Institute for Energy Economics and Financial Analysis

Fact Sheet

Recommendations to enhance ESG ratings

As sustainable investments become mainstream, tools such as ESG ratings have been developed to better assess a company.

However, major shortcomings of ESG ratings include:

! Current ESG ratings generally do not specifically measure a company's impact on the planet and society.

! ESG ratings are wide and conflicting, making them difficult to compare.

! Rating biases due to industry, geographical location or company size could represent an inaccurate ESG performance.

! Aggregating E, S and G into a single metric is not an accurate translation of a company's ESG performance.

> **"If ESG ratings are to encourage sustainable investments, significant improvements of the rating system are crucial for investors and the overall capital market."**
>
> Hazel James Ilango | Energy Finance Analyst, Debt Markets

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ESG rating providers should ideally align their objectives, measurements, methodologies and ESG outcomes:

1. **Formulate universally accepted and transparent frameworks for ESG disclosure and rating methodology, down to definitions as to what an ESG rating should measure**
    - Enable rating comparability between companies irrespective of the sector, geographical region or company size
    - Integrate an updated ESG+Impact rating system proposed by Proof of Impact to evaluate:
        - Data quality
        - Practices in ESG and impact management based on SDGs
        - Performance rating based on a company's ESG related KPIs (e.g. GHG emissions, gender diversity and employee turnover)

2. **Adopt mandatory reporting of each E, S, and G pillar and its key sub-components, as well as more transparent methodology disclosure**
    - Provide more clarity on the criteria applied in identifying key ESG factors
    - Facilitate investors with a specific ESG focus, such as climate change or human development
    - Include a disclosure vs performance score:
        - A disclosure score examines the level of information disclosure by companies with a focus on qualitative indicators
        - A performance score measures ESG performance with an emphasis on quantitative indicators.

3. **Enable disclosure of ESG rating transition over time or provide an accuracy rate.**
    - Help investors to evaluate the validity of the provider's ESG rating source and incentivize ESG providers to improve.
    - The accuracy and credibility of ESG ratings could be reflected in stable ratings, with no steep or drastic changes since its initial rating assignment.

4. **Regulatory intervention in the ESG rating sector is necessary.**
    - Effective regulation to define the purpose of ESG ratings and improve their consistency, transparency and accuracy
    - ESG ratings will be meaningful to investors and companies when this sector is regulated and has a common language.

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Improving ESG rating for the utilities sector

Problem: *Clean energy companies may be underrated due to a number of factors. These include the subjective nature of ESG ratings, entrenched biasness and company's ESG disclosure.*

> **IEEFA's analysis of 267 utility companies finds that only 40% disclosed complete and material metrics related to renewable energy usage."**
>
> Hazel James Ilango | Energy Finance Analyst, Debt Markets

1. Strengthening rating providers' or companies' **renewable energy disclosure** is needed to gauge overall low carbon transition measures.
2. **A green revenue indicator** could help gauge the proportion of a company's revenue that is truly "green", such as the disclosure of renewable energy power generation revenue.
3. **Renewable energy procurement** such as new renewable generation added to the grid, viability of clean energy strategy and carbon reduction should be distinctly addressed in ESG scoring methodologies.