AGENDA

Boards Grapple with Including Climate Goals in LTI Plans

By Frederic Lee | January 22, 2024

Although the number of large companies disclosing ESG measures in incentive plans has increased over the past five years, boards are wrestling with whether to include environmental goals in executives' long-term incentive programs, according to a new paper.

Research has shown that most companies using ESG measures in incentive plans apply them to annual incentive plans only. Yet, companies that embed climate in long-term incentives are more successful in their efforts, says the new paper, from researchers at **Stanford University**'s Rock Center for Corporate Governance.

To get the most out of climate-linked metrics, compensation committees should structure their plans carefully and make sure metrics are aligned with strategic plans, sources told Agenda.

Monique Melis, managing director and global head of financial services compliance and regulation at **Kroll**, told Agenda that there's uncertainty about what types of environmental metrics boards should include in long-term plans.

She said that metrics must be properly measurable if they're going into LTIPs, and that's a big challenge for certain environmental metrics.

"If it's vague and unmeasurable, then you can't put it into a long-term plan," said Melis, explaining that such a scenario could backfire and potentially upset shareholders.

Most companies continue to measure ESG metrics on a qualitative or discretionary basis, according to **Sara Salzbank**, a consultant at compensation consulting firm **FW Cook**. That's because many companies don't have the forecasting precision to set quantifiable long-term environmental goals over three-year periods, she wrote in an email. For many companies, climate change and sustainability objectives will evolve over the course of decades, making goal-setting more difficult.

Meanwhile, there are also technical accounting implications.

"For companies with equity-based, multi-year plans (which is the majority of large companies), discretion in measurement may lead to variable accounting on the award — a consequence some companies may not be willing to accept," wrote Salzbank.

The vast majority of companies that apply ESG measures in incentive plans use only annual incentive plans, according to a 2023 study from FW Cook, which analyzed the use of ESG metrics in annual and long-term incentive plans among the 250 U.S.-listed companies in the S&P 500 with the largest market capitalizations.

Crucial Simplicity

That said, long-term incentive plans with environmental metrics are not unheard-of.

For one, **APA Corporation**, the holding company for oil and gas production company Apache Corporation, filed a Form 8-K on Jan. 12 describing the approval of an updated performance share program by the board of directors' compensation committee.

Long-term performance shares granted to executive officers will vest on the basis of three individually weighted measures of performance, including one sustainability measure. Reduction of the company's global methane intensity will make up 20% of the award.

According to the filing, the percentage of reduction of methane will be measured over the performance period compared to a previous baseline year to calculate the three-year reduction in methane intensity. The calculation will rely on standards applicable to the countries in which APA operates.

APA has long included ESG-metrics in its short-term incentives. In 2022, it introduced a long-term incentive goal to "deliver capital and operational projects that collectively will eliminate at least 1M tonnes of annualized CO2 emissions" by the end of 2024. For 2023, it included a LTI goal to reduce its Scope 1 greenhouse gas emission intensity by at least 5% by 2025.

"When setting our ESG goals, we focus on issues that are pertinent to our business and where we believe we can have meaningful impact, resulting in actionable targets for the short and medium term," an APA spokesperson wrote in an email. "By tying the ESG goals to employee compensation, we demonstrate our commitment to emissions reductions and the value we place on environmental stewardship."

Melis said that simplicity is crucial in climate metrics, because if there are too many climate quotas and measures included in incentive plans, they become difficult to gauge.

Boards have a choice of how to structure climate metrics if they include them in executive compensation plans, according to the Stanford paper. They can apply discrete weighting, which means a specific percentage of the bonus is awarded or withheld based on the achievement of a quantitative metric, or the scorecard method, whereby a specific percentage is awarded based on the achievement of a mix of quantitative and qualitative metrics.

Other climate metric structures include the modifier method, which means that the overall bonus earned based on primary metrics is adjusted up or down within a specified range based on the level of achievement of the modifier goal, and the discretionary structure, whereby the board determines at its own discretion whether a bonus payment is merited, according to the paper.

Climate programs work best when goals are included in executive and senior-manager compensation arrangements for the purpose of fully aligning the organization with its commitments, the research found. It added that many companies use annual bonus programs to achieve that aim, but the most successful companies also work climate initiatives into long-term incentive programs in order to match the timing of goals and compensation payouts.

Seth Kirkham, chief investment officer for global equities at **Galvanize Climate Solutions** and one of the authors of the Stanford paper, told Agenda that long-term compensation plans are typically driven by quantitative metrics.

In the case of climate objectives, that could mean a multiyear decarbonization plan that ties into the form and payout of the LTIP, he said in an email statement. Alternatively, short-term compensation does not always have to be quantitative and therefore allows for subjective review of climate performance, said Kirkham.

“Whether corporations are looking to lead on the climate transition or simply to minimize legal and reputational risk, we believe that executive compensation structures [that] reward meeting specific emissions abatement objectives could represent a powerful mechanism to hold management teams accountable for meeting climate goals,” Kirkham said.

He added that companies are starting to wake up to the investment opportunity of the ensuing energy transition away from fossil fuels, and by rewarding efforts to meet net-zero pledges, executives are seeing synergies with their total shareholder return and profitability goals. “They go hand in hand,” Kirkham said.

From the outside, investors can have trouble gaining insight into the climate initiatives that companies implement, where their milestones are set and how much money the companies have invested in these initiatives, according to the paper. Companies’ voluntary sustainability reports reveal some data, but corporate carbon reduction programs specifically are a “black box” to institutional investors who are weighing the economic impact of climate change on their portfolios, the paper said.

Similarly, the research explained, the broader investment community appreciates sustainability efforts, viewing them as a de-risking move for companies. Additionally, “local communities and customer groups see environmental abatement efforts as necessary for companies to maintain their social license to operate.”

Still, Melis said, recent controversy surrounding ESG has hampered the likelihood of boards’ using these metrics in comp incentive plans going forward, particularly in the long-term component.

From a financial services viewpoint, there is confusion about what the "E" in ESG wholly represents, she continued. For example, banks are doing good work in terms of the "S" and the "G" because of regulatory pressure, but there isn’t enough clarity on how the banking sector should address the environmental part of ESG, she said.

“Goal-setting presents challenges, said Salzbank. “Leadership at many companies already express difficulty in setting goals covering a typical award’s three-year horizon. This is even more so true for ESG objectives tied to programs that are in their relative infancy,” she added.

It remains to be seen how the market will evolve regarding ESG metrics and executive compensation, but in any event, directors should be prepared to communicate to stakeholders how selected ESG measures are aligned with the company’s business strategy and are key to long-term financial results, said Salzbank.
