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Emerging 2025 Incentive Design Trends in the Oil and Gas Sector

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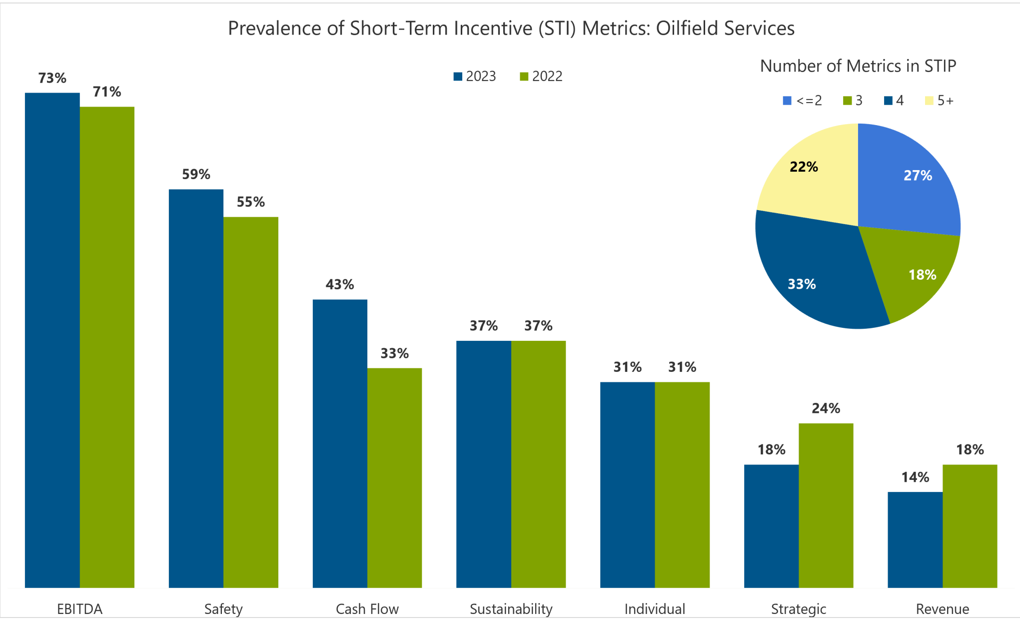
Introduction

Based on the most recent public filings throughout 2024, there is some interesting executive incentive plan data among two of the larger subsectors: oilfield services (OFS) and exploration and production (E&P). Based on an 84-company group of constituents that represent these two groups, we offer a look at year-over-year trends, as well as differences between the two sub-sectors and their outlook for 2025.

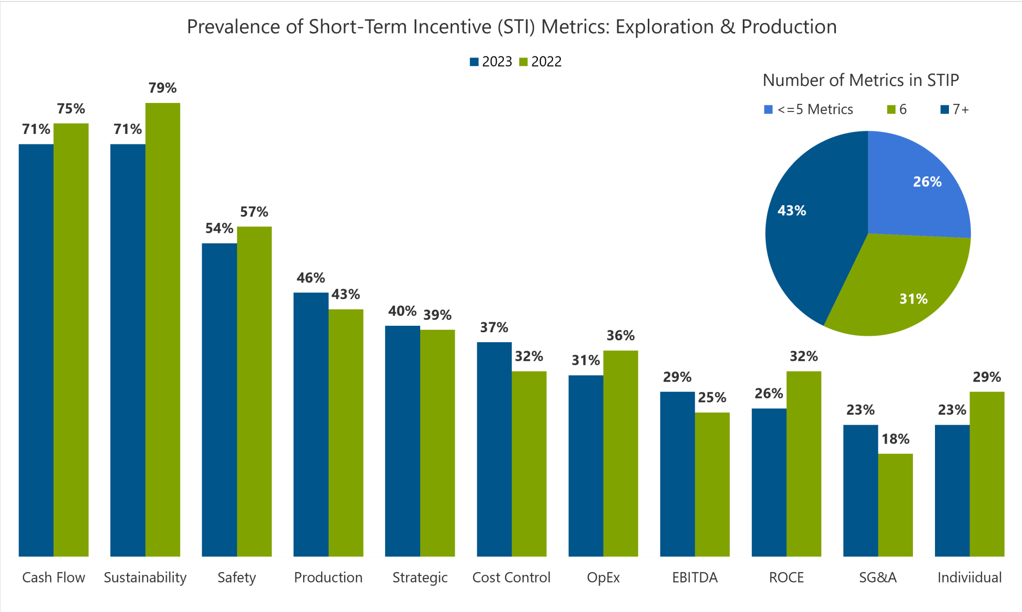
Annual Incentive Plan Design: Number and Types of Metrics

One of the areas where we see the starkest contrast between oil and gas industry sectors is in the number of annual incentive plan criteria that is used to evaluate performance. Oilfield service firms generally incorporate simpler plans, with 78% of the OFS group reporting four or less performance metrics.



EBITDA and cash flow are considerably more prevalent than other financial measures, with 73% and 43%, respectively, reporting the use of one or both measures. Safety and other sustainability-related goals continue to be prevalent within these plans, with the prevalence of safety metrics increasing slightly from the previous year to 59% and sustainability goals remaining level at 37%.

E&P firms, on the other hand, have more complex plans with 74% of firms using at least six performance metrics. This is usually because E&P firms focus more on cost control and do so by isolating various cost inputs such as finding and development costs, general/admin expenses, and operating expenses. E&P firms also tend to incorporate more strategic/operational measures such as production goals and the execution of project milestones.

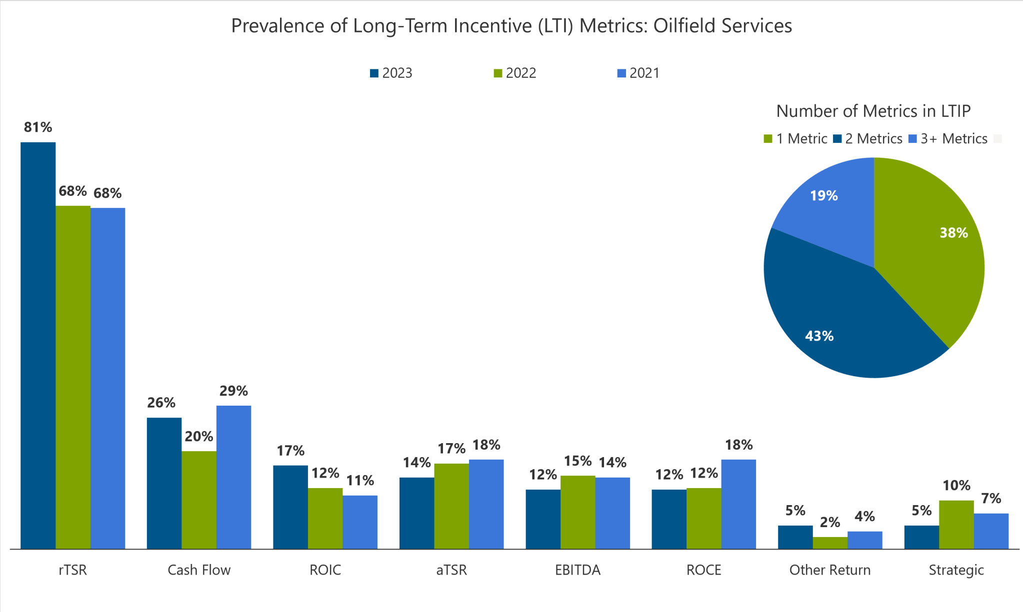


Cash flow measures are the most utilized financial criteria, followed by various cost control metrics, operating expenses (OpEx), and EBITDA. Non-financial measures like sustainability, safety, production, and strategic goals are each used by at least 40 percent of the E&P firms in the group.

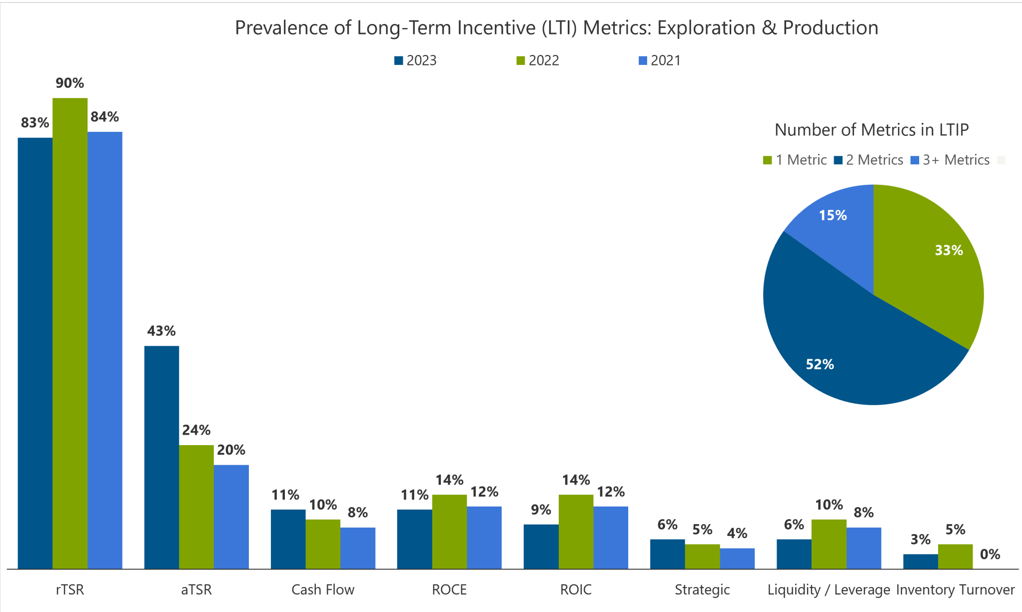
Long-Term Incentive Plan Design: Number and Types of Metrics

Total Shareholder Return (TSR) metrics continue to be the most commonly utilized long-term performance measures across all oil and gas sectors. The preference of these metrics from shareholders and compensation committees tends to lead to a heavier weighting (roughly 70-80% of plan total for E&P and OFS firms, on average). As shown below for both OFS and E&P firms, more than 90% of firms studied use three or fewer performance metrics in their long-term incentive (LTI) plans.

Outside of TSR measures, the two sectors use similar performance criteria, but with a few key differences: OFS firms, as shown below, apply a heavier emphasis on return-based metrics like ROIC and/or ROCE, with roughly 30% of the sector using some form of returns to in determining long-term incentive payouts.



E&P firms, while still frequently incorporating return-based metrics, differ slightly in determining LTI payouts. As shown below, while ROIC and ROCE are still highly prevalent, E&P companies more frequently prioritize metrics such as liquidity and/or leverage and inventory turnover.



It is also worth noting that E&P companies also measure performance via Absolute TSR (aTSR) at roughly three times the rate of OFS companies. This is often done in conjunction with Relative TSR (rTSR) metrics or as a performance modifier.

Outlook for Sustainability-Related Performance Criteria

ESG topics (and more specifically, DE&I) have become polarizing over the last year, leading to negative shareholder sentiments regarding the inclusion of such metrics in annual and long-term performance plans without a clear link to financial results. Many oil and gas companies are generally taking one of two actions: 1) relabeling their “ESG” metrics to “sustainability” and focusing on safety and environmental goals or 2) removing ESG-related criteria altogether and focusing on safety.

We should note that most companies will continue to maintain ESG- and DE&I-related initiatives internally, just without distinct metrics in the incentive plans. We have already seen these metrics plateau in 2023 plans, and will likely see a downward trend in the coming years.

Outlook for Fiscal Year 2025

In line with historical norms, we do not expect to see dramatic changes in incentive plan design going into 2025. The trend of removing ESG-related goals from incentive plans will likely continue, being replaced by safety and sustainability-related goals. Both E&P and OFS firms will take a hard look at goal-setting for these metrics, as the uncertainty of performance in a cyclical industry makes establishing performance standards a difficult task.

Companies should review performance levels for their incentive plans (and potentially corresponding payouts) and consider reducing threshold performance from historical norms to mitigate some of this risk. On top of these market factors, an incoming administration that has emphasized domestic production gives leadership teams and compensation committees one more variable to consider when setting goals for 2025.

About the Author

Malcolm Adkins is a managing director in Pearl Meyer's Houston office, and a staff manager and energy practice leader for the firm. He has over 15 years of compensation consulting experience with an emphasis on the assessment and design of executive and director pay programs, including assisting clients with compensation benchmarking and pay practices, annual and long-term incentive plan design, peer group development and pay-for-performance assessments, governance issues, and M&A support.

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