ELLASON LLP

LENS ON:

Emissions-related targets in executive incentive plans

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Ahead of the opening of the COP26 summit in Glasgow this weekend, and the London Stock Exchange's recently-released guidance for FTSE-listed companies on carbon-related disclosure, this Ellason lens looks in more detail at emissions-related measures in FTSE350 incentive plans.

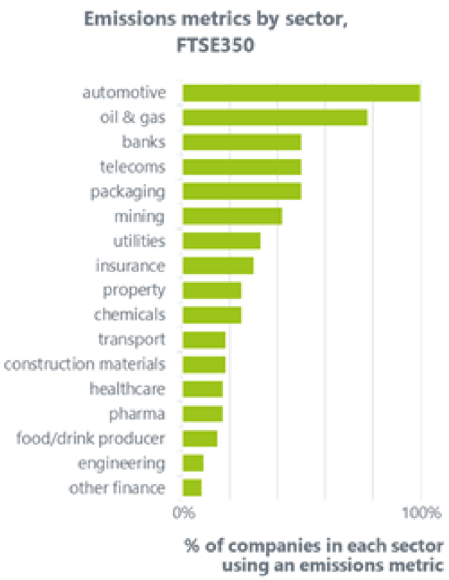
Market practice

Emissions/decarbonisation measures are growing in prevalence across the FTSE350, and evenly spread between short- and long-term incentives. 17% of FTSE100 companies use such a metric in their bonus, and 17% use one in their LTIP; in the FTSE250, these figures are 7% and 6% respectively. The typical weighting on these measures is summarised in the table below:

Emissions-related metrics, typical weighting

	FTSE100		FTSE250	
	Bonus	LTIP	Bonus	LTIP
75th percentile	14%	18%	10%	12%
Median	**6%**	**10%**	**10%**	**10%**
25th percentile	3%	7%	5%	9%

Understandably, the prevalence of emissions-related metrics currently is sector dependent; with 'carbon intense' industries such as extractive sectors and the automotive industry more likely than others to have already adopted such measures in executive incentives.



Approach to target setting

Many companies are still at an early stage in the development of their ESG strategies, and some have not yet disclosed their targets or provided any detail about how they intend to assess performance. However, where this information is disclosed, the majority (75%) of emissions metrics are assessed on a formulaic basis against quantitative targets, rather than using Remuneration Committee discretion.

Where quantitative targets are set (as for the majority of LTIPs and in some bonus plans), output-based assessments are typically based on a measurable reduction in CO_2 emissions. Targets are expressed either as a percentage reduction from the emissions in a 'baseline' year, or as the weight of carbon dioxide as a proportion of total emissions (e.g. tCO_2e). In some cases, the reduction is revenue or volume adjusted. For example, National Express (a FTSE250 transport company) calibrates targets on the basis of tonnes of CO_2 emissions per million passenger kilometres. At this early stage, most companies are focusing on Scope 1 and 2 emissions (the company's own direct emissions and those it indirectly produces through the generation of purchased energy), though a very small number have begun to measure Scope 3 emissions (i.e. those produced elsewhere in the company's value chain).

Where emissions targets are input-based (more commonly in the bonus), they tend to comprise early stage actions executives must take in order to reduce emissions at a later stage, such as designing a roadmap to net zero and getting it approved, or making a public commitment to specific targets.

Alongside targets directly linked to emissions reduction, some companies are also targeting 'green' financial metrics, such as revenues from environmentally-friendly products and technologies. Whilst not directly used in its incentives, the French company, Danone, reports a carbon-adjusted earnings per share (i.e. adjusting for the estimated financial impact of Scope 1, 2 and 3 emissions on their value chain).

Ellason commentary: Many organisations (particularly those in heavier industries) have already embedded sustainability (and emissions specifically) as a core pillar of both their 'licence to operate' and investment proposition. Aligning executive incentives more closely with these goals will help reinforce to stakeholder groups their importance to success, the definition of which will likely continue to broaden beyond financial parameters. However, the process of introducing sustainability goals (whether or not emissions-related) into incentives is not simple. Effective solutions will require tailoring to individual company circumstances, including measure selection and definition, target setting and performance assessments.

Please do not hesitate to contact any of the Ellason team should you wish to discuss this issue further.