Post #41: Effective Use of Discretion in Annual Incentives

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Going into 2015, annual incentive goal-setting was challenging for oil & gas companies, to say the least. E&P companies were wrestling with lowering production, where production *growth* is traditionally a cornerstone E&P bonus metric. Services and drilling companies were experiencing lower utilization rates and revenue squeeze as E&P's fought to reduce expenses. The price of oil was volatile and plummeting. While we generally expected lower payouts on average relative to historical levels, we also knew that some companies across the various energy sectors had relatively strong financial and operational performance despite significantly depressed stock prices, setting up further challenges in determining appropriate payouts.

Nearing the end of this year's "proxy season," we have observed a variety of bonus payout outcomes, and means of determining the payouts, from 2015 performance. For example, across a sample of 32 publicly-traded large E&P companies, we found that 50% applied negative discretion or subjective assessment (e.g., through an "individual performance" component) to reduce annual incentive payouts from the formulaic outcome. While formulaic outcomes averaged above-target based on achievement versus established goals, discretionary adjustments reduced the payouts, on average, to target levels:

E&P Sample (N = 32)	Median	Average
STI Goal-Based Outcome (% of Target)	131%	128%
Discretionary/Subjective Adjustment	-14%	-18%
Ultimate STI Payout (% of Target)	100%	99%

Across a sample of 15 prominent public oilfield services and drillers, 40% applied negative discretion or subjective adjustment to reduce median payouts from 100% of target based on formulaic outcomes to 75% of target after discretionary assessment:

Oilfield Services/Drillers Sample (N=15)	Median	Average
STI Goal-Based Outcome (% of Target)	100%	86%
Discretionary/Subjective Adjustment	-10%	-10%
Ultimate STI Payout (% of Target)	75%	73%

A few noteworthy examples to illustrate this across the broader energy industry include:

- Rowan Cos., which limited the discretionary strategic objectives component to target, despite exceeding these objectives, resulting in the total payout of 152.5% of target.
- Atwood Oceanics, where quantitative performance achievement for its CEO would have earned 151.5% of target, but the Compensation Committee reduced payouts to 107% of target for non-formulaic outcomes such as poor TSR and erosion of backlog.
- Comstock Resources would have earned a 124% of target payout based on performance achievement, but decided to pay a zero bonus due to the difficult industry conditions.

This all reinforces the importance of compensation committees maintaining some degree of subjectivity or discretion in determining bonus payouts, especially during volatile commodity cycles. While often unpopular among proxy advisors and institutional shareholders, discretion provides the ability to evaluate the year and use judgment to adjust payouts accordingly. *Negative* discretion or subjective reduction is generally supported by shareholders and proxy advisors, and has effectively been used by compensation committees across the energy industry to help align rewards with the shareholder experience of the past year.