# ESG Essentials: value-to-society – bridging gap between absolute, relative assessment

**Relative or absolute? The distinction divides assessments of corporate sustainability. Relative measures are more common despite serious shortcomings, but new regulation favours absolute ones, imperfect though they are too.**

The new EU Taxonomy provides a description of sustainable environmental activities in an absolute sense while technical thresholds for transitional activities are set relative to sectoral leaders, all amid efforts by Brussels to standardise reporting on environmental, social and governance (ESG) factors across companies.

In contrast, the most- used provider of sustainability ratings measures the sustainability of companies in relationship to others in the same sector.

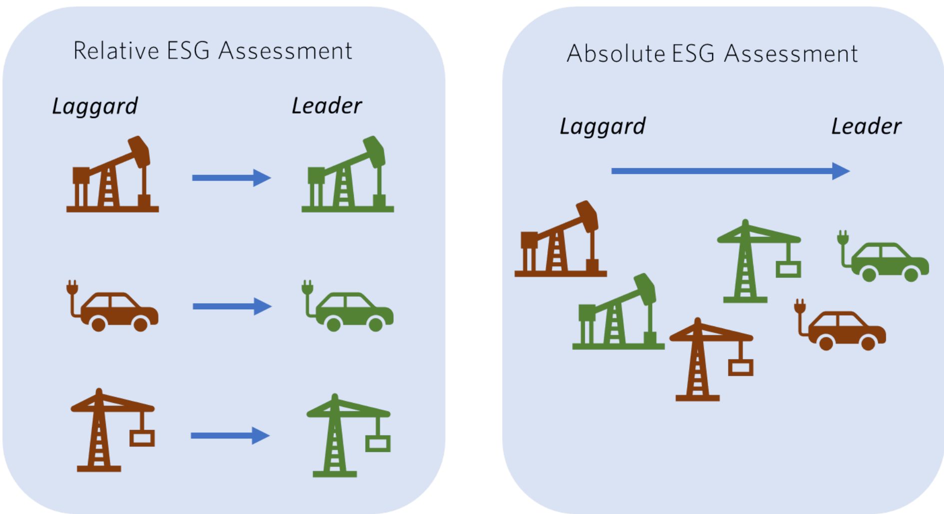
Such “best-in-class” assessments are good for detecting which players are leading the way in meeting common ESG challenges through sector-specific technological advances, efficiency gains or sustainability policies.

Take the hypothetical case of a coal-based electricity utility investing heavily in renewable energy to change its business model. The utility is making a more positive net contribution to the environment than a competitor whose environmental impact – whether adverse or favourable – is static. Such assessments provide a potentially useful guide for investors to measure relative contributions to transformation.

The problem is that sustainability itself cannot be compartmentalised - whether our focus is looking at the impact of corporate activities on the environment and society at large or the ESG-related risks that a company faces - particularly in the long term given that risks are linked to the impacts.

An absolute approach, such as “value-to-society”, avoids these problems by allowing impact investors to assess corporates across sectors. “Value-to-society” takes a holistic view at a corporate in summing up the indirect impact of business models on the environment and greater society from costs related to supply chains towards contributions and costs of produced output during use phase and final disposal. However, it is a challenging one, partly because it shows how crucial it is to include analysis of corporate supply chains for which data are partial at best.

**Figure 1: Different outcomes: absolute vs relative ESG industry assessments**




Source: Scope ESG Analysis GmbH

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# ESG Essentials: value-to-society to bridge the gap between absolute and relative assessments

**Relative assessments are easy to read – but not transparent**

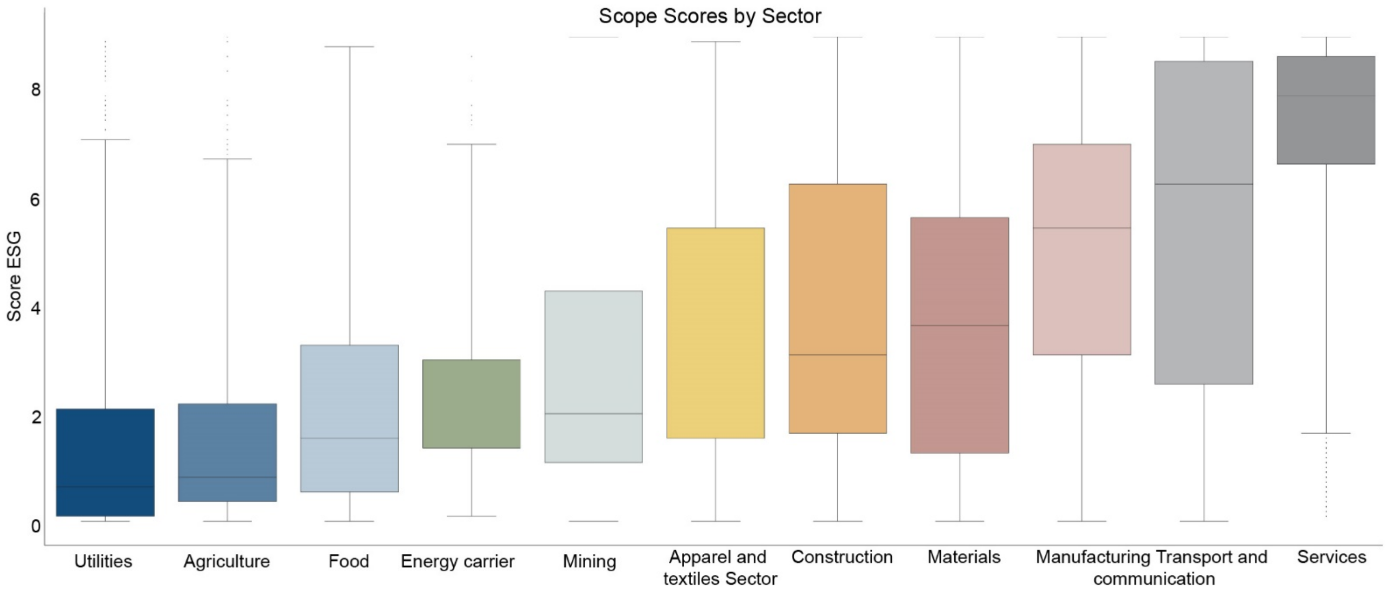
“Best-in-class” assessments ignore the overall ESG impact of a particular sector. For instance, integrated oil & gas companies (IOCs) such as Royal Dutch Shell and Total SE have high sustainability ratings from one leading ESG-rating provider, which, while arguably merited in comparison with other IOCs, leaves them, somewhat incongruously, as highly rated as Siemens Gamesa Renewables, a Spain-based wind-turbine manufacturer. The problem is not with the rating – but the nature of relative ESG scoring.

Secondly, “best-in-class” measures ignore absolute sectoral impacts, which remain important considerations for impact-oriented investors who want to avoid some activities in their portfolios. In addition, industrial peer groups are broadly defined while impacts within a given sector can differ widely, for instance in manufacturing. Also, large corporates are often structured as conglomerates with multiple business segment activities.

**Absolute scores are more transparent but more complex**

Using our macro-economic approach to approximate supply-chain impacts in the absence of reliable corporate data – in which we monetise the absolute outcomes to illustrate how material they are – we can see that industries at the origin of supply chains (agriculture, utilities) receive the worst scores. They are closely followed by their clients next in the value chain (food processing, mining, energy carrier). On average, companies in sectors with a small share of value added rooted deep in the supply chain achieve the best scores.

**Figure 2: Scope’s ESG scoring across sectoral activities (the higher the score, the more benign the ESG impact)**




Source: Scope ESG Analysis GmbH

However, a holistic “value-to-society” assessment requires understanding upstream supply-chain related impacts and analysis of the contribution of the company’s produced output to wider society – the downstream. Without such analysis, we are left with relative assessment of corporates within industries to prevent ourselves from comparing apples with pears.

Compare a T-shirt – made from petroleum-based synthetics that is perhaps worn only once before being thrown away - with a solar panel, with a sizeable environmental impact in being manufactured but a likely long, environmentally friendly industrial life before final recycling. Relative approaches fail to capture this distinction. Apparel makers Adidas and H&M typically receive as high ESG ratings as manufacturers of wind-power systems such as Vestas.

**Value-to-society approach can bridge the gap; requires data**

The “value-to-society” approach integrates the analysis of impacts from the production phase to the contribution to society during the lifetime of the product’s use. However, this approach has its own shortcomings. In particular, the analysis of the contribution of a product to society involves more subjective judgement: how do we compare the societal value of medicines, energy, food and cars?

The answer requires objective concepts to evaluate and quantify benefits to society, but it remains to be seen whether internationally agreed norms and principles can be agreed. The EU Taxonomy illustrates the trade-offs that will need to be made, with its definition of “enabling activities” which contribute indirectly to low-carbon outcome such as manufacturing wind- or hydro-power turbines. In addition, the EU defines direct “mitigating activities” such as the production of renewable energy and so-called “transition activities” such as carbon-efficient aluminium production.

To conclude, the “value-to-society” approach makes relative comparisons fully redundant if we can undertake a holistic assessment of corporate impacts over the life cycle of produced output. The aggregation of benefits and costs to society express the net impact that investors are ultimately after. However, this holistic assessment requires more comparable data and objective assessments of contribution value.

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