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Global Asset Management
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Carbon emissions: why measuring matters for better ESG analysis

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Emerging market extraction companies are an easy target for ESG scrutiny. But analysis bias to one end of the supply chain risks reducing investors' ability to engage for positive influence.

For ESG-conscious investors, extractive industries – such as oil, gas and mining – are typical causes for concern. Especially when these companies operate out of emerging markets, where business practices can be more opaque and ESG disclosure levels are typically weaker than in developed markets.

While the gap in financial reporting practices between the two regions is slowly closing, we still think it's wise to take extra care when it comes to ESG analysis. It's all too easy to focus on ESG data that's easy to measure and readily available, when what's really most informative might be missing from the equation.

Take carbon emissions, for example.

These have been followed for far longer than many other environmental factors. As such, measurements are more standardised and it's easier to model companies that don't report their emission levels. One of the most common reasons for a company to be screened out of an investment portfolio is carbon emissions.

But even as a broadly standardised metric, measurement challenges remain.

The three scopes of carbon emissions

Emissions are usually classed into three groups, or "scopes":

- **Scope 1** are created in the direct course of a company's business, such as by burning fuel.
- **Scope 2** are created by generating a company's energy, such as through the power plants that power its factories.
- **Scope 3** covers everything else – all the indirect emissions created in the extraction, production and transport of raw materials a company uses.

To reduce emissions globally, we need to consider all three. Scope 1 and scope 2, which are broadly direct emissions, can be measured easily. But as estimating scope 3 requires mapping all companies in the supply chain, most measures of carbon intensity focus only on the first two.

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This risks the so-called "streetlight effect" – searching for something only where it's easiest to find.

But scope 3 emissions matter, even if we can't measure them reliably. Without good data, screening is typically biased against the extractive end of the supply chain, flattering the companies that are end-users of the commodities that extractive companies produce, such as power. For more holistic ESG analysis, we must account for scope 3, even if only qualitatively.

Measuring ESG progress over the whole supply chain?

Commodity extraction is where the greatest potential environmental risk lies. The problem for investors is that you can't easily separate the ESG record of a mining company in the Congo from an electric vehicle producer in California.

Unless we find alternatives for the metals in electric batteries you can't have one company without the other.

Even extraction companies that are proactive about ESG factors often believe they will never improve investors' perceptions, because of their place in the supply chain. Yet many of these companies could continue without international investment. This creates a risk that they give up trying to improve, cutting off investors' ability to influence them and isolating companies with the greatest potential for ESG gains.

At BlueBay, we work out companies' current ESG ranking. But we also engage and assess their trajectory to ensure we reward progress. It is difficult to assign ESG blame throughout the supply chain, but we must avoid bias towards data that's easiest to measure.

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