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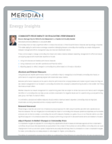

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COMMODITY PRICE IMPACT ON EVALUATING PERFORMANCE

How to Manage Pay for Performance Measures in a Volatile Commodity Market

Posted by Christina Medland on January 31, 2014

Commodity prices can have a significant effect on share price and also on financial performance measures used by energy companies. This makes paying for performance at energy companies challenging because commodity price volatility can create misalignment between management efforts, management pay outcomes and shareholder returns.

Three common ways to manage commodity price impact and create a balance between rewarding management for effort and results and aligning payouts with shareholder experience include:

1. Using both absolute and relative performance measures
2. Using a balanced score card with operational and financial metrics
3. Adjusting payouts to reflect changes in commodity price, either based on a formula or discretion

Absolute and Relative Measures

Using absolute and relative performance metrics in combination helps to manage (but not eliminate) commodity price impact on performance in a way that is generally aligned with shareholder value creation.

Absolute performance measures can be used to drive the performance the company believes will create long-term value, but they can also reward management for an increase in commodity price when the company is underperforming its peers or the market—the "rising tide floats all boats" effect.

Relative measures can reward management for outperforming peers that are subject to similar macroeconomic factors, which mitigates the effect of commodity price, but they can also provide compensation for negative results and for outperforming a poorly performing peer group—the "best of a bad lot" effect.

In combination, absolute and relative measures should provide a maximum award only when commodity prices are high (and shareholders are being rewarded) and the company outperforms peers.

Balanced Scorecard

Many energy companies use some form of balanced scorecard approach for their annual incentive plan with both operational and financial measures. This can mitigate (but not eliminate) the impact of commodity price because operational objectives, such as barrels produced, are not tied as closely to commodity price as profit measures. However, too great a focus on non-financial metrics can drive significant payouts in circumstances where the company is performing poorly both in absolute financial terms and relative to its peers

Adjust Payouts to Reflect Changes in Commodity Price

If compensation targets are adjusted for commodity price, adjustments should increase and decrease payouts and the compensation committee should ensure that adjustments are appropriate in the context of the business as a whole. While commodity price can cause misalignment in both up and down cycles, if adjustments are purely discretionary, there is a temptation to lower compensation targets for lower commodity price, but rarely pressure to raise targets for higher commodity price.

The design of compensation programs should reflect an understanding of the influence of commodity price, but pay outcomes should not be disconnected from commodity price fluctuations. Executives at energy companies should expect some compensation volatility aligned with commodity price.