

The Missing Link:

**Aligning
Executive
Compensation
with
Climate
Action**

2023

GALVANIZE
CLIMATE SOLUTIONS

in
collaboration
with

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About this Work

This research is a collaboration between Galvanize Climate Solutions and the Stanford Graduate School of Business' Corporate Governance Research Initiative to respond to growing investor and company interest in linking executive compensation with corporate decarbonization commitments. This work would not have been possible without the contributions of both teams and organizations.



Galvanize Climate Solutions is a climate-focused global investment firm delivering capital and expertise to accelerate climate solutions. Founded by Katie Hall and Tom Steyer, Galvanize invests across asset classes including venture capital and growth equity, public equities, and real estate. We integrate expertise across investment, climate impact, measurement, market development, talent, technology, and policy with the aim of driving material climate impact and creating long-term value for our investors.



The **Stanford Graduate School of Business' Corporate Governance Research Initiative** provides research and insights on a broad range of issues facing corporations and boards of directors that includes executive compensation, board governance, CEO succession, and proxy voting. Through our research and efforts, we strive to engage academics and professionals to bridge the gap between theory and practice, and promote corporate governance as an independent area of teaching and scholarship in business schools worldwide.

Executive summary

Aligning executive compensation with corporate climate commitments represents a powerful lever to ensure companies appropriately manage climate-related risks and meet publicly-stated targets. In this report, we explore the essential tenets of a credible and effective climate-aligned compensation scheme.

Given company commitments are typically rooted in 2030 and 2050 Net Zero goals consistent with the 2015 Paris Accords, shareholders have limited insight into what to expect in the intervening years and how likely a company will be to meet its commitments. The growing frequency of adverse climate events paired with recent climate disclosure legislation in the US and EU make it increasingly urgent that management teams and investors alike address climate risks, disclose emissions, and fulfill stated commitments. Shareholders risk substantial financial harm if corporate stakeholders “kick the can down the road,” rather than establish credible plans to achieve publicly committed targets. **Accordingly, executives should be materially rewarded for the operational, strategic and capital allocation choices their organizations make today that pave a path to deliver on those goals, and shareholders should have sufficient disclosures to ensure adherence and accountability.**

This framework was developed by examining the experiences of executives at seven public and private companies and asset owners representing in aggregate over \$4 trillion in market cap that have made meaningful climate commitments and have linked their goals to compensation. Through these interviews, we posit that the following **five foundational pillars characterize a best-in-class corporate sustainability compensation scheme:**

01

ALIGNMENT of underlying targets to the Paris Accord. A company's climate commitment should map to the standards of the Paris Accord, ideally using the Science Based Targets Initiative's (SBTi) methodology to set appropriate near- and long-term targets for all emissions.

02

GRANULARITY of intermediate plans. Long-term targets require clearly-delineated and attainable intermediate milestones that map to quarterly, annual, and multi-year budgets, supported by granular plans for capital allocation and procurement.

03

TRANSPARENCY of the organization's intended plans. The interim targets, long-term targets, and supporting business plans should be visible to shareholders, board members, and executives, as well as to managers and employees across the organization. Climate goals should be clearly and consistently articulated to divisional leaders and functional groups to reduce organizational inertia and motivate employees around the financial, organizational, and environmental imperative of decarbonization.

04

MATERIALITY to the corporate executive. The rewards for meeting climate pledges should constitute a material part of at-risk compensation to meaningfully encourage performance.

05

ADAPTABILITY over time. Baselines inevitably change with company growth and acquisitions and as such, carbon abatement curves will need to adapt and recalibrate over time. Similarly, climate-aligned compensation plans must reflect the need for adjustment. This allows for an internally-consistent plan that accounts for thoughtful capital allocation and operational complexity, while also preserving a sense of urgency and protecting the company from the allegation that it is not taking the matter seriously.

1.0

INTRODUCTION

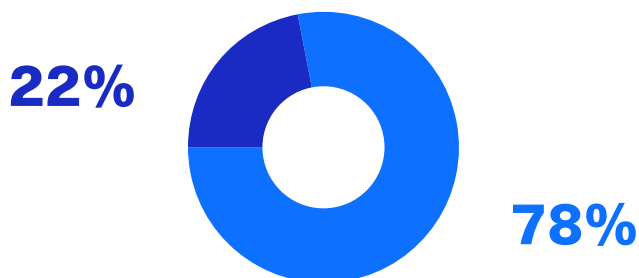
Why aligning executive compensation with corporate commitments matters

Corporations play a crucial role in addressing the climate challenge. In addition to mounting stakeholder pressure to account for and address climate change, regulations now enshrine corporations' responsibilities into law by requiring comprehensive climate disclosures and holding companies accountable to stated commitments. Given this growing imperative, companies can demonstrate their intention to take decisive action towards net zero emissions by tying climate goals to their incentives scheme.

There is no path to global net zero without meaningful contribution from publicly-listed companies: 78% of historic emissions since 1988 from non-state-owned companies come from listed firms.¹ Accordingly, firms increasingly acknowledge and report the risks posed to their economic value. Over 58% of global public companies now disclose climate risks in accordance with the recommendations of the Task Force on Climate-Related Financial Disclosures, reflecting that climate risks are also financial risks.²

Exhibit 1. Sources of Global Cumulative Greenhouse Gas Emissions since 1988 (Excludes State-Owned Companies)

● Private companies ● Publicly listed companies



Source: CDP Research, "The Carbon Majors Report" (2017)

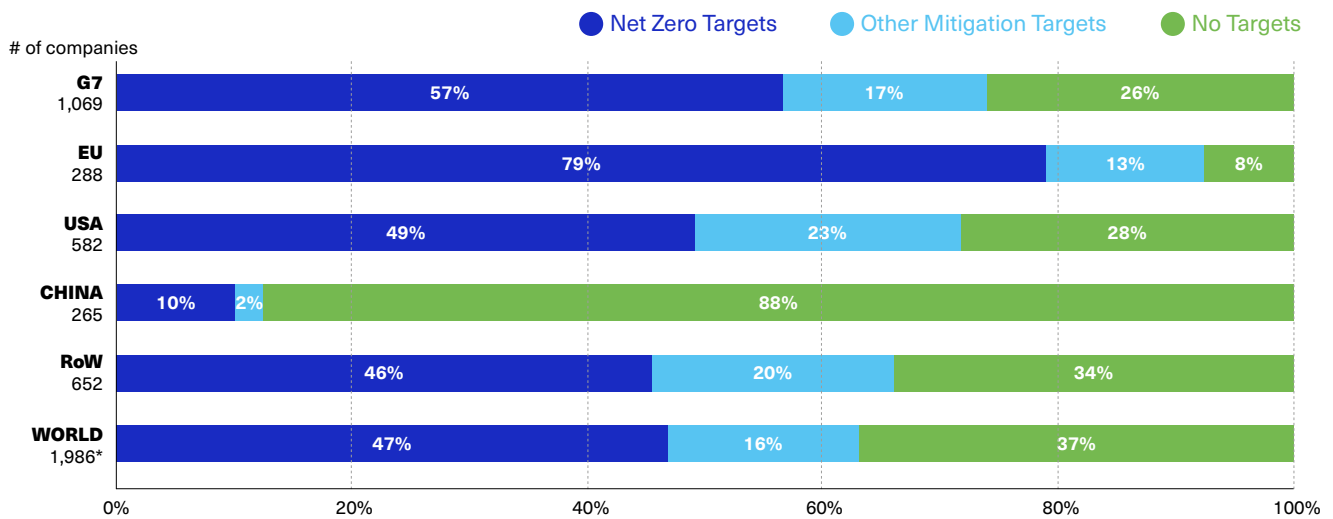
Accordingly, many companies have made voluntary pledges in recent years to reduce their greenhouse gas emission ("GHGs") in response to pressure from investors, boards, consumers, and other stakeholders. Approximately half of the world's largest 2,000 companies on the Forbes Global 2000 have established carbon emissions targets and pledged Net Zero targets, and over 60% of this group have set mitigation targets of any kind (see Exhibit 2).³ These pledges reflect company commitments to reducing their emissions footprints over time in alignment with the legally-binding goals of the 2015 Paris Agreement ("Paris Accords", or "Paris"; see Definition 1).

DEFINITION 1

Fundamentals Of Corporate Climate Commitments: Paris Agreement

The Paris Agreement, often referred to as the Paris Accord, is an international treaty established in 2015 that aims to address climate change and reduce greenhouse gas emissions. The primary goal of the Paris Agreement is to limit the increase in global average temperature to well below 2 degrees Celsius (3.6 degrees Fahrenheit) above pre-industrial levels. The ideal aim of the Paris Agreement is to limit the temperature increase to 1.5 degrees Celsius as 1.5-degrees implies lower risks and less severe climate impact.

Exhibit 2. Climate Target Status of World's Largest ~2,000 Companies



*Note: Forbes determined the 2023 Global 2000 by ranking companies based on four metrics: sales, profits, assets and market value as of May 5, 2023 to determine the largest 2,000. The global total is 1,986 because some companies have since been acquired or moved to private ownership. Source: Net Zero Tracker, "Net Zero Stocktake 2023" (June 2023)

A promise to reduce emissions, however, does not necessarily mean that emissions reduction targets will be met—or that management teams have the appropriate incentives to drive the transition.⁵ In practice, few companies have developed a tactical plan to decarbonize or even to fulfill stated commitments. Only 3% of companies in the US have disclosed a complete plan to meet their pledge, while 44% have no disclosed plan at all.⁶ Just 4% of corporate commitments meet the UN guidelines for quality, which entail coverage of all emissions scopes and annual progress updates towards interim and long-term targets.⁷

Gartner estimates that by 2026, as many as 80% of global enterprises with net zero goals will have to restate their interim milestones associated with these commitments.⁸ A Bain survey of large corporations found that 75% of business leaders believed they were not effectively integrating sustainability into their businesses; as it stands, 24% of companies surveyed revealed they are not on-track for Scope 1 and 2 goals, and 35% have fallen behind on Scope 3 targets.⁹ This reflects several dynamics: first, that the duration of targets (typically decades-long) far exceeds the average tenure of C-suite leaders (estimated at just 4.9 years) and second, that designing and implementing a decarbonization strategy requires a level of collaboration executives are not always incentivized to pursue.¹⁰ This should be cause for concern; listed companies contribute to a global emissions rate on track to warm the planet by 2.9°C¹¹ as global emissions writ large are projected to rise 11% by 2030.¹²

→ **Shareholders should be alarmed.** While 2030/2050 goals are long-dated, companies will be forced to publicly reckon with whether their commitments are credible in short order. Boards and management teams will be asked—by regulators, consumers, and stakeholders—why they continue to allow their companies to affirm commitments not supported by robust or credible plans.

4%

of corporate climate commitments meet the UN guidelines for quality⁷

44%

of US companies with climate targets have disclosed no plan for achieving goals⁶

80%

of companies with net zero goals may have to restate plans associated with those goals by 2026⁸

Historically, corporate reporting of emissions has been voluntary, and companies have not been widely held accountable for publicly-announced targets. This is changing: the European Corporate Sustainability Reporting Directive regulations (“CSRD”) and the recently-passed California Climate Disclosure Bills will effectively compel the vast majority of S&P 500, large-cap European companies, and scaled private companies to disclose their GHG footprints. California’s AB 1305, which will go into effect in January 2024, also requires companies making marketing claims about emissions reductions to provide documentation about how such reductions were actually accomplished.¹³ **With these disclosures comes incremental pressure—and legal liability—for corporations to commit to abating their footprints and to adhere to these commitments.**¹⁴

→ **For management teams and boards**, the gap between targets and action reflects a lack of accountability and incentives. Developing and implementing a decarbonization strategy requires large-scale collaboration across organizations and adherence to a specific plan over long time horizons. Whether corporations are looking to lead on the climate transition or simply to minimize legal and reputational risk, executive compensation structures that reward meeting specific emissions abatement objectives could represent a powerful mechanism to hold management teams accountable for meeting climate goals. By holding to climate targets, firms mitigate their exposure to the underlying risks posed by climate transition as well. But not all compensation structures are made equal. In this report, we describe foundational principles for an effective climate-linked incentive.

→ **For investors and owners of these companies**, executive compensation represents a crucial lever through which institutional investors can evaluate and influence a company’s commitment to decarbonization. A company that is committed to achieving an objective—strategic, financial, operational, or otherwise—typically provides executives with a monetary incentive to achieve that goal. And companies with an incentive to act will typically have more granular plans for how initiatives can be integrated into business strategy and operations. Public shareholders are explicitly empowered to influence a company’s corporate priorities via the proxy voting process that gives shareholders direct influence on compensation practices.

As outsiders, it is difficult for investors to gain insight into the emissions reduction and climate programs companies have implemented. What investments has a company made—in efficiency, supply chain, innovations, and technology—to achieve these goals? To what extent have carbon reduction initiatives been fully integrated into operations, strategy, and business model? How realistic are the assumptions that underlie corporate projections for carbon reduction? While published sustainability reports support some of this analysis, the answers are generally opaque to investors.¹⁴ By requiring companies to institute long-term incentives tied to granular climate plans, investors can be assured that management teams have appropriate operational and capital allocation programs in place to drive GHG reductions.

Understanding the achievability of corporates’ commitments is an important lens for investors to make informed underwriting decisions. **Investors ultimately bear the financial outcome, as terminal value can be directly influenced by a company’s success or failure to meet publicly-stated goals and address sustainability issues over the long-term.**

In theory, if a company prioritizes a strategic or financial objective, it will compensate the executive team accordingly for success on that objective. As one study of corporate culture succinctly concludes: “People will invariably do what you pay them to do.”¹⁶

With these disclosures comes incremental pressure—and legal liability—for corporations to make commitments to abate their footprints and to adhere to them. Investors ultimately bear the financial outcomes.

2.0 The Current State of Pay

In general, stakeholders design executive compensation to incentivize managerial decisions that maximize shareholder value over the long-term. Because executives increasingly acknowledge managing Environmental, Social and Governance (ESG) considerations as central to business strategy, ESG metrics are increasingly incorporated into executive pay practices.¹⁷ **Today, over 50% of the S&P 500 today links ESG goals to some aspect of executive pay.**¹⁸ In this report, we investigate specifically the design of climate-linked compensation, which we define as a subset of ESG-linked compensation schemes.

Links between executive pay and environmental objectives are less common than other forms of ESG-linked pay. PwC found in a survey of FTSE 100 companies that the most common compensation-linked targets relate to employee engagement or health and safety (56%) as opposed to diversity and inclusion (41%) or decarbonization (35%).¹⁹ Among the S&P 500, over twice as many companies have linked pay to a diversity and inclusion component (27%) versus a carbon footprint component (12%).²⁰

Exhibit 3. Prevalence of metrics linked to compensation among S&P 500 companies: Environmental metrics typically less prevalent than Diversity & Inclusion metrics

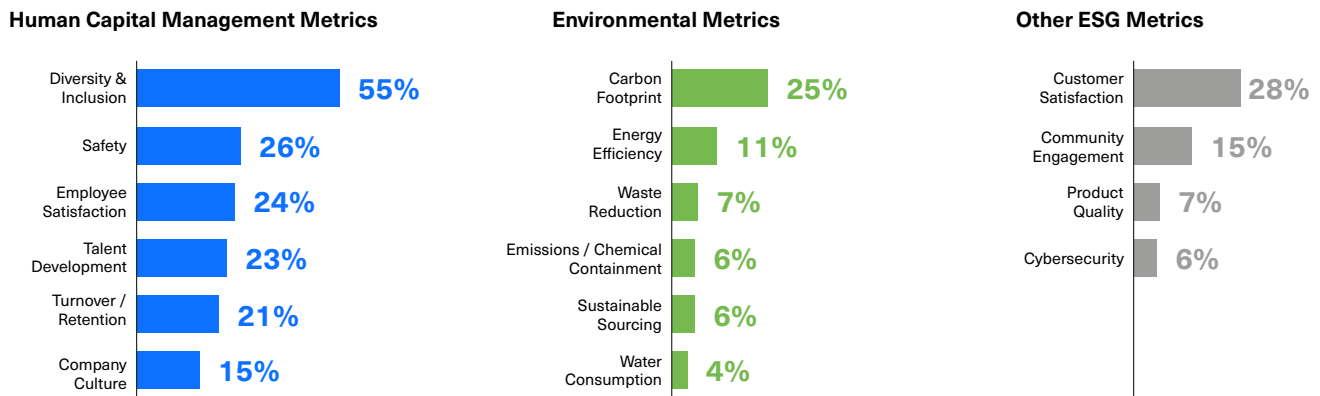
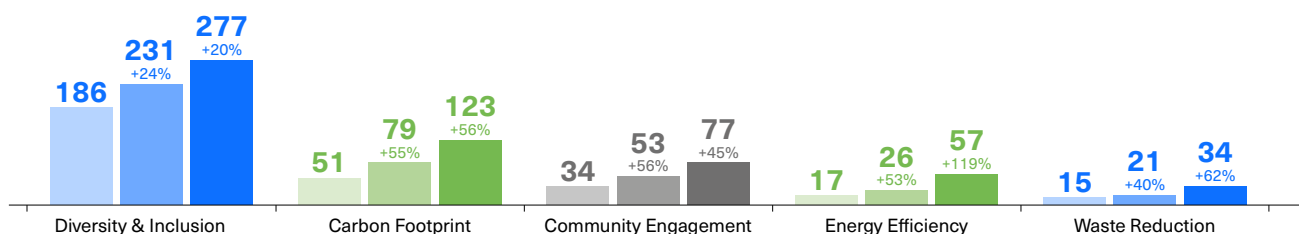


Exhibit 4. Year-over-Year Prevalence of Metric-Linked Compensation among S&P 500 companies

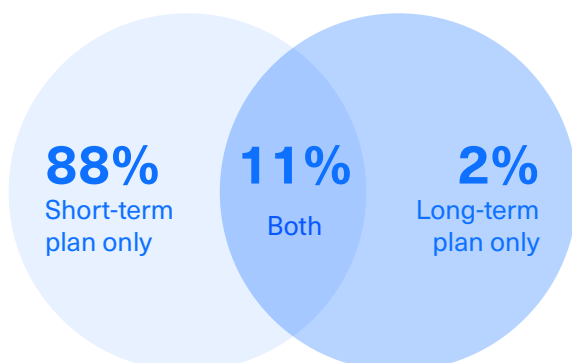


Sources for both: Semler Brossy, "ESG + Incentives, 2023 Report," (2023).

The prevalence of an environmental link to compensation varies by industry. Typically, more extractive industries see greater adoption of environmental targets in pay. Among energy and materials companies and utilities, over 70% of companies have adopted environmental considerations into some aspect of their compensation; consumer companies (staples and discretionary) and technology companies are the least likely, with fewer than 40% of these companies linking pay to environmental goals in 2022.²¹ In general, businesses are more likely to factor environmental considerations into compensation when the firm's impact on the environment is highly material.²²

Even among companies that have instituted environmentally-linked compensation, there is considerable variance in both the environmental metrics selected as well as the components of compensation to which those metrics are linked. Among S&P 500 companies with environmentally-linked pay, 52% specify GHG emissions targets. Companies also make links to water, land use, and waste production, but emissions abatement remains the most prevalent goal to incentivize (see Exhibit 3).²³ Today, these incentives primarily apply to annual bonuses: Willis Towers Watson estimates that US and EU companies are 2.5x as likely to link environmental measures to short term bonuses as they are to link to long-term incentive plans (LTIP).²⁴ Among S&P 500 companies with ESG-linked pay, 12% use the LTIP, whereas 98% incorporate similar goals into annual bonuses.²⁵ Materiality ultimately varies considerably; the typical weighting for all ESG metrics together in the overall compensation program is less than 20%, although it may be as low as 1% or smaller.²⁶ Compensation schemes are also still in flux, and in particular have evolved how the award is earned. Companies who have been early adopters of such structures continue to evolve their incentive schemes and drive towards more objective performance measures and quantifiable outcomes, as opposed to subjective assessments by the Board.²⁷

Exhibit 5. Incentives most commonly placed in the Annual Incentive Plan / Short Term Incentive Plan



Source: Semler Brossy, "ESG + Incentives, 2023 Report," (2023). Data for S&P 500 companies.

The world is dynamic: incentives must be thoughtfully designed to mitigate unintended consequences.

ESG-linked pay should do more than serve as positive signaling: these incentives should be designed to close the gap between organizational aspirations and realized outcomes. Research into the efficacy of compensation schemes has shown that these measures are most effective if they employ specific, objective data. Unstructured or subjective executive compensation structures might ultimately reflect an 'agency problem:' managerial rent-seeking rather than the collective motivation to achieve real outcomes.²⁸

While the use of ESG incentive metrics is increasingly prevalent, public disclosure of specific metrics embedded in goals—and of performance against these metrics—remains inadequate.²⁹ Most companies who include ESG metrics in their incentives do not disclose detail on the performance goals for their ESG metrics; companies who use qualitative frameworks typically disclose even less.³⁰ But research shows that introducing a measurable, objective outcome—for example, an emissions target—in executive compensation schemes can significantly focus organization efforts towards that specific goal.³¹ **Transparency around both the design of environmentally-linked metrics and management's performance against them is imperative for the board and external and internal stakeholders alike.**

As with any incentive program, emissions-linked compensation schemes can be gamed or yield incongruous results. For example, in our research respondents noted that metrics that are consistently met year after year are perhaps not sufficiently rigorous or demanding. There is also the risk that overt specificity misses the overall objective of the effort, particularly if the chosen metrics misframe an organization's environmental responsibility. Consider Marathon Petroleum's awarding of full environmental incentive pay to executives in the same year that 1,400 barrels of diesel fuel spilled in Indiana.³² In this case, incentive metrics accounted for the number of significant oil spills, rather than the volume of oil spilled, and as such in 2018 Marathon's CEO received the full environmental pay-out and was deemed to have achieved "excellence in environmental, personal safety and process safety improvement" that year. The world is dynamic: shareholder and board vigilance remains necessary, and incentives must be thoughtfully designed to mitigate unintended consequences.

3.0

Foundational Pillars of Effective Climate-Linked Compensation

While companies' journeys to climate-aligned compensation vary, we posit that there are certain attributes that are necessary for a plan to be effective, both in terms of ability to motivate leaders and teams and align performance to net zero targets, as well as minimize the legal and financial risk posed by failing to meet stated goals. **This framework was developed by examining the experiences of executives at seven public and private companies and asset owners that have made meaningful climate commitments and have linked their goals to compensation, including Schneider Electric, Nike, Mars**

and Norges.³³ Interviewed companies in aggregate represent over \$4 trillion in market capitalization across technology, consumer, and industrial sectors.

We encourage management and compensation teams implementing incentives to align to these principles. Institutional investors can leverage the following attributes to understand the efficacy of existing climate-linked compensation schemes and to support portfolio companies in designing highly effective incentives.

Best-in-class climate-aligned compensation programs are characterized by the following attributes:

01 ALIGNMENT. An effective incentive is only as good as the design of its underlying goal. Companies' climate commitments should map to the standards of the Paris Accord, ideally using the SBTi methodology to set appropriate near- and long-term targets for all emissions (see Definition 2). Where relevant commitment standards or required data do not yet exist, companies commit to evaluating baseline measurements within a reasonable time period as a first step. The use of global scientific standards ensures that companies are aligned with the internationally-recognized standard of performance. Companies should ensure that interim targets are transparent and ladder up to the companies' declared long-term climate objectives.

02 GRANULARITY. Long-term targets require clearly-delineated, attainable intermediate milestones that map to quarterly, annual, and multi-year budgets, supported by granular plans for capital allocation and procurement. Companies should invest up-front in systems for raw data collection and analysis, and entrust data reporting processes to a small team of experts to ensure consistency and accuracy. Reported metrics should eventually be audited for accuracy and reliability. Compensation programs linked to granular, trackable targets promote discipline within the company and among executives to adhere to already-committed-to, long-dated promises. Company compensation plans should link to Scope 1 and 2 emissions to the best of a company's ability, based on the reliability of data collection and reporting. As companies refine their ability to measure emissions outside their own operations with supply chain partners, they should aim to incorporate Scope 3 emissions in their targets.

DEFINITION 2

Fundamentals Of Corporate Climate Commitments: Science-Based Targets

Throughout this report we refer to **Science-Based Targets (SBTs)**, which represent a highly credible standard against which corporations can set near- and long-term climate commitments. SBTs are established in accordance with the best available climate science and designed to reflect the specific contributions an organization needs to deliver to meet the goals of Paris and avoid warming beyond 1.5 or 2 degrees Celsius. The **Science-Based Targets Initiative (SBTi)** is a collaborative effort among leading organizations including the Carbon Disclosure Project, the United Nations Global Compact, World Resources Institute, and the World Wildlife Fund, and offers guidance and resources for organizations to develop and implement science-based targets. SBTi takes into account the emissions profiles of specific sectors and industries and typically addresses all three scopes of GHGs, including direct emissions (**Scope 1**), indirect emissions from energy use (**Scope 2**), and indirect emissions from the value chain (**Scope 3**).

03

TRANSPARENCY. The interim targets, long-term targets, and supporting business plan should be visible to shareholders, board members, and executives, as well as to managers and employees across the organization. Executives should have meaningful control over the delivery of identified targets, and shareholders should be able to evaluate plans and progress. Climate goals should be clearly and consistently articulated to divisional leaders and within functional groups to reduce organizational inertia and motivate employees around the financial, organizational, and environmental imperative of decarbonization.

04

MATERIALITY. The rewards for meeting climate pledges should constitute a material part of at-risk compensation for the corporate executive to meaningfully encourage performance.

05

ADAPTABILITY. Baselines inevitably change with company growth and acquisitions and as such, carbon abatement curves will need to adapt and recalibrate over time. Similarly, climate-aligned compensation plans must reflect the need for adjustment. For companies at the beginning of their compensation alignment journey, it may make sense to disclose a commitment to integrate climate goals into executive compensation structures by a future date: a “commitment to a commitment”. This allows for an internally-consistent plan that accounts for thoughtful capital allocation and operational complexity, while also preserving a sense of urgency and protecting the company from the allegation that it is not taking the matter seriously.

Additional process and design elements can also help maximize outcomes:

→ **LEADERSHIP.**

Leaders, including the CEO, senior executive team, and board embrace and are aligned to the company’s climate goals. Leaders maximizing the financial outcome for shareholders see climate efforts as not subordinate to strategic and financial objectives but, in fact, integral to them. Leadership incentives, in turn, ensure that achievable decarbonization objectives are embedded in the company’s overall strategy, budgets, and culture. Progress stalls without the express commitment from senior leadership.

→ **SIMPLICITY.**

Climate objectives are few in number, low in redundancy, and quantifiable to optimize focus. Climate targets are not “fungible” with other non-financial objectives (e.g., broader “ESG” goals). The specific, quantifiable, SBTs and commitments associated with the Paris Agreement make it possible to specifically isolate time-based climate goals and tie executive remuneration to them.

→ **DURATION.**

These climate-linked rewards are structured as part of the long-term incentive plan (LTIP) given most of executive compensation is contained in long-term compensation, and hard-to-abate GHGs require many years of action and initiatives. The achievement of annual goals instills confidence that long-term objectives will be met. The annual incentive program reinforces annual targets, which support long-term goals.

We recognize that these recommendations are not a panacea, but rather guiding principles for effective climate-linked compensation. As noted, gaming will remain an issue, as will verifying the integrity of the underlying data. Effective implementation of these best practices requires alignment with best-in-class voluntary standards such as SBTi as well as shareholder vigilance.

These principles can shed light on the efficacy of existing climate-linked compensation schemes and support companies in designing highly effective incentives.

4.0

APPENDIX: A Meta-Case Study of Companies’ Journeys towards Climate-Aligned Compensation

Over the course of this research, we interviewed board members, Chief Sustainability Officers, and senior executives at asset owners and public and private companies across the technology, consumer, and industrial sectors that have made meaningful climate commitments, representing in aggregate over \$4 trillion in market capitalization. These executives spoke candidly about the evolution of their programs, the decision to include climate targets in compensation, their rationale behind design and measurement choices, and the organizational impact and learnings from these efforts.

The experiences of these companies demonstrate that companies approach sustainability from different starting points and have different stories to tell about how their programs are launched, accepted, institutionalized, refined, and supported. Nonetheless, leaders across sectors and firm types view compensation as a central means of signaling the importance of climate objectives and holding executives accountable to achieving them.

4.1 Findings related to compensation plan design and scope of participants

→ **Executives stress the importance of simplicity.** Executives observed that the selected structure should clearly articulate to employees the link between pay and performance goals. Multiple interviewees related that when employees cannot easily see the linkage between climate metric performance and awarded compensation, they are unlikely to adjust their behavior in pursuit of climate goals. In a similar vein, interviewees observed that employees were confused or dismissive of non-financial compensation metrics when compensation or performance were tied to an overly-expansive list spanning a wide variety of aspirations.

→ **Materiality matters.** Executives also expressed the importance of materiality of the award for climate progress within the overall compensation scheme. Two firms, which both have

developed and matured their incentive programs for over a decade, have explored increasing the weighting of climate progress to strengthen the incentive. One company first assigned a five percent weighting, and subsequently increased this to twenty percent.

→ **Companies have a range of incentive structure options.** A key aspect of incentive design is thoughtfully choosing the structure; companies vary in their choice depending on the maturity and granularity of their plans and ability to measure progress. Generally speaking, assigning a discrete weighting to a performance metric creates the strongest incentive to achieve a goal, while a discretionary bonus structure is the weakest. See Table 1 below.

Table 1. Incentive structures

Structure	Definition ³⁵	Prevalence among companies with ESG goals ³⁶
Discrete weighting	A specific percentage of the bonus is awarded (or withheld) based on the achievement of a quantitative metric.	26%
Scorecard	A specific percentage of the bonus is awarded based on the achievement of a mix of quantitative and qualitative metrics.	40%
Modifier	The overall bonus earned based on primary metrics (generally financial performance) is adjusted up or down within a specified range based on the level of achievement of the modifier goal.	14%
Discretionary	The board determines at its own discretion whether a bonus payment is merited.	21%

→ **Incentives and priorities typically start at the top.** Among the companies interviewed, climate-linked bonuses were generally offered from senior-most leadership down to plant managers or supply chain managers. In a large multinational company, this could include several thousand employees. For companies that include climate in the LTIP, the population was generally smaller, encompassing up to several hundred executives. Some companies only incentivize the C-suite or just the CEO - as few as one or up to twelve leaders. In general, however, leaders agree that it is most important to create alignment between C-level officer compensation and decarbonization/sustainability goals and that doing so is more critical than creating a broad-based plan at multiple levels of the organization. A leader at a major industrial company emphasized that, fundamentally, managers respond to leadership's focus, particularly in solving for longer-term efforts and priorities.

→ **Companies evolve the structure of their incentives over time.** Almost all companies interviewed include climate objec-

tives in the annual bonus program rather than the LTIP. These programs are structured in a variety of ways: as a discrete weighting, a modifier (contingent upon hitting financial targets), or a scorecard. Some companies originally began with a discretionary award and moved toward rigorous targets as the program matured and had generated more buy-in from employees.

→ **Executives acknowledge the challenge that annual bonuses do not reflect the time frames of climate targets.** While more interviewed companies use the annual bonus rather than the LTIP to institutionalize climate objectives, there is recognition of the timing mismatch this creates. Because climate initiatives (and targets) are long-term in nature, it logically follows to include them in the LTIP. LTIPs also represent a much larger portion of total compensation than the annual bonus, so including climate goals in the LTIP gives them significantly more weight overall. Interviewed companies expressed interest in exploring climate-linked LTIP over time as their own programs evolve.³⁷

4.2 Findings related to setting targets and milestones

Two primary considerations in setting climate-related objectives are the achievability of goals and the choice of metrics. Companies recognize the difficulty in making goals both rigorous enough to stretch the organization and realistic enough that they can be achieved. Typical Paris-aligned commitments require that companies reduce emissions 45% by 2030, and 100% by 2050, although specific emissions reductions targets may vary by sector depending on the availability and cost of available solutions and the projected pace of adoption.³⁸

→ **Emissions scopes.** For most interviewed companies, the bulk of the effort to-date has focused on Scope 1 emissions (directly controlled by the company) and Scope 2 emissions (indirect emissions through purchased electricity, steam, heating and cooling). Scope 3 emissions (those generated by end users, customers, suppliers and partners) are understood to be larger in scale but much more difficult to measure and influence, and therefore less of an immediate focus, particularly for linking compensation.

Companies adopt a range of metrics, from qualitative (such as assessing holistically whether a given function had contributed towards overall climate objectives) to specific quantitative goals linked to their SBTs (such as whether an organization or part of an organization had hit specific emissions reductions objectives).³⁹

→ **Long-term objectives are broken down into annual goals.** Many companies acknowledge that it takes time to learn how

to break down multi-year targets into reasonable one-year goals. Through iterative efforts, they learn how efficiency programs, sourcing programs, and technology solutions translate to specific emission reductions, and how to best educate and engage suppliers.

→ **Every company's specific near-term and medium-term targets varied with their decarbonization approach and growth strategy.** While some companies aim to realize straight-line reductions (for example, 3 percent annual decreases in absolute terms), others are on a "hockey-stick" growth trajectory, wherein they primarily focus on reducing emissions per unit output. To address this tension, companies can align their target design to SBTi best practice, which provides guidance on how companies can set both absolute and intensity-based objectives that are consistent with long-term net zero targets.

→ **Most companies interviewed tie annual compensation metrics to one-year objectives and tailor these metrics to the job function and level of authority of the individual.** Senior leadership can be held responsible for organizational or divisional goals; employees farther down the organization can be given metrics that roll up in support of these objectives. Supply chain and production managers typically have different climate metrics from functions such as sales and product design, with metrics reflecting key performance indicators within their day-to-day domains. The objective in goal-setting is to establish a glidepath whereby annual emis-

sions reductions or targets lead to the achievement of long-term goals at the firm level. Companies struggle with the real possibility of how to adapt if annual targets are missed, putting long-term goals at risk. Companies recognize both the risk and damage that might occur if long-term targets are missed. They also recognize this possibility, given the long-term nature of the goal and the assumptions to achieve outer-year targets.

→ **Ultimately, effective plans reconcile the short-term/annual efforts with the companies' long-term commitments by integrating both into strategic and operational plans.** This allows for internal consistency and gives management the flexibility to modify targets as required by circumstance. This integration also increases the likelihood of adherence by integrating climate efforts with the companies' operational and capital allocation planning.

4.3 Findings related to implementation and buy-in

For most companies, adopting climate targets and tying goals to compensation is a multi-year (even decades-long) process, requiring staged implementation and iteration as incentive programs are scaled across the organization.

→ **Organizational resistance to these efforts tends to center less on the need to address climate change than on the practicality of tying pay to climate.** Examples of organizational resistance include board members concerned about the cost of initiatives (one company referred to this as “fears of...stealing from shareholders”), senior executives split on whether climate is a win-win for stakeholders or costly, engineers focused on product quality (whereby reducing carbon footprint is a lower priority and can be seen as increasing product cost), and marketers trained not to take into account self-reported factors that customers say drive their purchase

decisions (customers might say they will pay more for an environmentally-friendly product when their behavior suggests they will or do not). Companies observed generational differences, with older and younger demographics split on their readiness to accept the importance of goals. Additionally, companies that experience financial difficulty are less likely to prioritize climate objectives when the core business requires all of management's focus.

→ **Companies phase the implementation, first adopting metrics to test their use and calculation before tying metrics to compensation.** Some also start by only incentivizing the C-Suite, adding climate goals to senior executive bonuses before rolling out incentives to larger populations in recognition of leadership's ability to set the tone before driving broader cultural alignment.

4.4 Findings related to organizational oversight

→ **Interviewees indicate that the response of stakeholders to corporate efforts is generally positive.** All interviewees indicated that their employees are proud to know that they work for a company that prioritizes decarbonization. Suppliers typically understand the business imperative of supporting climate efforts but seek further support in implementing targets and decarbonization strategies. Institutional investors with an ESG mandate embrace the institutionalization of carbon reduction programs and reinforcing these programs through compensation. The broader investment community appreciates sustainability efforts as de-risking the company because of the aforementioned legal, regulatory and operational risks, as well as—in the case of companies that have made climate pledges—the risk that a company will be exposed for failing to institute the behavioral changes required to deliver on those commitments. Action on climate is not undertaken to achieve a specific public profile; actually, shareholders face operational, legal, and financial risks when companies fail to set targets and take action.

While local communities and customer groups see environmental abatement efforts as necessary for companies to maintain their social license to operate, there is a meaningful financial opportunity to be gained by considering the secular changes across the economy as corporations decarbonize.

→ **Across companies, climate reporting and progress ultimately rolls up to the Board of Directors.** Companies who have set commitments and implemented incentive programs indicate high board engagement across multiple committees. Performance is tracked by the Corporate Responsibility Committee, Technology Committee (to the extent internal innovation is required to achieve goals), as well as the Compensation, Governance, and Audit Committees. The board considers the rigor of goals and whether climate goals are a distraction to or at odds with other business objectives, once they grasp the operating and investment requirements to achieve climate targets, progress, and results.

About the Authors



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Seth Kirkham approaches investing with a deep fundamental process and cross sectoral understanding of our climate-driven economic transition. He has spent 25 years in financial markets, with experience investing across the entire market but with periodic focus on key relevant sectors to the transition, including energy, utilities, industrials and transportation. Seth was previously the co-Portfolio Manager and co-Head of Research at DSAM Partners, a \$2 billion equity long-short fund focused on EU and US equities. Prior to DSAM, Seth served as a Senior Analyst at ECAP, where he was a founding partner, this too was a \$2bn aum fund, and before that Caxton. Seth has also served as a VP in equity research at Goldman Sachs in London and as a portfolio manager at Investec Asset Management. Seth started in the industry by completing the graduate program at Schroders Investment Management in London.



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Asad Rahman has been investing in financial markets for the past 18 years. He has invested across sectors and geographies, with a particular focus on the consumer, industrial, infrastructure, transportation and telecom/media sectors. Over the course of his career, he has worked closely with management teams and boards at a variety of companies in the US, EU and Asia as an engaged, constructive shareholder. Shareholder engagement will be an important dimension of the climate-driven transition. He was previously a Managing Director at TOMS Capital, a co-founder and Managing Partner at Akaris Global Partners, and a Partner at Mason Capital. He started his career as an Associate at the Boston Consulting Group. Asad graduated summa cum laude from Duke University with a degree in Economics, Politics and Development.



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We are grateful to the following individuals and firms for sharing their insights and experiences with us. We are also grateful to the numerous leaders who spoke to us anonymously about their journey.

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