Position paper on Shell’s draft remuneration policy

This briefing analyses Shell’s updated remuneration policy. It highlights how the proposed framework continues to support corporate behaviour that could put shareholder value at risk, and suggests next steps for investors engaging around the low carbon transition.

Shell has released a presentation outlining its proposed remuneration policy ahead of the 2017 AGM. If supported by 50% of shareholders in a binding vote, this framework will remain in place for three years until 2020. While incentives in and of themselves will not drive the transition to a low carbon strategy, getting them wrong at this point could cement an unsustainable business model that puts shareholder value at risk. Investors supportive of the Paris Agreement should use their vote on remuneration to hold Shell to account on the direction executives are incentivised to drive the company toward.

While certain updates can be welcomed, ultimately, the new policy fails to signal the changes required for alignment with a <2°C world; continuing to reward the delivery of a high-carbon strategy. This paper begins by outlining the case for challenging Shell’s strategic misalignment with the Paris Agreement. It then analyses how the updated remuneration policy continues to incentivise executive actions that could be misaligned with the long-term interests of shareholders. Finally, it considers conditions that investors might set for voting against or abstaining on the remuneration vote at the 2017 AGM.

Strategic misalignment with the Paris Agreement

Through the Paris Agreement, international governments have committed to limit global temperature rises to well below 2°C, with an ambition for 1.5 (hereafter, <2°C). For high probability <2°C pathways, full decarbonisation of global energy and industry is needed by mid-century - entailing an enormous turnaround from business as usual. Recent analysis has shown that the potential carbon emissions from oil and gas reserves in currently operating fields would alone exceed the 1.5°C carbon budget. These findings speak to the need to ensure capital is not allocated to explore, develop and produce additional reserves inconsistent with the remaining <2°C carbon budget.

Shell is not currently positioning itself for commercial resilience under scenarios consistent with the Paris Agreement. The company has made explicit that it has “no immediate plans to move to a net-zero emissions portfolio over [its] investment horizon of 10 - 20 years”. The demand projections the company considers most likely are consistent with around 3°C of warming - an outcome that governments have agreed presents unacceptably high levels of risk. Analysis of Shell’s corporate reporting has highlighted concerns about the company’s apparent lack of preparation for scenarios consistent with the Paris Agreement. This is particularly disconcerting given firm’s limited capital flexibility, identified by CDP research - putting shareholder value at even greater risk under low carbon scenarios.

Shell’s current business model presents a double-edged risk to investors. In the case that emission
cuts are successful, capital allocated to explore for and develop hydrocarbon projects unneeded under low carbon, low demand scenarios will be lost where assets are unable to earn returns prior to the end of their economic life. Conversely, if we head for the high carbon scenarios that Shell is currently planning for, investors will face portfolio-wide value destruction through the systemic risks that unmitigated temperature rises pose to the global economy.

There are concerns that fossil fuel companies forging ahead with strategies predicated on the assumption that we will be unsuccessful in limiting temperature rises to <2°C could contribute to a self-fulfilling prophecy of climate failure. While there is an important need to focus on demand-side changes (i.e. electric vehicle fleets, low carbon infrastructure, utilities etc), Oil Change International highlights three reasons why it will be harder to cut emissions if we do not challenge the lock-in of supply-side arrangements. Firstly, supply does not passively match demand, but the two interact. More supply can lead to lower prices, contributing to increased consumer consumption - and therefore emissions. Secondly, since companies have a strong economic incentive in not letting assets become stranded, upfront investments in project development could lead to a lock-in of hydrocarbon production for decades to come. Finally, there is a risk that the sector’s continued commitment to high carbon strategies can contribute to political inertia around enacting tougher climate legislation, due to the lobbying force of dominant industries and political desire to protect jobs.

Investors committed to the rapid decarbonisation of the global economy are increasingly calling on oil and gas companies for robust transition planning and climate resilient business strategies. Engagement strategies focussed on the transition to a <2°C aligned business model - requesting a timely, managed wind-down of hydrocarbon production - are in the best interest of long-term investors seeking to preserve value at a portfolio-wide level.

**Shell’s remuneration updates: An endorsement of business as usual**

**Annual bonus**

Unchanged from previous years, the annual bonus is weighted 50% for operational excellence, 30% of cash flows from operations and 20% for sustainable development. Within these areas, proposed updates have been made. These are explored below.

**Delivery of hydrocarbon projects**

The proposed Annual Bonus maintains a 50% weighting for ‘operational excellence’, focussed on delivering hydrocarbon products to the market. This has been updated with the following amendments:

- 0.5% increase in production (kboe/ d) to 12.5%
- 0.5% increase in refinery and chemical plant availability to 12.5%
- A decreased emphasis on project delivery, down from 20% to 12.5%
- Increased focus on LNG sales (from 6% to 12.5%)
Some of these changes point in the right direction. For example, the reduced focus on project delivery is welcome. It is not in the interest of shareholders for investee companies to deliver projects that do not provide long-term value, supported by compensation structures that reward their delivery irrespective of project profitability. For example, BP’s decision to leave the Great Australian Bight due to the project’s lack of competitiveness is arguably better aligned with the interests of shareholders than a decision to forge ahead to meet targets. Nonetheless, Shell’s proposed 12.5% weighting for project delivery is not unsubstantial, and could still discourage executives from making prudent decisions regarding major projects.

Following the BG merger, liquefied natural gas (LNG) receives greater emphasis - with LNG sales counting for 12.5% of the annual bonus. The role of gas as a bridging fuel in a decarbonising energy mix is often overstated, and the advantages that gas has over coal are undermined in part by high methane emissions. While there is a risk that renewables will leapfrog coal and gas in power generation, another market opening comes from the shipping industry. Tightening environmental legislation means that LNG is forecast to replace traditional heavy fuel oil. However, the near-term profitability of LNG has been undermined by over-supply. Indeed, some analysts are predicting supply of the commodity will outstrip demand for rest of the decade. This goes some way to explain why the LNG metric Shell has included focuses on sales targets, rather than project profitability. Given the 20+ year lifespan of certain major LNG contracts, investors may seek to analyse different demand forecasts over this horizon, considering how alternative low carbon scenarios could further challenge the profitability of this market.

**The crucial timescale to 2020**

Overall, while Shell’s proposed operational incentives do not explicitly encourage executives to replace existing reserves, the reaffirmation of ‘business as usual’ does nothing to signal the necessary shift towards a long-term strategy for <2°C resilience. While investors would not expect companies to shift their core business overnight, there is a need for year-on-year changes to reduce focus on oil and gas production in line with low carbon scenarios.

This inertia is relevant because, if approved by shareholders, this remuneration policy will remain in place until 2020. While the current round of national climate pledges would limit temperature rises to around 2.7°C; the Paris Agreement contains a ‘ratchetting mechanism’ to achieve the <2°C restriction, requiring nations to increase the ambition of their pledges every five years. The first round of renewed pledges will be enacted in 2020. The way Shell positions itself over the next three years will help determine whether the company is a winner or loser in a post-2020 climate policy landscape. There is a possibility that greater action could be catalysed sooner, if governments take heed of a recent UN study that found bolder emissions cuts will be required before 2020 if the 1.5°C limit is to be adhered to.

"It might be argued that committing to a low carbon transition plan now would be premature, since the industry has historically made bullish forecasts of oil demand for decades to come. However, Shell’s Chief Financial Officer himself has recently acknowledged that oil could peak in as little as five years, driven by energy efficiency and substitution measures. Structural demand destruction for oil and gas is being witnessed at a much faster pace than major energy analysts had previously predicted. These changing patterns are reflected in the IEA’s 2016 World Energy Outlook, which supports Carbon Tracker’s findings that planning for ‘business as usual’ could potentially waste $200bn in exploration costs - not to mention lost revenues - with 190 billion unneeded barrels under the updated 450 scenario, consistent with a 50% chance of 2°C. Even more value would be at risk under scenarios more closely aligned to the 1.5°C goal."
To protect shareholder value under rapidly changing circumstances, Shell must act decisively to integrate an orderly and managed transition pathway into the company’s strategy, smoothing the way against future shocks and potential losses.

Cash flows from operations

Cash flow from operations continues to receive a 30% weighting. Carbon Tracker warns against this ‘stealth’ volume metric. Just as reserve replacement could encourage financially imprudent behaviour, so too can these measures. While operational costs feed into these, so do production volumes. As such, these targets can push executives towards the hydrocarbon operations that currently contribute towards cash flows. For instance, Shell identifies conventional oil and gas, integrated gas and tar sands as its “cash engines”. Unless Shell has re-engineered its formula for calculating this target, investors can question whether its heavily-weighted inclusion is consistent with a shift towards a <2°C strategy.

What about the new GHG target?

Shell’s annual bonus has a 20% weighting for ‘sustainable development’. The previous environmental targets (water use, oil spill volumes and Refinery Energy Intensity Index) have been replaced by a 10% weighted metric for greenhouse gas emissions (GHG) management. The removal of emphasis on water use and oil spills is not a welcome move. These issues should be a focus for all companies operating in the fossil fuel industry, with water use being a major environmental issue for shale oil/gas operations. It would have been preferable for the 10% GHG weighting to have been taken from elsewhere - for example, from the 50% weighting for ‘operational excellence’.

Engagements with the company have indicated that this new metric will focus on operational emissions. Arguably, reducing methane emissions from operations should be seen as part of operational excellence, rather than sustainable development. Further, reducing operational emissions plays a very limited role in ensuring portfolio resilience under low carbon, low demand scenarios; it also does not address the risk of stranded assets. As the graph below illustrates, operational emissions only make up a small proportion of the company’s total emissions - the majority of which are expended by consumers on combustion.

Of course, fossil fuel companies have limited control over consumer-expended emissions. While it is not unwelcome that firms seek to reduce operational emissions, a holistic approach that accounts for likely changes in consumption of fossil fuel products would much better prepare oil and gas companies for commercial resilience under a <2°C scenario. This does not mean that firms like Shell need to take responsibility for reducing demand for hydrocarbon projects (i.e. through electric vehicle sales). Rather, it requires companies to be forward-thinking when allocating capital to develop projects and explore for reserves, winding down production for consistency with low carbon demand scenarios. While it may be hard to capture this in a remuneration metric, this must be reflected in Shell’s underpinning strategy. The annual bonus’ overriding focus on delivering hydrocarbon products seems likely to outweigh the largely symbolic inclusion of the GHG metric, discouraging executives from the shift away from fossil fuels.
from ‘business as usual’ that would be required to achieve <2°C alignment. Given its lack of meaningful contribution to incentivising a climate resilient business model, it falls far short of satisfying the needs of investors concerned about climate risk.

Changes to the Long-Term Incentive Plan

A few alterations have also been made to Shell’s Long-Term Incentive Plan (LTIP), which focuses on financial metrics.

Earnings Per Share (EPS) has been replaced by Free Cash Flow (FCF), weighted at 25%. There has been a 5% weighted increase for Return on Average Capital Employed (ROACE), up to 25%. These metrics can incentivise capital discipline, promoting a more efficient approach to capital allocation that discourages high risk expenditure. Under low carbon scenarios, stringent capital discipline is to be encouraged. The focus should be on cash flow from existing operations rather than project delivery of new oil and gas projects.

Nonetheless, capital discipline in itself is not synonymous with low carbon resilience. Openings for international oil companies in conventional, state-owned oil provinces such as those in Iran could lead to an influx of hydrocarbons with lower breakeven prices. As such, simply focusing on projects lower down the cost-curve could still lead companies to develop and produce more oil and gas than consistent with the <2°C carbon budget.

Investors should request a more explicit signal that the company is linking capital discipline to the low carbon transition.

Another change in the LTIP is to include ‘post-holding’ requirements that remain in force beyond the tenure of executives. The period of performance measurement is three years, with an additional two year holding period. This timeline is unchanged from the previous remuneration policy and continues to fall short of aligning the interests of executives with those of long-term shareholders. 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, beyond the five year horizon.

Overall, the revised LTIP offers nothing to focus executive attention on the complex, long-term climate challenges that the industry faces.

Conclusion

The way Shell positions itself over the next three years will determine whether the company is able to protect shareholder value in a post-2020 climate policy landscape. Investors engaging with Shell around the need for robust, <2°C resilient transition planning will be left dissatisfied by the company’s proposed remuneration updates. The company has not done enough to demonstrate it is operationalising necessary strategic changes into its core governance structures.

Image source: Presentation by Gerard Kleisterlee: Remuneration Q4 2016 Engagement (Shell, 2016)
Of course, transition pathways will be led by strategy, not incentives. Nonetheless, given that compensation structures should stem from and assist the delivery of a company’s underpinning strategy, discontent with the latter will almost unavoidably lead to discontent with the former. This means the remuneration vote is in many respects a proxy for the strategic direction that executives are being rewarded to pursue.

Investors engaging with Shell around the need for robust, <2°C resilient transition planning will be left dissatisfied by the company’s proposed remuneration updates.

The 2017 vote on remuneration thus offers shareholders an important opportunity to demonstrate concern over Shell’s strategic misalignment for <2°C resilience. ShareAction encourages investors to set the following conditions for Shell. If the company is not able to meet either of these prior to the AGM in May 2017, we recommend investors warn management that they will not support the remuneration policy, either by abstaining or voting against the resolution.

- Shell’s underpinning corporate strategy explicitly indicates the firm’s intent to transition for a <2°C resilient business model, signposting the short-, medium- and long-term changes this will entail for the company.
- The final remuneration policy acknowledges and focuses executive attention on the long-term strategic changes required to ensure portfolio resilience under <2°C scenarios, reflecting the need to reallocate capital away from the development and production of hydrocarbon projects and operations.
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