What if $70 oil is the new normal? Or $50?!!

Since the summer of 2014, oil and gas equities have seen a sharp selloff that will affect 2014/2015 executive pay decisions in several ways and may influence broader compensation plans in the long term.

First, the generally strong operational results for oil and gas companies during most of 2014 are juxtaposed to the negative investment returns of 2014 (the S&P/TSX Capped Energy Index was off 19% during 2014 and 18% during 2012-2014). In light of this, how should boards evaluate 2014 performance?

Second, the decline in oil and gas prices has caused havoc with the 2015 operating and capital spending plans in the oil and gas industry and, along with them, company compensation programs. Many operating goals for 2015, set only a few months ago, are now unattainable. In many cases, past stock option grants are deeply underwater and outstanding full value awards (like restricted stock units (RSUs) and performance stock units (PSUs)) have lost considerable value. Issuers need to evaluate closely whether to continue current long-term incentive grant practices (based on grant date dollar value) as they risk producing both unacceptably high dilution and windfall gains when equity prices turn around (particularly stock options). Employee morale, motivation and "retention hooks", already hard hit, are at risk of deteriorating further. What is a board to do in today's environment of empowered shareholders who have little appetite for pay concessions to executives, and a demonstrated willingness to vote against Say on Pay (SOP) and members of compensation committees?

Third, if $70 oil (or lower?) is the new "normal", then cost structures, including compensation costs for office and field employees, need to be reconsidered or retested.

As with previous shocks experienced in 1998 and 2008, boards and management teams will need to consider how and when to respond. However, 2014 is different for a few reasons. Experts indicate that this is not another slump in demand, but rather a longer term issue of oversupply that may depress commodity prices for some time. Regarding executive compensation, an increasingly vigilant and assertive shareholder community will be scrutinizing issuers. SOP and majority voting for directors is no longer nascent, but rather a recognized investor tool. Some of the short-term decisions discussed for 2014 and 2015 below were raised in 2008. The longer-term decisions reflect the implications of a supply imbalance rather than the relatively short decline in demand experienced in 2008/09.

We expect shareholder advisors (Institutional Shareholder Services and Glass Lewis) to take a short term view of the effectiveness of pay programs for 2014. They will look carefully for the alignment of pay and performance, much like the scrutiny put upon by gold issuers in early 2014, many of whom received reduced SOP votes resulting from recommendations "against".

Boards of these companies need to continue to balance the interests of the company (attract, retain and motivate talent) with their responsibility to shareholders (align pay to performance over time, and manage cost prudently over the short to long-term). In doing so, boards (1) will assess several key considerations related to compensation, (2) will consider 2014 and 2015 pay decisions in the context of potentially outdated pay data, revised operating budgets and depressed equity values, and (3) may need to question some widely followed compensation strategies in the longer-term.

Key Considerations for Boards

Performance: Boards should assess their company's relative financial situation, notably debt levels. Those issuers most impacted by the current market will be assessed as the underperformers by most proxy advisory screens. While the advisors will be cognizant of extraneous market conditions, they will not have a comprehensive understanding of each company's leverage to underlying commodity prices, cost structure and debt levels. Understanding the potential outcome of the advisors' analysis may be important context to making pay decisions and to disclosing the rationale of those decisions.

Retention vs. Motivation: We do not expect precipitous action on retention - actual flight risk is much reduced in an environment where recent layoffs signal an oversupply of talent. And while leadership and succession plans need to be preserved and key talent needs to be protected, the "need" may be redefined. Boards may find that motivating employees is challenging - if lower commodity prices are here for a while, then employees may have low expectations for gains from certain equity plans (stock options) as well as for payouts from 2015 bonuses.

Transparency:

- Communication amongst board members and between the board and management, early and often, will ease the discussion of evaluating 2014 performance, setting 2015 goals, and considering changes to pay plans.
- Enhance disclosure, especially where the board applied judgment to 2014 payouts and where the 2015 compensation plans have been changed in response to the current commodities market. As well, boards and committees that disclose their efforts to monitor the current market economics will likely get greater support from shareholders and their advisors.
- Some compensation decisions may not be immediately obvious to the shareholder community, so directors, board chairs and compensation committee chairs in particular, may need to meet with shareholders and tell the story. Alternatively, boards can accept a higher risk of a negative response by uninformed shareholders.

Judgment: Board judgment is always required in setting corporate goals and interpreting corporate performance, and volatile markets make judgment all the more critical. In oil and gas, boards periodically apply judgment in response to sudden commodity prices movements - and 2014 is no different. For 2014, we expect shareholders to look for an explanation of how the decline in stock prices impacted executive bonuses, even where the board elects not to apply judgment. For 2015, judgment will be required in setting goals and in evaluating performance, including how management mitigated risk and leveraged opportunities. In evaluating performance at year end, consideration should be given to the market conditions actually faced during 2015 relative to initial performance standards that, in hindsight, may have been understated or overstated.

Checklist for Short-term (2014/2015) Pay Decisions

Year End 2014

As a starting point, boards may want to question the ongoing relevance of pay data that suggests potentially inappropriate pay policies for the current market (e.g., "automatic" salary increases, expected value of long-term incentive awards). Boards may also want to consider the following:

2015 Base Salary Increases: For firms that have not yet finalized their salary budgets, those budgets are expected to be more modest, and especially so for executives. They may elect to defer salary increases as long as possible (to year end?) until prospects for the industry become clearer. (For firms that have already communicated salary increases for 2015, rescinding those increases is not practical.)

2014 Bonus Payments: Most issuers are committed to paying bonuses that reflect 2014 corporate performance - especially for key contributors in non-executive roles. While paid in good faith, the declining stock market raises the bar on the disclosure of the underlying rationale for executive bonuses. For issuers that have been particularly impacted by the market selloff relative to peers, boards may wish to consider applying negative discretion and/or the deferral of awards into stock or RSUs.

Evaluation of "Pay for Performance": When evaluating "pay for performance", consider disclosing realized/realizable pay to convey the decline in the executive's net worth resulting from the decline in stock prices, and which demonstrates the alignment of long-term incentive (LTI) awards to performance more clearly than does the Summary Compensation Table.

Planning for 2015

2015 Short-Term Performance goals: Employees have lost significant value over the past year and performance goals will need to be seen as achievable in order to be motivating. Key performance measures will include reductions in sustainable capital and operating expense/costs, and cash flow. However, boards will also need to consider whether shareholders will support the same level of "target" bonus for 2015 "budget" operational performance, particularly if budgeted cash flow has been reduced significantly. Boards should also consider the treatment of any unintended "windfall" if the commodity prices rebound during 2015.

2015 LTIP Grants: The combination of lower option values (as a percent of stock prices) and lower stock prices means that typical approaches to determining LTI awards may result in too much dilution today, and the potential for "windfall" gains when stock prices rally.

- Consider replacing all or a portion of stock option awards with full value shares (e.g. RSUs/PSUs) that vest based on performance and/or are granted based on performance. To show shareholders the alignment of pay to performance for executives, and to better support key employees, further distinguish LTI design between executives and non-executives.
- Look at alternative approaches to determine the size of long-term incentive grants (e.g., allocate a pool determined as a percent of shares outstanding, or based on a long-term average price).
- Plan for the 2016 LTIP grant soon, in the event that 2015 is not "the bottom".

Stock Ownership Levels: Review stock ownership guidelines (SOGs) for any unintended consequences. In particular, requiring executives to "double down" to meet SOGs after a significant drop in commodity prices may create more ill will among executives than support from shareholders.

Longer Term Pay Considerations

Boards also oversee non-executive pay programs, and while not scrutinized by shareholders to the same degree, the cost of these programs may dwarf executive compensation. Boards should avoid "knee jerk" reactions - executives and astute employees understand that oil and gas is a cyclical industry. Nonetheless, many oil and gas companies have adopted compensation strategies that appear generous by the standards of most other industries (e.g., salary increases, size of bonus pools, participation in long-term incentive plans, number of "flex" days). As many gas-weighted producers that survived the natural gas price decline of 2008-2009 can attest, if this current market represents the new normal, then it's also a "wake-up call" to:

1. reduce costs, including compensation costs to office and field employees; and,
2. better differentiate pay for performance by reallocating compensation expenses to key roles and to top performers - most companies have only a few people that fit both of these categories.

In considering these changes, issuers will balance the need to improve the financial strength of the company (and be an acquirer, rather than acquired) with the risk of lowering the cost of its talent which has an inherent "first mover disadvantage".

Conclusion

Recent market activity has created compensation challenges for the boards of oil and gas companies. These market conditions have implications for 2014 and 2015 pay decisions and may impact the long-term structure of compensation programs. The responsibility falls on the board to continue to balance between attracting, retaining and motivating top-performing employees and aligning compensation over the short to long-term with returns to shareholders. The balanced solution allows issuers to manage change while minimizing the scrutiny of proxy advisors and institutional shareholders. Despite the recent down trend in oil and gas equities, these challenges in fact represent a unique opportunity to redefine compensation plans. Prudence suggests issuers communicate clearly to shareholders, apply judgment to executive pay decisions, and look for ways to reduce compensation costs.

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