Post #76: Implications of the New Pay vs. Performance Disclosure Rule on Oil & Gas Companies: Company-Selected Performance Metrics

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On August 25, 2022, the Securities Exchange Commission (SEC) adopted a final rule on the mandated pay-versus-performance (PVP) disclosure, which will be required for most companies' 2023 proxy statements. As you may recall, this new rule came out of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

In summary, this new rule will require the disclosure of an additional proxy compensation table ("PVP table") and supporting narrative, aimed at illustrating the relationship between what the SEC refers to as "Compensation Actually Paid" (CAP) and company performance. For more information about the specifics of the rule, please refer to our recent Client Update and webinar. While most of the disclosure is prescribed, the SEC does leave room for companies to make choices in certain key areas. This update is intended to focus on two areas where companies have a choice with the disclosure of certain metrics, and how oil & gas companies might respond.

Identification of Company-Selected Performance Metric

The rule mandates the PVP table disclose company performance in the following three areas:

1. Cumulative total shareholder return (TSR) for the company,
2. Peer group cumulative TSR, and
3. Net income.

In addition, the rule requires the PVP table to include a company-selected financial metric. This financial metric must be the "most important" financial measure that links CAP to company performance and can be any GAAP measure, any measure derived wholly or in part from a GAAP measure, stock price or TSR.

So what measure should oil & gas companies use? The obvious place to start is by reviewing the list of performance metrics already included within the company's executive incentive plans and disclosed in the CD&A; however, it is important to note that the company-selected metric must differ from the three aforementioned metrics required by the SEC. For context, the table below includes frequently reported incentive plan metrics disclosed in companies' 2022 proxy statements as researched by Meridian. *Note: Not all of these would qualify as a "financial" metric for purpose of determining the company-selected metric.*

	E&P	**Midstream**	**Oil Field Services**
Short-Term Incentive Plan	Free Cash Flow Capital/Other Costs Production Growth Return on Capital Environment/Safety	EBITDA Distributable Cash Flow G&A Costs	EBITDA Cash Flow Return on Assets/Capital
Long-Term Incentive Plan	Relative TSR Absolute TSR Return on Capital	Relative TSR Distributable Cash Flow Return on Assets/Capital	Relative TSR Return on Assets/Capital EBITDA

In addition, companies may wish to review their recent public filings and investor presentations for company performance measures commonly communicated to the investment community. Two metrics that might receive some consideration within the oil & gas industry are one-year stock price change and one-year relative TSR percentile rank. Given that the vast majority of executives' total compensation is equity-based, changes in stock price may better illustrate the relationship of pay and performance than a financial metric; therefore, the former metric may show strong alignment with CAP. Similarly, the significant weighting of Relative TSR at most oil & gas companies may indicate strong alignment with relative TSR percentile rank.

Management and Boards might benefit from modeling the relationships between CAP and various definitions of company performance to aid in the selection of the company-selected financial measure.

Selection of Three to Seven Financial Performance Measures

Following the PVP table, companies are required to include additional supportive disclosures. Among other topics that must be addressed, a company must include a tabular disclosure of three to seven financial performance measures that the company determines are its "most important measures" used to link compensation actually paid to each NEO and company performance. There is no requirement to rank the measures or show financial outcomes, and a company may include non-financial measures, if desired.

As with the company-selected metric in the PVP table, we expect most companies to start by reviewing the list of performance metrics already included within the company's executive incentive plans and disclosed in the CD&A. Presumably those that have the highest weightings should be featured, and it's permissible to include those metrics already included in the primary PVP table (the company-selected measure must be included in this list).

For illustrative purposes, the tabular disclosure for an E&P company could look like this, where a list of typical E&P incentive plan measures is shown in alphabetical order:

Capital Expenditures
Free Cash Flow
Growth in Reserves
Other Costs
Relative TSR Ranking vs. Performance Peers
Return on Capital Employed

And for this example, while other metrics are clearly important to E&P companies, they need not all be listed in this table. For example, while there is no doubt that E&P companies are focused on metrics such as employee health & safety and environmental goals, the basis for inclusion in this list is whether they are among the "most important" measures used to link CAP and performance for the most recent fiscal year. We imagine a number of company performance metrics do not meet this standard.

Whatever approaches are selected by oil & gas companies on these two areas, there will undoubtedly be some evolution after the first year of disclosure. We encourage management teams to begin internal reviews and modeling this fall and to start socializing the company's direction with board members.

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