

# Paying for net zero

Using incentives to create  
accountability for climate goals



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# Foreword

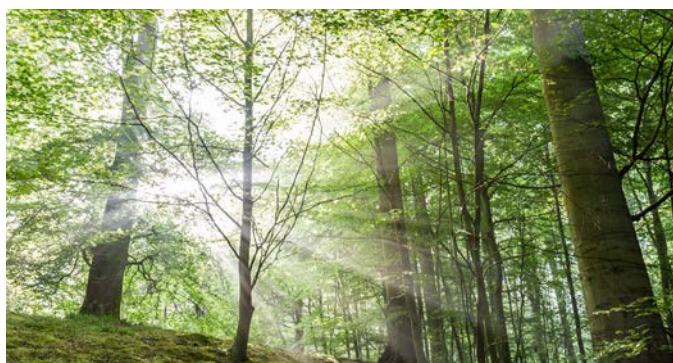
With Environmental, Social and Governance (ESG) metrics increasingly being linked to executive pay, we ask: how well is this working?

This report is a collaboration between PwC and the Leadership Institute at London Business School, and is the third in our series examining ESG targets in pay. Our 2021 report [Paying well by paying for good<sup>1</sup>](https://www.pwc.co.uk/services/human-resource-services/insights/environmental-social-governance-exec-pay-report.html) looked at how to link executive pay to ESG, while our 2022 report [Paying for good for all<sup>2</sup>](https://www.pwc.com/payingforgoodforall) reviewed ESG and reward across a global workforce.

In this report we have focused on carbon targets in pay at major European companies. Climate is the area of ESG with the strongest investor consensus, most well-developed strategies, and the best comparability between companies. Europe is the region where the practice of linking pay to ESG targets is most developed. So to the extent that there is best practice, we should find it here. However, we find that most carbon targets in pay fall short of investor expectations.

For this report we have also sought the input of Cevian Capital, a leading European activist investor. Since 2021 they have been a vocal advocate for the use of ESG and carbon measures in executive pay. Their insight has helped to supplement our own experience to develop the framework we use here for evaluating incentive practices against investor expectations. We have asked Cevian Capital to provide their views on the findings in a separate comment to this report, and would like to thank Harlan Zimmerman and Raphael Mattei for their constructive engagement and challenge through this project.

In our earlier reports we highlighted that there are risks and potential unintended consequences of linking pay to ESG targets, as well as benefits. And by itself, pay can never correct for a major unpriced externality. But the practice is now already widespread. Our 2022 survey found that 82% of senior leaders now have ESG targets in their pay.



The challenge now must be to do it well, so that pay targets make a meaningful contribution to helping companies meet their climate goals. Yet what is clear from our analysis is that many companies have some way to go to meet investor expectations for significant, measurable, and transparent targets. Common gaps relate to the weighting applied to the measure, the degree of transparency of targets (especially prospectively), and the clarity with which the targets are linked to announced company decarbonisation goals. Yet on the positive side, many of these issues are easily fixed. We provide some thoughts on what a market-leading disclosure might look like.

Our report lands at a testing time for investor-company dialogue on ESG. Investors are criticising some companies for taking insufficient account of their impact on the environment, whereas companies are criticising some investors for micromanaging them on ESG issues that they do not always see as central to strategy and value creation. The investor push for ESG targets in pay risks adding to this tension.

However, putting ESG targets in pay is not always as simple as it seems and should not be viewed as the sole litmus test of a company's commitments to ESG priorities. But at the same time, companies need to recognise that if ESG targets are included in pay, then the practice needs to be executed to a high standard.

The focus on climate, and its link to pay, is only likely to increase, and investors will continue to raise their expectations.

This report has been developed to help companies who decide to make a link between carbon commitments and executive pay to do so in a way that meets those expectations and supports achievement of decarbonisation goals.

We would like to thank the many people involved in preparing this report, in particular Duncan Hawthorne and Matt Reah who led on the research and report writing.

**Phillippa O'Connor**

**Partner, PwC UK**

**Tom Gosling**

**Executive Fellow, Department of Finance and Leadership Institute, London Business School**

<sup>1</sup> <https://www.pwc.co.uk/services/human-resource-services/insights/environmental-social-governance-exec-pay-report.html>

<sup>2</sup> <https://www.pwc.com/payingforgoodforall>

# Comment from Cevian Capital

This report from PwC and LBS is no ordinary study of remuneration trends. This concerns matters of existential consequence.

Climate change is the single biggest challenge many companies will face over the coming decades. Companies must rethink the way they run their businesses to transition towards a clean and energy efficient future. New technologies need to be developed, industrial bases transformed, and supply chains redesigned.

Companies that adapt well will survive. Some will thrive by embracing the opportunities created by momentous change. There will also be dinosaurs that greenwash their way towards extinction.

Boards and shareholders are already playing a critical role in determining the winners and the losers. Together, we are determining whether the entire corporate sector ameliorates or compounds the global impact of climate change.

Crucially important is how well boards address climate change in management incentive plans, and how well shareholders employ their say-on-pay rights to ensure the right outcomes.

Our conviction in the importance of incentives is based on Cevian Capital's 20 years' of constructive activist investing in European public companies. Reworking management incentive plans has always been a key tool in transforming corporate behaviour and increasing long-term value.

As Cevian sought to enhance the ability of its portfolio companies to successfully confront the challenges and opportunities of climate change (and other sustainability factors), it became clear to us:

**Executive pay should be used to create incentives and accountability to ensure delivery of mission-critical sustainability outcomes that are not reflected in EPS or TSR – at least not during the timeframes that matter for most CEOs. 2030, 2040 and 2050 emissions goals should be broken-down into robust, actionable roadmaps, which should be embedded into the long-term incentive plans of the management teams we depend on to progress towards these goals.**

In early 2021, we began to publicly advocate for this approach, including robust use of say-on-pay to support it. It has been encouraging to see the widespread adoption of emissions-linked pay metrics, particularly in companies where emissions are material. There has also been rapidly growing support from investors, investor associations, and climate-focused organisations.

But this excellent and comprehensive report shows that we are not yet where we need to be.

Most relevant companies have added such metrics in recent years. Progress – but checking that box is no longer sufficient.

To separate the committed companies from the greenwashers, investors now look to the quality and rigour of emissions-linked pay metrics. Increasingly, we expect metrics that are:

- Significant (meaningful for execs, and tied to strategy).
- Measurable (numeric, discrete metrics – no scorecards).
- Prospectively and fully transparent, so investors (and other stakeholders) can precisely see the ambition levels reflected in the targets when we are asked to vote on pay plans.
- Clearly and rigorously tied to companies' public emissions commitments.

This report evidences that few companies are meeting these expectations.

Of course, there are well intentioned boards that promulgate emissions-linked pay targets that don't meet these quality requirements. Perhaps they'd like more data first, or are used to running shadow metrics for a few years. As this report rightly acknowledges, there are challenges and complexities.

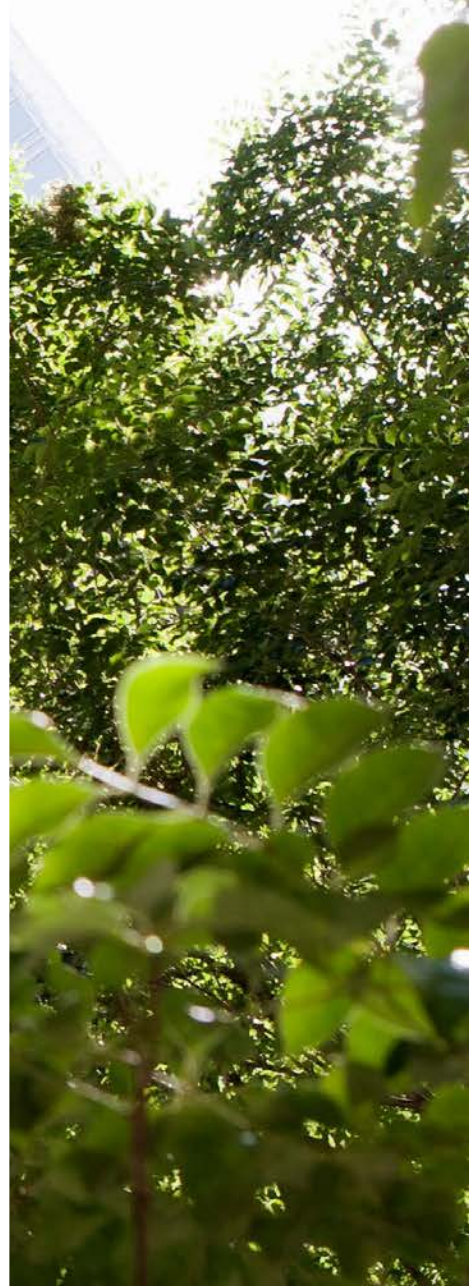
However, societal and investor urgency is high. It is increasing rapidly. We can all see how quickly the world is changing. Carbon pricing will probably start to bite soon, which is an additional, concrete impetus to move without delay.

We are not willing to wait. If you are not already making clear progress, then you are already late.

We believe the boards of our companies are capable of meeting these challenges.

This report provides a valuable pathway to best practice. PwC and LBS have performed an important service by preparing it. We urge boards and management teams to take full advantage of the findings and guidance it sets out.

**Harlan Zimmerman**  
Senior Partner, Cevian Capital



# Context

We've seen a big push on ESG, and especially carbon reduction, in the last few years, with an expectation that ESG goals are integrated into company strategies and plans.

Investors, and even regulators, see executive pay as an important mechanism to accelerate progress towards achievement of ESG goals. Our previous report, *Paying for good for all*, found that 85% of investors believe that pay targets are a useful way to force companies to set short-term targets towards long-term ESG goals, such as net zero by 2050. That same report found that, globally, four out of every five senior leaders already have ESG targets in their pay.

So the practice has certainly caught on, but what about the quality? Could poor quality implementation of ESG targets in pay just lead to more pay, not more ESG? So two years on, we decided to come back and take a look at how well ESG targets are being implemented, with a particular focus on climate change.

## Why focus on carbon?

We focused on carbon as the ESG area with:

- Best comparability between companies.
- Strongest investor consensus.
- Mature company strategies for net zero.
- Publicly disclosed company targets.
- External independent body focus e.g. SBTi<sup>3</sup>.

Overall, if companies are going to do a good job of linking pay to ESG anywhere, it is likely to be in the area of climate.

Furthermore, a number of investors see climate as an area where there needs to be a forcing mechanism to make emissions reductions happen – to turn aspirational 2050 net zero pledges into shorter-term targets against which management can be held accountable. A number of investors have even said that, for companies that can have a significant impact on climate change, they will vote against pay structures that don't include carbon targets.

## Investor pressure for ESG in executive pay

- 2021: Cevian published demand for ESG targets in management compensation plans.
- 2022: Allianz committed to vote against large European companies that fail to link executive pay to ESG metrics.
- 2022: LGIM expect companies in most sectors to include climate targets (SBTi linked or similar) in Long-term Incentive Plans ('LTIPs') with a 20% weighting from 2025.

## Purpose of report

This report is primarily aimed at boards wanting to include carbon targets in pay in an effective way that also meets investor expectations.

In the first half of this report we look at whether current practices are meeting investor expectations:

- How have large European companies implemented carbon targets in pay? Have the biggest emitters moved further on putting carbon into executive pay?
- How well have companies met investor expectations on implementing carbon targets in pay?

In the second half of this report we look at some 'devil in the detail' challenges and complexities of including carbon targets in pay:

- What are some of the challenges when linking pay to carbon targets?
- Are carbon targets always relevant? Or will alternative approaches work better for some companies?

In the Appendix we provide an example of our view of best practice disclosure.



<sup>3</sup> Science Based Targets initiative

# Executive summary

We studied the adoption of carbon targets in 50 of the largest European listed companies.

All companies in this group are talking about reducing carbon emissions, and the vast majority (78%) have now adopted some form of carbon target in executive pay.

We have then assessed these carbon targets against four criteria: are the targets significant, measurable, transparent, and demonstrably linked to long-term carbon reduction goals? These criteria reflect the investor consensus for what constitutes a robust carbon target.

While there has been rapid adoption of carbon pay targets in the last couple of years, only one company's carbon pay measures met every one of our criteria. And payouts on carbon targets disclosed in 2022 averaged 86%, with over half paying out at 100%. This is surprisingly high given the common understanding that we're making inadequate progress on reducing carbon emissions, which raises the question on whether the carbon targets in pay are working.

The criteria that companies' carbon measures most commonly failed to meet relate to the weighting (which is frequently quite low), the transparency of targets (which are rarely prospectively disclosed), and their quantitative link to the company's stated long-term carbon reduction goals (which is often unclear).

There are some easy opportunities to improve here, especially through creating a demonstrable, and prospectively disclosed, link between pay targets and announced carbon targets. This link often exists but is rarely drawn out in a way that enables investors to compare the consistency of pay goals with stated medium to long-term commitments.

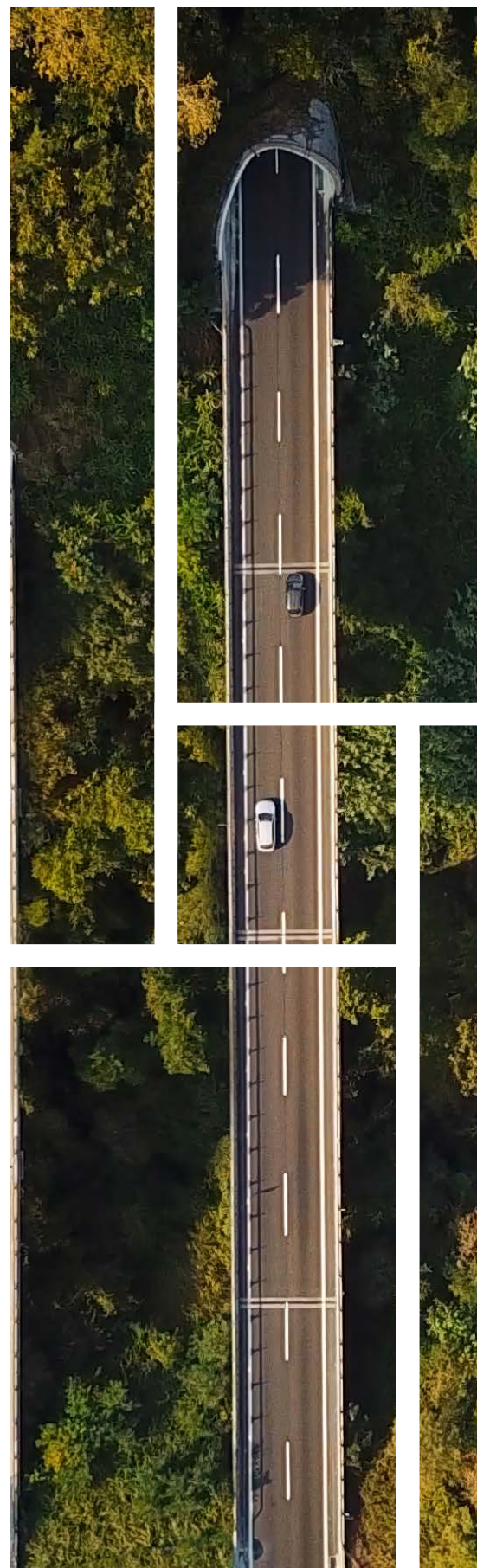
We found that the bigger carbon emitters are more likely to put carbon measures in executive pay and more likely to score well against investor expectations. This suggests that focussed investor engagement through, for example, the Climate Action 100+ ('CA100+') group is having an impact. And indeed, investors are ramping up the pressure to ensure companies follow their expectations for executive pay carbon reduction targets. In the coming years we will see more say-on-pay voting activity driven by this issue, as Allianz, Cevian, and LGIM have made clear. This has the potential to lead to more transparent and challenging targets, but there are some inherent complexities in the creation of effective executive pay arrangements.

Adopting carbon targets in executive pay raises issues for executive line-of-sight (particularly Scope 3), and questions on how to capture total impact (e.g. M&A activity, offsets), so careful design is required. In some cases a company's core business product may positively impact the environment in a way that offsets the impact of its emissions. And over time, the expansion of direct regulatory interventions such as emissions trading schemes may replace the need for pay targets.

More broadly, a successful carbon transition for society is not going to involve each company linearly reducing carbon. And as long as the carbon negative externality is not regulated or priced, there are limits to the extent to which pay targets can overcome fundamental economics.

These inherent complexities create challenges for pay design, as each company looks to make its unique contribution to the transition, while continuing to create value for shareholders.

This is the balance that needs to be struck, as boards include carbon targets in their pay schemes.



# Meeting investor expectations?

## Investor expectations criteria

Investor views seem to be moving towards a clear consensus that, where carbon targets are used in executive pay, they should be significant, measurable, transparent, and with a disclosed link to long-term carbon goals.

We broadly support the investor consensus that carbon targets in pay should follow these principles, and therefore we have researched the current status of how companies are structuring executive pay carbon targets against this framework.

## Secondary areas named by some investors

Investors also want targets to be stretching – ambitious beyond the day-to-day – so that companies move the dial. However, it is challenging to assess and cross compare the ambition of each company's long-term carbon plans.

Some investors push for use of targets authorised by the Science Based Targets initiative (SBTi). However, these targets are pegged to the aspiration to hold global warming to less than 1.5°C, which some companies (and investors) view as a forlorn hope. It can also be argued that the SBTi methodologies can only ever approximate the likely pathway to a successful transition. Given the difficulty of directly assessing stretch using an independent methodology, we instead focus on the alignment of targets to stated carbon commitments. We also use actual payout levels on carbon metrics as a proxy for targets' stretch.

Some investors have a clear view that carbon targets should be in the Long-term Incentive Plan (LTIP) rather than bonus, given that climate targets are generally longer-term goals. However, there is no consensus for this, and we believe there can be good arguments for using bonus instead. Therefore, we do not use this as a criterion in our assessment.

## Investor expectations consensus principles



### 1. Significant:

A separate and meaningful percentage of incentives linked to pay, so that management care about the measure.



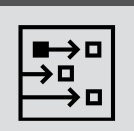
### 2. Measurable:

Objective and quantifiable targets, so that management are held to account.



### 3. Transparent:

Externally clear and prospectively disclosed targets, so that the goalposts can't move.



### 4. Disclosed link to long-term carbon goals:

Clearly explained link between pay targets and stated carbon strategic goals, creating a clear bridge between the short and long term.



## Our research

We have reviewed the disclosures of 50 of the largest European companies (the STOXX Europe 50 constituents) for their approach on carbon in executive pay to see how closely this aligns with investor expectations.

We have broken the companies down into 'CA100+' companies (14 out of the 50) and 'non-CA100+' companies (36 out of the 50) to look at differences in approaches. Climate Action 100+ is an organisation that focuses on the companies (the CA100+) that 'are key to driving the global net zero emissions transition' and 'account for up to 80% of global corporate industrial GHG emissions'.

We use the CA100+ list as a proxy for the biggest emitters, with arguably the most to do on carbon emissions. This is also a group that has been subject to the most intense investor engagement on carbon reduction.

We assess the companies' pay targets against the four criteria outlined above. We have scored companies based on whether they have taken a 'Basic' or 'Better' approach in each area.

In some cases companies adopt carbon targets in both bonus and LTIP. In these cases we have based our assessment on the plan that shows the strongest execution of carbon targets.





## Our findings vs investor expectations

### Disclosure of company-level carbon targets

All STOXX Europe 50 companies have hit a baseline of disclosing carbon emissions and all have set a carbon reduction plan in their company strategy statement.

The levels of maturity of carbon reduction strategies are similar in CA100+ companies and non-CA100+ companies, with 68% of companies using SBTi approved carbon reduction plans.

CA100+ companies have, in general, targeted a slower pace for reaching net zero than non-CA100+ companies, with median targeted net zero dates of, respectively, 2050 and 2030. This is not a surprise given that many CA100+ businesses operate in hard-to-abate sectors.

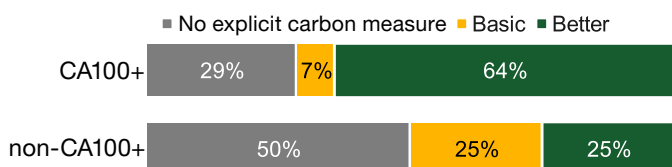
### In executive pay

Almost all companies reference that carbon is considered in executive pay (100% of CA100+), but there is a wide spectrum of approaches for how it has been adopted.

At one end of the spectrum, carbon is just one item on a list to consider as part of a basket of qualitative ESG measures, and at the other end, carbon can be a separately weighted quantitative component of the incentive plan tied directly into strategy. We now go through the criteria in more detail.

## 1. Significant?

- **Basic:** Separate weighting on carbon.
- **Better:** Weighting of at least 10% in either annual bonus or LTIP.
- **Example of 'Better':** '10% of the bonus is based on reducing Greenhouse gas emissions intensity'.



71% of CA100+ companies translate carbon strategy into an explicit carbon measure in executive pay with a separate weighting (vs 50% of non-CA100+ companies). However, only 64% of CA100+ companies have an explicit carbon measure worth 10% or more of the incentive (vs 25% of the non-CA100+ companies).

|            | Weighting of carbon measures |     |     |      |     |     |
|------------|------------------------------|-----|-----|------|-----|-----|
|            | Bonus                        |     |     | LTIP |     |     |
|            | LQ                           | M   | UQ  | LQ   | M   | UQ  |
| CA100+     | 7%                           | 13% | 15% | 10%  | 10% | 25% |
| non-CA100+ | 5%                           | 6%  | 12% | 6%   | 10% | 14% |

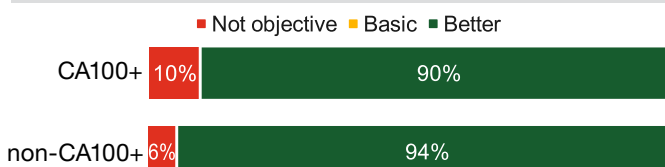
CA100+ companies have significantly higher weightings for carbon measures in pay plans.

In *Paying for good for all*, we found that investors are looking for a weighting of 10%-20% on ESG targets, of which carbon targets form a part. This has informed our benchmark of 10% weighting to climate measures for the 'Better' standard.

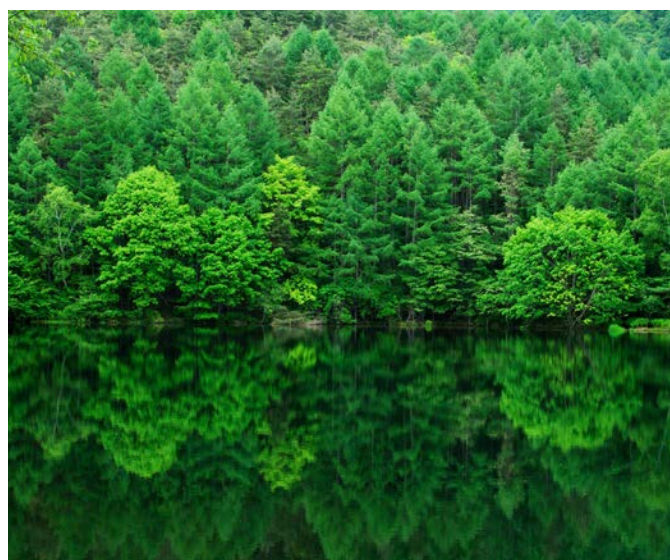
**From this point on, our analysis focuses on companies with a separately weighted carbon measure.**

## 2. Measurable?

- **Basic:** Targets are objective.
- **Better:** Targets are quantitatively assessable.
- **Example of 'Better':** 'Reduce Scope 3 emissions by 25% from the 2019 baseline'.

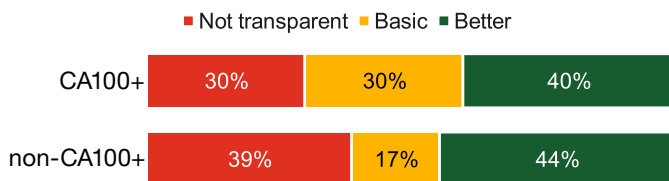


Where explicit carbon measures in pay are implemented, we find that these are generally measurable, with 90% of CA100+ company carbon measures being measurable (vs 94% of non-CA100+ companies).



### 3. Transparent?

- **Basic:** Targets disclosed retrospectively.
- **Better:** Targets disclosed prospectively.
- **Example of 'Better':** 'For the upcoming bonus grant, the threshold, target and maximum payouts will be achieved if Scope 3 emissions reductions are 15%, 25%, and 30% vs 2019 baseline'.

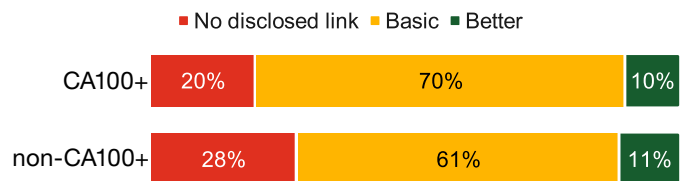


Of the CA100+ companies that have an explicit carbon measure in pay, 70% externally disclose the measures and targets, but only 40% disclose the target before the performance period begins (vs 61% and 44% respectively for non-CA100+).

Overall, fewer than half of companies disclose targets prospectively. Many investors view prospective disclosure as a critical component in building trust, while also enabling timely engagement with companies on the level of stretch implied by the short-term to medium-term carbon targets.

### 4. Disclosed link to long-term carbon goals?

- **Basic:** A statement that incentive goals tie into the company's strategic carbon reduction plan.
- **Better:** Clear disclosure of how the short-term incentive targets lie on the path to the long-term company carbon reduction plan.
- **Example of 'Better':** 'Reduce emission intensity to 95g CO<sub>2</sub>/kWh over next 3 years, on path to 39g CO<sub>2</sub>/kWh by 2040, and 0g CO<sub>2</sub>/kWh by 2050'.

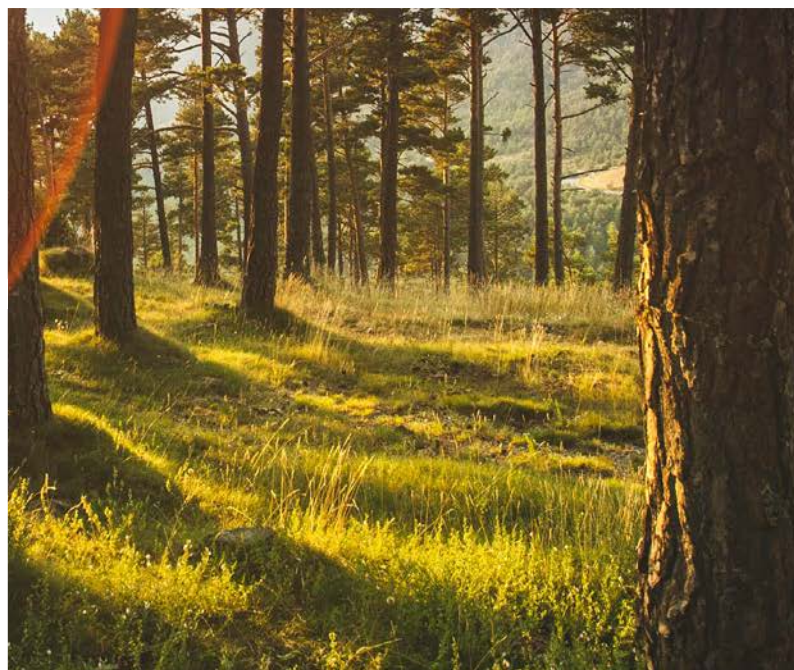
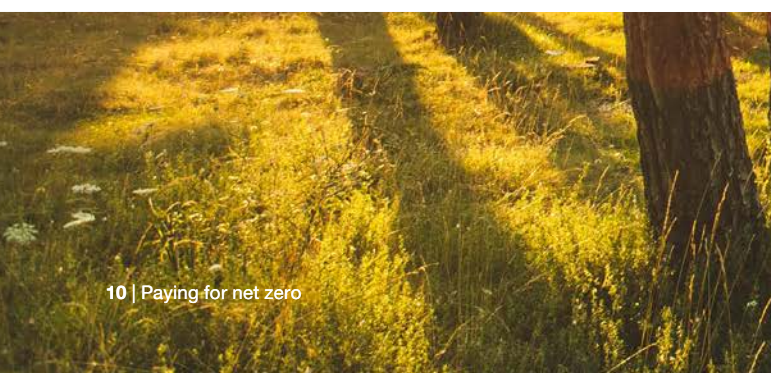
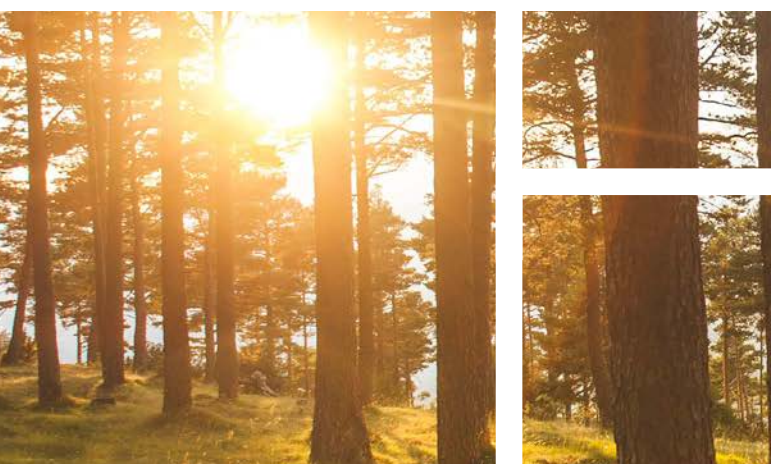


80% of CA100+ companies that have an explicit carbon measure in pay have, at the very least, a broad statement linking this carbon measure to their long-term company plan (vs 72% of non-CA100+ companies).

By contrast, only 10% of CA100+ companies provide a more comprehensive link (e.g. supported by numbers) versus 11% of non-CA100+ companies.

For many, there is room for improvement, e.g. via setting out the long-term goal, and the intermediate steps to reach that goal, and how executive pay targets link to these steps.

Given that it is likely in many cases that the target is indeed linked to the company strategy behind the scenes, this is an easy opportunity for immediate improvement.



## Secondary areas named by some investors

It is difficult to directly compare stretch across different companies' carbon measures, but we do note that payouts on carbon metrics in executive bonuses have been higher compared to other non-financial criteria such as strategic progress, customer experience, and safety metrics.

Payouts on carbon targets in 2022 averaged 86% of maximum with over half paying out at 100%. This compared with typical average incentive pay-outs on other measures of around 75% over a number of years.

Have these companies really done so well on climate? This seems difficult to square with the consensus that overall progress on climate change is insufficient.

Different investors have different views on whether carbon targets are best suited to bonus or LTIP.

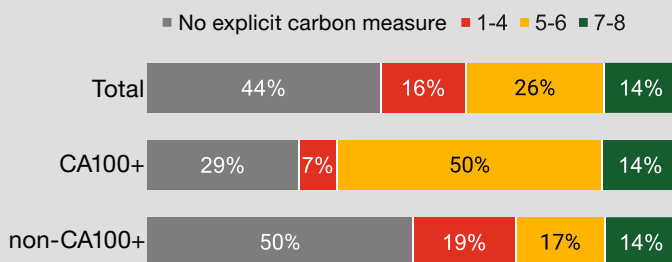
- Of the CA100+ companies who have an explicit carbon measure, 30% have it in bonus, 40% have it in LTIP and 30% have one in both.
- Of the non-CA100+ companies who have an explicit carbon measure, 39% have it in bonus, 50% have it in LTIP and 11% have one in both.

We believe that there are arguments for including carbon targets in bonus or LTIP depending on the circumstances. It is the design of the measure, and the prospective transparency of target disclosure, that matters more than the plan it resides in.

## Overall

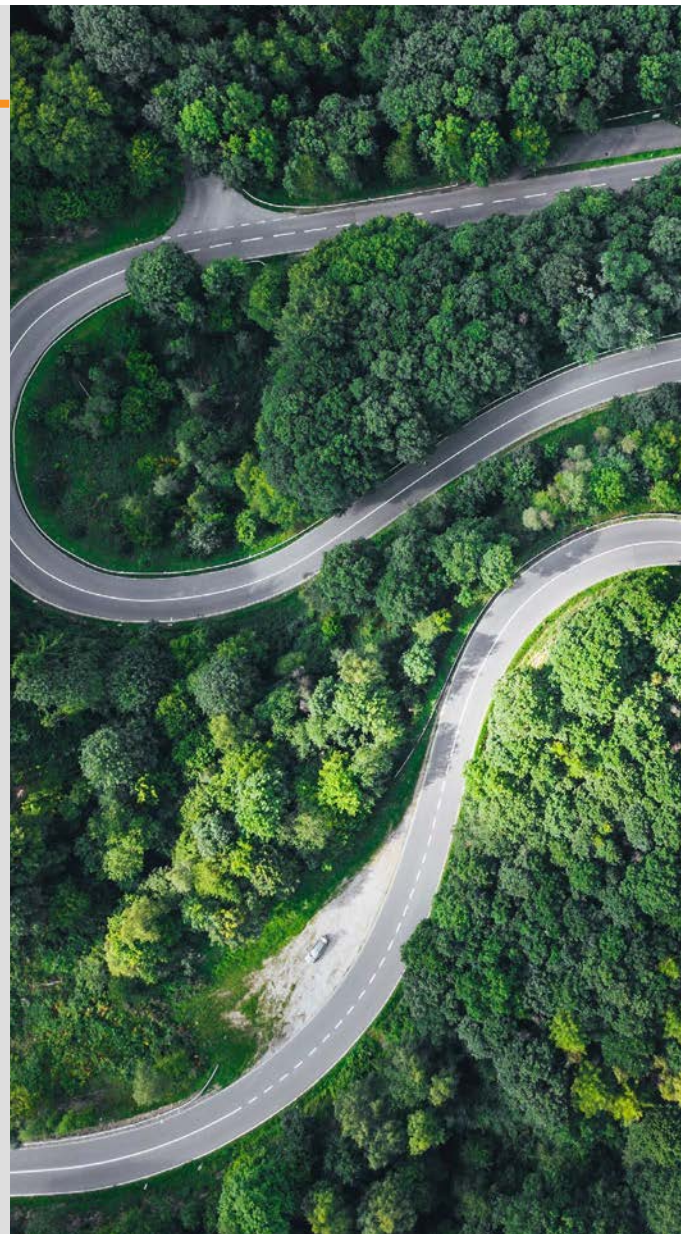
For the four criteria outlined above, we gave a company one point if they met the criterion at the Basic level and two points if they met it at the Better level. This gives a maximum score of eight points.

**Percentage of companies with each score on operation and disclosure of carbon executive pay targets (1 point for Basic, 2 points for Better on each area).**



When looking at the overall picture, many companies use pay targets that meet some of the investors' criteria, but only one of the companies in the sample met all of the investor expectations at the Better level, scoring a maximum eight points.

Seven out of 50 companies score well across the criteria, with seven points or more out of eight. A further 13 companies have made a good start, scoring five or six points. But this still leaves 30 out of 50 companies either with no targets or targets with significant room for improvement.





## Moving towards investor expectations

For some companies, better disclosure of what they are already doing would be an easy win. For others, a more fundamental rethink of their carbon measures may be required.

Simple steps can make a huge difference. Many companies fell short by not having a separately weighted measure or by simply having too low a weighting.

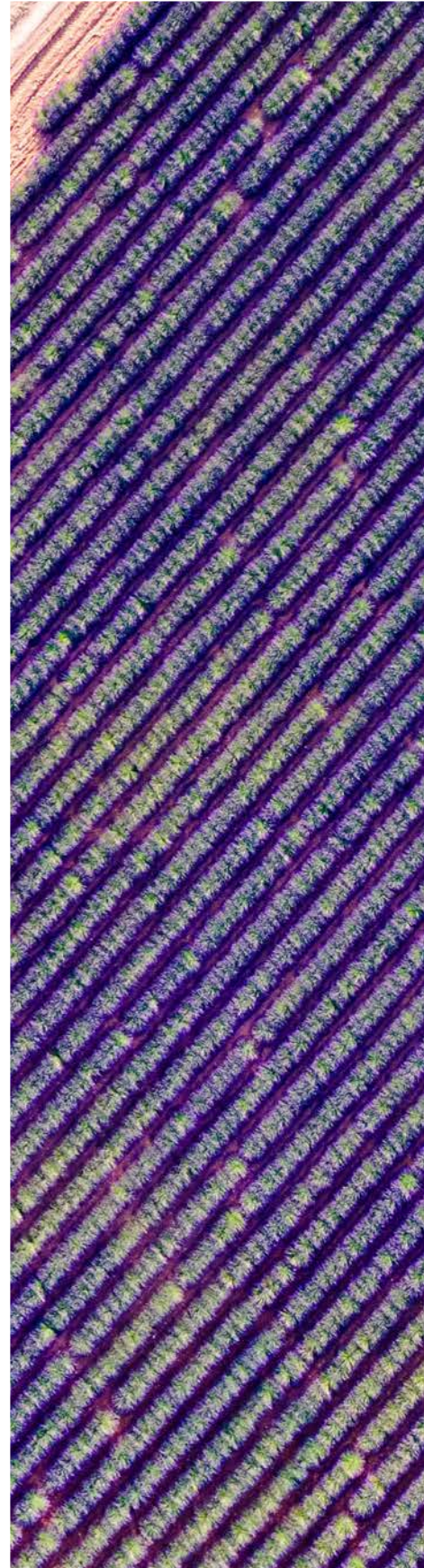
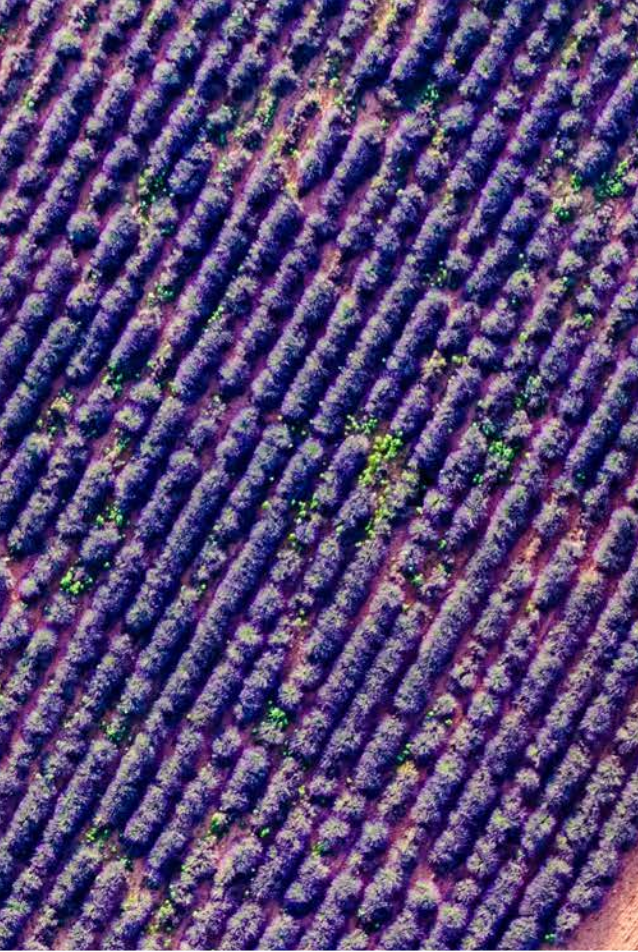
Amongst those that had ring-fenced a measure, poor disclosure was the most common reason for low scores. Prospective disclosure was rare, and only 10% of companies clearly explained how pay targets formed an adequate stepping stone towards their longer-term carbon reduction goals. Presumably most companies that set a target had made such a link, but missed the opportunity to explain that clearly to investors.

A leading example from our analysis of disclosures in 2022 is TotalEnergies, which was the only company to score maximum points on our assessment. They disclose their strategic 2025 GHG reduction target in Mt CO<sub>2</sub>e, and disclose how their executive pay targets to reduce carbon emissions directly tie into that long-term ambition, by setting a Mt CO<sub>2</sub>e to hit by 2022, in line with this ambition.

Other positive examples include ABB, AstraZeneca, AXA, Enel, Reckitt and Santander, each of which score seven out of a possible eight points. But in the case of most companies reviewed, there are opportunities for further steps to fully meet investor expectations.

Even for a company scoring full marks on these criteria, there is still room for improvement on disclosure to continue the journey from Basic to Better to **Best**.

In the Appendix we set out an example of our view of best practice disclosure for executive pay carbon measures.



# The devil is in the detail

Setting carbon targets in pay sounds like it shouldn't be too hard. But our discussions with clients highlight a number of issues that frequently come up, which means it's not so easy.

## Carbon is not like other executive pay metrics

With value-related targets (e.g. revenue, profit), it's a general rule that 'more is better'. With carbon, 'less is better' will be the norm, which creates a number of knotty issues:

- What about acquisitions and disposals?
- What if company A can produce at a lower carbon intensity than company B, then shouldn't we accept A's emissions growing if it is taking production from B?
- How do we deal with hard-to-measure Scope 3 that isn't in management's line of sight?
- When should we consider that regulation has overtaken the need for pay targets?

Some of these problems are common to all incentive measures. Others arise from a particular difficulty in setting carbon targets: the attempt to break down a systemic issue into company-specific goals. Boards need to grapple with these challenges to ensure we are designing executive incentives to have maximum impact.

## Challenges on how to set carbon targets

We set out key questions boards will need to decide on when selecting carbon metrics. The right answer will vary for each individual company, but having this decision framework in place will support boards to adopt effective carbon measures in pay.

## Should executive pay carbon targets be based on CO<sub>2</sub> or CO<sub>2</sub> equivalents?

**Example:** A company sets targets on reduction of CO<sub>2</sub>, but ignores SF<sub>6</sub> which is 23,000 times as potent.

Targets should generally be measured on a CO<sub>2</sub>e basis to capture the total effect of GHG emissions. It is too simplistic to focus just on CO<sub>2</sub> alone, and indeed the large majority of companies use CO<sub>2</sub>e based targets.



## Should executive pay carbon targets be adjusted for transactions?

**Example:** A company with carbon-heavy and carbon-light divisions. Divesting higher emitting assets doesn't reduce the amount of carbon, it just transfers emissions elsewhere.

**Example:** A company buying brown assets to 'green' them. This brings carbon emissions into the company with the aim to solve the problem.

In most cases executive teams should not be encouraged or discouraged from making a strategic acquisition or disposal on the basis that this may artificially increase or decrease company carbon emissions. Some companies may even buy brown assets with the intention of greening them.

In many cases the most appropriate approach will be to focus executive pay targets on underlying organic improvements and to restate carbon performance for executive pay purposes when there is a transaction.

## Should offsets count for executive pay purposes?

**Example:** A company is carbon neutral due to their purchase of significant amounts of carbon offsets.

Carbon offsets are controversial, and the Science Based Targets initiative only allows the use of offsets for a small percentage of residual hard-to-abate emissions.

Given the importance of primary emissions reduction, and the variable quality of current offset markets, most companies will set targets without allowance for offsets. And ultimately, if a company wants to use offsets, they don't need to incentivise the CEO to do it.



## Should executive pay targets use absolute carbon emissions or carbon intensity?

**Example:** A company's carbon emissions grow as they build market share, but their emissions per unit revenue fall.

Ultimately global warming is driven by absolute tonnes of CO<sub>2</sub>e, not emissions intensity, which suggests the use of absolute targets.

But for a single company this risks creating a perverse incentive, for example penalising a highly carbon-efficient company that grows its market share. Yet growth of a low emissions intensity business, winning market share from a high emissions intensity business, could be beneficial for aggregate societal emissions.

The Science Based Targets initiative allows both absolute and intensity measures of emissions, although, perhaps surprisingly, most pay targets are absolute. Whichever approach is taken requires consistency with the stated strategy and with sector pathways for decarbonisation.

## Should pay measures include Scope 3 emissions?

**Example:** A company has limited direct emissions but there are significant emissions upstream in the supply chain.

**Example:** An oil producer has most emissions driven by use of its product ('downstream').

Measurement challenges may mean that only a portion of Scope 3 emissions will be accurately assessable.

Executive pay targets should arguably reflect material upstream supply chain emissions to ensure total impact is considered, and to remove perverse incentives to shift emissions into the supply chain.

Downstream Scope 3 emissions are more complicated and business specific, although in some cases they are by far the most material aspect.

Boards will need to balance materiality of climate impact with line-of-sight for executives, and the reality of current commercial incentives, given that downstream emissions are directly linked to sales volumes.

In some cases businesses can change their products to encourage a change in emissions in use, and therefore it is more reasonable to include such Scope 3 areas in executive pay targets.

In our experience, many companies have started by assessing Scope 1 and 2, with the idea that this could later be expanded to incorporate Scope 3 once measurement methodologies have been improved.

## Challenges on whether carbon targets are relevant

In some cases, businesses may consider that carbon targets are not relevant for them. For the following areas we don't have clear answers across all companies, but they are critical for boards to consider.

A company that considers that carbon targets are not the right way to go should be prepared to make the case, but should do so clearly and carefully.

### Are carbon measures relevant for low emitting companies?

**Example:** Many companies with very low emissions have adopted carbon measures.

It seems reasonable for CA100+ companies or companies with SASB<sup>4</sup> materiality on GHG emissions to focus on carbon in executive pay.

For other companies, there may be more pressing ESG and non-ESG focus areas for pay instead of carbon emissions.

For example, some investors have focused their demand for carbon targets on just the sectors where carbon emissions are most material.

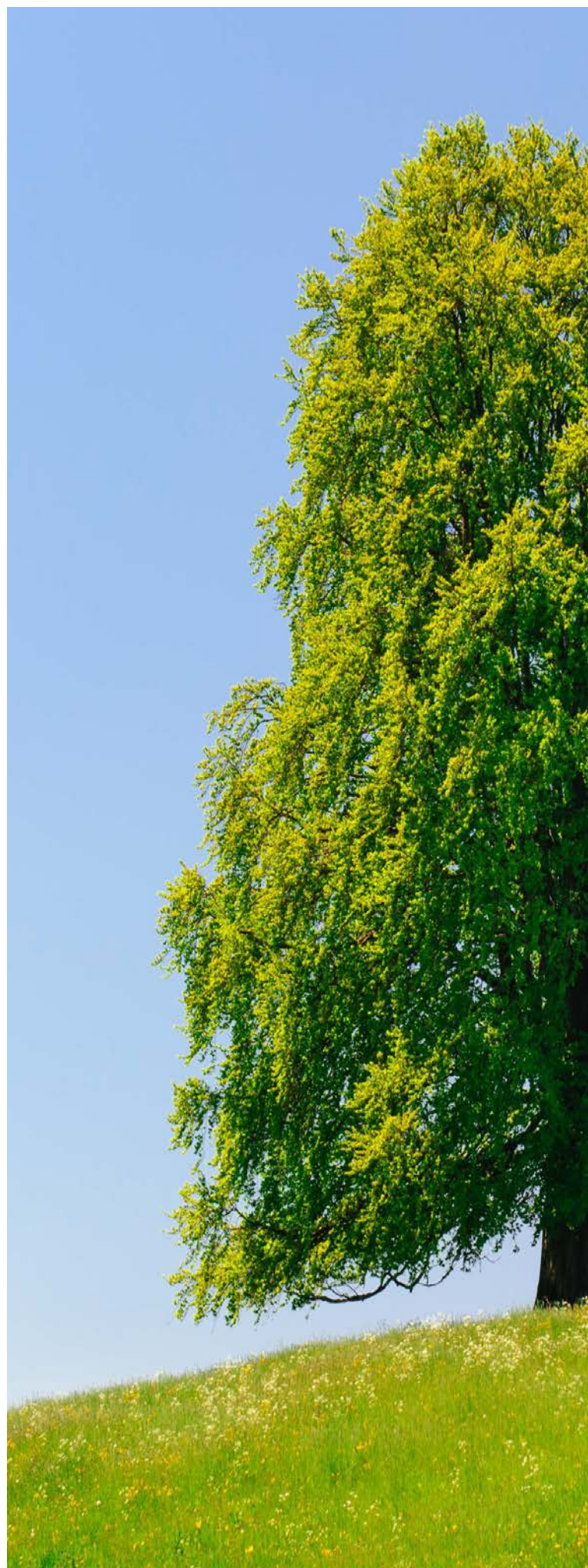
### Should Scope 4 emissions affect targets?

**Example:** A manufacturer emits significant amounts of carbon in chemicals manufacturing, but these chemicals are used to reduce 3x the level of emissions in other processes for their customers.

Some companies' operations result in 'avoided' or 'Scope 4' emissions. If the Scope 4 emissions intensity exceeds Scopes 1 to 3, arguably growth in the business is the most important factor to incentivise.

However, Scope 4 is even harder to assess than Scope 3 (which already has significant measurement issues). Moreover, if Scopes 1 to 3 are material relative to Scope 4, then reducing these relative to the Scope 4 benefit may still be worthwhile.

<sup>4</sup> Sustainability Accounting Standards Board





## Are carbon targets relevant for companies covered by carbon trading scheme?

**Example:** A company in a Carbon Trading Scheme (such as EU ETS). In theory, the company's economic incentives are already aligned with net zero by 2050.

To the extent that the carbon trading scheme fully internalises the cost of carbon into the company's P&L, there should not be a need for an additional executive pay measure.

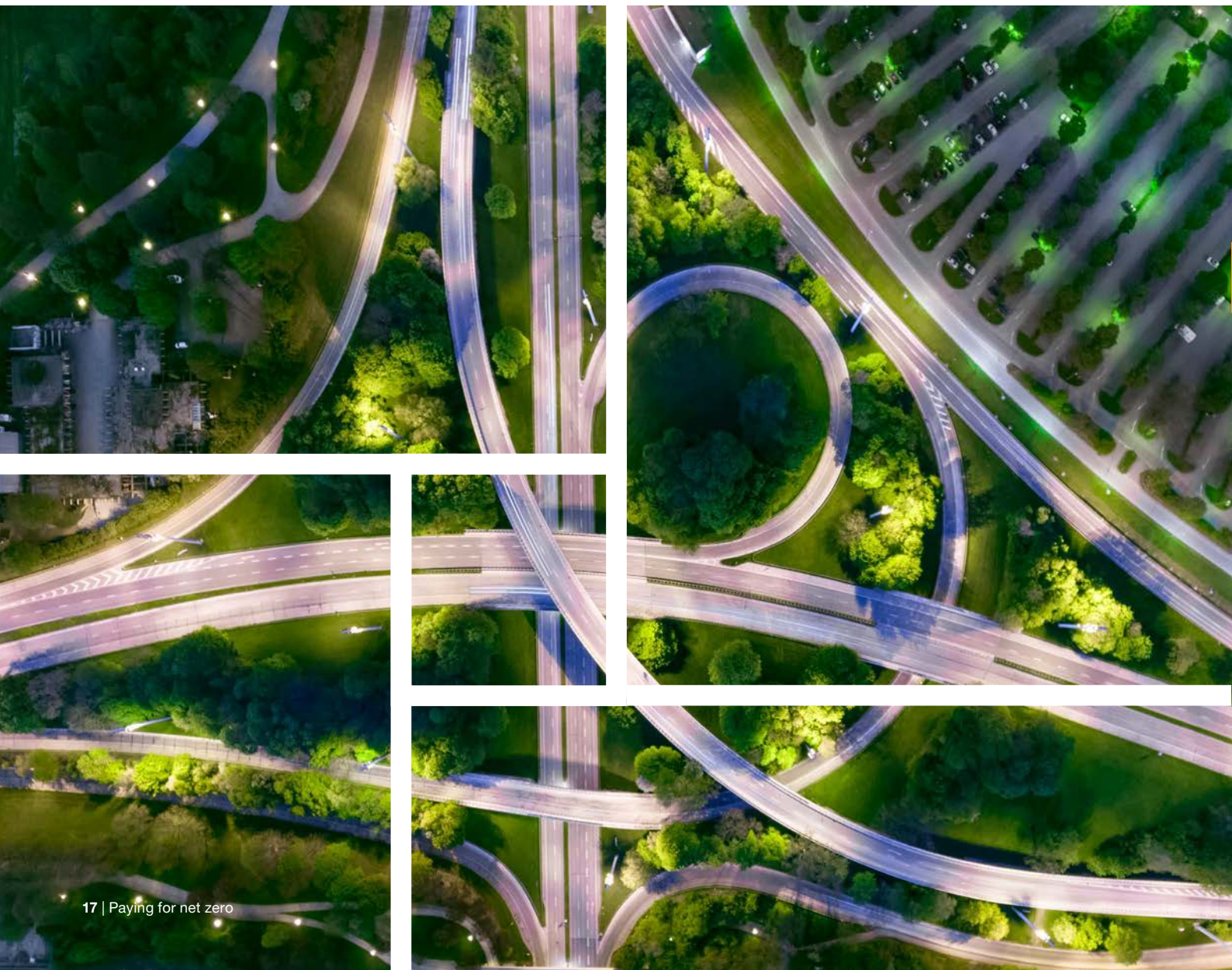
The number of companies for which this is currently true may be limited. However, as carbon trading schemes expand in terms of companies and activities covered, this reduces the need for separate executive pay carbon targets.

## Should executive pay targets focus on new sources of competitive advantage over carbon reductions?

**Example:** An Oil & Gas company has selected executive pay measures including growing a new lower-carbon energy product offerings business, and developing emission sinks.

If companies can find a way for their core business to contribute to the carbon transition, then this may be the strongest way to positively link business economics with this goal, while also drawing on what the company does best.

However, for many businesses the carbon impact of the legacy business may still dominate until the new business is established, and a balance of metrics may be appropriate.



# Conclusion

## Room for improvement

There is growing momentum from investors and companies to tackle the carbon transition – carbon commitments are now widespread, and this is increasingly being reflected in carbon targets in pay. But our assessment showed that only 14% of companies have targets that are significant, measurable, transparent, and with a disclosed link to strategy. And average pay-outs for climate targets suggest too modest a level of ambition in those pay goals.

There are easy wins for improved targets, most notably around prospective transparency of targets and a clearly explained link to longer-term carbon goals.

But there are good examples to encourage progress and we expect significant improvements through shareholder engagement in the coming years.

## Looking to the future

Our current assessment shows room for improvement even against our 'Basic' and 'Better' assessments. But the goalposts are likely to move. 'Best' practice remains some way into the future and investor expectations will likely become more, rather than less, demanding.

Additionally, there are at least four likely future trends that companies should prepare for, which have not been included in our assessment:

- **Integration with transition plans.** With the widening adoption of transition plans across the world, and especially in Europe, there will be an expectation of tight coherence between the objectives set out in those plans and targets that are included in executive pay.
- **Independent verification.** As reporting and assurance standards develop in relation to climate goals and outcomes, investors will want to see that targets and attainment have been subject to appropriate internal and external independent verification.
- **External standards.** The Science Based Targets initiative uses a relatively crude measure of decarbonisation pathways. But in combination with the development of national net-zero strategies we can expect to see more granular sector-based transition pathways. These will lead to more sophisticated benchmarks as to what represents a credible transition pathway, and investors will expect targets to line up with these.
- **Integration of climate with other ESG issues.** Increasingly, climate is not viewed in isolation but as one of a set of interconnected ESG issues that must be solved for simultaneously. Biodiversity and land usage are two such additional issues. As standards and benchmarks develop in these areas, there will be an expectation for them to be included in climate plans and pay targets.

## No panacea, but part of the picture

Linking executive pay to climate goals is not a panacea: executive pay targets can never overcome the fact that carbon is not properly priced, what Sir Nicholas Stern has called 'the greatest market failure the world has ever seen'. But done well it can, in the right circumstances, reinforce executive accountability to meet short-term targets towards long-term climate goals.

If we think executive pay is part of the solution, there needs to be more ambition to implement carbon targets robustly and effectively, using the power of incentives to support the push for net zero.



# Appendix – Mock-up of ‘Generico’ executive pay carbon targets to meet investor expectations

In this appendix we set out an example of our view of how a generic company (‘Generico’) could disclose its executive pay carbon measures to align with investor expectations.

## 1. Annual report disclosure on long term carbon reduction goals in company strategy

In 2022 at Generico we continued to implement our ESG strategy, with a focus on our 2050 net zero ambition. In order to successfully meet our ambitious net zero target by 2050 and provide accountability along the way we have introduced the following steps in 2022.

| SBTi accreditation achieved for our carbon reduction targets  | Improved our GHG emissions disclosures  | Aligned our executive compensation with our long-term strategy   |
|---|---|--|
| In 2019, our carbon reduction targets were developed in accordance with guidance from the Science Based Targets initiative (SBTi). Early in 2022, we received approval by the SBTi confirming that they are in line with the 1.5°C scenario of the Paris Agreement. | In 2022, we worked with third parties to calculate and monitor the business functions that make up the largest proportions of our total Scope 3 (indirect) GHG emissions. In addition, we now have an independent third party assuring our Scope 1, 2 and 3 GHG emissions, as well as our carbon intensity (Scope 1 and 2) calculation. | In order to appropriately incentivise our Executive Directors to make strong progress towards our ambitious net zero strategy, as of 2023, Generico will be introducing challenging carbon reduction metrics in variable remuneration plans (see Directors' Remuneration Report for more details). |

## 2. Remuneration report disclosure on carbon measures in LTIP

In 2023, LTIP measures will reflect the importance of Generico’s transition to net zero ambition. For 10% of the award, the greenhouse gas emissions intensity (Scopes 1 and 2), will be assessed each year based on Generico’s independently audited carbon intensity calculation. A further 10% of the award, Scope 3 CO<sub>2</sub> emission reduction compared to the 2019 baseline, will be assessed by analysing the group’s reduction of its three largest Scope 3 emission contributors (business travel, waste generated from operations, and Generico’s investment portfolio).

| Performance measure  | Weighting | Threshold (25% payout) | Target (50% payout) | Maximum (100% payout) |
|--|-----------|------------------------|---------------------|-----------------------|
| Greenhouse gas emissions intensity (Scopes 1 and 2) <sup>1</sup> .     | 10%       | 99                     | 95                  | 85                    |
| Scope 3 CO <sub>2</sub> emissions reduction compared to 2019 baseline. | 10%       | 15%                    | 25%                 | 30%                   |

<sup>1</sup> Scope 1 and 2 carbon intensity (tonnes of CO<sub>2</sub>e per unit revenue in £000)

### 3. Remuneration report disclosure on linkage of executive pay measures to long-term carbon reduction goals

In 2019, we set out our ambition to achieve a net zero status by 2050 as part of Generico's wider ESG strategy. In order to ensure our Executive Directors are directly incentivised to achieve this ambitious net zero ambition, Generico has included this section in the report to transparently set out how each carbon measure is directly linked to this goal. Target payout levels for the LTIP are aligned with attainment of the 2025 goal, with maximum payout achieved for a stretch level of performance positioned between the 2025 and 2030 objectives.

| LTIP measure   | 2050 goal                           | Link between performance measures and 2050 goal  | Path to net zero |      |      |      |      |
|--|-------------------------------------|--|------------------|------|------|------|------|
|  |                                     |  | 2022             | 2025 | 2030 | 2040 | 2050 |
| Greenhouse gas emissions intensity (Scopes 1 and 2) <sup>1,2</sup>                   | Carbon neutral (direct emissions)   | If this target is met then Generico will be on a strong trajectory to reach its short (2025), medium (2040), and long-term (2050) goals of direct emissions reduction.   | 120              | 95   | 60   | 39   | 0    |
| Scope 3 CO <sub>2</sub> emissions reduction compared to 2019 baseline <sup>1,3</sup> | Carbon neutral (indirect emissions) | For 2022, this measure has been refined. In order to reach the goal of carbon neutral indirect emissions by 2050, it was decided by the Committee that pay should be focused on the three largest Scope 3 contributors, making this metric more measurable and transparent in order to reach Generico's short, medium, and long-term goal of indirect emissions reduction. | 10%              | 25%  | 40%  | 80%  | 100% |

<sup>1</sup> Offsets used to reduce only residual amounts of Scope 1,2, and 3 emissions

<sup>2</sup> Scope 1 and 2 carbon intensity (tonnes of CO<sub>2</sub>e per unit revenue in £000)

<sup>3</sup> Based on Generico's three largest Scope 3 emission contributors (business travel, waste generated from operations, and Generico's investment portfolio)

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