Bringing Alignment and Accountability to the E&P Sector

The public E&P sector is broken, and the root cause of the problem is a lack of alignment between executives and shareholders. The misalignment that begins with skewed incentives and low insider ownership is compounded by boards who appear unwilling to hold management teams accountable. Executive compensation remains elevated irrespective of performance and there is virtually no threat of dismissal. As a result, executives look to extend their runway of optionality rather than preserve and maximize long-term value. Unless accountability and alignment are restored, the sector will struggle to attract capital and remain unprepared for the energy transition.

This paper outlines the role of incentives in influencing behavior, identifies the deficiencies in E&P governance and provides a roadmap for promoting shareholder alignment. The paper is intended to be read alongside our previous two white papers on the operating model and environmental performance. Combined, we believe these create a framework to make E&Ps investable again.

The Path to Relevance

As we outlined in our original white paper, "Preparing the E&P Sector for the Energy Transition: A New Business Model" there are five core operating components to making the public E&P sector investable again:

1. Provide visibility into returning 100% of the enterprise value to shareholders within 10 years

2. Commit to reinvesting less than 70% of cashflow

3. Reduce balance sheet leverage targets to 1.0x ND/EBITDA or below

4. Align management compensation with the interests of shareholders

5. Make capital allocation decisions with an understanding of the environmental impact

While we have witnessed some progress around evolving the operating model and the conversation around environmental performance is intensifying, we have yet to see an acknowledgment of the need to meaningfully reform incentive structures. Despite being commonly perceived as less material, the realignment of incentives is critical to ensuring operating and environmental reforms are not abandoned as commodity prices rise.

Misaligned incentives are also an impediment to further industry consolidation. It is well accepted that there are too many undersized companies drilling shale wells, but a lack of meaningful equity ownership and annuity-like compensation structures make it economically irrational for CEOs to vote themselves out of a job. This is not a new problem. T. Boone Pickens tried to shine a light on the same issue over three decades ago:

> *"Boards of directors don't stop mergers or block offers for companies. The CEOs do. Not one out of fifty boards will stand up to a CEO. In most cases, the CEO knows the board is beholden to him because he put them there in the first place. Although most CEOs own a few thousand shares of stock, their value as an incentive is insignificant compared to that of the four Ps: pay, perks, power and prestige."*
>
> *- T. Boone Pickens, Jr. (Boone, 1987)*

The threat of irrelevance in the face of the energy transition requires a sense of urgency yet to be observed within E&P boardrooms. It is time for independent directors to challenge the status quo.

Why Incentives Matter

At the heart of any discussion around corporate governance is the agency problem between shareholders and management; it is the separation of ownership and control. Executive compensation is intended to address this issue by crafting ways to motivate managers to internalize the wealth effects of their decisions.[1]

> *"Properly designed performance measures and executive incentive compensation schemes are central to the value creation process. Their purpose is straightforward - to motivate managers to create value by rewarding them for the value created"*
>
> *-Alfred Rappaport 1986*

When compensation becomes a right rather than a reward, the entire relationship breaks down. In several influential papers, Bebchuk et al. warned that the greatest threat to optimal contracting is the "managerial power approach." Their concern is that boards do not operate at arm's length in devising executive compensation and that executives maintain the power to influence their own pay. To camouflage their excess rent extraction, companies create suboptimal incentives that can be detrimental to shareholder value.[2] A Fortune 500 CEO anonymously conceded in an interview that when structuring executive compensation "there's no one representing shareholders. It's like having labor negotiations where one side doesn't care."[3]

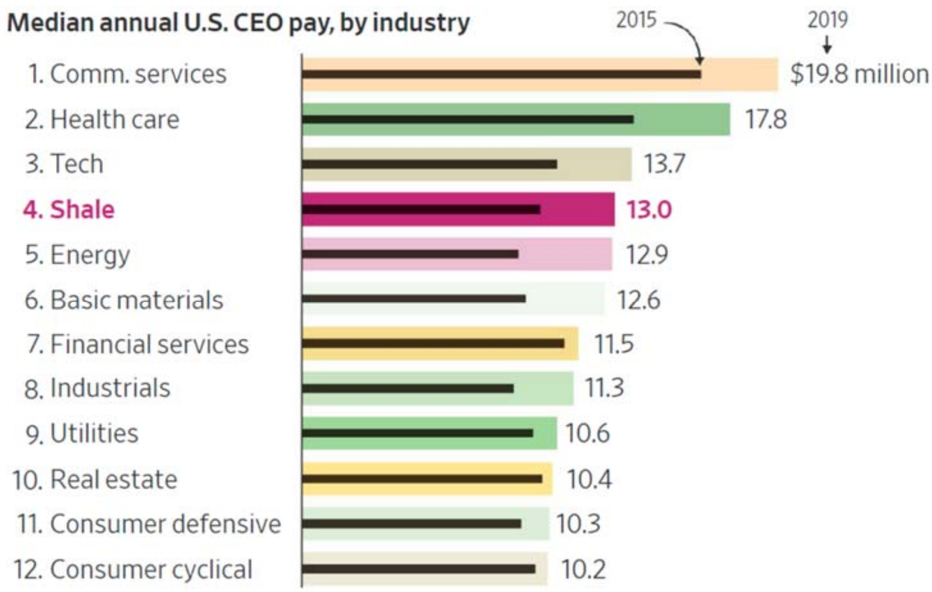
Michael Jensen, a leading academic voice on corporate governance, references this power dynamic in his critique of board culture. He describes how deference to the CEO with politeness and courtesy at the expense of truth and frankness renders the board ineffective: "By rewarding consent and discouraging conflicts, CEOs have the power to control the board, which in turn ultimately reduces the CEO's and the company's performance."[4] The problem is one of asymmetric risk-reward. The benefits of challenging the CEO are low (minimal equity ownership amongst board members), while the potential costs are high (the CEO controls the board nomination process). The only solution is comprehensive governance reform that addresses board oversight in parallel with realigning executive compensation.

Houston, We Have a Problem

The managerial power approach predicts that companies with greater CEO influence will see higher levels of pay with lower sensitivity to performance. While this phenomenon is not unique to the E&P sector, the industry is notable for its generous compensation packages in the face of value destruction. Despite being the worst performing sector on a three-, five- and ten-year basis, a recent Wall Street Journal study found that Energy was one of the highest paying sectors in 2019:

[1] https://corpgov.law.harvard.edu/2019/02/05/executive-compensation-corporate-governance-and-say-on-pay/
[2] http://www.law.harvard.edu/faculty/bebchuk/pdfs/2002.Bebchuk.Fried.Walker.ChicLR.Managerial.Power.pdf
[3] http://www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf
[4] https://www.hbs.edu/faculty/Pages/item.aspx?num=6595

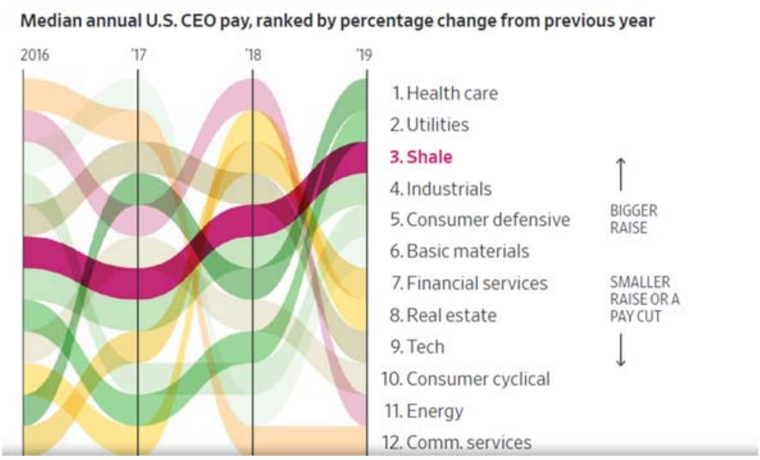
Figure 1: Annual CEO Pay by Industry



Source: WSJ

While the overall energy sector saw a decline in CEO compensation, US E&P companies saw one of the largest increases in median pay over the last three years:

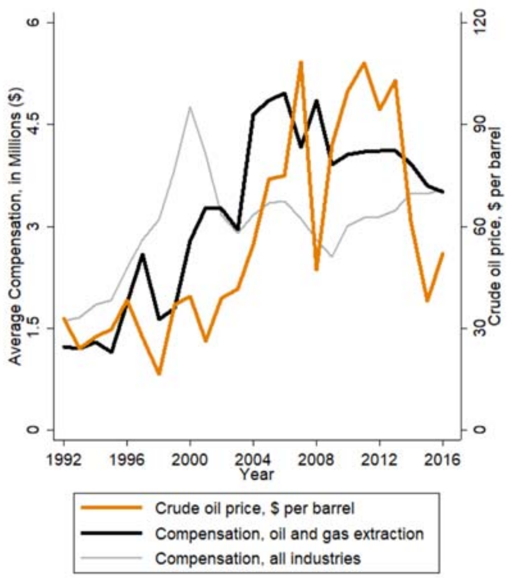
Figure 2: Percentage Change in CEO Pay



Source: WSJ

The rise in pay can largely be attributed to the recovery in oil prices from the lows of 2016. A paper from the National Bureau of Economic Research published in December 2018 titled *"Are Energy Executives Rewarded for Luck?"* looked at data from 78 companies over 24 years. The authors found that "executive compensation at US oil and gas companies is still closely tied to oil prices, indicating that executives continue to be rewarded for luck.” What is most concerning is the asymmetry where pay is “three times as sensitive to luck when luck is improving, i.e. when oil prices are rising.” Compensation levels rose well above other industries from 2004-2014 when oil prices were elevated but never fell back below those industries as oil prices collapsed:

Figure 3: CEO Compensation vs Oil Prices



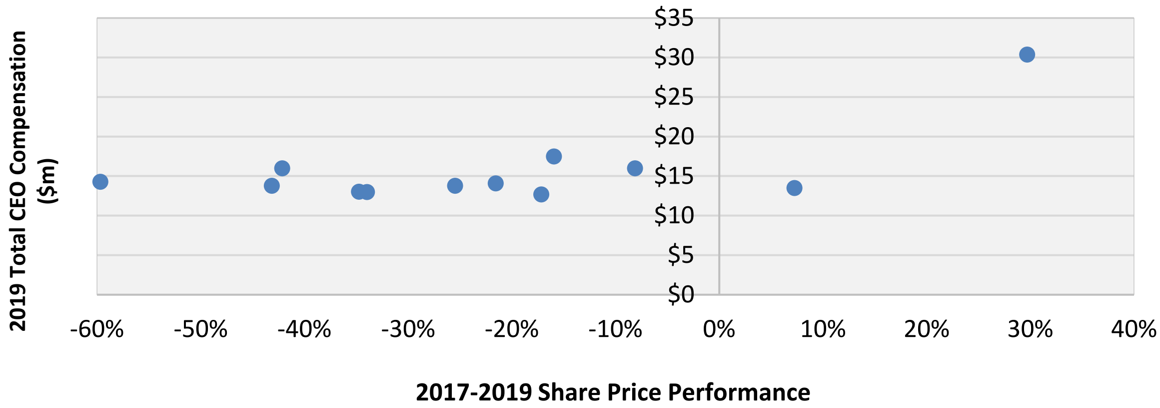
Source: Davis & Hausman, Are Energy Executives Rewarded for Luck?

The authors conclude that the “asymmetry is suggestive of rent extraction, consistent with executives having co-opted the compensation process and increasing their pay when the firm is earning windfall profits.”[5]

Focusing on median pay understates the problem because it ignores a troubling lack of dispersion among companies. If we analyze the share price performance from 2017 to 2019 for the 12 E&P companies currently included in the S&P 500, the spread was -60% to +30% with a median of -24%. However, eight of those 12 companies awarded their CEO between $12.7m to $14.3m in total compensation in 2019. The difference between the median of $13.9m and the lowest paid CEO was less than 10%. In other words, the penalty for underperformance is trivial.

[5] https://www.nber.org/papers/w25391

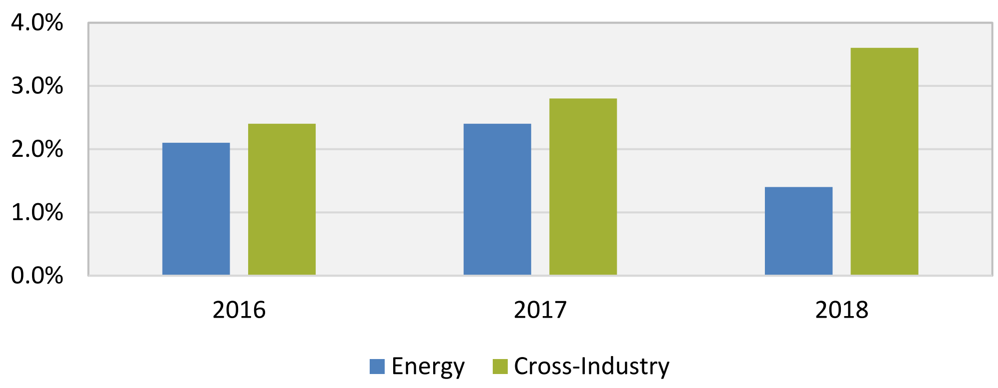
Figure 4: 2019 CEO Compensation vs 3-year Share Price Performance



The asymmetry to oil prices and absence of variability in CEO pay is further compounded by the lack of insider ownership. The median ownership of those same 12 CEOs is only 0.18%, with only one CEO owning more than 1% of the shares outstanding. The market value of the 0.18% today is only $10.6m, worth less than one year of annual compensation. Boards must simply question whether CEOs still have enough skin in the game to promote the long-term interests of the companies they are entrusted to manage, especially when contrasting the material decline in the value of their holdings with the trend of rising compensation.

A reasonable counterargument would be that a CEO does not require an effective compensation plan or meaningful stock ownership to incentivize him or her; the threat of being terminated, with the associated financial and reputational risks, should be enough. However, despite being the worst performing sector with the highest number of bankruptcies over the past five years, CEOs within the energy sector have been terminated at a lower rate than other industries.[6]

Figure 5: CEO Dismissal Rate



Source: PWC

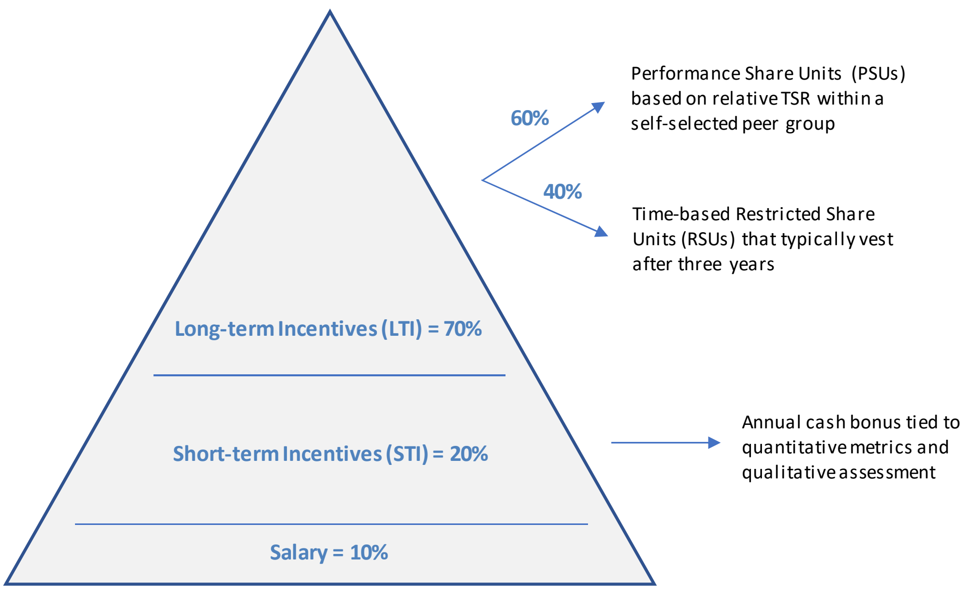
[6] https://www.strategyand.pwc.com/gx/en/insights/ceo-success.html

Given that the primary responsibility of a board of directors is to hire and fire the CEO, the low rate of dismissal is further evidence of the distorted power dynamic. A lack of sensitivity of pay to performance, low insider ownership and minimal threat of dismissal each contribute to the misalignment of interests with shareholders.

Identifying the Deficiencies

Executive compensation for the E&P sector is typically constructed using a three-tiered system:

Figure 6: E&P Compensation Structure



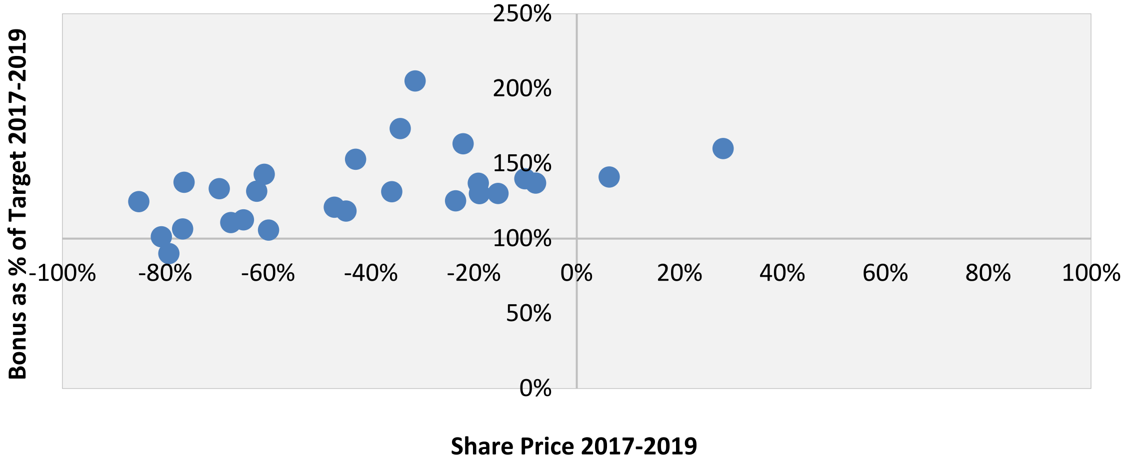
Having such a large weighting to long-term incentives should theoretically drive alignment with shareholders. It is therefore difficult for outside observers to understand how compensation could remain elevated for such a poor performing sector. We attribute the divergence between pay and performance to four fundamental issues within this tiered system:

1) Annual Bonuses with Low Correlation to Shareholder Value Creation

In looking at annual cash bonuses we broadened the analysis to 28 US E&P companies.[7] All but two companies saw their share price decline from 2017 to 2019, yet the average three-year bonus payout as a percentage of target was 133%. Only one CEO had a cumulative payout below 100%, and that company has since declared bankruptcy.

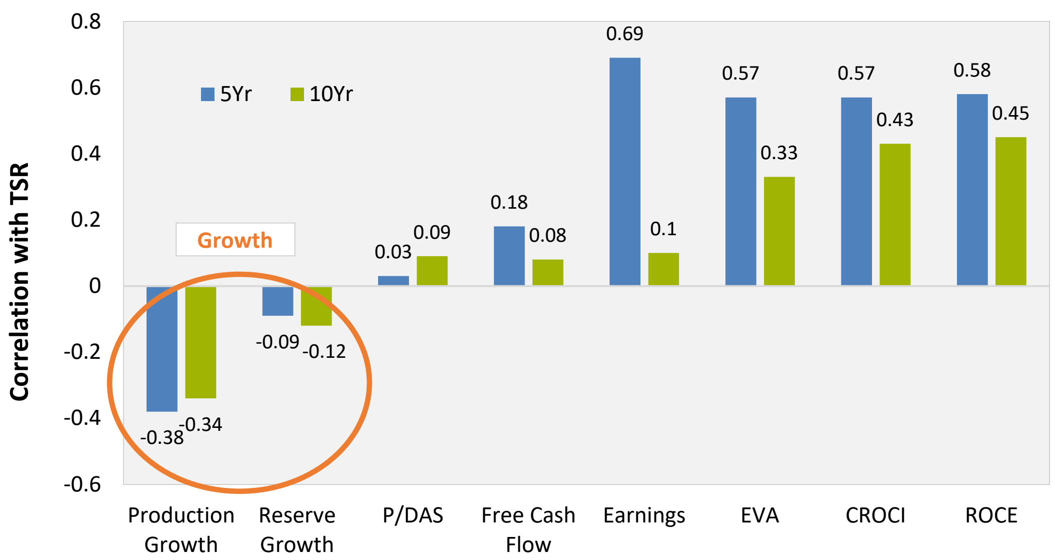
[7] *Kimmeridge selected the peer group constituents which are comprised of listed E&P companies determined to be of sufficient size and relevance (the Kimmeridge Peer Group)*

Figure 7: Payout as % of Target vs. Share Price Performance



Evercore ISI, a sell-side research firm who was early in identifying these issues, has developed Shareholder Alignment Coefficients that measure the five- and 10-year correlations between CEO incentive metrics and TSR. They concluded that earnings, EVA, CROCI and ROCE have the highest correlation with TSR, but found that those factors only represented 16% of short-term metrics for E&P companies in 2019. Conversely, operating metrics that often show an inverse correlation to TSR and "strategic goals" still represented 33% of the total.

Figure 8: Shareholder Alignment Coefficients



Source: Evercore ISI

2) Scoring Systems Skewed in Favor of Management

While the problem starts with selecting the wrong metrics, it is compounded by a lack of integrity in the scoring system. This issue draws much less investor scrutiny, likely due to a lack of transparency in most compensation plans and is best illustrated with examples from 2019 proxy statements.

Example 1

In one case, an E&P company slightly beat their production target (by 1%) and scored 147% relative to a target of 100%. When they missed their free cash flow (by 5%) and capital efficiency (by 7%) targets, they were still given scores of 90% and 95%.

To move from 100% of target to zero, the company would have to miss production by 7%. To achieve 200% of target the company would only have to beat production by 2.9%.

Figure 9: Production Payout Distribution

We observe the same asymmetry with the capital efficiency metric. To move from 100% of target to zero, the company would have to miss the efficiency target by 20%. To achieve 200% of target the company would only have to beat the efficiency target by 9%.

Figure 10: Capital Efficiency Payout Distribution

In both cases the scorecard is skewed in favor of management through a non-linear distribution of potential outcomes.

Example 2

A second way for companies to introduce asymmetry in favor of management is the multiplier itself. One company set a 200% payout for beating their oil production target by 5%. Missing the target by 5% would result in a 50% payout. Another company used a more even distribution around 50%, 100% and 150%, but introduced a fourth category called “outperform.” This allowed for a 200% payout with no disclosure of a corresponding downside threshold for 0%.

Below Target	50%
Target Range	100%
Above Target	150%
Outperform	200%

Unfortunately, these are but two examples of what we believe is a widespread issue in the industry. The consistent asymmetry between ‘success’ and ‘failure’ is symptomatic of compensation schemes that are designed to reward CEOs with annual bonuses above target. Like a casino, boards have set the odds so that the house always wins. Some companies do not even disclose the goal posts around each metric, which is more troubling. In addition to adopting metrics that correlate with shareholder value creation, boards should set transparent parameters with proportional penalties and rewards.

3) Time-Based Stock Grants

Kimmeridge believes that long-term incentives should be 100% performance based. Across the 28 E&P companies we analyzed, all but one utilized time-based RSUs. On average, time-based RSUs represented 28% of total compensation and over 40% of long-term incentives in 2019. Companies categorize these stock grants as “at-risk” compensation given fluctuations in the underlying share price. However, stock acquired at zero cost without a performance threshold is simply a payoff to management for continued employment. If the stock falls, the CEO is granted a greater number of shares the following year to compensate for the lower price. There is no alignment with shareholders who are risking their capital, especially when companies allow for the settlement of RSUs in cash. As shareholders we are then told that this is all in the name of “talent retention.” But talent retention hardly seems to be an issue when we cannot find a recent example of a CEO being hired away to a competitor or another industry. And there is a bigger question around how boards can identify talent in a sector that has consistently destroyed so much shareholder value.

4) Narrow Peer Group for Performance-Based Component

Arguably the most hazardous component of E&P compensation plans is the over reliance on relative total shareholder returns (RTSR) for the performance-based component of long-term incentives. This practice is disproportionately used within the Energy sector.[8]

Figure 11: Use of Relative TSR by Sector

	GICS Sector	% Using RTSR	RTSR as Long-Term Incentive Metric: % Using	Median % of Performance Share Units	Mode % of Performance Share Units	RTSR as Long-Term Incentive Modifier
Core RTSR	Utilities	100%	89%	50%	50%	11%
	Energy	81%	100%	100%	100%	—
	Real Estate	88%	100%	75%	100%	—
	Materials	76%	84%	56%	100%	16%
	Core RTSR	86%	94%	62%	100%	6%
Non-Core RTSR	Health Care	56%	79%	50%	50%	21%
	Information Technology	49%	82%	50%	100%	18%
	Industrials	50%	74%	50%	50%	26%
	Consumer Staples	47%	75%	50%	50%	25%
	Consumer Discretionary	38%	67%	50%	50%	33%
	Financials	33%	68%	50%	50%	32%
	Telecommunication Services	100%	67%	—	—	33%
	Non-Core RTSR	45%	75%	50%	50%	25%
	S&P 500	55%	82%	50%	50%	18%

Source: Ben Burney, 2018 relative TSR prevalence and Design of S&P 500 Companies

In theory, relative performance should help isolate management actions from extraneous factors such as commodity prices. In practice, however, it breeds a herd mentality with little incentive to evolve the business model to compete with other industries. Studies have shown

[8] https://corpgov.law.harvard.edu/2018/10/04/2018-relative-tsr-prevalence-and-design-of-sp-500-companies/

that relative performance is not causal to improved company performance and allows for payouts to be largely dictated by reversion to the mean.

> *"Relative TSR is an output—comparing a company's TSR to a peer set—without a specific connection to the financial and operational measures in the company's business plan. This minimizes the incentive impact, resulting in a game of chance with reversion to the mean (i.e., consistent use of the same comparator group will inevitably result in periods of underperformance and outperformance due to TSR fluctuations in the comparator group)."*[9]

The issue is amplified by the selection of such a narrow peer group. With the typical peer group of US E&Ps representing only 4-7% of global oil and gas production, companies are being compared to only a small subset of the industry. If the goal is to evolve the business model to attract investors back to the sector, ignoring the broader opportunity set and allowing management teams to be paid for being "less bad" is not the solution. Finally, many companies target median performance, which can lead to CEOs being paid 100% of target with negative returns while failing to outperform their peers.

Ownership Mentality Begins with the Board

While alignment with investors can be improved through reforming executive compensation, it will only be effective if boards are willing to provide independent oversight. Kimmeridge believes there are several conditions that can be implemented to strengthen board oversight:

1) **Mandate upfront stock purchases**
2) **Directors' fees paid in equity that is restricted for tenure**
3) **Ownership thresholds for board tenure over five and seven years**
4) **Directors are no longer designated as independent after nine years**

The lack of liquidity can also be offset by raising director fees, conditional on a reduction in the size of the board. Both Bebchuk and Jensen, who were cited earlier in the paper, conclude that larger boards are an impediment to effective oversight. When boards grow beyond 7-8 people there is less individual accountability and it becomes more difficult for a board of directors to oppose the CEO. For the 28 E&P companies that we analyzed, the average board size was 10. If shareholders can obtain a smaller, more effective board for the same cost it would be a win-win.

Principles for Reforming Executive Compensation

While we recognize that an executive compensation plan should be unique to each individual company, we want to offer four principles that could be introduced to promote alignment with shareholders.

[9] https://corpgov.law.harvard.edu/2019/08/25/relative-performance-and-incentive-metrics/

1) **Eliminate growth metrics and discretion from short-term incentives**
2) **100% performance-based long-term incentives that are only settled in shares**
3) **Deemphasize relative TSR in favor of long-term financial measures**
4) **Increase change of control payouts with improved shareholder alignment**

Below we offer suggestions on how these principles could be implemented through a conceptual framework.

Short-Term Incentives (STI)

We would eliminate all growth-related metrics such as production, reserves or cash flow. We would focus on metrics that are aligned with the evolution of the E&P business model including reinvestment rates, debt paydown, return of capital and progress towards longer-term, science-based emission reduction targets. Metrics should be kept consistent each year so that it promotes continuous improvement and accommodates the inherent cyclicality of the business. There should be transparency and integrity in setting targets commensurate with payouts for success and failure. We would incentivize executives to take restricted equity over cash by offering 0.8x target in cash and 1.2x target in equity.

Long-Term Incentives (LTI)

We would eliminate all time-based compensation and move to 100% performance based. TSR should be no greater than 50% of long-term incentives. Relative peer groups should be expanded to encompass a broader universe (i.e., XOP Index, S&P 500 Energy, S&P 500 Energy + Industrials). Payout should be based on the intersection of three-year relative and absolute TSR with greater variability around 100% payout. Under this framework, payout is maxed at 75% for negative TSR. To achieve greater than a 100% payout a company would have to be first quartile on a relative basis or produce a 10% annualized return. A bottom quartile company with negative returns would get a 0% LTI payout, while a top quartile company with 15% annualized returns would get a 300% payout. Most plans max out at 200% today.

Figure 12: Example of Payout Matrix for Relative and Absolute TSR

	Relative TSR (quartile)			
	1st	**2nd**	**3rd**	**4th**
<0%	75%	50%	25%	0%
>5%	100%	75%	50%	25%
>10%	200%	100%	75%	50%
>15%	300%	200%	100%	75%

At least 50% of long-term incentives should be tied to financial performance that is aligned with long-term shareholder value creation. We propose two options below that could each make up 25% of LTI:

Capital Payback (25%)

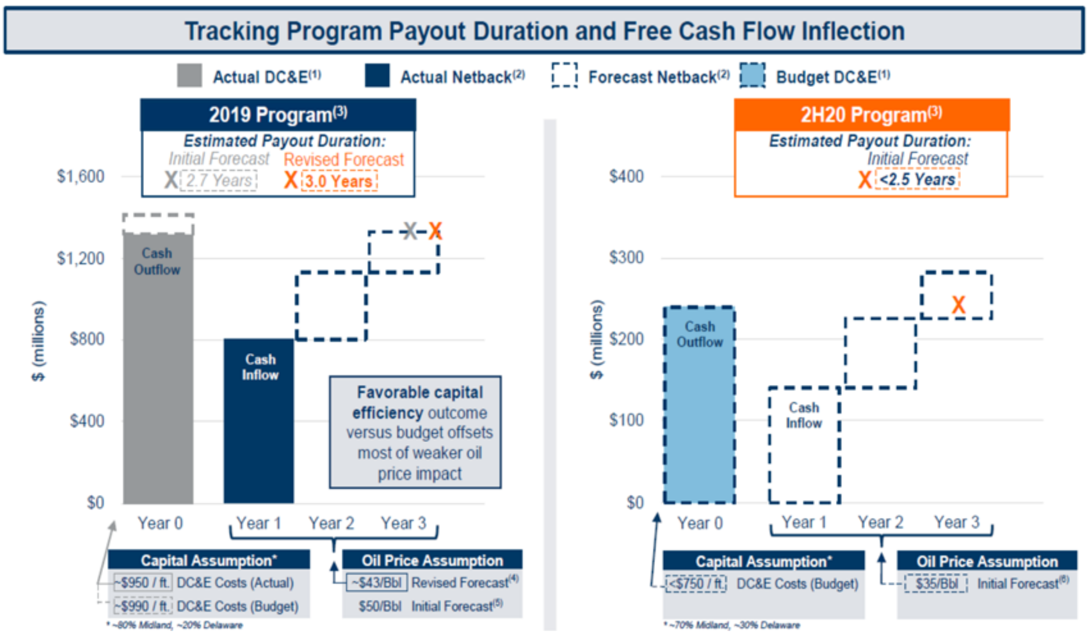
For such a capital-intensive industry it is critical that companies demonstrate that they earn a return on their investments. This should not be an IRR calculation which makes assumptions for unknown future variables such as reserves or commodity prices. It should be a look-back analysis of realized cash-on-cash returns. For US shale companies with short-cycle assets, this portion of LTI should vest relative to a target of a three-year payback of each year's capital budget, inclusive of G&A.

Figure 13: Example of Payout for Three-Year Capital Payback

3 Year Capital Payback	Pay vs Target
60%	0%
70%	25%
80%	50%
90%	75%
100%	100%
110%	125%
120%	150%
130%	175%
140%	200%

We have seen operators like Parsley begin to provide disclosure around the capital payback and all companies should already be tracking this data internally. The key will be to provide enough transparency behind the calculation in order to convince investors of its integrity.

Figure 14: Parsley Capital Program Payout Schedule



Source: Parsley Corporate Presentation

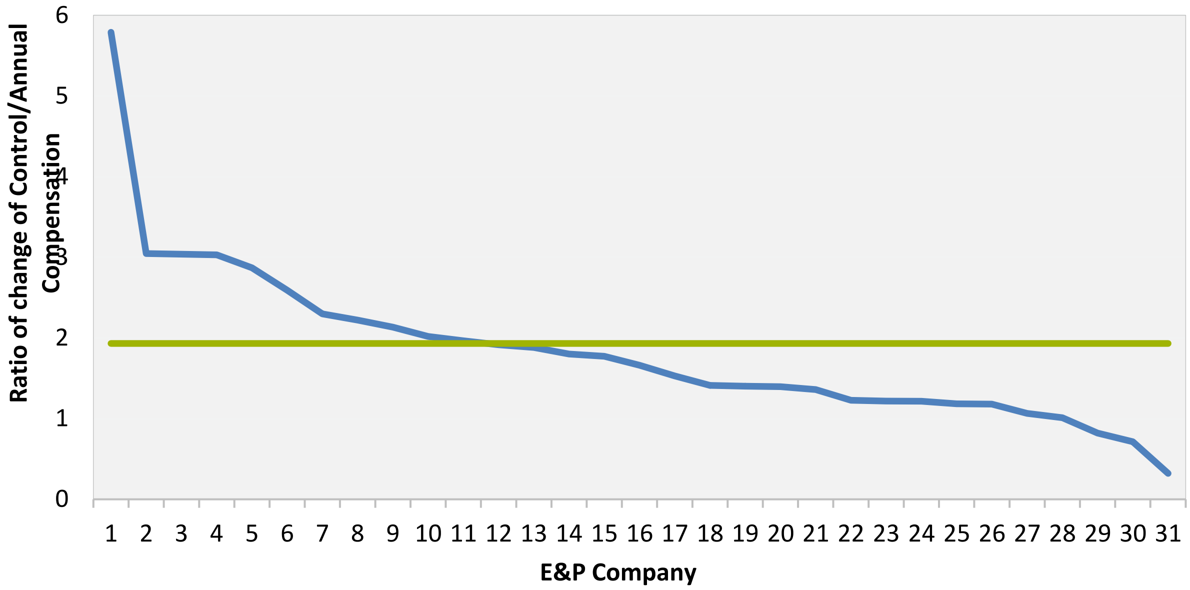
Cumulative Free Cash Flow (25%)

Performance shares would vest at target upon the cumulative generation of free cash flow over five years. The long-term time horizon should account for the cyclicality in oil prices. If management teams believe the best path to maximizing shareholder value is reinvesting to generate a more significant wedge of free cash flow in the future, than they would not get paid until it materializes. A five-year forecast of free cash flow at strip prices should be expected from public E&P companies each year and form the basis for this target.

Change of Control

There is universal agreement that the E&P industry must consolidate to realize cost reductions that accrue to all shareholders. However, looking at the change of control premium relative to 2019 CEO compensation, the average CEO would make less than 2x their annual compensation by stepping down. It’s not an economically rational decision for them to sell or merge if they believe they can retain their job for the next couple years at their existing level of compensation.

Figure 15: Change of Control Payments vs. 2019 Compensation



However, the answer is not simply to inflate the premium and give CEOs the option to walk away with a cash payout in a low premium merger with little regard for shareholders. Once again, it all comes down to alignment. We would offer higher premiums contingent on taking restricted stock in the combined entity. For example, if a CEO has annual average compensation of $10 million, we would calculate the payout based on their election of stock versus cash:

Figure 16: Example of Change of Control Payment relative to Cash %

% Cash	Multiplier	Amount ($m)
100%	1.5x	$15
75%	2.0x	$20
50%	2.5x	$25
25%	3.0x	$30
0%	3.5x	$35

There should be a minimum three-year lock up. Deferred vesting could help address the 280G excise tax above 2.99x annual compensation that utilizes a present value calculation and we would rely on compensation consultants to suggest the most tax efficient structure. There is clearly a need to encourage further rationalization across the sector, but if a CEO isn't willing to take equity in the deal, why should investors?

Conclusion

It is easy to criticize E&P executive compensation, but more difficult to offer viable alternatives. Our objective is not to reduce aggregate compensation levels, rather to improve management's alignment with shareholders. Effective governance necessitates investor engagement and reform requires shareholders to vote against misaligned compensation plans. Boards must recognize the degree of urgency to fix a broken model. There are always risks to doing things differently, but the greatest risk to the E&P sector is maintaining the status quo. We are asking directors to serve their shareholders by implementing the principles we have outlined in this paper and becoming a catalyst for change.

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