Energy Insights

Post #72: TSR Peer Group Management

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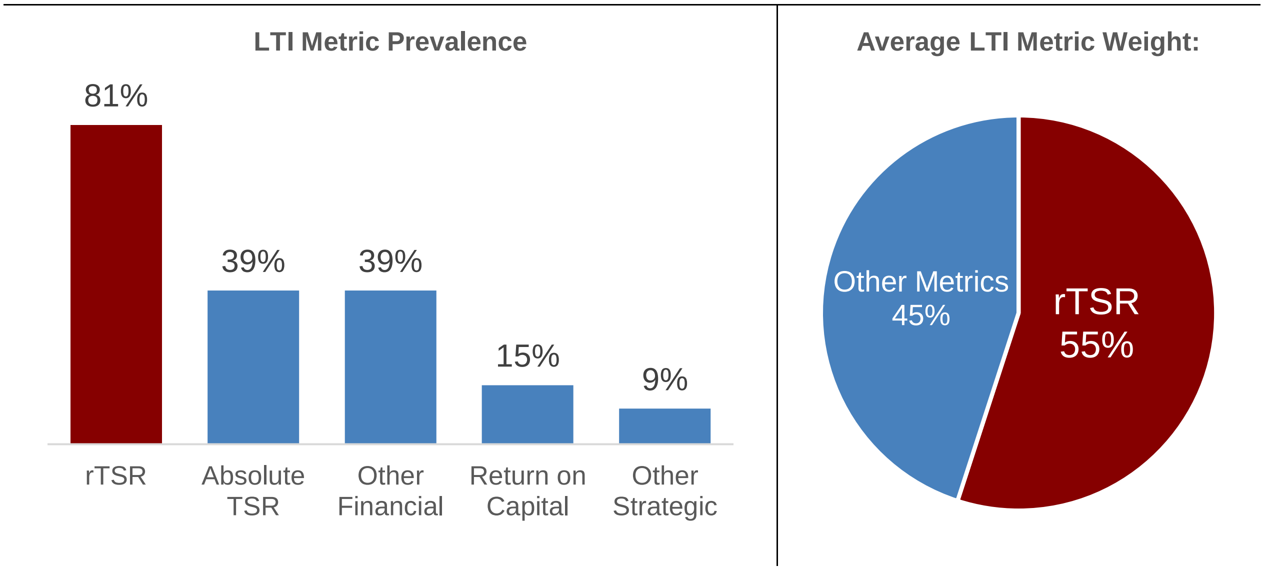
Transparency, simplicity, and a built-in buffer against the impact of commodity price cycles have helped relative TSR (rTSR) remain by far the most popular performance metric in long-term incentive plans across the oil and gas industry. However, in an increasingly acquisitive industry environment, maintaining a robust group of rTSR peers can be challenging. In our latest blog we take a closer look at several ways in which companies do, or could, address changes to impacted peer companies in outstanding performance cycles.

Relative TSR: Still Top of the Pops for Long-term Performance Measurement

RTSR as a long-term performance metric has many critics. In the oil and gas sector in particular, investors have expressed concerns about the historical predominance of rTSR, and how it can deliver above-target payouts even when share price is falling. This criticism has played a key role in driving a gradual shift away from rTSR as the sole measure of performance-based equity awards for industry executives.

Nevertheless, rTSR remains by far the most prevalent performance measure in long-term incentive plans across the oil and gas industry, and there is no indication that it is going away any time soon. It may be imperfect but it remains an effective and transparent way to measure company performance while mitigating for the impact of commodity price movement.

Oil & Gas Long-term Incentive Performance Measures[1]



In an environment of uncertainty and industry transformation, rTSR also avoids the need to set multi-year financial goals. Just pick your peer group, plug, and play. Unfortunately, that same environment of uncertainty that makes

[1] Based on 2021 proxy disclosures for 93 publicly-traded U.S. upstream oil & gas, midstream oil & gas, and oilfield services & equipment companies with performance-based long-term incentive awards

multi-year goal setting so daunting has increased the difficulty of selecting sufficiently robust peer groups and managing the composition of those peer groups over a full three-year performance period.

Peer Group Changes: Traditional Approaches to rTSR Peer List Management

Under normal circumstances, some change within the rTSR peer group due to M&A (or restructuring) activity is a reasonable expectation over a three-year performance period. In these situations, we typically see companies apply one of several "common sense" solutions. The alternatives listed in the table below for addressing peer group changes reflect common, practical guidelines intended to preserve the original intent of rTSR awards while avoiding unnecessary administrative complexity.

Peer Situation	Proposed Decision Rule	Rationale/Discussion
Bankruptcy	**Peer remains and moves to the bottom of the group** for ranking purposes	You outperformed the bankrupt peer and should get credit for doing so
Delisting	Keep peer in group at OTC price	You (presumably) outperformed the delisted peer and should get credit for doing so
Acquisition	**Remove peer from the group** with no replacement	• Simplest approach • Can result in too few peers by end of period • Best if you have a large peer group
	Lock in peer's relative position either just prior to deal announcement or at deal close	• Relatively simple • Truncates peer performance period and may miss out on material commodity price changes later in the performance period • Preserves a peer, but may not be appropriate for acquisition early in the performance cycle
	Substitute, preferably from a pre-established list of alternatives	• Relatively simple • Presumes that you can select a suitable peer from a list of companies that weren't good enough to be included in the original group

An Industry in Transition: Is a More Nuanced Approach Called For?

The "traditional" approaches above are all relatively easy to understand and simple to apply. However, two of the three acquisition alternatives shown can be challenging for oil and gas companies in the context of increased consolidation and a dwindling number of relevant "substitution" peers. Additional administrative complexity notwithstanding, today's acquisitive industry environment may call for a more nuanced approach. The table below summarizes two additional alternatives that add complexity but can potentially avoid shrinking the peer list while preserving the integrity of the rTSR program:

Approach for Addressing Peer Acquisition	Basic Concept	Additional Considerations

Follow the investment	• Measure peer performance through acquisition • Convert the investment into a corresponding investment in shares of the acquiring/ surviving company	**Pro** • May be viewed as the most precise or accurate representation of rTSR especially in a situation where a peer is acquired in a stock-for-stock, low-premium merger of equals where investors looking for a payoff from consolidation and scale have to stay with the new company over the long term **Con** • Potentially the most complex approach • The acquiring company or resulting combination may not be an appropriate comparator for your company – or may not be publicly traded • If all or a significant portion of the acquisition is in the form of cash then a more "traditional" approach of locking in relative position may be more appropriate
Reinvest in an index	• Measure peer performance through acquisition • Convert the investment into a broad industry index (e.g., XOP) and carry that investment through the end of the performance period	**Pro** • May be viewed positively by some investors who have called for accountability to broader peer groups than just a focused list of direct competitors • Conversion to an index may be viewed as more objective than substitution with another industry peer **Con** • Presumes that there is an index that provides an acceptable representation of investment alternatives • If there are multiple acquisitions you could effectively end up with a broad industry index as a peer multiple times in your rTSR group

Bottom Line

In thinking through rTSR peer group management, it's not hard to identify a number of "what if" scenarios that require additional discussion. Fortunately, in a post-162(m) world, Compensation Committees have more flexibility to evaluate each individual situation using their discretion. The application of discretion in managing the peer group does involve some risk, including the risk that changes may be viewed as "cherry-picking", or the risk of mark-to-fair value accounting if terms and conditions aren't sufficiently defined for the auditors on the grant date. However, discretion may also be critical in getting to the right answer for appropriately measuring and rewarding performance.

What's next? We suggest reviewing grant agreements to understand what guidelines (if any) currently govern the composition of your rTSR peer group. If appropriate, consider prospective changes to ensure that your Committee has reasonable flexibility to adjust to changing circumstances. And finally, as changes happen in your peer group, keep the Compensation Committee regularly apprised of the potential implications so that when it comes time for final approval there are (as much as possible) no surprises!

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