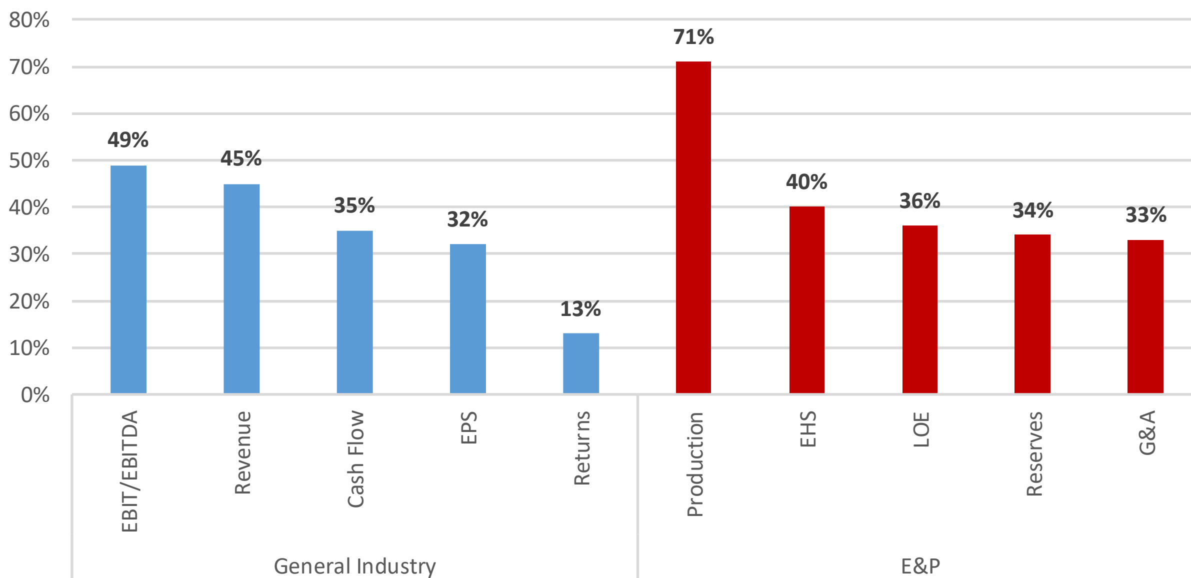
## *Post #61: Predicting the Future of E&P Bonus Design*

***From Jon Szabo, Partner, Dallas, Texas***

The current oil and gas market challenges are testing the efficacy of prevailing bonus plan structures among exploration and production (E&P) companies. E&P bonus plans have historically aligned with growth and investment, focusing on volume (production and reserves) and cost reduction, measures that are more controllable by management and less impacted by commodity prices than earnings-based metrics.

In recent years, investors and analysts have been increasingly critical of E&P bonus payout misalignment with shareholder returns and financial performance in a lower commodity price environment. In response, E&P companies began adding "returns" and capital efficiency metrics to their bonus plans. These metrics were added to what were already full scorecards, often with five or more quantitative metrics plus an individual or discretionary component. With that many metrics, some payout is bound to be generated, and, despite the market downturn that began several years ago, E&P bonuses remained strong. But until very recently, competition for petro-technical talent has been fierce, and strong bonus outcomes certainly help attract and retain talent.

Contrast that with the broader marketplace, and you will find bonus plans much more focused on one or two (less commonly three) performance metrics, often heavily weighted towards earnings. An example is the oilfield services sector, where bonuses are commonly weighted towards EBITDA and cash flow, and payouts fluctuate more with the ups and downs of the industry.



To be clear, this blog is not advocating for homogenizing bonus plans with the broader general industry. But instead it is intended to highlight an opportunity that E&P companies have to rethink, and possibly reconstruct, their bonus plans to better align with the new realities of the E&P industry that will likely require greater focus on efficiencies and returns (or self-sufficiency) than on growth and investment. So what might a 2021 E&P bonus plans look like in order to be more aligned with the new industry realities?

We could see bonus plan metrics culled to two or three, directly linked to the viability of their business, with a stronger tie to near-term profits and cash affordability. Emphasis on production may continue to fade, particularly given the supply/demand imbalance currently disrupting the industry. Expense metrics may be less compelling given dramatic cuts recently taken. The current environment may force E&P companies to focus on generating cash returns and using their balance sheet to create free cash flow. This will likely take precedent as we enter 2021, along with the continued importance of environmental and safety.

***A View Into the Future of E&P Bonus Plans?***

| Feature | Historical Approach | Future Approach? |
|---|---|---|
| **Performance Focus** | Long-term growth/investment | Near-term profitability/cash flow |
| **Complexity** | High: five or more quantitative and qualitative measures | Low(er): two or three critical measures |
| **Key Metrics** | Volume (production), investment (reserves), and cost control | EBITDA, cash flow, debt reduction, capital efficiency, ESG |

Compensation Committees should challenge their thinking relative to current bonus plan designs over the next six months. With retention less of an issue at the moment, Committees may feel liberated to consider more dramatic change. And even if design changes are not made, the thought process will be healthy.

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