# CEO COMPENSATION AND ITS IMPACT ON COMPANY PERFORMANCE: A COMPARISON BETWEEN FORTUNE 500 COMPANIES AND BC CROWN CORPORATIONS

by

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# PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF

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**Abstract** 

Executive compensation practices are changing. Recent corporate compensation

scandals have caused great public outrage in light of worsening economic conditions.

Sarbanes-Oxley Legislation has reformed how publicly traded companies compensate

and report compensation of top executives. BC Crown Corporations have had to deal

with even stricter legislation dealing with executive compensation practices. Publicly

traded companies need to try harder to comply with the spirit of transparency laws. BC

Crown Corporations have capped CEO compensation, but could be in danger of losing

their top employees to the private sector.

**Keywords:** Executive Compensation, Sarbanes-Oxley Reforms, BC Crown Corporations

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# **Dedication**

To my family

and

To the people who work in the public sector – your service is of great value.

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# **Glossary**

ASAI Average Service Availability Index

BC British Columbia

BCLC British Columbia Lottery Corporation

BCTC British Columbia Transmission Corporation

BCUC British Columbia Utilities Commission

CAD Canadian Dollars

CAIDI Customer Average Interruption Duration Index

CD&A Compensation Discussion and Analysis

CELID-6 (customers experiencing longest interruption duration) refers to the percentage of

customers experiencing longest interruption duration of six or more hours,

excluding major events

CEMI-4 (customers experiencing multiple interruptions) refers to the percentage of

customers experiencing four or more outage interruptions per year, excluding major

events

CEO Chief Executive Officer

CFO Chief Financial Officer

CPP Canada Pension Plan

EBIT Earnings before interest or taxes

EBITDAM Earnings before interest, taxes, depreciation, amortization, or management fees

EI Employment Insurance

FCF Free cash flow

G&A General and administration

GE General Electric

ICBC The Insurance Corporation of British Columbia

LTIP Long term incentive pay

OCF Operating cash flow

OMA Operations, Maintenance, and Administration

PPE Property, Plant, and Equipment

PSEC Public Sector Employer's Council

R&D Research and Development

RONA Return on Net Assets

SAIDI System Average Interruption Duration Index

SEC Securities Exchange Commission

SERP Supplemental Executive Retirement Plan

SOX the Sarbanes-Oxley legislation

STIP Short term incentive pay

USD American Dollars

### 1: Introduction

The topic of corporate governance has risen to the fore in recently with the world economic crisis sparked by the earnings restatements of many of the largest retail banks as they marked down the toxic debts they carried. When ailing insurer AIG paid out its executive bonuses shortly after having received government bailout monies, pundits railed against them and public opinion was galvanized against the fat cat CEOs of all large companies. (Linn, 2009)

We have our own homegrown criminal CEOs in Canada, Lord Black was recently jailed for his part in a scandal in which he bilked his company, Hollinger International, for tens of millions of dollars in unearned compensation. The arrogant manner in which he publicly addressed the issues that lead to his removal from Hollinger and his eventual indictment was enough to make him guilty in the court of public opinion long before his conviction. An example of this attitude came in 2003 after he was forced to resign from his position as CEO of Hollinger and the company's stock rose as shortly thereafter. Lord Black said:

"I just made 50-million bucks yesterday. That's a flame out I could get used to"
(Gray, 2003)

Other American CEOs who took notorious amounts of compensation for doing less than satisfactory jobs of managing their companies were also in the news during the lead up to the economic crisis. One of the more notorious of these was Home Depot

CEO Robert Nardelli who was forced to resign after the company had underperformed under his direction. At the time of his resignation in 2007, he managed to walk away with a severance package totaling \$210 million USD. Shareholders of the company were enraged and filed a lawsuit to try to stop him from receiving this money. (Grow, 2007) Ironically, Mr. Nardelli was able to get another job almost immediately following this scandal and took charge of the Chrysler Company shortly thereafter. During his time at this company, he was unable to turn it around and just two years after he started there, Chrysler filed for bankruptcy protection. The US government had given Chrysler one round of bailout money to try to save it from bankruptcy and would have given the company a second round of money but for one problem. The US government put a new condition on the second round of bailout money that would force the top 25 executives at the company to sign an agreement capping their compensation. They were unable to get the agreement of all 25 of these executives. Executive compensation may have been the final nail in Chrysler's coffin. (Cho, Whoriskey, & Paley, 2009)

In British Columbia, we have several crown corporations that are ultimately responsible to the taxpayers in the province, and their governance is closely monitored not only by government, but by the press besides. The transparency required of crown corporations insures public access to records of executive compensation, and the numbers are deemed newsworthy by local papers. As recently as December 2008, The Vancouver Sun Newspaper ran a story about the salaries of public sector employees under the title "More than 750 public-sector employees earn \$200,000 or more". (Skelton, 2008) When the salaries of private sector executives in the United States or even Ontario are taken into consideration, this may not seem like an outrageous amount, but in BC this is

highlighted by Canada Census data that shows family incomes in BC have not risen at the same rate as the rest of the country. (Panzenboeck, 2009). The average family in BC sees an annual income of only \$62,346, less than one third the amount highlighted in the Vancouver Sun headline. (Panzenboeck, 2009)The Vancouver Sun Article also directs readers to a database compiled by the newspaper that lists the salaries 30,000 public sector employees. (Skelton, 2008)

Real scandals have also touched crown corporations in recent years. In 2003, BC crown corporation BC Rail was sold to CN, causing the opposition party of the day to question payments to one of the players involved. It was alleged that Patrick Kinsella was paid approximately \$300,000 over 4 years for helping to sell BC Rail, but that at the same time, Kinsella was also connected to CN Rail. As of April 2009, the matter was still under investigation and generating news stories (Hall & Shaw, 2009) Low ethical standards and corrupt management were revealed at ICBC when an investigation into the re-selling of vehicles was launched. The consultants hired to investigate recommended the insurance company tighten its policies and procedures. (Vancouver Sun, 2008)

The Public Sector Employer's Council does require a high degree of transparency when it comes to the compensation of top executives. For a comparison of the PSEC requirements and the SEC requirements in the US, see table 1:

Table 1 Comparison of PSEC and SEC Compensation Reporting Regulations

	PSEC Requirements	SEC Requirements
Whose salary must be reported?	CEO and next four highest ranking executives when they earn more than CAD\$125,000 base salary	CEO, CFO, and next three most highly compensated executives when they earn more than USD\$100,000
In what format should this reporting take place?	Senior employee compensation report form	Compensation Discussion and Analysis including a table of salaries and other benefits
In what format must this information be made available?	This information must be made available on the Employer's website and contracts of employment must be made available during business hours.	This information must be filed with the SEC, which makes it available on its website.

(The Public Sector Employers' Council, 2008) (Garfinkle, 2006)

How is it possible that these Crown Corporations have managed to keep their executive compensation at a reasonable level and yet still get value from their CEOs with regard to financial results? This paper will show that BC Crown Corporations do not overpay their CEOs, and that the CEOs of these Crown Corporations deliver value to their employers. We will explore the state of CEO compensation in S&P 500 companies in the post Sarbanes Oxley Era and detail the current thinking on Executive Compensation best practices. We will look at the compensation practices and financial results of four BC Crown corporations, and compare the largest Crown Corporation with a Comparable S&P 500 company. This will show the value that Crown Corporation

CEOs provide to their main stakeholders, the taxpayers and whether or not they are actually worth what they are being paid.

#### 1.1 The problem with powerful CEOs

Power goes hand in hand with business and money. Does there have to be corruption where there is power? There does not. There are checks and balances that can be put in place to ensure that a CEO uses the power of the CEO position to benefit the company first and the CEO second, but this takes the guidance and will of a strong board.

In many of the cases of CEOs who were overcompensated for their subpar performance, the problems lay in the way their pay was structured. CEO compensation packages have stock options and bonus incentives as well as Supplementary Executive Retirement Plans. These are all areas that can lead to the CEO doing what is best for his compensation package rather than serving the long term interests of the company or the general interests of the majority of the shareholders.

In order to overcome this potential conflict of interests between the Principal (the company) and the Agent (the CEO), boards form compensation committees that carefully review the compensation packages received by executives and board members, and they generally hire expert compensation consultants to assist in the design of these packages. But how can we guarantee that these committee members and the compensation consultants are not also subject to the failings of agency issues or conflicts of interest. In the cases of some companies, the CEO and the Chairman of the Board are one and the same. In cases such as these it means that the CEOs are essentially signing their own pay-cheques. If the other members of the board are also employees of the company or

are colleagues of the CEO from other companies upon whose boards the CEO sits, there are even more opportunities for abuse of CEO power. If the compensation committee, which is made up of board members, hires a private consultant to provide expertise in the area of executive compensation, then that consultant needs to get the approval of the board in order to continue the contract. If the CEO serves as the chairman of the board, then the CEO can affect whether or not the consultant is hired again. In some cases, consulting firms may provide more than one service to a company. In cases such as this, there could be pressure from within the consulting firm itself for the compensation consultants to come up with a CEO compensation package that is pleasing to the CEO rather than one that motivates the CEO to behave in a certain fashion.

These issues are resolved if the board is independent and the compensation consultant used is an outside consultant who is only brought in for this single purpose. This is easier said than done. For a board to be truly independent from the CEO it should be nominated by shareholder proxy. There is the danger that if a board is truly independent in this way and the CEO wields less power, that it will leave the company open to hostile takeover every time powerful shareholders don't like the actions of the CEO. This could be detrimental to the long term health of the company if the shareholders are of the short term profit taking variety. In the case of hiring independent consultants, this can also be difficult. If a consulting firm already has vast knowledge of the inner workings of a company, its corporate culture, and mission, it is easier for that consultant to design compensation packages that are attuned to those needs. An outside company would have a much steeper learning curve in this respect and would have to

waste expensive man hours getting to know the company at a sufficiently deep level in order to effectively act on its behalf.

# 1.2 Keeping the executives on the straight and narrow while still keeping them

If you want a CEO to govern a company properly and make sure to serve the interests of the shareholders, then that CEO must be fairly compensated. In fact, if a CEO is not well compensated, there may be more temptation to do unscrupulous things. Stock based compensation is supposed to align the interests of the CEO with that of the company, but in some cases, it has failed to do so. If the CEO is able to manipulate the stock price in the period of time surrounding the vesting of his compensation stock, then the CEO will be doing harm to the company. If CEOs are unable to buy stock in their companies at preferential rates, then they may decide not to do so with their own money and may then not be as strongly interested in the share price of their companies.

In cases where a company wants to force the CEO to look at longer-term measures of success other than stock price, it may be necessary for the board to use some other form of compensation. It is upsetting to investors, however, if a company's stock is underperforming from one quarter to the next and the CEO is receiving a cash bonus as a result. If the board is not careful, it may find itself up for replacement by some activist shareholders looking to improve their returns and to oust a CEO who is not aligned with their interests. Should the CEO be found guilty of some wrongdoing, the board members could end up in the uncomfortable predicament of defending themselves against a lawsuit for secondary wrongdoing and put their personal fortunes at risk. (Rugen, 2008)

One of the key factors in keeping a CEO working for the interests of the company is for the independent board to meet regularly without the CEO present (Rugen, 2008) so that the board members can shape the direction they would like to see the company take.

# 2: CEO Compensation in the USA - post Sarbanes-Oxley Legislation

In the fallout of the Enron accounting scandal of 2001, the Sarbanes-Oxley legislation was passed in 2002. Commonly known as SOX, This piece of legislation sought to bring reform to clamp down on the creative accounting practices that lead to false reporting of profits where none really existed, and to make sure that the audit process was independent of management and independent of the influence of other branches of the audit consultancy firm hired. Transparency in governance was a big part of the SOX legislation, and there were sweeping reforms made with regard to the independence of boards and committees. The need for reform at this point in the history of the United States economy was so great that this legislation passed with almost no opposition. Amazingly, there was no regulation of executive compensation in this historic piece of legislation. (Dalton & Dalton, 2008)

The SEC has drafted rules regarding compensation committees that require companies to submit a Compensation Disclosure and Analysis (CD&A) with its other SEC filings, and this document is supposed to be written in "plain English" so that any potential investor could theoretically easily understand how the CEO and other top executives are being compensated. The reality of CD&A filings is less than satisfactory. The compensation committees have had great difficulty simplifying the language used to describe their mandates and the nuances of their compensation packages and thus have not pleased the SEC Chair with their attempts at clear language. On average, most of

these documents are upwards of 5000 words and written at the PhD. level of readability. (Dalton & Dalton, 2008) This is hardly what was intended by the spirit of the CD&A requirements.

The restatement of earnings is one area where SOX actually does step in and take an active role in CEO compensation – well in the disgorgement of that compensation, anyways. If there has been some form of misconduct or non-compliance in the financial statements of a public company, then the CEO and CFO can be made to give back, or rather the SEC can "claw back" any of the incentives that were paid to the those top executives up to 12 months after the financial information is made public. This section of SOX, section 304, does not specify what kind of misconduct or whose misconduct is required for the clawback to kick in or who can file for one. So far, only the SEC has been able to set a 304 disgorgement hearing in motion, and it actually took them until 2007 to do so. (Goodman & McPhee, 2008).

SOX has no guidelines in place for equity compensation of CEOs. For a company to be listed on the New York Stock Exchange, they must hold a stock holder vote to approve any equity compensation plans – with some exceptions. Employment inducement is an exception, as are some retirement plans under the internal revenue code. (Morgan, Lewis, & Bockius LLP, 2008) This is one place where there is room for abuse if the compensation committee is not on the ball. There is the potential for a CEO to demand a large head-hunting fee in the form of stock or options, and then the same CEO could negotiate a large retirement plan without having to get shareholder approval under these rules.

That we don't really know the details of what CEOs are earning with regard to their total compensation packages makes it difficult to judge the level of sincerity of some of the CEOs who volunteered to work without pay or for the token sum of one dollar until their companies managed to weather the economic crisis of 2008/2009. If a CEO makes most of his money from the lavish stock package received as a welcoming gift to the new company or from a 401(a) plan for retirement, it is likely better for the CEO's personal bottom line if the stock prices rise – another sure way to make stock prices go up is for the company to announce that a multimillion dollar expense (the CEO's salary) has just disappeared from the books.

In the case of Robert Nardelli, he was working for Chrysler for no salary at the time the company went Bankrupt. But what was Nardelli's total financial stake in Chrysler? Nardelli claims that he has no severance package with Chrysler (Simon, 2009), but what about other holdings in the company? After his executives prevented the company from taking a second round of bailout money from the federal government in the USA, what was in it for him if the company failed as a result of the executives not signing on to a pay cap?

Pay caps have been one of the very powers that SOX has given the average stockholder in theory; a non-binding shareholder vote on executive compensation. The proxy power will allow ordinary shareholders to ask for (and maybe even get) some reform over how top-level employees are remunerated.

## 2.1 Reporting of CEO Income – Example: General Electric

There are three main ways in which CEOs are paid: Salary, Stock Options, and Supplemental Executive Retirement Plans. Each of these things is reported in a slightly different way, and this has an impact on how shareholders see the executives in their company. As an example of how compensation is reported we will take a look at the compensation for General Electric CEO Jeff Immelt for the year 2008 as reported in the GE 2009 Proxy Statement CD&A.

GE was ranked 6<sup>th</sup> on the Fortune 500 list of companies (Fortune Magazine, 2008), and the company is reported to have outperformed the S&P 500 index in the past year. (General Electric, 2009)The Proxy statement reports that there is no employment agreement between named executives (Immelt included) and the company and that there is also no severance agreement in place. It goes further to state that were there to be the possibility of severance pay, that this would be voted on by shareholders if it were to be in excess of 2.99 times the value of the executive's base salary and bonus. It would appear that the company has taken a lesson from Home Depot.

#### **2.1.1** Salary

For the year 2008, Jeff Immelt's base salary was reported at \$3.3 million USD and this was the same as the previous year. Because of the difficult economic circumstances that prevented Immelt from reaching the goals set for this year, he declined his bonus and his long-term performance award. This means that the cash portion of his compensation was reduced from \$9.1 Million in 2007 to just his base salary of \$3.3 Million USD in 2008. This is a decrease of 64%. (General Electric, 2009)

#### 2.1.2 Equity compensation

Jeff Immelt did receive equity compensation in the year 2008 in the amount of \$2,044,000USD. This was less than half the amount of equity compensation he received in the previous year. This was because his equity compensation is based entirely on key performance measures. Because the company did not meet its goals for the year, 50% of the Restricted Shared Units allotted to Mr. Immelt in 2004 expired, and he was only able to realize 125,000 of them. Furthermore, the Units he did receive had a market value of only at only \$11.10USD on their vesting date. To further show his solidarity with shareholders, Immelt bought an additional 317,000 shares of GE stock on the open market, which put his ownership up to 3 times more than the company's ownership requirements. Considering the grant prices on his stock options from previous years (ranging in price from \$27.05 to \$57.31) the open market is now a real discount in comparison to what he would ordinarily have paid in the past. (General Electric, 2009)

#### 2.1.3 Supplemental Executive Retirement Plan reporting

The Executive pension plan at GE includes both the regular employee pension plan and the Supplemental Executive Retirement Plan (SERP). Executives are normally not eligible for the SERP if they leave the company before the age of 60. Immelt's SERP compensation varies from one year to the next. In 2008, he earned \$3,563,466 in his pension plan. This is much more than the two previous years when he received much more cash compensation in the way of a bonus and his stock compensation was worth more. In 2006 his pension increased by \$1,036,908 and in 2007 it increased by \$78,290. (General Electric, 2009) It appears as though the pension plan is being used to sweeten the pot in a poorly performing economy. This is not unusual in companies where the

board is not truly independent of the CEO. A study out by Paul Kalyta out of Ottawa University found that CEO power over the board had a significant outcome with regard to the pension as a percentage of total income. (Kalyta, 2009) In Immelt's case, he serves as Chairman of the board, which definitely puts him in a position of power over the other board members.

#### 2.2 The fallout from SOX

#### 2.2.1 What effect CD&A requirements have had

CD&A's have been very difficult to craft. The transparency asked for by the SEC in these documents is not being met and likely cannot be met by many companies. If a company were to publish all of the criteria upon which its compensation were based, it could put it at a distinct disadvantage. A company's internal business strategy needs to be kept from its competitors and were it divulged in publicly available documents, would be disastrous. (Dalton & Dalton, 2008) An example of this would be a company that is trying to enter a certain geographical market through acquisitions of smaller companies. If this goal were published in its CD&A as one of the measures by which the CEO was to be judged for compensation purposes, it could derail its plans for expansion by alerting competitors.

Shareholders have been exercising their proxy power since the SOX legislation. There have been an increasing number of Proxy votes on CEO compensation and the outcome of those non-binding votes has not been in favour of higher compensation for the executives (Dalton & Dalton, 2008). There has been an increase in the number of

companies that have been going private and therefore do not have to file anything with the SEC. It is possible that this is one negative outcome of SOX. (Clark, 2007)

#### 2.2.2 Clawbacks

The SEC has not made much use of the clawback clause in SOX. This could be for two reasons; either the publicly held companies that have had earnings restatements in the post SOX era were all purely accidental and there was no fault involved, or the SEC does not have the resources to pursue these cases in the way that SOX intended. I believe the latter is the more likely of the two possibilities. Boards and shareholders have been taking the matter into their own hands. Of 2100 companies surveyed in 2008, 300 of them had clawback provisions up from 14 companies with clawback provisions 4 years before. As well, there were 32 proposals for clawback provisions submitted by shareholders between 2004 and 2008. These shareholder proposals have had the support of the SEC and companies are rarely allowed to exclude them. (Goodman & McPhee, 2008)

There has been research to suggest that the career penalties faced by executives from restatement firms are already very strict. A study by Desai, Hogan, and Wilkins found that firms which restated earnings generally had higher turnover of upper management than control firms. Executives who had been let go in the wake of a restatement scandal were less likely to find new employment due to the stigma of their role in the restatement. Those who were able to find new employment were not able to find the same level of work and compensation that they previously enjoyed. (Desai, Hogan, & Wilkins, 2006)

# 3: Best Practices for CEO Compensation

In order to examine best practices for CEO compensation, we must take a look at all of the players involved. We will first examine the Board of Directors who has the final say in the amount of the CEO's remuneration. The group that advises the board at large on this issue is the compensation committee. The compensation committee may take the advice of an outside consultant called a compensation consultant. This consultant may provide research and calculations to help the committee find the best level and format of compensation to offer its top executives. The following will detail the interaction between these players and outline the typical factors that they consider in crafting a compensation agreement.

## **3.1** The Board of Directors Compensation Committee

The compensation committee should be made up of independent board members. This requires that the board members on the committee are not in the direct employ of the CEO and do not have any conflicts of interest such as sitting on other boards with the CEO of the company. The compensation committee should have clear strategic goals for the company in mind when crafting the CEO's compensation package as well as keeping the interests of the ordinary shareholders in mind.

Problems arise when the compensation committee is not truly independent of the CEO. If the members of the compensation committee are company insiders, there is a potential for pressure from the CEO to influence their compensation package decisions.

There is an argument that industry insiders make the best board members because they will have the background to understand where the CEO is coming from and not be intimidated into making decisions because of their lack of knowledge. (Bragues, 2007) There is a duty for board members to inform themselves and to do independent research to make sure that the goals set for a company are done so in the interests of the company and not the interests of the CEO or other high level executives, and compensation committees are coming under more scrutiny to make sure that they are behaving truly independently from their CEOs.

## 3.2 Compensation Consulting Firms

Compensation committees should be able to hire outside consultants as they see fit. There are firms that specialize in compensation consulting, and there are other firms that are general consultancy firms that offer compensation consulting as part of their overall menu of services. There are two schools of thought on the use of consultants. On one hand, compensation consultants can provide expert advice on what compensation packages look like across an industry and in comparison to comparable companies. This can be very useful and can make a company's CEO compensation more uniform with that of similar companies and thus draw less attention from shareholders and other critics. On the other hand, there is the opinion that the use of compensation consultants drives up the cost of compensation. (Clark, 2007) There are a few different reasons why this might happen, and some of them are quite avoidable.

If a compensation consulting firm is trying to curry favour with the CEO, then there is the temptation for them to make high salary recommendations. In order to justify large compensation packages, comparisons with dissimilar companies might be made. If

the consultant is comparing two companies that are in a similar industry but have vastly different earnings, then a regression analysis might be done to figure out how to scale equivalent compensation on the basis of the similar companies of different sizes. In some cases, the regression will have too low an R-square value to be significant (less than 0.25) in which case it should not be used. (Lipman & Hall, 2008)

Another area of great controversy is the independence of the compensation consultant. In cases where the compensation consultant is a branch of a firm that provides other, larger revenue generating services to the company, the compensation tends to be much higher than it would have been if the compensation consultants had no conflict of interests. In a study that measured fee ratios, the 25 Fortune 250 companies whose compensation consultants were deemed to have the highest conflict of interests paid their CEOs an average of 67% more than companies who used completely independent compensation consultants. (United States House of Representatives Committee on Oversight and Government Reform, 2007) It is therefore imperative that compensation committees hire their compensation consultation firms completely separately from audit and other higher fee consultants.

For truly independent compensation consultants, the compensation committee should make clear that the contract will be only for compensation consultation and will not extend to other areas of consultation for a period of time. Some consultation firms require their compensation consultants to do cross-selling of firm services and use compensation consulting as a foot in the door to sell more lucrative services such as audit. (United States House of Representatives Committee on Oversight and Government Reform, 2007) This is more potential for conflict of interests and the compensation

committee needs to protect the company from salary inflation due to sales tactics on the part of consultants.

### 3.3 Crafting a Compensation Package

When one is trying to decide what to pay for something, it pays to comparison shop. For Compensation committees looking to pay a CEO this is done by benchmarking with like companies. Benchmark companies should be of a similar size or in a similar industry to get a valid comparison. This is one area that a compensation consultant can really be of great assistance to the compensation committee. If the committee has a philosophy about how they would like their compensation to measure up to that of benchmark firms, then the compensation consultant can use their extensive proprietary database to follow those guidelines or conduct original commissioned research of SEC filings and other publicly available information. If the committee is less certain of how it would like to measure up to other firms, the compensation consultant can conduct an analysis of what the committee is looking to achieve and what resources it has to put toward a CEO compensation package and make recommendations based on the results of that analysis. (Welch-O'Connor, 2009)

Another measure to take into account is that of internal pay equity amongst executives. The CEO should not make so much more than the top executives in a firm that there is a terrific inequity of pay. The CEO is a member of a management team, and as such shouldn't be placed on a pedestal in terms of compensation, but at the same time, CEO compensation cannot be measured by the lowest paid salaries in a company. Internal pay equity is a delicate balance and the compensation committee needs to consider its company's overall philosophy with regard to the value of its workforce when

deciding how much more the CEO should receive in comparison to other employees.

(Lipman & Hall, 2008)

One goal of any CEO compensation package is to align the interests of the CEO with the interests of the company to eliminate the agency issue. One of the difficulties in writing such a contract is that it can be incredibly complex almost to the point of ceasing to motivate the desired behaviors if the person cannot readily see the connection between actions and consequences. One of the consequences of a CEO's actions is stock price. Because the CEO is directly responsible for making decisions that will have an effect on stock price, many companies require the CEO to own a certain minimum number of shares at all times.

Another way to tie CEO compensation to stock price is to allow the CEO stock options. This means that the CEO will have the option to buy the stock after a certain time has passed. At that time, the options have vested, and the CEO can exercise the options and purchase the stock. If the value of the stock has surpassed the option price at that point, then the CEO makes a profit.

Options can be fraught with dangers for the company. Backdating is one practice that was used pre-SOX to the benefit of CEOs and to the detriment of the shareholder. The executives would backdate the purchase of their options to the point where the price was even lower than their strike price, and then turn around and sell them when the price was the highest – kind of like picking the winner after the race has been run and backdating your bet to the starting line.

Another illegal activity that was taking place was the spring-loading of options.

This was when CEOs would exercise their options directly before an announcement that would drive up the share price.

To prevent both backdating and spring loading of stock options, they have to be treated very carefully, especially with regard to timing. The compensation committee should only make grants at set times of year (such as end of quarter, or some other regularly occurring time) or in case of certain events such as a new hire or a merger with another company. When the compensation committee does make a grant, it should be outside of normal trading hours so that the last stock price can be used, and they must actually meet in order to grant the options rather than just give written consent, because it is hard to prove when written consent was actually given. (Lipman & Hall, 2008) This can help communicate to shareholders that the CEO must purchase shares and assume the same risk associated with that purchase that any other shareholder would face.

A CEO must be motivated to conduct the company in such a manner that it achieves its long-term goals while maintaining profitability in the short term. To insure that long-term strategies are adhered to for the health of the company, the compensation committee needs to discuss with the CEO what those goals are and what acceptable milestones of those goals might be. In this way, the CEO can be rewarded if the long-term goals are met or penalized if they are not. The goals should be specific and quantified with regard to their worth to the company. The achievement of these goals will afford the CEO bonuses as a percentage of his base pay. The committee should be sure to differentiate between the movement of the overall market and the actual performance of the company. There is less motivation for a CEO to manage effectively

in boom times if the market will provide his performance bonus for him. (Lipman & Hall, 2008)

Perquisites (perks) have come under scrutiny recently and according to the SEC must be listed in detail if they amount to more than \$10,000 per year. In order to avoid listing these benefits for shareholder (who might object to the memberships of exclusive country clubs being provided to the CEO at great expense to the company) some companies elected to simply add the cash equivalent of the perquisites to the base pay of the CEOs.

# **4:** BC Crown Corporations – CEO Compensation

The crown corporations of British Columbia are required to get approval from the Public Sector Employers Council (PSEC) for any executive compensation plan they devise. The policies set out under the Public Sector Employers Act cover Excluded and Executive Employees. To qualify, the CEO must be paid in excess of \$125,000. This act specifically addresses compensation plans as well as severance plans and vacation and sick leave accrual. Some of the compensation plan information that is required by PSEC includes base and total salary range for the position, sectoral standards and guidelines, and description of Perquisites, benefits, and bonus and incentive pay. As of 2008, PSEC put a salary cap in place for all public employees of \$550,000 total compensation. This meant, in effect, that there will be no way for some of the Crown Corporation CEOs to reach their maximum variable pay because that could put them over the salary cap instituted by the legislature. (Nancy Olewiler, 2009)

## 4.1 BC Hydro

#### 4.1.1 BC Hydro CEO Compensation

BC Hydro is the electric utility for the province of British Columbia. The compensation philosophy outlined in the CD&A for BC Hydro compares BC Hydro executive salaries with local administrative roles, Canada wide manager and professional roles in all companies over \$1Billion in revenue regardless of industry, and roles specific to Canadian electric utilities and oil and gas companies. Pay for executives has both a

merit based component and a variable incentive based component. The CEO for BC Hydro is Bob Elton. Mr. Elton has been the CEO at BC Hydro since 2003. For fiscal year 2007/2008, Mr. Elton received a total compensation package of \$570,897, of which, \$169,920 was incentive plan compensation. In this year, his salary was \$294,025. The rest of the total compensation package was made up by pension in the amount of \$72,036 and other compensation in the amount of \$34,916. (BC Hydro, 2008 (b))

The pension plan for the CEO of BC Hydro uses a formula of *Total Pension* = 2% \* years of service \* best average earnings for 60 consecutive months.

This pension plan requires the participant contribute at a rate of 6.31% of gross earnings. The plan also allows for purchase of additional years of service at the rate of 12 time bank days or equivalent in cash per year purchased. (BC Hydro, 2008 (b))

#### 4.1.2 BC Hydro Company Performance Measures

The main categories that BC Hydro uses to judge its performance are: Safety, Reliability, Financial Results, Customer Satisfaction, People, and Environment. In the 2008Annual Report, the company outlines what its goals for these categories were, the measures of those goals, and whether or not the goals were met.

Safety was slightly problematic for the company this year. The corporate goals for Injury Frequency and Injury Severity were not met. With regard to Injury frequency, the target of 1.9 incidents per 200,000 hours worked was lower than the actual frequency for 2008 of 2.8 incidents per 200,000 hours worked. The company has raised the threshold for 2009 to 2.4 incidents per 200,000 hours worked. The Injury Severity target of 25 calendar days lost per 200,000hours worked was not met either. The actual number

of days lost per 200,000 hours worked was 39.3. The report notes that the number of serious incidents was reduced, but that several vehicle incidents had a big impact on the number of days lost.

Reliability has several different measures. The first measure of reliability performance used by BC Hydro is Winter Generation Availability Factor. The target for this measure was 96.20% and was not met. The actual Winter Generation Ability Factor was measured at 94.88%. The company negotiated load curtailment agreements with some of its large customers to manage the risk of shortfall in the future. Four of the measures used are to quantify disruptions to customers. These are: ASAI (which measures the percentage of time power is available) CAIDI (average number of interruption hours per interrupted customer) CEMI-4 (customers experiencing multiple disruptions) and CELID-6 (customers experiencing longest interruption duration) Due to the particularly bad storm season, the company did not meet any of these targets, but when the actual numbers were normalized for major events, then the company found it would have met the CELID-6 and CEMI-4 targets had it not been for the severity of the season.

Demand side management is the flip side of the reliability coin. Because BC Hydro is a monopoly, it must make sure that demand stays below its supply capacity. Some of the demand side management activities that are highlighted by this measure are conservation, efficiency, and load displacement. The target of 300 Gigawatt hours saved was surpassed at 326.

BC Hydro set its financial goals by net income for the year 2008. This goal was exceeded. The target net income for 2008 was \$365 Million and the actual net income

was \$369 Million. It was noted that the company benefited from high water inflows for the year and that this lowered the overall cost of energy. It is important to remember that BC Hydro was only allowed to make a maximum net income of \$369 Million by the BCUC.

Customer satisfaction targets for the year were 80% satisfied or very satisfied as measured on a 4 point survey scale across the index of the following drivers: providing reliable electricity, value for money, commitment to customer service, acting in the best interest of British Columbians, and efforts to communicate with customers and communities. The company surpassed this target with an actual score of 90% satisfaction rate.

BC Hydro's goals regarding its people are measured by vacancy rate and by employee engagement. The target vacancy rate of positions for 2008 was 10.2% and the actual rate was 8.7% employee engagement is measured on a five point scale. Target levels for 2008 were set at 3.5 but actual engagement was only measured at 3.36.

Environmental goals are measured by how many Environmental Regulatory compliance incidents are recorded over the year. The target number of incidents for the year was 15. The actual number of incidents recorded was 39. The company fell far short of meeting its target. (BC Hydro, 2008 (a))

#### 4.2 BCLC

#### **4.2.1** BCLC CEO Compensation

In 2007, the BCLC decided not to renew CEO Vic Poleschuk's contract and in so doing, triggered his severance package. This entitled him to 18 months of severance pay

(1 month for every year worked up to a maximum of 18 months). This payout caused some criticism from BC opposition legislature members. The opposition pointed to the fact that the interim CEO for BCLC was the former deputy minister of the Premier. (BC NDP, 2007) Because of this turnover, it is more difficult to see the actual CEO compensation for that year. What BCLC does provide, however, is a good accounting of what monies are being paid out to former CEO Poleschuk. Some of the terms of his retirement package are: 2 years of pension credit for each year worked from October 1, 1999, contributions to the maximum pension plan allowance are made at 4.4% of earnings under the Year's Maximum Pensionable Earnings and 6% thereafter. In Poleschuk's case, he is also eligible for the supplementary pension plan which mirrors the retirement pension plan but allows higher limits than the Income Tax Act allows for a regular retirement pension plan. In fiscal year 2007/2008, Poleschuk's total compensation was \$842,201. This number includes severance - \$42,307.69, salary continuance -\$204,080.37, performance bonus - \$144,375, and a lump sum of \$19,044 for long-term disability. (British Columbia Lottery Corporation, 2008 (b))

#### **4.2.2** BCLC Company Performance Measures

BCLC sets out three goals in its annual report. They are: to provide outstanding gaming entertainment generating income for the public good, to be a respected organization that has a broad base of public support, and to have a workforce passionately driving the success of the business. The company uses many different measurements of these goals.

In the arena of providing outstanding gaming entertainment generating income for the public good, BCLC measures revenue generation, operating cost ratio, net income, full-time employee equivalents, player participation, and player satisfaction. The financial goals of revenue generation (\$2.495 Billion target, \$2.559Billion actual) and net income (\$1.033Billion target, \$1.110 actual) were exceeded by the corporation in the year 2008, and the company also considers itself to have achieved its operating ratio target (11.1% target, 10.9% actual), but when it came to full time equivalents, the corporation did not meet its target (target 633, actual 638). Both player participation and player satisfaction targets were not achieved for the year of 2008. The actual participation rate among adult residents who had played a lottery game or visited a gaming facility in the month prior to the publication of the data was 58% which fell short of the target participation rate of 67%. Player satisfaction as measured by a continuous tracking study and gaming facility exit interviews was 84%, which did not meet the target of 88%.

With regard to their goal of being a respected organization that has a broad base of public support, BCLC measured four separate areas. Public support of gaming was measured at 62% of adults in British Columbia supporting legalized gaming. This exceeded the target level that was 52%. The public support of BCLC was measured at 64% of adults in BC having a favourable impression of the organization, which was below the target level of 65%. The target of 56% of adults agreeing that BCLC markets in a socially responsible way was exceeded, with an actual agreement rate of 61%. Public awareness of the beneficiaries of gaming was measured as a percentage of adults who have an awareness of how gaming income is distributed. The target rate of 35% awareness was achieved.

The goal of having a workforce passionately driving the success of the business was measured with an employee engagement "pulse check" or survey of 81% of employees. This survey revealed that the actual engagement level of employees was only 44%, which was lower than the target level of 60%. (BC Lottery Corporation, 2008 (a))

#### **4.3** BCTC

### **4.3.1** BCTC CEO Compensation

BCTC uses an external consultant to compare its compensation with that of comparable companies in the private sector. Because the salary and incentive portions of its compensation packages were found to be typically lower in value than those of its private sector counterparts, BCTC has instituted paid time-off programs and enhanced pension plans for its executives. In Fiscal year 2008, President and CEO Jane Peverett received a base salary of \$282,134. The base salary for the CEO is set by predetermining a salary range which the board and the government of British Columbia regularly review and renegotiate. When the base pay is set, the CEOs annual performance is reviewed by the board taken into account by the Human Resources, Safety, & Environment Committee.

The CEO sets goals at the beginning of each fiscal year and these are approved by the board. The board uses these goals to evaluate the CEO's performance at the end of the fiscal year and uses this to determine the CEOs performance pay. The CEO's performance pay is attributed 30% to individual achievement and 70% on reaching corporate goals. The target amount for this award is 30% of the CEO's base pay. In

Fiscal Year 2008, the CEO received an incentive plan award of \$107,303 which is 39% of base pay.

Like the other Crown Corporations, BCTC's CEO has a pension plan that includes a Supplementary Retirement Plan to cover benefits over the limit set by the Income Tax Act. The current service cost of the unfunded SRP combined with the company contributions to the registered pension plan for Peverett is \$51,853. Peverett also received \$39,996 in other compensation for fiscal year 2008 which included health benefits, paid time off, a vehicle allowance, paid parking, CPP, EI, and Worksafe premiums, and payouts of earned time off, bringing her total compensation package to \$481,286. (British Columbia Transmission Corporation, 2008)

#### **4.3.2** BCTC Company Performance Measures

BCTC used six goal areas to set performance targets in 2008. These strategic goal areas were: Reliability and Service, Market Efficiency, Environment and Safety, Relationships, Organization and People, and Cost Management.

BCTC aimed to achieve reliability improvements and deliver outstanding service in 2008. This goal was measured using SAIDI (System Average Interruption Duration Index). The target for 2008 of 2.18interruption hours was not met. Actual interruption hours were 2.43. This is due to the major weather-related events that took place in this year.

As yet, BCTC has no measures in place to judge its Market Efficiency goal, but is developing some for the future.

BCTC measures its Environment and Safety goal in two ways. The first is a count of reportable environmental incidents. The target number of such incidents was 9, and this target was met for the year 2008. Safety is measured by a count of lost time accidents for both BCTC and independent contractors. BCTC met its own goal of 0 lost time accidents, and the target for contractors, set at 17 lost time accidents, was also met.

The relationships goal of building open and constructive relationships with First Nations and stakeholders is measured in an annual survey. The target for positive or neutral responses in this survey was 90%, but the actual rate of 87% positive or neutral responses failed to meet the target.

The goal for organization and people was to build an Engaged and highly skilled workforce. This was measured with a survey that measures employee engagement on a 5 point scale. The company set a target employee engagement score of 3.4 and more than met this with an actual score of 3.53.

The final goal outlined for BCTC is to maintain prudent financial management of capital and operating expenditures. The measure used for this is called OMA (Operations, Maintenance, and Administration) actual against plan. The target was to be within 98% to 102% of plan levels for OMA costs, and the actual level was 101.7% of plan levels. This target was met. (BC Transmission Corporation, 2008 (a))

#### **4.4 ICBC**

#### **4.4.1 ICBC CEO Compensation**

ICBC has recently changed its method of compensation to include more performance based elements and to be more competitive in the labour market and attract

more experienced and better qualified employees. The comparator groups used to establish ICBCs base rate of pay include: Canadian Insurance companies, Canadian Industry (revenue\$1B to \$10B) and Canadian government and Crown Corporations. ICBC used information from the database of compensation consulting firm Towers Perrin to arrive at these comparisons. The CEOs salary is not set by the board. The CEO receives Short Term Incentive Pay (STIP) as well as Long Term Incentive Pay (LTIP). The Short term incentive pay is split 75% corporate performance and 25% personal performance for the CEO. The STIP award can range anywhere from 0 to 35% of the CEOs base pay, but the actual target is 20%. The LTIP program defers payout over a period of three years and in so doing, brings the interests of the CEO and the long term interests of the company together. The CEO at ICBC receives a modest perquisite allowance of \$18,500. The CEO compensation plan includes both a regular pension plan and a Supplemental Employee Retirement plan to cove the gap between what the income tax act will allow the regular plan to cover, and a retirement benefit that is commensurate with the level of salary expected by such a high level professional as a CEO. In the year 2007, Paul Taylor, CEO of ICBC earned a grand total of \$524,750. This amount includes Base salary, long and short term incentive Pay, pension, health benefits, and other forms of compensation. (Insurance Corporation of British Columbia, 2008 (a)) As Taylor voluntarily resigned in May of 2008, he was not entitled to severance. (CanWest MediaWorks Publications Inc, 2008)

#### **4.4.2** ICBC Company Performance Measures

ICBC outlines four performance goal areas in its 2008 annual report. They are: Customer Focus, Financial Responsibility, High Performing, Engaged, and Capable

People, and Operational Excellence. Each of the goals has specific measures of performance.

Performance in customer focus is measured in three different areas: insurance services satisfaction, claims services satisfaction, and driver licensing satisfaction. The planned level of insurance services satisfaction for 2008 was set at 93%. The actual level of insurance services satisfaction, as measured by ongoing surveys conducted by an independent research firm was also 93%. The planned level of satisfaction in the area of claims services was set at 83% for the year 2008. Actual claims services satisfaction surpassed planned levels, and reached 85%. The planned level of driver licensing satisfaction (91%) was also surpassed by the actual results for 2008(93%).

Financial responsibility is a goal that ICBC measures by several different means. They are: minimum capital test, combined ratio, loss ratio, expense ratio, and investment return. The minimum Capital Test compares the company's available capital to the capital required. This shows the company's ability to protect customers from external negative drivers that might otherwise require rate hikes. The planned minimum Capital level for 2008 was 150% and the actual level far exceeded this at 209%. The combined ratio, an overall insurance industry profitability ratio, had target levels of 106.1% (indicating a planned loss) and actual levels were 95.9% (indicating an actual profit). This success is attributed to low claims adjustments and higher premiums earned. The low claims adjustments may in part be due to the dryer weather experienced by drivers in 2008. The loss ratio measures the profitability of insurance products; the lower the percentage, the more profitable the insurance product is. The loss ratio planned by ICBC for 2008 was 87%. The actual loss ratio for the year was much more favourable at 77.6%.

The expense ratio, which measures the percentage of non-claims costs to insurance premium dollars earned, was planned at 19.5% for 2008. ICBC did better than that, coming in at only 18.8%. Investments are measured against standard market benchmarks, and the target for the year is set at 0.269% over the benchmark. The Benchmark for 2008 turned out to be 4% (becomes target rate of 4.269%) and ICBC surpassed this with an actual return of 4.53% for its investments in 2008.

ICBC measures how well it is achieving its goal of having high performing, engaged and capable people by use of an employee engagement index. The planned rate of engagement for 2008 was 52%. The actual rate was quite a bit less than this at 44%. The target for 2009 has been lowered to 48%.

There are two measures of operational excellence at ICBC: insurance operating cost per policy and driver licensing cost per transaction. The planned insurance operating cost per policy for 2008 was \$193. The actual cost was lower than target at \$189 per policy. This was attributed to lower than plan operating expenses and acquisition costs. The driver licensing cost per transaction was planned at \$9.4 per transaction, but the actual costs were slightly higher at \$9.7 per transaction. This was due to lower than expected transaction volumes. (Insurance Corporation of British Columbia, 2008 (b))

## **5:** BC Crown Corporations – Financials

To determine the financial performance of each of the companies, I took the 5 most recent years' financial statements from each company and looked at the performance of each over time. In the case of crown corporations, there are many financial ratios that do not apply because there is only one shareholder (the government of the people of British Columbia) and that shareholder dictates what the corporations are allowed to charge for services and what portion of income earned may be kept as retained earnings and what must be returned to the customers (who are the ultimate shareholders as well). There is also the problem of CEO turnover. In this analysis, while I look at partial years and prior years for comparative purposes, I focus on actual full years served by the CEOs to get a sense of their successes as managers.

## 5.1 BC Hydro

Return on Net Assets		RONA =				
	Return on Ne	i Assets	NONA –	fixed asset	s +net working capital	
	2008	2007		2006	2005	2004
	9.26%	10.43%	8	3.83%	9.08%	7.28

2004 was Bob Elton's first full year of managing BC Hydro. The RONA for that year was only 7.28%, but he quickly brought that up to a robust 9.08% which has remained somewhat steady since. There is one anomaly year in 2007, which could be attributed to the relatively low operating expenses incurred that year relative to stable

revenues as compared to the year prior. In 2008 operating costs rose and subsequently, the RONA returned to near its previous levels.

Net Profit Margin		$Net \ Profit \ Margin = \frac{Net \ Income}{Total \ Revenues}$			
2008	2007	2006	2005	2004	
7.60%	9.71%	6.17%	10.79%	2.86%	

The Net Profit Margin shows more volatility than the RONA. In 2004the sickly 2.86% Net Profit margin can be attributed in part to the extremely high amortization charges that the company was deducting as an expense at that time.

Amortization as a Percent of Revenue

2008	2007	2006	2005	2004
7.58%	9.02%	9.53%	11.01%	15.74%

The extreme increase in Net profit margin in 2005 is also due in part to a onetime payment from Alcan, so the following year's Net Profit margin is probably more indicative of the level of change that took place as a result of management's direction. In 2007there is another Net Profit Margin peak. This once again points to the low operations expenses for that year.

#### Debt to Asset Ratio

2008	2007	2006	2005	2004
85.89%	86.14%	86.56%	86.35%	86.16%

The debt to asset ratio has remained very steady under Elton's management, which is commendable in light of the heavy property plant and equipment additions made in 2008. In years prior, the PPE of the company remained fairly stable, the large increase in 2008 indicates expansion. While overall debt increased in an amount similar to the PPE increase, Current Portion of Long Term Debt was actually reduced and Other Debt also saw a reduction. This indicates good management of funding sources and shows that the company is able to balance new expenditures without hurting liquidity

Operations Expense as a percent of revenue

2008	2007	2006	2005	2004
10.65%	6.58%	8.65%	7.87%	10.46%

In 2008 the Operations Expense as a percent of revenue exceeded that of 2004. This could be due to the PPE acquisition in 2008. It is possible that the new asset is not yet in service and generating revenue. At this point, it is not a strike against management, but if the ratio doesn't improve over time, it will be of concern. (BC Hydro, 2004 (a)) (BC Hydro, 2006) (BC Hydro, 2008 (a))

#### 5.2 BCLC

Vic Poleschuk was CEO of BCLC from 1999 until 2007; after the BC lottery retailer ticket switching scandal, he was let go and replaced by Interim CEO Dana Hayden. (British Columbia Lottery Corporation, 2008 (b)) I have chosen to examine the most recent five years of data available for BCLC to get an idea of how BCLC measures

up with the other crown corporations in a similar economic climate. 2008, while not directly under the control of Vic Poleschuk, would have been influenced by actions and policies set by him in the previous year, so I have included it in my analysis.

Return on Net Assets 
$$RONA = \frac{EBIT}{fixed \ assets + net \ working \ capital}$$
2008 2007 2006 2005 2004
551% 477% 512% 452% 998%

Lotteries are not fixed asset heavy businesses. The RONA for BCLC does not compare directly with that of BC Hydro, but gives us an idea of how the BCLC assets were being managed from year to year. The standout is the change from 2004 to 2005. The RONA is halved in 2005 and never returns to 2004 levels. What is the cause for this drastic drop? A doubling of Property Plant and Equipment is the most obvious answer. According to the 2006 annual report, BCLC's PPE for 2005 was \$112,003,000 as compared to \$55,106,000 in 2004. The Casino at Hastings Park Racetrack was behind schedule in this year and did not come on line as scheduled. Despite this, Net Income was not affected and the corporation posted increased earnings every year of the period in question.

Net Profit Margin		$Net\ Profit\ Margin = rac{Net\ Income}{Total\ Revenues}$		
2008	2007	2006	2005	2004
42.55%	42.01%	40.81%	40.39%	38.51%

Starting in 2004, BCLC's Net Profit Margin rose consistently. This is likely a direct result of careful management and movement into newer products such as electronic gambling. Over the 5 years, the Net Profit Margin was a success for Poleschuk and his

team. (BC Lottery Corporation, 2005) (BC Lottery Corporation, 2007) (BC Lottery Corporation, 2008 (a))

#### **5.3** BCTC

Jane Peverett became CEO of BCTC in April of 2005. This corporation was only formed in May of 2003, 2 years before and at that time, Peverett was CFO. (British Columbia Transmission Corporation) This CEO has had the opportunity to shape the company from the outset, but we will focus on the financial data starting from the 2006 annual report and only use the data from the 2004and 2005 reports for comparison..

Return on Net Assets 
$$RONA = \frac{EBIT}{fixed \ assets + net \ working \ capital}$$
2008 2007 2006 2005 2004
3.97% 4.81% 17.08% 6.97% 3.02%

The Return on Net Assets for BCTC has some wild swings; most of this has to do with the Tariff rate that has been approved by the utility commission. The theory behind the tariff rate is that BCTC will charge the residents of British Columbia no more than is absolutely necessary for BCTC and BC Hydro's revenue requirements plus a maintenance charge and that any surpluses will be returned to the public. In some years, the surplus collected was quite marked – such was the case in 2006, when not only was the RONA at an all time high, but so was Cash on the balance sheet at \$36,038,000 (almost triple its balance in its next highest year). If we disregard 2006 as an outlier and use 2005 for the basis of comparison, we see that the RONA is steadily declining. What is the reason for this? Property, Plant, and Equipment has more than doubled from \$61,849,000 in 2005 to \$155,713,000. This combined with the fact that the earnings

have been relatively stable has meant that the Assets do not appear to be earning more money for the company. This is misleading, however, because the BCUC does not allow for an increase of profits at BCTC without a valid revenue requirement.

Net Profit Margin		$Net\ Profit\ Margin = \frac{Net\ Income}{Total\ Revenues}$			
2008	2007	2006	2005	2004	
1.65%	1.65%	6.56%	3.57%	2.19%	

The Net Profit margin, like the RONA, has one outlier year, but can still be studied if that year is disregarded. In 2007 and 2008, the net profit margin was completely steady at 1.65%. This is more than a coincidence. In 2008, a change in accounting created a slight increase in earnings (\$400,000) and this money was refunded to the public through the Revenue Deferral account. It would seem that BCTC and the utility commission have found the net profit margin that is acceptable for the corporation.

Debt to Asset Ratio

2008	2007	2006	2005	2004
76.47%	72.29%	72.50%	74.05%	69.44%

2008 shows a significant increase in the Debt to Asset Ratio for BCTC. This is explained by the PPE increase in the same year. The main areas of acquisition with regards to PPE are buildings (\$75,908,000 in 2008 as compared to \$2,140,000 the previous year) and computer hardware and software (\$43,396,000 in 2008 compared to \$19,344,000 in 2007) These increases may be due to the new program going forth to expand transmission services from Surrey to Bellingham and expansion of dynamic scheduling services (allowing for generation, transmission, and sale of power from BC

when demand is high in other areas) to Montana. (BC Transmission Corporation, 2004) (BC Transmission Corporation, 2006) (BC Transmission Corporation, 2008 (a))

#### **5.4 ICBC**

Paul Taylor's time as CEO of ICBC began in October of 2004 and ended May 2 of 2008 amid a scandal involving rebuilt cars being sold from the corporation's research facility. Because his time at ICBC began late in 2004 and ended partway through 2008, the years of performance that are most relevant would be from 2005-2007.

Return on Net Assets		$RONA = \frac{EBIT}{fixed \ assets + net \ working \ capital}$		g capital	-	
2008	2007	2006	2005	2004		
10.04%	11.85%	9.54%	11.05%	13.07%		

In 2005, Paul Taylor's management team brought the RONA down by 2% from the previous year and in 2006 it came down another 1.5%. What caused this? In 2005, EBIT was down from the previous year, but the overall assets had gone up. This means that while the company was getting larger, it wasn't becoming more profitable. One of the large expenses that year was a bigger than usual charge for claims incurred. The claims were up from \$2,221,258,000 in 2004 to \$2,525,177,000 in 2005. This is an increase of 12% on the biggest expense item from the income statement. The following year saw another sizeable year over year when claims incurred increased to \$2,612,581,000 or 4.47% up from 2006. In 2008, the year in the middle of which Taylor resigned, this trend stopped and claims remained nearly unchanged from 2007.

Net Profit Margin

$$Net \ Profit \ Margin = \frac{Net \ Income}{Total \ Revenues}$$

2008	2007	2006	2005	2004
13.44%	18.10%	10.60%	6.27%	12.78%

The Net profit margin is quite volatile for this company. Compared to 2004, the profit margin is cut in half in 2005and by2007 it is nearly three times its 2005 rate. The reason for this can be seen in the movement of net income. Between 2004 and 2005 there was a 48.85% reduction in net income whereas 2006 and 2007 both showed increases in net income of 43.47% and 45.49% respectively. These increases stem from underwriting income and losses over the years and to the previously mentioned increase in commissions.

#### Debt to Asset Ratio

2008	2007	2006	2005	2004
76.03%	77.86%	83.17%	85.69%	87.61%

The assets of ICBC grew steadily over the five year period. In 2004, the company's assets were \$7.5 Billion and by 2008 they reached \$11.5 Billion. During this time the company's liabilities also increased from \$6.5 Billion to \$8.7 Billion. Therefore, while assets increased by an average of 10% per year, liabilities were only increasing by an average of 7% per year at the same time. This signifies that the company must have found another source of funding for these assets. Further investigation shows that retained earnings rose by23% per year on average over the period from 2004 to 2008, showing that management has been reinvesting profits back into the company and keeping it in a financially healthy position. (Insurance Corporation of British Columbia,

2004) (Insurance Corporation of British Columbia, 2006) (Insurance Corporation of British Columbia, 2008 (b))

# 5.5 Comparing the 4 crown corporations by size, complexity of performance criteria, and success

Table 2 Comparison of 4 Crown Corporations

		1	1	
	BC Hydro	BCLC	встс	ICBC
Size (measured by total assets)	\$13,610,000,000	\$316,488,000	\$287,257,000	\$11,476,492,000
Size (measured by total revenue)	\$4,855,000,000	\$2,559,187,000	\$193,405,000	\$3,700,389,000
Complexity of performance criteria (how many different measures of company performance are taken into account)	6 performance areas measured  13 measures of these areas	3 Performance areas measured  11 measures of these areas	6 Performance areas measured 7 measures of these areas	4 Performance areas measured  11 measures of these areas
Success (what percentage of performance targets were achieved or surpassed)	4/13 targets were achieved or surpassed	6/11 targets were achieved or surpassed	5/7 targets were achieved or surpassed 71%	9/11 targets were achieved or surpassed 82%

(BC Hydro, 2008 (a)) (BC Lottery Corporation, 2008 (a)) (BC Transmission

Corporation, 2008 (a)) (Insurance Corporation of British Columbia, 2008 (b))

Both BC Hydro and BCTC looked at more areas of performance in their performance reviews than ICBC or BCLC. For some of the corporations, their measures

of performance in some areas vastly outnumbered their measures of other performance areas. An example of this is BC Hydro's reliability, which is measured in 6 different ways. That it was a bad winter meant that BC Hydro did poorly in 5 of 6 reliability measures which account for nearly half of its quantitative performance measures listed in the annual report. BC Hydro's safety standards are measured in such a way that one incident could result in all executives receiving zero points for safety in their annual performance review. The company prides itself on its intricate safety data and ratings system. (Dale Flood, 2009) Some of BCLCs performance measures are measures of public awareness about the corporation's mandates. Such targets are more easily achieved than more complex targets such as improving employee engagement – an area that was difficult for all but BCTC.

It is important to note that the salary caps are the same for all of these companies regardless of the size or importance of the company. While BCTC is much smaller by revenue or assets than BC Hydro, CEO Jane Peverett of BCTC earned only 15% less than Hydro CEO Bob Elton. This inequity of pay for responsibility could lead top CEOs to become disheartened and seek work someplace that is more equitable in its method of determining pay rates.

# 6: Comparison of BC Hydro with a comparable S&P 500 company

### 6.1 Overview of BC Hydro and Dynegy Holdings Inc.

BC Hydro earned revenues of CAD\$4,855,000,000in the year 2008. In the same year, its Net income was CAD\$369,000,000. BC Hydro's total Assets for 2008 were CAD\$13,610,000,000. As a comparable S&P 500 company, I chose Dynegy Inc. Dynegy Inc. is a publicly traded company that sells electricity to key US markets. Dynegy reported revenues of USD\$3,549,000,000 and Total Assets of USD\$14,213,000,000. While slightly larger, than BC Hydro, Dynegy is not as profitable, with a net operating income of only \$174,000,000. (BC Hydro, 2008 (a)) (Dynegy Inc, 2008 (a))

Both companies' are affected strongly by climactic factors as well as economic factors that are beyond the control of the CEOs. One major difference between the two companies is that while BC Hydro depends mainly on hydroelectric dams, Dynegy relies mainly on natural gas fired plants in order to generate electricity. BC Hydro is the sole power Utility for British Columbia, in effect holding a monopoly on the main market in which it operates, however, Dynegy operates in the spot market, supplying electrical energy without long term contracts. This is highly risky for Dynegy and it has no guaranteed rate of return on its power generation facilities and projects. BC Hydro enjoys a solid credit rating of AAA from Standard and Poors (Standard and Poors, 2008).

Dynegy has a rating of B based on the weak power market conditions during this economic downturn. (Standard and Poors, 2009)

While there are many aspects of running a crown corporation that differ from running a publicly traded company, corporations of a similar size will carry a similar degree of complexity of operations, and while a crown corporation has no share prices to be concerned about, there are other challenges related to the regulatory burden placed on Crown Corporations by their government shareholder.

## **6.2** CEO Compensation at Dynegy

In order to determine its pay rates, Dynegy uses a group of six comparators that are involved in similar business activities (AES Corp., Allegheny Energy Inc., Edison International, Mirant Corporation, NRG Energy Inc. and Reliant Energy Inc.). (Dynegy Inc., 2008 (b))

Compensation consultant Towers Perrin aggregates the data and combines it with information from its 2008 Executive Compensation Database and Long-Term Incentive Plan Report and furnishes the committee with information regarding positions with like roles and responsibilities to the executives at Dynegy. The company prohibits Towers Perrin from doing any other consulting with Dynegy management without explicit approval from the Human Resources Committee. (Dynegy Inc., 2008 (b))

Using the information supplied by Towers Perrin, the committee chase to compensate its executives based 72% on long term Incentives, 10% on short term incentives, and 18% on base salary. Its target compensation level is 50<sup>th</sup> percentile within its comparator group. (Dynegy Inc., 2008 (b))

While Dynegy no longer has employment agreements with its executives (previous agreements were allowed to expire and the company now has a policy of not signing agreements with its executives) the company took no action against executives after an accounting restatement in 2008.

Short Term Incentives for Dynegy executives are paid in cash, while Long Term Incentives are paid in the form of equity incentives that vest three years after their grant date. Equity grants are made by the Human Resources Committee in a meeting near the beginning of the year using the closing price of the stock on the day of the meeting as the exercise price.

Because 2008 was a particularly unusual economic environment, many of the financial goals that the company set at the beginning of the year were based on assumptions that were wrong. The financial performance objectives for 2008 were:

EBITDAM of \$1.1B

OCF of \$635M

FCF of \$300M

G&A of \$175M

The operational performance objectives for Dynegy executives for 2008 included the following areas:

- Safety
- Environment
- Regulatory compliance and advocacy
- Operational flexibility
- On time and on budget for construction

- Monetization of one or more development projects
- Broaden scale and scope in key regions and create long term shareholder value
- Highest and best use of capital
- \$200mm in opportunistic asset sales
- Implementation of trading book structure, controls, metrics and policies
- On time and budget completion of system implementations
- Update Records and Information policy and related systems and structures
- Set up developmental plans for managing directors and above
- Keep up voluntary turnover at a rate of 6% or less and retain employees rated as outstanding and Excellent Contributors
- Set up training and rotation programs across key areas of the company (Dynegy Inc., 2008 (b))

The Compensation committee determined that the financial and non-financial performance in the year of 2008 merited partial short term incentive payments at a rate of 55% of maximum. For CEO Bruce A. Williamson, this amounted to \$550,000 Williamson's base pay for 2008was \$1,000,000 and he received \$1,521,032 in stock awards and \$1,860, 655 in option awards. Including pension and all other compensation (such as perquisites) Williamson received a total of USD\$5,430,559 in compensation for the year 2008. (Dynegy Inc., 2008 (b))

## 6.3 Comparison of CEO performance at BC Hydro and Dynegy

Dynegy claims that its anticipated general and administrative costs of approximately USD \$175 million in 2009 qualify it as having one of the leanest cost structures in the sector. In 2008, Dynegy's actual General and Administrative costs were USD \$157 million. (Dynegy Inc, 2008 (a)) Let us compare that number to BC Hydro. For 2008, BC hydro had general and administrative costs of CAD\$120Million. (BC Hydro, 2008 (a)) BC hydro has higher revenues than Dynegy and still manages to keep

its General and Administrative expenses lower. The amount being paid out to the top five executives of each company is one place to look in order to find out why these companies have such different general and administrative costs. Below is a chart of the different amounts spent on the top five named executive officers for both companies for the year 2008

Table 3 Salaries at BC Hydro and Dynegy

	ı	1	1
BC Hydro Executive Officers	BC Hydro Compensation	Dynegy Executive Officers	Dynegy Compensation
Elton, BG, CEO	CAD\$570,897	Bruce A Williamson, Chairman, President, and CEO	USD\$5,944,358
VanRuyven, B, Exec VP, CC&C	CAD\$426,507	Holli C. Nichols, Exec VP and CFO	USD\$1,903,645
Cowan, Alister, CFO (Until April 5 2008 therefore received no incentive for F08)	CAD\$336,949	J. Kevin Blodgett, General Counsel and Exec VP Administration	USD\$1,550,013
O'Riley, CK, Sr VP, EARG	CAD\$371,013	Lynn A. Lednicky, Exec VP – Asset Management, Government and Regulatory Affairs	USD\$1,494,825
Conway, T CEO Powerex	CAD\$367,339	Jason Hochberg Exec VP – Commercial and Market Analytics	USD\$1,983,401
Total for BC Hydro	CAD\$2,072,705	Total for Dynegy:	USD\$13,899,157

(BC Hydro, 2008 (b))

(Dynegy Inc., 2008 (b))

It becomes clear that Dynegy spends more than six times what BC Hydro does for the compensation of the top five executives. If this can be applied to all executive salaries across both companies, then it is easy to see why BC Hydro comes out ahead in this respect. So what is Dynegy getting for its money relative to BC Hydro? Both Dynegy and BC Hydro report Comprehensive Income as well as Net Income. Here the differences between the two companies become even more pronounced. BC Hydro's Comprehensive Income for 2008 was CAD\$445,000,000, and includes derivative hedging activity on the part of the company. (BC Hydro, 2008 (a)) Dynegy's Comprehensive Income for 2008 was in the negatives at USD\$(16,000,000). (Dynegy Inc, 2008 (a))This loss was mainly the result of mark to market losses, actuarial losses and amortization of unrealized prior service costs, and unrealized losses on securities and investments. When it comes to financial manoeuvrings, BC Hydro is better able to manage its activities and their results on the income statement.

Operationally, BC Hydro has the capacity to generate 11,280 Megawatts, considerably less than the 17,700 Megawatt generating capacity of Dynegy. In terms of operational revenue, BC Hydro brought in CAD\$4,855,000,000, whereas Dynegy made only USD\$3,549,000,000. BC Hydro is doing more with less. Dynegy is just not as efficient as BC Hydro when it comes to generating revenues. (BC Hydro, 2008 (a)) (Dynegy Inc, 2008 (a))

Even without taking BC Hydro's triple bottom line mandate into account, it is already ahead of Dynegy in terms of financial health. That the CEO of Dynegy earns ten times what the CEO of BC Hydro earns is not a measure of any difference in managerial talent, but more a difference in the circumstance of the laws governing the compensation of the two executives.

# Conclusion

Publicly traded companies have vastly different stakeholders and thus performance measures will be different. While there is no magic formula for manipulating the behaviour of CEOs to match with stakeholder needs, there are some principles that can be applied to all situations, regardless of the type of company being managed.

Corporate governance is the focus of much discussion in Crown Corporations and publicly traded companies alike. The push toward independent directors has been strong in both types of companies, and executive compensation has been affected. In the case of Crown Corporations, the legislators issued an actual pay cap, and in the case of SEC listed companies, the use of a compensation committee made up of independent directors, along with the regulations requiring details of CEO and other Named Executive compensation to be published in the proxy report has had the effect of bringing CEO salaries back down to earth.

Transparency of pay is less of an issue for BC Crown Corporations than it is for publicly traded companies in the US. The BC Crown Corporations have to complete a simple and specific form for the PSEC that clearly shows what is being paid to which executives. Publicly traded companies in the US are still struggling with the idea of simple. Many of the CD&A documents are confusing to the point of being misleading and there is too much open to interpretation with regard to how supplemental pensions are recorded. The hard numbers available from both kinds of companies do give

stakeholders useful insight into how efficiently General and Administrative dollars are being spent, and this practice of compensation publication could be expanded to more positions within the companies.

Long term and short-term variable pay are excellent ways to motivate CEOs to work for the overall success of the company. In cases where there is some kind of economic downturn, however, it is not fair that the CEOs be allowed to switch from equity pay to cash pay or from more variable pay to more base pay. This does not motivate anyone to try to mitigate the overall effects of the economy on the business. Neither should an upswing in the economy automatically be rewarded with extra variable pay as such compensation would reward CEOs without their having done anything to earn it. The pay packages for all CEOs need to take into consideration that everyone in the company, executives, workers, board members, shareholders, and other stakeholders, must all share in the same successes and losses. Losses borne by the shareholders should be visited upon the other stakeholders, and vice versa. For too long there were different classes of stakeholders in corporations, with the CEO and boards at the top and the shareholders and employees at the bottom. When the money ran short, the bottom suffered and the top did not. Such cases as Home Depot must never be allowed to happen again.

Publicly traded companies and Crown corporations are in competition for a shrinking talent pool at the upper management levels. Retention of top executive talent is a primary consideration for Human Resources committees of all companies. In the case of BC Crown corporations, they are under strict regulation regarding the maximum

allowable compensation of any one person each year. This means that these companies have to find innovative ways to compete for talent. Considering the booming economy and shrinking talent pool in the period leading up to the current economic recession, the crown corporations have done very well at retaining their top executives. Crown Corporations are forced to accommodate their CEOs in ways that are not damaging to the bottom line of the company. Some of the innovative ways that they can reward CEOs is with work-life balance initiatives allowing for time off, executive development to make sure that the experience that the CEO gains during his time at the company is fulfilling intellectually and has a positive impact on future earning potential, and allowing for contact with the people who are shaping the legislation that will affect the whole community. Time spent at a Crown Corporation can allow a CEO to have a chance at helping shape the governmental policies of the day.

The goal for Crown Corporations should be to hire civic-minded individuals who believe that working for the public good is a worthwhile pursuit and who also happen to be incredibly talented managers. This means that as well as having a set of personal values that is in line with public service, the type of people that are hired on as CEOs need to have the best training and highest levels of achievement. Promoting from within is one strategy that seems to work well. If employees have the opportunity to start their career with a company that allows them to develop, take time out for educational leave, and even pays for some of that education, they will have incentive to stay, even if the company doesn't pay as much as other companies. In the case of BC Hydro, they are currently exploring a system of grooming employees for eventual senior management positions. (Dale Flood, 2009) Crown corporations should look at all of their young

managerial staff as potential future CEOs and raise them up accordingly. There is also a better chance of Executives having a deep sense of long term goals if they plan to be with the company over the entire tenure of their careers. There is fear that executives will merely use their training as a way to get hired by a private or publicly traded company that will pay a higher salary, but this is less likely to be the case over time if the employees receive in house opportunities to utilize their training from the beginning. Training someone up to do a job and then not allowing them to use that training is very de-motivating and must be avoided.

There are many intrinsic motivators that can be used to motivate all employees, and there is no reason that these cannot apply to CEOs as well as those under them. The idea of achieving a personal best in something is one of the most motivating schemes.

Setting CEO goals high, but not impossibly so, and then regularly checking in with the HR committee as to the progress of those goals is very important for helping the CEO find his work meaningful and motivating. Having a real connection between cause and effect is also a big motivator. The CEO has great measures of the effect of his work in the pro forma statements that the corporation puts out each quarter, but the more human side of his performance may have to be brought to light in other ways. Some of the more qualitative goals may need to be discussed with the HR Committee to really have a full understanding of what effect the CEO is having on the company. (Nancy Olewiler, 2009)

Publicly traded companies could do with stricter regulation when it comes to CEO pay. The current legislation in the US does not provide salary caps, but does provide some regulation as to how CEO income must be reported. The shareholders need more protection than this. CEO compensation should be limited to a set percentage of net

income. As well, there should be legislation regarding pay equity in companies so that the workers at the bottom cannot be marginalized by an unscrupulous CEO. If there are set levels of pay equity for all levels of employee, then the only way a CEO will be able to raise his own compensation is by improving the performance of the company such that all employees benefit as well.

Regulations regarding CEO pay must be written in such a way that they cannot be interpreted differently from one company to the next. The "plain English" clause in SOX is quite loosely worded and completely open to interpretation, so much so that it has had no effect. In the case of this rule, it would have been more useful to set out guidelines as to document length and grade reading level.

The reaction to CEO compensation scandals has made lawmakers examine the balance of power between executives and shareholders. Robert A.G. Monks, the founder of ISS (Institutional Shareholder Services) calls for British style shareholder power. This would require an emergency general meeting at which the board and subsequently the CEO could be removed if requested by 10% of shareholders (Monks, 2008). I think that such measures are extreme and should be treated very cautiously. If a large hedge fund or two decided to go after the retained earnings of a company for dividend purposes, this could spell disaster for the company in the long term. In the cases of R&D or asset heavy industries, unscrupulous short term profit takers could be tempted toward the same kind of corruption that we are trying to prevent in CEOs. The way that this might be tempered is by requiring it to be a consortium of different shareholders (none of them with anything approaching minority control of the company) that can call an emergency

meeting. This forced dilution of power will enable further checks and balances so that we don't recreate the problem we are trying to solve.

Corporate governance at Crown Corporations would seem to be neatly taken care of by wise legislation and limits placed on the power of Boards at Crown Corporations. The Board Resourcing and Development Office of the government of British Columbia is the agency that oversees all of the board appointments for Crown Corporations. This office has guidelines that are laid out in an easy to read document regarding the best practices to be followed by crown agencies. These guidelines include such practices as not having the CEO and the board Chair as the same person. (Crown Agencies Secretariat • Board Resourcing and Development Office) In theory, these guidelines are the framework that keeps the Boards of Crown Corporations acting in the best interests of the shareholders. This is not necessarily the case if the shareholder we are thinking of is the citizenry of the province. In actual fact, the shareholder that boards and CEOs must please first is the Minister responsible. This is the person who has the power to make board and CEO appointments as well as to limit the amount paid to CEOs and boards. While the guidelines put in place by the Board Resourcing and Development Office seem like they are inviolable, they are only guidelines, and in cases where they are in conflict with legislation, then that legislation takes precedence. (Crown Agencies Secretariat • Board Resourcing and Development Office) This means that the government of the day is quite capable of enacting legislation to override any corporate governance rules that are inconvenient to their ends. It takes a resolute commitment to good corporate governance by the elected officials to make sure that they are not rendering the boards powerless and simply governing crown corporations in an autocratic fashion. In November of 2008, the

Minister of Energy, Mines and Petroleum Resources, Richard Neufeld, appointed exDeputy Minister to the Premier, David Emerson to the positions of CEO and Board Chair
at BC Transmission Corporation. (Morton, 2008) While Minister Neufeld may have had
compelling legitimate reasons for doing this, it brings to mind the question of whether or
not all of the corporate governance guidelines in place in BC's Crown Corporations are
just a show for the public or if they have a strong commitment from the Politicians and
the boards appointed by them. If there is the perception that the boards are merely
ornamental and that the real power over Crown Corporations lies within the legislature,
then the public may come to resent any salaries paid to those in charge at Crown
Corporations and there could be a backlash against these companies. Such a backlash
could result in their eventual privatization or elimination, which would be a great loss to
the people of British Columbia.

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