Post #74: The Current and Future Role of ESG in Oil & Gas Incentive Plans

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We have seen a significant increase in the use of ESG metrics within the Oil & Gas (O&G) industry, similar to other industries. As with most metrics, ESG metrics have their pros and cons, and should be considered carefully before including them in incentive plans. We have outlined a summary of current practices within the O&G industry, where we think ESG metrics will go from here, and important considerations when evaluating the inclusion of ESG metrics.

Common Types of Metrics and Rationale

While the O&G industry has long used safety as an incentive metric, most new ESG metrics within the O&G industry generally fit into a few categories:

Environmental footprint metrics

Environmental footprint metrics generally measure improvements in the environmental efficiency of company operations. This may include the reduction of emissions from company vehicles, real estate, etc. While often a focus area for O&G companies, these are not yet common as incentive metrics within the O&G space, except for the next category of metrics.

Emission reduction metrics

Emission reduction metrics are a type of environmental footprint metric that has become quite common at upstream E&P and downstream refining and marketing companies. These metrics include items like reductions in flaring, methane and/or greenhouse gas emissions, and are typically aligned with external commitments. So far, upstream and downstream companies have generally adopted these metrics in the annual incentive plan, but a few have added these metrics to recent long-term incentive awards.

Diversity and inclusion (D&I) metrics

D&I incentive metrics are relatively uncommon within the O&G industry. Where adopted, they are often scored on a qualitative basis, likely as one metric within the subjective portion of the annual incentive. Some other industries (e.g., utilities) have been more aggressive in the adoption of D&I metrics.

Business transformation metrics

This category includes metrics incentivizing a transformation of the business aligned with the expected energy transition. This could include tying a portion of the annual incentive to revenues or earnings from a new business line focused on renewables, carbon capture, or other low carbon initiatives. These do not measure the environmental footprint of the company, but rather the impact the company might have outside of traditional oil & gas. These are also not very common yet and may be challenging for some companies to adopt.

Potential Next Steps in ESG Metrics

With investors' heavy focus on ESG and improving sophistication of measurements, we anticipate that the use of ESG metrics within the O&G industry will grow and evolve over time. We imagine potential future trends might include:

- **<u>Even greater adoption of environmental metrics:</u>** Emission metrics will likely become even more prevalent in downstream and upstream industries. O&G companies will use these metrics to demonstrate how they can play a vital role in the potential energy transition by meeting the world's energy needs as efficiently and environmentally friendly as possible.

- **Increased prevalence in LTI plans:** ESG and sustainability generally have a long-term orientation, so it follows that they might fit well in LTI plans. To date, few companies have implemented ESG metrics in LTI plans, with the primary challenges of having consistent measurement approaches, the ability to set long-term goals, and having to manage metrics through acquisition and divestiture activity. However, some of those challenges are likely to be addressed over time as companies develop better measurement approaches and have more historical and peer disclosed data.
- **More third-party verification of results:** As ESG metrics become more prevalent in disclosures and incentive plans, there is a growing market for third-party verification of the data, particularly around environmental metrics. The more confidence that companies and Boards have in measuring the outcomes, the more likely they will use them in incentive plans, particularly LTI plans.
- **Increased adoption of D&I metrics:** Environmental metrics have been the primary ESG focus of the O&G industry, for good reason. However, the industry is also focused on improving D&I and many companies have made important progress. It is even harder to set appropriate goals within D&I, but we expect there will be more discussion around the best way to incentivize continued D&I progress, resulting in increased prevalence of D&I metrics within the industry, similar to some other industries.
- **Greater use of ESG metrics as a modifier:** To date, most O&G companies have adopted ESG metrics either as a weighted metric or as one factor in the subjective portion of the incentive. However, an alternative approach is to use the ESG metric as a modifier. A modifier avoids reducing the weighting on the underlying financial performance of the company; if financial performance is poor, ESG performance is not as relevant. We think this approach may become more prevalent, particularly if ESG metrics catch on in the LTI plan.

Important Considerations

I don't think any O&G company would argue that ESG and sustainability is not a focus for their organization. However, not every focus area belongs in an incentive plan, and there are unique challenges to ESG metrics that make it difficult to work them into incentive plans. A good incentive metric should:

- Align with the company's strategic plan/goals
- Allow for the measurement of tangible progress or results
- Have enough data history and confidence in the strategy to set reasonable goals over the desired timeframe
- Be verifiable by all parties involved and disclosable to investors

If there are ESG metrics that meet these requirements for your company, then it's worthwhile considering the best approach to incorporate them, perhaps including some of the examples above.

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