



Post #58: How should oil & gas companies approach their 2020 annual bonus?

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“Wait and see” seems to be the mantra of the day, particularly when it comes to an energy company’s annual bonus plan. We think that’s a prudent approach for the moment, as much uncertainty remains among the energy industry and broader economy.

However, as we think forward a few months, what alternatives might companies consider for the annual bonus? And what expectations might companies want to set in the near term?

Situations will vary significantly by company, but here are a few initial thoughts.

Developing an Approach

We suggest that an energy company consider the following questions before it commits to a 2020 bonus strategy:

- Does the original business plan and its performance targets remain credible?
- Might a bonus (in any amount) remain affordable at year end?
- What bonus compensation action will best align with investor expectations?
- What company statement best sets employee expectations about how their performance might contribute to a bonus payment at year end?

No doubt shareholders will expect a lower (or perhaps no) bonus pool at most energy companies this year. Concerns about employee retention and engagement likely hold less weight than in the past given the widespread headcount reductions across the industry. When considering potential alternatives, it might be helpful to draft the potential CD&A disclosure early in the process to refine the rationale for whatever approach a company takes for the remainder of the year. Considerations will vary based on the unique facts and circumstances specific to any individual company, and we may see the bonus approach play out differently between the various sectors of the energy industry.

For E&P Companies:

E&P companies typically have a scorecard of metrics used, along with a subjective component. The original bonus scorecard will likely have a mix of strong scores and weak scores at this point. The Committee will likely want to evaluate whether the original scorecard and resulting scores are still relevant in the current environment.

- Some companies may wish to reset their metrics based on their changing priorities and the new business plan; sending signals about the importance of driving cost reductions and free cash flow to ensure continued viability.

- Others may wish to leave the scorecard as-is or eliminate the scorecard entirely; instead sending signals through company actions and communications, rather than the bonus scorecard.

Whether or not a company resets their scorecard, we think a subjective assessment will likely be the determining factor at the end of the year for most E&P companies. Affordability and alignment with stakeholders (e.g., shareholders, employees) will govern the final outcome. Managing employee expectations will be important in the coming months; we have already seen examples of E&P companies communicating expectations for no or reduced bonuses. Communication strategy is critical for E&P companies given the history of relatively strong bonus payouts even as the market softened in recent years.

For Non-E&P Companies:

Bonus programs in the oilfield services, downstream, and other energy sectors typically have a heavier weighting on earnings goals. In many cases, participants already perceive their 2020 goals as unachievable and a low or no bonus as likely. In these cases, companies may consider potential strategies to adopt some incentive for the remainder of the year (albeit payout opportunities would likely be below target). Potential strategies might include:

- Remove the threshold (allowing the slope to continue to zero) to provide an opportunity for a small bonus;
- Split the bonus year into two parts if the second half of the year looks promising; for the second half bonus, a company might also reduce the prorated bonus opportunity or apply an upside limiter (e.g., capped at target or less) to mitigate the potential for a second half windfall;
- Carve out a small portion (20-30%) of the bonus for important non-financial metrics (e.g., safety, environmental) or metrics focused on liquidity and preserving cash, if these are not already part of the ongoing program; or
- Provide a small discretionary bonus pool at the end of the year for high performing individuals or those who took on significant additional responsibilities, likely excluding officers.

The Stakeholder Perspective

Ultimately, the Committee's discretion will play an important role in all of these circumstances. We think the Board's actions will likely be evaluated from a stakeholder perspective - were the 2020 bonus outcomes aligned with the experiences of shareholders, employees, customers, and suppliers? These will be important considerations in the Board's subjective assessment at the end of the year.

The next step for most companies will be determining whether to reset the bonus program, and how to establish parameters or expectations for the 2020 bonus outcomes. We've already seen examples of companies communicating (internally and externally) their expectations and expect to see more doing that over the coming months.

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