

## Takeaways from SEC Climate Disclosure Discussion

### *Scope 3 (+ financed) emissions, Science-based targets, and Carbon offsets*

*Hosted 3/1/22 by Americans for Financial Reform and Public Citizen.*

*Opening remarks were provided by Cynthia Cummis (World Resources Institute, GHG Protocol, Science Based Targets Initiative), Ivan Frishberg (Amalgamated Bank), and Danny Cullenward (CarbonPlan).*

[Note: The SEC issued its [climate disclosure proposal](#) on March 21, 2022. Comments are due May 20, 2022. The proposal includes GHG emissions but Scope 3 emissions and financed emissions must only be reported if issuers deem them material or if they've set a public Scope 3 target. Also, issuers are required to answer, if applicable, how carbon offsets factor into their risk management and strategy and certain details about their offsets including: the amount of carbon reduced or avoided, the source of the offsets, a description and location of the underlying projects, any registries or other authentication, and cost.]

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### **General**

- This SEC effort is about getting investors the info they need to make wise decisions, and to promote efficiency in the capital markets. Right now investors are wasting tons of time and resources investigating unreliable climate claims and data, asking companies for more information, and using shareholder engagement to obtain disclosures that are generally incomparable and incomplete. We should frame recommendations in the language of the information gaps that currently exist due to inconsistent, voluntary reporting.

### **Scope 3 Emissions and Science Based Targets**

- **Takeaway: Scope 3 accounting and emissions target setting is technically feasible for all public companies and not overly burdensome.**
- GHG Protocol (f. 1998) was the first ever standard developed for companies to measure and disclose their corporate-level greenhouse gas emissions.
- The standard for Scopes 1 and 2—emissions from company operations (Scope 1) and purchased electricity, heat, and steam (Scope 2)—was published in 2001.
  - Scope 3 is everything else upstream and downstream of a company's operations – the full value chain emissions from all the goods and services a company buys and sells within a given inventory year.
- In 2011, GHG Protocol published the Scope 3 accounting and reporting standard along with a product life cycle accounting and reporting standard. Since then there has been broad uptake of these standards—they are the most commonly-used standards across the corporate sector—thousands of companies across the world use them.
- The Science Based Targets Initiative (SBTI) – launched in 2015 – requires all companies to do a complete Scope 3 inventory and set targets when those emissions are significant (i.e., when over 40% of a company's total emissions are in Scope 3).

- Since that threshold came into place for SBTI, there has been much broader adoption of the Scope 3 GHG Protocol standard.
- The goal of SBTI is to make ambitious target-setting in line with the Paris agreement a standard practice around the world, and 2500 companies in many sectors have now made a commitment to set a science based target. About 1200 targets have now been validated by SBTI, with 100's of them coming from US companies. All these companies have done a full Scope 3 inventory and 95% of companies with validated science based targets hit the 40% threshold for needing to set a Scope 3 target.
- An aggregate total of scope 3 emissions is less meaningful and comparable than granular disclosure of the 15 categories of Scope 3 emission in the GHG Protocol.
- GHG corporate inventories were created to record a company's GHG inventory over time to track progress on reducing emissions. They were not initially intended to provide company-by-company comparisons, so the context and additional disclosures about how the company calculated its inventory, what choices it made, and underlying assumptions is an important part of reading these disclosures for comparability.
- There are lots of efforts and tools in place now to help companies tackle challenges regarding data quality and lack of transparency in supply chains.
- Scope 3 accounting can help companies and investors understand where the biggest climate impacts and risks are in their value chain and focus their reduction efforts (as part of their broader climate strategy) in the right place, and companies don't need perfect data to do that, especially for the small emission sources where companies are not going to focus their attention and which don't create large amounts of financial risk.
- For net zero plans, the focus must be on decarbonization. SBTI doesn't even allow offsets to meet science based targets—and nearly all companies need to plan to nearly fully decarbonize by 2050 to be certified.

### **Carbon Offsets and Carbon Removal**

- There are major integrity problems in the carbon offsets market. Offsets often do not deliver the purported climate benefits, and while the SEC can't solve those integrity problems, it can get investors the information they need to judge the credibility of offset claims and make wise decisions in public markets.
- Carbon offset registries—the organizations that issue carbon offset standards—track in public registries how many offsets have been issued under which protocol, but they don't disclose who claims the benefit of the offset. If you want to know what types of offsets companies are using in order to judge credibility, the SEC could require companies to disclose the project numbers so investors can look up on the registry the type of offset and other details about the project by issuers.
- It's essential that companies report their gross emissions separate from offset emissions, not lumped together.
- SEC should also standardize offset disclosure, including separate reporting of offsets based on "avoided emissions" vs "carbon removal from the atmosphere." This distinction matters because net-zero climate standards generally prohibit using credits for avoided emissions.

- If a company buys and retires an avoided emissions offset (e.g., building a wind farm instead of a coal plant generates “avoided” emissions credits) that’s not carbon removal (e.g., planting a new forest or building a machine to pull CO<sub>2</sub> out of the atmosphere generates carbon removal credits). And, what you need eventually to hit global net zero emissions is carbon removal because of hard-to-decarbonize sectors of the economy and land use change emissions.
- The Partnership for Carbon Accounting Financials (PCAF) shows exactly how one can separately report gross emissions, total credit use, and the breakdown of avoided emission and carbon removal credits.
- SEC should also require disclosure of additional info about how long carbon is claimed to be stored, the duration of the contract involved.
- This information is already known by the issuers, it’s just not currently being disclosed, so it should be feasible and low cost to get that information to investors.

### **Financed emissions**

- The Partnership for Carbon Accounting Financials (PCAF) is an accounting and disclosure methodology for category 15 of the GHG Protocol Scope 3 inventory—called “financed emissions”—comprised of the Scopes 1, 2, and 3 emissions from companies that banks and other financial institutions are investing in or lending to.
- The North American PCAF standard was launched in 2019, and currently \$64 trillion in assets have committed to the PCAF standard, including major players like Blackrock.
- The most recent guidance from the Task Force on Climate-Related Financial Disclosures (TCFD) recommends the use of PCAF for measuring and disclosing financed emissions, and it is also referenced in new banking regulations in the European Union.
- There is no reason why financial institutions—particularly banks—can’t disclose financed emissions under PCAF in the first year of reporting under the new SEC disclosure regime. The SEC could make this an almost immediate requirement.
- One area that is still a challenge is incorporating clients’ Scope 3 emissions so PCAF has taken a phased approach for some asset classes.
- The PCAF standard is still expanding right now to include new asset classes like emissions removals, green bonds, and sovereign bonds, as well as new categories of financed emissions like insured emissions and capital markets—or ‘facilitated’ – emissions.

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**On how prescriptive the SEC will need to be in pointing to the GHG Protocol...** There is still a little bit of flexibility built into GHG Protocol (e.g., how you draw the boundaries around your company of which there are three methods – operational, financial, or equity share), and that’s why the standard requires a lot of disclosure around decisions and assumptions made—including on boundary drawing, what activities were excluded and why, what are the data sources, and what are the calculation methods? These details must also be disclosed along with the topline emissions numbers.

**On comparability vs flexibility...** The approach of the GHG Protocol accounting methodology – while providing *some* flexibility that requires disclosure of assumptions and methodological choices to provide a complete picture of climate risk – is not too different from current financial reporting in which companies make lots of assumptions that must be analyzed by auditors, analysts, and investors. Further, under SEC Regulation SK companies are currently required to report on the *quality of earnings*—including whether or not earnings are likely to be repeatable from year to year rather than an anomaly or influenced by temporary conditions. Requiring that same level of context for climate disclosures would be a way to encourage consistent GHG Protocol accounting methodologies from year to year. Still, specific sectoral guidance, standardized assumptions, or additional sectoral metrics may be needed to improve comparability of quantitative disclosures between companies within sectors. These issues—of company-by-company comparability and of year-to-year consistency—can be addressed via inquiries from Division of Corporation Finance, SEC enforcement, or if there is consistent noncompliance or heterogeneity among reporting, through Staff Accounting Bulletins, perhaps providing sector-specific requirements.

**On whether or not banks are able to collect the relevant data from clients to calculate and disclose their financed emission immediately...** Banks currently have lots of data available, for example they can find utility-linked emissions data for every mortgage on their books. Blackrock was able to produce a Scope 3 GHG inventory for financed emissions within a year of making the commitment by using MSCI data—which is sometimes inaccurate but at least provides starter estimates. Banks also have a much higher level of control of what information they seek and can obtain from clients: if the right financial reporting data is not delivered the bank will simply not lend to them—and this can include requests for climate-related data.

**On data quality...** The data quality is only going to improve as reporting begins, and the more rapidly we use it and consume it and build it into disclosure systems, the more quickly it will become more accurate and credible. Right now banks are mostly relying on true cost MSCI data because it's more uniformly available, though of modest quality. But, it could become much more rigorous with standardized reporting in SEC filings.

**On estimating fossil fuel Scope 3 emissions from existing reserve disclosures multiplied by an IPCC effective CO2 emissions factor...** This gets you part of the way towards estimating fossil fuel Scope 3 emissions, but you can't do any oversight of the scientific integrity of the claims without a Scope 3 inventory, using established accounting, and disclosure of the assumptions made. There are also lots of Scope 3 emissions that won't be captured by embedded emissions within products sold for these firms.

**On the fact that the recent IPCC report says carbon dioxide removal (CDR) should not be relied upon for more than residual emissions after emissions reduction efforts are exhausted...** Early modeling made grossly heroic assumptions about our ability to suck massive amounts of carbon out of the atmosphere and justify ongoing emissions. There has been important critical pushback on that way of thinking about this. When you are at the point where

you mitigate almost all of global emissions—there are still places where we don't quite know how to eliminate the last residual emissions—but this is a small part of the problem, probably about 10%. CDR will be a meaningful but small component of our long term mitigation plan, but there is also skepticism about how commercially feasible some of these technological solutions are.

SBTI, for example, takes an envelope of scenarios that are very conservative and relies as little as possible or not at all on CDR when making assumptions about how much companies need to decarbonize—and all companies have to decarbonize by 90% or more.

SEC will not weigh in on the debate of whether or not CDR claims are credible. The benefit from this disclosure exercise is generating a lot more data and accountability tools that we've never had before. It's important for the SEC to help investors know what kind of CDR is being purported for a particular offset scheme, for example.

**On separate reporting of offsets vs. offset derivatives, and the developing practice of rolling over offset futures contracts rather than retiring them...** The offset derivative market is 2 to 4 times the size of the offset market, and analysis of the major Chicago Mercantile Exchange carbon offsets product has shown that the underlying assets are largely poor quality, usually avoided emissions credits. This is a problem because the *retirement* of the carbon credit is what justifies the claim to the climate benefit, no matter the type of credit. Whatever people do on the secondary derivatives markets shouldn't matter unless some entity takes ownership of the credit and retires it. There are also quality issues about what's being put into carbon offset-based index funds. A simple solution to this is: a company can report to the SEC the use of the credit if, and only if, they retired the credit on the appropriate carbon registry.

**On the role of assurance and auditing...** There have been a few examples of reasonable assurance (alleged) of Scope 3 emissions by firms like Deloitte and some boutique firms, but there is no formal auditing standard endorsed by PCAOB. One possible outcome is requiring reasonable assurance on Scopes 1 and 2, and limited assurance on scope 3 or a phase-in of reasonable assurance on Scope 3 with a later compliance date. Two challenges for providing reasonable assurance for Scope 3 are that there is a fair degree of estimation based on standard activity emissions assumptions, and that many of the emissions will occur in the future (for example emissions that come from the end use of products produced within the current year). On the other hand, when you think about reasonable assurance in the SEC context, the financial statements have to have reasonable assurance and they are based almost entirely on estimates—including estimates about future cash flows. This may mean it's even more important to have an auditor look over because there is so much discretion involved in making estimates. It may help to have a third party look at the process under which the estimate was developed, and look at whether the assumptions were reasonable. There is a valuable role here for assurance for Scopes 1, 2, and 3.

**On whether the SEC should set a materiality threshold by requiring Scope 3 emissions disclosure for companies with over 40% of total emissions in Scope 3...** While all companies in all sectors should be able to complete the Scope 3 inventory now and disclose

their results, if there were certain sectors with small Scope 3 emissions making the case that it's not material, that *could* be a feasible approach. But, allowing issuers to decide if their Scope 3 emissions are material would be repeating the mistakes of the 2010 guidance, and likely lead to significant underreporting.