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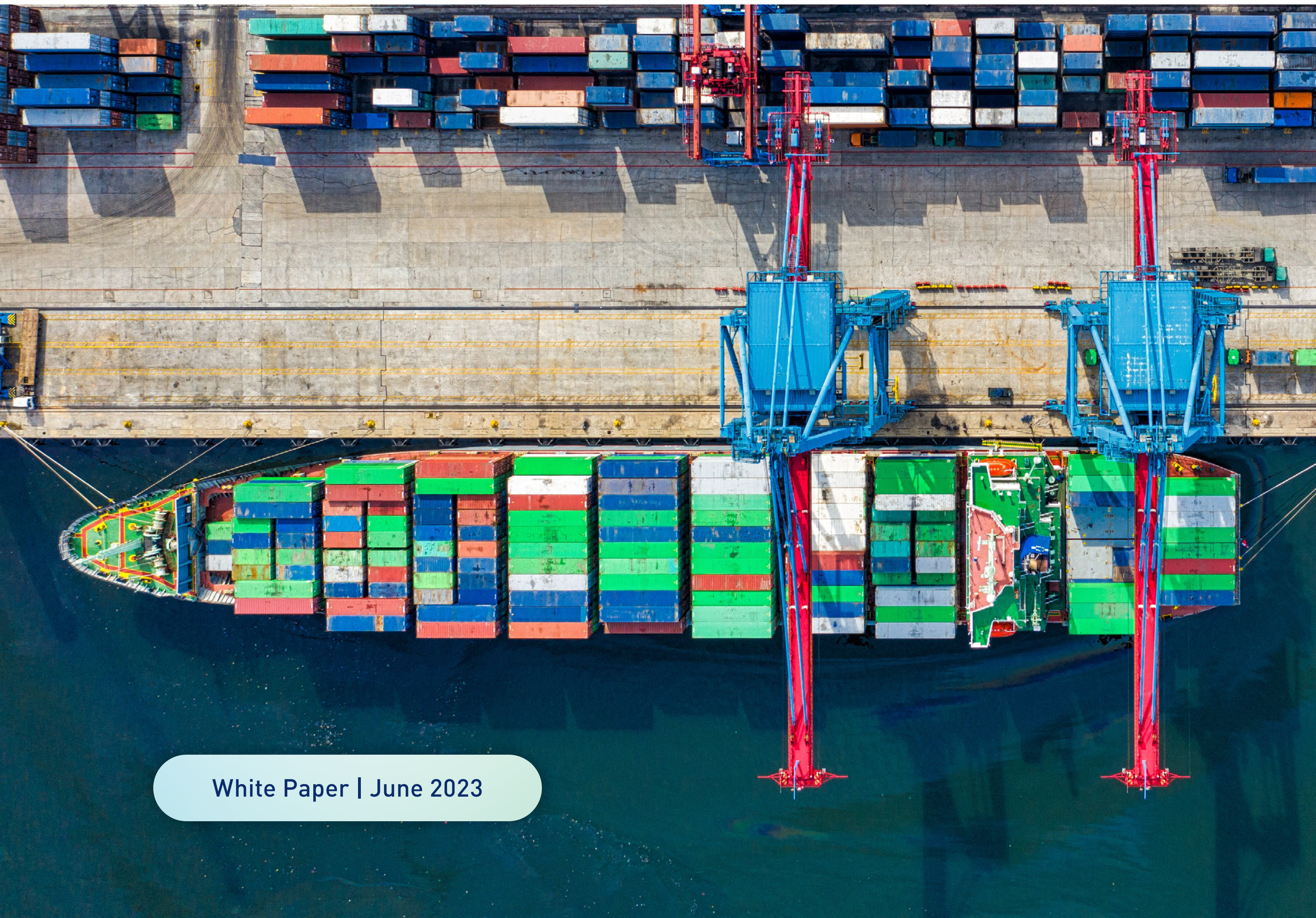
ESG SOLUTIONS

SCOPE 3 REPORTING AND THE SEC

Defining Materiality Under the SEC's Proposed Rule



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Introduction

In recent years, governments globally have enacted ESG-related disclosure regulations on companies that operate within their borders in an effort to increase accountability around climate risks and impacts.

A 2022 rule proposed by the U.S. Securities and Exchange Commission (SEC) would do just that—require publicly traded companies to report on greenhouse gas (GHG) emissions and reduction efforts, and include these reports in their financial statements. This reporting requirement would be standardized, pulling questions from the Taskforce for Climate-related Financial Disclosures (TCFD) and using standards for GHG accounting and reporting created by the Greenhouse Gas Protocol.

This white paper explores what the SEC ruling could mean for scope 3 emissions reporting among registered companies as well as how you can prepare for potential upcoming changes, including:

- Understanding scope 3 emissions categories
- Defining materiality under the SEC
- Determining if a scope 3 category is material to your company
- Envisioning a path forward in a world that's shining a spotlight on climate and carbon risk

SCOPE 3 EMISSIONS

As defined by the GHG Protocol, scope 3 emissions are indirect emissions that occur upstream and downstream in the value chain, with sources such as materials suppliers, product transportation and distribution, and employee commute. These indirect emissions often make up the vast majority of a company's total reported emissions.

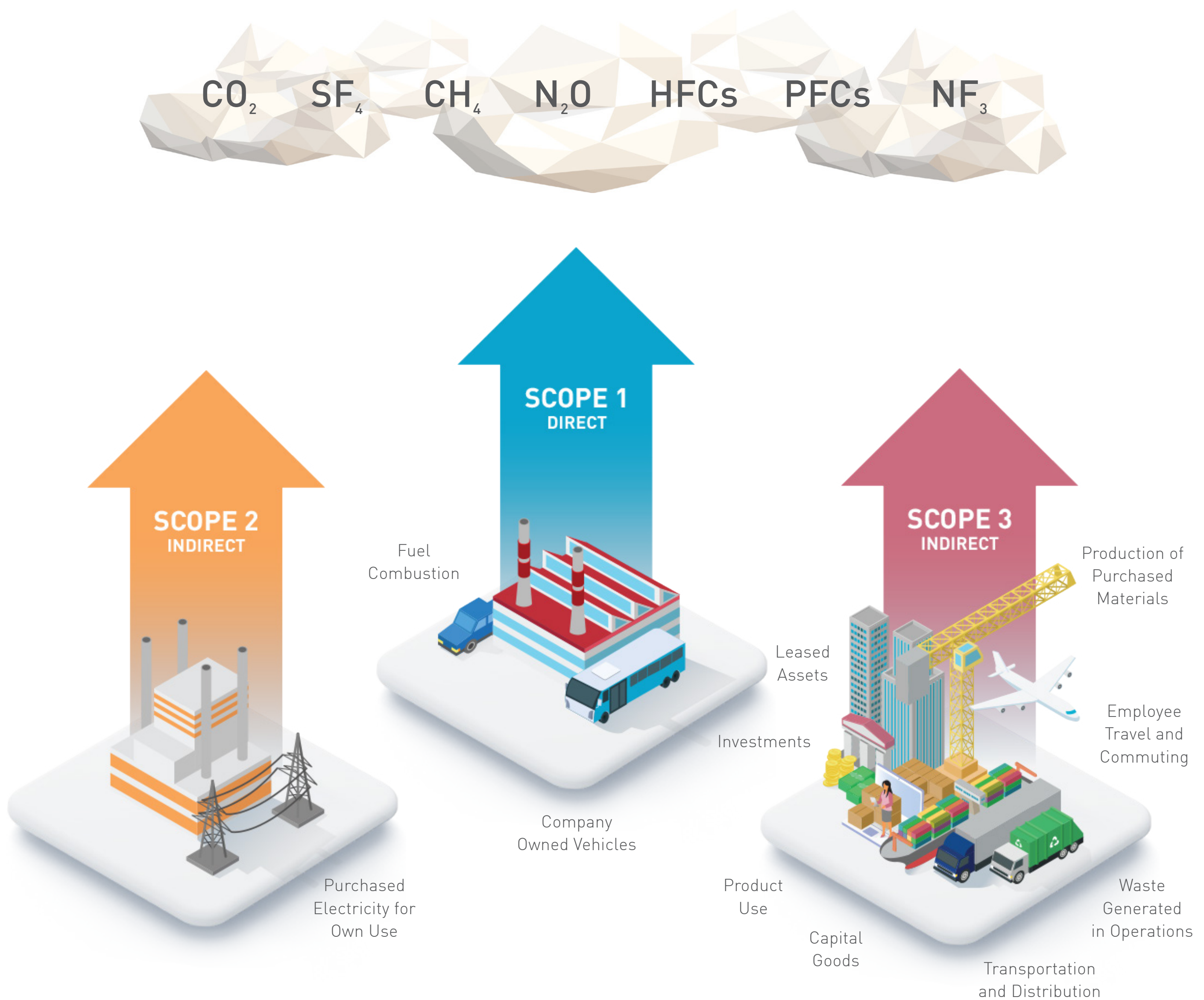
Why standardized disclosures?

To fulfill its role in protecting investors, the SEC is taking steps to enhance and standardize climate-related disclosures for its registered companies. Over the past few years, investors and shareholders have already begun imposing similar action on individual companies—in the form of climate reporting requirements, ESG-related shareholder proposals, and other asks—to ensure that investors are able to make informed decisions and ensure that companies are managing their climate-related risks and opportunities.

Scope 3 within the SEC's proposed rule

In early 2022, the SEC proposed rule changes that would require registered companies to prepare climate-related disclosures in registration statements and report filings.[1] The required disclosures would include information such as governance of climate-related risks, how these risks impact business strategy and outlook, how low-carbon transition activities impact financials, and GHG emissions disclosures.

If formally adopted, these GHG emissions disclosures would require reporting on scope 1 and 2 emissions for all companies and scope 3 emissions for *certain* companies, depending on materiality and company revenue. Companies required to disclose scope 3 emissions would be given an additional year to comply with these requirements.[2]



Potential legal challenges

If adopted as a final rule, the proposal is likely to face challenges from a number of parties, including affected companies, industry groups, and state officials. Existing opposition cites issues such as the SEC's limited authority,[3] the use of a third-party climate disclosure standard setter needing congressional approval,[4] and the inclusion of scope 3 reporting requirements,[5] arguing that scope 3 emissions are difficult to calculate and disclose.

THE CASE OF CALIFORNIA

Even if the SEC decides not to include scope 3 reporting requirements in its final rule, states like California may. Introduced in the California Senate on January 30, 2023, the California Climate Accountability Package is a suite of bills that "work together to improve transparency, standardize disclosures, align public investments with climate goals, and raise the bar on corporate action to address the climate crisis."[6]

Comprised of three bills—the Climate-Related Financial Risk Act (SB 261), the Climate Corporate Data Accountability Act (SB 253), and the Fossil Fuel Divestment Act (SB 252)—the Climate Accountability Package would impose much more significant climate disclosure-related obligations on companies doing business in California with total annual revenues over $500 million. In terms of scope 3, SB 253, in particular, would require all large corporations doing business in California to submit GHG emission disclosures aligned with the GHG Protocol—including scope 3 emissions. Disclosures would also need to be independently verified.

How to prepare

This instance of federal action is not an isolated change. Governments and investors globally are also calling for greater accountability on climate-related risks[7], and the SEC is merely taking steps to better align with investor interests and the ESG-related regulatory action already being taken worldwide. As the requirements for GHG emissions reporting continue to grow, companies should begin preparing as soon as possible. The time for action is now.

How do you know if your company will fall under the SEC's scope 3 reporting requirement? What steps can you take to understand what scope 3 categories are material to your organization?

Due to the breadth of scope 3 emissions sources and the potential difficulties involved in obtaining value chain data, completing a comprehensive scope 3 GHG inventory can prove challenging. However, establishing early communication with the right stakeholders and taking steps to understand and manage your company's scope 3 emissions data will put your organization on the path to resilience—before any regulations have even taken effect.

Next, we'll review how to evaluate what scope 3 categories are material to your organization and how to move forward in the face of an evolving regulatory environment.

Categorizing Scope 3 Emissions

The first step in putting together a scope 3 GHG inventory is understanding what scope 3 emissions are material to your organization. The GHG Protocol breaks down scope 3 emissions into fifteen standard categories—eight upstream and seven downstream. To help you understand the scope 3 categories before we dive into assessing the materiality of each, definitions of the categories have been provided below.

Scope 3 Categories and Definitions[8]

UPSTREAM

	Category	Definition
1.	**Purchased Goods and Services**	Emissions from the production of products/services purchased or acquired in the reporting year.
2.	**Capital Goods**	Emissions from the *production* of capital goods (or capital assets) purchased or acquired in the reporting year. Emissions from the use of capital goods by the reporting company are accounted for in either scope 1 or 2, rather than in scope 3.
3.	**Fuel-and-Enegy-Related Activities**	Emissions related to the production of fuels and energy purchased and consumed in the reporting year that are not included in scope 1 or 2.
4.	**Upstream Transportation and Distribution**	Emissions from transportation and distribution of *products purchased* in the reporting year between a company's tier 1 supplier and its own operations. Also includes emissions from transportation and distribution of *services purchased* in the reporting year, including inbound logistics, outbound logistics, and transportation and distribution between a company's own facilities in vehicles and facilities not owned or controlled by the reporting company.
5.	**Waste Generated in Operations**	Emissions from third-party disposal and treatment of waste generated in owned or controlled operations in the reporting year. This includes emissions from disposal of both solid waste and wastewater.
6.	**Business Travel**	Emissions from the transportation of employees for business-related activities in vehicles owned or operated by third parties. Companies may optionally include emissions from business travelers staying in hotels.
7.	**Employee Commuting**	Emissions from the transportation of employees between their homes and their worksites. Companies may include emissions from teleworking/remote work in this category.
8.	**Upstream Leased Assets**	Emissions from the operation of assets that are leased by the reporting company in the reporting year and not already included in the reporting company's scope 1 or scope 2 inventories. This category is applicable only to companies that operate leased assets (i.e., lessees).

Scope 3 Categories and Definitions[8]

DOWNSTREAM

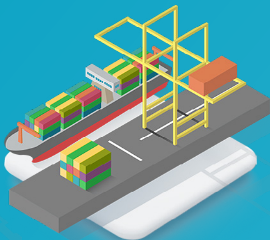
Category	Definition
9. Downstream Transportation and Distribution	Emissions that occur in the reporting year from transportation and distribution of sold products in vehicles and facilities not owned or controlled by the reporting company. This also includes emissions from retail and storage.
10. Processing of Sold Products	Emissions from the processing of sold intermediate products by third parties (e.g., manufacturers) after sale by the reporting company. Intermediate products are products that require further processing, transformation, or inclusion in another product before use.
11. Use of Sold Products	Emissions from the use of goods and services sold by the reporting company in the reporting year. A reporting company's scope 3 emissions from use of sold products include the scope 1 and scope 2 emissions of end users (consumers and business customers). Companies may optionally include emissions associated with maintenance of sold products during use.
12. End-of-Life-Treatment of Sold Products	Emissions from the waste disposal and treatment of products sold (in the reporting year) at the end of their life. This category includes the total expected end-of-life emissions from all products sold in the reporting year.
13. Downstream Leased Assets	Emissions from the operation of assets that are owned by the reporting company (acting as lessor) and leased to other entities in the reporting year that are not already included in scope 1 or scope 2. This category is applicable to lessors (i.e., companies that receive payments from lessees).
14. Franchises	Emissions from the operation of franchises not included in scope 1 or scope 2. This category is applicable to franchisors.
15. Investments	Emissions associated with the company's investments in the reporting year only, not already included in scope 1 or scope 2. This category is applicable to investors, financial services providers, and investors that are not profit driven (e.g., multilateral development banks).

SCOPE 3
EMISSIONS CATEGORIES

1. **Purchased goods and services**

2. **Capital goods**

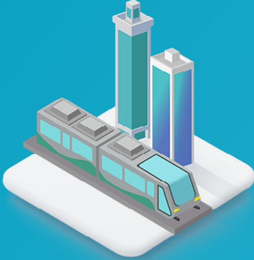
3. **Fuel- and energy-related activities (not included in scope 1 or 2)**



4. **Upstream transportation and distribution**

5. **Waste generated in operations**

6. **Business travel**



7. **Employee commuting**

8. **Upstream leased assets**

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**

Source: Greenhouse Gas Protocol. Technical Guidance for Calculating Scope 3 Emissions (version 1.0)

What's Considered Material?

According to the SEC ruling, a topic is material if "there is a substantial likelihood that a reasonable investor would consider it important when determining whether to buy or sell securities or how to vote."

It also advises that a materiality determination should be made with both quantitative and qualitative considerations. Magnitude and materiality over the short, medium, and long term should also be considered.

Determining materiality

The GHG Protocol provides a helpful starting point when assessing the materiality of scope 3 activities. The six criteria for identifying relevant scope 3 categories are:[9]

- **Size**: Activities in this category make up a significant amount of the company's total scope 3 emissions.
- **Influence**: The company can make potential emissions reductions within this category.
- **Risk**: This category contributes to the company's risk exposure, including reputational, regulatory, supply chain, or customer risks.
- **Stakeholders**: Key stakeholders consider activities within this category critical.
- **Outsourcing**: Activities within this category are outsourced, when they were previously or typically performed in-house.
- **Sector guidance**: This category has been identified as significant by sector-specific guidance. For example, the World Business Council for Sustainable Development's guide for electric utilities identifies scope 3 category 3 (Fuel- and energy-related activities) as "very high" materiality.[10]
- **Other**: This category meets other criteria for determining materiality, as developed by the company or industry sector.

The relative size of each scope 3 category along with an assessment of the six criteria listed will help determine which scope 3 categories are material to your organization.

Example: Assessing a category by Size

Once potentially relevant categories have been identified through a review of company operations, a spend-based screening analysis can be conducted to further understand the relative contribution of each scope 3 category to an organization's total scope 3 GHG emissions. Spend-based scope 3 GHG emissions inventories are the quickest way to inform the "Size" criteria for identifying relevant scope 3 categories.

Using the U.S. Environmental Protection Agency's (EPA's) GHG equivalencies calculator, we can determine emissions using the equation below:[11]

Referencing the EPA's supply chain GHG emission factors dataset[12], the following example calculates emissions from scope 3 category "Purchased Goods and Services" for a company purchasing "Computer and Electronic Products" in the reporting year.

Emissions Factor: 0.0927 kg CO_2e/2021 USD

USD spent on Computer and Electronic Products: $1,000,000 USD

Calculation: $1,000,000 USD x 0.0927 kg CO_2e/2021 USD **=** 92,678.41kg CO_2e

MATERIALITY

What does it mean when a scope 3 category is material to your company? Broadly speaking, "material" categories are those that are relevant and impactful to your organization and its stakeholders—in this case, we're talking about your investors. Materiality also changes over time, and what's material to you now may not be material to you in the future, and vice versa.

A Path Forward

Identifying which scope 3 GHG emissions categories are material to your organization is the first step in planning for potential future disclosure requirements.

This process will identify where to focus your efforts for scope 3 reporting in the near term. While material categories should be your priority, keep *all* categories in your peripheral vision, as they may be subject to regulation in the future, as we are seeing with pending regulation in California.

After material categories are identified, the next step is to conduct research to identify activity data that can be used to prepare more accurate GHG emission estimates. The activity data required for the emissions calculations depends on the reporting category and nature of your business operations. Scope 1 (direct) and scope 2 (indirect) GHG emissions data from vendors within your supply chain are a key component for calculating accurate scope 3 GHG emissions inventories for many organizations.

How can you improve supply chain data?

Work to collect better activity data from your suppliers by investing in supplier engagement. This will help streamline scope 3 data collection in the future, make your job much easier, and ensure more accurate data in the future.

Understanding the operations of your suppliers is an important step in ensuring that their scope 1 and scope 2 emissions data are accurate and complete. Encouraging key vendors to have their GHG emission inventories externally audited will ensure that the data are correct.

Higher levels of scrutiny around corporate GHG emissions are likely to continue on an upward trend as global regulators seek to increase transparency, protect investor interests, and mitigate the impacts of climate change. Now, more than ever, it is vital that organizations take steps to account for and understand their emission profiles, as well as take steps towards emission reductions.

ADEC ESG Solutions is a leading provider of sustainability services that help you track, understand, report on, and mitigate your GHG emissions. We work with organizations across the globe, spanning all industries, to develop impactful ESG strategies and initiatives to stay ahead of evolving regulations and best practices.

Contact our team to learn more about how we can support your ESG programs and be prepared for any challenge that lies ahead.

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