

# Choosing the performance option\*



2005 Global Equity Incentives Survey – Energy

\*connectedthinking

PRICEWATERHOUSECOOPERS 

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# Introduction

The challenges facing energy companies across the globe are immense. Supply and demand imbalances, increasing reliance on remote energy sources, the quest for technological innovation and diversification in the face of climate change concerns, new market mechanisms, competitive pressures, mergers and acquisitions and an ageing workforce all heighten the need for companies to ensure that they attract and retain the very best talent and expertise. Companies are continuously reviewing changes to their compensation strategy to give themselves a competitive and performance edge. Providing competitive compensation while simultaneously managing employment costs is a key goal.

Many factors have encouraged companies to redesign their equity-based compensation programmes – newly emphasised sensitivity to accounting expense, heightened pay scrutiny, conserving cash and controlling dilution. But, are they really broken? Do companies need to redesign their current stock-based plans to continue to support their strategy just as well or better? And, what impact will changes in equity and long-term incentive compensation for the top executives have on reward strategies for the middle manager and broad-based employee group? How do the changes to the company's stock-based compensation plans impact the global organisation? Companies need to address these critical issues in order to tailor solutions to their organisations' unique situations.

Despite the ongoing public debate, equity incentives remain an integral part of many companies' reward models. Energy companies are increasingly choosing the performance option as they align schemes more closely to performance goals. *Choosing the Performance Option\** takes an inside look at equity compensation in energy companies around the globe. PricewaterhouseCoopers' Global Equity Incentives Survey<sup>1</sup> is one of the most comprehensive studies of the design and administration of equity incentive compensation plans for multinational companies and this report focuses on the energy companies that participated in the 2005 survey. The results give us a unique window both on trends in the energy sector and how these fit or diverge from the wider global multinational context.

It is an exceedingly challenging yet interesting time in the world of compensation and benefits. We hope you find the *Choosing the Performance Option\** and the related *Trends in Times of Uncertainty – 2005 Global Equity Incentives Survey* of assistance as you seek to create the employee incentives that will help your company achieve its business objectives.

**Dina Pyron**  
Human Resource Services  
Energy Tax Partner

1 *Trends in Times of Uncertainty*, 2005 Global Equity Incentives Survey Executive Summary, PricewaterhouseCoopers.

# Report highlights

## Times of uncertainty

Against a background of regulatory change, an underlying theme of our 2005 survey is uncertainty. Over and over again, the percentage of respondents who choose ‘do not know’, ‘not sure’ and ‘explore alternatives’ is much higher than in any of the surveys we have conducted in the past.

## Ahead of the regulation

Unlike companies in some other sectors, however, energy companies are relatively unruffled by the new expensing rules set by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Over half of participating energy companies are already expensing options (more than four times the rate of hi-tech companies) and they are twice as likely as hi-tech companies to be in favour of expensing.

## Changing the equity compensation mix

In contrast to other sectors, no energy companies in our survey report that they will be eliminating stock option plans or reducing grant levels in reaction to new expensing rules. The changing regulatory landscape is, however, prompting energy companies to change the pattern of equity compensation. Half of the energy participants in our survey report that they expect to change to other plans or to explore alternatives. This is reflected in a decline in the use of options, Employee Stock Purchase Plans (ESPP) and Restricted Stock (RS)/Restricted Stock Units (RSU) in the energy sector.



## A move towards performance

Energy companies are aligning equity compensation more tightly to performance. This shift is happening at a faster pace in the energy sector than elsewhere. Energy companies report offering performance stock (PS) or performance stock units (PSU) and performance options at nearly twice the rate as our cross-industry sample. Nearly half of energy companies have some performance measure built into their process for granting options, more than twice the prevalence in our cross-industry sample.

## Grappling with compliance complexity

The complexity of different regulation in different territories, combined with regulatory change and the changes that come from dynamic M&A activity in the sector, mean that equity compensation compliance is a major challenge for energy companies. Half of energy companies report not knowing whether a compliance review has been taken in some, most, all or none of the countries that they operate in compared to 27% of our cross-industry sample.

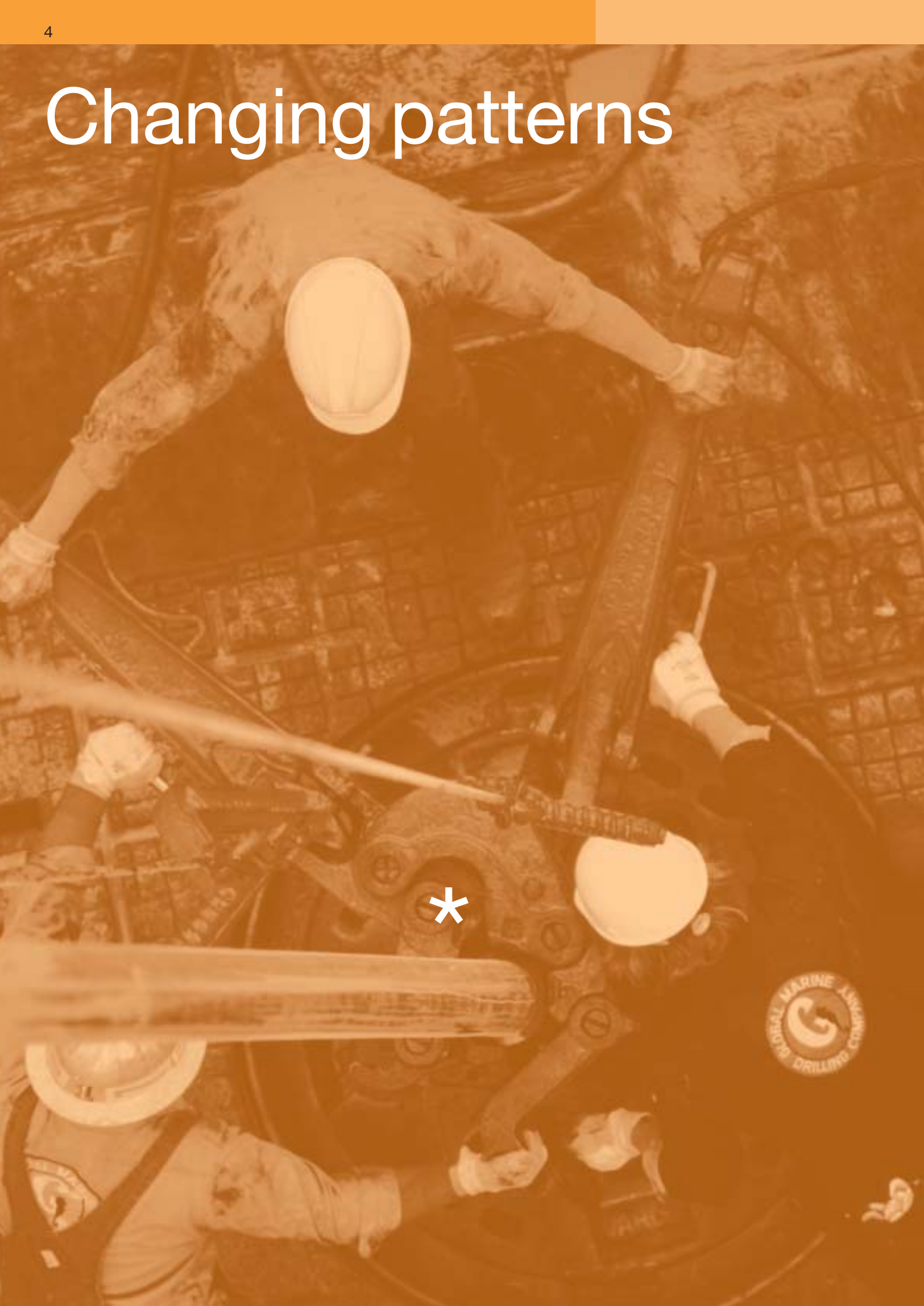
## Extending the reach of equity compensation

Despite the complexity of ensuring compliance across different territories, competitive dynamics in the sector and the operating challenge of attracting, developing and retaining local expertise are compelling energy companies to be proactive at deploying equity compensation in their foreign affiliates. Attracting and retaining top talent appears to outweigh the cost of adapting to new accounting and tax requirements.

## Conquering the communications challenge

Many energy companies report that the effectiveness of equity compensation plans in meeting their human resource goals is being undermined by the difficulty of ensuring that individual members of staff understand the plan benefits. Three out of ten energy companies say that employees do not understand their plan benefits very well.

# Changing patterns



Multinational energy companies face significant human resource planning and management challenges because they have large workforces with diverse skill sets and operation in numerous locations outside their home countries, including many developing and frontier markets particularly in the oil and gas sector. At the same time there are significant workforce replenishment challenges as energy companies contend with an ageing workforce.

Against this background energy companies are seeking to enhance their employee incentive strategies through the development of uniform global equity compensation programmes. Sixty-eight per cent of energy companies say the development of a uniform global programme lies behind their decision to offer stock-based compensation to their international employees. The need to match offers, from either local or international competitors for their talent base, is the motivating factor cited by most of the remaining companies.

## Regulatory changes

These are turbulent times for equity compensation. Corporate failings have heightened scrutiny of executive remuneration. Alongside this, the regulatory context for equity compensation is changing. It is perhaps unsurprising that an underlying theme of our 2005 survey is uncertainty. Over and over again, the percentage of respondents who choose 'do not know', 'not sure' and 'explore alternatives' is much higher than in any of the surveys we have conducted in the past.

On 16 December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123(R), Share-Based Payment (FAS 123(R)). FAS 123(R) revises FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123) and requires companies to expense the fair value of employee stock options and other forms of stock-based compensation. FAS 123(R) will have a substantial impact on the financial statements of many companies because of its requirements to expense the fair value of employee stock options and other forms of stock-based compensation, which will decrease income and earnings per share.

Most US-type employee stock purchase plans (ESPPs) will become compensatory under FAS 123(R) unless they meet a series of conditions, including a 'safe-harbour' discount to the purchase price of 5% (the majority of existing ESPPs have a 15% discount). For public companies, FAS 123(R) must be adopted no later than annual periods beginning after 15 June 2005 (or 15 December 2005 for small business issuers). As of 1 January 2005, the International Accounting Standards Board (IASB) has also issued their expensing pronouncement, which covers many non-US companies.

Across industry as a whole, companies are gathering the facts, educating themselves about the new regulations, bringing in the experts and investigating the best possible alternatives so that they will be able to take advantage of the changing landscape of equity compensation, rather than be hurt by it. As the new regulations bite, however, a new competitive picture will emerge and 'benchmarking yourself against your peers' will once again carry significant weight.

## Reaction 1: reducing or eliminating stock options

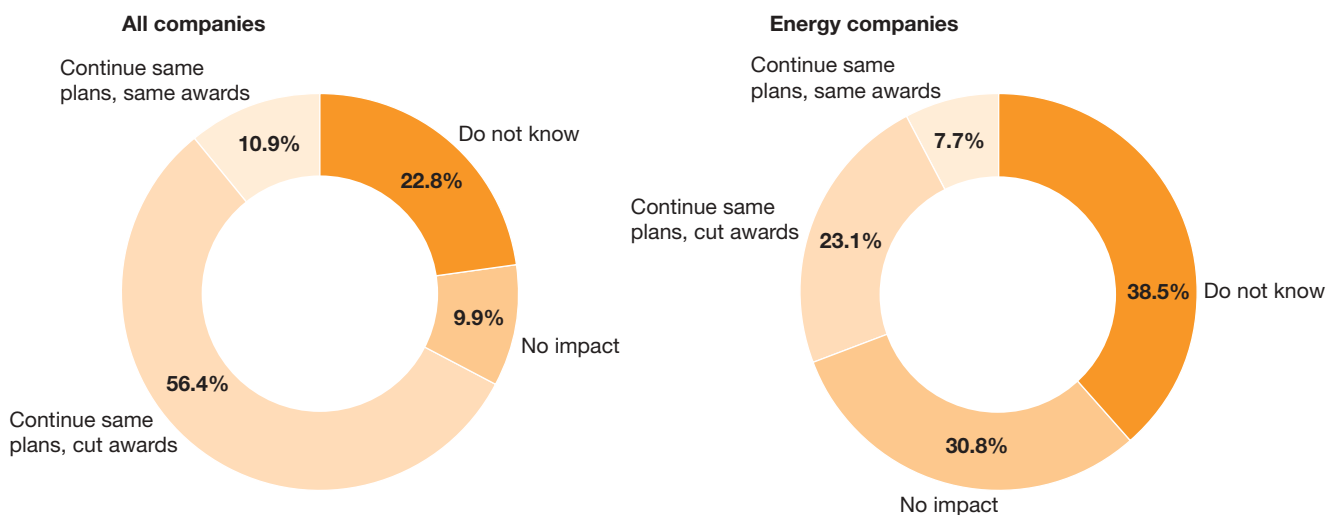
The most immediate reaction to the new accounting regulations is a reduction in stock option grant levels. Our survey shows a decline in 'plain vanilla' stock options and an assault on employee stock purchase plans. But is this really the end of the road for stock options? Among survey participants, stock option plans continue to be the most popular vehicle for equity compensation.

A decline in the use of stock options is evident. Over half of the cross-industry participants (56.4%) reported that, while they intended to continue with the same plans, they would be cutting awards (see figure 1). However, energy participants were three times as likely as the cross-industry group to report that mandatory expensing would have no impact on their company. Despite this, 23% of energy respondents report that the impact will be for their company to cut awards. As we shall see later in this report, the same trend is noticeable for employee stock purchase plans, such as '423 plans' in the US.

However, none of the energy companies in our survey report that they intend to go so far as to eliminate stock option plans altogether or reduce grant levels in reaction to new expensing rules. In contrast, 28.7% of companies in the cross-industry sample said that they would resort to such measures.

Unlike companies in other sectors, notably hi-tech companies, options have traditionally been restricted to the higher echelons of energy companies and so the impact of expensing is less significant than in other industries. Indeed, over half of the energy companies report that they are already expensing options whereas only 22% of the cross-industry sample were doing so. Despite this, there is a significant degree of hesitation and uncertainty in the energy sector on the effect of mandatory expensing of stock options. While three times as many companies in the energy sector (31%) compared to cross-industry respondents (10%) felt it would have no impact, rather more energy respondents (38.5%) said that they didn't yet know what the impact would be (see figure 1).

Figure 1: What do you think the impact of mandatory stock options expensing will be on your company?



**Note:** Total % share of responses

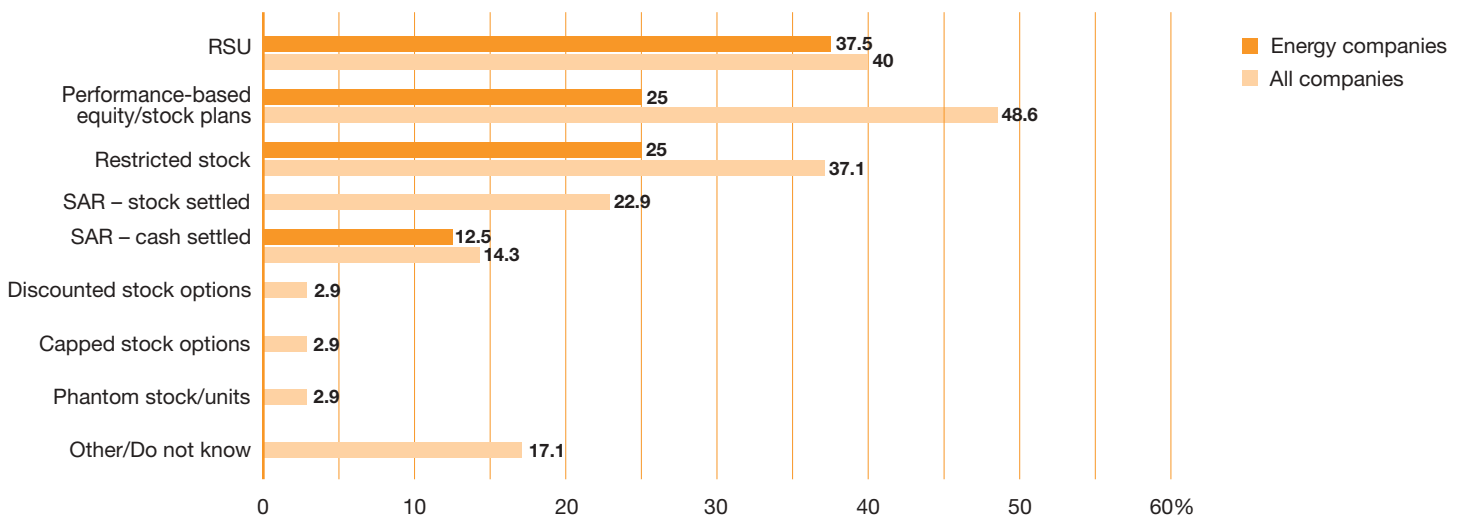
**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty*, 2005

## Reaction 2: switch to another plan or explore alternatives

It is encouraging that companies are not stopping with the first reaction: reduction or elimination of options. More than half of companies in the wider survey will either replace option plans or explore alternatives, thus indicating that the motivational value of long-term incentives remains strong, even in the face of such difficulties as designing a new plan or changing an existing one. A not so worrisome number, less than 5% of all organisations interviewed, will actually give up on stock-based plans altogether; we will closely monitor this statistic in future surveys. While 25% of energy companies report that they do not anticipate any changes to their equity plans next year, over 30% report changing their plan design and 44% more report that they are unsure or will look into alternatives.

In keeping with shareholder and investor interests, companies as a whole that are looking to switch to a new equity vehicle are focusing on performance-driven stock plans in the first place and restricted equity plans in the second. Among energy companies, the order of these two was reversed (see figure 2). Both vehicles, depending on size, may also allow some companies to recognise a smaller expense to their profit and loss account.

Figure 2: What equity compensation vehicles are you considering switching to?



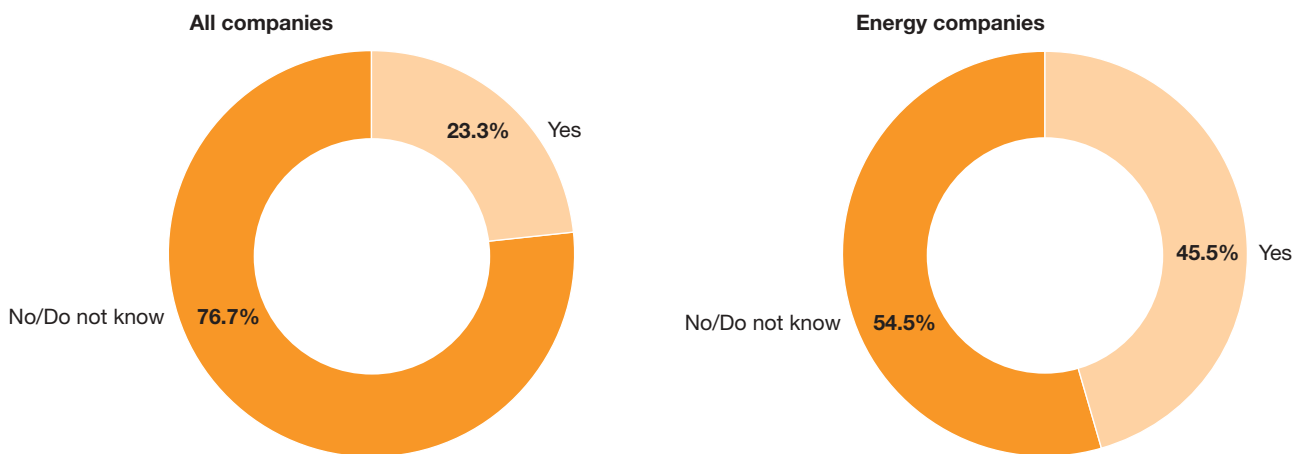
Note: % share of participating companies

Source: PricewaterhouseCoopers, *Trends in times of uncertainty 2005*

## A move to performance conditions

Energy companies have started to add performance conditions to their option plans, trending to UK-type incentives that are more focused on company or individual results while starting to restrict employee eligibility in these plans. Energy companies are nearly twice as likely as companies in the cross-industry sample to include performance measures in the conditions for granting employee stock options (see figure 3).

Figure 3: Does your stock option plan have performance measures for granting purposes?

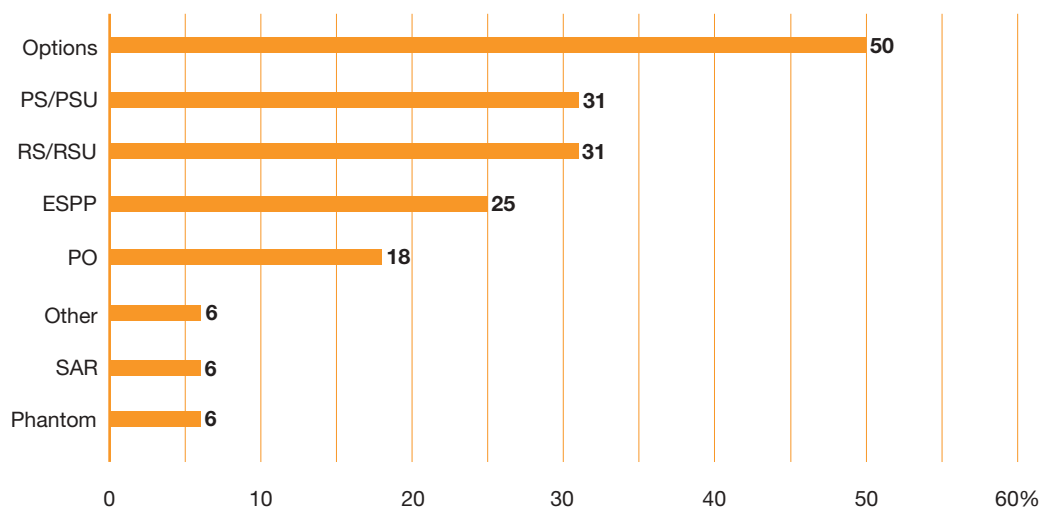


**Note:** Total % share of responses

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty, 2005*

Performance-based equity plans and restricted stock/unit plans are becoming more prevalent. Energy companies report offering performance stock and performance stock units even more frequently in the US than ESPPs and a majority of companies are now using a combination of equity vehicles, typically stock options, restricted stock and, performance stock/performance stock units (see figure 4).

Figure 4: Energy companies: types of equity compensation plans offered in the US in 2004



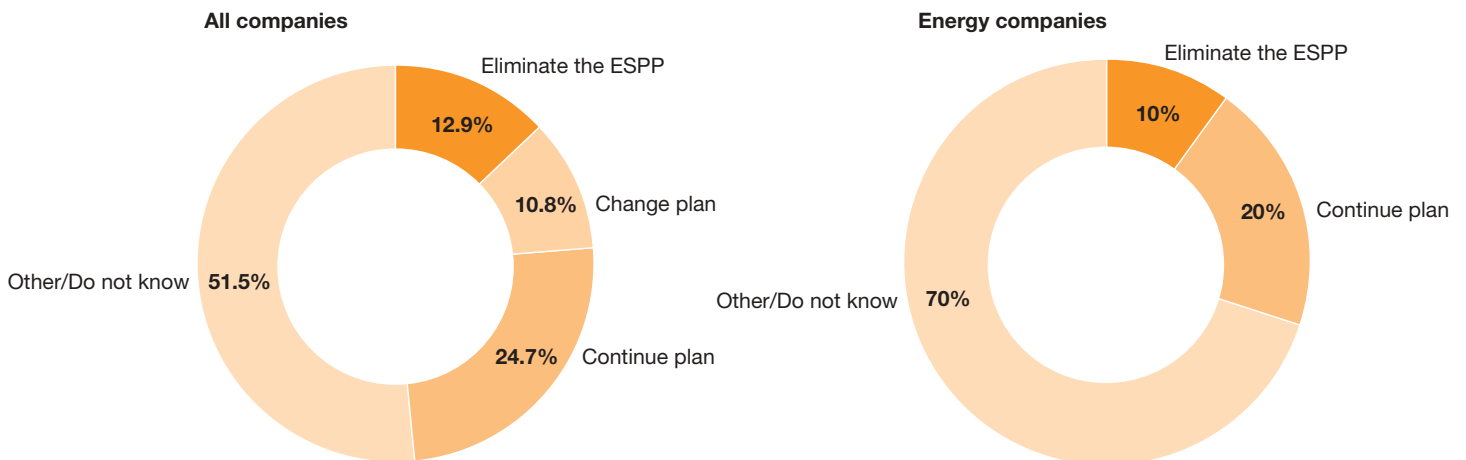
**Note:** % share of participating companies

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty 2005*

Significantly, energy companies were far less likely than cross-industry survey respondents to include ESPPs in the equity compensation mix, with only a quarter of energy companies deploying ESPPs compared to over half of the cross-industry sample. While there are signs of a decline in the number of companies offering ESPPs, uptake rates of this type of scheme remain high. Companies need to balance the benefits of the schemes against their accounting expense. The vast majority of companies are unclear about the future of ESPPs and only 20% of energy companies feel sure that they would continue such schemes in the event of increased accounting expense (see figure 5).



Figure 5: If accounting rules result in increased expense for stock purchase plan/ESPP what will your company do?



**Note:** Total % share of responses

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty, 2005*

In summary, it is clear that energy companies are far from taking an automatic stance to reduce equity compensation in reaction to regulatory changes. Indeed, such are the competitive dynamics of their international human resource climate that as many companies say they will be increasing the reach of equity compensation worldwide in the future as say they have plans to reduce it.

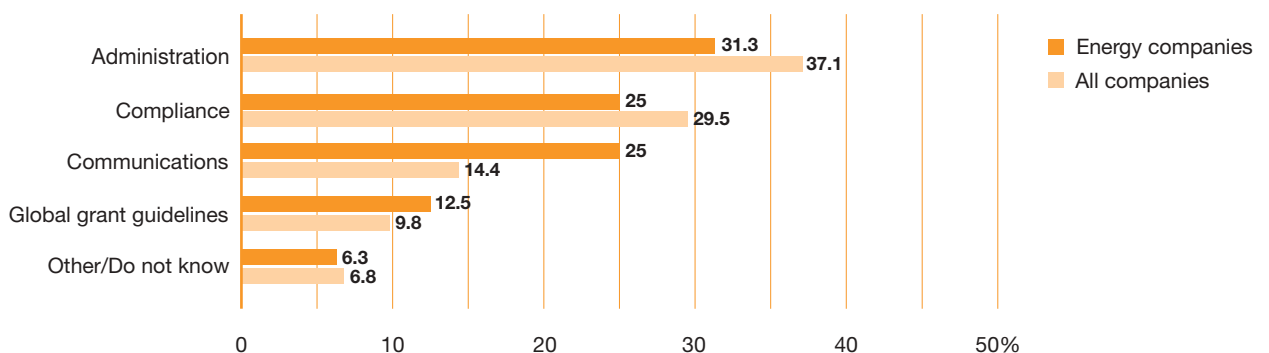
# Key challenges



The changing dynamics and global footprint of the energy sector creates additional challenges for HR professionals in energy companies running equity compensation schemes. As well as the headache of grappling with a variety of regulatory regimes in different territories, there has also been significant industry consolidation through merger and acquisition activity creating larger combined entities in all sectors of the industry. M&A activity in the utility sector in 2004, for example, returned to the record, heady heights last seen in the late 1990s. This brings with it the considerable difficulty of administering schemes with different company origins.

Compliance, administration and communications emerge as the three key challenges identified by the respondents in our global survey. In the energy sector, respondents put administration problems ahead of compliance in the list of challenges, perhaps reflecting the considerable consolidation that has taken place in the sector and the consequent variety of legacy schemes (see figure 6). The different ranking possibly also reflects the fact that energy companies are more likely to have already started measuring the challenge of administration in the context of expensing.

Figure 6: What are the most challenging aspects of global equity/stock option plans?



**Note:** % share of participating companies

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty 2005*

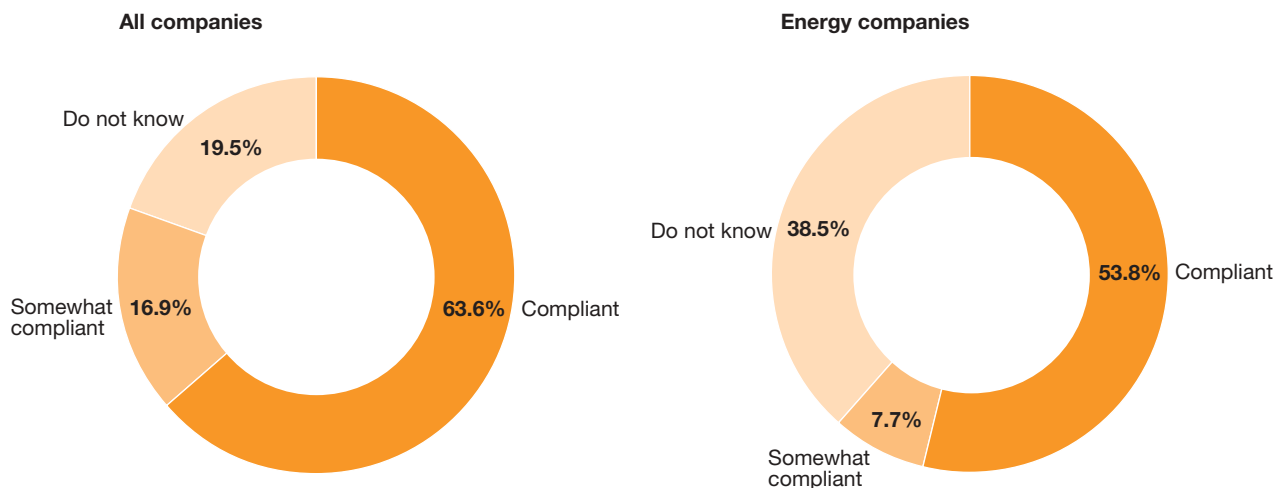
## Compliance

The number of employees covered by equity compensation schemes, the range of schemes, the inheritance of schemes from merged entities, the number of different regulatory regimes and the range of regulatory requirements all make compliance a demanding task. Nevertheless, 64% of cross-industry participants believe their plans are compliant. This may be a reflection of the fact that 56% of companies in the cross-industry sample report that they review their global plans annually or more frequently in most or all of the plan countries.

The results for the energy industry are not so optimistic. While 54% of energy participants believe that their plans are compliant, nearly 38.5% report not knowing where their company stands in terms of compliance (see figure 7).

Similarly, while 43% of the cross-industry sample review their plans at least annually, only 15% of energy companies say they review their plans this frequently. Moreover, 50% of energy respondents do not know whether a compliance review has taken place in some, most, all or none of the countries that they operate in compared to 27% of our cross-industry sample. The UK, the US and the Netherlands were cited as the most difficult countries in terms of compliance. Not surprisingly, these countries were also those in which audits by local tax authorities had been conducted most frequently.

Figure 7: What is your opinion of plan compliance



**Note:** Total % share of responses

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty, 2005*

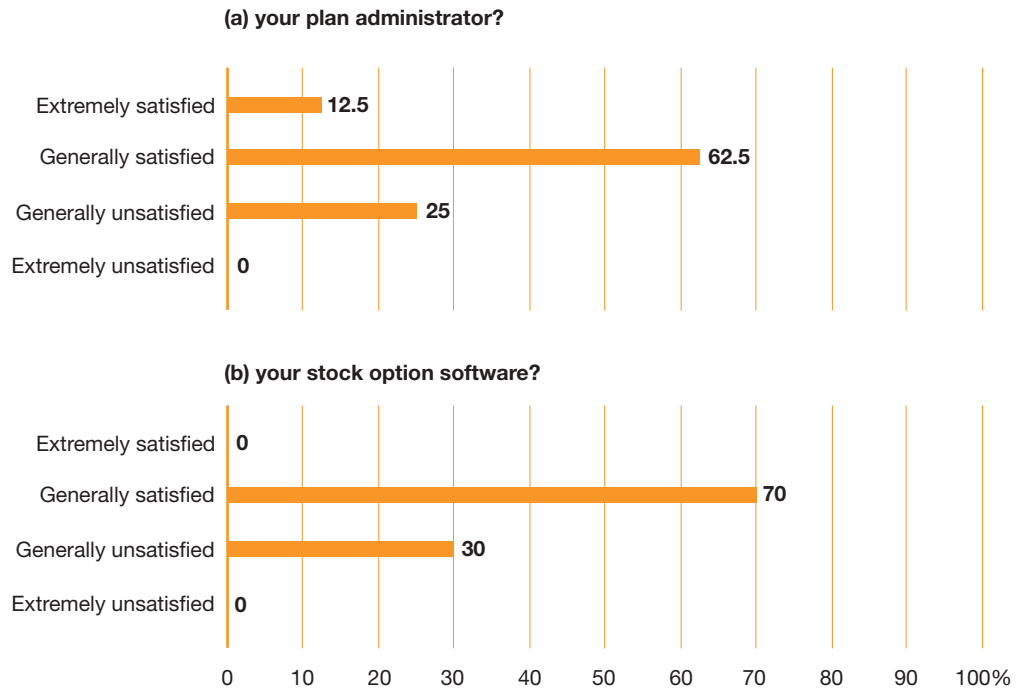
“While 54% of energy participants believe their plans are compliant, 38.5% report not knowing where their company stands in terms of compliance.”

## Administration

Although administration and process was cited as the second most prevalent challenge by companies in the wider survey, answers to other questions indicate that companies are generally satisfied with their administrator or plan software. However, energy companies are slightly more likely than the cross-industry group to be unsatisfied with their administrator or their options software (see figure 8). As electronic information and administration services become more mature, both corporate sponsors and plan participants seem to have greater comfort in using them. Seventy two per cent of this year's participants indicate that employees access their plan records via the internet, 64% report that award agreements are delivered via the internet and nearly half report that employees indicate acceptance of awards electronically.



Figure 8: How satisfied are you with:



**Note:** % share of participating companies

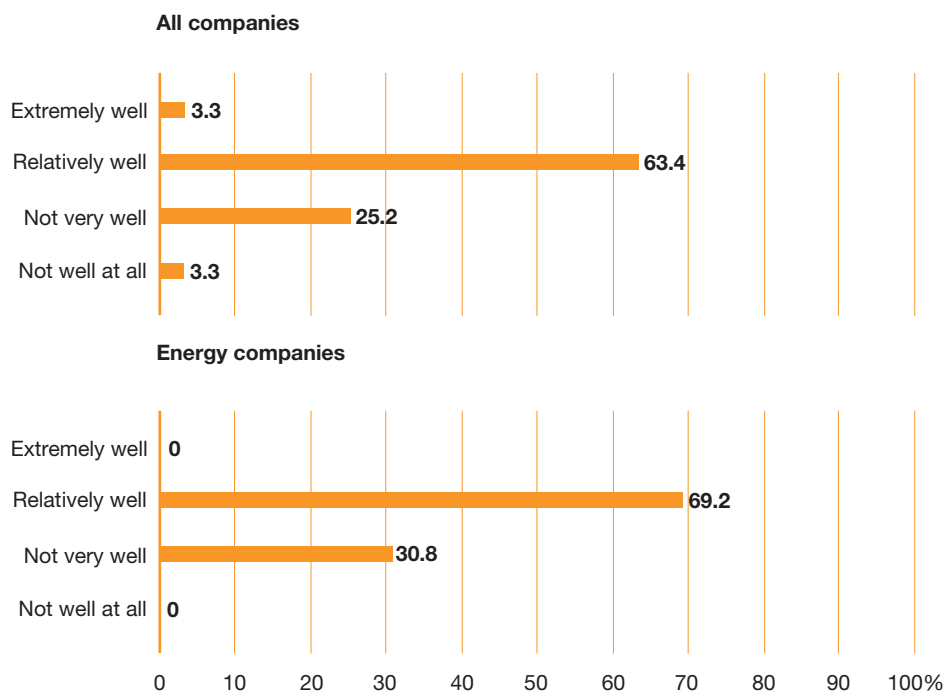
**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty 2005*

## Communications

Some energy companies report that the effectiveness of equity compensation plans in meeting their human resource goals is being undermined by the difficulty of ensuring that individual members of staff understand the plan benefits. Three out of ten energy respondents to our survey say that employees do not understand their plan benefits very well, a slightly higher percentage than our cross-industry respondents (see figure 9).

The internal communication media mix has shifted, with an emphasis now on high-level communications from senior management and use of electronic communications. Only around a quarter of energy companies use paper communications, instead access to the administrator's internet site or the company intranet is the predominant way of delivering employee access to plan records. However, just under a quarter (23%) of energy respondents report that they believe employees are unsatisfied with communications about equity compensation. The communications challenge will increase as changes continue in the type and design of scheme. Clearly, there is some way to go before companies can be sure they are effectively communicating their schemes to participants.

Figure 9: How well do you think your employees understand their global equity/stock benefits?



**Note:** % share of respondents. Chart excludes 'do not know'

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty 2005*

# Looking ahead

The equity compensation landscape is in flux. Equity compensation professionals face the pressures of expensing at the same time that the popularity of existing plans is reaching all time highs. As stock markets improve, stock option and employee stock purchase plans have regained much of their power as retention and attraction vehicles. Over 85% of participants in our survey, both cross-industry and specifically within the energy industry, feel that employees are satisfied with their current plans (mostly stock option plans).

Companies themselves also believe that current equity plans have achieved their initial goals and that the investment in them is money well spent. In the energy sector, 62% of respondents say that the costs of global equity plans are generally worth the benefits and a similar percentage report that their plans are designed to encourage a shareholder mindset for all employees.

Nonetheless, it is clear that companies are keeping their plans under very active review. Such active review is vital if the significant challenges of compliance, administration and communications are to be overcome. It is also necessary so that companies can be sure that their equity compensation strategy and choice of schemes is fully aligned with their business and shareholder goals.

The next few years will see the emergence of a new pattern of equity compensation schemes following the current regulatory changes. Companies that get the most competitive advantage from their schemes will be those who have tailored their scheme design and structure carefully to their performance objectives. In this respect, energy companies are well-placed and ahead of the curve but, in contrast, are struggling more than companies in other sectors with administrative and compliance challenges.

We hope you find this publication informative. If you would like to discuss the results of the survey and/or the other human resource issues highlighted in this publication, please get in touch with the appropriate PricewaterhouseCoopers contact listed at the end of this document.

# Energy's human capital landscape

The need to design equity compensation schemes that are competitive and efficient are highlighted by the human resource challenges facing energy companies.

## An ageing workforce

Oil and gas companies are facing a rapidly ageing workforce. The average age of oilfield engineers has risen to above 50 in the US and there are not enough recruits to sustain the US\$200bn planned investment in expansion over the next 15 years. Particularly among petroleum engineers, there will soon be more professionals leaving the industry (retiring, etc.) than entering the workforce. "Some companies are having difficulty finding people to fill positions," says Mark Rubin, executive vice-president of the Society of Petroleum Engineers in Dallas. "There is a question mark as to whether enough engineers are coming out of college," he says (Financial Times, 11 October 2004). Jim Hackett, chief executive of Anadarko, one of the biggest US independent oil groups, says: "those (companies) who solve this internal problem over the next five years are the ones who are going to win" (Financial Times, 29 March 2005). The problem is not limited to the US. It is replicated in many of the industrial nations around the world. The implications of the ageing workforce are many:

- *Successions planning and leadership development* will be brought to the forefront as companies strive to ensure that the next generation of company leaders have the requisite skills and experiences.
- The departing workforce will take with it much of the embedded knowledge of an organisation unless steps are taken in *mentoring, knowledge management* etc. to ensure that this knowledge is transferred to the organisation.
- *Workforce planning* will be needed to plan now where and how the company will locate, hire, train and retain its future employees.

## Increasing reliance on remote energy sources

The increasing reliance on remote energy sources will require companies to continue to staff projects in remote areas. As companies continue to expand alternative models – such as commuters, rotators, short-term assignees, etc. – to the traditional family-accompanied long-term international assignment will become more common. Companies will need to ensure compliance with the proper tax and immigration laws. In addition, they will need to review their current policies and support structure for international assignments.

## Globally mobile employees

The need for global agility, moving the right people to the right place around the world, means energy companies face particularly complex equity compensation and retirement administration challenges. As staff approach retirement, they are reviewing the patchwork of various plans they participated in as they relocated around the world and questioning if there is an adequate level of income replacement as well as questioning how the various plans will be taxed. In addition, as many globally mobile employees have received equity awards as they have relocated to various countries throughout their career, companies need to ensure that all tax liabilities due to trailing liabilities are being addressed.

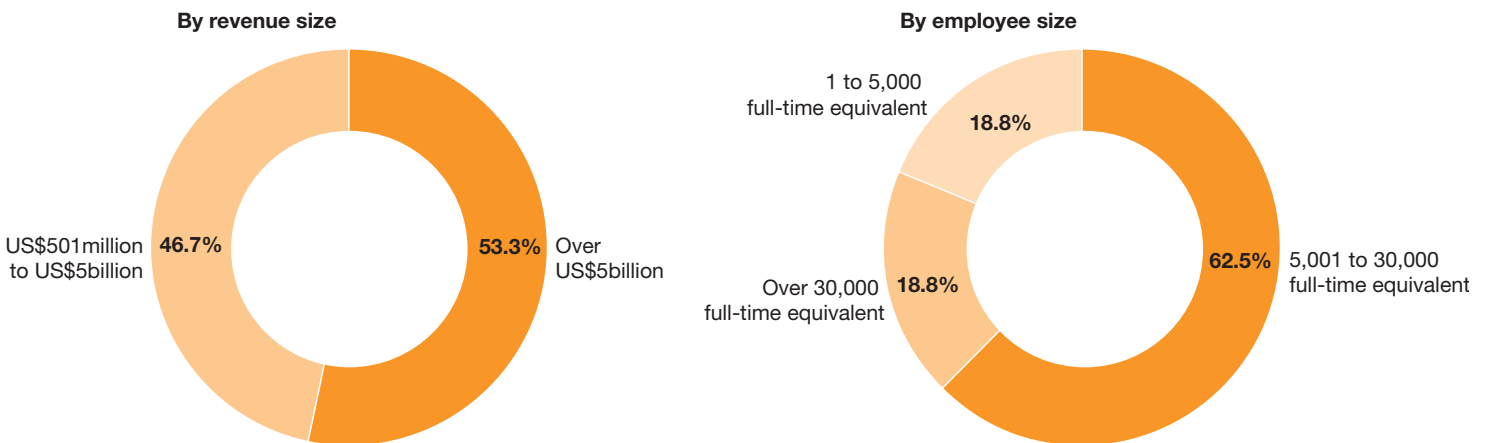


# Methodology

The survey, *Trends in Times of Uncertainty – 2005 Global Equity Incentives Survey*, was conducted between September and November 2004. Internet questionnaires were completed by 131 multinationals headquartered in 16 countries worldwide. Sixteen energy companies headquartered in five countries participated.

Our survey requested information on different types of equity plans, such as stock option plans, restricted stock/unit plans, employee stock purchase plans, and stock appreciation rights. We inquired about the design and administration of these plans throughout the world by asking more than 200 multiple-choice questions.

Figure 10: Participants



**Note:** Total % share of responses

**Source:** PricewaterhouseCoopers, *Trends in times of uncertainty, 2005*

The survey respondents profile ranged from Stock Plan Administrators to Compensation Rewards and Human Resources specialists.



## Participants by country

### Europe

Austria  
Belgium  
Denmark  
Finland  
France  
Germany  
Ireland  
Italy  
Netherlands  
Norway  
Spain  
Sweden  
Switzerland  
United Kingdom

### Asia-Pacific/Africa

Australia  
China  
Hong Kong  
India  
Japan  
Singapore  
South Africa  
South Korea  
Taiwan  
Thailand

### Americas

Canada  
Mexico  
United States

## Contents of the Report, *Trends in Times of Uncertainty – 2005 Global Equity Incentives Survey* include:

### Part I

Section 1: Organisation and Participant Information  
Section 2: General Information (Current Design Trends)  
Section 3: Accounting for Equity/Stock-Based Compensation  
Section 4: General Global Equity/Stock Plan Questions (Multinational Plans)  
Section 5: Equity/Stock-Based Compensation Compliance (Tax and Regulatory)  
Section 6: General Equity/Stock-Based Compensation Process (Administration)  
Section 7: Employee Communication

### Part II

Country-specific questions pertaining to equity-based compensation in the following countries:

- Australia
- Belgium
- Canada
- China
- France
- India
- Ireland
- Japan
- Netherlands
- Singapore
- South Africa
- South Korea
- Spain
- Switzerland
- Thailand
- United Kingdom
- United States

## To obtain the full report

To receive a copy of the complete report, *Trends in Times of Uncertainty – 2005 Global Equity Incentives Survey*, please contact:

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