The Impact of Consolidation in the Energy Sector on Executive Compensation – Part 2

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Performance Benchmarking Peer Selection Amidst Market Consolidation

As industry consolidation reshapes the energy sector, selecting relevant performance peer groups presents unique challenges. In part two of this three-part blog post series, we explore strategies to select reasonable performance peers for measuring relative performance. Performance peers are most often used to measure relative total shareholder return (TSR) but may also be used for relative operational and/or financial performance goals.

Key Considerations in Performance Peer Selection

An ideal performance peer is one that reflects both the business and market conditions of your company. Here are three factors to consider when evaluating performance peers:

- **Share Price Correlation and Volatility:** Look for companies with similar stock price behaviors, focusing on peers whose share prices react similarly to market forces.
- **Commodity Price Exposure:** Ideally, performance peers will have comparable exposure to commodity price movement and/or commodity mix.
- **Operational Footprint:** Areas of operation (offshore or onshore, domestic or international) can also be a helpful criterion to consider, as these factors can impact production profiles, cost structures, realized prices, and macro-economic influences.

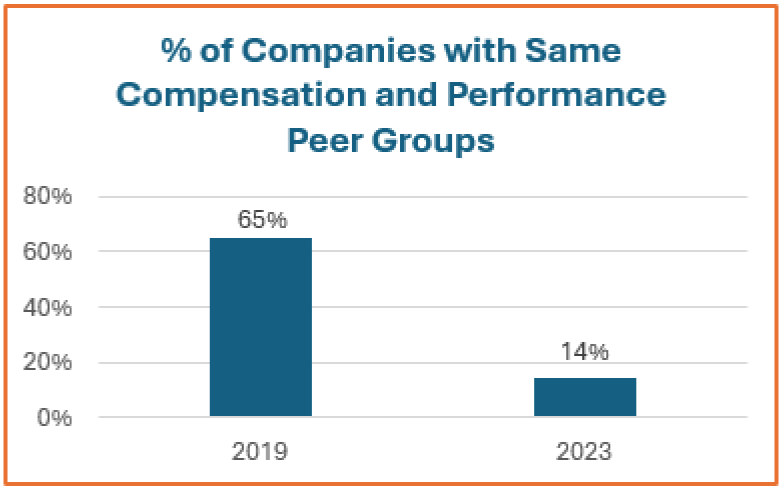
Constructing a Performance Peer Group

There are three primary approaches for developing performance peer groups:

1. **Using the Compensation Benchmarking Peer Group:** This was once the most common practice, viewed favorably because it is the simplest approach: select one set of peer companies that can be used as both compensation benchmarking and performance peers. However, as M&A activity has accelerated, companies may find that the compensation peer group, which focuses on companies of similar financial size, includes similarly sized compensation peers that are not good performance peers.
2. **Creating a Custom Performance Peer Group:** This approach allows companies to tailor their performance peers based on specific performance factors such as share price correlation and asset footprint. Although this approach adds some complexity because it requires maintenance of two separate peer groups (compensation and performance), creating custom performance peer groups is gaining traction as a way to create a set of relevant performance peers.

3. **Selecting a Market-Based Index:** For some, using constituents from an industry index such as the XOP provides an out-of-the-box performance peer group. This is another simple approach; the work has been done for you to determine the index constituents, and it requires little work in the way of peer group maintenance. However, market-based indexes will usually include some companies that are not ideal peers. For example, the XOP index includes a mix of upstream, downstream, midstream, integrated, and renewable energy companies.

In this evolving industry landscape, we have observed a significant shift from companies using the same group for both compensation and performance comparisons (over 60% of companies in 2019), to companies constructing separate peer groups for compensation benchmarking versus relative performance measurement (over 85% of companies in 2023).



Based on E&P companies from Meridian's proprietary Energy database

From an external perspective, we also note that the proxy advisors (ISS and Glass Lewis) tend to be agnostic on a company's approach to defining their performance peers.

Managing Acquisitions During the Performance Period

Once the performance peer group is constructed, defining the treatment of peers who are acquired mid-period requires careful consideration. Here are some methods to address this challenge:

1. **Remove Acquired Peers:** The simplest approach is to eliminate acquired peers from the group. While this approach is straightforward, it risks leaving too few companies for a meaningful comparison by the end of the period.

2. **Substitute from a "Bench" of Replacement Peers:** Creating a reserve of potential replacement peers can fill gaps. However, finding enough qualified replacements in a shrinking market remains a challenge, and this approach requires clear criteria for determining these substitutes.

3. **Lock the Acquired Company's Position at Deal Time:** In this approach, the acquired company's TSR ranking at the time of acquisition (or deal announcement) is frozen,

preserving its place in relation to the subject company. While this method is simpler than some, it may not suit performance periods with acquisitions early on.

4. **Convert to an Index:** A more complex approach is to measure the acquired company up until the deal announcement or the deal closes, then replace it with an energy index. This method retains some continuity and the size of the overall peer group, though it introduces complexity.

5. **Leave to Compensation Committee Discretion:** Many companies leave treatment of acquisitions to the Compensation Committee's discretion. Although this adds flexibility, it can also lead to varied interpretations across transactions, potentially complicating internal and external stakeholder perceptions.

Importantly, these options are not mutually exclusive. For instance, a peer acquisition early in a performance period may warrant a removal, while an acquisition near the end of a performance period may warrant a lock in or conversion to an index. It should be noted that bankruptcy of a performance peer is typically handled differently by keeping the company in the peer group but as the lowest performer.

Looking Ahead

Selecting a relevant and resilient performance peer group is crucial for energy companies navigating today's consolidating market. Addressing performance peer group composition and management of acquired peers within a consistent, thoughtfully designed framework enables companies to maintain relative performance measurements, even in an evolving landscape.

In Part Three, we will explore how energy consolidation impacts relative TSR calculations. Stay tuned for more insights on navigating executive compensation challenges in today's energy sector.

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