Sustainability Toolkit

GHG Accounting Risk in Transactions and JVs

Greenhouse gas (GHG) accounting—identifying all sources and sinks of GHG emissions—is a becoming a fundamental part of corporate sustainability. As the saying goes, you can't manage what you don't measure. And so accounting for an enterprise's total GHG emissions is the first step towards setting reduction targets, identifying emission reduction opportunities, and tracking progress.

In this last installment of our Sustainability Toolkit, we explain the ground rules for GHG accounting and introduce some important considerations companies should consider in allocating responsibility for GHG emissions in joint ventures and commercial transactions.

Below are some approaches to consider.

What is GHG accounting?

How should emissions be addressed in JVs and commercial transactions?

How does a company decide which emissions to report as its own?

COVINGTON

What is GHG accounting?

GHG accounting provides the basis for quantifying emissions and identifying whose emissions those are. It's the predicate both for mandatory government regulation of GHG emissions and for charting a company's progress towards enterprise-wide emission reduction objectives.

There are two distinct types of accounting methods:

Voluntary frameworks are used for purposes of reporting to investors and other stakeholders, including as part of a broader sustainability strategy. These adhere to several guiding principles: relevance, completeness, consistency, accuracy and transparency. The generally accepted method is widely referred to as "the GHG Protocol." Its use is required by climate risk disclosure reporting platforms recommended by Financial Stability Board's Task Force on Climate-related Financial Disclosures ("TCFD") and the Sustainability Accounting Standards Board's ("SASB") industry-specific standards.

Mandatory reporting frameworks are imposed by regulatory authorities to develop a sectoral or economy-wide inventories of sources of GHG emissions and implement emission reduction requirements. They are usually more prescriptive and can differ substantially in their point of regulation. They usually impose the obligation for reporting emissions upon a specific party in the value chain, often the entity that has control over the operations at the time when the emissions occur. But they can also impose the obligation on an entity that produces a product that generates emissions when it is consumed downstream in the value chain, such as the producer of transportation fuels.

How does a company decide which emissions to report as its own?

Under the GHG Protocol, there are two distinct approaches for deciding which emissions should be included as part of an enterprise-wide voluntary GHG report: equity share or control.

- Under the equity share approach, the company accounts for the emissions from a joint venture or operation based on its ownership interest.
- Under the control approach, the company accounts for all the emissions from operations it controls. To determine control, the company will apply one of two criteria: operational or financial control.

For wholly-owned subsidiaries, the choice of approach is of no consequence; i.e., the company will account for **100%** of the subsidiary's emissions, regardless whether it reports pursuant to the equity or control approach.

Where the company does not financially control a joint venture or partnership, that same **75%** equity interest would result in it reporting **75%** of the venture's emissions under the equity approach, but **0%** of its emissions under the control approach.

But where the parent owns less than **100%**, the choice of approach will impact how much of the subsidiary's emissions must be accounted for in the parent's GHG report.As an example, if a company owns a **75%** interest in a subsidiary that it financially controls, then the company would report **75%** of the subsidiary's emissions under the equity approach, but **100%** of its emissions under the control approach.

Where joint venture partners exercise joint financial control, each partner will report its respective equity share of emissions, regardless whether it has chosen the equity or control approach.

Much like financial accounting, a company may have its reports verified by an independent third party, who may require detailed information to support the company's decisions to include or exclude certain emissions sources. Often, where the company's chosen method aligns with its financial accounting methods, the verifier will accept decisions that align with how the company accounts for profits and losses from an operation in its audited financial reports, without requiring additional information.

- Importantly, participants in joint ventures, partnerships and other commercial transactions may decide how to allocate responsibility for reporting emissions from the joint venture or operation. Where those decisions are clearly reflected in governing documents or transaction terms, a third-party verifier may respect the parties' allocation and verify the company's reported emissions based upon the contractual allocation of responsibility.

The next important question for a company is what scope of emissions should be included in its reports. All standardized methods distinguish between three distinct "scopes" of emissions based on where, in the value chain, the actual emissions to the atmosphere occur and the reporting entity's responsibility for those emissions.

Scope 1 includes direct emissions, such as combustion and process emissions from sources owned or controlled by an entity. For example, if a company operates a gas-fired boiler, the emissions from combustion of the gas are within Scope 1. TCFD and SASB standards mandate reporting of a company's Scope 1 emissions.

Scope 2 includes indirect emissions from purchased electricity, steam and heating/cooling, such as the emissions associated with generation of the electricity consumed by a company. Reporting of Scope 2 emissions is required by the GHG Protocol and TCFD's recommendations, but not by SASB.

Scope 3 includes all other indirect emissions occurring both upstream and downstream as a result of a business' activities. This may include the upstream "lifecycle" emissions associated with fuels consumed by a company, as well as emissions associated with use of a company's products. Reporting of Scope 3 is optional and not required by SASB, but recommended where appropriate by TCFD. Particularly for companies engaged in the production of fossil fuels, reporting of Scope 3 emissions is gaining in prominence, as major producers chart their progress towards announced carbon reduction and neutrality targets.

How should emissions be addressed in JVs and commercial transactions?

Existing and future laws and government regulations to mitigate climate change may result in significant financial costs associated with an operation's GHG emissions. Such regulation may include direct imposition of a price on emissions, such as a tax, expenses to purchase emissions allowances to comply with a cap-and-trade program, or capital expenditures to reduce emissions, e.g., through addition of carbon capture and sequestration to a combustion source. While regulations are usually clear in their point of regulation—i.e., who is subject to the obligation—sometimes, the regulatory program may allow parties to shift that obligation by contract.

- Participants in a joint venture should be clear on the allocation of responsibility for complying with GHG regulations and associated costs. As a general principle, assigning responsibility to the participant whose activities determine how much the operation emits may best align economic incentives with emission reduction opportunities.
  - The scope of covered emissions should be drawn to account for all possible forms and points of regulation that could be imposed as a consequence of an operation's emissions, including its direct emissions, emissions associated with downstream consumption of its products, and emissions attributable to upstream production of the raw materials or fuels it consumes.
  - Terms allocating ownership and responsibility for such emissions should be clearly drawn; do not rely upon generic change in law or tax provisions to address GHG emissions.
  - For activities already subject to GHG regulations, the terms may expressly assign financial responsibility for compliance with those regulations and describe how the obligations will be discharged. To avoid disputes, they may also identify the basis for quantifying emissions and compensation, e.g., by reference to a specific index to determine the price of GHG allowances.

Separate and apart from the allocation of responsibility for complying with government regulations, participants in joint ventures and commercial transactions should also be sure to assign responsibility for reporting emissions. As institutional investors increasingly focus on climate risk, their assessment of a company's value and their investment decisions may increasingly be influenced by what a company discloses in its GHG reports and the degree of transparency and completeness of those reports.

- With that in mind, parties entering into a joint venture or commercial transaction should clearly allocate ownership of and responsibility for reporting all emissions from the operation occurring over the life of the venture or contract.
- Where joint venture participants are assigning an operation's direct emissions to the participant or counterparty served by the operation, the terms should be clearly drawn and mandate that such participant owns such emissions and will include them in its own emissions reports, obtain verification of those reports, and make them publicly available through a particular platform or means.
- Although mandatory reporting schemes may not allow parties to shift the reporting obligation from one party to another, the terms should make clear the parties' intention to assign responsibility for ownership and reporting of emissions in the manner described by the contract, both for purposes of voluntary reporting and any government-mandated reporting scheme, to the extent permitted by law.

Visit the Sustainability Toolkit and Explore the Topics

Defining Sustainability +	Public Policy: Climate Change +	Public Policy: COVID-19 +	Public Policy: Environmental Justice +	Public Policy: UN Sustainable Development Goals +
Engaging and Advising Boards of Directors +	Investor Expectations +	Corporate Disclosure: The Basics +	Corporate Disclosure: Standards and Initiatives +	Setting Corporate Goals +
M&A and JV Transactions +	Green Bonds and Sustainability-Linked Loans +	Carbon Markets +	Marketing Claims +	Crisis Management +
Insurance Implications +	Sustainability NGOs +	Corporate Energy Procurement Strategies +	ESG Rankings and Ratings +	GHG Accounting Risk in Transactions and JVs +