DEVELOPMENT AND TRENDS IN COMPENSATING OFFICERS AND DIRECTORS OVER THE LAST YEAR

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Current Environment

ON THE SURFACE

New mood of caution and restraint . . .

- Concern for restoring public and employee trust
- Greater accountability and control in the hands of compensation committees and their advisors
- Investor groups and their representatives (ISS and Glass-Lewis) more influential
  - Exposing and ratcheting down practices outside the norm
  - Using the ballot box

Current Environment

BELOW THE SURFACE

Nothing close to true reform . . .

- Reliance on pay surveys continues as justification for high pay
- Inflated option "Black-Scholes" values are being converted to real money and embedded in competitive compensation
- Goal-setting is imprecise and prone to sandbagging, as evidenced by higher 2004 cash bonuses
- Little abatement in recruiting premiums for star talent, or excessive severance packages (most of which were set before SOX)
- Increased transparency of "total" compensation likely to exert future upward pressure

CONVERTING FROM OPTION TO FULL VALUE AWARDS

- 1,000 stock options @ $50 with Black-Scholes of 60%
- Cost/value(?) of $30,000 (1,000 X $50 X .6)
- Math conversion = 600 shares of restricted stock ($30,000 ÷ 50)
- But need discount for differences in perceived value, generally 25-35%
- So, instead of 1.67:1, do 2.25:1 (450 shares) or 2.5:1 (400 shares)
- Employees happier; cost reduced from $30,000 to $22,000 or $20,000

THE REALITY

5-year transition in executive compensation…

	1st Phase	***2nd Phase***
Period	2002-03	2004-06
Catalysts	Sarbanes-Oxley, stock exchange rules, institutional investor initiatives	New FASB rules, option-valuation refinements, political/labor pressure
Focus	Corporate governance	Program design
Impact	Board compensation committee process	Use of stock options

MOST VISIBLE FACTORS INFLUENCING LT PROGRAMS

1. *Exchange-based shareholder approval rules (2003)*

- NASDAQ and NYSE now require shareholder approval of equity compensation plans
  - Eliminates "broad-based" plan and treasury exemptions (i.e., plans approved by the board, but not shareholders)
  - Retains exemption for new hire grants and shares granted in lieu of cash (i.e., voluntary deferred compensation)
- Requires shareholder approval of material amendments to equity plans, including stock option repricings
- **Implications** – Balance of power dilution shifts to shareholders

MOST VISIBLE FACTORS INFLUENCING LT PROGRAMS

2. FASB accounting changes for equity-based compensation

- **<u>Implications</u>** – Financial inefficiency:
  1. Accounting cost exceeds perceived value
     - Worse at lower levels
  2. Possibility of incurring earnings charges for awards that deliver little or no value to employees

DESIGN ALTERNATIVES

	Effect of New Accounting Standard	
Appreciation Awards	**Negative**	**Positive**
Stock Options (Plain Vanilla)	↓	
Incentive Stock Options (ISOs)	↓	
"Reload" Stock Options	↓	
Employee Stock Purchase Plans (ESPPs)	↓	
Premium-Priced Options/SARs*	↓	
Cash-Settled SARs*	↓	
Stock-Settled SARs*		↑
Discount-Priced Options/SARs*		↑
Performance-Vesting Options/SARs*		↑
Price-Vesting Options/SARs*		↑
Full-Value Awards		
Performance Shares/Share Units		↑
Restricted Stock/Stock Units	neutral	
Other Awards		
LTI Cash (Performance Units)	neutral	
Grants with Dividend Equivalents		↑
Grants without Dividend Equivalents		↑

* SARs are adversely affected by new nonqualified deferred compensation legislation

MOST VISIBLE FACTORS INFLUENCING LT PROGRAMS

3. SEC proxy disclosure project

- Expect project for enhanced disclosure:
  - <u>Executives</u>
    - SERP Expense
    - Option Value
    - Aircraft Costs
    - Deferred Interest
    - Other
  - <u>Directors</u>
    - Tabular Disclosure

MOST VISIBLE FACTORS INFLUENCING LT PROGRAMS

4. Deferred Compensation Taxation

- **"Job Act" of 2004** – Implication on
  - SARS/Discount Options
  - Option/RSU Deferrals
  - Deferral Election Timing
  - Subsequent Elections
  - In-service Distributions
  - Accelerated Distributions
  - Post-termination Distributions
  - Deferral Funding
  - CIC Distributions

AREAS OF CONCERN TO MANAGEMENT

- How to reduce the "cost" of stock options and/or increase their perceived value?
- How to avoid or ameliorate a fixed expense for options that results in no gain to employees?
- How to maintain broad-based equity incentives (e.g., ESPPs) under an option-expensing environment?
- How to introduce performance-based vesting for options and restricted stock in a cost- and value-effective manner?
- How to introduce performance-based grant practices to reduce entitlement?

THE DATA

Competitive data used for illustrations . . .

- Comes from the F.W. Cook & Co. database
  - Generally, large-caps (i.e., Fortune 250)
  - But representative of broader public-company practice
- Values options based on the Binomial model and standard assumptions

Market Trends

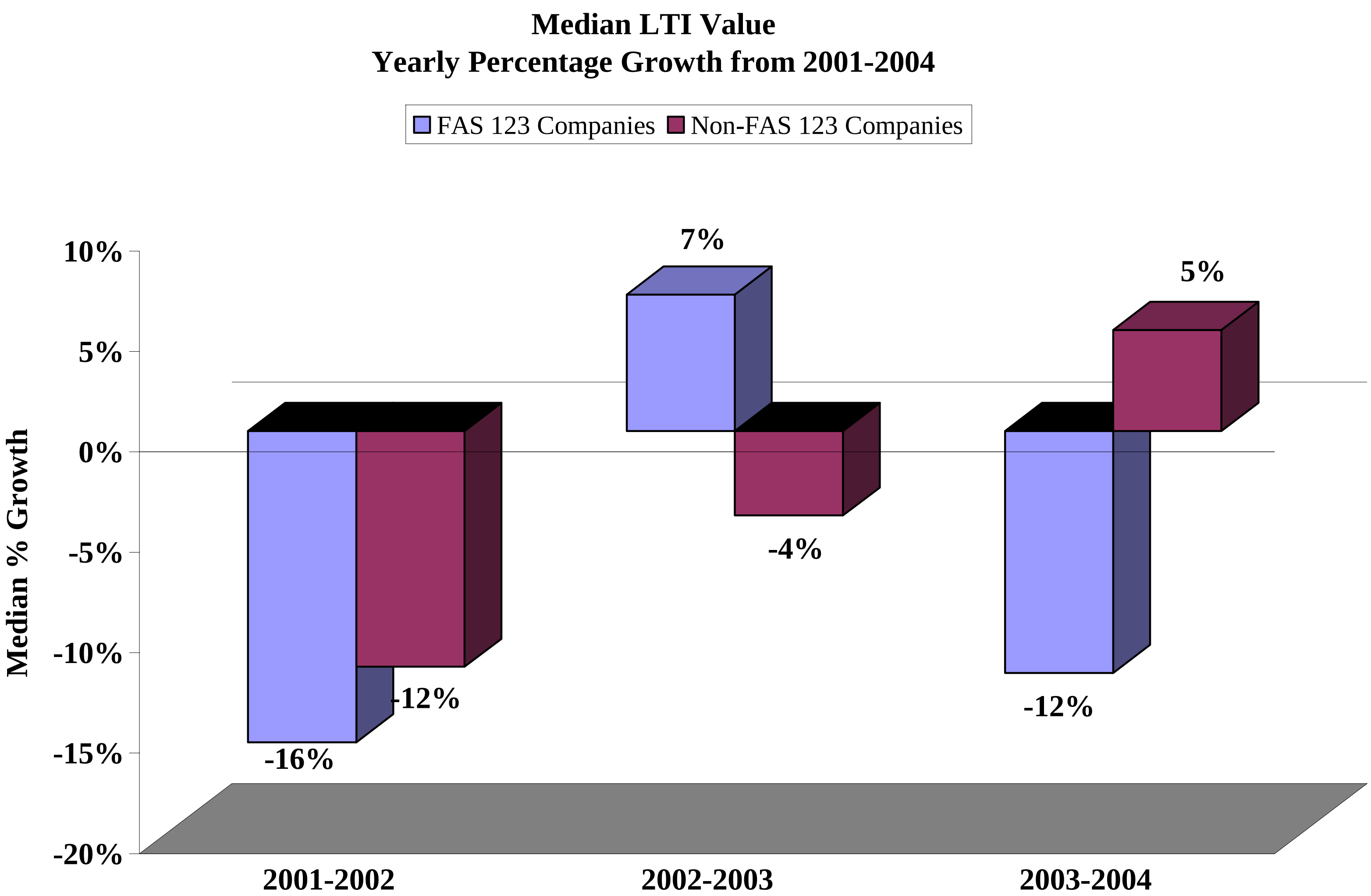
CASH COMPENSATION LEVELS

More stable than long-term grant values . . .

- Salaries moving with the average market at 3.5% to 4%
  - 3.6% vs. 3.5% last year
  - 3.9% at executive level; 3.4% for non-union hourly
- Upward movement in annual bonuses
  - Higher payouts for 2005 performance
  - Combination of improved performance over 2004 and achievable goals
  - Also, pressure to increase target awards and upside leverage

Market Trends

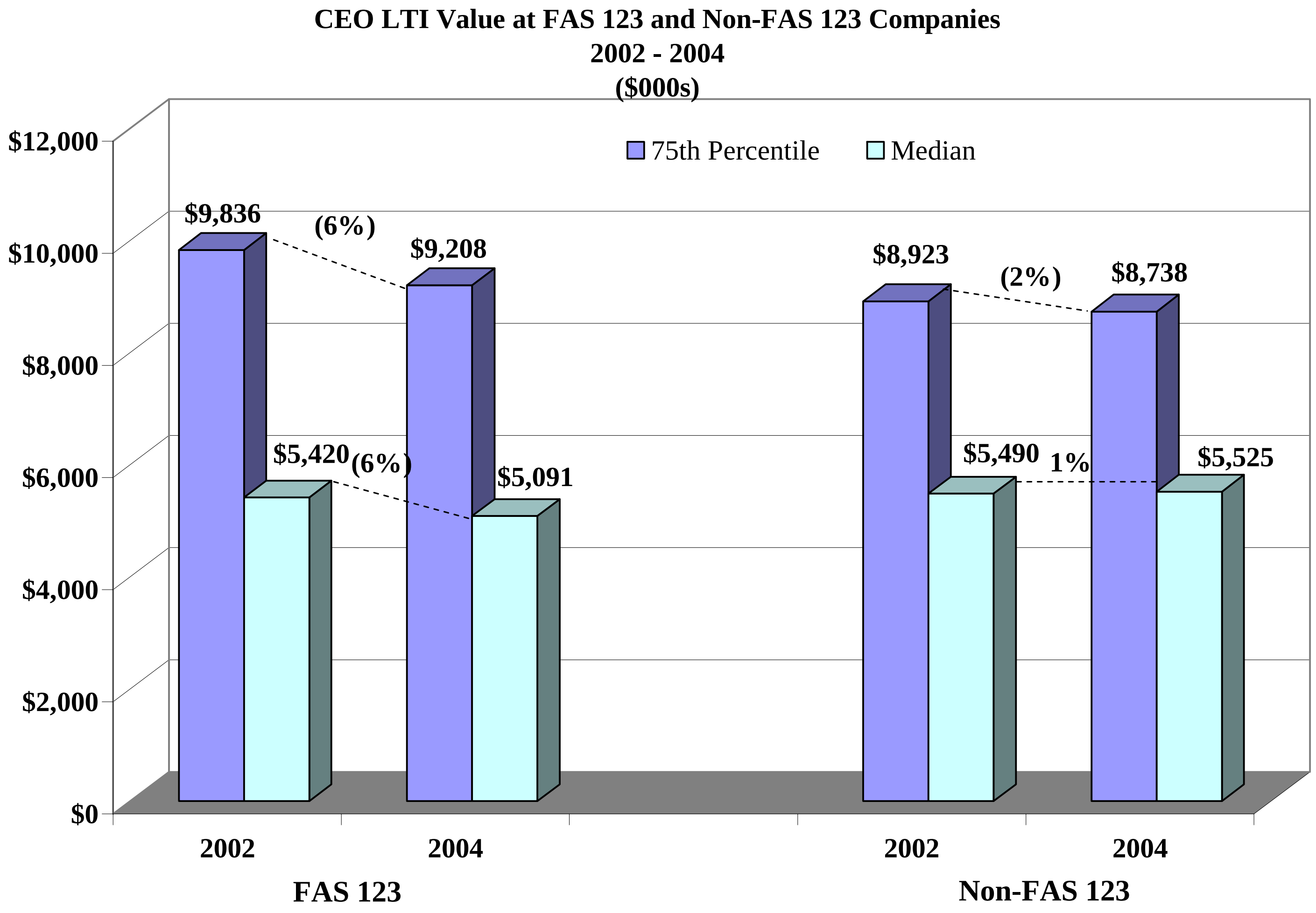
LONG-TERM GRANT VALUES



Market Trends

LONG-TERM GRANT VALUES

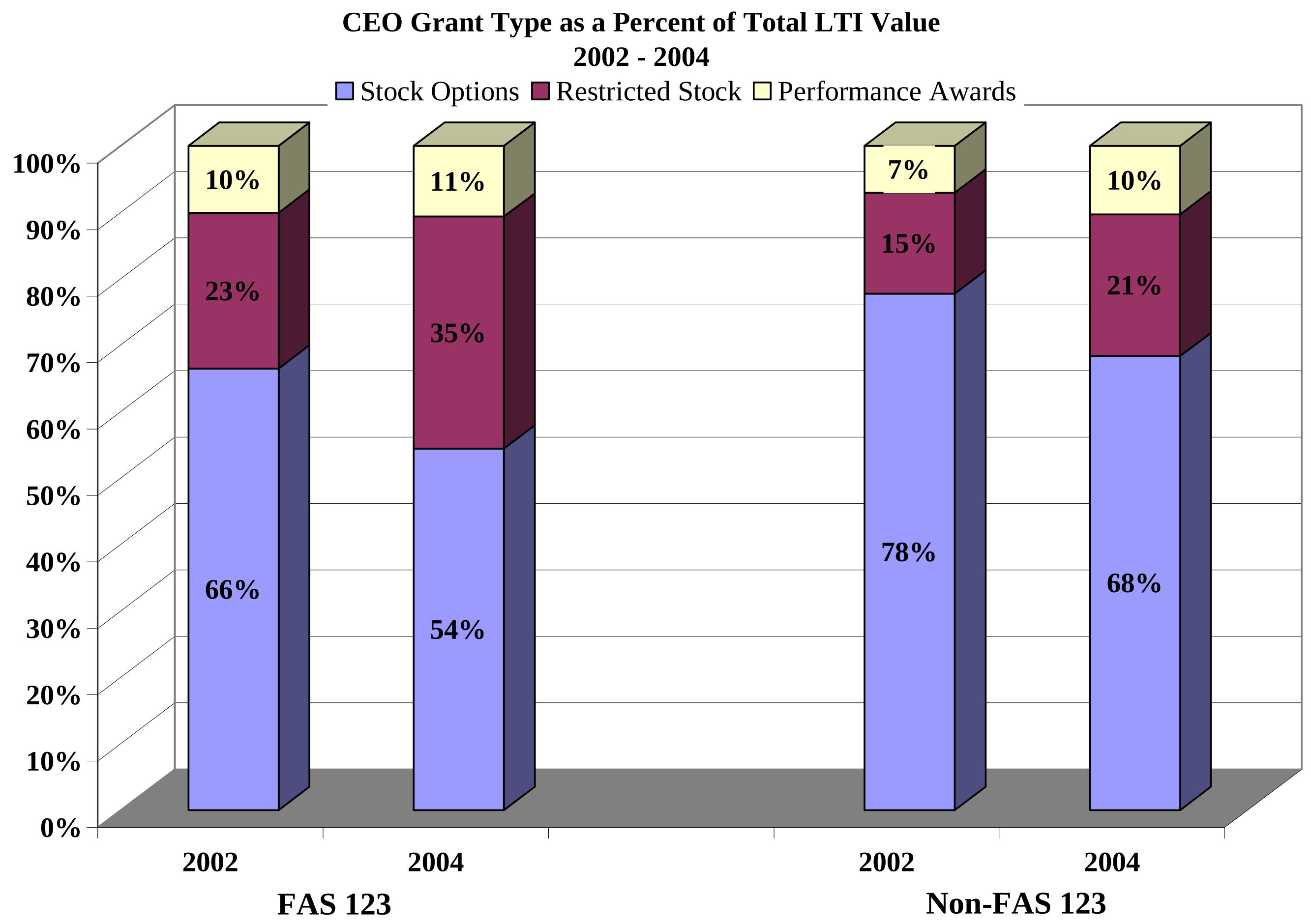
75th %ile has moved closer to the median . . .



Market Trends

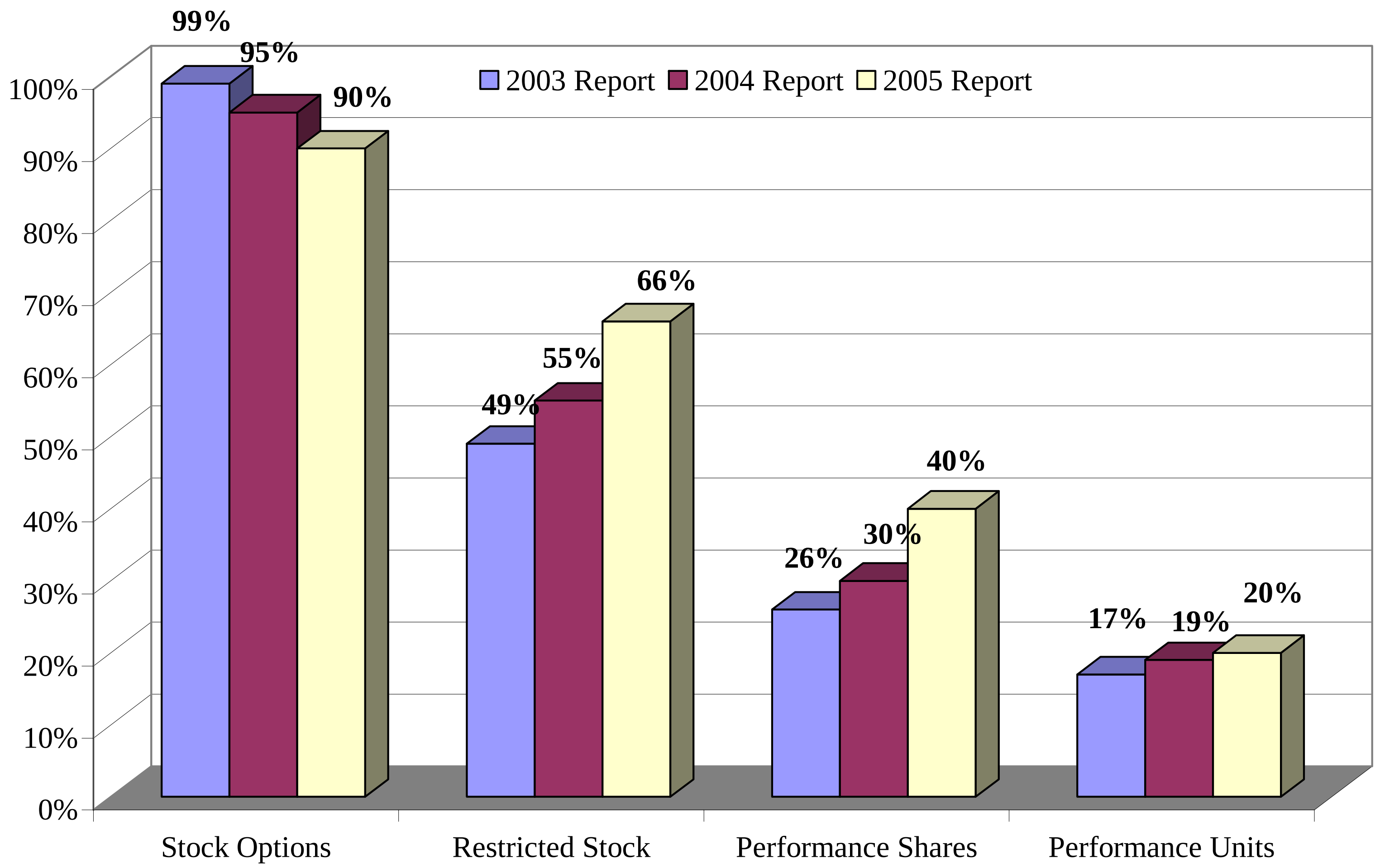
LONG-TERM MIX

Shift from options to full-value grants (i.e., restricted and performance stock/cash). . .

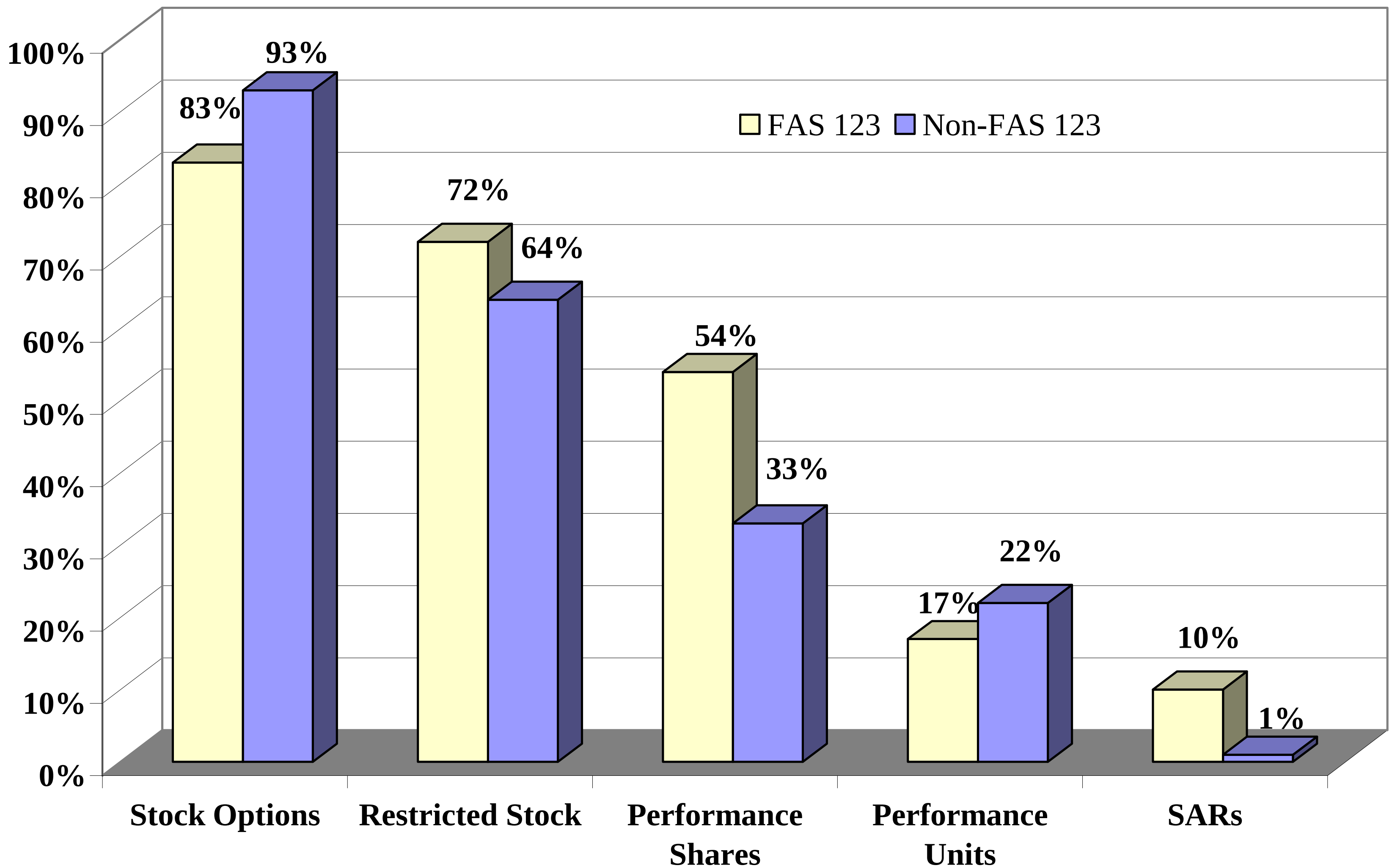


CHANGES IN LONG-TERM PRACTICES

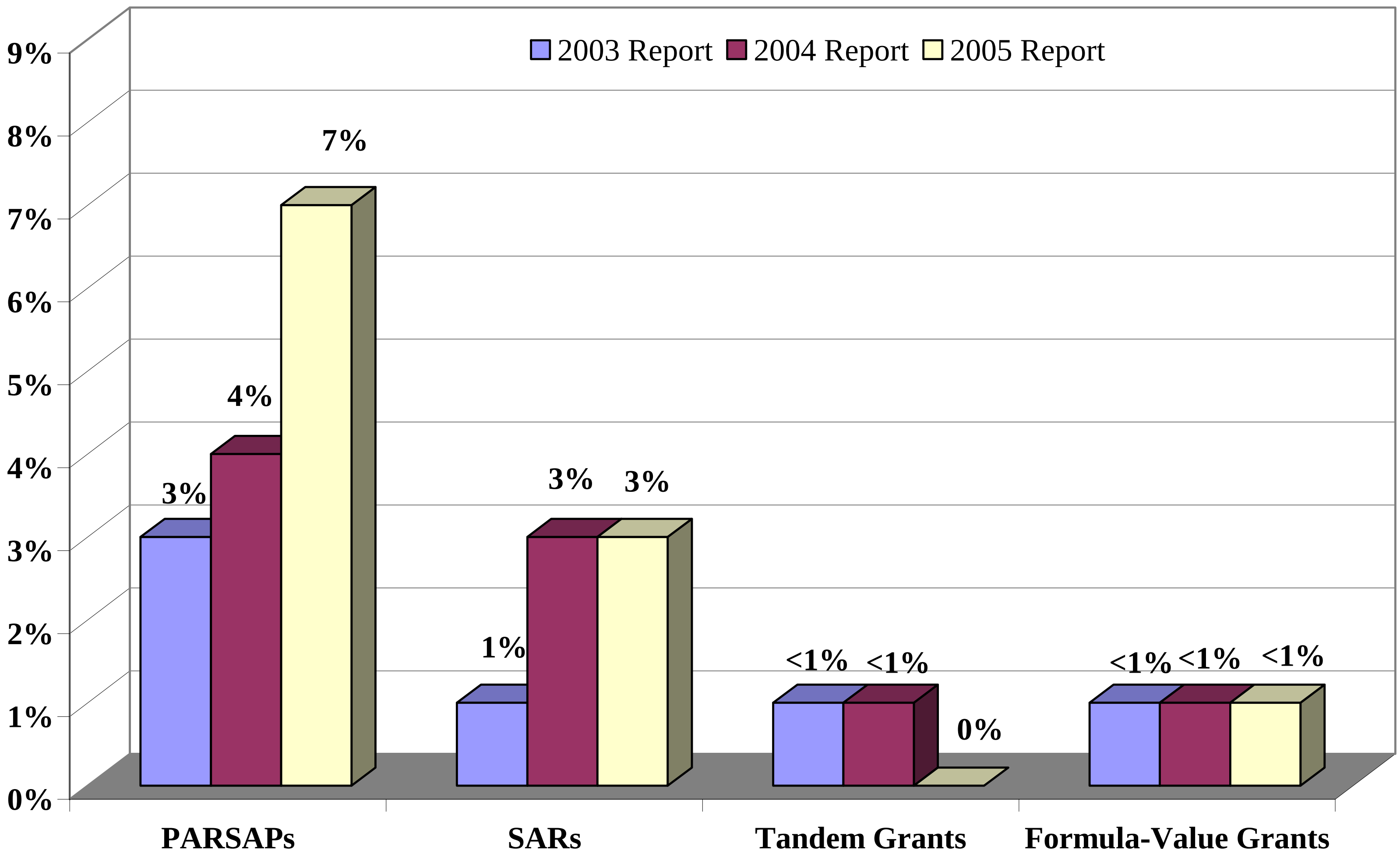
Executive Long-Term Incentive Grant Type Usage—Percent of Top 250 Companies



Grant Type Usage at FAS 123 Companies vs. Non-FAS Companies



Other Grant Type Variations – Percent of Top 250 Companies



HIGH-PROFILE CHANGES

Examples of how long-term incentive programs are evolving . . .

Company	*Recent Changes*
Exxon Mobil	Eliminated options, added restricted stock, continuing cash performance units
Hewlett-Packard	Reduced options, added cash performance units
General Electric	Eliminated options for CEO, replaced with performance shares; converted options to stock-based SARs for other executives
IBM	Eliminated plain-vanilla options and introduced premium-priced options (FMV + 10%) for top 300 senior executives; to receive and vest in FMV options, must buy and hold shares for 3 years
Microsoft	Eliminated options, added performance shares for top 600 executives and restricted stock for other employees

Market Trends

SHARE USAGE AND DILUTION

Look carefully beyond the numbers . . .

- "Run rates" and "overhang" as percentages of outstanding shares are no longer meaningful
  - Because of shift from options to full-value
- Decline in numbers of shares granted and outstanding does not mean lower grant value and expense
- Market value transfer (MVT) is a more relevant reference point
  - MVT measures grant value as a percent of company market-capitalization value
  - This is how ISS determines the reasonableness of share-pool authorization requests

MVT Analysis Detail

			2004
a	Options Granted		1,467,000
	Exchanged Options		-
	Net Options (a)		1,467,000
b	Wgt. Avg Ex. Price	$	16.51
c	Fair Value of Options Granted	$	11.06
d	Restricted/Performance Shares Granted		23,122
e	Fair/Grant Value per Share	$	17.26
	Fair Value - Grants		
f	Options (a*c)	$	16,227,514
g	Restricted/Performance Shares (d*e)	$	399,086
h	Performance Units	$	-
i	Total (f+g+h)	$	16,626,600
j	Weighted Avg. Grant Price ((f/i)*b)+(g/i)*e)	$	16.53
k	Wgt. Avg. Basic Shares O/S		23,951,000
l	Wgt. Avg. Market Capitalization (j*k)	$	395,862,179
m	**Market Value Transfer (i/l)**		**4.20%**

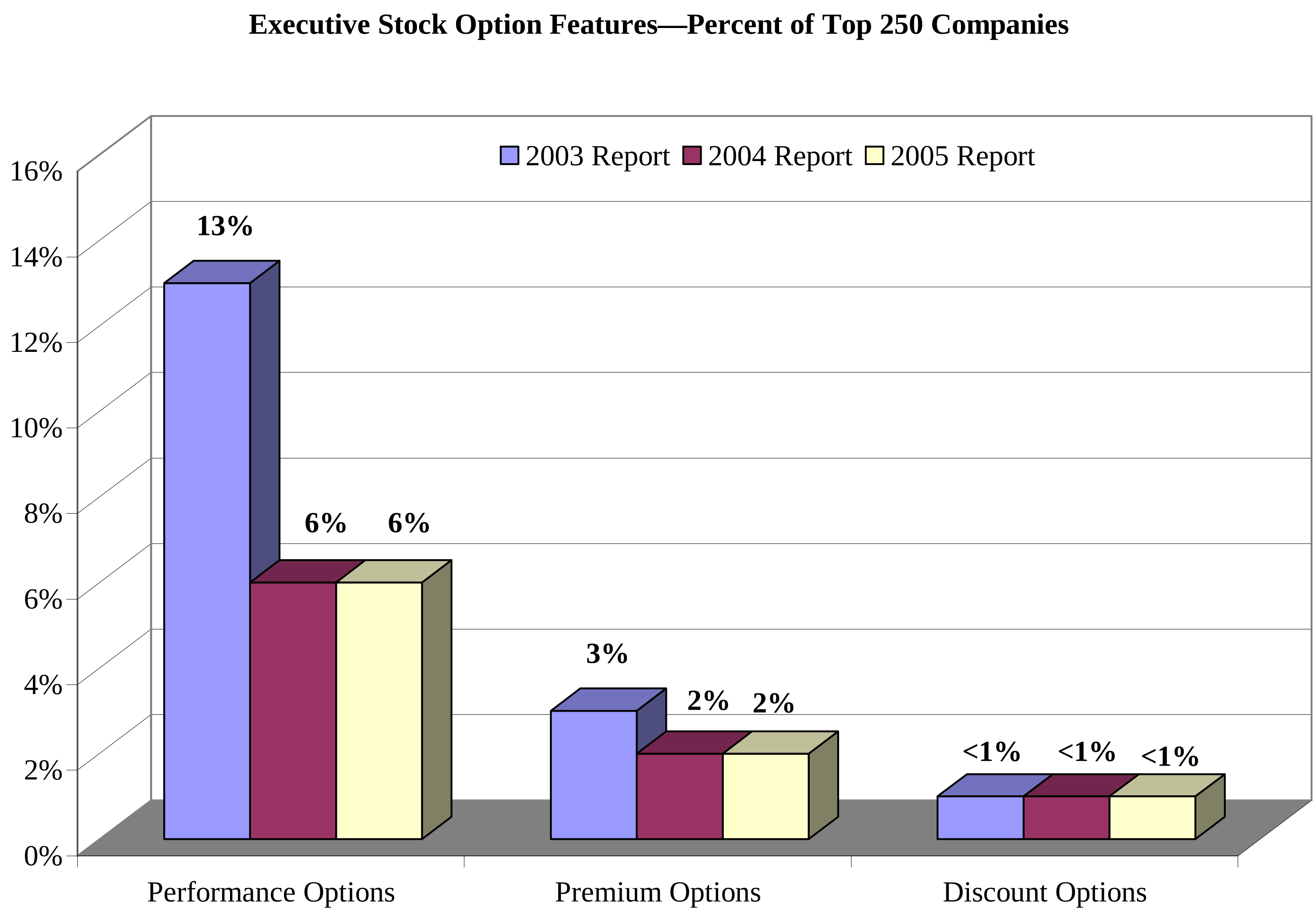
Market Trends

OPTION PROVISIONS

More talk than action so far in adapting to new accounting rules . . .

- Race to the bottom in valuations for expensing
- Some early design impact
  - Terms from 10 years to 7 years
  - Reloads disappearing
  - Less flexible post-employment vesting and exercise periods
- Interest in performance vesting, but no major examples
- Expected movement toward stock-based SARs in limbo
  - Okay with IRS but not ISS

Executive Stock Option Features – Percent of Top 250 Companies

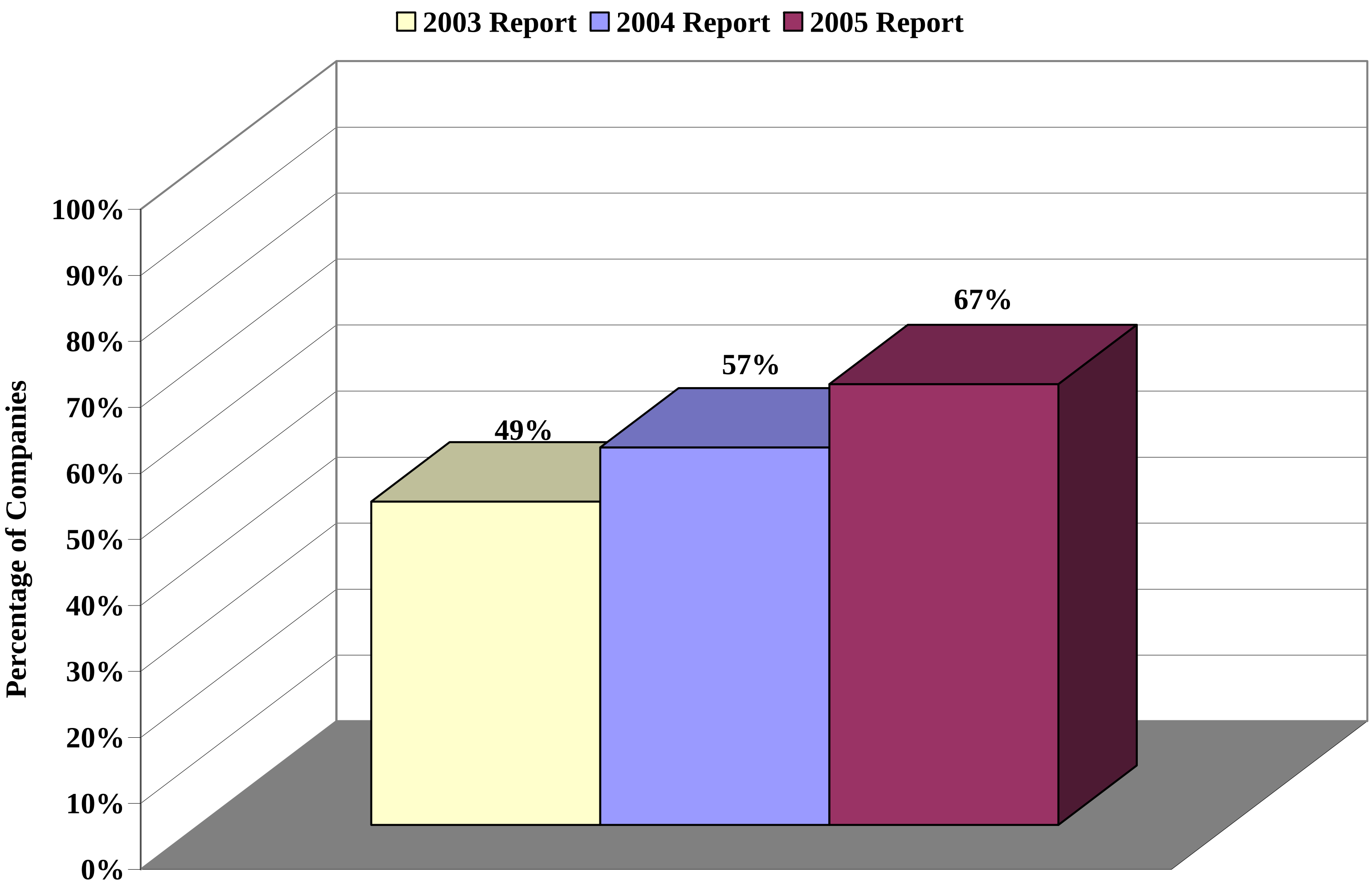


EXECUTIVE OWNERSHIP

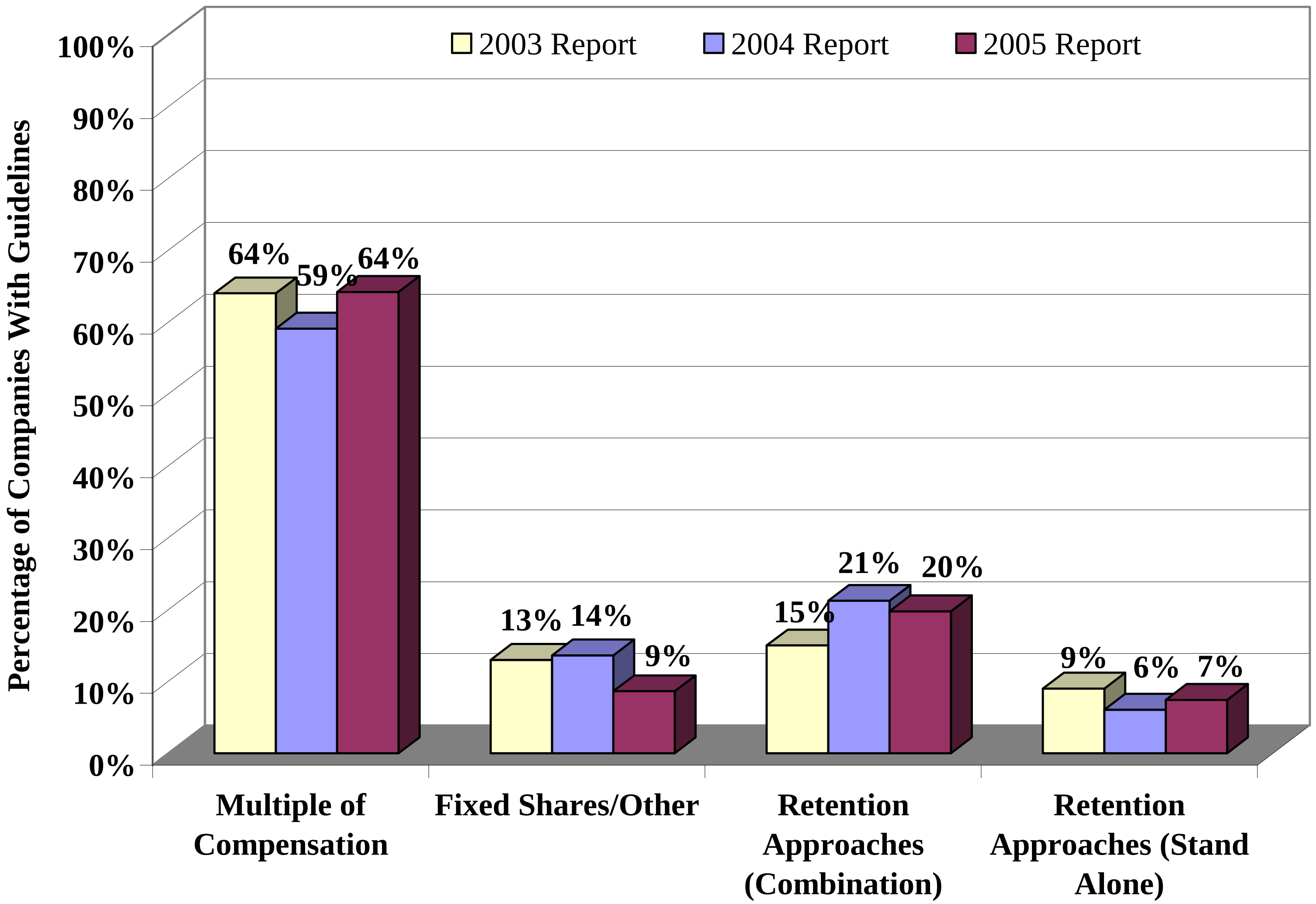
Pressure from shareholder groups is increasing prevalence and enforcement sanctions . . .

	"Best Practice"	***Reality***
Ownership Guidelines	Real ownership of specified salary multiple or number of shares; usually after 5 years	About 70% of large caps and increasing; fewer small caps and techs or West of the Mississippi
Retention Guidelines	Hold net shares from compensation program for at least 1 year (i.e., no run-up and flipping)	GE, Citicorp, Lilly and a couple of other early adopters; few followers

Prevalence of Executive Stock Ownership Guidelines



Types of Executive Stock Ownership Guidelines



MISCELLANEOUS

More time will be spent on . . .

- Setting goals for annual bonuses to better balance pay for performance and pay for results
- Valuing SERPs, above-market interest on deferred compensation, and severance arrangements
- Aligning outside directors' compensation with their current responsibilities and risks
  - And compensation committees again taking charge of directors' compensation, where it has moved to nominating/governance committees

TRY THIS APPROACH

	Alternative 1	*Alternative 2*	*Alternative 3*	*Alternative 4*
Senior Executives	Options – 50% Performance Shares/Cash – 50%	Options – 67% Restricted Stock – 33%	Options – 50% Performance Shares/ Cash – 50%	Performance Shares – 100%
Other LTI Participants	Options – 50% Performance Shares/ Cash or Restricted Stock – 50%	Options – 50% Restricted Stock – 50%	Performance Shares/Cash or Restricted Stock – 100%	Performance Shares or Restricted Stock – 100%

PAYING FOR PERFORMANCE

Key Principles

1. Limit non-variable components
   - Salary, perks
2. Emphasize variable elements
   - Payout and costs tied to results
3. Maintain accountability for failures
   - Avoid resets
4. Tie opportunity to operational and stock price results
5. Encourage executive ownership

Key Challenges

1. Discouraging "entitlement" mindset
2. Defining success
3. Selecting metrics
4. Setting target goals
   - Defining "reasonably achievable"
5. Ensuring affordability
6. Defining "market competitive"
7. Ensuring balance and durability
   - Financial vs. strategic goals
   - Mix of elements
8. Striving for perfection

SETTING GRANT GUIDELINES

A new approach for determining long-term grant size is necessary but controversial . . .

Old Method	*New Method*
Determine competitive individual grant values	Start with competitive aggregate grant value as a percent of company market cap
Convert to company shares (or cash)	Allocate to individuals based on competitive percent of total grant value
Add individual grants to determine total grants	

CONCLUSIONS

- Know the market environment and trends
- Look beyond the data
- Understand new and proposed regulations
- Listen to and anticipate shareholders
- Lead or follow

GLOSSARY

Appreciation Awards

Stock Options – Rights to purchase shares of company stock at a specified price over a stated period, usually 10 years or less; typically, the option price is 100 percent of market value at the time of grant, but can be more as in the case of premium stock options or less as in the case of discount stock options; may be granted in the form of tax-qualified incentive stock options (ISOs) or nonqualified stock options (NQSOs); variations of stock options include:

Reload Stock Options – (Sometimes referred to as "replacement" or "restoration" stock options) options that carry a feature under which new stock options are granted upon the stock-for-stock exercise of the original option; the reload option typically equals the number of shares tendered to exercise the original option, has an exercise price equal to the then-current fair market value of the company's stock, and is exercisable for the remaining term of the original option

Performance Stock Options – Options that have some aspect of their vesting subject to specified performance criteria; vesting can either be accelerated by or based solely on attainment of performance criteria

Premium Stock Options – Options that have an exercise price above market value at the time of grant

Discount Stock Options – Just the opposite of premium options, having an exercise price below market value at the time of grant

Indexed Stock Options – Options that have an exercise price that may fluctuate above or below market value at grant, depending on the company's stock price performance relative to a specified index or the movement of the index itself; indexed options differ from performance options in that the exercise price of indexed options typically remains variable until the option is exercised

Stock Appreciation Rights (SARs) – Rights to receive the increase since grant in the market price of company stock; actual payouts may be in stock or cash; variations of SARs include:

Tandem SARs – Rights to receive the gain on a stock option in lieu of exercising the option, with the exercise of one canceling the other

Freestanding SARs – Rights to receive the gain on a "phantom" stock option; freestanding SARs are granted independently from stock options and, therefore, the exercise of an option (if any) does not cancel the SAR

GLOSSARY

Full-Value Awards

Restricted Stock – Grants of actual shares of stock or stock units subject to restrictions and risk of forfeiture until vested solely by continued employment; typically, dividends or dividend rights are paid during the restriction period, either currently or credited and reinvested

Performance Shares – Grants of actual shares of stock or stock units whose payment is contingent on performance as measured against predetermined objectives over a multi-year period of time; same as restricted stock except that the shares are earned based on performance against objectives as well as continued employment; actual payouts may be in stock or cash

Performance Accelerated Restricted Stock Award Plans (PARSAPs) – Grants of restricted stock on which restrictions may lapse early based on performance as measured against predetermined objectives; if objectives are not realized, some or all restrictions lapse in time based solely on continued employment; also known as performance accelerated restricted stock (PARS) and time accelerated restricted stock award plans (TARSAPs)

Other Awards

Performance Units – Grants of cash allotments or dollar-denominated units whose payment or value is contingent on performance as measured against predetermined objectives over a multi-year period of time; unlike performance shares, the value paid does not fluctuate with stock price changes during the performance period; actual payouts may be in stock or cash

Dividend Rights – Rights to receive the equivalent of dividends paid on a specified number of company shares, and are usually granted in conjunction with other grant types, such as stock options or performance shares

FULL-VALUE LTI ALTERNATIVES

- In contrast to appreciation-only grant types (i.e., stock options and SARs), full-value grants have value at the time of grant that varies thereafter based on Company performance and/or subsequent changes in stock price
- Outlined below is a description of the various types of full-value awards that may be used as a substitute for or in conjunction with stock options

Time-Vested Restricted Stock

- Grants of actual shares of stock or stock units in which vesting is based solely on continued service
  - Restricted shares may cliff vest after a specified period of time (e.g., 100% after 4 years), or vest ratably over a specified period of time (e.g., 25% each year for 4 years)
- Under FAS 123R, the value of the restricted stock on grant date is charged to earnings over the vesting period
- Participants pay ordinary income tax on the actual value of the shares at vesting; the Company receives a tax deduction in the same amount at the same time[1]
- The Company has positive cash flow equal to the value of the tax deduction received upon vesting
- May be perceived negatively by shareholders as a "give-away" because of the absence of performance conditions on vesting

(1) Taxable income realized by executives who appear in the Company's proxy statement would not be deductible as performance-based compensation under Section 162(m) to the extent that, when combined with other non-performance-based pay (e.g., salary, taxable value of perquisites, etc.), it exceeds $1 million in any year

FULL-VALUE LTI ALTERNATIVES

Performance-Accelerated Restricted Stock

- Grants of actual shares of stock or stock units that cliff vest after a long period (e.g., after 7 years); however, vesting may be accelerated to an earlier date if predetermined performance goals are achieved
  - For example, if operating or net income goals are met annually, vesting of 20% of the award accelerates
  - If performance goals are not achieved, the unvested portion of the awards would be delayed until the service-based vesting date (i.e., the 7th anniversary of grant)
- Under Opinion 25, these awards have the advantage of preserving fixed grant date accounting treatment while incorporating performance conditions, but under FAS 123R, these awards are treated identically to traditional time-vested restricted stock (see above) and performance shares (see below)
- The participants pay ordinary income tax on the actual value of the shares at vesting; the Company receives a tax deduction in the same amount at the same time[(2)]
- Upon vesting, the Company has positive cash flow equal to the value of the tax deduction received

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(2) Taxable income realized by executives who appear in the Company's proxy statement would not be deductible as performance-based compensation under Section 162(m) to the extent that, when combined with other non-performance-based pay (e.g., salary, taxable value of perquisites, etc.), it exceeds $1 million in any year

FULL-VALUE LTI ALTERNATIVES

Performance Shares

- Grants of actual shares of stock or stock units, the same as restricted stock, but with vesting based on both continued service and the achievement of predetermined performance goals
  - Payouts vary based on changes in stock price and level of goal achievement
  - If the employee terminates prior to the end of the cycle or threshold performance objectives are missed, there is no gain to the employee (or cost to the Company)
- Performance goals are typically financial/operational targets set at the beginning of a multi-year performance period, but could relate to strategic objectives
  - Goals can be derived from the Company's long-term business plan or can be based on a fixed growth rate
    - Generally, the number of goals should be limited to no more than 2 or 3, since multiple goals tend to dilute focus and create complexity
- Participants are granted a target number of shares or share units at the beginning of the performance cycle
  - Shorter cycles, e.g., 12 to 24 months, are becoming more prevalent, reflecting the difficulties of setting long-term goals, with payment made in restricted stock subject to vesting based on continued service
- The number of shares earned at the end of the cycle may be higher or lower than target based on actual performance

FULL-VALUE LTI ALTERNATIVES

Performance Shares

- Payout is usually in shares but may be in cash, with an opportunity to defer to a future date (at participant's election) if in the form of share units
- Under FAS 123R, the market value on the date of grant of the performance shares ultimately earned is charged to earnings over the performance cycle (i.e., expense is not affected by share price variability during the performance cycle like under APB 25), assuming awards are delivered in shares
  - Performance shares are a better vehicle than time-vested restricted stock or performance-accelerated restricted stock under FAS 123R, because they receive fixed accounting treatment but are completely performance-contingent (i.e., costs are calibrated with Company performance)
  - Note that if payment is in cash, cost under FAS 123R is variable and equals the amount actually distributed to the participant (as opposed to the value of the shares at grant)
- Participants pay ordinary income tax on the actual value of the shares at payout; the Company receives a tax deduction in the same amount at the same time(3)
- Payment in shares creates positive cash flow equal to the tax deduction received, but creates shareholder dilution
- Payment in cash creates a cash flow cost equal to the earn-out minus the value of the tax deduction, but avoids shareholder dilution

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(3) Note that since the program is completely performance-based, there is no risk of lost deductions under Section 162(m) (assuming the plan is administered properly). This is another benefit relative to restricted stock and performance-accelerated restricted stock

FULL-VALUE LTI ALTERNATIVES

Performance Units

- Grants of cash or dollar-denominated units in which the payout is based on the achievement of predetermined performance goals, the same as described above for performance shares
  - The amount of the payout is <u>not</u> influenced by changes in stock price, although the earn-out may be delivered in either cash or shares (with opportunity to defer payout to a future date at participant's election)
- The number or value of the units earned at the end of the cycle may be higher or lower based on actual performance
- The estimated value of the payout is accrued quarterly over the performance cycle and trued-up at the end of the cycle
- Participants pay ordinary income tax on the actual value of the units at payout; the Company receives a tax deduction in the same amount at the same time(4)
- Payment in shares creates positive cash flow equal to the tax deduction received, but creates shareholder dilution
- Payment in cash creates a cash flow cost equal to the earn-out minus the value of the tax deduction, but avoids shareholder dilution

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(4) Note that since the program is completely performance-based, there is no risk of lost deductions under Section 162(m) (assuming the plan is administered properly)

FULL-VALUE LTI ALTERNATIVES

Summary of Characteristics

- A summary comparison of "plain vanilla" stock options versus the full-value LTI alternatives on seven important characteristics is contained in the table shown below

	"Plain Vanilla" Stock Options	***Time-Based Restricted Stock***	***Performance-Accelerated Restricted Stock***	***Performance Shares***	***PerformanceUnits***
Positive Shareholder Optics	Low, due to perceived absence of performance goals and lack of downside risk	Lowest, due to absence of performance goals and receipt of value even if price drops	Moderate, but less than Performance Shares or Units	High	High
Risk/Reward "Leverage"	High	Low	Low	Moderate	Low
Increased Focus on Operational Performance	Low	Low	Moderate	High	High
Linkage to Ownership Objectives	Moderate	High	High	Moderate/High	Low, unless paid in shares
Accounting Cost – FAS 123 Relative to Opinion 25	Higher	Same	Same	Lower, if paid in stock and price increases	Same
Potential Share Dilution Relative to Options	N/A	Lower	Lower	Lower	Lower
Absolute Share Dilution Relative to Options	N/A	Higher	Higher	Indeterminable	Indeterminable

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