INCORPORATING ESG AND CLIMATE MEASURES INTO EXECUTIVE PAY

November 2021

The use of Environmental, Social and Governance (ESG) measures within incentive plans continues to increase in prevalence in response to pressures from various stakeholders. Based on research conducted by Southlea and ESG data analytics firm ESGAUGE (refer to **Chart 1**), we found that 54% of S&P 500 companies disclosed the use of an ESG measure within their incentive arrangements in 2021 (we note that data on Canadian companies is currently being compiled). As summarized in **Chart 2**, ESG measures can be incorporated as a standalone metric (39% prevalence), within an overall business strategy scorecard (40%) or within individual performance assessments (58%).

Chart 1: Prevalence of ESG Measures

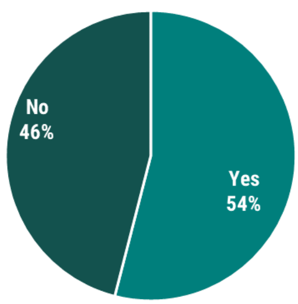
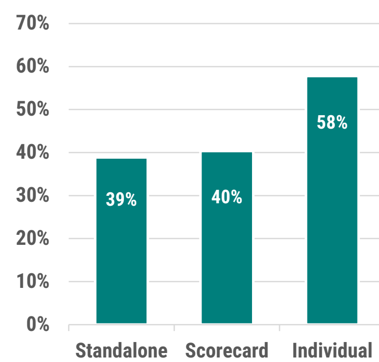
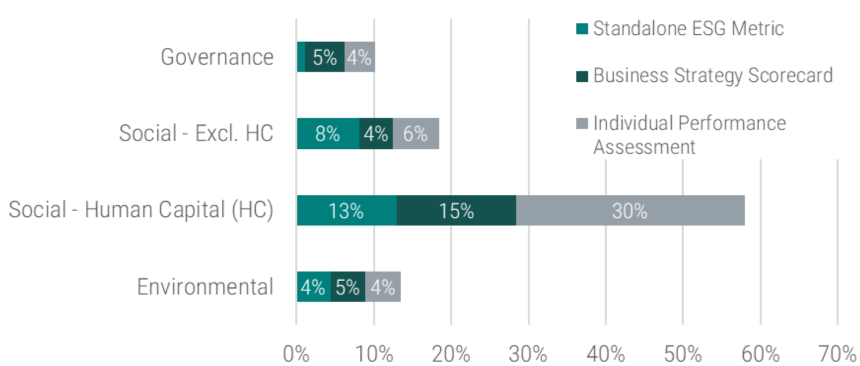


Chart 2: ESG Measurement Approach



The most common standalone metrics are operational such as customer service and employee health and safety (refer to **Chart 3**) – these measures have a history of being included within incentive plans. ESG measures within an overall scorecard and / or individual performance are most often qualitative in nature with new measures being added relating to diversity and inclusion strategies. Going forward we anticipate greater use of standalone ESG metrics – such as specific diversity targets (related to overall representation, hiring and/or retention) – that are measurable and formulaic, like other financial and operational measures currently included within incentive plans.

Chart 3: Types of ESG Measures



Issues Adopting ESG Measures

In our experience, market practice is interesting, but not necessarily helpful as it reflects past practice which is quickly outdated with current and emerging practices. Beyond the challenges of keeping pace with market practice, we are finding that companies are facing several discussion points when incorporating ESG measures within their incentive plans.

- Going beyond a "check-the-box" exercise
- Customizing to the organization's strategy
- Aligning with organization's ESG readiness
- Having the ability to measure and establish baselines
- Rationalizing ESG v. financial/market performance
- Defaulting to inclusion within short-term incentive plan
- Measuring inputs and process v. outcomes and impacts
- Considering implicit inclusion in other financial or market outcomes
- Not considering performance both relative to industry peers and broader market

ESG Incentive Design Principles

While we believe that ESG and climate change are important considerations, ESG strategies vary significantly between industries and between companies within an industry. To support the incorporation of ESG measures into incentive plans, the following incentive design principles can support the decision-making process:

Align	• Customize based on strategic objectives and materiality to key stakeholders • Consider maturity of the ESG strategy and whether changes may need to keep pace with the strategy overtime • Understand potential impact on financial and shareholder value, over which time periods, and how they are being factored into overall value • Determine interactions with other strategic priorities (capital expenditures, returns, growth)
Compare	• Align with external frameworks and/or industry standards • Understand how the potential measures impact ESG ratings
Measure	• Articulate the definition and measurement approach, including timelines • Establish baselines to understand current state • Determine short- and long-term trends and expectations • Test under different performance scenarios and relative to peers
Incorporate	• Determine how much impact the measure should have within total compensation • Confirm the incentive vehicle (short- and/or long-term incentives) and incorporation approach (modifier, weighted metric, gate)
Verify	• Measure in a simple way that is credible and consistent • Align across all external reporting (annual report, sustainability report, and proxy circular) • Incorporate into third-party audit and verification processes
Communicate	• Provide for clear and simple disclosure to plan participants and other stakeholders • Maintain regular reporting and tracking of progress

Climate Change Examples

We anticipate that companies will focus on the ESG measures that need to change overtime and climate change is a good example where we have seen numerous commitments to a “net-zero” target by 2050, with intermediate emissions reduction targets by 2030. While most companies have adopted ESG measures within their short-incentive plan (STIP), we anticipate that many climate change measures might be better suited in the long-term incentive plan given the timeframes required to make meaningful change. For example, if it is a longer-term target and/or progress will take many years (e.g., GHG reduction, workforce diversity), it may make sense to include as a 3-year target within the performance share unit (PSU) plan. In other cases, long-term incentives represent a greater proportion of total incentive pay, particularly for executives, and a 10% allocation in PSUs is more meaningful than 10% in the STIP.

We identified 22 companies in the Russell 3000 using some type of carbon footprint measure. Seventeen companies put this measure in the STIP with an average weighting of 7.5% and five companies put the measure in the long-term incentive plan (typically performance share units or PSUs) with weightings between 10% to 35%. Based on those that use PSUs, we provide examples below of different ways for its inclusion:

Metric definition	Company	Considerations
Absolute reduction in carbon dioxide emissions	Xcel Energy	Wide enough performance range to address externalities that may impact emissions Target setting should implicitly consider relative performance
Relative reduction in carbon emissions	Alcoa	Aligns with investor preferences to support climate leaders in their respective industry Can be hard to gauge progress as it is dependent on peers and ability to measure on a comparable basis (note: could look to external ESG ratings for validation)
Change in business mix that reduces emissions	Southern (net MW change) or Portland General Electric (clean MW growth)	More controllable for management team as emissions can be subject to externalities (e.g., weather) Targets need to be validated relative to carbon reduction trending given indirect link

Finally, there might be an opportunity to add a new/separate incentive plan that is customized to the specific ESG measure. For example, if you have a 10-year emission reduction target, it might make sense to adopt a 10-year PSU plan that is directly aligned with this target. This approach addresses concerns about how the target will be achieved during the interim periods and reinforces the importance of its achievement. While ten years is longer than most executives may want, there are ways to provide for payment to those retiring or leaving on good terms before the end of the period. In addition, companies will need to determine whether this additional incentive is carved-out of current compensation or is in addition given the importance of the ESG metric and alignment with incremental value creation.

Alternatively, some are advocating that strong performance supporting climate change through lower emissions will drive long-term share price returns, so might be better addressed in longer-vesting shares with post-employment hold periods. In the end, a combination of approaches may need to be taken depending on your ESG strategy, degree of maturity and current priorities.

ABOUT US

As a trusted independent advisor to boards and management teams, Southlea offers fresh insights and perspectives on people and pay programs to enhance business results. This means working collaboratively with boards and management teams using a proven approach to align pay outcomes with the achievement of an organization's strategy and performance objectives.

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