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Analysis of BP's 2017 remuneration policy

This paper analyses BP's proposed remuneration policy. It recommends voting against its approval, due to its misalignment with the interests of shareholders in the context of the low carbon transition.

Voting recommendation

This paper analyses the remuneration policy up for binding vote at the 2017 BP AGM.[1] While steps have been taken to address the complexity and level of reward, we find that insufficient progress has been made to focus executives on the strategic changes required for BP to transition to a low-carbon business model. Our concerns relate to three core issues that are summarised below:

1. The remuneration policy is underpinned by a corporate strategy that appears misaligned with the Paris Agreement's goal of limiting temperature rises to well below 2°C, with an ambition for 1.5°C. This means executives will be rewarded for delivering a strategy that does not protect the long-term interests of shareholders.
2. The timelines upon which compensation is calculated and granted are misaligned with the long-term horizons associated with hydrocarbon capex cycles, disruptive technology advances and changing emissions policy.
3. While progress has been made to include indicators that encourage low-carbon developments and investments, these do not appear to represent a platform for a business-wide alignment for <2°C resilience.

If, by the AGM, BP has not strengthened its commitment to the low-carbon transition, we recommend that investors vote against the remuneration policy. We encourage investors to communicate that this is due to a lack of proper consideration of the strategic changes required for low-carbon resilience.

Key challenges

ShareAction encourages investors to engage with BP on the need to commit to transitioning for <2°C resilience, with remuneration metrics that reward and encourage the delivery of a low-carbon strategy. We suggest that investors challenge BP on the areas below:

1. **Strategic planning** – BP's demand forecasts, capital expenditure plans and strategic priorities suggest the company is aligning for scenarios consistent with over 3°C of warming – more than double the Paris Agreement's ambition of 1.5°C.
2. **Long-term incentives** – The proposed remuneration policy could incentivise behaviour that is misaligned with the interests of long-term shareholders. BP's approach to long-term incentives should reflect the risk horizons associated with project capex cycles in the context of the low carbon transition.
3. **Business-wide transition** – While the 'strategic progress' element of BP's remuneration policy refers to low-carbon and renewables trading, there is limited evidence that these will fully focus executive attention on a business-wide transition for <2°C resilience. For example, BP proposes to spend $200 million a year on the 'venturing and low carbon' pillar of its strategy. This represents 1.3% of the company's total capital expenditure.

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Introduction & background

A combination of market, policy and technology-driven factors are transforming the energy sector. As the world embarks on a pathway of low-carbon economic development, shareholders need confidence that the leaders of major oil companies are focussed on adapting their business models for resilience against the backdrop of these long-term trends.

At BP's AGM this May, the company faces a binding vote on its remuneration policy. This vote provides investors with an opportunity to signal that they expect pay to be linked to sustainable performance. By indicating and rewarding the delivery of strategic priorities, incentive structures have an important role to play in the low-carbon transition, and aligning the interests of executives with those of long-term shareholders.

If supported by 50% of shareholders, the policy will remain in place until 2020. This timeline is critical for addressing climate change. 2020 is the last year by which emissions must peak to maintain a high probability of remaining below 2°C.[2] It is also important from a legislative perspective. The Paris Agreement requires nations to convene a facilitative dialogue to increase the ambition of their Nationally Determined Contributions (NDCs) emissions pledges in 2018, for submission in 2020.[3] It is important that the executives of high-carbon companies are focussed on taking decisive steps over the next three years to prepare for a rapidly decarbonising world.

In 2015, shareholder resolutions on climate risk were filed and passed at BP and Shell's AGMs. These provided a mandate to link KPIs and executive incentives to the long-term strategic changes required in the context of the transition to a low-carbon economy.[4] Having signalled this expectation by voting in support of the Aiming for A resolutions, investors must now hold the firms to account on how far they fulfilled the spirt of this request.

Despite the importance of linking remuneration to the low-carbon transition, there is a lack of clarity around what this might look like in practice. In 2016, ShareAction established a framework for investors to help assess whether remuneration policies are aligned with the changes required for oil majors to transition for resilience under <2°C pathways.[5] Following a comprehensive literature review and a series of interviews with industry experts, three criteria were developed. These included:

1. Strategic alignment with the transition for low-carbon resilience

Remuneration structures are designed to support the delivery of a company's strategic priorities. If the underpinning strategy is misaligned with low-carbon pathways, the remuneration policy is unlikely to be able to help incentivise <2°C resilience. The starting point for engagement is therefore an assessment of the firm's corporate strategy.

2. Removal of remuneration features unconducive to low-carbon resilience

Metrics that could actively discourage a timely transition to a low-carbon business model must be removed. These include volume-based production incentives and targets that could encourage short-sighted decisions, based on performance timelines insensitive to the risk horizons that long-term investors face.

3. Inclusion of measures that signal and reward delivery of a low-carbon strategy

Once companies have identified steps for transitioning for alignment with <2°C pathways, these can be integrated into their remuneration policies; actively acknowledging and rewarding the necessary strategic decisions required.

ShareAction has used this framework to analyse BP's updates. While the remuneration policy has been improved - particularly regarding reduced levels of pay and simplification of the structure - due to a continued lack of strategic commitment to the <2°C transition, we conclude that it is not in the best interests of long-term shareholders to support this policy. In a time of transformation of the energy mix, shareholder value will be put at risk if executives are not focussed on developing a business model that is resilient in the face of disruptive trends.

Overview of the proposed remuneration policy

BP's Executive Directors' remuneration structure is made up of a fixed element of basic pay, an annual bonus (worth up to 225% of salary) and performance shares (worth up to 500% of salary for the Group Chief Executive, and 450% for the Chief Financial Officer). An overview of the key measures and weightings is provided in the table below:

Element	Purpose and link to strategy
Salary and benefits	Provides fixed remuneration competitive within external markets. Benefits typically cover travel and medical allowances.
Annual bonus	Rewards the delivery of short-term performance targets derived from the company's annual plan and strategy. 50% is delivered in cash, and 50% in shares that vest after three years. Measures are related to 'safety', 'reliable operations' and 'financial performance', weighted at 20%, 30% and 50%. The detail of the targets is considered commercially sensitive, and disclosed by the remuneration committee in a subsequent year. For 2017, safety is measured using the frequency of recordable injuries (weighted at 10%), and Tier 1 process safety (10%). Reliable operations are measured using upstream operating efficiency (15%) and downstream refining availability (15%). Financial performance is measured using operating cash flow (this excludes Gulf of Mexico oil spill payments, and is weighted at 20%), underlying replacement cost profit (20%), and upstream unit production costs (10%).
Performance shares	Rewards longer term performance linked directly to BP's strategic priorities, measured over a three year performance period. Shares are subject to a three year holding period, applied beyond an Executive Director's tenure. The measures for 2017 focus on shareholder value (50%), return on average capital employed (30%), and strategic progress (20%). The 'strategic progress' indicator is measured by (a) the company's shift to gas and advantaged oil in the upstream; (b) market-led growth in the downstream; (c) venturing and low-carbon across multiple fronts; (d) gas, power and renewables trading and marketing growth. The targets and weightings for individual strategic priorities are not disclosed.
Pension	Recognises competitive practice in home country.
Shareholding	As a percentage of the base salary, the CEO and the CFO are expected to maintain a shareholding of at least 500% of their salary. It is expected that both executives will maintain a shareholding of at least 250% of their salary for two years following retirement.

1. Strategic alignment with the transition for low-carbon resilience

The first step for investors deciding whether to support BP's remuneration policy is to examine the strategy that it rewards executives for delivering. While a number of low-carbon pathways have been identified for oil majors,[6] central to any credible strategy is the requirement that capital is not allocated to explore, develop and produce reserves inconsistent with the remaining <2°C carbon budget. This capital could be returned to shareholders through increased dividend payments or share buybacks - as part of a managed decline strategy - or reinvested by the company in low-carbon products and services, such as renewables.

This section highlights evidence to suggest BP is not committed to a credible <2°C strategy. While it is positive to see a low-carbon element in the refreshed strategy, the firm's overall position – reflected in its demand forecast predictions, strategic priorities and capital expenditure plans – is not one of a wholescale transition for low-carbon resilience.

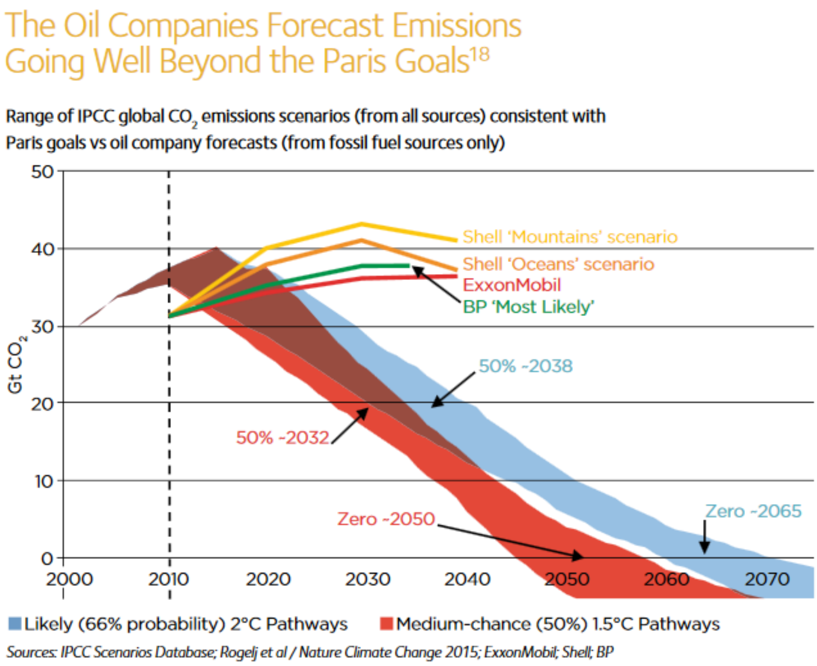
Demand forecasts

The demand projections BP considers 'most likely' are inconsistent with the goals of the Paris Agreement. Analysis highlights the discrepancy between BP's 'Most Likely' scenarios, and 1.5°C and 2°C pathways (see graph below).[7]

When providing shareholders with the 2017 strategic update, Chief Executive Bob Dudley stated that "we see oil and gas continuing to meet at least half of all demand for the next several decades",[8] in contrast to the mid-century decarbonisation required to stay below 2°C. Some of BP's outlooks envision scenarios where oil demand does not fall until the second half of the century.[9] Other industry sources are less bullish. OPEC have suggested that oil demand might peak within a decade.[10] Rival oil majors such as Shell and Statoil have suggested that peak demand could arise in as little as five years' time.[11]

Recent policy developments challenge some of BP's core forecasting assumptions. The 2017 Energy Outlook predicts strong oil demand growth from emerging economies such as China and India, with only 5% of the global vehicle fleet being electric by 2035.[12] However, India has recently announced plans to electrify 100% of its vehicles by 2030.[13] Using subsidies and legislative changes, China is encouraging the rapid growth of its electric vehicle market, as it seeks to boost economic innovation and curtail air pollution.[14] These changes will have significant implications on future demand for liquid fuels.

If BP's forecasts are used to inform strategy and capital allocation, shareholder value will be put at risk. In the case that emission cuts are successful, capital allocated to develop hydrocarbon projects unneeded under low-carbon scenarios will be



Source: Oil Change International and Greenpeace UK (2017) wasted if these assets are unable to earn returns prior to the end of their economic life (the 'stranded asset' argument).[15] Conversely, if BP's predications are correct and fossil fuels continue to be developed at today's rates, investors will face portfolio-wide value losses through the systemic risks that unmitigated temperature rises pose to the global economy.[16] A recent study found that continuing to emit emissions on a 'business as usual' trajectory could entail a value at risk of up to 16.9% of the world's assets under management by 2050.[17]

Strategic priorities and capital allocation

This year, BP has set out strategic updates based on four priority areas. The table below raises questions about whether these are consistent with the transition for a <2°C aligned business model.

Strategic priority	Challenges to low-carbon resilience
Competitive upstream portfolio: shift to gas and advantaged oil in the upstream	BP seeks to expand oil production by around 1 million barrels per day by 2021. Recent investments include large-scale, long-life projects, including a 40-year agreement in Abu Dhabi. The deal in the Azeri-Chirag-Gunashli, one of the largest oilfields in the world, extends a production-sharing agreement to 2049. Some of the company's new infrastructure projects are also long-term: with the North Sea Schiehallion field running through to 2035. While these can seem attractive from an economy of scale perspective, the lack of capital flexibility they can entail might undermine BP's resilience to low-carbon scenarios. By making commitments to projects that rely on multi-decade demand forecasts, capital is put at risk from rapid changes to the energy mix, or policy changes to limit emissions. BP predicts that by 2020, a quarter of its Upstream portfolio will be in deepwater.[18] With high break-even prices,[19] some deepwater projects are at risk of being left economically stranded under low-carbon scenarios. BP expects 60% of its portfolio to be gas within a decade. With lower emissions than coal and oil, gas is often described as a 'transitional fuel'. Research from the Stockholm Environmental Institute finds that gas can only be considered a transitional fuel if robust guardrails are applied, including: eliminating methane leakages; strategically yielding the greatest substitution effect by displacing coal; and preventing low-carbon technology lock-out (i.e., developments in gas made at the expense of progress in renewables).[20] Investors can question how BP performs against these criteria. BP's strategy involves a focus on 'new large-scale gas projects', investing in mega-gas projects such as Shah Deniz State 2 in Azerbaijan which has so far required $28bn in capital investment. Shah Deniz is one the world's largest gas developments, and is accompanied by the construction of major new pipeline infrastructure to export gas to European markets, including the Trans-Adriatic pipeline of which BP is a 20% shareholder. This major investment depends on questionable assumptions about future European gas demand. The EU's 2050 Energy Strategy foresees natural gas decreasing under all scenarios,[21] with the EU's gas demand data significantly lower than BP's forecasts.[23] European expansion of wind and solar energy has already reduced demand for gas-fired generation, and hastened the shut-down in the coal and gas-fired power plant industry.[23] The elevated risk of methane leakage posed by extensive transportation further challenges the low-carbon credentials of these assets. With long-term horizons, major infrastructure projects could contribute to the lock-out of alternative renewable infrastructure.[24]

	The same risks apply to BP's liquefied natural gas (LNG) assets, which have been recently expanded.[25] BP envisions a strong growth of LNG,[26] reflected in the firm's recent investment decisions including twenty-year contracts for projects like Coral South.[27] Many LNG assets have high-cost operations, putting them at risk under low-demand scenarios.[28] A 2015 report by Carbon Tracker suggested that 100% of BP's LNG expenditure are unnecessary under low-demand scenarios.[29] Oil and gas majors have recently had to shelve various LNG assets following a supply glut.[30] This comes after repeated warnings from financial analysts over the long-term risks associated with overestimating demand growth. The company's remaining oil sands assets in the Athabasca region of Canada, are also similarly reliant on high prices, posing challenges to their long-term resilience.[31]
Market-led growth in the downstream	BP's focus on growth involves (a) competitiveness improvements in refining and petrochemicals processing, (b) growth of fuels marketing and lubricants, (c) the creation of new offers in fuels, lubricants and petrochemicals, and (d) the development of new business models. Investors may question the resilience of BP's downstream strategy under disruptive low-carbon scenarios and the drive to curb high-contaminant fuels like diesel.[32] Low-carbon technologies could significantly alter the market conditions for both upstream and downstream industries, and include electric vehicles, renewable electricity, and additive manufacturing.[33] 3D printing is forecast to grow exponentially according to a range of studies.[34] BP has acknowledged that additive manufacturing could reduce demand in the maritime freight industry, cutting demand for international bunker fuel.[35] BP's demand outlooks suggest that until 2050, electric cars will be less economically viable than conventional fuels.[36] Other studies have suggested far earlier dates. Bloomberg New Energy Finance noted that the fall in battery prices could bring the cost of EVs below conventional-fuel vehicles by 2025, highlighting that "[t]he electric vehicle revolution could turn out to be more dramatic than governments and oil companies have yet realised."[37]
Venturing and low-carbon across multiple fronts	One of the pillars of BP's new strategy is 'being involved in the transition to a lower carbon future'.[38] BP plans on investing around $200 million a year in its lower-carbon pillar. This represents just 1.3% of the company's total capital expenditure. It also is significantly lower than previous years: in 2005, BP planned to spend $800m a year on renewable energy. With regards to its biofuels business, BP asserts that it is 'working to produce biofuels that are low-cost, low-carbon, scalable and competitive without subsidies.' Various studies assessing the greenhouse gas intensity of biofuels have cast doubt on their ecological benefits, showing their emissions to be unfavourable when compared to standard crude oil.[39]
Modernising the group	BP's modernisation focus includes (a) simplifying the company's organisation, (b) productivity-enhancing digital solutions, (c) maximising value from assets in oil, gas, power and renewables through trading activities, (d) improving motivation and company morale and (e) continue improving the safety and reliability of operations. Currently, there are limited publicly available details about how these five objectives will be delivered.

Portfolio and Equity Assets

BP has a 19.75% equity interest in Rosneft, the world's second largest publicly traded oil company by production volumes.[40] Carbon Tracker listed Rosneft as the oil company with the third highest level of unnecessary capex under the IEA 450 scenario, with over $69bn heading towards projects requiring breakeven prices of over $80 per barrel.[41] Furthermore, Rosneft has recently expanded its Arctic ventures - projects which tend to sit at the higher end of the cost curve.[42] Investors might question how BP's ambition to be 'fit for the future' extends into its exposure to Rosneft.

BP's subsidiary Pan American Energy has made significant investments in tight gas formations in South America, including a 35 year contract with the Argentine government.[43] Analysis suggests that when these emissions are included, the total GHG footprint of shale gas can be higher than oil and coal.[44] Methane leakages are often significantly higher than companies report. A recent study found that natural gas power plants release up to 120 times more methane than earlier estimates suggested.[45] In light of these challenges, investors might query if future investments - particularly in higher-cost shale oil and gas - represent the most prudent future option.

The burden of proof falls on BP to demonstrate to investors that it is developing a strategy that is resilient to <2°C pathways, and not expanding the company's foothold in high-carbon assets.

Summary and key recommendations for investors

- The first step when considering BP's remuneration policy is to assess the strategy that it rewards executives for delivering. BP's demand forecasts, strategic priorities and capital allocations suggest BP could be aligning for scenarios consistent with over 3°C of warming – more than double the Paris Agreement's ambition of 1.5°C.
- BP plans on investing $200 million a year in its lower-carbon pillar. This represents just 1.3% of the company's total capital expenditure.
- Disruptive low-carbon trends could pose challenges to the firm's upstream and downstream strategies. While BP states commitment to capital discipline, recent investments in long-life and large-scale hydrocarbon projects could leave the company misaligned with <2°C pathways.
- We recommend that investors engage with BP on the need to signal a clear commitment to transition for <2°C resilience. Over time, the firm should provide evidence to investors to prove this commitment is being operationalised in its strategy and capital allocation decisions.

2. Removal of remuneration features unconducive for low-carbon resilience

While strategy will be the key indicator of BP's commitment to the low-carbon transition, there are certain remuneration features that could actively discourage executives from making the decisions required for a successful transition. Metrics that could be unconducive for low-carbon resilience must be altered, including volume-based production measures, and performance timelines that do not reflect long-term risk horizons.[46]

Volume-related and project delivery metrics

BP has this year removed the Reserves Replacement Ratio. Furthermore, and unlike Royal Dutch Shell, BP's remuneration proposal does not include targets linked to project delivery, maximising hydrocarbon production or LNG liquefaction volumes. This can be welcomed by shareholders.

Performance timelines that do not reflect risk horizons

For hydrocarbon projects that span decades from initial exploration to production and sale, decisions about capital expenditure made by executives today will have consequences for shareholder value far into the future. Executives should not be rewarded for conduct that could pose liabilities to long-term shareholders. Currently, BP's performance shares includes a three-year performance measurement and additional three-year vesting period. 50% of the annual bonus is delivered in shares rewarded after a three-year vesting period. These timeframes do not reflect the risk horizons of the projects on which executives are making investment decisions upon, which can have lifecycles of over 40 years

There are concerns associated with extending performance measurements far beyond the likely tenure of executives - i.e. the idea of a 10-year LTIP. A potential way around this could be for the company to identify steps needed to protect shareholder value over 20+ years, then to translate these factors into measures that support the delivery of a long-term strategy on a year-by-year basis.[47] 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. What this would look like in practice would depend on the transition strategy pursued.

> “Executives should not be rewarded for conduct that could pose liabilities to long-term shareholders.

BP suggests that the shareholdings that executives are required to hold help align their interests with those of shareholders. As a percentage of the base salary, the CEO and the CFO are expected to maintain a shareholding of at least 500% of salary. It is expected that both executives will maintain a shareholding of at least 250% of salary for two years following retirement. While there is a good case for using equity-based rewards, this is only true if the holding periods are meaningfully extended. For example, before filing for Chapter 11 bankruptcy, Peabody Energy 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.[48] Furthermore, institutional investors with portfolios containing stock that will be adversely affected by high-carbon scenarios – such as agriculture, forestry and infrastructure – have considerably different interests from those of BP's executives. While BP might be able to profit under scenarios consistent with 3°C of warming, most institutional investors will suffer losses at a portfolio-wide level.

Summary and key recommendations for investors

- BP's remuneration policy is not heavily weighted towards hydrocarbon production, and the company has removed the Reserves Replacement Ratio (RRR) incentive.
- However, the policy still risks incentivising executive behaviour that is misaligned with the long-term interests of shareholders, due to performance and vesting timelines that do not reflect the risk horizons associated with hydrocarbon projects.
- Investors should encourage BP to describe more clearly the long-term strategy that it has in place to protect shareholder value under a <2°C transition in able to provide assurance that the interests of executives are being aligned with the long-term interests of shareholders.

3. Include measures that signal and reward the successful delivery of a <2°C strategy

A carefully considered remuneration policy could play a helpful role in rewarding executives for overseeing a successful low-carbon transition. The remuneration committee has made headway to include factors that could help focus on low-carbon resilience, with measures that encourage capital discipline and strategic targets related to renewables. However, progress needs to be made on clarifying BP's strategic alignment with <2°C pathways in order to assure shareholders of executives' commitment to low carbon resilience. Without this, the positive potential of the current indicators is undermined.

Strategic priorities

20% of BP's performance shares are based on strategic progress targets. These cover the four areas below:

- Shift to gas and advantaged oil in the upstream
- Market led growth in the downstream
- Venturing and low-carbon across multiple fronts
- Gas, power and renewables trading and marketing growth

There is scope for these elements to be incorporated into a strategy for low carbon resilience, and these indicators could be welcome by investors if they were more clearly tied to a <2°C aligned transition plan. Further details about the specific targets are not currently disclosed. Without knowing the weightings for different components (i.e. oil vs. renewables) it is hard to assess the relative focus given to low carbon elements of the strategy, and how ambitious the targets are.

Prior to approving the vesting of shares, the committee will take into account environmental factors, including issues around carbon and climate change. This concept could be a helpful component of a low-carbon remuneration policy. However, there is limited disclosure about these thresholds and whether they require executives to meet ambitious targets.

Capital discipline

BP's remuneration policy contains a number of elements that encourage capital discipline and a shift away from high-cost projects. This includes Return on Average Capital Employed, Total Shareholder Return (TSR), and targets in the Annual Bonus related to underlying replacement cost profit and upstream unit production costs. Under a low-carbon transition strategy where companies wind down hydrocarbon production and return cash to shareholders through increased dividends or share buy-backs, measures that focus on capital discipline and shareholder returns could play a supportive role.

However, there is a need for greater strategic clarity if these measures are to be considered part of a well-managed transition plan. A focus on lower cost projects in itself does not guarantee low-carbon resilience, particularly if more low-cost oil enters the market. An increasing number of state-owned, conventional hydrocarbon reserves are being opened up for partnerships with international oil companies, from Iran [49] to Mexico.[50] Majors are also looking at ways to cut costs in traditionally expensive operations. For example, Shell is currently deploying a 'budget' deepwater strategy.[51] This could mean that even some lower cost projects could be left surplus to requirements in the future under low-demand scenarios.

As such, while the current remuneration policy shows potential for playing a conducive role in incentivising the shift to a low-carbon business model, the current lack of a clear underpinning <2°C transition plan means that it is unable to fully signal the long-term strategic changes required in the context of the transition to a low-carbon economy, as requested by the Aiming for A resolution.

Summary and key recommendations for investors

- BP has taken steps to include metrics that promote capital discipline, and has included strategic indicators that focus on low-carbon developments and renewables. While these steps are to be encouraged, they need to be meaningfully linked to a long-term strategy for <2°C resilience in order to assure shareholders of the company's commitment to a low-carbon future.

Conclusion and next steps

This paper has considered whether shareholders should vote to approve the remuneration policy that BP has put up for a binding vote at the 2017 AGM. It notes the positive steps that the remuneration committee has taken to address concerns about complexity and quantum, and also recognises the potential that the policy shows for aligning executives to focus on strategic changes that could enable low-carbon resilience. Notably, BP has done better than Shell to remove volume-based targets from the remuneration policy. However, the company's lack of clarity regarding the company's <2°C transition plan means that fundamentally, the policy is geared to reward a strategy that puts shareholder value at risk.

As such, ShareAction encourages investors to engage with BP on the need to signal a stronger commitment to making the transition for <2°C resilience. If by the time of the AGM insufficient progress towards this goal has been made, we encourage investors to **vote against** the remuneration policy, and communicate the reasons why.

The following conditions or adjustments would merit an endorsement of the policy:

- BP underpinning corporate strategy explicitly indicates the firm's intent to transition for a <2°C resilient business model, signposting 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 resilience under <2°C scenarios, reflecting the need to reallocate capital away from the development and production of hydrocarbon projects and operations.

By clearly signalling their expectation for the company to commit for a <2°C aligned transition plan, investors can provide BP with a mandate to play a stronger leadership role in the low-carbon transition. On the other hand, supporting a remuneration package that incentivises risky behaviour is a vote against the interests of long-term shareholders in the company. A vote against management would send BP a clear signal that investors will not support 'business as usual' going forward.

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