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ASSESSING LONG-TERM PERFORMANCE

Combining Absolute and Relative Measures in the Energy Industry

Posted by Christina Medland on May 30, 2013

Measuring long-term performance for companies in the energy industry is challenging because macro-economic factors, such as commodity prices, and company specific factors, such as particular asset portfolios, make it difficult to assess performance.

A mix of absolute and relative measures can moderate the pervasive effect of commodity price and other external influences in a way that is transparent to shareholders, improves executive "line of sight" and aligns pay with company performance.

Used alone, absolute and relative measures can each provide inappropriate incentives.

- **Absolute measures** can reward management for an increase in commodity price or other positive external influence, even when the company is underperforming its peers or the market—the "rising tide lifts all boats" effect.
- **Relative measures** can reward management for outperforming a poorly performing peer group, in circumstances where shareholder return is negative—the "best of a bad lot" effect.

A balance of relative and absolute measures moderates the influence of external factors, without disconnecting pay from shareholder experience. The combination provides ***moderate*** compensation when the company outperforms its peer group in a bad market ***or*** provides good results while lagging its peers. ***High*** levels of compensation are paid only when shareholder returns are positive ***and*** the company outperforms its peers.

The most common relative measure is total shareholder return (TSR). The challenge with relative TSR is choosing the right peer group of similarly situated companies. For energy companies, the performance peer group will ideally be the same as the compensation peer group, but this does not have to be the case. The performance peer group can include companies which would be too big or small for assessing compensation, and should exclude companies which do not have the same exposure to commodity price and other macro-economic or company specific factors. If there is not an appropriate peer group, performance can also be measured relative to broader stock or price index.

Some companies measure relative performance against other financial and operating metrics such as earnings growth or return on capital employed. There are, however, a few difficulties with hardwiring compensation to other relative metrics:

- Companies define operational and financial metrics differently, so it can be difficult to compare apples to apples.
- Companies have differing strategies and asset portfolios which impact comparisons of specific operating or financial metrics. For example, the costs per barrel for an oil sands company will be very different than for a company producing natural gas from Marcellus shale.
- Many operational or financial metrics are not disclosed until companies file their annual report, which is usually after most companies pay incentives.

There continues to be no perfect incentive program, but combining absolute and relative metrics can create an effective balance.

Meridian Comment

Meridian's 2013 North America Oil & Gas E&P Compensation Survey now accepting data submissions through June 28.