Executive Insights

Scope 3 Emissions: A Wicked Problem That Requires Genuine Strategic Focus

Delivering net zero is a major consideration for all businesses today. In recent time, industries and businesses around the world have made considerable progress in improving performance regarding direct (Scope 1) emissions — those that come from their own operations — and indirect (Scope 2) emissions, derived from purchased electricity, heat, steam and cooling.

Public consciousness continues to rise around net zero emissions, with the United Nations climate summit in Glasgow in November 2021, known as COP26, making net zero a particular focus point for governments, international bodies and industry groups, not to mention the general public.

Australia is one of the world's biggest fossil fuel exporters and per-capita emitters. This year's Australian Securities Exchange (ASX) reporting season has seen a growing number of listed businesses — including mining giants, power utilities and manufacturers — publicly commit to neutralising their emissions by 2050 or earlier.

Currently, most companies are focused on auditing their Scope 1 and Scope 2 emissions and outlining their commitments to achieving net zero through relatively simple mechanisms such as green power purchase agreements. Assessing and planning for net zero around Scopes 1 and 2 can be challenging, but these emissions can be directly managed, so businesses can choose to address them by modifying current operations and processes.

For nearly every industry around the world, however, a much larger category of carbon emissions — Scope 3 — now presents far greater strategic challenges.

The challenges around Scope 3

Scope 3 emissions are indirect carbon emissions that occur across an organisation's value and supply chains, from its suppliers in producing goods or services ('upstream' of the organisation's business operations), or from its distributors or customers in consuming its goods or services ('downstream').

Unlike with their solutions around the largely manageable Scope 1 and 2 emissions, many businesses are leaving Scope 3 emissions unabated, for several commonly cited reasons. First, Scope 3 emissions fall outside a company's direct management or ownership, making them difficult to control. Second, they are hard to assess, due to the difficulty of collecting high-quality data on type or volume of emissions. And third, emissions are often accounted for by several different companies in a supply chain, which raises the question of who should be responsible for reducing them.

Some businesses see the Scope 3 emissions issue as too big and too hard to tackle straight away, and instead favour grappling with the more immediate need to manage their Scope 1 and 2 emissions. Further complicating the issue, privately owned businesses can experience less pressure to address their Scope 3 emissions than publicly listed companies, whose institutional shareholder audiences are only too ready to hold them to account.

Scope 3 emissions: A wicked problem that requires genuine strategic focus was produced by David Ogilvy, lead Partner of L.E.K.'s Industrials Practice in Australia and a Partner in L.E.K.'s Sustainability Centre of Excellence and Alastair Phillips who is a Partner in L.E.K's Melbourne Practice where he works with energy and environment, building and construction materials, and surface transport clients.

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Examples of the latter situation include original equipment manufacturers (OEMs) in the fast moving consumer goods and automotive industries, as well as companies active in the energy and natural resources industries. This investor pressure will continuously increase as new reporting standards arise, such as those driven by the future International Sustainability Standards Board (ISSB), an outcome of COP26.

Businesses are running out of time to understand and implement Scope 3 reductions — and they are running out of excuses to delay doing so. More and more, consumers and end users are changing their own purchasing behaviours to reduce their Scope 1 and Scope 2 emissions — which, along with the upstream and downstream considerations, there are inevitably some business's Scope 3 emissions.

Another factor to consider is that sophisticated professional procurement departments are increasingly evaluating the carbon footprint of their suppliers along with their other procurement considerations. This ensures that they are actively managing their own Scope 3 emissions upstream. This in turn forces you as a supplier to actively manage your own carbon footprint (and your own Scope 3 emissions), as you otherwise risk being delisted by these customers.

If a business is slow to grasp the impact of all these changes, then it will miss out on the ensuing opportunities. By identifying these insights early and acting first, some businesses will become the 'disruptors' and take a market lead. Those that don't act will lose out accordingly.

The challenges inherent in addressing Scope 3 emissions will themselves be an essential factor in driving change. Because Scope 3 applies to all industries, achieving net zero for these emissions will have a far greater impact on business operations than managing Scope 1 and 2 emissions.

Organisations with large value and supply chains — retailers, manufacturers, logistics operators and primary industry businesses — will be particularly affected. In Europe, the carbon border tax will have a massive impact on contribution margins. In some cases, it will no longer make sense to import goods that are assembled by or sourced from companies outside of the European Union (EU), in environments that do not meet EU climate standards. And this is not specific to the EU: other nations like the United States and Canada are also exploring similar mechanisms to tax carbon embedded in imported goods.

Managing Scope 3 down to net zero will require major, comprehensive changes within businesses and their associated value chains. The result will be a seismic shift, in a very short space of time, in the way industries operate.

Businesses that don't understand Scope 3's strategic implications on their operations — and the need to plan for managing them now — will quickly be left behind by more agile competitors jumping to take a market lead. To handle these challenges, businesses must position considerations around Scope 3 at the very heart of their strategic planning.

Examples that highlight the complexities

Two different industry examples illustrate the size of the problem and the inherent opportunities in 'getting it right'.

Consider, first, a large supermarket chain. Managing its suppliers' Scope 3 emissions will require a titanic renegotiation of supply agreements and logistics arrangements, affecting everything in the company's operations.

The business will need to consider all aspects of the supply chain: the manufacture and remanufacture of raw materials into grocery products; the packaging and transportation of these products from manufacturers to distribution hubs and stores; and the warehousing of all the products before they finally make it to the supermarket shelves. Looking downstream, supermarket operators should also consider the potential impact of consumers shifting longer term to lower-carbon products; the greater demand for plant-based food products as customers shift away from carbon-intensive meats; and the broader global effects of climate change on agricultural production, including the areas where products are currently grown, sourced and refined.

The supermarket chain's own suppliers and partners will strive to fulfil their own commitments to managing their Scope 3 emissions. Although some will be more efficient than others, all can be managed successfully by tighter contracts and supply agreements that clearly spell out the supermarket chain's Scope 3 net zero emissions requirements. As a savvy business, the chain will not only be aware of Scope 3 impacts, but also look to position its sourcing and investment activities to stay ahead of this trend.

Second, consider an airport operator, which faces a similar situation with some variations. The aviation industry today is focused generally on achieving net zero targets across Scope 1 and 2 emissions. But with more than 80% of airport carbon emissions typically coming from a variety of Scope 3 sources — vehicle transport to and from airports; jets burning fuel as they take off, land or idle on the tarmac; and myriad activities by airport suppliers and retail tenants — clearly this will be a far more critical challenge for operators.

Airlines and the aviation industry are already under public pressure to improve their emissions performance. Airport operators are very aware of the need to be good 'green' corporate citizens — and they have already made significant advances in managing Scope 1 and 2 emissions.

But Scope 3 presents a whole set of far greater challenges to their current operations. Operators need to consider and decide on substantial changes across their entire supply and value chains.

Which alternative passenger transport options to and from the airport present the best Scope 3 emissions profiles? How will the operator introduce a reliable supplier of sustainable aviation fuel supplies? Does the current fuel supplier even have an effective Scope 3 strategy that matches the airport's own requirements? How will the operator ensure that rental car tenants (often with huge carpark allocations at the airport) continue to reduce their own emissions load to generate a positive effect on the airport's Scope 3 profile? Will the operator need to replace aircraft towing and shunting vehicles with electric or other alternative-fuel options?

And what impact will government regulation, shareholder expectations and other stakeholder activities have on all this? Airport operators are particularly attuned to the 'noise' from these audiences and the need to act responsibly in the eyes of stakeholders. But should they expect more support from local government or industry bodies in tackling Scope 3? What might this support look like, and how can they start to lobby for it?

Industries and individual businesses alike must now ask themselves these types of questions as they strive toward making net zero a reality across their entire emissions environment. For businesses to reposition themselves as competitive for the longer term, company leadership — from boards to the C-suite — must employ hard, deep strategic thinking to tackle Scope 3 issues.

Huge opportunities for those with the right strategy

Scope 3 also presents enormous opportunities for a strategic business to differentiate and to disrupt an entire industry. A business that chooses to consider and resolve its indirect emissions will not only mitigate risk within its value chain and address stakeholder concerns, but will also open itself up to innovation and collaboration with suppliers, business partners, customers and other stakeholders.

As a starting point, businesses will need to measure and understand their Scope 3 emissions and exposure in detail. Furthermore, they must consider likely future trends around decarbonisation and how these will affect the demand for their products or services further along their value chain.

The focus will tend to be more downstream than upstream: suppliers will need to consider their Scope 3 emissions in relation to their customers' operations, and those customers in turn will need to consider how their own customers' behaviours will impact their Scope 3 emissions. After all, your customers will be less likely to demand your products or services if these are creating a scope 1 & 2 problem for them.

For many companies, most of their greenhouse gas (GHG) emissions and cost reduction opportunities lie outside their own operations. But a company's Scope 3 emissions often overlap with other companies' emissions, so the thinking and programming required to reduce these emissions also bring to light multiple opportunities to collaborate on joint reduction activities.

In such an environment of co-creation, businesses can work together to identify improvements in supply chain management, cost reductions, new and innovative products and services, and other elements that distinguish genuine industry visionaries and disruptors from the broader industry pack.

What specific steps must businesses make to identify and reduce their Scope 3 emissions? The answer lies in discrete steps such as the following, which need to be factored into a business's broader strategic direction:

- Auditing the business's supply chain to assess where the greatest levels of indirect emissions currently occur and whether these will improve or decline over time.
- Identifying the best opportunities across the supply and value chains for energy efficiency improvements and other cost reduction opportunities.
- Determining which suppliers are focused on their own Scope 3 situation, and whether they are open to working together to improve Scope 3 across shared supply and value chains.
- Designing and implementing improvements to products and services, making them as energy-efficient as possible during use by customers and other downstream stakeholders.
- Developing and introducing to market new products and services with much less potential for downstream emissions.
- Considering other strategic investments that will best align to shifting consumer and customer trends as stakeholders increasingly become aware of emissions and related climate impacts and change their behaviours accordingly. These investments should create competitive advantage for the business while ensuring it stays ahead of slower competitors.
- Engaging with customers and other users of the business's products or services, to understand those users' emissions footprints in relation to these services and products. This engagement can then lead to further emissions reductions around how customers use the products and services.
- Positively interact with employees within the business in reducing emissions from business travel and employee commuting.

How much time is left?

There is still time for businesses to consider and implement Scope 3 programming. The 2021 ASX reporting season (in Australia at least) would seem to suggest that most listed businesses will report on their Scope 1 and 2 controls in this year's results. Planning for Scope 3 emissions will be an expectation by next year for publicly listed businesses, with perhaps a further year's grace for private businesses.

But success around Scope 3 is not just about having something to say to the business community and the public. The fundamental challenges and opportunities presented by Scope 3 will force industries and businesses to think hard about their current business processes. Notwithstanding the huge potential for innovation and market leadership, businesses must beware the dangers of being left behind in the rush to grapple with, and take advantage of, the challenge of achieving net zero with Scope 3.

The issue is a fast-moving one, with many major industry players already starting to make serious decisions around how they will pivot to deal with, and benefit from, Scope 3 emissions planning. The right strategy — and strategic planning process — will be the key to assessing where a business sits relative to its peers and how innovators can move quickly to take the lead, to differentiate and prosper from this seismic shift in emissions control.

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