Report Launch: **Role of Supply Chain (Scope 3) Emissions in Decarbonization and Compliance**

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European Roundtable on Climate Change and Sustainable Transition

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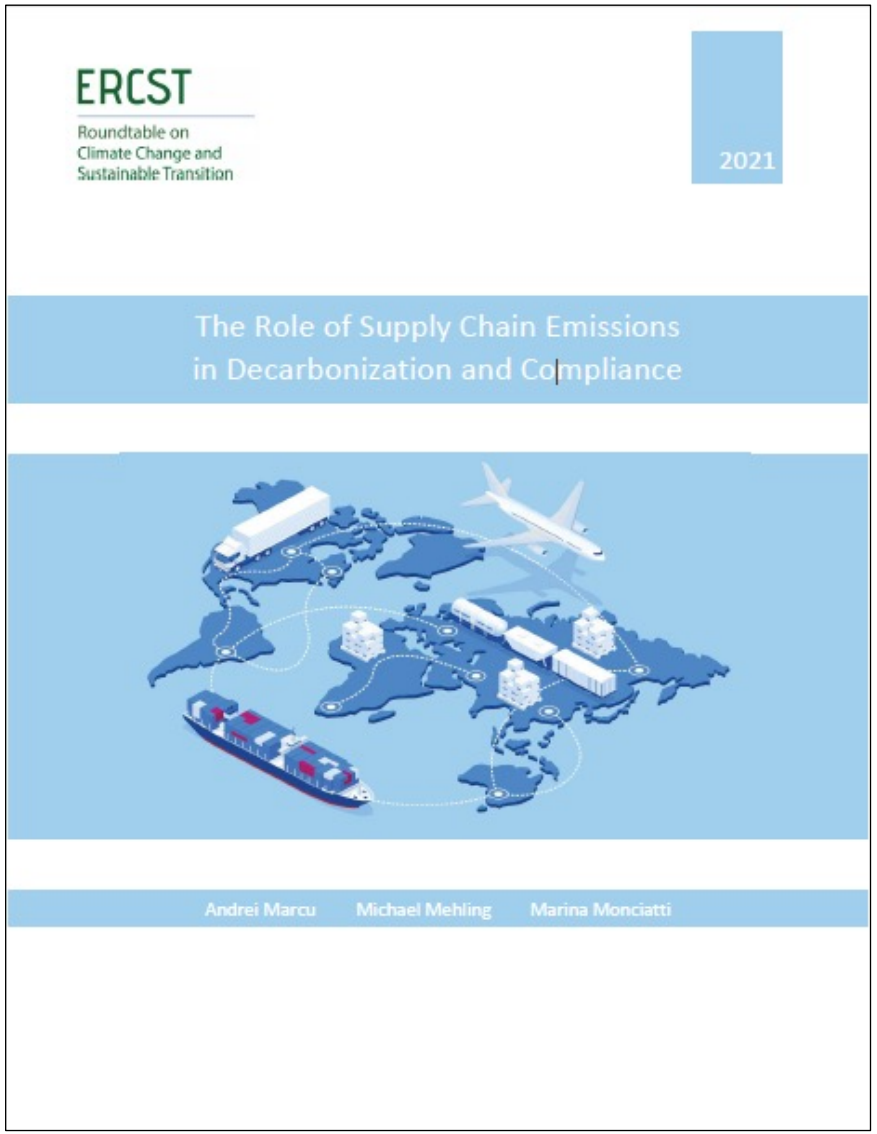
Report Structure



Putting Scope 3 emissions into context

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- **Scope 1:** **direct GHG emissions** from operations that are owned or controlled by the company; emissions from combustion in owned or controlled boilers, furnaces, vehicles, etc. or emissions from chemical production in owned or controlled process equipment;

- **Scope 2:** **indirect GHG emissions** from the consumption of purchased electricity, heat, steam and cooling; these emissions can be reduced by investing in energy efficiency or by switching to less GHG intensive sources of electricity; and

- **Scope 3:** all the other **indirect GHG emissions** that are a consequence of the activities of the company (in the value chain), but occur from sources not owned or controlled by the company.

- Greenhouse Gas Protocol - WRI, WBCSD
- Scope 3 emissions are also equated with the life cycle emissions of a product (Product Environmental Footprint (PEF) and Organization Environmental Footprint (OEF)) or simply referred to as “indirect emissions” of a company’s activities in other cases.

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Scope 3 emissions categories

No.*	Upstream categories	No.*	Downstream categories
3.1	Purchased goods and services	3.9	Downstream transportation and distribution
3.2	Capital goods	3.10	Processing of sold products
3.3	Fuel- and energy related activities	3.11	Use of sold products
3.4	Upstream transportation and distribution	3.12	End-of-life treatment of sold products
3.5	Waste generated in operations	3.13	Downstream leased assets
3.6	Business travel	3.14	Franchises
3.7	Employee commuting	3.15	Investments
3.8	Upstream leased assets		

Source: GHG Protocol Corporate Value Chain (Scope 3) Standard

- GHG Protocol provides different methods to measure and calculate Scope 3 emissions based on the data availability of each sector
- Most common: supplier specific method, hybrid method, average data method and spend based method

Supply chain emissions: an opportunity for mitigation

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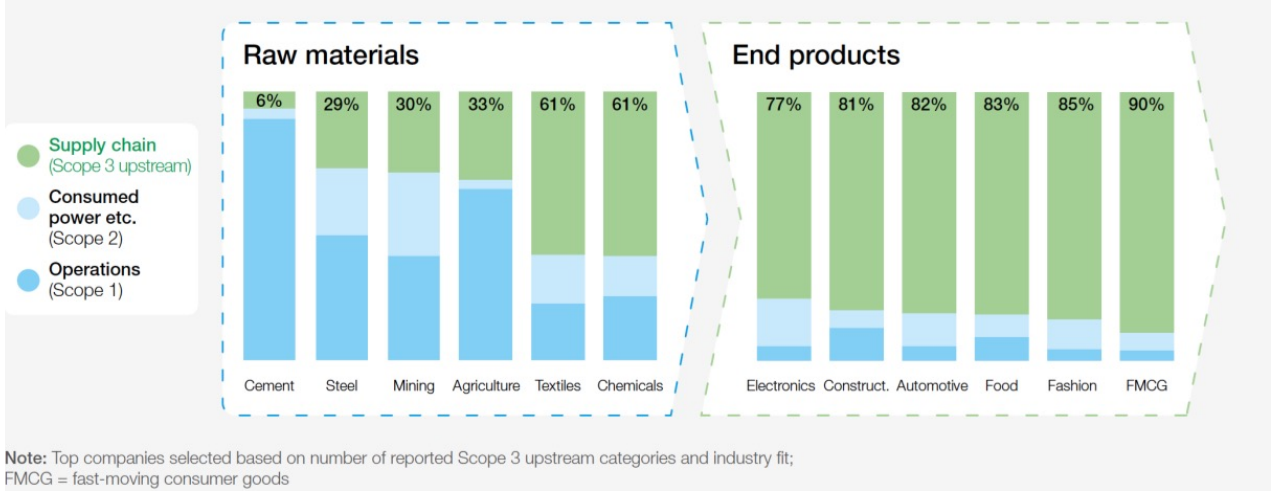
- A company's supply chain emissions (Scope 3) are on **average 5.5 times larger than its Scope 1 and 2 emissions** (CDP, 2019)

Figure 1. *Emissions in supply chains often exceed those in operations: emissions split in Scope 1, 2 and 3 upstream for selected industries (CO2e,2019)*



Note: Top companies selected based on number of reported Scope 3 upstream categories and industry fit; FMCG = fast-moving consumer goods

Source: *CDP, BCG (2021)*

- **Understanding the climate related risks and opportunities of a company's value chain matters**
- Companies will face up to **US$120 billion in costs from environmental risks in their supply chains by 2026** (CDP, 2021)
- **Risks:** regulatory, financial, reliability and business interruption, decreased demand for products and corporate reputation
- **Opportunities:** operational efficiency and cost savings, innovation driver, increased customer loyalty, improved stakeholder relations and company differentiation

Why supply chain emissions matter in a low carbon world

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Global level

- **Growing momentum** to reach **net-zero** emissions by mid-century. 58 countries have communicated a net-zero targets
- **Heterogenous process** and **asymmetrical abilities** to reduce emissions throughout supply chains
- In a world in which mitigation is lagging behind committed targets and time is of the essence, tackling supply chain emissions **can meaningfully accelerate decarbonization**
- Emission reductions along the supply chain can be challenging and come at a cost; **catalysing this potential will require incentives:**
  - **'Soft' incentives** from shareholder pressure and evolving consumer demand (TCFD, SBTi)
  - Even though soft incentives have an important role to play, they will likely not trigger the full potential for supply chain emission reductions: **that requires policies**

Currently at EU level, Scope 3 emissions don't fall under any specific legislative file

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EU level

- **In the EU**, the forthcoming Climate Law and the intermediate target for 2030 make clear to corporations that **all emissions will need to tend towards zero in the longer term,** and if they are not already regulated now, they will eventually
- **Opportunity space for voluntary commitments** will decline and at some point **have to disappear**
- Legislation currently governing EU climate ambition is primarily **focused on Scope 1 emissions**, and to **some extent on Scope 2 emissions** (e.g. through requirements for energy efficiency improvements or renewable energy targets)
- There is currently **no systematic approach for supply chain (Scope 3) emissions** in EU climate policy
- **Linkages**: EU Sustainable Finance Taxonomy, RED II (upstream emissions), CEAP
- At the same time, companies are facing **growing pressure from asset owners, customers, employees, lawmakers, and activists** to reduce emissions across their entire value-chain

ERCST's work on supply chain emissions

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- In view of the growing importance of addressing supply chain emissions, ERCST has embarked on an exploration of the main issues and options regarding how to identify and measure these emissions, and **what role they should play in the transition to a low-carbon future**
- Focusing on the following questions:
  - How reductions of Scope 3 emissions can be incentivized;
  - If, how, and under what circumstances these incentives can increase flexibility for those that have existing (Scope 1) compliance obligations; and
  - How methodological challenges – such as attribution and accounting of supply chain emissions and their reduction – need to be understood and resolved
- **Launched the workstream** on supply chain emissions in late 2020
- **3 Workshops with stakeholders** including key actors from different industry sectors (cement, chemicals, steel, oil & gas and others), government actors, consultancies, industry associations, think tanks
- **Consultations with Member States**: Sweden, Spain, France, Poland, Czech Republic and Netherlands

Identified conceptual and methodological issues

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1. Measurement and attribution of supply chain emissions

- Measuring supply chain emissions can be a challenging task, with often fragmented supply chains distributed across different countries and from Tier 1 to Tier n suppliers
- Not many companies measure and disclose their entire Scope 3 emissions, and when they do, they are often forced to rely on unreliable data or industry average emission factors

2. Additionality of supply chain emission reductions

- Incentives only make sense if these reductions would not otherwise happen, or are already required from another emitter as Scope 1 or 2 emission reductions
- This has been a controversial and methodologically intractable concept that emerged in baseline-and-credit approaches (e.g. CDM, Art 6.4 of the Paris Agreement)

Identified conceptual and methodological issues (2)

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3. Accounting for supply chain emission reductions

- By definition, one actor's Scope 1 emissions are Scope 3 emissions for a number of other actors
- Scope 3 emissions can take place in different jurisdictions
- More than one actor could claim credit for supply chain (Scope 3) emission reductions, and there are currently no clear guidelines specifying how this attribution should take place in order to avoid double counting

4. Allocating the Benefits of Supply Chain Emission Reductions

- It is critical to understand how to attribute emission reductions as a Scope 3 reduction in a value chain
- To attribute Scope 3 emissions reductions, there will need to be certain requirements that have to be considered, including rules to address the following – not necessarily exhaustive – list of issues:
  - Has an entity claiming the reductions taken action?
  - Has that action been additional - has it already been incentivized through a regulatory mechanism?
  - Was the action the result of another incentive, such as a[nother] voluntary commitment?
  - Is there another benefit to be derived from having taken the action – is this a disqualifying condition?

Steps for reducing supply chain emissions

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Understading the supply chain
Its characteristics beyond Tier 1 suppliers

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Identifying emission sources
Carried in conjunction with suppliers and end-users

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Measuring emissions
GHG Protocol Corporate Value Chain Standard, PEF or OEF, and ISO 14064-1 Standard

↓

Reporting emissions
Company level, national level (UK SECR, FR Bilan GES, etc.), voluntary initiatives (CDP, etc.)

↓

Setting targets
Company level, voluntary initiatives (SBTi)

↓

Designating abatement measures and reducing emissions
More efficient supply chains, switching suppliers, improving circularity, carbon offset projects, removals, etc.

Taking Stock: Scope 3 Frameworks and Initiatives

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- Organizations taking on voluntary commitments - including Scope 3 emissions reductions - that in excess of their regulatory obligations
- In many cases, these organizations are the only ones that possess the resources, capacity, and technological know-how to undertake such emission reductions
- While these voluntary emission reductions can already be impressive, they are nevertheless only a fraction of the reductions that could likely be achieved by offering robust incentives

Voluntary frameworks

Voluntary frameworks/initiatives	Function
GHG Protocol Corporate Value Chain (Scope 3) Standard	*Accounting and measurement*
ISO (International Organization for Standardization) 14064-1 Standard	*Accounting and measurement*
Small and medium-sized enterprises (SMEs) Climate Hub	*Accounting, measurement and setting targets*
Carbon Disclosure Project (CDP)	*Disclosure and reporting*
Science Based Targets Imitative (SBTi)	*Setting targets*
Task Force on Climate-related Financial Disclosure (TCFD)	*Financial Disclosure*
PAS 2060 (by British Standards Institute)	*Standards*
ISO/WD 14068 Carbon neutrality	*Standards*
EU Product and Organization Environmental Footprint (PEF and OEF)	*Standard*
Coalition on Materials Emissions Transparency (COMET)	*Accounting and measurement*
Global Logistics Emissions Council (GLEC) Framework	*Accounting, measurement and reporting*
Race to Zero by the UNFCCC	*Coalition and network of net zero init.*

Source: ERCST (2021)

Compliance frameworks

United Kingdom:

- Streamlined Energy and Carbon Reporting (SECR) policy

France:

- *Bilan d'Émissions de GES under the Grenelle II Law n°2010-788* Article 75

Australia:

- National Greenhouse and Energy Reporting Act 2007 (NGER Act)

Scope 3 emissions reporting are recommended, but remain voluntary

Existing Initiatives at Member State Level

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Spain

- *Spanish Registry of Carbon Footprint, Offsetting and CO_2 Removal, Royal Decree* – voluntary scheme which includes Scope 3 emissions
- *Spanish Climate Change and Energy Transition Law 7/2021, Article 32 point 5.e)* - listed companies to integrate climate change risk including direct and indirect emissions
- Some autonomous communities in Spain, including Baleares and Catalunya, are considering making reporting of Scope 3 emissions mandatory

France

- *Law n°2010-788, Bilan d'Émissions de GES, Grenelle II* – reporting of Scope 1-2 mandatory and Scope 3 recommended
- *Law 2015-992*, *Transition Energétique pour la Croissance Verte*, *Article 173* requires listed companies to disclose financial risks related to the effects of climate change, including disclosure of material elements of their indirect (Scope 3) emissions
- *Decree n°2021-1004 on energy and environmental performance requirements of building constructions in France* - standard for all new build developments on their maximum carbon footprint
- Provision in the *French Climate Law No. 2021-1104 of August 22, 2021, Article 12* – on carbon neutrality

Netherlands

- Stimulation of sustainable energy production and climate transition (SDE++) – subsidies including for CCS and CCU
- *Contemplating different options that would enable the deployment of innovative low carbon technologies and scale up the circular economy at industrial level*

Sweden

- *Investing in innovative technologies for the production of high-performing low-weight steel, there is no reward or crediting scheme that would compensate for such costs*

Options for the provision of Scope 3 incentives

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Subsidies and Sate Aid Regulation for Scope 3 incentives

- Incentivizing deployment of low carbon technologies via State aid guidelines for Energy and Climate

Scope 3 incentives related to the EU Emissions Trading System (ETS)

- Operationalizing Art. 24a of the EU ETS Directive (Domestic Offset Projects)
- Including Scope 3 emissions in the EU ETS
- Carbon Capture and Storage (CCS) and Carbon Capture and Utilization (CCU)
- New market-based instrument in a non-covered sector (e.g. waste) which could be linked to EU ETS
- A new supply-chain Emissions Trading System (ETS)
- Carbon Storage Obligations (CSO)

Scope 3 incentives in the Sustainable Finance Agenda

- Sustainable Finance Taxonomy: expanding LCA requirements
- Expanding companies' reporting obligations
- Making credit ratings dependent on emission performances

Other approaches

- Creating a market for low-carbon products
- Including Scope 3 Criteria in EU Environmental and Human Rights Due Diligence for Supply Chains
- Acceptance of Carbon Inset Investments as a viable means for Scope 3 Emission Reductions

Scope 3 Incentives related to the EU Emissions Trading System (ETS)

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Scope 3 incentives in the Sustainable Finance Agenda

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- Sustainable Finance Taxonomy: Expanding LCA requirements
  - Companies that will claim to be taxonomy compliant will have to use LCA methodologies to prove their alignment with the EU Taxonomy
- Expanding Companies' Reporting Obligations
  - CSRD - introducing more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards.
- Making Credit Ratings Dependent on Emission Performance
  - Including Scope 3 in the guidelines on disclosure requirements for credit ratings agencies - European Securities and Markets Authority (ESMA)

Other Approaches

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- Creating a Market for Low-Carbon Products
  i. Sustainable products policy initiative (SPI) including a revision of the Eco-design Directive to widen its scope beyond energy-related products
  ii. Ensuring applicability of the initiative on substantiating green claims across the entire value chain (PEF and OEF)
  iii. Mandatory green public procurement (GPP) criteria and targets in sectoral legislation
  iv. Providing financial incentives for companies to increase the uptake of low-carbon inputs and materials throughout their value-chain
  v. Introducing a consumer charge based on the carbon intensity of products; and,
  vi. Carbon contracts for differences (CCfD)

Related to new CEAP

- Including Scope 3 Criteria in EU Environmental and Human Rights Due Diligence for Supply Chains
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Outlook and Recommendations

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- Providing incentives could leverage the **decarbonization efforts of certain hard-to-abate sectors** that are currently struggling to decarbonize at the required speed
- Not all emitters are equally equipped with resources and knowledge to reduce emissions, and ambitious climate policies also create winners and losers. **Creating incentives** for supply chain (Scope 3) emission reductions **can help leverage** the **greater financial, technical, and human resource capacities** of important stakeholders to accelerate emission reductions in their supply chain which would not otherwise be feasible due to lack of capacities
- **'You cannot reduce what you cannot measure':** it is pivotal that companies have the right tools and frameworks available for measuring their supply chain emissions
- The **risk of double counting** and other types of overlap with voluntary commitments (e.g. SBTi) and existing mitigation policies should be carefully assessed and **addressed when designing these policy incentives**

Outlook and Recommendations (2)

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- Due to the complex nature of Scope 3 emissions, it would be virtually **impossible to find a one-size-fits-all mechanism** for Scope 3 reductions. Instead, **solutions should be looked at on a sector-by-sector basis**
- **Addressing value chain emissions** and providing incentives **at the European level would avoid asymmetries and allow for harmonization across Member States**. Nevertheless, if a specific solution works better at a different governance level – e.g. Member State, regional or local – it should not be dismissed on that basis
- While selected policies in the EU currently deal with upstream supply chain emissions of certain sectors (e.g. SF, RED II), it is **critical that policy incentives are designed to also deal with downstream emissions**
- The **importance of circularity** and a circular carbon economy **should be examined for its contribution to the Paris Agreement**

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Thank you!

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