ESG METRIC SELECTION CONSIDERATIONS

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ESG metrics are a valuable tool to align executive interests with company goals and corporate governance expectations. It is important to carefully select ESG metrics and structure the compensation packages such that they are implemented in a meaningful and impactful way. **This article outlines considerations for selecting ESG metrics for inclusion in a compensation program**, and walks through an illustrative example.

Earlier articles in our series outlined the rationale for including ESG in executive compensation and introduced a framework to guide companies in identifying where they are in their ESG journey. Our next article will examine whether a company's selected ESG metric(s) should be incorporated in the short or long term incentive program.

Process for Metric Selection

The determination as to which ESG metric(s) will be used in the compensation program naturally follows the assessment of the company's "current state," and its capacity to effectively implement an ESG metric. Once the company is ready to select metrics, the process may be summarized as follows:

1) Develop guiding principles that the metric(s) should capture
2) Determine the appropriate type of metric (i.e., "general issue category")
3) Select potential ESG metrics that fall within the general issue category
4) Evaluate the selected metrics against the principles, ultimately leading to the selection of a metric

1) Develop Guiding Principles

In order to evaluate which metrics are the most appropriate, it is often useful to compare them against a set of criteria.

The illustration below outlines select guiding principles that can be used to assess the appropriateness of ESG metrics. A Board may select some or all of these examples to help define what the compensation philosophy is founded on.

Philosophy

- ✓ **Simplicity vs. Complexity**: In terms of communicating the impact of the measure, but also in terms of reporting and calculating the results
- ✓ **Ownership**: Within reasonable line of sight / control of participants

Impact

- ✓ **Materiality**: Assessment of the extent of impacts to the Company (based on materiality assessment / SASB framework / other)
- ✓ **Stakeholder Concerns**: Responsiveness to shareholder engagement / concerns (e.g., shareholder proposal)

Transparency & Communication

- ✓ **Transparency**: Comfort in disclosing "misses" (i.e., transparency to broader stakeholders)
- ✓ **Consistency**: Alignment with communicated corporate strategy/strategic priorities in the [short term / long term]
- ✓ **Accuracy**: Preference for metric that can be validated by external parties

Mechanical

- ✓ **Item Measured**: Preference for [input / output] measure
- ✓ **Inward vs Outward Looking**: Preference for [absolute / relative] measure
- ✓ **Predictability**: Metric can be reasonably and reliably predicted [1-3] years in the future (i.e., within incentive program timeline) with interim targets, as required

2) Determine the Appropriate Type of Metric

After establishing guiding principles, the next step is to determine which type of ESG metric is most relevant for the organization and incentive program.

As a starting point, we have used SASB's breakdown of issues by "dimension" and "general issue category," which is one approach to categorizing measures (in the absence of a pre-existing approach by the company). SASB outlines 5 different dimensions (environment, social capital, human capital, business model and innovation, leadership and governance), with several general issue categories within each.

For the purpose of this illustration, we have selected the *Environment* dimension, with a focus on the *GHG Emissions* general issue category[1]:

SASB Dimension	SASB General Issue Category
Environment	GHG Emissions
	Air Quality
	Energy Management
	Water & Wastewater Management
	Waste & Hazardous Materials Management
	Ecological Impacts

[1] Source: SASB Materiality Finder

3) Select Potential ESG Metrics

Once the "type" of metric has been confirmed, the next step is selecting the specific metric within that category. This may be informed by factors including the KPIs the company is currently tracking, peer practices, and SASB's suggested measures for each category.

Using the example of GHG emissions above, we have illustrated 3 metrics: Carbon Footprint (Scope 1), Emissions Intensity, and Carbon Offsetting:

GHG Emissions Metrics

Carbon Footprint (Scope 1)	Direct GHG emissions caused by an organization (e.g., vehicles)
Emissions Intensity	The amount of GHG emissions per unit of output (e.g., per dollar of revenue, per product unit, per employee)
Carbon Offsetting	The amount of GHG emissions that have been avoided, reduced, or sequestered by offsetting actions, such as investing in renewable energy or planting trees

4) Evaluate Selected Metrics Against the Guiding Principles

Finally, a matrix may be created using the guiding principles developed in step 1 and the metrics identified in step 3, as illustrated below. This can help determine which metrics best align with the guiding principles and needs of the organization.

ILLUSTRATIVE

Guiding Principles	Metrics: Carbon Footprint (Scope 1)	Metrics: Emissions Intensity	Metrics: Carbon Offsetting
Aligned with long-term corporate strategic goals	◕	◕	◕
Responsiveness to shareholder engagement / concerns	◔	◕	◔
Goals are measurable within incentive plan timeline	◑	◑	◕
Preference for output measure	●	●	◑
Preference for absolute measure	◕	●	◕
Comfort in disclosing "misses"	◑	◑	◕
TOTAL	◕	●	◑

Next Steps

This ESG metric selection process is one approach that companies can leverage in their journey to incorporate ESG metrics into their incentive programs. The use of ESG metrics in incentives is an evolving process, and may be especially challenging when determining metrics in the first few years of the program.

Of course, it would be unusual for a company to select ESG metric(s) without considering how they fit into the current programs. **Our next article will address how these metrics may be incorporated into the short-term or long-term incentive plan, and future articles will discuss considerations for metric structure, weighting, and calibration.** ***To ensure you receive future articles in this series, subscribe here.***

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