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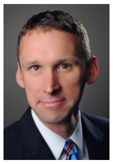

SHOULD BONUS OUTCOMES BE DIFFERENT BY LEVEL?

Insights into whether there should be different standards for executive bonuses than for the broader population, and whether executives shouldbe held to a higher standard of accountability to shareholders.

Posted by Chris Havey on September 19, 2014

In our experience, a large number of oil & gas companies provide the same bonus funding level for all bonus-eligible employees in the organization. There may be differentiation based on individual or business unit performance (horizontal differentiation) but no differentiation based on the level (vertical differentiation).

This approach helps establish an inclusive culture – everybody is in this together. However, there are a few recent changes that may impact this approach, including the following:

- Say on Pay—Greater pressure for holding executives to a higher standard of accountability.
- Greater emphasis on variable pay for the broader population to manage costs—Variable pay has almost become a performance-based salary replacement.
- Greater weighting on LTI for executives—This is particularly true in oil & gas, with its long-term investment horizons. This de-emphasizes the role of annual incentives in the executive compensation package.
- Retention concerns for key technical roles in the oil & gas industry—Consistently strong bonus payouts may help retain top performers.

With these trends, should there be different standards for executive bonuses than for the broader population? Should executives be held to a higher standard of accountability to shareholders?

For the broader population, the bonus might be structured similar to a traditional “profit sharing” program with individual differentiation. Profits (or other organization-wide metrics) fund the pool and the strong individuals or groups receive a greater portion of that funding than average or poor performing individuals or groups. This requires effective performance management processes and managers that can make tough decisions around individual differentiation.

For the executive team, the board should focus more on properly aligning the long-term incentive program than how the annual incentive is funded. LTI comprises over 50% of targeted pay for many organizations in the oil & gas industry. In companies that perform well, LTI provides the performance leverage and wealth accumulation opportunity.

The biggest concern we’ve observed in disconnecting executives from the broader population is having one group win while the other loses – specifically, a higher bonus for executives. Companies can incorporate “checks” into the bonus program to avoid this potential issue. For example, the board can apply discretion to lower executive bonuses if funding is higher than the broader population.

Vertically differentiating the bonus program may help address issues around Say on Pay and retention. Determining whether vertical differentiation is right for your organization requires an assessment of the company’s culture, but building some “checks” into the program may help alleviate certain concerns.

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