WHERE THE RUBBER MEETS THE ROAD

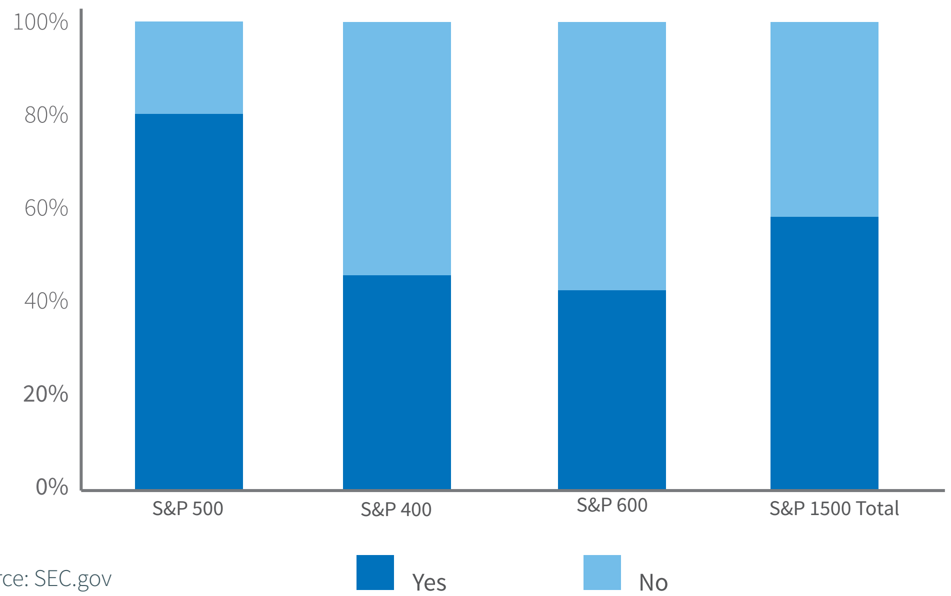
How Energy Companies Conduct Shareholder Engagement Today

An active effort to communicate with the voting decision-makers at major shareholders is now effectively the standard for most mid-to-large-cap energy companies, based on a review of proxy statement disclosures from the 81 energy companies comprising the S&P 1500 Energy Index in 2017.

Energy companies face unique challenges in the proxy voting space relative to the rest of the issuer community. Over the last five years, energy companies have faced more volatility than other industries based on their exposure to global commodity prices, leading to market-lagging performance in certain periods that has led to more scrutiny in the context of executive pay. Further, energy companies naturally face more risks in the environmental and social realm, and tend to draw an outsized count of shareholder proposals from investors seeking to improve both ESG disclosure and practices. Hence, it's clear that these companies have responded by proactively approaching the investment community and generating a dialogue.

Figure 1 shows that in 2017 a full 80% of the 30 S&P 500 energy constituents conducted an active shareholder engagement program and tout it in their proxy statements. Further, even in the small-cap (S&P 600) space, nearly 40% of companies are following the best practices of their large-cap brethren.

Figure 1: 2017 S&P 1500 Energy Companies – Disclose Shareholder Engagement Program?



Source: SEC.gov

The nature of this outreach program varies from company to company, but most issuers seek to reach out to offer an opportunity for communication with company reps to at least a majority of shares outstanding, often encompassing the top 25-50 institutional holders. Unlike ongoing investor relations communication, the response rate from voting decision-makers at investors is generally lower, but issuers that provide such details report actual engagements (meetings or calls) with between 30-50% of shares outstanding (Figure 2).

Figure 2: S&P 1500 Energy Companies – Disclosed Outreach Programs Investor Coverage

	Outreach to Issuers		Interactions with Holders	
Index	# Issuers	Avg % S/O Covered	# Issuers	Avg % S/O Covered
S&P 500	9	57%	8	38%
S&P 400	5	68%	4	53%
S&P 600	6	54%	4	30%
S&P 1500 Total	**20**	**59%**	**16**	**40%**

Source: SEC.gov

Many companies, such as Apache Corp (Figure 3) and Chesapeake Energy, describe a year-round shareholder engagement program, with two or more periods of outreach per year involving two-way communication with company representatives and occasionally directors. Refiner Andeavor (formerly Tesoro) goes as far as a letter from the lead independent director to each holder with >0.5% of shares outstanding, with a personal invitation to engage

Figure 3 – Apache Corp. Shareholder Engagement Program Summary

2016 → 2017

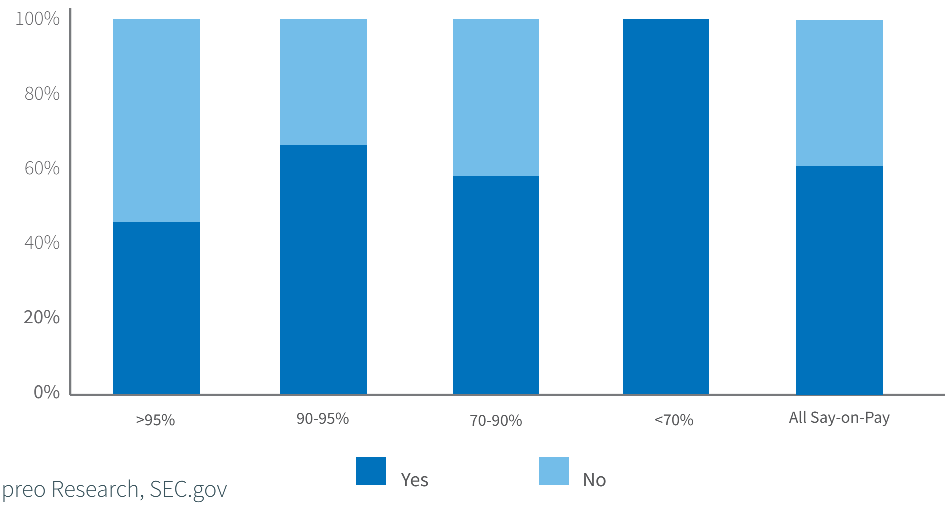
1. **May to July** – Review and summarize feedback from annual meeting and identify potential areas of concern
2. **August to October** – Meet with shareholders and consider issues raised
3. **November to January** – Continue to meet with shareholders, modify meeting content based on early feedback, and identify any other areas of concern
4. **February to April** – Complete shareholder meetings, meet internally to review feedback received and consider modification of governance policies and compensation plans

Source: Apache Corp., 2017 proxy statement

SAY-ON-PAY AND SHAREHOLDER ENGAGEMENT

It should be noted that for many of the companies reviewed, shareholder outreach is less of an option than a near necessity. Companies either failing their say-on-pay votes, or falling short of a minimum threshold (typically 70% for ISS and 75% for Glass Lewis), are obligated to communicate with shareholders regarding their compensation packages or risk an automatic "no" from the proxy advisor in the following year. Of the small-cap S&P 600 universe, 11 of 28 (39%) of issuers disclose an active shareholder engagement program – but of the 11 disclosing, 4 were communicating in response to say-on-pay results of under 70% support in the year prior (Bill Barrett, Cloud Peak, Noble Corp, and Archrock), while just two disclosers reached out in support of a compensation program that received over 95% support in 2016. Figure 4 shows the distribution of outreach programs relative to their corresponding prior-year say-on-pay votes.

Figure 4 – 2017 S&P 1500 Energy - Shareholder Engagement Program Disclosure by 2016 SOP Vote



Source: Ipreo Research, SEC.gov

TOPICS AND PREPARATION

While the issuers cited above with say-on-pay concerns tend to focus their discussions by involving HR and compensation professionals (and often the chairperson of the compensation committee), most issuers not under immediate concerns will conduct broader discussions – generally preparing for the engagement by providing the investor with an agenda and proactively mentioning specific areas where more color may add to the investor's understanding. Issuers will often cite these topics directly in the proxy statement – Figure 5 covers the range of topics for which issuers have sought investor feedback (most issuers mention multiple topics). Note the heavy focus on compensation in the small-cap range, while larger / more visible companies are likely to seek details on the company's environmental and social disclosures.

Figure 5– 2017 S&P 1500 Energy – Topics Discussed in Shareholder Engagement

Index	General Governance Policies	Board Composition	Compensation	Succession Planning	Environmental/Social Issues	Proxy Access	Strategy/ Capital Allocation
S&P 500	8	1	17	2	5	2	3
S&P 400	3	4	6	-	2	-	1
S&P 600	1	-	5	-	-	-	-
S&P 1500 Total	**12**	**4**	**4**	**4**	**4**	**4**	**4**

Source: SEC.gov

Many companies will specifically cite changes made based on shareholder feedback. As the proxy access concept has spread over the last several years, many energy companies specifically highlight enacting this shareholder-friendly regime; other companies mention enacting majority vote standards, declassifying the board, or other governance changes. However, the vast majority of changes disclosed center in the compensation area, with energy companies mentioning changing the nature of discretionary compensation, redefining incentive plan targets, or creating new clawback plans that protect shareholders from executive fraud.

WHAT TO DO NEXT?

To put it bluntly – in any sector, not just energy – if you're not engaging with shareholders, you're in the minority. The two mega-trends facing the investment community make this dialogue even more of a requirement. Passive investment continues to expand rapidly as a share of overall investment, with many issuers seeing passive holders as 25% or more of the shareholder base – these investors are passive when it comes to investment decisions, but active when it comes to voting decisions. Further – the increased attention on investment stewardship from asset owners (such as state and municipal pension plans) means an ever-increasing portion of the shareholder base is either making active voting decisions themselves, or outsourcing voting to a manager with a more active voting policy.

In this environment, companies that proactively engage with investors have a distinct advantage, potentially insulating themselves against future "surprise" votes while making a strong statement to the company's owners about their commitment to best practices.

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