

Energy Insights



EXERCISE OF DISCRETION IN INCENTIVE PLANS: GOOD, BAD OR UGLY

The Question of How to Appropriately Exercise Discretion is Becoming More and More Difficult for Firms

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As shareholders and proxy advisors increase their focus on pay for performance, the questions of whether and how to exercise discretion in compensation programs have become more important and much more difficult to answer. For energy companies in particular the ground continues to shift. Companies have been moving a lot over the last few years from fully discretionary to formulaic programs back to somewhere in the middle.

Once a Committee has gone through the difficult processes of assessing performance metrics for alignment with strategy and shareholder experience and testing performance levels for appropriate stretch, the temptation is to step back and let the plan automatically drive the payouts. Unfortunately, this is no longer the right answer and Committees need to be actively engaged in assessing final payouts.

While proxy advisors prefer that discretion only be exercised to decrease incentive payouts, sophisticated shareholders expect the Committee to exercise business judgment to ensure that payouts are appropriate given the performance of the business, an exercise that can make both the Committee and management nervous. Every company should develop a process that fits their business needs and culture. The following guidelines can be tailored to work for your organization and may help alleviate anxiety and provide a good basis for proxy disclosure:

- Start the process with clear metrics and defined payout curves as the foundation for the incentive program
- Distinguish between the exercise of discretion and adjustments to GAAP measures—where possible, adjustments from GAAP measures should be specified in advance, at least on a principled basis, rather than considered once the year's results are finalized
- Establish a framework for the exercise of discretion
 - Consider a maximum adjustment upwards and downwards from the plan results, e.g. the Committee has discretion to increase or decrease payouts by a maximum of 20%
 - Specify, in advance, the factors the Committee will take into account in exercising its discretion, such as total shareholder return, achievement of strategic milestones, performance relative to commodity price, environmental and safety performance
- Review progress against performance targets and discuss issues, conditions and performance that may result in an exercise of discretion at Committee meetings throughout the year, so there are no surprises for management or Committee members.
- Apply discretion on a principled basis and consistently year over year
- Avoid using discretion to provide payouts in a year when performance is poor—where retention is a concern, use an express retention vehicle.

An appropriate exercise of discretion should be easy to explain to shareholders and management and should achieve a balance between management's efforts and accomplishments and shareholder experience.