

Incentivising the low carbon transition: Linking climate resilience to BP and Shell's remuneration policies

This briefing sets out the case for linking executive compensation to the low carbon transition. It suggests an engagement approach with BP and Shell, in light of the binding votes on remuneration at their 2017 AGMs.

Action to mitigate climate change poses an existential threat to companies whose commercial success depends on a high-carbon future. In the Paris Treaty, international governments agreed to limit global temperature rises to 'well below' 2°C, with an ambition for 1.5. Both China and the US have formally committed to ratify this deal. Neither BP nor Shell have yet made the changes required to ensure portfolio resilience under this legislative outcome. Investors must engage with the companies to ensure they are integrating and operationalising a long-term strategy to protect shareholder value under a <2°C scenario.

At their 2017 AGMs, binding votes will be cast by shareholders on BP and Shell's remuneration policies. This paper presents the case for linking executive compensation to the low carbon transition. Engagements on remuneration provide investors with an ideal opportunity to express their views on a firm's strategic direction, and to make it clear they expect executives to be incentivised to meet climate-aligned corporate goals and targets. The paper provides a brief overview of BP and Shell's current remuneration policies and KPIs, before exploring three objectives of a potential engagement plan. These include:

- 1. Alignment of strategic objectives and KPIs with the transition for low carbon resilience.** For alignment with carbon-constrained circumstances, BP and Shell must ensure their forward-looking plans are commercially resilient under <2°C scenarios. Since remuneration structures are designed to help deliver on the firm's objectives, this must be the starting point of engagement.
- 2. Removal of metrics uncondusive to low carbon resilience.** Metrics that could actively discourage low carbon resilience must be removed, including volume-based production measures and performance timelines that do not reflect long-term risk horizons.
- 3. Inclusion of measures that signal and reward the delivery of a low carbon strategy.** Once BP and Shell have identified the steps required to transition for low carbon resilience, remuneration metrics should be selected to acknowledge and reward their delivery.

During this critical tenure, executives must be focused on the key challenge of adapting for low

carbon resilience. If BP and Shell fail to demonstrate that they are operationalising climate risk into executive compensation and, more importantly, their underpinning corporate strategies, ShareAction recommends that investors vote down their remuneration policies at the 2017 AGMs.

The climate case for engaging on remuneration

The need for urgent action

During UN negotiations in 2015 at COP21, international governments agreed to limit temperature rises to ‘well below’ 2°C, with an ambition for 1.5 (hereinafter <2°C). While the current round of pledges overshoot this and add up to around 2.7°C of temperature rises;¹ the Paris Treaty contains a ‘ratchetting mechanism’ to achieve the <2°C goal, requiring nations to convene a ‘facilitative dialogue’ and increase the ambition of their pledges every five years. The first dialogue takes place in 2018, with the reviewed pledges decided in 2020.

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For fossil fuel companies to adapt for commercial resilience under <2°C scenarios, fundamental changes to their business models must be made – such as those outlined in the Carbon Tracker Fossil Fuel Transition Blueprint series.² Companies must wind down hydrocarbon operations for consistency with low carbon demand scenarios, returning capital to shareholders and/or investing it in profitable low carbon assets. These changes will take time to

implement, and should begin immediately for the realisation of a smooth transition.

At their 2017 AGMs, binding votes will be cast on BP and Shell’s remuneration policies. If approved by shareholders, these will remain in place until 2020, overlapping with the review process agreed under the Paris Treaty. Investors must engage with the companies to encourage integration of long-term strategies into core governance processes, protecting shareholder value under low carbon scenarios.

The role of remuneration

In corporate governance theory, remuneration practices should stem from and assist in the delivery of a company’s underlying strategy. In practice, however, remuneration frameworks can have perverse consequences that influence strategic direction. For instance, cash flow targets can encourage investment decisions such as cutting expenditure on research and development, impacting on business operations.³ Despite this role that incentives can play in influencing corporate behaviour, the low carbon transition must be led by strategy. The decision to wind down high carbon operations cannot be executed by the remuneration committee, nor the decision to make large investments in low carbon assets. These are the decisions that will be vital for determining <2°C resilience. While incentives in and of themselves will not drive the transition, getting them wrong at this critical point will reaffirm a business model that is unsustainable and damaging to the companies’ long-term viability.

The golden thread between strategy and remuneration make it an important ground for setting expectations of low carbon resilience. Engagements on remuneration—including the binding vote—provide investors with the opportunity to voice assent or disapproval of the direction that executives are rewarded to drive the company towards. There is also a positive case for focusing on remuneration. Underpinned by a <2°C aligned strategy, innovative compensation structures could play a supportive role in focussing attention on its delivery.

Remuneration consultants play an important role in influencing new remuneration policies, measures and targets. As well as signalling their expectations directly to the companies, investors should engage with consultants to ensure their concerns are being represented.

Directors' duties

In the UK, under the Company's Act 2006, directors must satisfy a number of duties when exercising their discretionary decision-making powers. A director must act in a way they consider, in good faith, would most likely "promote the success of the company" for the benefit of its shareholders as a whole.⁴ When exercising this duty, directors must regard the long term consequences of decisions, and their impact on the community and environment. They must exercise "reasonable care, skill and diligence" in decision making and general stewardship responsibilities.⁵ These duties speak to the legal imperative for directors of fossil fuel companies to plan for commercial resilience under future low carbon scenarios.⁶ Remuneration policies that encourage executives to forge ahead with strategies predicated on continued reliance on hydrocarbons do not adequately consider the long-term health of the company, nor the wealth of its shareholders.

to a low carbon economy".⁷

Investors must now ensure that BP and Shell are developing incentive frameworks that are instrumental in signalling and rewarding the transition for low carbon resilience. If the remuneration policies presented by the companies are not suitable for addressing this challenge, shareholders should exercise their right to vote down the binding resolution on remuneration at the 2017 AGMs.

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2015 resolutions on climate resilience

BP and Shell have a mandate from investors to link KPIs and executive incentives to climate considerations. In 2015, special resolutions were filed and passed at the companies, directing them to provide information on areas relevant for assessing their resilience under low carbon scenarios. The supporting statement circulated with the resolution stated that: "Transitions that span decades are complex to manage and often require lead indicators and incentives... [I]nvestors are interested in [the company's] evolving approach to KPIs and executive incentives, in the context of the transition

An overview of BP and Shell's current remuneration policies

BP⁸

Salary and Benefits

"Provides base-level fixed remuneration to reflect the scale and dynamics of the business, and to be competitive with the external market."

Annual bonus

"Provides a variable level of remuneration dependent on short-term performance against the annual plan." Specific measures and targets are determined yearly by the remuneration committee. In 2015, the annual cash bonus was based on safety (30%) and value (70%). Safety measures include loss of primary containment, process safety tier 1 events and recordable injury frequency. Value measures include operating cash flow, underlying replacement cost profit, net investment, corporate and functional costs and major project delivery.

Deferred bonus

A third of the annual bonus is required to be deferred and up to a further third can be deferred voluntarily. The committee identifies the specific strategic imperatives to be included every year. Rewarded after six years. A safety and environmental sustainability hurdle is applied to all deferred shares, which determines if they vest fully, although details of this hurdle are not disclosed.

Performance shares

"Ties the largest part of remuneration to long-term performance relative to measures linked directly to strategic priorities". Performance shares will vest on the following three performance measures: total shareholder return (TSR) relative to other oil majors, operating cash flow and strategic imperatives. Released after six years.

In 2015, the strategic imperatives this was

Shell⁹

Base salary

"Rewards day-to-day leadership and strategic direction. Competitively positioned recognising the scope and complexity of the role to attract and retain Executive Directors."

Annual bonus and Deferred Bonus Plan (DBP)

"Rewards performance against a scorecard of short-term strategic targets and individual achievement. To reinforce alignment with shareholder interests, 50% is deferred and the other 50% is delivered in cash." Taking the Shell Business Plan into consideration, each year the Board agrees the scorecard targets and weightings to support the delivery of the strategy. Measures are related to financial performance (30%), operational excellence (50%) and sustainable development (20%). The DBP is awarded after five years, measured over one year with a three year deferral period.

In 2015, financial performance was measured by operational cash flow. Operational excellence was measured by project delivery (20% total weighting), production (kboe/d) (12%), liquified natural gas (LNG) sales (6%) and refinery and chemical plant availability (12%). Sustainable development was measured by injuries per million hours (5%), operational Tier 1 process safety events (5%), volume of operational spills (4%), Refinery Energy Intensity Index (4%) and fresh water intensity (2%).

Long-term Incentive Plan (LTIP)

Rewards medium- to long-term outperformance of the business relative to other oil majors on measures considered key outcomes of the delivery of the strategy. Award levels are determined annually by REMCO (Remuneration Committee). Performance is assessed over a three-year period based on relative growth of the following: total shareholder return (TSR) (30%), earnings per share (EPS) on a current cost of supplies basis

based upon were composed of safety and operational risk, relative reserves replacement ratio (RRR) and major project delivery. For the TSR and the RRR measures, the comparator group consisted of ExxonMobil, Shell, Total and Chevron.

Pension

Recognises competitive practice in home-country.

(30%), return on average capital employed (ROACE) (20%) and net cash from operating activities (20%). The LTIP sees award released after six years, with performance measured over three years, with a further two year retention period.

Pension

Provides a competitive retirement provision in line with the individual's base country benefits policy, to attract and retain Executive Directors.

Shareholding

Aligns interests of Executive Directors with those of shareholders. As a % of base salary, CEO must have 700% shareholding, and other Executive Directors 400%. Executive Directors are expected to build up their shareholding to the required level over a period of five years from appointment and, once reached, to maintain this level for the full period of their appointment.

An overview of BP and Shell's key performance indicators

BP

S = used to measure progress against strategy
R = used to determine remuneration

- Underlying RC profit per ordinary share (S, R)
- Operating cash flow (S, R)
- Gearing (S)
- Refining availability (S)
- Reported recordable injury frequency (S, R)
- Loss of primary containment (S, R)
- Total shareholder return (S, R)
- Reserves replacement ratio (S, R)
- Major project delivery (S, R)
- Production (mboe/ d) (S)
- Tier 1 process safety events (S, R)
- Greenhouse gas emissions (operational) (S)
- Group priorities index
- Diversity and inclusion

Shell

- Total shareholder return
- Net cash from operating activities (\$ billion)
- Project delivery
- Production available for sale (thousand boe/d)
- Equity sales of LNG (million tonnes)
- Refinery and chemical plant availability
- Injuries per million working hours

Additional performance indicators

- Earnings on a current cost of supplies basis (attributable to Shell)
- Capital investment (\$ million)
- Return on average capital employed
- Gearing
- Employees
- Proved oil and gas reserves (million boe)
- Operational spills
- Refining Energy Intensity Index
- Direct greenhouse gas emissions
- Number of operational Tier 1 process safety events

Strategic objectives and KPIs that signal the transition to low carbon resilience

The corporate strategy and objectives underpinning BP and Shell's remuneration policies will be critical in determining the firms' success in transitioning for <2°C resilience. For example, a reward structure that encourages investment in renewables but keeps incentivising the replenishment of fossil fuel reserves may ultimately be worse for low carbon alignment.

Identifying low carbon strategic objectives and KPIs

Investors should set expectations for a strategy consistent with the <2°C carbon budget, with timelines and measures that allow for the evaluation of its implementation. While <2°C pathways are likely to be non-linear and differ from company to company, key to a well-managed transition will be the reallocation of capital away from the exploration and production of hydrocarbon reserves unneeded under low carbon demand scenarios. This capital could be returned to shareholders through increased dividend payments, or invested by the companies in low-carbon portfolio diversification. Debate surrounds whether oil and gas companies have the capabilities to diversify in a way that can generate acceptable returns.¹⁰ However, Danish company DONG Energy has moved from fossil fuels to renewable generation, using oil revenues to fund renewable investments.¹¹

The companies' objectives and KPIs must fundamentally recognise that the operations and strategies that were profitable in the past will have limited relevance in a low carbon economy. A step in this direction was taken recently by French oil giant Total, in aligning its portfolio with the IEA 450 demand scenario – which leaves a 50% chance of limiting temperature rises to 2°C.¹² DONG Energy has ambitious targets for installing offshore 6.5GW offshore wind by 2020—enough to power 16 million Europeans.¹³ These substantive commitments suggest that the companies are proactively managing climate risk.

How does climate currently feature?

Currently, BP and Shell's strategic objectives fail to identify measures that would helpfully indicate their transition for low carbon resilience. Indeed, both firms are explicit in their misalignment with

<2°C scenarios. Throughout BP's 2016 reporting, it is made clear the company does not believe a <2°C outcome needs planning for. It is stated that: "[fossil fuels] currently account for around 56% of total energy consumption, and we believe that will decrease to about 54% in 2035. For comparison, under [the IEA 450 scenario], oil and gas make up 44% [of the energy mix] in 2040 – assuming carbon capture and storage is widely deployed".¹⁴ Further, BP projects that "global CO2 emissions from fossil fuels may be 20% higher in 2035 than they were in 2014... This is not what BP wants to see, but what we currently think is likely."¹⁵ Likewise, Shell states it has "no immediate plans to move to a net-zero emissions portfolio over [its] investment horizon of 10-20 years".¹⁶

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Despite the emphasis that both companies give to capital discipline and 'value rather than volume', their current high carbon outlooks could result in capital expenditure decisions that put value at risk under carbon-constrained circumstances. Both companies remain focused on pursuing future hydrocarbon growth. BP seeks to strengthen its portfolio of, "longer-life assets – across deep water, giant fields, gas value chains and unconventional – to provide BP with momentum for years to come",¹⁷ measured using a 'production' metric. The firm seeks to "build a strong pipeline for future growth", measured through the 'proved reserves replacement ratio'. Shell focuses "on exploration for new crude oil and natural gas reserves and on developing major new projects", with "significant growth potential" identified in deep-water operations and "substantial longer-term growth potential" in heavy oil and oil and

gas plays.¹⁸ These are reflected in KPIs of ‘project delivery’ and ‘production available for sale’, and an additional performance indicator of ‘proved oil and gas reserves’.

Both companies have KPIs for operational emission reductions. These fall well short of incentivising the change in strategic direction required for establishing low carbon resilience. The largest proportion of the companies’ emissions are not operational, but those expended by consumers (roughly 80–90%).¹⁹ A holistic approach to emissions management would take into account the changes in consumption of fossil fuel products under <2°C scenarios, and not just the need to reduce operational emissions.

Removal of metrics uncondusive for low carbon resilience

As a minimum, BP and Shell’s updated remuneration policies should not contain metrics that are detrimental for achieving <2°C resilience. These include measures that incentivise volume based production of hydrocarbons, and strategic timelines that are unreflective of the risk horizons associated with decisions made by today’s executives.

Explicit and concealed volume related metrics for hydrocarbons

The metrics perhaps most clearly misaligned with the low carbon transition are those focused on hydrocarbon production and exploration. These are contained in BP’s current performance shares plan, with reserves replacement ratio (RRR) and major project delivery accounting for two-thirds of the overall weighting. These measures are not linked to returns on production, nor the delivery of long-term value. Shell removed hydrocarbon production growth as a performance measure in 2013, although ‘production available for sale’ (kboe/ d) and ‘project delivery’ remain within the company’s KPIs. As explained below, there is a strong case to remove these metrics from incentive structures.

For international oil companies to maintain high replacement ratios in the context of declining access to conventional oil fields, executives are encouraged towards nonconventional and frontier projects that tend to be higher cost and higher risk – including tar sands and deepwater.²⁰ As highlighted by the work of Carbon Tracker and others, these costly

projects will be left economically stranded under low carbon, low demand scenarios.²¹ Today’s remaining conventional oil fields are predominately located in Saudi Arabia, Kuwait, Iraq and Iran. Despite the lower break-even prices associated with these regions, political circumstances and economic sanctions can have a disruptive impacts on operations.²²

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The current low oil price environment is set against a long-term outlook of permanent structural demand destruction for fossil fuel products. This is being catalysed by a variety of factors, including the international penetration of renewable energy technologies,²³ decarbonisation of the global vehicle fleet,²⁴ improvements to energy efficiency, a shift towards low carbon infrastructure, and slowdown of growth in primary emerging markets.²⁵

It is not in the best interests of shareholders for oil companies to reward delivery of projects with high break-even costs, nor those unneeded under low-demand scenarios. Recent analysis by Carbon Tracker highlighted how shareholder value would be better preserved if oil majors were to align their portfolios for consistency with the IEA 450 demand scenario.²⁶ Where large upfront investments have been made in major projects, it can be hard for companies to walk away; yet in the long term the development of these assets may not be the most prudent use of capital. A low carbon transition strategy should instead encourage executives to identify the projects that should or should not be delivered, and incentivise far-sighted decision making around their execution.

Carbon Tracker also cautions use of ‘stealth’ volume measures, “masquerading as financial measures. Examples of these include group cash flow and group profit targets.”²⁷ While operational costs feed into these, so too do production volumes. As

such, these targets push companies towards the hydrocarbon operations that currently contribute towards cash flows. For instance, Shell identifies conventional oil and gas, integrated gas and tar sands mining as its 'cash engines'.²⁸ Investors have become used to seeing these metrics included in remuneration policies, and may be reluctant to see them removed. Indeed, cash flow is seen as key for assessing whether oil and gas companies will be able to maintain debt payments. This assumption must be challenged. Under carbon-constrained circumstances, it will not be possible to rely on the traditional 'cash engines' to maintain cash flows or debt payments. The companies must be challenged to decouple cash flow measures from hydrocarbon production.

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Performance timelines that do not reflect risk horizons

The ability of BP and Shell to adapt for long-term low carbon resilience is being determined by decisions made today. Executives should not be rewarded for conduct that could pose significant liabilities to long-term shareholders. Currently, the companies' long term incentive plans (LTIPs) use three year performance measurements. For hydrocarbon projects that span decades from initial exploration to production and sale, decisions about capital expenditure made today will have consequences for shareholder value far into the future. For example, Shell states it has an investment horizon of 10–20 years.²⁹

There are concerns associated with extending performance measurements beyond the likely tenure of executives - i.e. the idea of a 10 year LTIP. These include the lack of strategic flexibility these plans might entail, and that the quantum of end-sum pay-outs might be controversially high. Whether these concerns are valid is perhaps best determined on a case-by-case basis.

There are other ways of linking remuneration to a long-term approach. Starting with the question: 'What is needed to protect shareholder value in the long-run?', companies can identify the key factors that would help achieve this goal – for instance, winding down hydrocarbon exploration, investing in successful low carbon assets, etc. These factors can then be translated into measures that support the delivery of a long-term strategy on a year-by-year basis.³⁰ This means executives are not tied to inflexible 10 year plans, but can still be rewarded for pursuing strategies consistent with the long-term interests of shareholders.

Rewarding executives with shares is another method intended to align executive interests with those of shareholders, tying their fortune to the company's success.³¹ For Shell, as a percentage of the base salary, the CEO currently must have a 700% shareholding, and other Executive Directors 400%. BP does not have specified holding requirements. Both companies reward shares through their deferred annual bonus mechanisms and LTIPs. However, since these rewards can be collected after six years (BP) and five years (Shell), there remains a misalignment with long-term shareholder interest. This was seen with coal company Peabody Energy. Before filing for Chapter 11 bankruptcy, Peabody executives cashed in stock options worth a combined \$47 million between 2008 and 2011. In July 2015, Peabody stock closed at \$1.20 per share, compared to \$63.98 at the end of 2010.³² While there is a good case for using equity-based rewards, this is only true if the holding periods are meaningfully extended. Under a managed decline strategy, with cash returns to shareholders, equity rewards could act as an annuity for executives.

Inclusion of measures that signal and reward the successful delivery of a <2°C strategy

Once BP and Shell have identified the steps required to transition for low carbon resilience,

remuneration metrics should be selected to acknowledge and reward their delivery. Depending on the chosen path, different measures will be more or less suitable. Certain themes that might be included are explored below. These are not presented as a definitive list of options, but rather a starting point for discussions on innovative thinking around remuneration in the low carbon context.

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Realignment of executive remuneration with risk horizons and stakeholder interest

It has been discussed above how BP and Shell might realign executive compensation with risk horizons. While the underlying strategy needs to be sensitive of 10+ year value preservation, this does not necessarily mean performance measures must be stretched over such long timespans. Rewards based on shorter-term performance could play a role in incentivising the low carbon transition if they are clearly linked to the delivery of a <2°C strategy. There could also be a role for increasing the proportion of the reward paid in shares, held over longer time periods. The release of these shares could be subject to carbon hurdles to help encourage a long-term, climate-aligned approach.

Discussions on alignment of interests usually refer to the relationship between executives and shareholders. However, another important set of stakeholders to be considered are the companies' employees, whose interests are put at considerable risk under certain low carbon outcomes. It is important to note that while a managed decline strategy could lead to job losses, workers would fare worst under an unmanaged decline brought on

by bankruptcy or insolvency. A balanced scorecard with measures such as retraining programmes, pension guarantees and long-term financial security could help align the interests of executives with employees.

Linking remuneration to total lifecycle emissions

Currently, BP and Shell's emissions-related KPIs are focused on a small section of the companies' total carbon footprint. As the economy shifts towards decarbonisation, both energy producers and consumers will have to adapt their behaviour. A more comprehensive approach focused on total lifecycle emissions would allow BP and Shell to develop portfolio resilience in the face of these changing circumstances.

There are questions about how fossil fuel companies can measure, benchmark and reduce their total lifecycle emissions. For instance, companies have limited knowledge of what consumers do with their product – whether a shipload of gas gets burnt to provide electricity, or turned into plastics.³³ This could in part be resolved by better data collection and supply chain transparency; offering a stronger sense of how products are being used, and revealing intervention points to reduce emissions through engagement with distributors and consumers. Another useful measurement for managing total lifecycle emissions is the calculation of 'potential emissions' stored in the fossil fuel reserves that companies are looking to produce. A draft methodology for reporting on this has been developed by the World Resource Institute.³⁴ Although challenging, it is not impossible for calculation tools and reduction mechanisms to be established. To avoid total lifecycle emission metrics being seen as a 'soft' target, this would need to be tied up to a plan with quantifiable measures and milestones.

Incentivising a wind down of assets

To align for <2°C resilience, a wind down of high carbon assets will be required. By winding down before their competitors generally recognise the decline, companies can avoid losses that peers may subsequently bear. Capital released from these projects could be returned to investors, if this is determined the best way to preserve shareholder value. When companies are going through this process, lead indicators and KPIs can be used. For example, executives could be incentivised to wind down operations identified as high-risk under <2°C scenarios, measured through increased cash

returns to shareholders alongside metrics related to best practices in decommissioning.

Incentivising low carbon investment

For fossil fuel companies seeking to diversify into renewables and other low carbon opportunities, it is necessary to consider how this can be supported by remuneration structures. This links to the need to reassess risk timelines. Over the current one to three year periods used to measure financial performance, executives are unlikely to see a return on capital employed in renewables. Similarly, the upfront investment costs necessary for portfolio diversification might challenge the companies' ability to maintain dividend payments in the short-term, affecting TSR targets.

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While there is an underlying question of whether it is preferable for Shell and BP to deploy capital to renewables instead of returning cash to shareholders, if their low carbon investments deliver demonstrable value, then they should be rewarded for this. It will be necessary for the companies to devise reward structures that do not encourage deployment of capital to low carbon investments in a manner detached from the delivery of long-term value. Instead, future bonuses could be made available to executives who successfully develop low carbon divisions, rewarded after a suitable maturity period. This might encourage executives to make well-thought through plans for profitable and sustainable portfolio diversification.

Conclusion and recommendations

In this paper, ShareAction has presented three steps that investors should pursue when engaging with BP and Shell – in the run up to the AGM, and by exercising their voting rights – on the companies' updated remuneration policies. These engagements present an important occasion for investors to signal their expectations around the strategic direction of the companies, with the binding vote providing a timely opportunity to express assent or disapproval of whether this is in the best long-term interests of shareholders. If BP and Shell fail to demonstrate that they are operationalising climate risk into this core governance structure, ShareAction recommends investors vote down the updated remuneration policies.

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