Preparing pay plans for what's next

In a 'lower for longer' price environment, such as in the energy industry's upstream sector, boards face key issues.

BY STEPHEN CHARLEBOIS AND ANDREW PLATT

The oil environment over the past 18 months has raised a stiff challenge to energy-company compensation committees. In 2015, typical industry pay plans that were neatly crafted to reward executives for increased production and exploration paid off when executives delivered on their promises. But the payoff was often misaligned with share price performance, which fell dramatically across the industry.

This situation raises the question as to how compensation committees should respond when commodity-price-driven bottom-line performance doesn't deliver to investors in the same degree as it does to executives.

In the Short-Term . . . With the future of oil prices still unknown and potential that the market reverses course, resist drastic changes to incentive plan design. Instead, look to adjust weightings in the annual incentive plan to match the company's current strategy. For example, if the company is limiting new exploration and focusing on maximizing current opportunities, lower the weighting on reserve additions and encourage more efficient capital spending. If commodity prices stay low, you may also want to add goals tied to debt reduction, such as debt-to-capital ratio or interest expense per barrel.

At the same time, be wary of focusing on efficiency metrics, like the cost of reserve additions per barrel. Moving the strategic focus of the company towards lean production and cost-effective reserve additions is an appropriate response in a low price environment, but efficiency metrics are subject to awkward distortions when measured on a one-year basis. Measuring reserve additions against capital spent in a given year ignores the issue that reserves are often a result of several years of capital investment — reserves added this year are likely the result of capital invested in prior years.

We don't recommend removing efficiency metrics from the annual plan, of course. But rewards in the annual plan will pay out more fairly if you balance operational metrics, like capital spending, with shareholder-centric metrics, like return on capital employed. You can also monitor efficiency metrics outside the pay plan over several years and use the findings to inform the committee's year-end decisions.

In the Long-Term . . . Fine-tuning of this kind, and the downward discretion as used by a large number of committees in 2015, may not be enough to adequately align pay with longer-term operating and share price performance.

In a "lower for longer" price environment, boards face key issues related to prioritizing resources, trimming costs, and operating as either 'generalists' (e.g. integrated oil companies) or 'specialists' (e.g., E&Ps with a focus on unconventional or regional plays). Key discussion questions going forward include:

1. Structural Shifts in Pay: Does the shift from 'generalist' to 'specialist' operator, exacerbated by the down market, require a structural decrease in pay levels for the industry? Pay levels would reflect the more focused, smaller, and less complex nature of the businesses.

2. More Explicit Focus on Profitability: Cost interventions in the industry often yield only short-term benefits (costs begin to escalate 12-24 months after a cost reset); does the industry as a whole need to look at profitability-related metrics becoming a more prominent component of annual pay?

3. Alignment of Succession Planning and Pay with Industry Trends: With the recent uptick in industry layoffs, the supply and demand equation for talent has shifted. Compounded by an aging workforce, committee members need to ask: Do our current succession plans and accompanying retirement practices give us a competitive advantage in a market where later-career hires with key skills have become the norm?

4. Greater Customization within Long-Term Performance Plans: If the current price environment persists, companies and committees will need to revisit both the level and structure of equity awards. Areas of focus should be: (i) Can we continue to dilute our shareholders at historical levels given the high level of equity financing, and the cuts or potential cuts to dividends? and (ii) Upstream has historically focused on TSR as the prominent or only measure of performance. As capital employed continues to grow, and after-tax profits fall, is now the time for the industry to reconsider a more diversified approach?

What's important is to avoid changing the rules of the game wholesale in this first year. Keep pay plan elements stable in the short-term — this will motivate executives to leverage those things that drive profit, and will avoid a narrative to the market or proxy advisors that the pay program is being manipulated towards higher payouts. However, difficult longer-term questions remain within the industry when pay programs continue to pay out at or above target while companies are losing billions of dollars, and shareholders have experienced multiple years of losses. ■

Stephen Charlebois is a senior consultant and **Andrew Platt** is a senior associate with executive compensation consulting firm Semler Brossy (www.semlerbrossy.com). Semler Brossy's Michael Haimson also contributed to this article.