Adapting to Change?

MM&K Oil & Gas Remuneration Dinner

On 3rd October 2012, MM&K held a dinner for those, from within the oil & gas sector, involved in the design and implementation of executive remuneration policy. Guests included chief executives, other executive directors, remuneration committee members and their principal in-house advisers. Over dinner there was discussion about:

Summary

Dinner guests agreed that executive remuneration structures need to be designed very differently depending on the business characteristics and stage of development of an E&P company

The application of standard 'best practice' models has worked counter to this. New government regulation and improved shareholder understanding may make a confident approach to remuneration more easily achieved. However, there is a danger of over regulation driving Exploration companies to seek finance outside the regulated equity markets.

Introduction

Paul Norris introduced the subject. His key points were:

1. New legislation will change the landscape of reporting on directors' remuneration, creating opportunities for oil & gas companies, which are no strangers to change, especially to review incentive policies and to design plans which are consistent with the investment/return cycles and the key drivers of performance in the sector.
2. Recognising the diversity within the sector (within E & P there is a small number of large companies with sustainable cash in-flows and a large number of smaller exploration companies hungry for cash and capital investment but having little or no cash in-flows … and there is the services sector) Paul Norris referred to MM&K's study of the E & P sector which found the following:
    - Share prices are dependent on the market price of oil
    - Little connection between stated KPIs and LTI performance measures
    - Almost blanket use of comparative TSR and EPS performance measures in LTIs
    - Little use of LTI targets reflecting the efficient use of capital in a highly capital intensive industry

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- o Despite long investment/return cycles, performance is almost exclusively measured over three year periods.

3. This incentive plan design pattern is replicated in (especially the larger end of) the services sector, where share prices are also closely related to the politics of oil.
4. Reflecting on how it has come to pass that LTI design in the sector bears little relationship to the nature and economics of the oil business, Paul Norris commented that because, in the new regulatory environment, there will have to be a concentration on:
   - o the linkages between LTI performance measures and corporate KPIs,
   - o the relationship between Directors' remuneration and business strategy and
   - o an active engagement between companies and their principal (institutional) investors,
5. There will be pressure on oil & gas companies to design incentive plans which are fit for purpose from a company perspective and which are consistent with the economics of the sector.
6. Commenting on whether any significant change in incentive plan design is likely in practice to happen, Paul Norris said there is already some (nascent) evidence. Whilst there is still a tendency towards comparative TSR and EPS, a number of plans internationally are based on a wider range of measures. In addition, the UK Government wills it and it is unlikely that a future Labour Government would change materially the thrust of the new legislation proposed by BIS.
7. In summary, for oil & gas company remuneration committees this means there is some work to be done on:
   - o articulating the pay strategy
   - o identifying short and long term KPIs, which reflect progress towards achieving the strategic goals,
   - o linking incentive plan performance measures closely to those KPIs and
   - o developing a constructive dialogue with investors.

Discussion followed. The main points made included the following:

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The impact of regulation

1. Primarily as a result of failures in the banking industry UK PLC is now facing a period of unprecedented increase in regulation, including many changes to the reporting of executive remuneration.
2. Regulation 'works' (or perhaps is a less bitter pill to swallow) for FTSE350 companies, but it does not necessarily work for smaller companies.
3. The equity markets (especially AIM) have often been the salvation of the Exploration industry, but it is becoming increasingly impracticable for Exploration companies to comply with all the regulatory requirements.
4. At the point where the demands of the regulators become too great Exploration companies may be forced to seek funding from private markets. It poses the question 'should Exploration companies be listed at all?'

What is the correct remuneration structure for Exploration companies?

5. Exploration companies and production companies are very different animals. As a result they need to be remunerated differently.
6. There is a real problem in measuring and recognising through bonuses the achievement of intermediate goals in Exploration companies.
7. Investors in Exploration companies cannot and do not expect to receive dividend payments and their measurement of performance is very commonly one dimensional, i.e. go, find oil, exit. So companies aligning their remuneration model with the business objectives will pay a large proportion in shares/options. Although the payment of annual bonuses is common practice in Production companies, this is not viable for many exploration companies. Furthermore the payment of a 'bonus' to executives for what investors may consider to be 'doing their job' is not considered appropriate.
8. The problem with these two different models arises when there is a misalignment of expectations. This is commonly brought about by executives in Exploration businesses comparing themselves with their 'peers' in Production companies who are operating under the other model.

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9. The use of equity in Exploration companies provides perfect alignment between the interests of the shareholders and the management team, but this message is often misunderstood. Different businesses and different stakeholders focus on different time horizons. Investment managers focus on the short term whereas companies focus on the truly long term. The challenge is to align incentive plan design with the investment/return cycles appropriate to the business.
10. There is also the question of who to include in any such equity arrangements. This question is commonly answered with 'all those with tangible influence on achieving the business plan'. But this raises a further question. Does the expertise in the exploration model lie with the management team or the technical team?
11. Exploration companies face stiff competition for talent. The Exploration industry in its current entrepreneurial form is relatively young and so the pool of talent has experience accumulated in the last decade alone.

Service Companies

12. Oil Services companies' futures follow closely those of the companies they serve. MM&K research shows a strong link between the share price of service companies and the price of oil (which is largely determined politically).
13. Remuneration committees at Service companies must take account of this incentive design and performance measures.
14. This is made harder by the fact that the market recognises share price performance and does not necessarily recognise the measures that would be used in a good remuneration structure.

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