Incorporating ESG Measures into Compensation Programs: Large Utilities Leading the Way

by: Caroline Montalbano and Jessica Page

Companies across all industries continue to focus on defining and advancing their **E**nvironmental, **S**ocial, and **G**overnance (ESG) strategy. One key challenge is determining how to measure meaningful progress of ESG initiatives. As companies identify critical ESG objectives, management teams and Board members are also evaluating if, and when, these measures should be included in compensation incentive programs.

Recently, we observe larger utility companies leading the way in incorporating ESG objectives into incentive plans. Based on most recent proxy disclosures, Utilities incorporated ESG goals into incentive programs at a faster pace than general industry with 76% of S&P 500 utility companies including an ESG metric in the company's short- and/or long-term incentive program. The prevalence decreases to 63% among general industry S&P 500 companies.

Excluding workforce safety metrics, which have historically been commonly included in incentive plans, we observe utility companies introducing ESG measures focused on diversity, equity and inclusion (DE&I) and environmental advancements, with metrics designed to measure DE&I initiatives quickly becoming the most prevalent ESG metrics in the utilities space. Three quarters (75%) of S&P 500 utilities that include ESG metrics in short-term incentive plans incorporate metrics focused on DE&I compared to 62% among general industry.

Utilities provide services to diverse groups of customers, and many utilities seek to reflect that diversity in their workforce demographics. Incorporating measures focused on increasing diversity and creating an inclusive culture reinforces the company's commitment to this objective for both internal (employees) and external (investors) stakeholders.

Use of these metrics varies. The most typical practice is to include the measure on a qualitative basis, generally within the individual or strategic component of the short-term incentive plan. Alternatively, like with other financial or operational metrics, companies assign a weight to the diversity metric or incorporate it as a payout modifier. The specific objectives companies choose to measure in this space vary given each organization's specific workforce and business strategy. Outlined below are examples of frequently used goals and measures.

Outcome-Based Measures

Outcome-based DE&I metrics measure specific results of an initiative such as incremental growth of racial and gender representation within the workforce or improvements in supplier diversity. For example, improving diversity of executive and leadership populations and increasing the company's spend or investment with minority- or women-owned business are outcome-based measures. Increasing representation of diverse talent in critical succession plans is also a commonly used outcome-based measure.

Behavioral-Based Measures

Behavioral-based measures tend to focus on objectives aimed at instilling programs and practices to develop a pipeline of diverse talent. Examples of behavioral-based measures are forging strategic recruiting partnerships with local universities as a means of bringing new and diverse talent into the workforce, deploying training programs on inclusive behaviors or inclusion of diverse talent in company leadership and mentoring programs or new position applicant pools.

Qualitative Measures

DE&I and environmental objectives are most often measured qualitatively, particularly where companies are evaluating achievement across multiple fronts. For example, developing a DE&I roadmap, educating the workforce or leaders on key issues, responding to employee engagement feedback, and fostering a more inclusive culture are all examples of DE&I objectives that would likely be considered in a qualitative review for specific individuals during annual performance reviews.

Successfully Incorporating ESG and DE&I Measures into Incentive Plans

Inclusion of ESG metrics in incentive plans can reinforce the company's commitment to making progress on important initiatives that may not always be measurable in quantifiable financial results. However, before companies move to link these measures to executive pay, it is important to evaluate where the company is in its own ESG journey and identify which measures make the most sense given the company's strategy and the behaviors it wants to incentivize. Below are key steps to evaluate readiness in this space:

1. Most importantly, identify metrics that support the overall business strategy, that can be clearly communicated to participants and that participants have line of sight to impact.
2. Consider if and how ESG data is currently being tracked and reported on within current systems. Companies may consider tracking the metric for at least one full performance period as a shadow metric to ensure stakeholders understand how the measure is calculated and how performance will be assessed.
3. Determine what meaningful progress or success looks like for the organization. Use this analysis to help inform the goals and targets for the incentive plan period.
4. Assess how the data will be validated and disclosed when determining final outcomes. Will the data be subject to a review or audit process to confirm the results? What might the disclosure look like when describing results in the proxy? How will outcomes be communicated to workforce participants?
5. Assess which participants or office locations can meaningfully impact the results. This may inform decisions around applicability of the ESG measure by location or within the pool of incentive plan participants.

What is Next for ESG metrics at Utilities?

As companies across all industries finalize their incentive plan designs for 2022, we anticipate that the prevalence of ESG measures in incentive plans will continue to grow. For large utilities in particular, in addition to DE&I measures, we may see metrics related to environmental goals such as emissions reduction, renewables growth and the energy transition feature prominently in compensation plans as utilities continue to play a critical role leading in this space.