POSITION PAPER

A driver for the just transition: Why we need better regulation for a fair and transparent ESG ratings market

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Elia Group uses ESG ratings among others to have the non-financial reporting and efforts in terms of environmental, social and governance activities verified externally.

We believe that ESG rating results send important, market-relevant signals about a company's efforts; but only, if they rely on accurate data, clear methodology and a transparent process.

However, incomplete databases and intransparent rating procedures currently create results with little explanatory power that are sometimes even incorrect. Some dysfunctional market elements and distortions need to be eliminated in order to create a level playing field for companies subject to ratings and rating agencies. To enable comparability between rating results, we therefore consider a legal European framework the best option to solve the issues described in this position paper. Elia Group therefore welcomes the European Commission's initiative and targeted consultation on the matter. A common framework could, without any doubt, also send important signals to the international level and create spill-over effects, establishing a "gold standard" for ESG ratings globally.

1. Methodological discrepancies undermine fair process and credible rating results

The most important obstacle to a fair and transparent ratings market is the lack of transparency regarding the methodologies used by the rating agencies. Different methodological approaches create discrepancies between ratings from different providers, as they lead to very different results. Changing methodologies by one single provider can equally have this effect, creating the impression that a rating has either increased or decreased depending on the methodology used, instead of actual performance. As a company subject to unsolicited ratings, providers do usually not disclose their methodological approach to us. In practice, this means that a company's ESG performance can vary substantially – depending on the rating provider and the methodology chosen in a specific year. The lack of transparency regarding the rating methodology therefore undermines the justification and comparability and development of the results, and consequently fails to fulfil its potential as a credible indicator for ESG performance.

We thus suggest that the Commission should set a framework with minimum standards regarding the methodology applied for ESG rating agencies. The providers should disclose in a transparent manner their detailed methodology to the subject of a rating prior to the start of a rating process. To ensure a fair and transparent rating, the methodology should be disclosed together with the rating score.

2. **Lack of transparent data basis impedes legitimacy of rating results**

Nowadays, providers carry out ESG ratings about companies on a solicited basis, but more often on an unsolicited basis, and some agencies exclusively rate on an unsolicited basis (for instance MSCI) – sometimes even without the company's knowledge. Especially in the latter case, rating agencies may use whatever data is publicly available on the ESG performance of a company. Even if the rated companies know about the unsolicited rating, providers are not required to disclose to the rating subjects what kind of data it used as a basis for the rating. This practice can significantly distort the result, as a company cannot verify the quality and accuracy of the data; the results depend only on the efforts the individual agencies invest. Even if companies provide data, there is no guarantee that this data will be included in the rating. In fact, if incorrect or old information is included in a rating, there is no way for companies to verify this or correct the underlying information. However, the effects can be extremely damaging and reduce the explanatory power and thus the trust in the rating itself.

The Commission should therefore take action to ensure that providers use complete, accurate and the latest available data on a company's ESG performance, requiring rating agencies to disclose the type and the source of the information used. We suggest that the Commissions sets up minimum requirements for the data basis that providers must use. This could be a general template based on the requirements of the integrated reporting methodology in line with CSRD reporting requirements. To mitigate the risks of abuse, the Commission should also establish a European complaint mechanism, chaired by a designated ombudsperson, in case a company suspects unfair treatment or rating based on inaccurate data.

3. **The lack of regional and sector-specific knowledge distorts the rating market**

Rating agencies tend to apply their ESG methodology as one-size-fits-all solutions to whole economic segments – like the energy sector – without differentiation regarding (macro-) regional legal and sector-specific requirements. This poses a threat to the validity of the rating results, as completely unsuitable criteria may be applied to companies. For instance, companies should not be penalized in the rating for a failure to comply with a certain criterion, if this criterion is unsuitable due to legal compliance reasons, e.g. national or EU law. Another example for an unsuitable category specific to the energy sector is that a company may be rated in a category where it is not even economically active, i.e. a TSO should not be rated in the category of a nuclear waste disposal strategy, because TSOs simply do not produce nuclear waste.

In order to avoid unnecessary distortions of rating results, we propose to introduce the possibility that justified non-applicability can be selected by the companies subject to ratings, based on the methodology disclosure at the beginning of the rating process.

4. Efficient ratings need adequate process and communication standards

The lack of supervision and enforcement of sound rating practices has led to unpredictable rating processes without any boundaries in terms of communication, leaving companies subject to ratings at the mercy of providers. Companies have usually very little time to prepare the data requested or even complete questionnaires. Sometimes, companies are asked to provide the aggregated information and data within 48 hours. In turn, when companies have questions about the process or other enquiries, with some agencies there are no means to establish a contact to the rating agencies, or even get a reply, leading to a situation of one-dimensional communication.

To enable a fair process that gives companies enough time to assemble specific information, we propose that the Commission set up the necessary rules to allow companies a period of four weeks to assemble and provide feedback and information following a request by a rating agency. On top of that, rating agencies should be required to name contact persons (ideally the analysts themselves) for enquiries and clarification matters on the rating and the rating process.

Conclusion

To conclude, we would like to stress again the importance of a European Regulation of ESG ratings. This would not only improve the quality and reliability of ratings but establish clear rules for transparent and streamlined procedures. A simplification and harmonisation of rating standards would facilitate comparability between ratings and also allow to compare the myriad of different rating providers and their methodologies. Once established, more predictable, transparent and simplified procedures will ultimately also reduce the administrative burden of companies.