
ESG & Executive Compensation in 2021

Driving ESG and corporate
strategy with executive pay.

LC

LANE CAPUTO
COMPENSATION

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EXECUTIVE SUMMARY

The extent to which organizations are perceived to be responding to Environmental, Social, and Governance (ESG) issues is becoming increasingly important to various stakeholders. This perception can impact the view of the organization and its sector, its impact to the 'social good', and generally the concept of whether an organization has earned its perceived license to operate.

Just as important for many companies, the world's largest institutional investors are increasingly scrutinizing their investment strategies and assessments of risk versus return through an ESG lens. As the investment community's focus on ESG intensifies, companies' relative responsiveness to ESG concerns will create winners and losers in the competition for progressively choosier capital.

The influx of retail and institutional investment into sustainable funds has increased materially over the past several years. To further underpin this shift, institutional investors have been dramatically escalating their engagement efforts with the companies in which they invest to accelerate the focus of these companies on addressing ESG issues. In turn, management teams and boards of directors must devote time and resources to respond to the growing chorus of demands for increased analysis, measurement, disclosure, and mitigation of ESG risk into their companies' business planning cycle.

If ESG issues will be playing a larger role within corporate strategy, should ESG targets – and performance against those targets – not also play a larger role in executive pay programs? We are seeing a growing consensus that these two topics should be more closely intertwined.

Focusing on the energy sector, the findings in this report show that both the tracking and reporting of ESG metrics and the integration of these metrics into executive pay plans are in their infancy. With that said, the extractive industries in general and the energy sector specifically, have a head start in many aspects of ESG tracking and reporting via their historical focus on both Health, Safety & Environment (HSE) and community relations within their operations. With this historical focus on many elements of ESG, albeit by another name, and a strong governance foundation initially developed to ensure fiscal and reserves reporting, the energy sector is well-positioned to more fully integrate ESG performance into executive pay programs.

WHY COMPANIES SHOULD CARE ABOUT ESG

While energy organizations will always be measured according to their financial and operational success, we are now entering an era whereby the sustainability of this financial and operational performance (and, therefore, the very market value of a company) is being calculated with an eye on an organization’s identification and mitigation of the ESG risks that it faces now and in the future.

A discussion of ESG and its risk is really a discussion of governance as all aspects of the ESG spectrum fall under the broader umbrella of the board of directors’ oversight of risk and the sustainable business practices that will ultimately deliver sustainable financial returns. One can easily see from sample topics listed in **Table 1** below that all ESG factors are equally important in building and maintaining a sustainable business and companies have been successfully managing many of these ESG topics for decades.

Most recently, certain Social and Governance (e.g. gender & diversity, board composition) and Environmental (e.g. climate change) initiatives have been at the forefront of the ESG discussion. For the extractive industries in particular, the focus on climate change and other Environment aspects of the ESG spectrum are being weighted more heavily by ESG standard setters (e.g. Sustainability Accounting Standards Board [SASB], Task Force for Climate-Related Financial Disclosure [TCFD]), asset managers and ratings agencies. Failure to adequately address the ESG concerns of asset managers and ratings agencies may soon impact the ability of companies to raise capital.

Some examples of ESG factors are listed in **Table 1** below.

Table 1: Examples of Environmental, Social, and Governance Matters

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate change impacts and GHG emissions	Labour standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Executive succession planning
Air, water, resource depletion or pollution	Customer satisfaction	Audit committee structure
Waste management	Community relations	Bribery and corruption
Biodiversity impacts	Gender and diversity	Whistleblower programs
	Safety management	

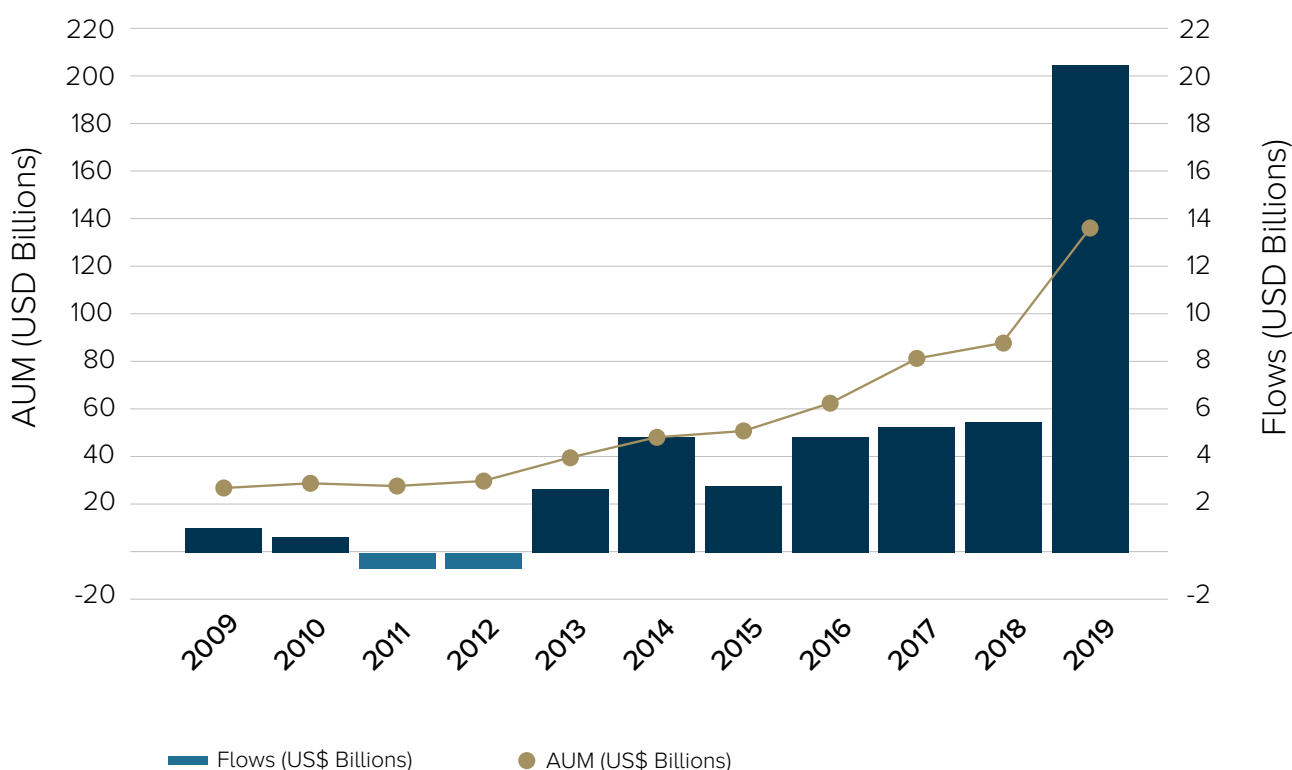
Source: Adapted from GAO analysis of documentation from the CFA Institute, Sustainable Accounting Standards Board and Principles for Responsible Investing

Moving towards Sustainable Investing

The rise of ESG concerns among investors is not a new phenomenon, but the topic has become more prominent in the eyes of both retail and institutional investors over the last few years. As shown in **Figure 1**, net asset inflows into sustainable funds in the U.S. totaled a record \$USD 21.4 billion in 2019, up nearly 400 percent from the prior record set in 2018¹, and to a total assets under management (AUM) increased significantly to just under \$USD 140 billion in 2019. Similarly, in Canada, funds invested in Canadian-domiciled sustainable funds in Q1 2020 eclipsed sustainable investment in all of 2019.²

"Net asset inflows into sustainable funds in the U.S. totaled a record \$USD 21.4 billion in 2019."

Figure 1: Total Assets Under Management in US-based Sustainable Funds



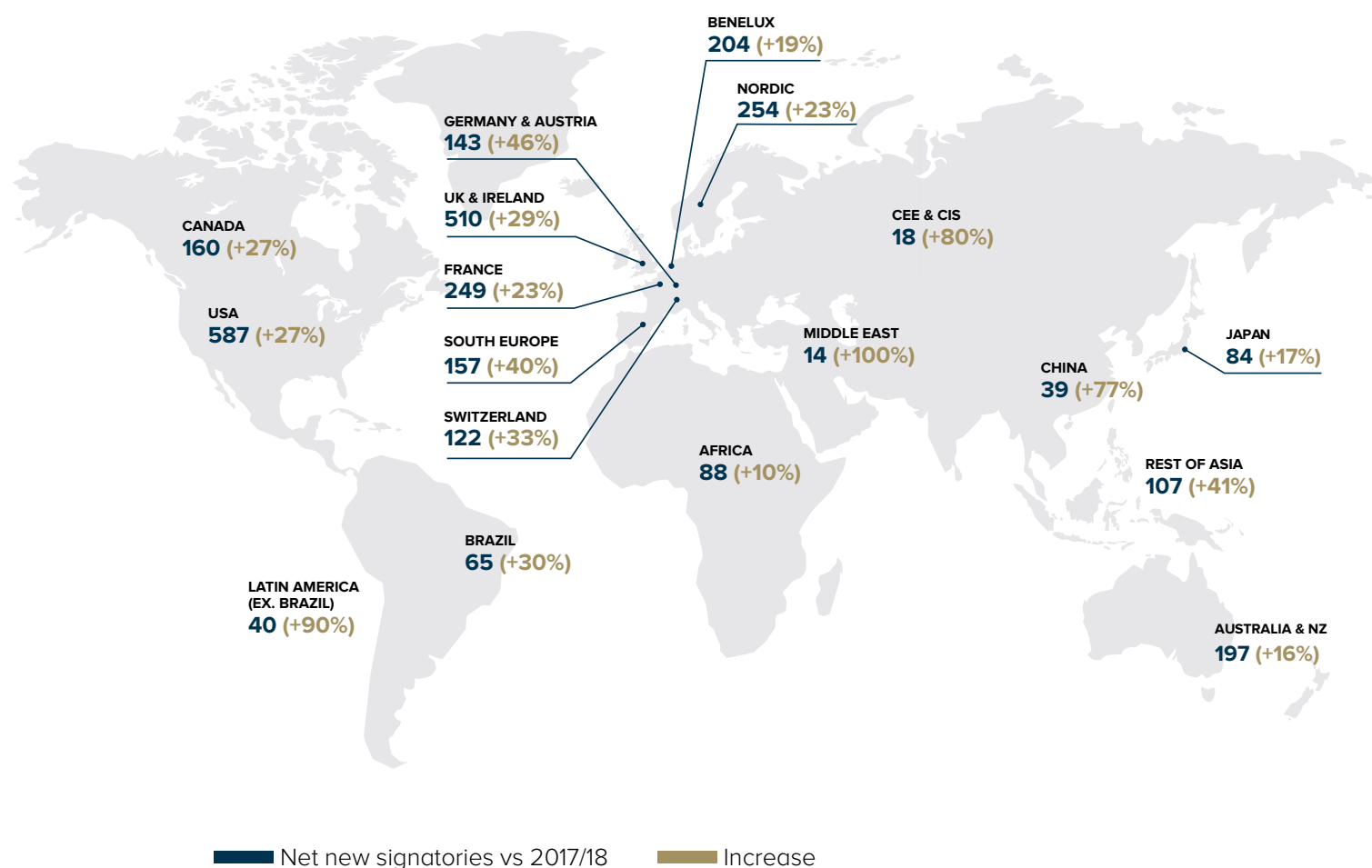
The world's largest institutional investors are responding to, or leading, the movement towards sustainable investing. Take, for example, the UN's Principles for Responsible Investment (PRI), which requires all signatories commit to incorporating ESG issues into their investment practices. PRI now has more than 3,000 signatories, representing \$USD 103 trillion in AUM.

¹ Morningstar – *Sustainable Funds U.S. Landscape Report - February 19, 2020*

² Morningstar – *Canadian ESG funds grew faster May 7, 2020*

Or, look at the closely affiliated investor initiative Climate Action 100+, whose signatories aim to engage with the world's top greenhouse gas emitters to drive the clean energy transition in line with the goals of the Paris Agreement and the Taskforce on Climate-related Financial Disclosures (TCFD) principles. Climate Action 100+ now has 500 institutional investors representing \$47 trillion US in AUM (see **Figure 2** below).

Figure 2: Climate Action 100+ Net New Signatories By Region



As of March 2020.
Net new signatures since 1 April, 2019

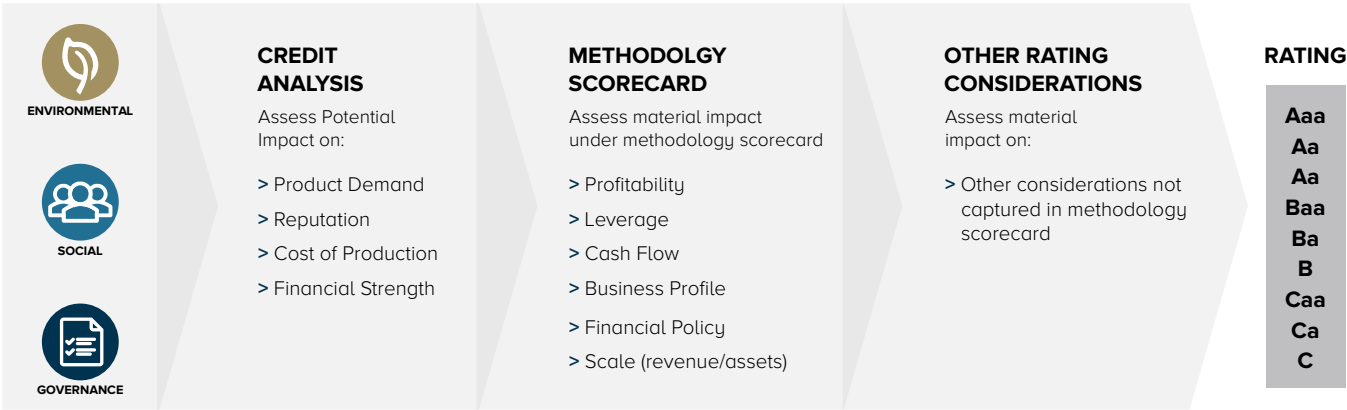
Source: Climate Action 100+

These investors, in their marketing material, proxy voting guidelines, and increasingly via direct engagement with listed issuers, have detailed the importance of measuring, reporting, and mitigating ESG risk across investee companies' operations.

While there has been a significant increase in ESG-related shareholder proposals in both the 2019 and 2020 AGM seasons, many resolutions are being defeated at the AGMs. Not because there has been no movement on making the case for ESG reporting, but because the larger institutional investors have directly negotiated agreements with their listed issuers in line with their own sustainable investment criteria. Having secured commitments on ESG initiatives they support, these large investors often then vote against some of the more generic ESG resolutions from other parties.

The ESG risk to cost of capital also holds true for debt financing. As shown in **Figure 3**, Moody's credit ratings now include considerations for ESG risk.

Figure 3: How ESG Can Be Assessed To Inform Credit Ratings



Source: Moody's Investors Service

SUSTAINABLE INVESTORS IN ACTION

There are many investors active in the Canadian energy sector with clear sustainable investing guidelines. The guidelines of some of the more active asset managers in the sector have been outlined below. There has been a notable increase in focus on the Environmental category of sustainable investing in most asset managers' 2020 guidance, in line with accelerating climate change attention across the globe. The most frequently reported engagement topics from these asset managers over the past several years have been in the Governance category (board independence, term limits, diversity targets, executive remuneration); however, given the climate change focus of most of the guidance we have reviewed, we expect the Environmental category to see an increasing engagement focus moving forward.

BlackRock – Investment Stewardship Engagement Priorities for 2020

(PRI, Climate Action 100+ signatory; SASB and TCFD proponent)

“Management of climate and environment-related factors is an increasingly defining factor in companies' long-term prospects. We also believe that robust disclosure is essential for investors to effectively gauge companies' preparedness for environmental risks and opportunities. We are asking that by the end of 2020, companies issue reports aligned with the recommendations of the Sustainability Accounting Standards Board (SASB) and the Taskforce on Climate-related Financial Disclosures (TCFD). We will hold directors accountable if a company does not make adequate progress on such disclosures.”

Fidelity – ESG Report 2020

(PRI, Climate Action 100+ signatory; TCFD proponent)

“For 2020, our climate priority will be to work with companies to disclose scope 1, 2 and 3 emissions (i.e. direct emissions from operating activities and energy use, and indirect emissions within value chains) and set measurable targets to achieve decarbonisation.

“We will also seek to engage on specific social themes such as employee welfare and to understand how companies are pivoting their business models towards greater social purpose. At Fidelity, we see better disclosure as fundamental to improving sustainability within companies. We take the opportunity whenever we engage with companies to recommend that they consider TCFD-aligned disclosure.”

RBC Global Asset Management – Our Approach to Responsible Investment 2020

(PRI, Climate Action 100+ signatory; SASB and TCFD proponent)

“Our investment teams meet with the issuers in which we invest on an ongoing basis. Typically, the purpose of our engagements includes:

1. Seeking better disclosure of ESG risks and opportunities and the steps the issuer is taking to address them.
2. Encouraging more effective management of ESG factors when we believe they may impact the investment value.
3. Where an issuer is lagging its peers on a material ESG issue, seeking a commitment for change, monitoring any changes, and encouraging continued improvements that will positively impact the long-term value of our investment.”

Vanguard – 2020 Investment Stewardship Annual Report

(PRI signatory; SASB and TCFD proponent)

“We encourage companies to align their reporting with the TCFD, an industry group that developed consistent frameworks that enable companies and shareholders to measure and respond to climate-change risks. We support the Paris Agreement, which seeks to limit the global temperature increase to below 2 degrees Celsius. And our due-diligence process also incorporates peer comparisons and guidelines from the Sustainability Accounting Standards Board (SASB) that identify material risks for different market sectors.”

DETERMINING WHAT TO REPORT AND WHERE

Once an organization has determined that it wants to actively manage ESG issues, it is advisable to follow one (or two) of a multitude of ESG reporting standards to create a meaningful sustainability report that details your organization's actions to address ESG factors and impacts. Below we summarize three ESG reporting standards that have seen the most uptake from companies in the extractive sectors.

Global Reporting Initiative (GRI)

GRI outlines 34 topic-specific standards for sustainability reporting. Sustainability reporting, as promoted by the GRI Standards, is an organization's practice of reporting publicly on its economic, environmental and/or social impacts – positive or negative – towards the goal of sustainable development.

As one of the first sustainability standards created, GRI has a significant following; however, the investment community is rapidly switching focus to other standards (see SASB and TCFD below) which require stronger future commitments and goal setting versus simply reporting past information.



Sustainability Accounting Standards Board (SASB)

Created with significant input from capital markets participants, SASB assigns industry-specific reporting requirements to companies operating across a possible 26 primary industries - each having their own reporting standard. SASB requires organizations to disclose ESG risk and the strategies and targets employed to mitigate these risks. SASB standards are focused on the broad ESG spectrum and climate-related reporting under SASB is designed to work in tandem with TCFD.



Task Force on Climate Related Financial Disclosures (TCFD)

Created with input from the big accounting firms and other capital markets participants, TCFD reporting guidelines are specific to climate change-related disclosures and are designed to work in tandem with the broader ESG disclosure under SASB. The TCFD standard identifies several categories of climate-related risk and areas of opportunity across four broad disclosures: governance, strategy, risk management and metrics & measures. Disclosures include identifying risk – including the impact of regulatory changes - and setting, evaluating and reporting on targets (including the organization's strategic investment in green technology) designed to mitigate these risks to the company.



HOW THE MARKET HAS RESPONDED: SUSTAINABILITY REPORTING IN THE S&P/TSX CAPPED ENERGY INDEX

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To investigate how Canadian energy companies have responded to stakeholder pressure to increase ESG reporting and mitigate ESG risk, we studied the ESG filings (e.g. sustainability reports) of the constituents of the S&P/TSX Capped Energy Index. When reviewing these filings, we attributed metrics from each company's sustainability reports as either an Environmental, Social, or Governance metric in accordance with the various stakeholder groups' (SASB, GRI, etc.) categorization of these metrics.

For clarity in our analysis below a key performance indicator (KPI) is the quantifiable measure used to track the performance of companies against an ESG metric over time (e.g. total recordable injury frequency rates, or "TRIF") and a target is the specific level of performance being strived for or the desired outcome against that metric (e.g. 'the company is targeting a TRIF of 1.3 for 2020').

Our Findings

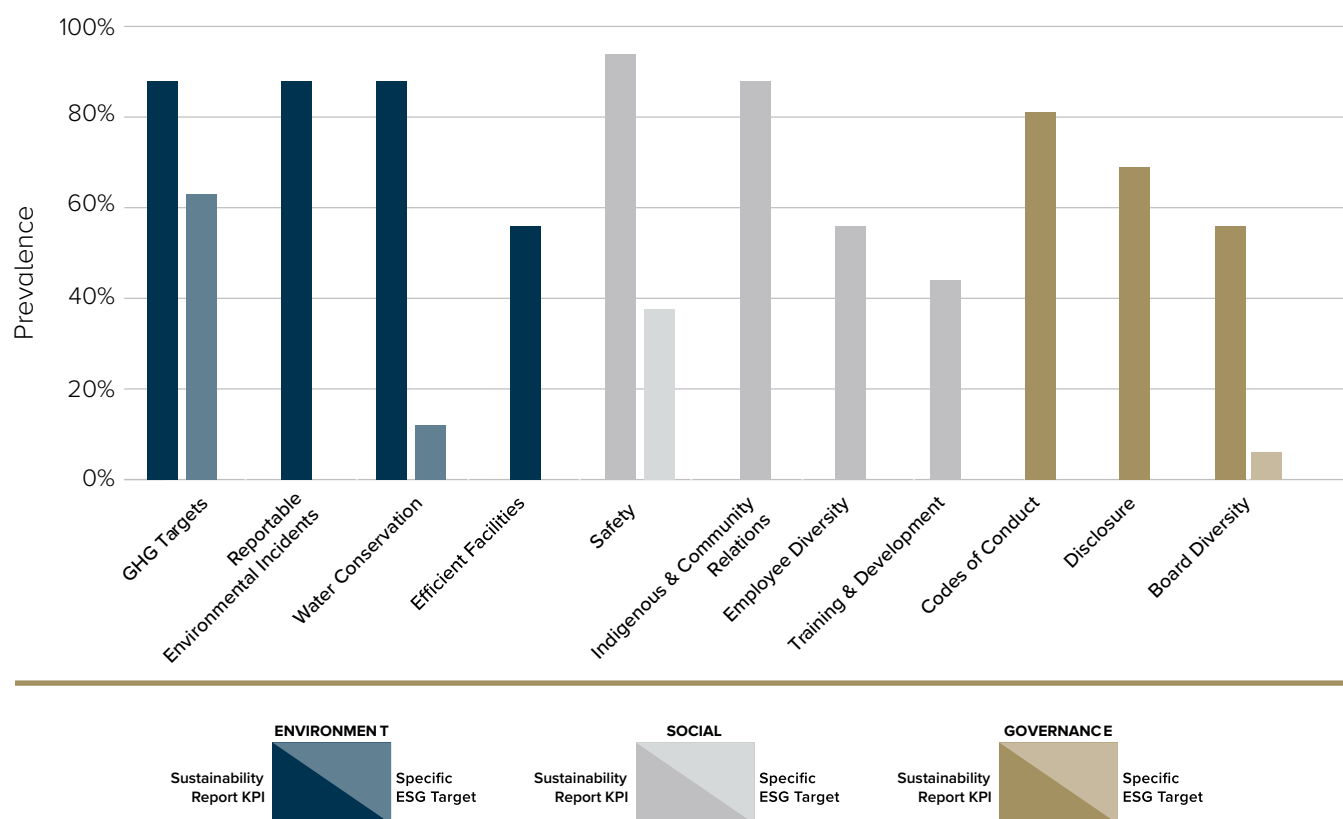
All but one member of the Capped Energy Index publishes an annual Sustainability or ESG Report. One company, Suncor Energy, also publishes a standalone Climate Risk Report in addition to its Sustainability Report.

The use of the TCFD and SASB reporting standards are equally prevalent in the index at 56% (GRI 67%). The larger cap companies in the index tend to be more aligned with TCFD and SASB, with several companies reporting against both standards. The lower cap companies in the index have typically favoured the GRI reporting guidelines.

Unsurprisingly, given the nature of the operations in the energy sector, Social and Environmental considerations are the most prevalent KPIs in the Sustainability Reports, with Safety (94 percent), followed by Indigenous & Community relations, Water Conservation, Environmental Incidents (Spills/Leaks mitigation) and GHG Emissions (88 percent each) being the most prevalent KPIs reported by Capped Energy Index companies.

Most Capped Energy Index companies also use specific KPIs rather than general greenwashing discussion of ESG issues to report on various factors in the 11 major ESG categories listed in **Figure 4**, however, targets for those KPIs are generally not common.

Figure 4: Prevalence of ESG KPIs and Targets in Sustainability Reports
Companies in the S&P/TSX Capped Energy Index



There is a high prevalence of companies reporting and tracking ESG KPIs in sustainability reports, however, few provide specific targets for performance against these KPIs.

Notably, specific Greenhouse Gas reduction targets are the most prevalently disclosed target in the sector, reflecting both the major Environmental issue for the sector and the adoption of the TCFD disclosure guidelines by 56 percent of the index.

Other than GHG and Safety, we note an overall lack of specific target setting for KPIs reported in energy organizations' sustainability reporting. It is unclear if this is the result of a perceived lack of importance to demonstrate progress against reported KPIs within these disclosures or the inability to directly control, influence, and measure that progress.

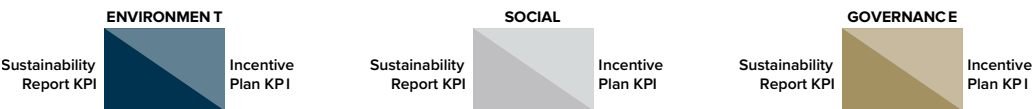
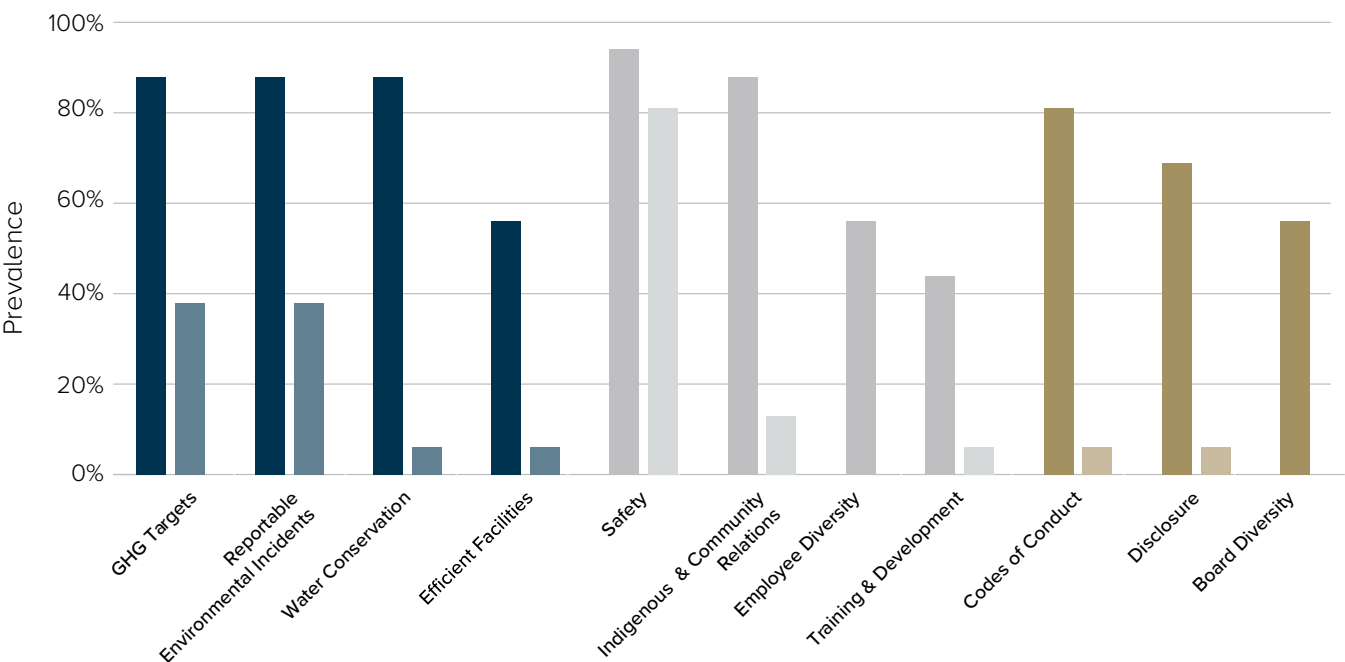
There could also be a reluctance to disclose a KPI target that, while reasonable, could be viewed negatively by some stakeholders. For example, setting a target for Spills/Leaks at anything other than zero may not be well received by certain stakeholders.

EXECUTIVE PAY AND ESG

As stakeholders' focus on ESG reporting has increased materially, so has the incorporation of ESG risk into companies' strategic planning processes in general. We next looked to see if there was any overlap between ESG reporting and tracking already being undertaken for sustainability reporting purposes and the ESG KPIs being measured by issuers in their executive pay programs.

As ESG issues become an increasingly important part of many companies' business strategies, executive efforts should be aligned with this evolving area of strategy. As with most key areas of business strategy, alignment of executives' efforts is facilitated (and communicated to stakeholders) via inclusion of ESG KPIs in executive incentive plans.

Figure 5: Prevalence of KPIs in Both Sustainability Reports and Executive Pay Plans
Companies in the S&P/TSX Capped Energy Index



This chart directly compares the prevalence of the same KPIs in both the sustainability reports and the variable pay plans of Capped Energy Index companies.

As with the sustainability reporting mentioned previously, we attributed metrics from the variable pay discussion in each company's compensation disclosure (CD&A portion of each company's management information circular) as either 'E', 'S', or 'G' based on their characterization by the various stakeholder groups and regardless of how each company may label these metrics as 'operations', 'HSE', 'CSR' in their variable pay plans. We recorded the presence of a KPI, whether or not it was a qualitative (no associated target) or quantitative (specific target level of performance).

"Only 38 percent of Capped Energy Index companies track some measure of GHG reduction targets in their executive pay programs."

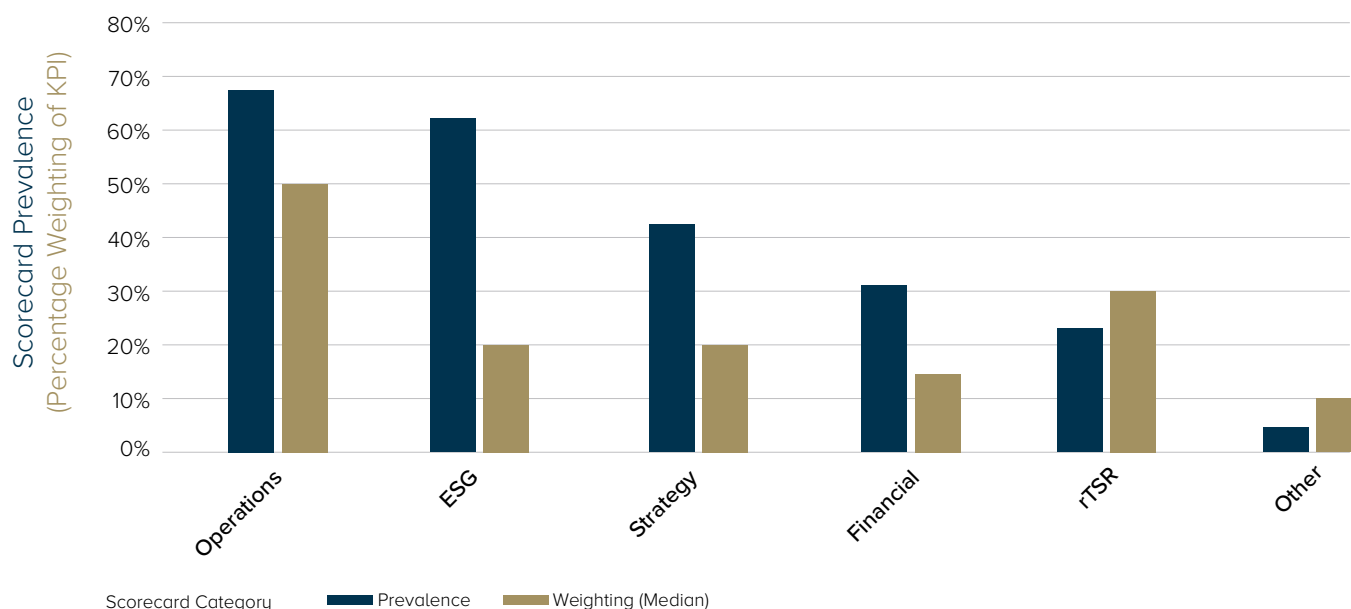
Interestingly, existing executive incentive plan scorecards for the Capped Energy Index companies include a broad range of ESG KPIs that are also addressed within these companies' sustainability reports. Notably:

- Eighty-one percent of Capped Energy Index companies track and reward (or penalize) safety performance at their operations (below the 94 percent prevalence of this KPI in sustainability reports). Despite the clear role that safety plays in executive pay plans, specific safety performance targets are only communicated by 38 percent of index companies in their sustainability reporting.
- Only 38 percent of Capped Energy Index companies track some measure of GHG reduction KPIs in their executive pay programs, yet 88 percent track and report their GHG emissions in their Sustainability Reports.
- The tracking of spills or leaks is included in 88 percent of sustainability reporting, however, only 38 percent of companies track these KPIs in their incentive scorecards.

Given the existential financial, social, and political risk to the sector posed by its GHG emissions profile, it is surprising that GHG reduction KPIs are only included in 38 percent of Capped Energy Index companies' variable pay scorecards.

The inclusion of ESG KPIs in executive pay programs, especially those with a safety or environmental focus, has been a fixture in the sector over the long-term. However, with the mounting pressure to report and mitigate ESG issues, how does the ESG weighting within scorecards compare to the weighting of operational and financial performance?

Figure 6: The Prevalence of Categories vs. Their Weighting in the Short-Term Incentive Scorecards of Capped Energy Index Companies



As seen in **Figure 6**, although ESG topics are the second most prevalent short-term incentive (STI) scorecard metric, the ESG category is tied with strategic goals/milestones as the third highest weighted metric (20 percent weighting) in most of the Capped Energy Index short-term incentive plan scorecards.

Also notable in our review of ESG metrics in executive pay plans is the relative absence of ESG KPIs in the long-term incentive plans of the Capped Energy Index companies. Only one company specifically mentioned sustainability as a KPI in its Performance Share Unit (PSU) awards. Another company indirectly ties sustainable practices to the vesting of its executives' PSUs with a 25 percent weighting on the execution of its strategic plan, which is heavily focused on ESG excellence.

The longer-term timelines involved with material and continuous improvement in some ESG issues – e.g. GHG emissions reduction targets, water conservation, Indigenous engagement – combined with the strategic imperative with today's expectations to continuously improve in many of these areas, seems ideally suited to be measured over the timelines associated with long-term incentive plans.

WHAT'S NEXT?

The rise of sustainable investment principles and most major asset managers' commitment to these principles means that ESG's place in corporate strategy and risk management should be receiving meaningful focus alongside financial and operational performance. As a fundamental contributor to economic success in a world focused on sustainable business practices, our question to companies is: should ESG performance not play a much larger role in executive pay programs and how do boards oversee the greater focus on ESG within these programs?

As capital continues to flee the sector and securing investment becomes increasingly competitive, it is more important than ever for organizations to consider how they present their ESG strategy and achievements. While some progress has been made in ESG target setting and reporting across the energy sector, there is room to improve how these disclosures are positioned to investors, and in how incentive plans are aligned to reflect the importance of ESG to the future success of the sector in Canada and beyond.

"No longer can businesses take a 'wait and see' approach to ESG practices."

No longer can businesses take a 'wait and see' approach to ESG practices - the viability of the sector and of individual companies within the sector are dependent upon their thoughtful approach to this evolving area. Lane Caputo is uniquely positioned to advise boards and their executive teams on communicating the importance of their organization's ESG strategy and performance to both internal and external stakeholders through the thoughtful inclusion of ESG within executive pay plans. Our trusted team of advisors have worked closely with boards and executive teams for years, providing advice on linking executive incentives to corporate strategy – expertise we know is required to ensure robust governance of ESG issues, maximize performance on targeted KPIs and position ESG priorities with stakeholders while managing the unique risks and opportunities of the energy sector.

As 2020 draws to a close and we approach a new fiscal year, strategic plans will be revisited, and milestones and targets will be set for the year(s) ahead. No doubt ESG issues will figure more prominently in this business planning cycle than ever before. Please contact us to discuss how we can assist you in communicating your organization's ESG activities more effectively by thoughtful and strategic linkage to executive rewards programs.

Additional Reading

The most comprehensive view of all the stakeholders involved with the ESG movement that we've seen:

<https://bit.ly/2K4kUiO>

Larry Fink's 2020 letter to CEOs regarding the 'fundamental reshaping of finance':

<https://bit.ly/3qAoBNt>

Letter from the eight largest Canadian pension funds to Canadian companies regarding the adoption of SASB and TCFD:

<https://bit.ly/33RPfYm>



ABOUT **LANE CAPUTO**

Lane Caputo Compensation Inc. is an independent executive compensation advisory firm specializing in guiding boards and leadership teams in linking their organization's performance - from strategy to execution - to executive compensation programs.

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