Paying for ESG

In response to increasing pressure from institutional investors, proxy advisors and other stakeholders, companies have increased their focus on environmental, social and governance (ESG), and many are including or contemplating the inclusion of ESG measures in incentive plans.

Environmentally sensitive businesses (such as mining and oil and gas) have traditionally included employee safety metrics and environmental spills as part of their incentive measures. These traditional measures are now being "repackaged" as ESG measures and the focus on broader sustainability metrics—carbon footprint, greenhouse gas emissions and climate change—is increasing.

The COVID-19 pandemic, and the broader societal focus on diversity, equity and inclusion, have increased pressure on companies to consider including incentive measures based more on the *social* "pillar" of ESG. However, including broader climate change and social metrics in incentive plans is not without challenges.

The ESG Journey

For many companies, adding ESG metrics to incentive plans is part of a process that may take several years to execute. A multi-step process could include, for example:

1. *Identifying* specific ESG priorities that are central to the business, understand the status quo for these priorities and their link to business strategy, and set sustainable business goals and objectives.

2. *Disclosing* the status quo and the business actions and initiatives underway to improve key areas of ESG focus, to help "set the stage" and contextualize specific goals/measures of progress toward long-term objectives.

3. *Incorporating* ESG metrics in incentive plans, by focusing on specific, measurable and time-bounded objectives that align with strategic priorities and improvements in business performance.

ESG Incentive Metrics

The transition from ESG-as-objective to ESG-as-incentive has significant challenges.

- Aspirational sustainability goals can make sense as part of a strategic plan, but paying for ESG introduces pressure to precisely and accurately measure performance—this has particular challenges for metrics such as "climate change impact", which cannot be directly measured, but are typically estimated.

- Paying for achievement of diversity goals can have unintended consequences, such as impacting workplace culture where diverse employees can be viewed as hired or promoted due to diversity, rather than competence—potentially exacerbating any biases that already exist.

  — Measuring "diversity" is particularly challenging, with a tension between *precise* criteria that may seem like quotas, and *directional* criteria that may seem inadequate to the importance of the issue.

— For example, setting more process-focused goals (e.g., requirements related to interviewing diverse candidates, training and education, or "Town Hall" communications) can avoid unintended consequences, but process goals are typically milestone based, and may be viewed as lacking real "stretch".

It is important to select ESG metrics that are operationally and strategically relevant to the business, and that the company disclose them explicitly. The best ESG compensation metrics have five key attributes, but covering all five equally well is unlikely:

- Clearly identifiable as E, S or G
- Directly related to key strategic / business priorities
- Measurable
- Directly improve financial performance
- Targeted at individuals who can impact outcomes

For example, a fuel efficiency measure for a transportation company is (i) An "Environmental" measure; (ii) Directly related to the business priority of improving operating efficiency; (iii) Clearly measurable; (iv) Drives cost savings that directly improve profitability; and (v) Can be targeted to senior executives. This is an ideal example, however many ESG metrics will not meet all five of these criteria—e.g., greenhouse gas emissions may be "calculated or estimated," not directly measured based on observable data, and may not have a near-term direct impact on the bottom line.

As companies work through the ESG continuum, they may need to be more accepting (at least for a time) of compensation principles that are qualitative and less precise than we have come to expect from incentive measures. Committees will need to use judgment and to focus on progress toward long-term sustainable value creation, to avoid unintended consequences.

Ultimately, some ESG design may follow the path that safety measures have taken. Early safety measures in industries like mining and oil & gas focused on reduction in reportable incidents and injuries. However, this had the potential to drive underreporting and actually impair safety culture. For many companies, safety in incentive plans has since evolved to include a combination of "leading" measures to improve safety culture (e.g., development of critical incident protocols), combined with "lagging" measures to ensure that the improvement in safety culture is effective in keeping employees safe (e.g., injury / incident reporting).

Below are some questions that may help companies to evaluate potential ESG metrics:

- Which ESG metrics are most important for the business?
- Which of these metrics are practically measurable or quantifiable?
- How have ESG metrics been tracking over time—is there a history of performance against which to set goal?
- How are ESG goals disclosed, internally and externally?
- What external parties are tracking / reporting on the company's ESG metrics, and what measures are they focused on?

- Which ESG issues may warrant additional focus by the board and management?
- What unintended consequences may arise from introducing a new ESG metric?
- Are ESG metrics better suited for short or long-term incentive programs?

Meridian's Research

Meridian reviewed the use of ESG metrics in incentive plans at those S&P 500 companies with early 2021 disclosure. Our interim results indicate that:

- ESG metrics have increased in prevalence in annual incentive plans, to nearly 60% of companies in the study, but only ~ 5% of companies in the study included ESG metrics in their long-term incentive plans.
- In short-term incentive plans, companies typically assess ESG results on a qualitative basis; in long-term plans, the metrics are more quantitative.
- Social issues tend to be the most prevalent, led by a focus on diversity, equity and inclusion. While performance metrics related to human capital are relatively new, we anticipate the prevalence of these metrics to increase over time due to stakeholder interest and the recent SEC requirement to include disclosure on human capital management in annual filings for U.S. issuers.
- Environmental metrics tended to be concentrated in the Energy, Utilities, Materials, Capital Goods, and Real Estate sectors. Typical metrics related to safety, emissions, carbon footprint, and renewable energy.
- Approximately one-third of companies disclosed an assigned weight for ESG metrics in their annual incentive plans (most commonly 10% or 20%). The remaining two-thirds did not disclose an assigned weight and often included these metrics in the broader list of other unweighted individual performance objectives.

We expect the prevalence and nature of ESG metrics in incentive plans to evolve rapidly. It will be critically important for companies to take the time necessary to include the right metrics, in the right way, in their incentive design.

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