



Industry overview — as it relates to executive compensation

Oil and gas

Climate change is thought to adversely affect oil and gas (O&G) more than any other global industry, and COVID-19 has put more pressure on the industry, resulting in the permanent closure of some drilling sites. Energy demand forecasts that take climate-related policy changes into account indicate that oil income could fall by more than 50%.

While the industry is accustomed to managing complex operational and political risks, including safety and environment, the burning of fossil fuels and link to carbon production is seen as a major cause of climate risk and global warming. Various stakeholders are increasingly demanding that O&G companies articulate their plans for reducing carbon emissions of both their operations and their products for some time. The imperative and continued pressure for the industry to act is undeniable.



Regulatory, governance and investor drivers

From a regulatory and governance perspective, O&G companies regularly encounter legal challenges. Here are a just two examples:

- Earlier this year, activist investors required that two board directors step down for perceived insufficient action.
- A Dutch civil court mandated that a company cut its CO₂ emissions by 45% by 2030 compared to 2019 levels.

Additionally, O&G companies may face stricter standards in terms of financing and insurance coverage as financial institutions and insurers increase their demands on the industry. For example, The World Bank will no longer finance post-2019 upstream oil and gas projects; U.S. and European banks such as Goldman Sachs, JP Morgan, HSBC, Deutsche Bank, among others have already or have committed to end financing of Arctic oil and gas projects. And Swiss Re will gradually cut support in underwriting and asset management to the world's 10% most carbon-intensive oil and gas producers by 2023.

Investors are also driving the need for a fundamental shift in O&G companies' business models as they increase demands for climate-related transparency, actions to manage climate risk exposures, divestiture from fossil fuels and portfolio changes in favor of outperforming ethical funds. Groups such as the Climate Action 100+, Transition Pathway Initiative (TPI) and the Global Investor Coalition on Climate Change (GIC), representing more than \$50 trillion in assets under management advocate for companies to reveal long-term plans for tackling climate change.

Additionally:

- \$31 trillion (one-third of total assets under management globally) is held in green investments, up 34% from 2016, and as of September 2019, about \$11 trillion in assets under management were divested from fossil fuels, up from just \$52 billion in 2014.
- Approximately \$2.6 trillion was invested in renewables from 2010 to 2019, with the majority flowing into solar and wind. Institutional investors (representing \$6.8 trillion in assets) are expected to nearly double allocations to renewables to 7.1% over the next five years.



The industry response

In response, major O&G companies are using capital raised from production to fund new clean energy investments and initiatives and see climate-change action as an opportunity to present a more positive brand with a less carbon-intensive portfolio. They are optimizing operations and minimizing waste, investing in carbon capture and storage and decarbonization technology, and diversifying investment beyond traditional renewables such as hydrogen. However, smaller companies are still focusing on production and extraction at a commodity price, typically with limited resources to focus on sustainability.

A key challenge for the industry is the pace of change that is being targeted for decarbonization and the degree of change of strategy and infrastructure required to do so, combined with the need to continue to be profitable and deliver shareholder value.



What are companies measuring and reporting?

Companies are more likely to have material business discussions and narrative in annual reports that focuses on Scope 1 and 2 emissions, whereas actions to address Scope 3 emissions is less advanced (consistent with other industries). O&G companies are mainly measuring:

- Carbon emissions (likely to be measured over the long term and tracking against net zero emission targets that most major market players have committed to)
- Recordable environmental events: reportable events reductions (likely to be measured over the short term)
- Water waste and efficiency

The supermajors provide a leading indicator of shareholder sentiment and market direction. They have responded to shareholder and activist scrutiny in recent years with increased transparency regarding climate goals and timing. In terms of aligning climate targets with executive compensation, environmental and safety-related metrics have been in incentive plans for some time, but there is now more emphasis on them, more detail in metrics target disclosures and more of a specific link to climate.

With regards to climate-specific metrics, a reduction in net carbon emissions is commonly the primary goal, along with strategic change metrics (e.g. energy transition or reweighting of portfolios). Reportable environmental events and waste and water efficiency are also commonly seen. Across the industry, metrics can be fairly subjective, expressed in terms of “improvement in...” although we expect targets to become increasingly quantifiable and externally verifiable.



Aligning climate goals and targets with executive compensation

Traditionally, environment-related metrics have been more prevalent in short-term incentives, but we are now seeing more in long-term incentives and more metrics with more meaningful weightings. Compared to other industries, it is accepted practice to have a relatively large proportion of incentive performance measurement based on non-financial metrics, such as safety, production and reserve management. Therefore, including climate goals is not viewed as distracting from the financial focus. Having said this, the focus on financials and sustainable margin energy production remains the largest portion of incentives.

European majors (BP, Shell, Eni and Total Energies) are leading the way in terms of climate goals within executive incentives, with greater emphasis on climate metrics within their incentive plans – each having introduced climate metrics to their long-term incentive programs over the past two years. We expect North American O&G companies to follow suit and expand the use of climate metrics in their compensation programs, including long-term incentive plans (LTIPs), over the next one to three years.

Example targets include:

- In short-term incentive programs, greenhouse gas and emission reductions, energy transition, Scope 1 and 2 emissions intensity, carbon neutrality strategy and renewable growth
- In long-term incentive programs, Scope 1 and 2 decarbonization versus three-year targets; energy transition – electricity from renewables; circular economy – bio-fuels projects; greenhouse gas and emissions reduction (Scopes 1, 2 and 3) objectives for each for 2021, 2022 and 2023 – absolute and relative to 2015 emissions.



Challenges aligning climate goals and executive compensation

As companies come under pressure to decarbonize and invest in changes to their operating models, they could see slimmer profit margins. This may cause challenges in terms of executive compensation design and achieving the appropriate balance of pay versus long-term climate goals versus immediate short-term economic and shareholder value (particularly for smaller companies), as well as retaining and motivating key talent to achieve short-, mid- and long-term strategies.

There has been some debate in the industry around the using restricted stock units (RSUs) rather than performance-based long-term incentive plans to mitigate the focus on volatile commodity prices that are largely out of management's control. Where RSU's are implemented, there is some pressure in European markets to have an underpin as a minimum level of performance before the RSU's vest. Given the importance of climate change to the industry and investors as well as a minimum financial return, it may be expected in the future that a climate-related goal would be part of the framework of the plan as an additional gateway metric.



Leading company example — Royal Dutch Shell

- **Metric name and description:** Upstream and Integrated Gas GHG intensity (Tonnes of CO2 equivalent/tonne of hydrocarbon production available for sale)
 - **Weight in vehicle:** 4% of annual bonus scorecard
- **Metric name:** Refining GHG intensity (Tonnes of CO2 equivalent per Solomon's Utilised Equivalent Distillation Capacity (UEDC))
 - **Weight in vehicle:** 4% of annual bonus scorecard
- **Metric name and description:** Chemicals GHG intensity (Tonnes of CO2 equivalent/tonne of petrochemicals production)
 - **Weight in vehicle:** 2% of annual bonus scorecard
- **Metric name and description:** Energy Transition Measures – 1. NCF Reduction Target (measured against 2016 base year – 79 grams of CO2 equivalent per megajoule), 2. Growing power business, 3. Advanced biofuels technology, 4. Systems to capture and absorb
 - **Weight in vehicle:** 10% of long-term incentive plan