Road to net zero… incentivising leadership

September 2021

Overview and summary

In the coming months, the UK will host the 26th UN Climate Change Conference (COP26), with countries coming together to accelerate action towards the Paris Agreement and the UN Framework on Climate Change. With increasing focus on the corporate sector to mitigate the impacts of climate change, the actions of business executives are seen as critical in this area.

Companies, investors and wider stakeholders are increasingly aware that climate strategy will be intrinsically linked to future business resilience and can positively impact many areas, from talent attraction to employee engagement. In the last six months, twelve FTSE 100 companies have committed to a 'say on climate' vote and this trend is expected to continue, reflecting the growing imperative around how businesses plan to deliver their net zero goals.

Mandatory reporting under the Taskforce for Climate-related Financial Disclosures (TCFD) framework is now in place for premium listed companies with accounting periods starting on or after 1 January 2021. With climate set to transform the global economy over the next three decades, we are seeing an exponential shift in the focus on the action of boards in this area.

Climate and incentive plans – an emerging debate

As part of a wider trend towards the use of Environmental, Social and Governance (ESG) metrics in executive incentive plans, companies are increasingly incorporating the delivery of climate goals under annual and long-term reward frameworks.

While there are mixed views around the inclusion of ESG metrics in executive incentive plans, it can be a powerful tool in driving leadership behaviours when structured in the right way and linked to transparent and quantifiable performance targets. Net zero goals set in line with the Science Based Targets initiative (SBTi) provide one route for boards in demonstrating that targets are aligned with the Paris Agreement and latest climate science, enabling a consistent framework across the corporate sector.

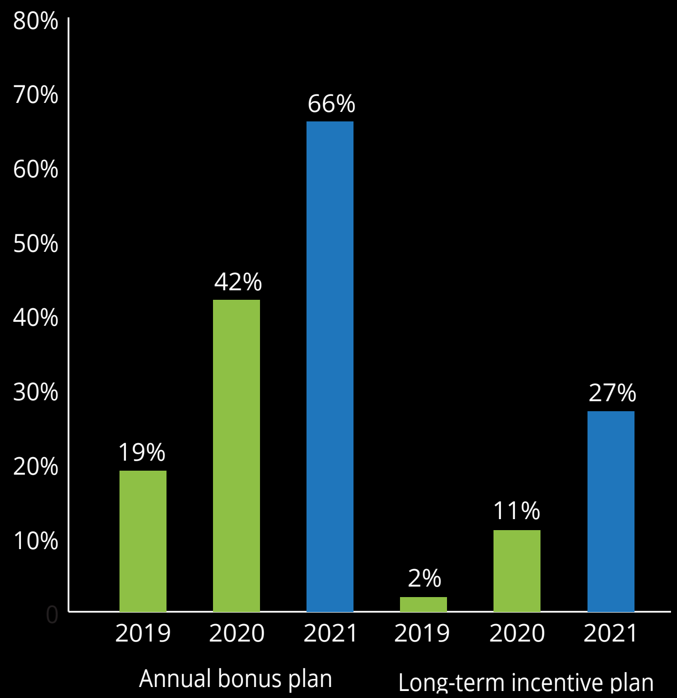
The same principles apply as for financial metrics - remuneration committees should ensure that sufficient flexibility exists to safeguard against rewards for failure, and seek external assurance around target setting and performance out-turns. Where boards can demonstrate clear alignment to strategy and future business performance, the inclusion of climate metrics can send an important signal to executives, employees, investors and wider stakeholders and incentivise the collaborative change required to meet the UK's net zero ambition.

Stephen Cahill, Vice Chairman

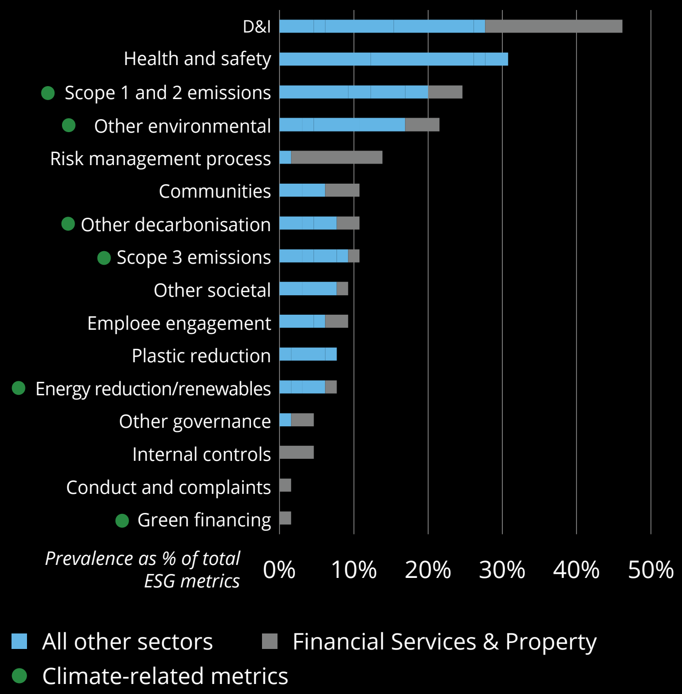
Head of UK Executive Compensation Consulting Practice

Increasing use of ESG metrics in executive incentive plans, and growing focus on climate

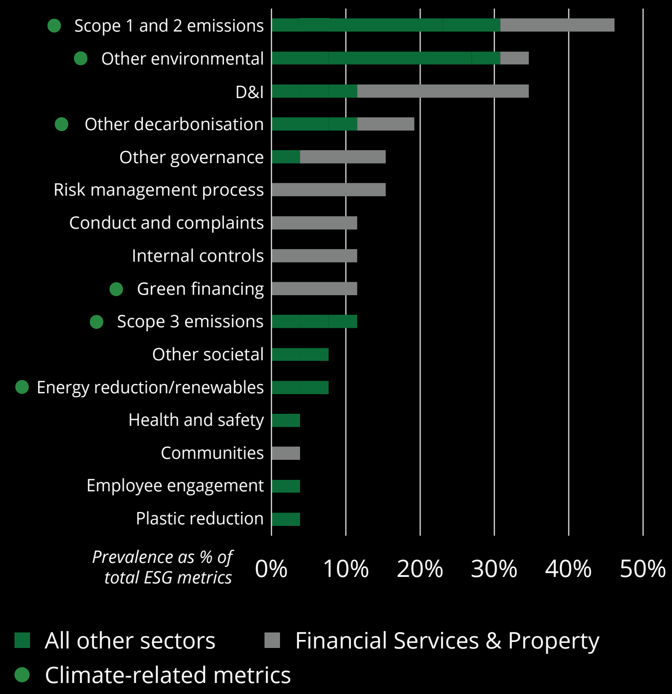
FTSE 100 - ESG metrics in incentive plans



ESG metrics – annual bonus plans



ESG metrics – long-term incentive plans (LTIP)

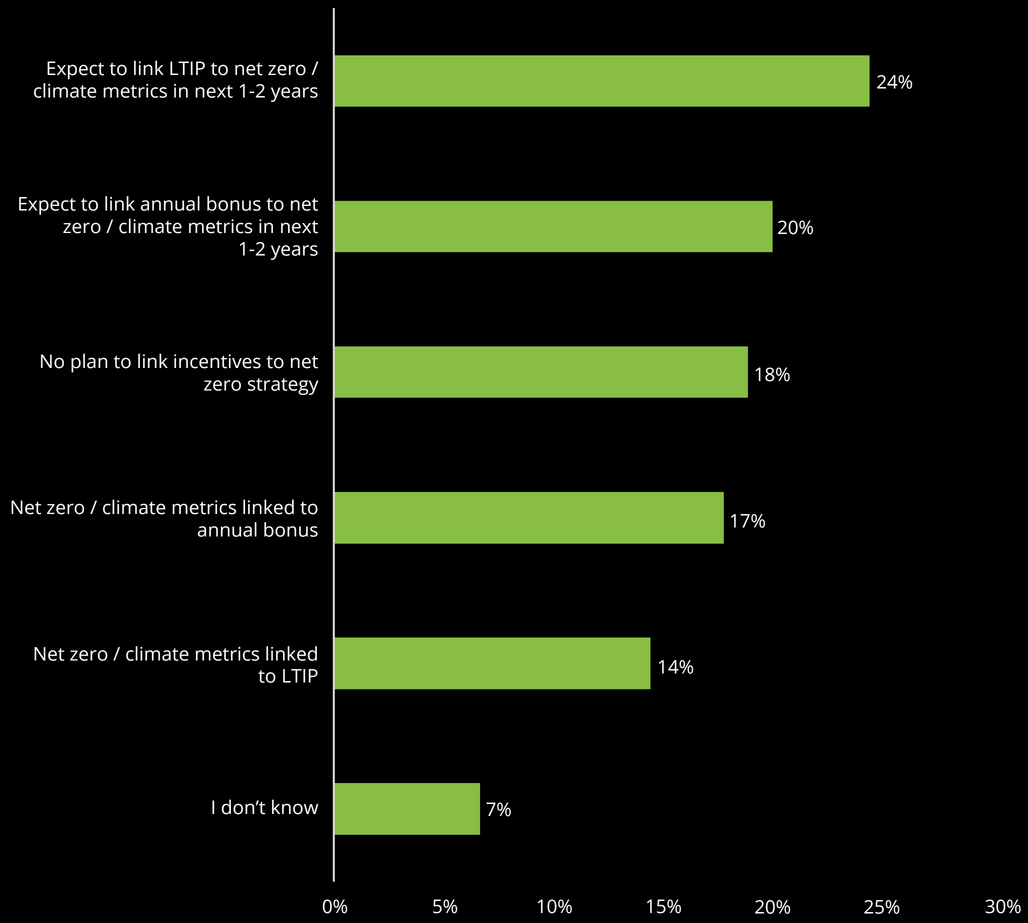


In the last year we have seen increasing use of ESG metrics linked to climate, in particular under long-term incentive plans (LTIPs). Over 50% of ESG measures included in long-term incentive plans are climate-related goals.

While 'first movers' in this area were in the extraction industry, we are now seeing other sectors such as financial services commit to climate goals e.g. green financing.

We expect to see a further shift in companies linking incentive plans to net zero / climate goals in the next 1 - 2 years

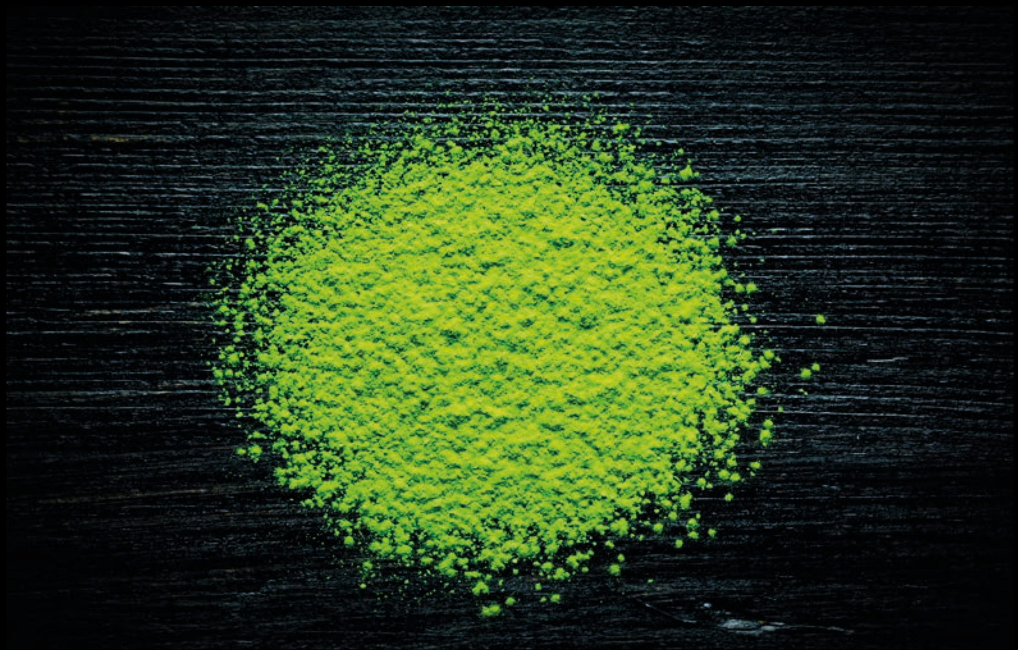
Deloitte Academy poll – describe your net zero strategy and approach to executive remuneration?



Deloitte Academy poll on 30 June 2021 (92 responses)

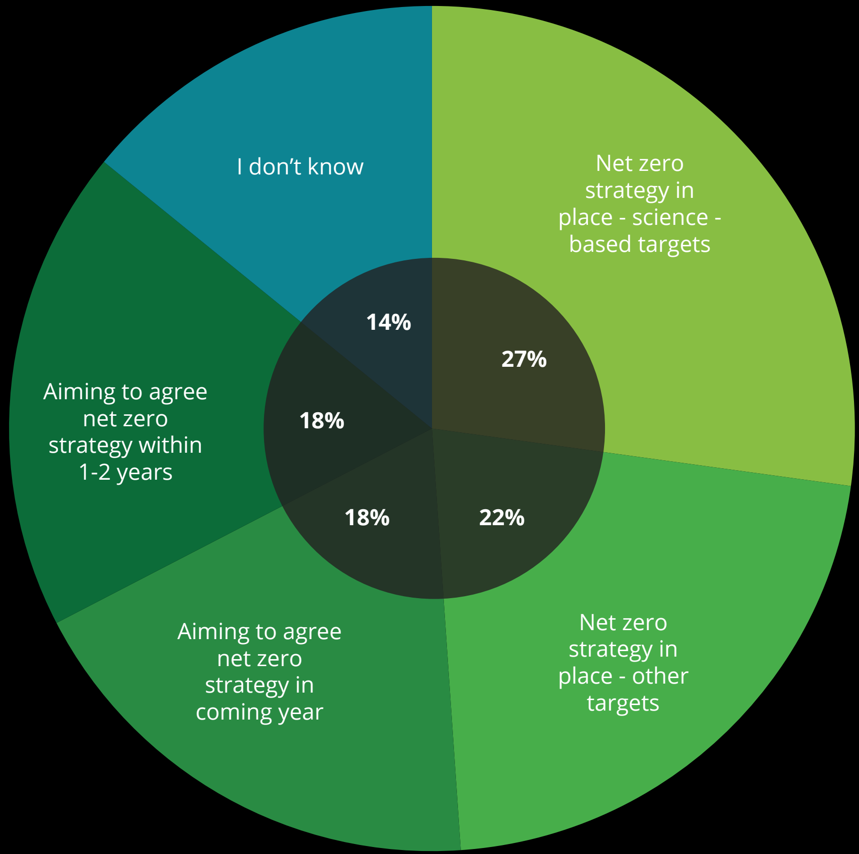
In a recent Deloitte poll, 24% of companies expected to introduce net zero / climate metrics under the long-term incentive plan in the next 1-2 years.

20% of companies expected to introduce net zero / climate metrics goals under the annual bonus plan in the next 1-2 years.



Science-based targets are often favoured by investors, as they allow businesses to demonstrate that net zero goals align with the Paris Agreement and latest climate science

Deloitte Academy poll – describe your net zero strategy and approach to science-based targets?



Deloitte Academy poll on 30 June 2021 (92 responses)

Over one-half of FTSE 100 companies have disclosed that they have applied for, or already have approved, net zero goals under the Science Based Targets initiative (SBTi).

According to a recent Deloitte poll, the vast majority of companies have agreed, or are aiming to agree, their net zero strategy in the next 1-2 years.

Science-based targets – what are they?

Around 189 countries signed up to the Paris Agreement, which aims to keep the global average temperature increase to well below 2 degrees centigrade.

The Science Based Targets Initiative (SBTi) allows businesses to demonstrate that their subsequent targets are in line with the Paris Agreement and latest climate science – with over 1,000 organisations signed up to date.

Things to know:

- Science-based targets provide validation for decarbonisation ambitions. This is a formal, validated approach, and as part of the process, a company's targets will be approved by the SBTi.
- There are specific steps to getting involved. First, a letter is submitted outlining the intent to set a Science Based Target, which is developed and presented for official validation. Once validated, it can be announced and companies will track their progress every year.
- Science-based targets may not be the right way forward for every business. Some companies are looking to be more ambitious by doing more than their 'fair share' in decarbonising – for example by reaching Net Zero on Scope 1, 2 and 3 well in advance of 2050.
- Finally, climate change and nature loss are closely linked, and so a SBTi Network is now working to develop targets for water, land, ocean and biodiversity.

Scope 1, 2 or 3 emissions?

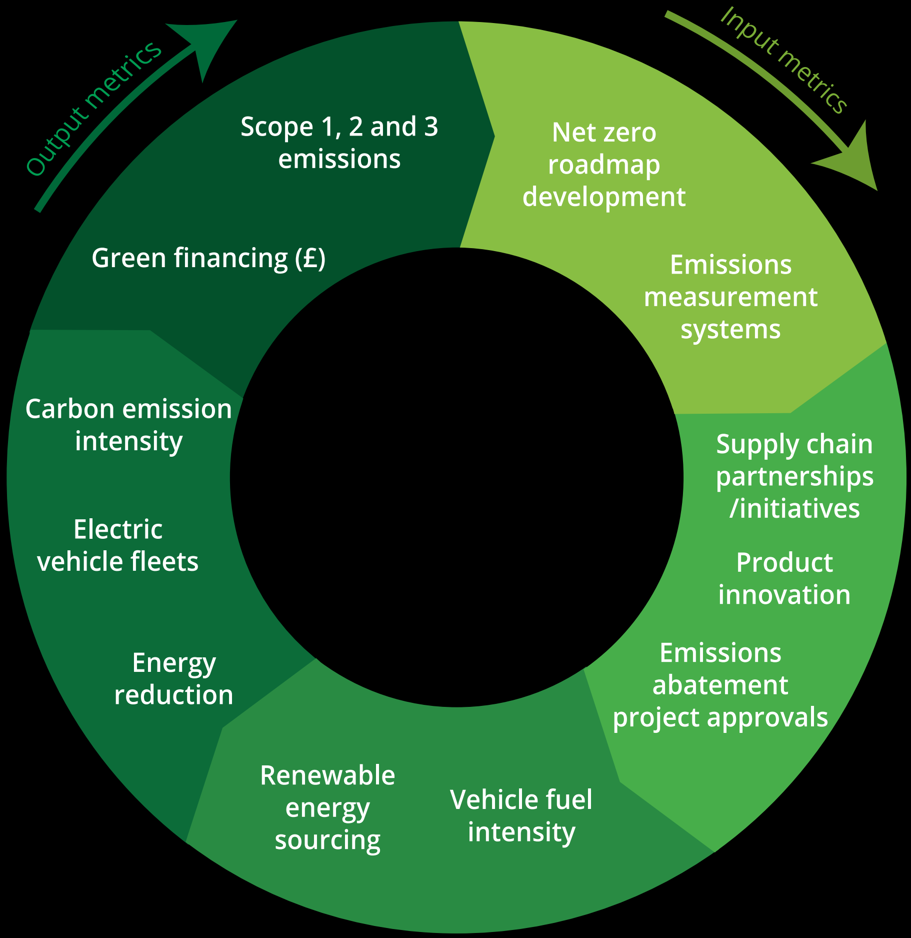
Scope 1, 2 and 3 is a way of categorising the different kinds of carbon emissions a company creates in its own operations, and in its wider value chain.

Scope 1 Green House Gas (GHG) emissions that a company makes directly e.g. while running its boilers and vehicles.	• Companies will normally have the source data needed to convert direct purchases of gas and electricity into a value in tonnes of GHGs. • This information may sit with procurement, finance, estates management, or in a sustainability function.
Scope 2 Emissions that a company makes indirectly e.g. the electricity or energy it buys for heating and cooling buildings, that is being produced on its behalf.	• In some cases, solutions exist to deliver net zero for Scope 1 and 2 emissions. • For example, an organisation can source renewable electricity, renewable gas, or electrify its heat demand, or transition to electric vehicles.
Scope 3 All emissions that an organisation is indirectly responsible for, up and down its value chain. For example, from buying products from its suppliers, and from its products when customers use them.	• For many businesses, Scope 3 emissions account for more than 70% of their carbon footprint. For example, for an organisation that manufactures products, there will often be significant carbon emissions from the extraction, manufacture and processing of the raw materials. • Many companies are looking to collaborate on solutions to reduce emissions with current suppliers, or consider changes to the supply chain. However, in most areas, suppliers will have considerable influence on how emissions are reduced through their own purchasing decisions, and product design. • Definitions for what constitutes net zero ambition can vary - but businesses looking to adopt best practice will commit to tackling Scope 3 emissions as part of their plans. • Mapping an emissions footprint by scale, and how much control a company has over the source, is a good way to start addressing them – in particular identifying emissions 'hotspots' within easy reach and making these the first ports of call.

'Scopes' are the basis for mandatory TCFD GHG reporting in the UK, effective for premium listed companies in respect of accounting periods from 1 January 2021.

For many businesses, scope 3 emissions account for more than 70% of their carbon footprint.

Considering climate metrics – examples



A range of input and output metrics are used under incentive plans, typically focussed on material areas of an organisation's carbon footprint, as well as their ability to track and measure emissions.

ESG metrics in remuneration – investor perspectives

"ESG measures should be material to the business and quantifiable. In each case, the link to strategy and method of performance measurement should be clearly explained" *Investment Association*

"Use financial and ESG metrics for measuring executive performance which focus on outcomes rather than inputs to potential corporate performance" *Schroders*

"If the board decides to use ESG-type criteria, these criteria should be linked to material issues and they must be quantifiable, transparent and auditable. These criteria should reflect the strategic priorities of the company" *Blackrock*

"ESG metrics should be meaningful, measurable, aligned to the company's strategy and subject to third-party verification. [..] Where ESG metrics are included as part of the long-term incentive, we would not expect this to be weighted more than one-third of the total award." *Legal and General Investment Management*

Incentive plans and climate - case studies

Case studies – Scope 1, 2 and 3 emissions (science-based targets)

Case study - AstraZeneca plc

From 2021, Performance Share Plan (PSP) includes a 10% weighting based on reduction of Scope 1 and 2 emissions.

- AstraZeneca's Ambition Zero Carbon strategy is based on a goal to be zero carbon across global operations by 2025 (Scopes 1 and 2) and carbon negative across the entire value chain by 2030 (Scopes 1, 2 and 3).
- The strategy goes beyond the verified reduction goals of AstraZeneca's existing Scope 1 and 2 Science Based Targets to limit global warming to 1.5°C.
- From 2021, a metric focusing on the delivery of these commitments will be included in the long-term incentive plan (PSP).
- The new PSP metric is based on Scope 1 and Scope 2 emissions reductions, as measured against a 2015 baseline.
- Targets and assessment of performance against this metric will be determined in line with the World Resources Institute/World Business Council for Sustainable Development GHG Protocol methodology for accounting and reporting of the emissions footprint.
- Three year performance period to end of 2023.
- 20% vesting for 60% reduction from 2015 baseline, full vesting for 68% reduction from 2015 baseline.

Case study – Dixons Carphone plc

From 2021/22, Annual Bonus Plan includes a 5% weighting based on reduction of Scope 1 and 2 emissions.

- Dixons Carphone has committed to reduce absolute Scope 1 and Scope 2 GHG emissions by 50% by 2029/30 from a 2019/20 base year.
- The emissions reduction targets have been approved by the SBTi as consistent with levels required to meet the goals of the Paris Agreement.
- From 2021/22, the Annual Bonus Plan will include new metrics focussed on environment including reduction of Scope 1 and 2 Carbon Emissions (5% weighting) and recycling by increasing e-waste Take Back (5% weighting).
- Retrospective disclosure of the targets and performance against them will be provided in next year's Remuneration Report.

Case study – J Sainsbury plc

From 2021/22, new 2021 Win in Food Incentive Plan will include a metric based on reduction of Scope 1, 2 and 3 emissions.

- The new 2021 Win in Food incentive plan incorporates eight key metrics underpinning the new strategy. This includes progress against Net Zero Scope 1, 2 and 3 targets, as part of a strategic indicators scorecard (20% weighting).
- The Science Based Targets initiative (SBTi) has approved Sainsbury's targets set for Scopes 1, 2 and 3. For Scopes 1 and 2, these include the reduction of emissions from Sainsbury's own operations to Net Zero by 2040.
- Under the 2021 Win in Food incentive plan, Scope 1, 2 and 3 targets have been set at threshold and stretch against a 18/19 baseline, for a three year performance period to 2024.

Case study – Croda plc

From 2020, long-term incentive plan included a sustainability metric including Scope 1 and Scope 2 emissions (5% weighting) and for 2021 a Scope 1 science-based emissions reduction target (7.5%).

- First introduced a Sustainability metric under the long-term incentive in 2020 (10% weighting), based on decarbonisation roadmaps and measurable reductions in Scope 1 and 2 emissions.
- For 2021, the Sustainability metric (15% weighting) is aligned to the delivery of Croda's "Climate Positive" and "Land Positive" sustainability commitment. This included a reduction target (7.5% weighting) specifically aimed at Scope 1 emissions and aligned with a Science Based Target (SBT). Reductions measured over three-year performance period, and compared to verified emissions in 2020.

Case studies – spotlight on banking sector

Case study – HSBC plc

For 2020 awards, new Environment and Sustainability metrics with 25% weighting under long-term incentive plan (LTIP), focussed on carbon reduction and sustainable financing.

- In 2020, a new Environment and Sustainability scorecard measure was added to align to HSBC's climate ambition - to bring carbon emissions in its own operations to net zero by 2030 and support customers in the transition to a more sustainable future with financing, facilitation and investments of $750bn to $1tn over the same time period.
- Under the long-term incentive plan, an Environment and Sustainability metrics will apply with a weighting of 25%, based on:

- **Carbon Reduction (% reduction)** - measured based on percentage reduction in **total energy and travel emissions** achieved by 31 December 2023 using 2019 as the baseline. Threshold to maximum range of 42% to 51% reduction over the performance period.
- **Sustainable finance and investment ($bn) –** based on cumulative financing provided over a four year period (threshold to maximum range of $200m to $260m).

Case study – Barclays plc

From 2021, new Climate metric under long-term incentive plan (LTIP) with 10% weighting, focussed on aligning financing activities with the Paris Agreement goals.

- Ambition to be a net zero bank across Scopes 1, 2 and 3 by 2050 and a commitment to align all financing activities with the goals of the Paris Climate Agreement.
- From 2021, addition of a specific Climate measure with a weighting of 10% of the 2021-2023 LTIP.
- The evaluation will focus on progress towards our ambition to be a net zero bank by 2050 including:

- Commitment to **align financing** with the goals of the **Paris Climate Agreement**
- Commitment to **£100bn of green financing by 2030**

- There will be detailed retrospective narrative on progress over the period, including consideration of progress towards other relevant targets.

Case study – NatWest plc

From 2020, performance scorecard for long-term incentive award at executive director and executive committee level includes metrics focussed on climate ambition to 'be a leading bank helping to address the climate challenge'.

- Performance scorecard used to assess 2022 long-term incentive awards includes the following climate-focussed metrics:

- **Reduce carbon emissions** from direct operational footprint by 25% from 2019 baseline
- **£8bn funding and financing for climate** and sustainable finance in 2021
- **Complete footprint estimate** of 2019 total financed emissions
- Develop estimates aligned with the 2015 Paris Agreement for a further 4 sectors

Case study – Lloyds Banking Group plc

2021 Group Performance Scorecard includes 7.5% weighting based on reducing operational carbon emissions.

'We expect the specific measures for these commitments to evolve over time, most notably to reflect our increasing role in supporting the UK's climate change goals.' **2020 Lloyds Banking Group Annual Report**

- Under 2021 Group Performance Scorecard (used to determine 2021 performance share awards and 2022 long-term share plan awards) based on key financial and strategic metrics, including 7.5% weighting on reducing operational carbon emissions.
- Targets to be disclosed in 2021 Annual Report.

Case studies – spotlight on utilities sector

Case study – Severn Trent plc

As part of Severn Trent's Triple Carbon Pledge and 2030 net zero ambition, a new LTIP metric will apply from 2021/22, with a focus on carbon reduction (20% weighting).

- New sustainability measure focussed on commitment to net-zero carbon emissions by 2030 as part of Severn Trent's Triple Carbon Pledge.

Direct contributors *to carbon reduction*
- Roll-out of electric car and light commercial fleet
- Renewable energy generation

Innovation for *carbon reduction*
- Delivery of innovation trials with opportunity greater than 7.5 ktCO2e
- Establish effective monitoring on operational waste treatment sites

'The two Innovation for Carbon Reduction components have been chosen for their importance in making significant progress towards our goal of achieving net-zero carbon emissions by 2030. The Committee intends to focus them on the achievement of specific and targeted emissions reductions as soon as it is feasible to do so.'
Severn Trent Annual Report 2020/21

Case study – SSE plc

SSE assesses progress against key sustainability goals under the Annual Incentive Plan (20% weighting). Four key targets are linked to the UN's Sustainable Development Goals (SDGs).

- 20% weighting under annual bonus plan linked to progress against four UN SDG goals for 2030. Quantifiable metrics set in the following areas:

Carbon intensity - Cut carbon intensity by 60% by 2030
Renewable output - Treble renewable energy output by 2030
Electric vehicle infrastructure - Help accommodate 10m electric vehicles in GB by 2030.
Fair tax and Living Wage - Champion Fair Tax and a real Living Wage.

Case study – Pennon Group plc

As part of a commitment to net zero carbon by 2030, from 2021/22 individual/personal objectives under the annual bonus plan will be replaced with key ESG goals including carbon emissions reduction (20% weighting).

- From 2021/22 the personal element of the annual bonus plan (20% weighting) will be replaced with ESG goals including carbon emissions reduction goals, working environment for employees and diversity. Details of the targets will be disclosed in next year's annual report.
- Operates alongside key operational metrics such as leakage and wastewater pollution incidents, and customer service scores.

Case studies – spotlight on extraction sector

Case study – Royal Dutch Shell plc

From 2021, Shell increased the weighting of energy transition metrics under the annual bonus and LTIP. New GHG abatement metric and removal of link to production volumes.

From 2021, Royal Dutch Shell strengthened existing energy transition and net zero metrics under incentive plans, in line with its 2020 strategy to be a net-zero emissions energy business by 2050.

Annual bonus plan

- From 2021, energy transition metric increased from 10% to 15% weighting, and linked to greenhouse gas (GHG) intensity of main business lines and from 2021, a new GHG-abatement target. The new metric measures execution of GHG abatement projects linked to achieving net-zero operational emissions.
- Removal of the link to hydrocarbon production volumes.

Long-Term Incentive Plan

- From 2021, increased weighting on the Net Carbon Footprint (NCF) energy transition condition from 10% to 20% of the award, in line with weighting of financial metrics such as free cash flow.

Case study – BP plc

For 2021, 15% of annual bonus based on sustainable emissions reduction.
40% of LTIP based on strategic scorecard including delivering value in hydrocarbon business and low carbon electricity and energy.

From 2021, BP plc set performance metrics under the annual bonus and long-term incentive plan aligned with the transition strategy announced in September 2020, focussed on three key areas: low carbon electricity and energy; convenience and mobility; and resilient and focused hydrocarbons.

Annual bonus plan

- 15% of annual bonus plan linked to sustainable emissions reduction.

Long-Term Incentive Plan

- 40% weighting of strategic scorecard under LTIP linked to three focus areas of transition strategy including low carbon electricity and energy; convenience and mobility; and resilient and focused hydrocarbons.
- Remuneration committee retains discretion to allow 'for the anticipated evolution of the low carbon business environment.'

Case study – Rio Tinto plc

From 2021, Rio Tinto is including an environmental metric based on progressing Scope 3 emissions and abatement projects/partnerships, alongside a range of ESG metrics under the Short-Term Incentive Plan.

Under 2021 Short-Term Incentive Plan, environmental objectives (5% weighting) included as part of range of ESG objectives:

- Approval of C02e abatement projects (0.22Mt C02e – 0.37Mt C02e target to outstanding range).
- Delivery of goals to progress scope 3 partnership strategy across value chain.

Rio Tinto disclosed 2021 bonus targets prospectively, recognising that they were not considered commercially sensitive.

'Climate change is one of the key long-term environmental challenges facing us as well as a source of potential opportunities. We must and want to be part of the solution. The targets set are driven from our roadmap to execute against our climate change ambitions. As we are neither able to control nor accurately measure scope 3 emissions, our strategy remains to impact positive change in this area through partnerships focused on the decarbonisation of the value chain.' Rio Tinto Annual Report 2020

Climate and incentives - considerations for remuneration committees

01

Which metric?

The discussion should start at the Board.

While some remuneration committees are feeling pressure to act in light of rapidly shifting market practice, the primary 'test' for investors will be alignment with the wider strategic narrative. Any metric should focus on the most material aspects of the climate plan.

With COP26 on the horizon, many businesses are revisiting how they articulate the opportunity of climate strategy, seeking to link it more directly to business activity (e.g. to reduce the carbon intensity of product sales over time). We expect to see metrics further evolve in the coming years.

02

Input or output?

Some investors favour output metrics rather than inputs to potential performance.

Consider where you are in your measurement journey and ability to track and measure outputs. A range of metrics are being used and investors will look at the extent to which incentive targets are quantifiable, transparent and verifiable.

Some companies are starting out with input metrics, but committing to keep under review as measurement systems evolve.

03

Baseline and performance period

Climate metrics are increasingly being incorporated under long-term incentive plans.

While climate metrics are being incorporated under both annual and long-term incentive plans, there is some evidence that output-based climate metrics are increasingly being introduced under the LTIP, with three year interim targets set by reference to longer-term net zero ambitions. The journey to net zero over a specific timeframe may not be linear, so explain your approach.

If you are setting a baseline, this should be representative of your typical GHG profile. For many businesses, 2020 was a very different world in light of COVID-19, with some opting to use 2019 as a baseline.

Climate and incentives - considerations for remuneration committees

04

Target setting

When it comes to target setting, the devil is in the detail.

Unlike financial metrics, many companies are measuring their carbon footprint for the first time. In many cases, this may not be budgeted or forecast - the quality of data is different and can be challenging to interpret.

For example, in the same way currency can impact financial performance, conversion factors (the multipliers used to turn business activity into carbon footprint) can change year on year.

Target setting is likely to involve input from the sustainability, HR and finance functions and approval may be sought by the sustainability committee. External assurance can also be helpful.

Consider whether targets will be set on a binary basis or with a threshold to maximum performance range – this is likely to depend on weightings, plan design and how climate ambitions have been articulated.

05

Adjustment and verification

Allow flexibility for judgement and discretion.

Remuneration committees should be open and transparent in communicating how they plan to assess performance and progress, including where expected judgement and discretion may be required. Plan documentation should include flexibility to allow for any appropriate adjustments required to ensure 'like for like' measurement at the end of the performance period.

Many committees are seeking external verification of performance out-turns linked to pay.

06

Disclosure and communication

Linking pay to climate ambition can send a powerful message.

While LTIP performance targets will typically be disclosed upfront, some companies are also disclosing annual bonus targets on a prospective basis, where not considered commercially sensitive.

Linking executive incentives to climate ambitions can send a powerful message to all stakeholders, so use internal and external communication tools to maximise your impact in this area.

What next?

Most businesses are at the start of their climate journey, and market practice will continually evolve in terms of how ESG and climate metrics are incorporated under incentive plans.

Over the last year, shareholder interest has intensified around how remuneration strategies reflect the risks and opportunities of climate change, and expanded investor and proxy guidance may be issued in this area.

As companies increasingly develop science-based net zero goals and improve their ability to monitor and measure Scope 1, 2 and 3 emissions, we expect to see greater focus on performance outputs, as well as better articulation of how climate is linked to business activity and opportunity.

Finally, climate change and nature loss are closely linked, and a Science Based Targets Network is working to develop targets for water, land, ocean and biodiversity. This is expected to provide a collaborative framework against which to measure and incentivise progress in the wider environmental landscape.

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