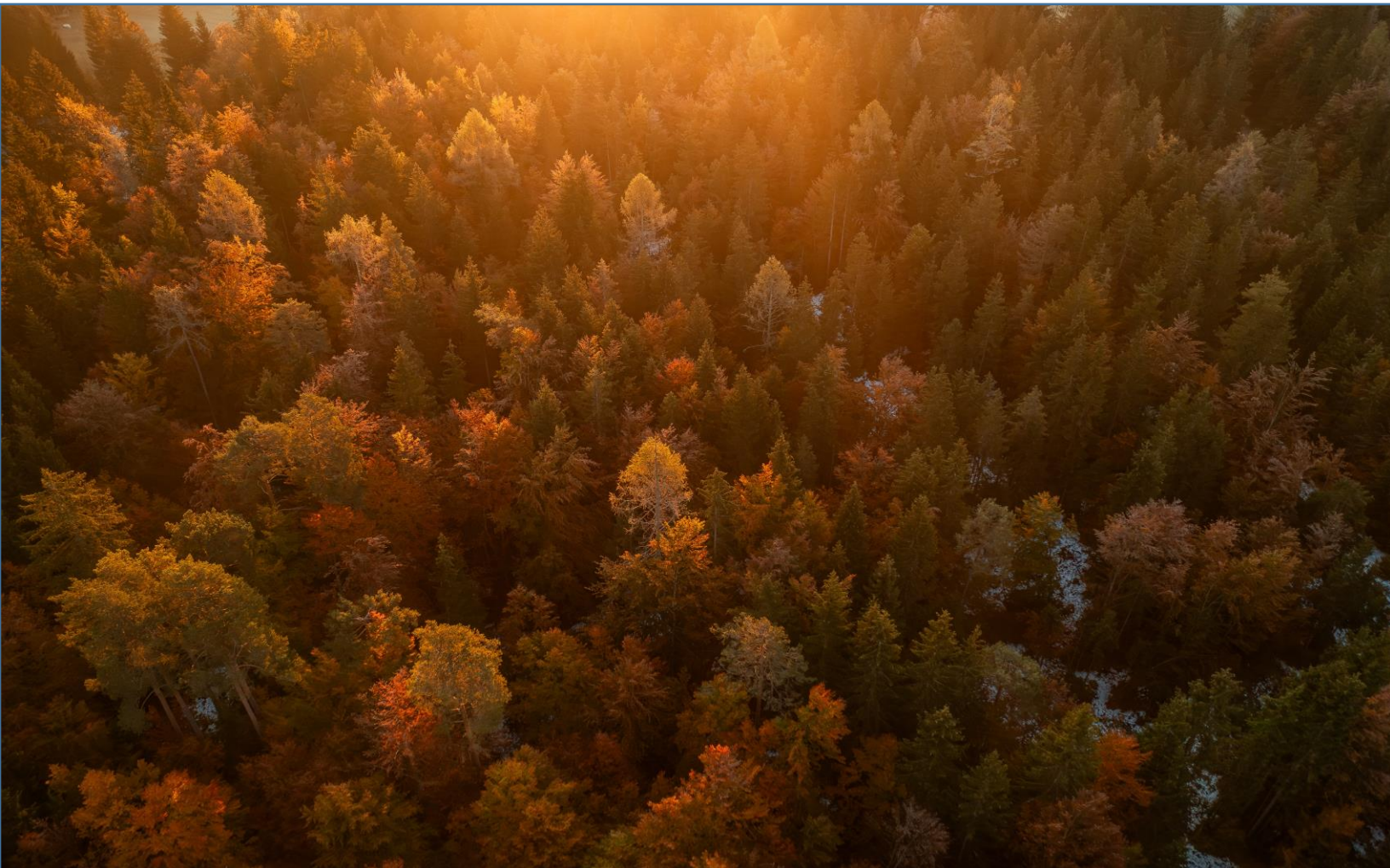


# Embedding sustainability and responsible practices in rating framework design

How a greater policy focus on sustainability is motivating a re-examination of risk and opportunity



Saudi Arabia is the tenth largest GHG emitter in the world (JRC/IEA 2023 report). The country is highly susceptible to desertification, air pollution, and water scarcity. Against this backdrop, reversing the impact of climate change and environment conservation comes to the forefront when configuring sustainability policy initiatives.

The history dates back to 2018 when the Saudi Stock Exchange partnered with the UN Sustainable Stock Exchange to promote awareness about Environmental, Social, and Governance (ESG) initiatives and encourage sustainable investments. The Saudi Stock Exchange furthered its intent by publishing ESG guidelines to aid corporations in sustainability reporting. In 2021, Saudi Green Initiatives laid out a long-term climate action plan to become Net Zero by 2060, increase vegetative cover, and protect the land and seas. The impact of these ongoing developments is building industry awareness: a PWC survey in 2022 revealed that over 60% of respondents are actively integrating ESG into business decision-making.

In the absence of ESG regulations, rating agencies serve to play a pioneering role in steering companies toward effective disclosure, risk identification, value creation, and meeting stakeholder expectations. Axial Consulting's ESG Rating Framework (Framework) was constructed with the intent to validate existing corporate practices and serve as a guide for plugging critical gaps.

## **Skeletal Description of the Framework**

The Framework was designed in a series of steps encompassing methodology design, database development, a three-part questionnaire, and a scoring model.

### *1.1 Methodology Design*

The first task was to identify overarching themes and issues applicable to each E, S, and G component. Axial relied on ESG methodologies developed by international rating agencies such as MSCI, Moody's, S&P, and Fitch to draw out relevant Themes, Factors, and Indicators (see Illustration 1.0). These details were modified as necessary to fit the local market context and subsequently categorized across the five sectors (see Sector Performance Matrix) of KSA's economy.

Themes, Factors, and Indicators: For the Environmental part, Climate Change and Natural Capital were two out of the five relevant themes. Factors were used to define each theme. In the case of climate change, these included carbon emissions and climate change vulnerability, to name a few. Indicators were used as measures of factor performance.

### *1.2 Database Development*

The frequency of ESG disclosures varies considerably across KSA-based corporations. A lack of consistency meant that our sample size had to be restricted to companies with consistent disclosures. An added challenge in this exercise was the scarcity and variance of data reported across our sample's sustainability reports.

Our database design was split into three components (E, S, and G) and mirrored the themes-factors-indicators pattern set by our methodologies. Reports published by our sample companies were analyzed to identify performance trends and disclosures. The constituent data were disintegrated and categorized into relevant themes and factors.

### 1.3 Three-Part Questionnaire

The shortcomings associated with sustainability reports meant that they could not be solely relied on to develop comprehensive performance benchmarks for scoring ESG performance. Therefore, we turned to international best practices and frameworks such as B-Impact Assessment, GRI standards, WEF Metrics, and S&P’s Corporate Sustainability Handbook. This helped identify critical theme- and factor-specific issues applicable to each sector leading to the development of a three-part ESG rating questionnaire comprising a total of 548 questions.

### 1.4 Scoring Model

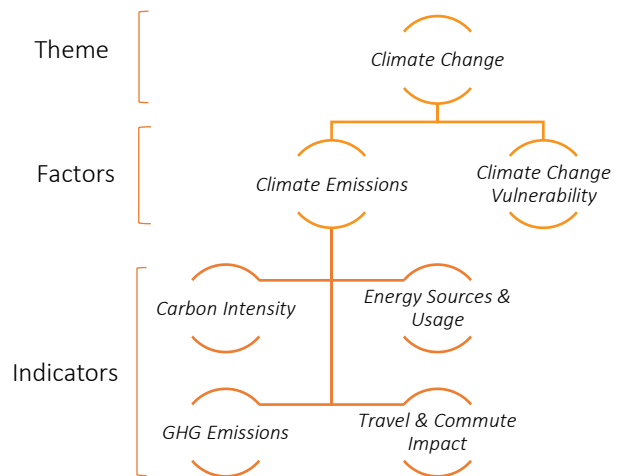
A unique feature of Axial’s ESG scoring model is that it is highly customizable: each factor has been assessed for its relevance and level of materiality to a specific sector. Furthermore, implications of Vision 2030’s Saudi Nationalization Scheme (Nitaqat) on performance have duly been incorporated into our evaluation of Social factors.

Similar to other Framework elements, Axial’s scoring model was segregated into three

parts (E, S, and G). Each part incorporated both average and suggested factor weights, the latter reflecting our team’s best judgment of the importance and materiality of the proposed factor for the subject sector.

Axial’s scoring model is intended to be used in conjunction with a proposed six-level rating scale with 1 representing excellent performance and 6 representing very poor performance.

**Illustration 1.0: Themes, Factors, and Indicators**



## Key Insights

### Environment Component

Our study of sustainability reports found that the Oil & Gas sector was most active when it comes to environmental disclosures, in general, and pollution and waste and carbon emissions, in particular. The deployment of carbon capture technologies has been a common feature across this industry. Comparatively, a significant number of companies across our sample have been reporting on their GHG emissions (Scope 1, Scope 2, NOx, Sox) while Scope 3 emissions disclosures haven't been very elaborate.

Energy efficiency innovations and the adoption of renewables has been favorably observed in the Banking and Financial Institutions, Oil & Gas, and Services sectors.

Most sectors, except Oil & Gas, need to be more active when it comes to engaging stakeholders during environmental impact assessments.

### Social Component

Across our sample, each sector is taking visible strides in promoting DEI and wellness, health, and safety alongside other measures. The Services and Manufacturing sectors have demonstrated the strongest performance on this front. We also observed that disclosures on supply chain management and social policy initiatives have been generally lacking.

### Governance Component

All five sectors have some ground to cover regarding disclosures concerning ownership structures, the board, and the management team. On a positive note, the sectors have been quite active in enhancing their ethical code of conduct through training programs such as anti-corruption and stakeholder engagement.

## Sector Performance Matrix

Key		Poor	Average	Good	Very Good	No Score Assigned
Performance						
Range		0-25%	26-50%	51-74%	75-100%	-
ESG Component	Theme	Oil & Gas	Services	Manufacturing	Banking & Financial Institutions	Construction
Environment	Climate Change	Good	Average	Average	Very Good	Poor
	Natural Capital	Average	Average	Average	No Score Assigned	Poor
	Pollution and Waste	Good	Average	Average	Average	Average
	Environmental Opportunities	Average	Average	Average	Very Good	Average
	Environmental Management	Average	Average	Average	Average	Average
Social	Human Capital	Good	Very Good	Very Good	Very Good	Average
	Product Liability	Very Good	Average	Average	Average	Average
	Community	Average	Average	Very Good	Average	Average
	Supply Chain Management	Average	Average	Average	Average	Average
	Collaboration and Partnership	No Score Assigned	Average	No Score Assigned	Average	No Score Assigned
	Social Opportunities	No Score Assigned	Average	No Score Assigned	Average	No Score Assigned
Governance	Social Management	Average	Average	Average	Average	Average
	Corporate Governance	Average	Average	Average	Average	Average
	Corporate Behavior	Average	Average	Average	Average	Average



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