Pearl Meyer

ADVISOR BLOG

An Emerging Trend for the Energy Industry in 2020: Applying Discretion to Short-Term Incentives May Be More Common

AUTHOR

Malcolm Adkins
Vice President

The economic impacts of the global pandemic, combined with the steep decline in oil prices, presents an exceptional business environment, even for oil and gas. While we see some unexpected stabilization, companies in many industries continue to struggle with deep declines in earnings, employment levels, and equity value. One current concern for compensation committees and management is how to administer short-term incentive plans this year, when in many cases, performance levels fall below threshold performance standards set before the impacts of the pandemic where evident.

Upon initial reflection, one may conclude that below-target or zero incentive payouts for poor 2020 performance are appropriate, given performance outcomes. After all, this is how incentive plans are designed to operate—pay levels commensurate with performance. A "play it where it lies" approach is on its face the most straightforward and defensible position to take.

However, in most cases the pandemic is likely a major—if not *the* major—factor in producing financial results that are below expectations. If that is in fact the case, does it make sense to "punish" employees for results that are significantly outside of what anyone thought possible at the beginning of this year? Incentive plans in this industry are already usually designed in a way that accounts for the significant impact of commodity prices on results, which have little or nothing to do with employee performance. Does the pandemic effect warrant additional discretion due to its particularly unforeseen nature?

As counter-intuitive as it may seem, there is a meaningful level of turnover right now, especially at the corporate level, whereby qualified professionals and managers with transferable skillsets are leaving the oil and gas industry for similar positions in more attractive (i.e., less volatile) industries. Will a zero or below-target bonus contribute to this turnover momentum and become a source of competitive disadvantage when economic conditions improve? In addition to appearing punitive to those without fault, the real dollar costs and upheaval that turnover brings should be weighted in your decision.

Let's consider our latest intelligence with respect to marketplace trends. The central tendency is to not change performance measures or standards for the 2020 performance year, or to have created modified performance measures and standards for the second half of the year. However, we are seeing a clear willingness among boards to consider applying discretion to 2020 awards.

Pearl Meyer conducted a recent survey to answer questions many of our clients are asking, the most urgent of which are what level of bonus (if any) are companies expecting to pay out, how has the COVID-19/oil price combination decline impacted the plan, and will discretion be applied to the payout? We received responses from over 35 oil and gas companies, and found that around half surveyed are strongly considering using discretion, with the exception of the segments under significant cash constraints, such as drilling. This may provide some market precedent for your company to at least consider using discretion for this year's short-term incentive plan payout determinations.

If your company decides to consider exercising discretion, we suggest that committees develop a framework in advance of any decisions. This framework should include agreed-upon positions and any information necessary for the committee to make an informed decision. Some questions to discuss:

- Can the company quantify some/all material impacts to the incentive goals from the pandemic?
- What other goals and financial/operational/strategic inputs should be considered?
- What does "good" performance look like?
- How should the company report progress to the committee during the year?
- Can the company afford a payout, how much can it afford, and what has been accrued to date?
- Who participates in the short-term incentive plan and how would payouts look for executives relative to other employees?
- What are some strategic objectives that could be considered, even with COVID, and how well can we measure success?

While Pearl Meyer does not consider guidance from governance groups such as ISS and Glass-Lewis to be a prescription for how companies design incentive plans, we do recommend that compensation committees remain mindful of potential reactions from these groups. As we monitor guidance issued from these groups, we find that ISS generally wants to see contemporaneous disclosures of changes to bonus plans, rather than waiting for the 2021 proxy, and Glass-Lewis issued a peremptory warning that executive compensation should not be protected at the expense of employees and shareholders. Further, while not an endorsement of using discretion, ISS recently published four case studies that suggest some range of flexibility in determining 2020 short-term incentive payouts.

Finally, now may be an ideal time to begin considering design changes for the 2021 short-term incentive plan. Our discussions with clients indicate that companies are considering a wide range of alternatives, such as quarterly measurement periods, relative performance measures, introduction of more operational measures to supplement earnings or cash flow measures, and formal ESG measures.

About the Author

Malcolm Adkins has over 10 years of compensation consulting experience, including four years with Pearl Meyer in the Houston office. Prior to joining Pearl Meyer, he served as a compensation consultant at Aon Hewitt and Longnecker and Associates. Over the course of his career, Malcolm has developed broad experience consulting to senior management and boards of directors on a variety of compensation and governance related matters.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in Atlanta, Baltimore, Boston, Charlotte, Chicago, Houston, London, Los Angeles, New York, Raleigh, and San Jose.

Pearl Meyer

ATLANTA
(770) 261-4080
atlanta@pearlmeyer.com

BALTIMORE
(410) 494-4100
baltimore@pearlmeyer.com

BOSTON
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
(713) 568-2200
houston@pearlmeyer.com

LONDON
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
(213) 438-6500
losangeles@pearlmeyer.com

NEW YORK
(212) 644-2300
newyork@pearlmeyer.com

RALEIGH
(919) 644-6962
raleigh@pearlmeyer.com

SAN JOSE
(669) 800-5074
sanjose@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.