Intelligence MEMOS

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To: Canadian Security Administrators

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Re: **Let's Focus on Scope 1 Measures of Carbon Emissions**

The Canadian Securities Administrators (CSA) is seeking comments on its proposal for carbon emission reporting by firms listed on Canadian stock exchanges, part of the worldwide move to mandatory climate-related disclosure.

In its call for consultation two weeks ago, the CSA said it is considering allowing firms an option to disclose only Scope 1 emissions, namely emissions from sources owned or controlled by the disclosing company. This would allow firms to avoid disclosure of Scope 3 emissions, which are indirect or downstream emissions when consumers use the firms' products, and Scope 2 emissions, which single out high-emitting energy suppliers.

Some have been critical of permitting firms to opt out of disclosing Scope 3 emissions. However, the CSA's measures can be defended from the perspective that it is better to develop more precise, consistent and comparable Scope 1 measures since firms will need significant time, money and expertise to quantify such emissions.

It is better for Scope 1 emissions to be done well and have well-developed standards so that they can be included in some form of integrated reporting within audited financial statements or in Management Discussion & Analysis rather than simply in management commentary.

Audit assurance will likely not be cost-effective for anything but Scope 1 measures. Over time, a firm's efforts to reduce its own (Scope 1) emissions and investors' ability to benchmark and peer review firms in the same business will lead to a competitive drive to reduce emissions – both in absolute terms, relative to peer companies, and relative to earnings. A focus on well-developed, reliable and consistently reported Scope 1 measures will gradually flow-through to lower emissions reported under Scope 3.

A lack of control over upstream and downstream emissions could make for inaccurate and inconsistent Scope 3 metrics. In this context, Scope 3 disclosures will be the weakest link in a chain, potentially making the All-Scope measures less reliable and less useful.

In aggregate, disclosures of Scope 2 and 3 emissions count the same emission output multiple times over for most firms. For example, if Firm A bought hydro from Supplier B, then Supplier B would have to disclose its own emissions under Scope 1 and Firm A's emissions under Scope 3. Firm A, in turn, would have to report its own emissions under Scope 1, Supplier B's emissions under Scope 2, and Firm A's customer emissions under Scope 3. If measured correctly and disclosed consistently, it becomes obvious that both Firm A's and Supplier B's emissions are each double-counted in aggregate. In a complex and deep supply chain, the same emissions could be counted multiple times over, resulting in misleading measures of aggregate societal impact of carbon emissions. Double counting Scope 3 emissions would overstate the disclosed emission metrics of a vertically integrated firm in which different multi-jurisdictional subsidiaries also report separately.

As Scope 1 reporting is made mandatory, it will encourage downstream providers of goods and services to pay more for carbon-friendly inputs. For example, tenants may choose to rent facilities in a zero carbon certified building such as Toronto's Scotia Plaza, so that they can report lower Scope 1 emissions. In a competitive market for both investors and customers, tenants will be induced to consider their leasing costs as the total of financial cost of the lease plus emissions. Building owners may choose to undertake (positive net present value) capital upgrades to achieve zero carbon certification for their facilities with some assurance that they will be able to demand higher rents in a competitive market because tenants need to report lower Scope 1 emissions.

Mandatory disclosure of reliable Scope 1 emissions could lead to metrics such as "emissions per share" with their separate standards for materiality. Executive compensation could be aligned with simultaneous maximization of earnings per share and minimization of emissions per share relative to peer companies. Stakeholders such as investors and employees can make their decisions on how well companies trade off between the two metrics.

Consistent disclosure of such measures may also reveal synergistic or takeover opportunities if a firm's Scope 1 emissions are higher than peer companies, and the purchaser has a feasible proprietary plan that can reduce emissions more effectively. This would be similar to how firms today can create shareholder value by taking over high-cost firms and bringing their costs down.

Ultimately, Scope 1 disclosures should enable consumers at all levels to make sound tradeoffs between financial cost and emission metrics. Consumers at each stage of a supply chain should be left to make their own tradeoffs. Counting the same emissions multiple times under Scope 3 reporting will not improve consumers' ability to make those decisions.

Over time, as more standardized and consistent metrics are developed, a more comprehensive All-Scope reporting may be feasible.

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