Post #79: Absolutely: The Story of a PSU Performance Metric

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Since 2019 we have seen a significant increase in the prevalence of absolute total shareholder return (ATSR) as a performance measure in long-term incentive programs within the oil and gas industry, particularly upstream. The addition of an ATSR measure can be popular with investors, signaling a clear commitment to shareholder alignment. ATSR also presents profound challenges as an incentive metric for management teams in a highly cyclical industry sector where commodity price movement can easily overwhelm business strategy.

Recent History

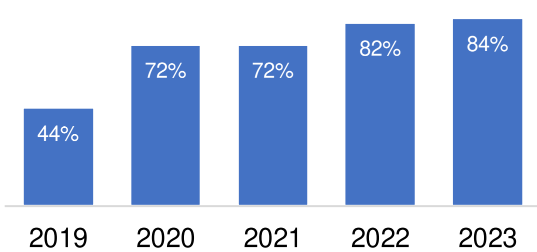
Most of the increase in prevalence over recent years has been driven by investor criticism of the industry's historical emphasis on relative TSR (RTSR). To aggravated investors, ATSR was seen as a necessary antidote to performance share unit programs paying out above target for outperforming peer groups where every company was delivering negative absolute returns.

Companies in the industry have responded by incorporating ATSR in a variety of ways within their long-term incentive programs:

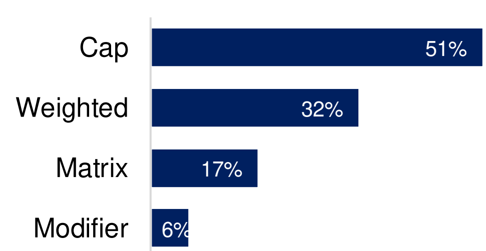
Common Application of Absolute TSR as a Performance Metric	
Cap	RTSR payouts are capped, usually at 100% of target, if absolute returns are negative
Modifier	RTSR payouts are modified, sometimes either up or down, based upon ATSR performance over the same performance period
Matrix	ATSR is included in a matrix with RTSR where payout is directly dependent upon both performance metrics
Weighted	ATSR is a standalone weighted performance metric that operates independent of RTSR or any other metrics in the performance share unit program

To assess changes in prevalence, we reviewed compensation disclosures for a broad group of upstream oil and gas companies over the past five proxy seasons (2019 – 2023). During this time, the prevalence of ATSR as a factor in performance share unit plans has nearly doubled, from 44% of companies in our database in 2019 to 84% in 2023.

ATSR in Upstream Oil & Gas PSU Awards by Proxy Year



How is ATSR Applied? (2023 Proxy Year)



Source: Meridian E&P proxy database. Note that some companies apply ATSR in more than one way, so prevalence statistics for application add up to more than 100%.

The most common application (51% of companies) is as a cap on relative TSR payouts if absolute TSR is negative. However, nearly a third of the companies in our database have added absolute TSR as a separate, weighted factor indicating that ATSR has not only increased in prevalence but in impact.

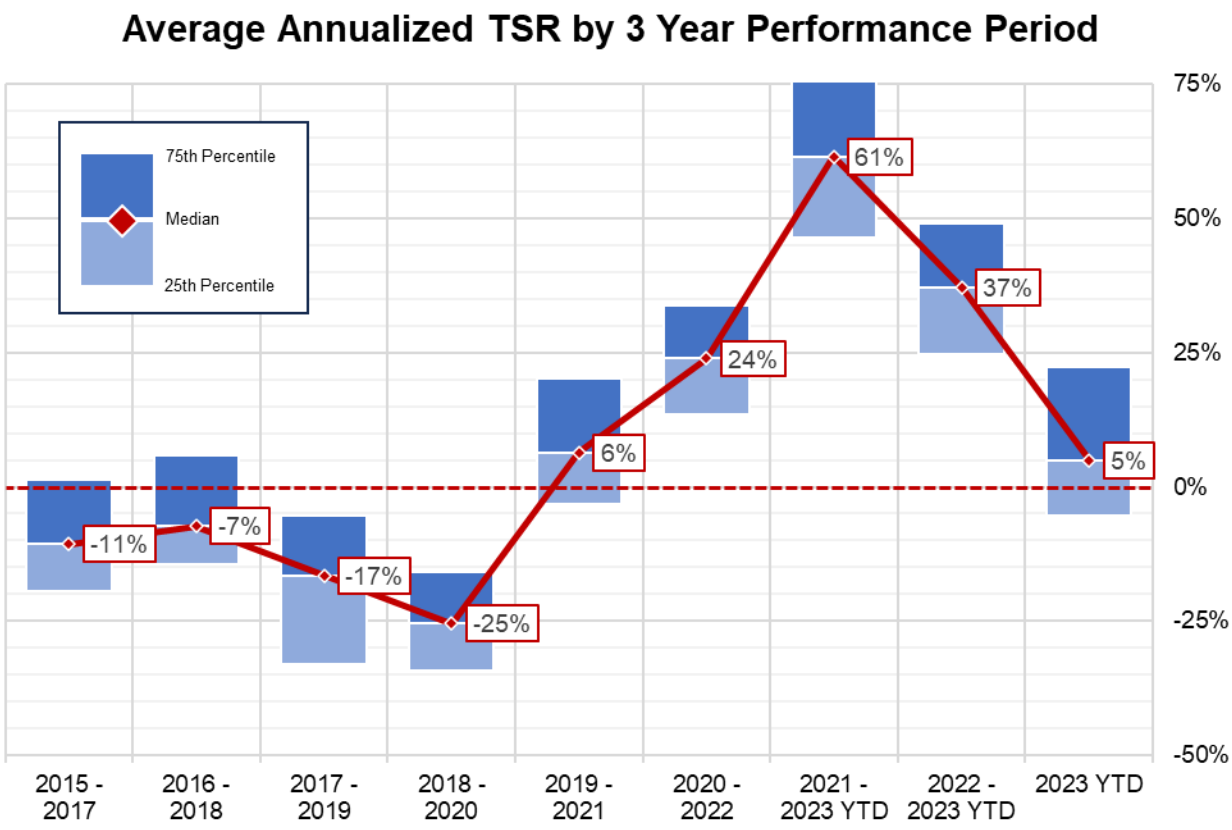
Appeal of ATSR

The appeal of ATSR is easy to understand: it enforces direct alignment between incentive plan outcomes and investor experience. When applied as a standalone metric, ATSR doubles down on shareholder alignment. The payout factor moves in tandem with the changing value of the underlying shares, amplifying the impact of both positive and negative price changes. Willingness to be directly exposed to absolute changes in total shareholder return performance can be a powerful message from management to shareholders about their commitment to alignment.

Challenges of ATSR

The challenge of using ATSR as a performance and incentive metric is also easy to understand. **In the oil and gas sector, absolute stock price performance is largely a reflection of commodity price movement**. Consequently, ATSR is more a measure of where you are in the commodity price cycle than it is of management performance – and the volatility of that cycle can make the establishment of meaningful performance standards challenging.

The chart below summarizes total shareholder return performance among companies in our upstream oil and gas database over multiple three-year performance cycles, including three incomplete cycles measured through the end of October 2023. Over this period, the average three-year TSR outcome is negative nearly 50% of the time.



If we compare these numbers to average ATSR performance standards in our database (see table below), seven of nine cycles (78%) have a median TSR outcome that is either above max or below threshold.

Average ATSR Standards (Standalone Metrics)	
Performance Level	**Annualized TSR**
Maximum	22%
Target	12%
Threshold	3%

In other words, depending on where you are in the price cycle, an ATSR award may feel to a recipient more like a lottery ticket than a performance incentive. That potential volatility may be why more companies have applied ATSR as a modifier to calibrate RTSR payouts than have applied it as a standalone, weighted metric.

Looking Ahead

Oil and gas companies have diversified and differentiated their mix of long-term incentive metrics over the last several years in response to external criticism and evolving business strategies. During this time we have seen increased prevalence of ATSR noted above. We have also seen more companies adding absolute financial metrics like return on capital, EBITDA and Cash Flow to supplement historical reliance on TSR metrics. Some companies have even begun to include strategic metrics and ESG.

Following generally strong SOP support in 2022 and 2023 for oil and gas companies, we do not expect to see significant changes in program design heading into 2024. However, companies in the industry continue to revisit the nature and extent of commodity price exposure they have in their incentive programs. The “right” application of ATSR in your incentive program (cap, modifier, weighted factor, etc.) will depend upon the outcome of that conversation, as you seek to strike the right balance of price-positive, price-negative, and price-neutral metrics in your incentive programs.

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