

22 May, 2000

Mr P McMahan
Committee Secretary
House of Representatives Standing Committee
on Employment, Education and Work Place Relations
Parliament House
Canberra, ACT 2600

Dear Mr McMahan

Reference is made to your letter of 6 January 2000 in which you sought responses to a number of questions in relation to the inquiry being undertaken into employee share ownership in Australian enterprises. The following repeats and then responds to each of the questions.

Q1. The Committee has received evidence about the use of shares and options as a form of remuneration for executives.

- *Do you think this practice is becoming more common in Australia?*
- *How effective are shares and options as attraction and retention tools, for executive and non-executive employees?*

Before answering this question it needs to be noted that the predominant use of share and option plans is as the long term incentive (LTI) component of remuneration. However it should also be noted that it is common practice for executives and directors to be able to take part of their remuneration (on a “salary sacrifice” basis) in the form of company shares to take advantage of the up to 10 year tax deferral available under division 13A of the Income Tax Assessment Act.

Attachment A provides data from the Hay Executive Reward Service database (lists of participants are provided as attachment B). This data clearly indicates two developments in relation to the use of share and option plans. Firstly the size of allocations is increasing in real terms as evidenced by the percentage increase in the median of market practice expressed as a multiple of salary. Secondly, allocations are being extended to lower level executives as evidence by the high percentage increases in the % of incumbents receiving in senior executive grades A, B and C.

We do not collect similar data for general employees but our consulting experience would indicate that most companies with executive share and/or option plans also have a general employee share plan (options plans are rarely used for general employees). Also there seems to be a trend towards higher allocations in general employee plans.

The main role of the share or option plans is to focus executives on growing shareholder value. Being part of remuneration their other role is to aid in the attraction and retention of executives. Because share and option plans represent the main opportunity that executives have for asset accumulation (outside superannuation and the family home) they have become the most important part of remuneration for senior executives. Therefore they, along with the other elements of remuneration, do influence executives when making career move decisions. When the plans are designed to act as golden handcuffs they can be particularly effective in helping to retain key executives and other employees. An example of this type of plan is when shares are allocated to an executive but will be forfeited should he or she leave the company within a specified period after the shares were allocated.

Q2. Do you have any evidence that this form of remuneration has long-term benefits for the performance of companies and the interests of shareholders?

Because it is not possible to establish a control group against which to compare, it has not been possible to establish a scientifically valid cause and effect relationship between the use of equity based LTI plans and either improved company performance or increased shareholder value. However there is a correlation between companies that have equity based LTI plans and those that are top companies. Virtually all of the top (largest) Australian companies have equity based LTI plans.

The rationale for using equity based LTI plans is agency theory. Briefly this theory states that for executives to think and behave like owners of the business they must benefit in much the same way as owners do from improving the performance of the company. Thus short term incentives allow them to participate in the annual performance and the LTIs allow them to participate in the growth in value of the business.

Q3. What do you think the future for this kind of remuneration will be in Australia?

Based on current laws we expect the use of this type of remuneration to consolidate and become accepted as a normal part of the remuneration transaction for employees of listed public companies. The changes to capital gains tax will encourage the use of leveraged plans such as options and share purchase loan plans. However the structure of option plans will be modified to ensure that CGT applies to all or most of the growth in the share price. Share purchase loan plans do not need to be amended for growth in the share price to be taxed under the CGT provisions. Some resistance will continue to apply to the use of share purchase loan plans for executives as they do not readily lend themselves to the application of performance hurdles for vesting of the shares.

If taxation of trusts means that they become unsuitable for use in relation to share and option plans then the structure of the plans will simply be changed so as to minimise or avoid the adverse impact of the tax changes.

In this regard it should be noted that the absence of a tax deduction for the benefit provided to executives from options has not constrained their use even though the full benefit has usually been taxed as income of the executives. Usually when a benefit is taxed as income of employees the cost qualifies as an income tax deduction for the company. Tax has not been the driver for the expansion in use of these plans for executives and it will take very penal tax provisions to reverse the current trends.

For general employee plans the tax exemption concession has not been sufficient to lead to a strong spread of the use of these plans through “free” share allocations. The reason being that the cost to the company has been seen as too high for the perceived return to the company from the plan. Hence share purchase loan plans continue to be the main form of general employee share plan. In this regard it should be noted that “salary sacrifice” approaches usually do not achieve high levels of take-up among general employees because they do not have sufficient uncommitted income to be able to divert part to the purchase of shares, even if the benefit is tax exempt.

Q4. Would removing the present cessation requirements and replacing them with a single requirement, that tax is payable on disposal of the shares or options, be compatible with the aims of employee share schemes?

Shares acquired under general employee tax exempt plans are taxed on disposal of the shares under the CGT provisions. Therefore the cessation requirements are not relevant.

The cessation requirements are also not relevant to share purchase loan plans as tax generally arises on disposal of the shares.

The cessation requirement will become irrelevant in option plans once they are restructured to take advantage of the new CGT provisions. Executives will either be electing to be taxed on receipt of the options or will be purchasing the options to take them outside the employee share scheme provisions and thereby changing the main taxing point to disposal of the shares after the options have been exercised. Company loans will fund the tax or the cost of the options. Our view is that the use of option plans would be tempered if a combination of three elements were to be introduced as an elective alternative to the current treatment of options. They are:

- FBT on options when granted,
- tax deduction for the company for the value of the options taxed for FBT purposes, and
- gains from options in excess of the FBT taxable value being taxed under the CGT provisions, with 50% of such gains from options issued at least 12 months earlier only to be taxed.

The cessation requirement will remain relevant to share award plans. These plans are mainly used for “salary sacrifice” share purchases for executives and directors. We consider the 10 year deferral to be reasonable for this type of plan. For LTI share award plans the 10 year deferral period is adequate given that planning cycles rarely extend beyond 5 years.

Nevertheless, to avoid the current problem of employees being taxed on an unrealised benefit and therefore being, in effect, forced to sell shares, a change of the taxing point to the time of disposal would be an improvement consistent with the principles of employee share ownership.

Q5. *The following is an excerpt from the Business Review Weekly 8 Feb, 1999:
(Quote not repeated)*

- Are you aware of this case?
- How wide spread are schemes such as this?

This type of scheme has only recently started to emerge and follows on from the use of this type of scheme in the UK with Rio Tinto being one of the first examples in Australia. Its popularity has been driven by the application of tougher and tougher performance hurdles to the vesting of options. Performance hurdles usually relate to performance relative to a peer group. If relatively good performance has been achieved then it is often felt that executives should be assured of some benefit. A benefit is only achieved from options if the share price rises and this may not occur particularly in a “bear market”. Shares produce a benefit even if the share price falls.

In essence this type of plan amounts to a cash bonus equal to the value of a parcel of shares if a performance hurdle has been met. However the cash bonus is used to purchase shares which qualify for tax deferral for up to 10 years. All the tax implications outlined in the article then follow. Remember that the executive is taxed on the full value of the shares under Division 13A (not under the CGT provisions) and on the dividends received.

A similar plan has been introduced by Telstra for its senior executives and was endorsed by the Government before implementation. We did not advise on the BHP plan but did advise Telstra.

Q6. *Is it usual practice to disclose the details of executive share options plans to share holders?*

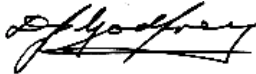
The Australian Stock Exchange Listing Rules currently require new plans, amendments to current plans and each allocation to directors to be approved by shareholders passing a special resolution (75% of votes in favor). These Rules are to be changed so that from July 2000 only directors’ allocations will need to be approved and then only via an ordinary resolution (50% of votes in favor).

It should be noted that plans that do not involve new issues of shares generally do not require shareholder approval. Thus not all plans require shareholder approval.

Limited disclosure occurs in annual reports but the main source of information for shareholders is the approval process, where it applies.

It is trusted that the foregoing information is of assistance. Should you require more information or clarification of any matter raised in this letter please feel free to contact us.

Yours sincerely



Denis Godfrey
Associate Director

Attachment A & B

ATTACHMENT B

List of Participants - Hay Group - Executive Reward Service

Page 1

Participating Company	1996	1999
INDUSTRIAL SECTOR		
Ancor Limited	✓	✓
The Australian Gas Light Company		✓
Australian National Industries Limited	✓	
Bonlac Foods Limited		✓
Boral Limited	✓	✓
The Broken Hill Proprietary Company Limited	✓	✓
BTR Nylex Group	✓	
Burns Philp & Co Limited	✓	
Capral Aluminium Limited		✓
Coca-Cola Amatil Limited	✓	✓
CSR Limited	✓	✓
Foster's Brewing Group Limited		✓
Howard Smith Limited	✓	✓
ICI Australia Limited	✓	
Mitsubishi Motors Australia Limited		✓
National Consolidated Limited	✓	
National Foods Limited	✓	✓
Orica Australia Limited		✓
Pioneer International Limited	✓	✓
Pivot Limited	✓	✓
Rothmans Holdings Limited	✓	
Smorgon Steel Group Limited		✓
Southcorp Holdings Limited		✓
Wesfarmers Limited	✓	✓
SERVICE SECTOR		
Ansett Australia		✓
Brambles Industries Limited	✓	✓
Cable & Wireless Optus Limited		✓
Coles Myer Limited	✓	✓
Foodland Associated Limited	✓	✓
Gas and Fuel Corporation of Victoria	✓	
Mayne Nickless Limited	✓	✓
Qantas Airways Limited	✓	✓
Tabcorp Holdings Limited	✓	✓
Telstra Corporation Limited	✓	✓
West Australian Newspapers Holdings Limited	✓	✓

ATTACHMENT B

List of Participants - Hay Group - Executive Reward Service

Page 7

ATTACHMENT B

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Page 1

Participating Company	1996	1999
Yellow Pages Australia	✓	
RESOURCES SECTOR		
Alcoa of Australia Limited	✓	
Ampolex Limited	✓	
APPL (Ampol)	✓	
Ashton Mining Limited	✓	✓
BP Australia Limited	✓	✓
Mobil Oil Australia Limited	✓	✓
Newcrest Mining Limited		✓
North Limited	✓	✓
Pasminco Limited		✓
RGC Limited	✓	
Rio Tinto Limited		✓
Shell Australia Limited	✓	
WMC Limited	✓	✓
Woodside Energy Limited		✓
Woodside Petroleum Limited	✓	
FINANCIAL SECTOR		
AMP Limited		✓
AMP Society	✓	
ANZ Banking Group Limited	✓	✓
AXA Australia		✓
Colonial Mutual Group	✓	✓
Commonwealth Bank of Australia	✓	✓
GIO Australia Holdings Limited		✓
MMI Limited	✓	
National Australia Bank Limited	✓	✓
National Mutual Life Association	✓	
NRMA Limited	✓	✓
Suncorp Insurance and Finance	✓	
Suncorp-Metway Limited		✓
Westpac Banking Corporation	✓	✓

Job Grade	Hay Points / Job Size	Median Market Value of Holding as Multiple of Salary as at			% of Incumbents Receiving		
		1-Jul-96	1-May-99	% Increase	1-Jul-96	1-May-99	% Increase
Senior Executive A	880-1055	1.41	1.74	23%	35%	72%	106%
Senior Executive B	1056-1260	2.18	1.77	-19%	33%	69%	109%
Senior Executive C	1261-1507	2.26	1.49	-34%	57%	72%	26%
Senior Executive D	1508-1800	2.3	3.24	41%	63%	85%	35%
Senior Executive E	18001-2112	2.81	4.07	45%	67%	95%	42%
Senior Executive F	2113-2432	2.86	4.78	67%	78%	99%	27%
Senior Executive G	2433-2800	4.93	5.15	4%	82%	87%	6%
Senior Executive H	2801-3200	5.21	6.31	21%	91%	93%	2%
Senior Executive I	3201-3680	4.6	3.68	-20%	81%	100%	23%
Senior Executive J	3681-5000	10.46	13.68	31%	80%	100%	25%

ATTACHMENT B

List of Participants - Hay Group - Executive Reward Service

CEO A	2501-4500	2.27	6.26	176%	71%	69%	-3%
CEO B	4501-6000	5.04	7.74	54%	70%	100%	43%
CEO C	6001-7500	7.24	11.15	54%	86%	100%	16%