

DPS FRAMEWORK SCHEDULE 4: LETTER OF APPOINTMENT AND CONTRACT TERMS

Part 1: Letter of Appointment

To whom it may concern,

Letter of Appointment

This letter of Appointment dated Wednesday, 19th February 2020 is issued in accordance with the provisions of the DPS Agreement (RM8018) between CCS and the Supplier.

Capitalised terms and expressions used in this letter have the same meanings as in the Contract Terms unless the context otherwise requires.

Order Number:	CR20006 - Pay for performance? An assessment of the prevalence and impacts of different performance targets used in executive remuneration packages.
From:	The Department for The Department for Business, energy and Industrial Strategy (BEIS) 1 Victoria Street, Westminster, London, SW1H 0ET ("Customer")
To:	PricewaterhouseCoopers LLP, 7 More London Riverside, London, United Kingdom, SE1 2RT ("Supplier")
Effective Date:	Friday, 21 st February 2020
Expiry Date:	Friday, 31 st July 2020
Services required:	Set out in Section 2, Part B (Specification) of the DPS Agreement and refined by: the Customer's Project Specification attached at Annex A and the Supplier's Proposal attached at Annex B.
Contract Charges (including any applicable discount(s), but excluding VAT):	£90,176.00 excluding VAT
Insurance Requirements	Additional public liability insurance to cover all risks in the performance of the Contract, with a minimum limit of £5 million for each individual claim

	<p>Additional employers' liability insurance with a minimum limit of £5 million indemnity</p> <p>Additional professional indemnity insurance adequate to cover all risks in the performance of the Contract with a minimum limit of indemnity of £2 million for each individual claim.</p> <p>Product liability insurance cover all risks in the provision of Deliverables under the Contract, with a minimum limit of £5 million for each individual claim.</p>
Liability Requirements	Suppliers limitation of Liability (Clause 18.2 of the Contract Terms);
Customer billing address for invoicing:	All invoices should be sent to should be sent to finance@services.ukabs.co.uk or Billingham (UKSBS, Queensway House, West Precinct, Billingham, TS23 2NF).

GDPR	NA
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FORMATION OF CONTRACT

BY SIGNING AND RETURNING THIS LETTER OF APPOINTMENT (which may be done by electronic means) the Supplier agrees to enter a Contract with the Customer to provide the Services in accordance with the terms of this letter and the Contract Terms.

The Parties hereby acknowledge and agree that they have read this letter and the Contract Terms.

The Parties hereby acknowledge and agree that this Contract shall be formed when the Customer acknowledges (which may be done by electronic means) the receipt of the signed copy of this letter from the Supplier within two (2) Working Days from such receipt

For and on behalf of the Supplier:

For and on behalf of the Customer:

Name and Title:

Name and Title:

Signature:

Signature:

Date:

25 / 2 / 2020

Date:

03/03/20

ANNEX A

Customer Project Specification

To be determined by the Customer at Call for Competition stage

Background

Following a 2017 Conservative manifesto commitment, BEIS commissioned research looking specifically into potential links between the use of share buybacks and executive pay. The research investigated the hypothesis that share buybacks are used to artificially meet earnings per share (EPS) targets in executive remuneration plans. The research did not find evidence to support such a link, and it also did not identify evidence that the use of share buybacks is associated negatively with investment levels. However, the research did find some initial evidence that the existence of EPS targets in executive remuneration targets is directly negatively correlated with lower investment levels. While this initial evidence is not evidence for a causal link, it does match up with similar academic research which identifies that CEOs carry out short-termist action at times of large equity vesting.

Existing, published US research (Bennett, B., Bettis, J. C., Gopalan, R., & Milbourn, T. (2017). *Compensation goals and firm performance*. *Journal of Financial Economics*) looks at companies in the close vicinity of either hitting or missing specific targets. It "finds that a disproportionately large number of firms exceed their goals by a small margin as compared to the number that fall short of the goal by a similar margin." This suggests that companies/executives take action to push them over the target and emphasises that targets can be 'gamed'. It also finds that firms that just hit EPS targets have lower R&D expenditures, and that such gaming is particularly common for earnings targets and in instances where companies have a single target rather than a more balanced selection.

Given the initial finding of the buyback research and the existing US evidence referred to above, the Department wants to follow-up on the preliminary finding that came out of the buyback research. The Department has in fact announced that it will do so. The research will not only shed further light on potential problems with executive pay targets (an area that has received increased criticism, with companies coming under pressure to simplify pay structures), but it will also be part of a wider research agenda we have developed. It will help look further into one of the proposed drivers of business short-termism in the UK.

Aims and Objectives

The research will investigate three main areas:

1. **Prevalence of targets and whether their design is accurately measuring executive performance.** How prevalent are specific performance targets (EPS, profit-measures...) in executive remuneration packages, both in Long-Term Incentive Plans but also in annual bonus plans? Are targets designed to avoid 'pay-for-luck' or is performance against many targets actually beyond the control of executives (for example, strongly influenced by the wider economic environment)?
2. **How challenging are targets? Do some targets act as de-facto base pay? To what extent are targets met? Are some targets being met consistently and at much higher levels than others? Which targets appear 'softer'?**

- 3. Potential links between targets and short-termist/myopic executive decision-making.** Is there a relation between the existence of specific pay targets (such as EPS) and short-termist action, such as reduced investment levels? Do some targets appear more susceptible to being 'gamed'?

Government has made legislative changes and supported/initiated non-legislative changes to the executive pay framework over the last years. At the same time, there is large appetite to address what is perceived as short-termism of UK companies. This research is part of our wider research agenda looking into the potential drivers of short-termism. Outputs and findings will be used to inform further policy development and briefing.

Suggested Methodology

- 1. Literature review.** The existing academic body of evidence on executive pay is extensive, but largely focuses on the US and on equity vesting rather than specific performance targets. For example, the fact that CEOs take short-term action at times of large amounts of equity vesting subject to specific targets is well established (for example: Edmans, A., Fang, V. W., & Lewellen, K. A. (2017); or Edmans, A., Fang, V. W., & Huang, A. H. (2017)). This already highlights potential challenges with CEO contracts in which there are cliff-edge moments at which large amounts of equity vest subject to a specific performance target (such as in LTIPs).

However, that research largely addresses the issue of "cliff-edges" (times at which a large amount of equity vests in a non-linear/smooth fashion) rather than the incentives provided by specific performance measures and targets which determine whether equity vests in the first place.

Such research has been carried out using US data in: *Bennett, B., Bettis, J. C., Gopalan, R., & Milbourn, T. (2017). Compensation goals and firm performance. Journal of Financial Economics, 124(2), 307-330.* Using a large dataset of performance goals employed in executive incentive contracts, they find that a disproportionately large number of firms exceed their goals by a small margin as compared to the number that fall short of the goal by a similar margin. This asymmetry is particularly acute for earnings goals, when compensation is contingent on a single goal, when the pay-performance relationship around the goal is concave-shaped and for grants with non-equity-based payouts. Firms that exceed their compensation target by a small margin are more likely to beat the target the next period and CEOs of firms that miss their targets are more likely to experience a forced turnover/redundancy. Firms that just exceed their EPS goals have higher abnormal accruals and lower Research and Development (R&D) expenditures, and firms that just exceed their profit goals have lower SG&A expenditures. Overall, the results highlight some of the costs of linking managerial compensation to specific compensation targets.

The literature review should include an assessment of these and similar papers, focusing on UK and international research. Particular focus should be placed on the available academic evidence.

- 2. Quantitative data analysis (descriptive).** Investigation of UK executive pay data (focus on FTSE350 companies) such as provided by Manifest/Minerva (the Department holds a subscription to this data) or ISS to develop basic descriptive statistics to answer the first two research questions identified above: prevalence of different targets and the degree to which different targets are met. This may require some additional desk-based

research, for example to look into individual remuneration reports where individual targets are not identified with enough precision; for example, where it is not clear whether a specific EPS target was adjusted or not for exchange rate changes. Some data manipulation will also be necessary to transform relative and absolute targets into a single comparable measure.

Quantitative data analysis (Inferential). Where needed, adding financial information from datasets such as FAME/Capital IQ. We then propose a replication of the methodology applied in Bennett et al, i.e. statistical/econometric threshold analysis, to investigate question 3. above. We are though open to alternative methodological suggestions.

Deliverables

- (March). Initial methodology note. Following the project initiation, we would like to receive a short paper/methodology note that sets out the agreed upon methodological approach.
- (May). Following the literature review work and initial statistical analysis, we would like to receive interim findings, either as an interim report or in the form of a slide-pack.
- (July). Final report as well as underlying data.

To facilitate good project management, we would ask for:

- Regular catch-ups (over phone by default)
- At least three in-person meetings: 1) initiation meeting; 2) interim findings discussion; and 3) presentation of final results.

Part 2: Contract Terms



Contract Terms v6.0