



IIGCC Discussion Paper:

**Investor approaches to scope 3:
its importance, challenges and
implications for decarbonising
portfolios**



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About this paper

This discussion paper on **scope 3 emissions** outlines investor perspectives on both the importance and the complexity of the value chain emissions of their investee companies in the context of achieving net zero portfolio emissions.

Previously, IIGCC indicated¹ that these emissions should be treated as distinct from scopes 1 and 2, due to measurement and aggregation challenges, and that further work would be needed to deliver specific guidance to investors on addressing this topic. An IIGCC scope 3 working group was established earlier this year with the objective of developing such guidance.

The paper aims to articulate the specific nuance and challenges of addressing scope 3.

The paper is structured as follows:

- An introduction to the scope 3 challenge
- A review of the market context and how the concept of emissions scopes was developed
- A proposed theory of change for investors to address scope 3 emissions
- An exploration of key challenges
- Next steps

This paper focusses primarily on publicly listed corporate instruments, including both equity and debt. The scope 3 emissions of other asset classes covered by the NZIF will be addressed in future work.

This is the first output of IIGCC's scope 3 working group. Later this year, the working group will look to release guidance for investors on how to address scope 3 emissions of their investments in the context of the challenges that are outlined herein.

¹ Version 1.0 of the Net Zero Investment Framework (NZIF)

1 Executive summary

- Greenhouse gas (GHG) emissions, usually measured in carbon dioxide equivalent (CO₂e), has historically been the most commonly used quantitative metric to understand a company's impact on climate change. Entities typically report on these emissions through the GHG Protocol, a voluntary emissions reporting standard which categorises emissions into scopes 1, 2 and 3 (Figure 1).
- **Scope 3 represents emissions from the value chain** of the reporting entity, covering both the upstream supply chain and downstream customer activity. Value chain activities are split into fifteen different categories, some of which are vastly more material to the overall emissions footprint than others², and at present, it is up to the reporting company to determine which are relevant for it to report. The regulatory direction of travel is towards more clarity around scope 3 disclosure, which is increasing the urgency for companies and investors to familiarise themselves with it and prepare to calculate and disclose.
- Presently, there are practical challenges with reporting, estimation and calculation of scope 3 data, which has led to a fragmented data landscape that lacks coverage and quality across the investable universe. Whilst the data is improving, including due to notable efforts by a number of industry actors, it is unlikely to be consistent and credible across investors' whole portfolios in a timeframe consistent with the urgent need to address climate change issues and manage climate-related risks.
- Yet, without recognising the scope 3 emissions of a company, it is not possible to fully understand and assess its contribution to climate change. Scope 3 is often where major emissions sources exist within investment portfolios. For example, the emissions associated with producing livestock feed for an agribusiness, or the combustion of fossil fuel products by a customer of an oil and gas exploration and production company. These areas can also indicate climate transition risks investors might be exposed to via the value chains of the assets they invest in. This is particularly true for some of the overall highest emitting sectors and therefore is of material relevance within investment portfolios.
- Beyond practical data and calculation concerns, there are several inherent challenges that arise when looking at scope 3 from an investment portfolio level. Within portfolios, there are often multiple companies exposed to the same tonne of GHG, given that one company's value chain emissions are another company's direct emissions. The purpose of measuring scope 3 emissions is not to assign emissions ownership but to assess one entity's carbon exposure. So, aggregation of multiple companies' scope 3 can lead to meaningless metrics that would incentivise undesirable outcomes and therefore cannot be used to underpin decision-making or track progress.

² CDP, Technical note: https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf

- But information on the scope 3 emissions of investee companies is vital for investors looking to credibly decarbonise their portfolios – and manage climate-related risks. Given that simply aggregating these emissions into portfolio level metrics (as is the case for scopes 1 and 2) could drive undesirable outcomes, there is a need to develop an alternative approach. This paper aims to articulate these challenges and lay the foundations for an investor-led solution to addressing scope 3 emissions within investment portfolios.

Figure 1: Three emissions scopes of the Greenhouse Gas Protocol, simplified

Source: Adapted from Greenhouse Gas Protocol



2 Introduction

Background

Greenhouse gas (GHG) emissions, usually measured in carbon dioxide equivalent (CO₂e), has historically been the primary quantitative metric used to understand a company's impact on climate change.

Entities can report on their GHG emissions against the GHG Protocol (GHGP), initially a voluntary emissions reporting standard, which sets out a series of calculation guidelines based on a three-scope model (Figure 1). Scope 1 covers emissions from operations owned or controlled by the reporting company, Scope 2 covers emissions from purchased energy services³, and Scope 3 covers emissions from the broader value chain. Scope 3 is further split into 15 distinct categories, which cover emissions produced in the supply chain and those generated when the company's products or services are used by customers, as well as other areas such as business travel and employee commuting (Figure 3). These categories are outlined in Figure 3 and each has its own dedicated guidance from the GHGP. The most important scope 3 category for investors is category 15 which represents the emissions of their investments, which in turn categorise their own emissions into scopes 1, 2 and 3. Now, reporting on scope 3 category 15 emissions by an investor is typically limited to the scope 1 and 2 emissions of the investments and does not typically include the scope 3 of investees. The focus of this paper centres around these emissions: the scope 3 of investments.

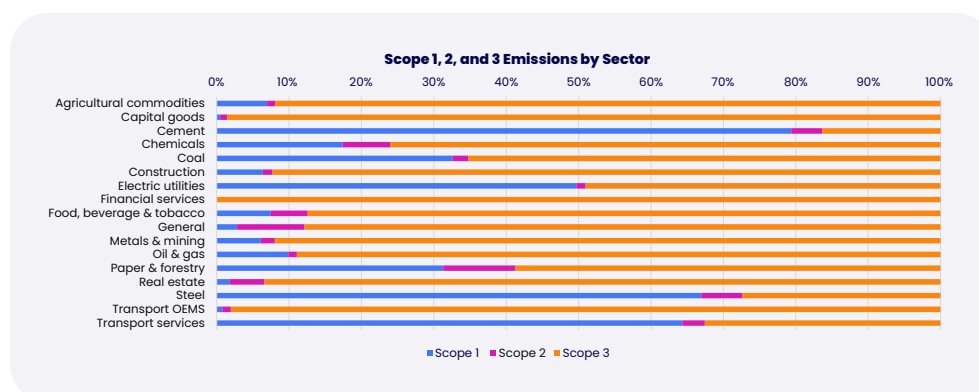
The GHGP has since been adopted by other voluntary frameworks and by some regulators as the basis for climate-related disclosures of quantitative metrics. At present, it is typically up to the reporting company to determine which of the 15 scope 3 categories are relevant to report. The current state of play of disclosure, and perceived relevance of categories to companies in each sector, is outlined by CDP in its Technical Note: Relevance of Scope 3 Categories by Sector⁴. The materiality of each category varies by sector, but for the majority of sectors, the magnitude of scope 3 emissions tends to largely outweigh scopes 1 and 2 (Figure 2).

³ Specifically, scope 2 emissions relate to the generation of purchased or acquired electricity, steam, heating, or cooling, which is consumed by the reporting company.

⁴ CDP, Technical note: https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf

Figure 2: Percentage of greenhouse gas (GHG) emissions by scope 1, 2 and 3 reported by CDP respondents

Source: CDP



However, regulatory direction of travel is towards more scope 3 disclosure, which is increasing the urgency for companies and investors to familiarise themselves with the topic and prepare for calculation and disclosure if they have not already done so. The GHGP underpins emissions reporting efforts by the majority of companies to date and is also included within other mainstream climate reporting frameworks, such as the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), The European Sustainability Reporting Standards (ESRS) and the International Sustainability Standards Board (ISSB) disclosures.

The challenge for investors

Whilst the three-scope model helps to break down emissions at company inventory level, it poses challenges when these emissions are viewed by investors at the level of financial portfolios. These include practical issues relating to data quality and coverage, methodological inconsistencies, and aggregation. There are also theoretical challenges related to a lack of a commonly accepted understanding of the materiality of scope 3 categories in different sectors, (mis-) incentivisation of investee practices on climate change, and navigating differing levels of influence over value chain emissions.

If left unaddressed, this presents investors with an incomplete picture of companies' GHG footprints, potentially unevaluated transition risks and unexplored opportunities to influence real economy emissions reductions. Ignoring scope 3 can further undermine decision-making on climate change, including allocation of engagement resources to priority areas. Further, investors are working to meet the recommendations of voluntary net zero commitments⁵, whilst navigating evolving expectations from regulators and other stakeholders with respect to scope 3 emissions.

This discussion paper sets out the initial theory of change investors might look to achieve by including scope 3 emissions of investments into their net zero approaches at portfolio level, as well as the current challenges to doing this in a credible way.

⁵ Such as the net zero commitment statements of the Paris Aligned Asset Owners and Net Zero Asset Manager initiatives.

Figure 3: The three emissions scopes as defined by the GHGP

Source: GHGP

Scope	Definition	Examples
Scope 1	Emissions from operations that are owned or controlled by the reporting company	Emissions from combustion in owned or controlled boilers, furnaces, vehicles, etc.; emissions from chemical production in owned or controlled process equipment
Scope 2	Emissions from the generation of purchased or acquired electricity, steam, heating, or cooling consumed by the reporting company	Use of purchased electricity, steam, heating, or cooling
Scope 3	All indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions	Production of purchased products, transportation of purchased products, or use of sold products

Figure 4: The fifteen scope 3 categories of the GHGP

Source: GHGP

Category	
Upstream	1 Purchased goods and services
	2 Capital goods
	3 Fuel- and energy-related activities not included in scope 1 or scope 2
	4 Upstream transportation and distribution
	5 Waste generated in operations
	6 Business travel
	7 Employee commuting
	8 Upstream leased assets
Downstream	9 Downstream transportation and distribution
	10 Processing of sold products
	11 Use of sold products
	12 End-of-life treatment of sold products
	13 Downstream leased assets
	14 Franchises
	15 Investments

3 Market context

Policy and regulation

The extent to which disclosure and management of scope 3 emissions is addressed by policymakers varies between jurisdictions and different reporting standards. To date, scope 3 disclosure by emitting entities has been largely applied on a voluntary or self-determined materiality basis, but this is gradually changing as emissions disclosure regulation is being implemented or considered in a number of regions.

In contrast, some regulations on financial products, such as the EU's Sustainable Finance Disclosure Regulations (SFDR), increasingly require investors to consider the scope 3 of their investments to justify claims of having a full understanding of the climate impacts of their investments. More widespread scope 3 disclosure requirements at the asset level would enable investors to better meet their obligations under this regulation.

Net zero initiatives and frameworks

Addressing scope 3 emissions is included in the voluntary commitment statements of both the Paris-aligned Asset Owners (PAAO) and Net Zero Asset Managers (NZAM) and is referenced in the implementation guidance for the Net Zero Investment Framework (NZIF).

Figure 5: Scope 3 requirements of IIGCC's net zero initiatives and methodologies

Scope 3 requirements		
Net zero initiative	<u>Paris-Aligned Asset Owners (PAAO)</u>	Scope 3 is included in commitment 3 to set objectives and targets, including an interim target for 2030 or sooner for reducing scope 1, 2 and 3 emissions associated with portfolios.
	<u>Net Zero Asset Managers (NZAM)</u>	Scope 3 is included in commitment 2, where assets or assets committed to be managed in line with the attainment of net zero emissions by 2050 or sooner should account for portfolio scope 1 & 2 emissions and, to the extent possible, material portfolio scope 3 emissions.
Net zero methodology for investors	<u>The Net Zero Investment Framework (NZIF)</u>	NZIF recommends that emissions reduction targets and monitoring at the portfolio level should include at least scope 1 and 2 emissions initially, and phase in scope 3 emissions over time, although these should be set and reported on separately given measurement and aggregation challenges.
Net zero methodology for corporates	<u>Climate Action 100+ Net Zero Benchmark</u>	At asset level, the Climate Action 100+ Disclosure Framework has several references to inclusion of scope 3 emissions. The most relevant Scope 3 GHG emissions categories for the sector should be covered in its overall ambition, targets and decarbonisation strategy.

The Greenhouse Gas Protocol

The GHG Protocol, the most widely used emissions accounting standard, was initially created as a joint initiative between the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD). Together with several large corporate partners, it published a discussion paper (“Safe Climate, Sound Business⁶”) on the need to standardise measurement of GHG emissions in 1998. This was followed by the first edition of the Corporate Standard in 2001, with subsequent guidance on scope 2 and scope 3, as well as additional supplementary guidance for some sectors or activities.

Since the publication of these initial standards there have been developments in greenhouse gas accounting and reporting, many of which are underpinned by the GHGP’s approach. This includes the creation of the Partnership for Carbon Accounting Financials (PCAF) standard for reporting on financed emissions (or category 15 of scope 3), the rise in corporate net zero targets, mandatory climate disclosure regulations, and advancements in research on climate science and the private sector’s role in combatting climate change.

The Protocol is currently undergoing a two-year review process, during which feedback has been invited on the current suite of corporate standards, including on the value chain standard. This will be followed by a restructure of the GHG Protocol’s governance and the release of revised texts across 2024 and 2025. Any revisions or amendments to the GHG Protocol’s Value Chain standards would impact the topics discussed within this paper.

⁶ WRI & WBCSD, <https://www.wri.org/research/safe-climate-sound-business>

4 Theory of change

Achieving emissions reductions in the real economy is a foundational principle of the Net Zero Investment Framework (NZIF). Whilst different types of investors have different levers at their disposal, NZIF encourages investors to maximise their efforts to achieve the greatest impact possible. With this in mind, it is important that any efforts to address scope 3 emissions of investment portfolios be done in a way that supports real-economy action on combatting climate change.

Why is scope 3 important to investors?

Scope 3 is an important indicator of the contribution of a company to climate change, including in many high-impact sectors. Without looking at scope 3 emissions, many of the key drivers of global climate change might not be captured, nor attributed to companies who can influence these activities. Many sectors, for example oil and gas, mining, autos and banks, are classified as high emitting based on their scope 3 emissions.

Without having to include scope 3 in their reporting, companies may also be incentivised to lower their reported emissions footprints by simply outsourcing manufacturing activities or leasing assets instead of owning them outright. This would shift emissions out of their direct emissions (scope 1 and 2) into their value chain (scope 3) emissions. Including scope 3 enables a lifecycle emissions approach that allows for a complete and fairer comparison of value chains.

Scope 3 emissions can be considered a good proxy for transition risk in most cases. It calls attention to the reality that companies can be – and typically are – exposed to climate transition risks across their broader value chains. Nevertheless, the magnitude and nature of the risks associated with any given tonne of scope 3 emissions are not directly equal across the categories and between companies. Therefore, a complete appreciation of climate transition risks to an investment portfolio requires an understanding of investee company value chains.

The magnitude of scope 3 emissions does not always directly equate to a corresponding negative impact on the climate, nor directly translate to a corresponding magnitude of transition risk, making it equally important to understand the qualitative nuance behind scope 3 data. For example, expansion of a low carbon-intensity company would increase its scope 3 emissions, but if it is capturing market share from a higher intensity company, the overall climate impact can be more positive than it might initially seem. It is critical to understand how these complexities develop when looking at the scope 3 emissions of multiple entities, i.e. in a portfolio. Qualitative narrative on scope 3 emissions is an important element for investors conveying the climate impacts of their investment decisions to stakeholders, for both asset managers and asset owners.

Some categories of scope 3 are vastly more material to a company's footprint than others, in fact, in most high emitting sectors, the scope 3 emissions profile is dominated by a small number of categories⁷. As well as emissions materiality, some categories are more strategically important to a company than others, in that the activities captured by that category are more intrinsic to its business model. This is perhaps most clearly seen in 'category 11: use of sold products' in which the emissions arise from a product that the company has decided to sell. In both instances, the importance of the different scope 3 categories varies by sector and company, yet in current disclosure practices they are broadly not distinguished in this way, although this is being improved by emerging materiality-based scope 3 reporting requirements in some jurisdictions. By understanding which categories are material for investee companies, investors can focus engagement where it can be most effective.

Additionally, including scope 3 emissions gives a better picture of the required actions to decarbonise the sector and/or market within which one company sits, across both its supply and demand side. Conversely, not including the most material scope 3 emissions within investor approaches to net zero risks missing many of the key opportunities to combat climate change and thereby mitigate climate risks.

What outcomes might investors look to achieve by addressing scope 3 emissions?

By including material scope 3 emissions, investors can look to:

1. Clearly identify the emissions 'hotspots' within portfolios and understand the complete emissions profile of a portfolio or fund
2. Focus asset-level engagement on the greatest opportunities to influence real economy decarbonisation
3. Identify and capitalise on opportunities to influence decarbonisation across the wider value chain of a specific sector
4. Better understand the transition risk and opportunity exposure of their portfolios and where it is concentrated in investments and/or segments

⁷ CDP, Technical Note: https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf

5 Challenges

There are a number of challenges for investors looking to utilise scope 3 data when assessing portfolio-, company- or asset-level performance on climate change, both on a practical level and in terms of the theoretical climate outcomes being incentivised. This section outlines some of the key practical and theoretical challenges for investors.

Complexities of value chain emissions reporting

The lack of coverage and quality of scope 3 data across the investable universe is a fundamental challenge. This is a challenge not just for investors but for all companies looking to understand their value chain emissions. By definition, obtaining reported data on value chain emissions relies on third parties. These could include upstream suppliers, transportation and logistics providers, or downstream users of the company's products and services. The complexity of global supply chains and the large number of companies involved in them means that tracking and managing these emissions can be a significant task. A company may need to perform their own estimations for activities in parts of their value chain over which they have limited visibility, or for counterparties that don't have the sufficient resource to perform the calculations themselves.

It should be noted that many companies and industry initiatives have made considerable progress towards improving reporting and disclosure of scope 3 data, and this is expected to continue to improve over time. Scope 3 calculations are inherently more complex and time-consuming to perform. Further, because they tend to be larger overall, they are also more likely to trigger restatements, which overall creates a high resource requirement for companies reporting on a voluntary basis. The creation of a regulatory imperative for emissions disclosure, such as through the adoption of the ISSB's sustainability reporting standards or the EU's Corporate Sustainability Due Diligence Directive (CSDDD), could significantly help to improve this challenge.

Multiple calculation approaches

There is no singular calculation approach for estimating scope 3 emissions that can be consistently applied across the board. In fact, there is a high degree of optionality and several different approaches that can be used, such as sector-level averages, spend-based calculations or activity-based calculations. These can rely on a number of different emissions factors that are available to companies. As companies across value chains improve their emissions reporting capabilities, it is typical to see changes in the way they calculate their emissions. For example, a company may move away from using sector averages, switch from spend-based to activity-based estimates, or may be able to take advantage of new more relevant emissions factors. These changes in calculation methodology usually require companies to re-baseline if they generate material differences to the base year emissions, which results in a backwards-facing restatement of emissions figures that can add up to be material at portfolio level. Therefore, changes in calculation methodology and or re-baselining by one highly material company can have a significant impact on the scope 3 emissions of a portfolio or fund.

It is also typical to see companies move from making their own scope 3 estimations towards using numbers reported by counterparties, as reporting across the value chain improves. Ultimately, underlying companies within a portfolio may be using different methodologies to calculate their scope 3 at one point in time, which means that investors do not get a consistent view of emissions across their portfolios. This is an inherent effect of the flexibility in calculation approaches under the GHGP's Value Chain Standard.

Companies typically begin reporting scope 3 emissions by focussing on the most material categories and/or those for which they have the best data. Data and methodologies for calculating these categories tend to be refined over time, leading to re-statements by reporting companies. Companies will also start to include additional categories over time, which results in higher overall scope 3 numbers. Ultimately, this reduces the comparability of year-on-year trends. Investors can seek to reconcile this by re-baselining, which is particularly pertinent when reporting against targets, but is a challenge to achieve accurately.

Estimations by third parties

Investors may also use third-party data providers to gather emissions data. There are a number of providers (see IIGCC's Data Catalogue), offering emissions data products, which can be helpful in principle where no data is available or specific company reports are unreliable. However, external estimations based on algorithms generally have a much lower degree of accuracy.

Further, each third-party provider has its own approach to estimating scope 3 emissions, with varying levels of transparency on how the estimates are calculated, as well as when and how methodologies are updated and revised year-on-year. Ultimately, these factors mean that the calculation basis and assumptions used to estimate scope 3 emissions numbers can vary significantly from company to company, which further undermines the comparability of the data.

Materiality varies and is inconsistently applied

The relative importance of the fifteen categories of scope 3 activities to a company's emissions footprint varies by scope 3 category and by sector. This has been recognised in reporting frameworks and mirrored in emerging sustainability disclosure regulation, both of which tend to promote a materiality-based approach to disclosing scope 3 emissions (for example the ISSB standards⁸).

It is important to recognise that across the investable universe, scope 3 on average is highly material to the average emissions profile of an individual company, as highlighted by CDP analysis of a sample of reporting companies that showed that across its high-impact sectors, scope 3 emissions accounted on average for 75% of total emissions⁹. This is particularly notable for sectors such as financial services, oil and gas and mining, in which scope 3 constitutes c. < 90% of emissions¹⁰. But this changes when looking at other sectors, such as cement, steel, and electric utilities, in which scopes 1 and 2 dominate more of the overall emissions profile.

Most importantly, materiality varies further when going down to the level of individual categories of scope 3 emissions. For example, in the same CDP analysis, 'category 1: purchased goods and services' comprised 69% of scope 3 emissions and 63% of total emissions of the sample of companies operating in the agricultural commodities sector. In this context, category 1 represents the upstream emissions from feed and fertiliser production, which are highly material to the agriculture sector's impact on climate change. Other categories, for example 'category 7: employee commuting', pale in comparison to this and are therefore a lower priority for agriculture companies to report on than category 1.

A materiality-based approach to scope 3 is therefore a sensible strategy for companies to maximise efforts where they have the greatest impact on combatting climate change, as long as this aligns with the categories that are material to their sector.

The challenge with respect to a materiality-first approach at present is that determination of what is material is down to individual company discretion. The GHGP provides guidance on how to conduct self-determined materiality assessments for scope 3 but this is not universally adopted and still leaves room for interpretation. This means that the quality of the materiality assessments performed varies from company to company.

⁸ ISSB S1 and S2, <https://www.ifrs.org/projects/completed-projects/2023/general-sustainability-related-disclosures/>

⁹ CDP, Technical Note: https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf

¹⁰ CDP, Technical Note: https://cdn.cdp.net/cdp-production/cms/guidance_docs/pdfs/000/003/504/original/CDP-technical-note-scope-3-relevance-by-sector.pdf

Figure 6: Criteria for determining relevant scope 3 categories

Source: GHG Protocol

Criteria	Description of activities
Size	They contribute significantly to the company's total anticipated scope 3 emissions
Influence	There are potential emissions reductions that could be undertaken or influenced by the company
Risk	They contribute to the company's risk exposure (e.g., climate change related risks such as financial, regulatory, supply chain, product and technology, compliance/litigation, and reputational risks)
Stakeholders	They are deemed critical by key stakeholders (e.g., customers, suppliers, investors or civil society)
Outsourcing	They are outsourced activities previously performed in-house or activities outsourced by the reporting company that are typically performed in-house by other companies in the reporting company's sector
Sector guidance	They have been identified as significant by sector-specific guidance
Spending or revenue analysis	They are areas that require a high level of spending or generate a high level of revenue (and are sometimes correlated with high GHG emissions)
Other	They meet any additional criteria developed by the company or industry sector

When it comes to materiality of categories, the ability of each reporting entity to obtain data and calculate their scope 3 emissions also varies depending on their counterparties, policy context, market context and in-house capabilities. Presently, this means that similar companies within a single sector don't always report on the same scope 3 categories; for example, one agribusiness could determine 'category 1: purchased goods and services' to be material and calculable, and therefore it would appear to have much higher GHG emissions than a second agribusiness of a similar size that has elected not to calculate this category. Therefore, companies with better GHG reporting practices could feel penalised whilst companies that fail to report material scope 3 emissions could fly under the radar. This also makes comparisons of scope 3 emissions disclosures at face numerical value somewhat unreliable without further qualitative context on the component categories.

This is one area in which the growing emphasis on emissions disclosures within the policy and regulatory landscape can provide much-needed clarity to the market, help to level the playing field and support investor decision-making.

Aggregation at portfolio level

Accounting for the same emission multiple times within one investment portfolio is an inherent consequence of the three-scope model of the GHGP, particularly where investors have exposure to multiple companies within the same value chain. For example, the emissions from driving a car could be counted under multiple companies that one investor is exposed to in its portfolio; the carmaker, the oil and gas company that produces and sells fuel, and the leasing company. The scope 1 of the auto manufacturer could be counted within the scope 3 of both of the other companies in this example, so the same emissions would be counted three times at the investment portfolio level. This problem is further compounded when considering the scope 3 emissions of investments in financial services companies, for whom the scope 3 of their own investments could be highly material.

Overall, double counting is inherent to the three-scope emissions accounting model when looking at multiple companies from a portfolio lens. This means that setting portfolio net zero targets on scope 3 could incentivise unintended outcomes – for example, investing in one company with a more integrated value chain to reduce the instances of double counting and therefore the overall emissions of the portfolio. In the example used above, an investor might be incentivised to invest in an auto manufacturer that also had an integrated leasing arm, to negate the double counting of those emissions between two separate entities. However, this is not necessarily the best outcome for combatting climate change nor for mitigating climate risk. Ultimately, it is important to recognise that the purpose of scope 3 data, even for one entity, is **not to assign emissions ownership but to assess its carbon exposure**, hence multiple entities can inherently be exposed to the same tonnes of carbon. Scope 3 accounting and target-setting at portfolio or fund level may not lead to real-world outcomes that help to reduce climate change, but it is important to understand these emissions at asset-level.

Incentivising outcomes

Greenhouse gas emissions at company level can help to represent the company's point-in-time impact on climate change, however it is well-recognised that this needs to be considered in the context of its overall transition strategy and whether its products and services will help to deliver a net zero economy. Measuring climate impact on point-in-time emissions alone could result in investment skewing towards companies in lower emitting sectors and away from companies in higher emitting sectors. This would happen regardless of whether they have a credible plan to support the transition, inherently limiting the ability of investors to influence emissions via engagement. This is better approached by looking at a company's emissions performance relative to its sector, as well as placing emissions in the context of other transition information, such as forward-looking climate targets and strategy¹¹.

¹¹ Climate Action 100+, <https://www.climateaction100.org/net-zero-company-benchmark/>

Similarly, higher scope 3 does not necessarily mean a worse climate impact¹². For example, assuming all scope 3 is properly accounted for by both companies, a company manufacturing a product that is durable and long-lasting could potentially have higher lifecycle emissions than a company that employs a ‘make to break’ strategy for a similar product that needs to be replaced more frequently. This would be inaccurate; instead the higher emissions of the first product are the result of its longevity. Such reporting may give a false impression that an investment in the latter company would be better for the climate, even though it produces an overall less sustainable product. Looking at emissions relative to industry- or product-specific intensity metrics can help to contextualise this.

Influencing scope 3 emissions

Companies are generally considered to have lower influence over their scope 3 emissions than their scope 1 and 2, however this varies under the company’s specific circumstances. For downstream emissions, where a company’s product is inherently carbon intensive in its use phase, the company can in principle control its scope 3 by controlling its production. For example, automakers transitioning from manufacturing Internal Combustion Engine (ICE) vehicles to electric vehicles (EVs), or energy companies shifting from fossil fuels towards providing renewable energy products and services.

With respect to upstream scope 3 emissions, mitigation primarily depends on the degree of influence the entity can have with its suppliers. Large companies that are prominent in their value chains in particular can play an essential role in driving the transition throughout their supply chains by encouraging their suppliers to innovate and compete. If a company is a significant customer of one of its suppliers, it can engage with that company, for example on improving the design of its products and services to reduce downstream emissions or end of life treatment. Where low-carbon alternatives are not yet developed, companies can also engage with industry initiatives to help new technologies to mature; for example customers reliant on cement or steel as input materials. This is also the case for carbon-intensive transportation and distribution emissions, such as those from shipping or aviation, in both upstream and downstream scope 3.

Another that causes variation in the level of influence over scope 3 emissions is proximity in the supply chain. Reporting entities tend to have a greater degree of transparency and communication with their tier 1 suppliers, but may struggle to access data and engagement opportunities with tier 2 and tier 3¹³ suppliers with whom they may not have a direct relationship. This lack of ability to influence can also be felt at investor level, due to the additional degree of removal from the emitting entity.

12 Robeco, <https://www.robeco.com/en-uk/insights/2023/09/the-problem-child-of-carbon-emissions-scope-3-part-one>

13 We Mean Business, <https://www.wemeanbusinesscoalition.org/business/the-supplier-cascade/>

The majority of sectors are also dependent on decarbonisation of the electricity grid to decarbonise. For example, auto manufacturers making electric vehicles require those vehicles to be running on zero-carbon electricity to be considered decarbonised themselves at company level. Further, when looking at the value chain as a whole, it is not always the biggest emitters that can drive the most impact or have the most influence.

More broadly, it is important to consider the different enabling environments within which companies, their supply chains and their customers operate, and the impact that a more supportive ecosystem, including but not limited to supportive policy and regulation, can have on facilitating progress in reducing emissions. One example might be a company whose supply chain sits broadly within jurisdictions with supportive climate policies in place. It will likely benefit from greater data transparency and quicker decarbonisation of its upstream scope 3, compared to a company that has a supply chain in jurisdictions without such policies. Despite no difference in action by the company, one could appear to have decarbonised its scope 3 emissions faster than the other.

Next steps

Scope 3 emissions are an essential part of understanding an individual company's impact on climate change. Whilst, as outlined in this paper, **aggregation** of scope 3 emissions at portfolio level leads to perverse outcomes, it is clear that **asset-level engagement** is an important lever that investors can use to understand and address these emissions within their portfolios.

By understanding the value chain emissions of portfolio companies, investors can better identify and prioritise engagement on decarbonisation. Whilst improvements to practical measures such as reported data and third-party estimations are needed over time, investors can start to deploy asset-level engagement on scope 3 emissions in material sectors and categories. However, there is a lack of comprehensive guidance on how best to approach scope 3 materiality assessment within portfolios.

This working group will reconvene for a second phase of work during the first half of 2024 to address the challenges outlined in this paper, building on existing work by both investors and industry groups to date. This will include an exploration of the materiality of scope 3 categories to different sectors and guidance on how investors can approach scope 3 emissions within their portfolios.

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