Post #69: E&P Short-Term Incentive Design Reflects Changing Priorities

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In early March, two of my colleagues published their forecast of executive compensation trends we would see in this year's oil and gas industry proxy filings. Among the expectations shared was that disclosed annual incentive plan metrics would reflect a shift in priorities among exploration and production companies. In light of changing industry dynamics, we expected to see movement away from volume metrics, and toward cash flow generation and an increased emphasis on environmental impact. Our review of 2021 E&P industry proxy filings bears this prediction out, showing some dramatic shifts in short-term incentive focus over the past three years.

How has the business model changed?

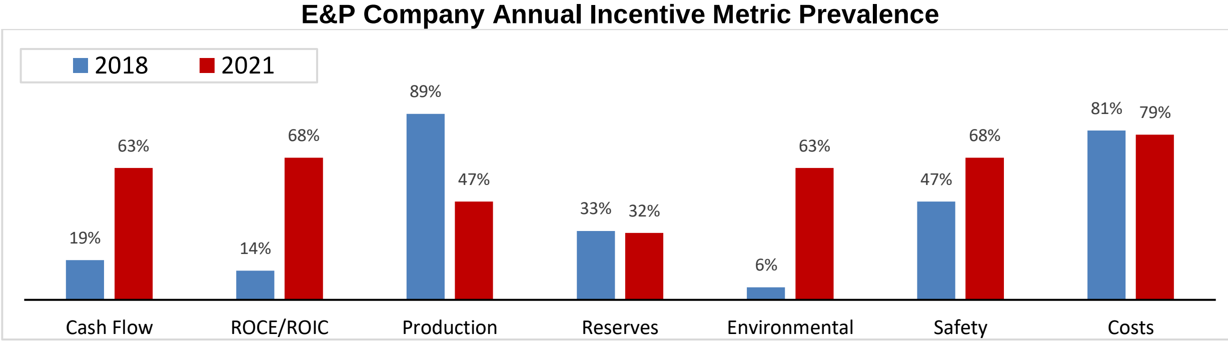
The much-maligned compensation model within the exploration and production industry evolved over many years of rising commodity prices, to align pay with a business model that valued long-term growth over current financial returns. Pay programs focused on operational measures within management's control and correlated with increasing shareholder returns, with limits on potential windfalls based on short-term commodity price variation. As a result, bonus plans prioritized production and reserve growth, safe operations, and cost control.

A sustained lower commodity price environment and investor sentiment that has shifted toward greater interest in sustainability and energy transition have changed the game, at least for now. While safe and efficient operations remain important, the ability to generate positive near-term capital returns, distribute capital back to shareholders, and reduce environmental impact have replaced debt-adjusted volume growth as key measures of success in the industry. Our experience, and our latest proxy research, indicate that annual incentive plans are adapting to fit this new reality.

What changes have we seen in bonus plan design?

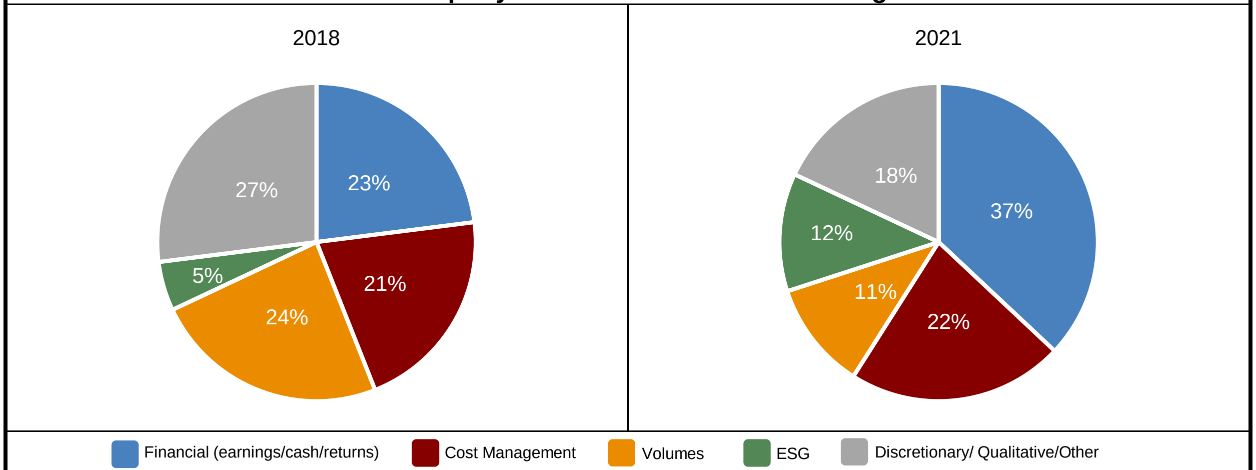
To test out our predictions, we compared publicly-disclosed plan design data for E&P companies with more than $2.5B in market cap in our 2018 (n=36) and 2021 (n=19) databases. What we found, while not surprising, indicated some significant changes.

E&P Company Annual Incentive Metric Prevalence



Cash flow, financial returns, and environmental stewardship are ascendant, while safe and efficient operations remain critical and volume goals have become less of a focus.

E&P Company Annual Incentive Metric Weights



The average E&P annual incentive plan is increasingly quantitative, with more than 50% of payout based on cost management, cash flow and financial returns

- **Volume measures have declined in prevalence and weight:** in 2018 filings, production was the single most common performance metric, and volumes made up nearly 25% of annual incentive determination on average. In 2021 proxies, fewer than half of the larger E&P companies in our sample included production as a performance metric.
- **Cash flow and returns are now more prevalent than production among larger E&Ps:** 60% of the largest E&P companies in our 2021 data set have a cash flow or financial return metric in their annual incentive plan. Including earnings metrics like EBITDA, 90% have at least one measure that is directly exposed to commodity price, as compared to 70% in 2018.
- **Discrete environmental metrics are significantly more common:** environmental metrics are not a new concept for E&P companies. However, they have historically been lumped in with broader strategic or health and safety goals and have been more focused on avoiding spills or major environmental incidents. In our 2021 sample, 63% of companies now have at least one discrete environmental performance goal, with increasing focus on climate and sustainability (GHG emissions, flaring, water recycling, etc.).

What to expect next

Changing performance metrics were just one development we have been tracking in 2021 proxy filings, along with lower overall bonus payouts for 2020 performance, reductions in long-term incentive values, changes to long-term incentive plan design, and deliberate reductions in overall levels of executive pay for some companies. While it may be too soon to say whether recent pay level changes reflect a durable trend, we expect changes to incentive plan design to be more lasting.

- Cash flow generation, financial returns, and capital discipline will remain a primary focus.
- Volume measures will remain common but less heavily-weighted, with emphasis on maintenance of a reasonable level of activity as opposed to growth.
- Environmental goals will continue to increase in prevalence and specificity as companies improve their tracking and reporting capabilities and gather more feedback from their shareholders about which measures of sustainability are most important.

It is important to note as well that our commentary is based upon proxy disclosures, only some of which provided insight regarding 2021 program design. Based upon our experience, the extent of change this year is, if anything, understated by our statistics. Please keep watching here for more insights.