS levels are not achieved no payment for cash conversion will be made
- Performance against personal objectives determined by line manager assessment and reviewed by the Remuneration Committee
- 50% of any payment will be deferred into shares for 3 years for Executive Directors

FY17 objectives	Entry	Target	Maximum	Allocation
Financial - EPS (30%)	-	37.1p 0%	40.8p 30%	75% Based on financial and KPI performance
Financial - Cash Conversion (20%)	Underlying cash flow from operations to be 97.2% of underlying profit from operations 0%	Underlying cash flow from operations to be 108% of underlying profit from operations 10%	Underlying cash flow from operations to be 118.8% of underlying profit from operations Up to 20%	
Corporate KPIs (25%)	Up to 25% (no EPS underpin)			
Personal (25%)	Up to 25% (no EPS underpin)			25% personal

Some of these changes will be incorporated into the FY16 DRR disclosure for bonus 2016 in which we will emphasise that 75% of our measures are quantitative (EPS/Cash/Corporate KPIs) and 25% personal objectives.

### Larger percentage opportunity on cash

The weightings of 30/20/25/25 of the current design puts slightly more emphasis on KPIs and Personal objectives than the split discussed by the Remuneration Committee of 30/30/20/20 which is a more conventional split across the elements. For those participants who have a bonus opportunity above 50% of salary the split has historically always been 25% personal and the balance financial which we are broadly returning to with the proposal for 2017. This is perhaps something for the 2018 review unless there is a strong desire to change the emphasis for bonus 2017. A possible alternative design is set out at below.

As a potential alternative, this option moves some more of the bonus into the financial category by increasing the percentage allocated to Cash and reducing the Corporate KPI and personal elements. There is no change to the EPS measure.

- Participants will have an EPS target and a cash target for 2017
- The payment of the Personal objectives and Corporate KPIs are not dependent on EPS levels being achieved
- If EPS levels are not achieved no payment for cash conversion will be made
- Corporate KPIs must be hard measures e.g. safety, cost and work winning and based on audited metrics
- Performance against personal objectives determined by line manager assessment and reviewed by the Remuneration Committee
- 50% of any payment will be deferred into shares for 3 years for Executive Directors

FY17 objectives	Entry	Target	Maximum	Allocation
Financial – EPS (30%)	-	37.1p 0%	40.8p 30%	80% Based on financial and KPI performance
Financial - Cash Conversion (30%)	Underlying cash flow from operations to be 97.2% of underlying profit from operations 0%	Underlying cash flow from operations to be 108% of underlying profit from operations 10%	Underlying cash flow from operations to be 118.8% of underlying profit from operations up to 30%	
Corporate KPIs (20%)	Up to 20% (no EPS underpin)			
Personal (20%)	Up to 20% (no EPS underpin)			

Clearly there are some issues for consideration if we make this change in 2017: If we intend a more fundamental review in for 2018 bonus we will have amended the bonus to some degree three years running which may concern investors and participants

## Bonus 2016

- 50% of any payment will be deferred for 3 years for Executive Directors.
- LEAP participants have a reduced financial element replaced by an opportunity measured by reference to individual stretch strategic targets.
- Participants will have an EPS target and a cash conversion target for 2016.
  - The payment of the personal and strategic elements are not dependent on EPS levels being achieved
  - EPS must be achieved for financial element to be paid. If EPS levels are not achieved no payment for cash conversion will be made.
  - Personal objectives include hard measures e.g. safety, cost and work winning.

+10%	Entry	Target	Maximum
<b>Financial - EPS</b>	-	36.1p 0%	39.7p Up to 30%
<b>Financial - Cash Conversion</b>	Underlying cash flow from operations to be 95% of underlying profit from operations 0%	Underlying cash flow from operations to be 100% of underlying profit from operations 10%	Underlying cash flow from operations to be 110% of underlying profit from operations Up to 20%
<b>Personal</b>	-	0%	Up to 25%
<b>Strategic</b>	-	0%	Up to 25%

## Bonus 2015

- Based on bonus 2014
- 50% of any payment will be deferred for 3 years for Executive Directors.
- LEAP participants have a reduced financial element replaced by an opportunity measured by reference to individual stretch strategic targets.
- Business Unit MDs had an EPS target only for 2015 rather than EPS and business unit PBT as in 2014.
  - The payment of the personal and strategic elements are not dependent on EPS levels being achieved
  - EPS must be achieved for financial element to be paid.
  - Personal objectives include hard measures e.g. safety, cost and work winning.

+10%	Entry	Target	Maximum
<b>EPS</b>	-	34.7p	38.1p
<b>Financial</b>	-	0%	50%
<b>Personal</b>	-	0%	Up to 25%
<b>Strategic</b>	-	0%	Up to 25%