Post #78: Pay for Performance vs. Pay for Alignment

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Most companies' compensation philosophies include similar principles. It usually includes some version of:

- Pay competitively to attract and retain
- Pay for performance
- Align with shareholders

There can sometimes be tension between these last two principles, particularly in an industry with heavy commodity influence like the oil and gas industry. Paying for performance is typically interpreted as paying the management team for performance in areas within their control. Aligning with shareholders is often interpreted as aligning management's outcomes with shareholders' outcomes – if shareholders win, management wins and vice versa.

In the oil and gas industry, shareholder outcomes can be heavily influenced by commodity price changes. So how should oil and gas companies balance paying for management's performance and aligning with shareholder outcomes?

Categorizing Incentive Metrics

When we evaluate potential incentive metrics, we can categorize into the following groups:

- **Price-Aligned**: These metrics most closely align with shareholders on an absolute basis. These metrics would include EBITDA or other earnings metrics, Cash Flow metrics, Return on Capital or other returns metrics, and Absolute TSR, among others. We'd likely also include metrics like debt reduction or liquidity, since the ability to pay down debt and the need for debt can be driven by commodity prices.
- **Price-Negative**: These metrics have the potential to be inversely impacted by commodity prices. Examples might include cost metrics (e.g., G&A, drilling and completion costs, transportation costs) and capital efficiency metrics (drilling rate of return assuming fixed commodity prices). While there isn't a direct relationship, these are likely to be harder to hit in higher commodity price environments, due to the impact of inflation and increased activity. We would also include financial measures that are neutralized for commodity prices, because while the top line impact of commodity price might be neutralized, the indirect impact on costs is rarely neutralized.
- **Price-Neutral**: These metrics are not influenced by commodity prices in any way and therefore should more accurately measure the performance of the management team, insulating them from factors outside of their control. These metrics might include operational metrics (e.g., downtime, production/reserves), traditional safety and ESG metrics (e.g., emissions), and relative TSR.

Understanding the Impact

These days, most incentive programs in the oil and gas industry are not 100% weighted to one of the above categories, but each company may have a different weighting of one category vs. the others.

A few potential examples:

- Company A has EBITDA heavily weighted in their STI plan and their LTI plan has ROCE and relative TSR equally weighted
- Company B has cost metrics heavily weighted in their STI plan and relative TSR as their sole LTI metric (with a negative TSR cap)

If we're in a strong price environment, Company A is more likely to payout better than Company B because EBITDA and ROCE are likely to outperform relative to original goals and Company B's cost metrics may be impacted by inflation. If we're in a down price environment, Company B is more likely to payout better than Company A because costs should outperform as the industry scales back activity and demand for inputs (services, equipment, labor) declines.

Determining Appropriate Weightings

Different Boards and management teams may have different points of view about what the appropriate relative weighting is for each of these categories. However, it's important for all oil and gas companies to understand the impact of these various categories on potential payouts and to proactively consider what the appropriate weightings should be for their company. We'd also suggest that once a philosophy is established, it is helpful to maintain a consistent approach across cycles. Credibility (to both management and shareholders) can be damaged if the approach changes with the cycle.

Key questions to consider would include:

- Which categories are represented by our current metrics and what are their relative weightings, in both annual and long-term incentives?
- Are we comfortable with the potential impact that commodity price swings (both positive and negative) may have on our incentive payouts?
- Does the relative weighting of the various categories appropriately balance paying the management team for performance and aligning them with the shareholder experience?

As we enter into the planning season for the 2024 incentives, we imagine this would be a relevant time to have these important conversations.