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Compensation Challenges in the Current Frozen Energy World

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Energy companies across the sector are facing issues of almost incredible dimensions. Characterizing today's environment as a perfect storm of problems dramatically understates the current situation. While the oil and gas industry is accustomed to cyclicality, current market conditions have resulted in an existential crisis that has frozen the energy world.

With crude oil prices falling approximately 60% year-to-date and no end in sight, it has literally become a money-losing proposition for many companies to produce a barrel of oil. North American oil and gas producers have already cut their capital spending by approximately 30% on average.

The commodity price decline, of course, is only one crisis facing energy companies. The COVID-19 virus has imposed an entire set of unprecedented challenges to all companies across industries. But, when applied to energy companies, the problems are exponentially increased. Although fuel costs are at decade-low prices, airlines have virtually shut down service, manufacturers have furloughed workers and suspended production and, most incredibly, with actual and self-imposed quarantines, the people of the world have effectively stopped traveling. Even at low prices, there is markedly less demand for oil and fuel.

For many energy companies, it may be a matter of hunkering down and waiting for these conditions to change for the better — leaning out and surviving, not necessarily thriving. This could require companies to preserve their infrastructure and workforces for the better days ahead. A properly structured compensation program may well be the key.

Compensation Programs Should Be Promptly Reviewed. In this environment of uncertainty and depressed stock prices, energy company compensation programs should be promptly reviewed, as in many cases they are no longer able to accomplish their intended goals of retaining key employees and incentivizing them to achieve the company's operational and strategic goals.

- At current stock prices, long-term incentive awards may have little or no realistic potential value to employees.
- Some programs lack flexibility and may be designed to motivate the wrong behaviors (e.g., increased production or drilling) in these turbulent times.
- Uncertainty regarding company performance in the current environment may create a lack of confidence in employees' ability to earn an annual bonus.
- Delaying the review of an energy company's compensation program runs the risk of demotivating the company's management team and potentially having them consider other options that may not be in the company's or its shareholders' best interests.

Considerations in Evaluating Compensation Programs. While each company will need to assess the impact of current market conditions on its specific circumstances, some of the questions that companies should consider include:

- How should annual and long-term incentives be structured so that the compensation programs will remain competitive for retaining and motivating management and key employees? Should shorter performance periods be used?
- How should performance be measured in a manner that is not captive to commodity and stock prices? Should E&P companies that have historically focused on production and reserve growth metrics switch to return-based, cost-cutting or cash preservation metrics? For oilfield services companies, are EBITDA-based metrics still realistic?
- How should cash preservation and G&A savings goals be balanced with retaining the management team and key employees?
- Should a one-time radical incentive plan be adopted as a "stop gap" to allow the company to make it through to next year when market conditions might be calmer?
- Are there any contractual or regulatory restrictions on the company's ability to modify its existing compensation programs? Would changes to the programs have any potential adverse accounting or tax consequences?
- Particularly if annual grants have not yet been made for 2020, do equity grants at current levels impact the depletion rate of the share pool in the company's equity plan or result in excessive burn rates?
- How will shareholders and proxy advisory firms react to changes in the company's compensation programs? How should those concerns be weighted given the

existential crisis facing the company?

- What are the potential risks of loss of critical personnel? Each company will need to evaluate its retention risks carefully — some may conclude that the lack of realistic alternatives in the energy industry substantially diminishes any concerns about retention. Others may still see retention risks for potential departures of key executives to other industries — talented executives typically have alternatives, even in difficult times. Moreover, companies may risk losing the chance to incent management to achieve goals that matter in the very short term (e.g., cash management).

Potential Alternatives to Consider. There is not a "one size fits all" solution to this quandary, but time is of the essence. Some companies may determine that no changes need to be made to their compensation programs. Other companies might adopt a "wait and see" approach and communicate to their employees that they plan to further evaluate changes to their compensation programs later in the year. While these approaches may provide flexibility and other benefits, they could cause employees to write off 2020 as a "lost cause" and give more consideration to alternative opportunities. If a company determines that changes to its compensation programs are warranted, it could adopt one or more of the following approaches:

- Adopt short-term (e.g., quarterly) programs for 2020 that permit the company to review and revise the goals more frequently and use ones that make sense at the current moment.
- Reset metrics for 2020 annual bonuses and/or outstanding performance-based equity awards (although the overlay of COVID-19 with the decline in commodity prices could make this difficult to do).
- Increase the level of discretion to adjust performance metrics in annual and/or long-term incentive awards.
- If the company has sufficient cash, implement cash-based programs as a supplement to, or replacement of, existing programs. In the short term, these programs could be retention-based to "calm the waters" and allow a management team to focus on the business at hand by providing a fully liquid benefit that is earned based on factors purely within their control. This approach may be particularly attractive given the difficulty of setting realistic operating goals in this rapidly changing environment.
- To manage limited equity plan share pools, (i) retain the discretion to settle equity awards in cash or stock, (ii) grant cash-based awards in lieu of equity-based awards (potentially with a discount to reflect reduction in volatility), and/or (iii) pay any portion of an annual incentive bonus originally scheduled to be settled in equity in cash instead (with or without a discount for volatility).

- Design and implement new compensation programs in a manner that would allow them to be sustainable in the event of a restructuring or bankruptcy.
- Reduce or freeze base salaries and/or target bonuses of certain executives (this could require the executives to consent to the changes to avoid triggering severance under employment agreements or severance plans).

To reiterate, there is no magic bullet solution for these unprecedented times in the energy industry. We remain committed to working with our clients to review and evaluate their compensation programs and help them find creative and practical approaches in this challenging environment.

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