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VCIG: Scope of operational control
Issues Paper

Objective

1. The EFRAG Secretariat proposed to the SRB that the feedback around differences in the applicability of operational control and the rationale for these are discussed by SR TEG and if relevant, appropriate redrafting is proposed, within the limits of an IG. This paper provides the feedback received as well as quotes from the standards for SR TEG's information to determine the limits of how this can be addressed in the VCIG.

Feedback received (paragraphs 56 to 80 of agenda paper 05-02)

2. Six respondents (standard setter, preparers, assurance providers) requested more examples to explain operational control and to clarify the concept and a standard setter considered that paragraphs 34 to 47 should more distinctly outline the two steps in defining the reporting scope of the undertaking: 1. financial control and 2. operational control analysis.
3. One assurance provider asked whether the concept of operational control is only relevant for impact metrics, or also for financial effects specifically or more generally for reporting on risks and opportunities.
4. Five respondents (assurance providers, preparers) thought that the concepts (including control, joint control and significant influence) differ from those per IFRS and the accounting directive. One respondent (preparer) requested a clarification on the reconciliation of the accounting treatment under financial control for financial reporting and operational control for sustainability reporting purposes.
5. One respondent (assurance provider) recommended that EFRAG further clarifies whether the assessment of operational control under the ESRS shall be made for any off-balance sheet asset operated or managed by the reporting undertaking considering the existing contractual arrangement governing its use.
6. Two respondents (standard setter, civil society) requested to clarify the difference between operational control and joint control and to elaborate on the approaches. Moreover, one respondent (standard setter) requested to clarify the relationship between operational control and financial control.
7. One respondent (other) argued that operational control is described with excessive technical detail. The section would benefit from some framing.
8. One respondent (civil society) considered that there is no reference in ESRS 1 and ESRS 2 to operational control, therefore it should be deleted from paragraph 47. The EFRAG Secretariat assumes the references were supposed to be ESRS S1 and S2.
9. One respondent (user) notes that the ESRS requirements to cover the company's operational control for environmental metrics may be more stringent than the GHG protocol which allows for financial control or equity share method. This may make it more difficult for companies to align with the ESRS requirements.

10. One respondent (standard setter) considered that in the introduction of the box "*Operational control (over an asset, a site, or a plant, JVs, Associates, etc.)",* it should explicitly state that operational control, as referred to in the GHG Protocol, pertains to technical operational control – signifying the ability to direct operations generating GHG emissions, not solely the ability to direct the financial operations of the entity generating GHG emissions, in relation to ESRS E1.
11. Two respondents (assurance provider, standard setter) requested clarification on the level at which operational control should be assessed (e.g. entity, site, facility) and whether it is possible that the unit of account might be different for ESRS E1, E2 and E4.
12. A standard setter considered that the relationship between financial and operational control is unclear with the following example: A owns the majority of shares in B and classifies B as a subsidiary, i.e., it has financial control, however C holds shares in B and has operational control over B's operations. Then, according to ESRS 1.62, undertaking A has to include 100% of B's emissions as scope 1 and 2 emissions, while, according to the concept of operational control, C has to include 100% of B's emissions as scope 1 and 2 emissions. Differences in the concepts may lead to double counting of B's scope 1 and 2 emissions.
13. Three respondents (consultant, preparer, assurance provider) noted that paragraph 35 should be clarified. If the internal transactions are not eliminated from sustainability reporting, they will result in double counting of emissions. When reporting under scope 1, 2 and 3 as a standalone, the parent would have purchases from subsidiaries. Keeping in view that a subsidiary is not the value chain, internal transactions need to be grouped under one impact and not reported upon twice (incoming and outgoing).
14. One respondent (preparer) suggested to delete the part on the financial accounting consolidation procedures.
15. One preparer recommended adding an ad hoc FAQ (Calculation of scope 3 emissions). This will be especially useful to avoid double counting when disclosing scope 3 emissions.
16. One assurance provider suggested to add examples on cases where the operational control may go beyond the own reporting boundary, particularly considering that these data may already be covered by another entity's reporting boundary and there is a risk of double reporting.

ESRS references

17. ESRS E1 paragraph 46 says: "*For its associates, joint ventures, unconsolidated subsidiaries (investment entities) and contractual arrangements that are joint arrangements* not structured through an entity (i.e., jointly controlled operations and assets), the undertaking shall include the GHG emissions *in accordance with* the extent of the *undertaking's operational control* over them." [emphasis added]
18. Annex 2 defines operational control as follows: "Operational control (over an entity, site, operation or asset) is the situation where the undertaking has the ability to direct the operational activities and relationships of the entity, *site, operation or asset*." [emphasis added]
19. ESRS E1 AR 40 adds: "…In practice, this happens when the undertaking holds the license - or permit - *to operate the assets* from these associates, joint ventures, unconsolidated subsidiaries (investment entities) and contractual arrangements." [emphasis added]
20. ESRS E2 paragraph 29 states: "The amounts referred in paragraph 28 shall be consolidated amounts *including the emissions from those facilities over which the undertaking has financial control and those over which it has operational control*. The consolidation shall include only the emissions from facilities for which the applicable threshold value specified in Annex II of

Regulation (EC) No 166/2006 is exceeded." [emphasis added] VCIG will be updated to reflect this specification.

21. ESRS E4 paragraph 16 requires: "The undertaking shall disclose: (a) a list of material sites in its own operations, *including sites under its operational control*, based on the results of paragraph 17(a)." [emphasis added]

VCIG drafting

22. The drafting of the VCIG refers to assets and sites as falling under operational control which is broader than in ESRS E1 read with AR 40.

23. The VCIG also says the following about ESRS E2 and E4: "ESRS E2-4 *Pollution of air, water and soil* also specifically includes those emissions from facilities under the operational control of the undertaking. Similarly, ESRS 4 *Biodiversity and ecosystem*s in paragraph 16 also includes sites under the operational control of the undertaking."

GHG protocol standard

24. "Companies shall account for and report their consolidated GHG data according to either the equity share or control approach as presented below. … Under the **equity share approach**, a company accounts for GHG emissions from operations according to its share of equity in the operation. The equity share reflects economic interest, which is the extent of rights a company has to the risks and rewards flowing from an operation. … The principle of economic substance taking precedent over legal form is consistent with international financial reporting standards. The staff preparing the inventory may therefore need to consult with the company's accounting or legal staff to ensure that the appropriate equity share percentage is applied for each joint operation."

25. "Under the **control approach**, a company accounts for 100 percent of the GHG emissions from operations over which it has control. It does not account for GHG emissions from operations in which it owns an interest but has no control. Control can be defined in either financial or operational terms. When using the control approach to consolidate GHG emissions, companies shall choose between either the operational control or financial control criteria." (page 17)

26. On page 21 the following paragraphs explain when the operational control approach may be best:

    - "Government reporting and emissions trading programs. Government regulatory programs will always need to monitor and enforce compliance. Since compliance responsibility generally falls to the operator (not equity holders or the group company that has financial control), governments will usually require reporting on the basis of operational control, either through a facility level-based system or involving the consolidation of data within certain geographical boundaries (e.g. the EU ETS will allocate emission permits to the operators of certain installations).

    - Liability and risk management. While reporting and compliance with regulations will most likely continue to be based directly on operational control, the ultimate financial liability will often rest with the group company that holds an equity share in the operation or has financial control over it. Hence, for assessing risk, GHG reporting on the basis of the equity share and financial control approaches provides a more complete picture. The equity share approach is likely to result in the most comprehensive coverage of liability and risks. In the future, companies might incur liabilities for GHG emissions produced by joint operations in which they have an interest, but over which they do not have financial control. For example, a company that is an equity shareholder in an operation but has no financial control over it might

face demands by the companies with a controlling share to cover its requisite share of GHG compliance costs."

EFRAG Secretariat analysis

27. The EFRAG Secretariat considers that the VCIG should be updated to reflect more precisely the scope per ESRS as set out above, even if this is not necessarily consistent across the different standards.

28. The Secretariat is also considering adding the following example with respect to GHG emissions which may help preparers:

Company A is a global fashion company. Company A holds a 30% ownership share in its associate, Company B. Company B is a key supplier of fabrics and 80% of the fabrics produced by Company B is supplied to Company A. If Company B has a GHG emissions total of 100,000 metric tons, how should it be accounted for in Company A's consolidated sustainability statements? It is assumed that both category 1 (emissions from Purchased goods and services) and category 15 (emissions from investments) are significant for Company A.

a) If A had operational control over B, it would include 100,000 metric tons as a separate category under Scope 1 or 2 as appropriate per E1 paragraph 50.

b) If A did not have operational control, A would include 80 000 metric tons GHG emissions is included in its Scope 3 reporting based on the information provided in accordance with ESRS 1.67, the "data of the associate or joint venture are not limited to the share of equity held but shall be taken into account on the basis of the impacts that are connected with the undertaking's products and services through its business relationships. the data of the associates or joint ventures are not limited to the share of equity held but shall be consistent with the approach adopted for other business relationships in the value chain."

Under ESRS 1, the emissions would be included in Category 1 "Purchased goods and services" (this may differ if the value chain relationship between the reporting entity and the associate has a different nature).

c) If there were no transactions between A and B, A would include 30 000 in Category 15 "Investments".

Question to EFRAG SR TEG

29. Does EFRAG SR TEG have proposals for further considerations that the EFRAG Secretariat have not included in the above paper?

Appendix 1: GHGP references in the BCs

Introduction

1. This appendix contains references in the basis for conclusions of the Environmental standards to the GHG Protocol. The EFRAG Secretariat notes that the references in the BCs are to the draft ESRS, rather than the one adopted by the EC.

ESRS E1

2. The following paragraphs in the basis for conclusions of ESRS E1 refer to the GHG Protocol.

BC91. This Disclosure Requirement builds on the definitions and rules of the GHG Protocol to reduce the burden for the undertakings that already apply it, as this framework is considered the leading accounting standard for GHG emissions. Disclosure Requirement E1-6 has also taken into consideration GRI 305 and ISO 14064-1:2018.

BC99. Paragraph 44 was included as a result of the public consultation, in order to clarify the application of the reporting boundary. The requirements under this paragraph are consistent with ESRS 1 requirements for the reporting undertaking and value chain. These requirements are aligned with both the accounting standards requirements for consolidation in the financial statements and the GHG protocol approaches for the consolidation of GHG emissions. In its consolidated financial statements, the reporting (parent) undertaking consolidates its financial statements with those of the entities that it controls (i.e., where it has financial control). Similarly, on the basis of having financial control, the reporting undertaking shall fully consolidate the GHG emissions from the entities that are part of the consolidated accounting group. The full consolidation of GHG emissions from financially controlled entities by the reporting undertaking results in relevant and faithfully represented information (i.e., outcomes from what is financially controlled is reflected as an outcome of a single economic entity).

BC100. For the GHG emissions from entities (associates, joint ventures and unconsolidated subsidiaries-investment entities) and contractual arrangements that are not within a legal entity (jointly controlled operations) that are part of the reporting undertaking's value chain but are outside the scope of full consolidation in the financial statements, the reporting undertaking shall only apply one of the GHG Protocol consolidation approaches (i.e., the operational control approach) but not the equity share approach (in line with ESRS 1 paragraph 71). As a result, the reporting undertaking fully consolidates the GHG emissions from these entities and contractual arrangements to the extent it has operational control (subject to the provision of ESRS 1 paragraph 71 stating that "the data of the associate or joint venture are (…) taken into account on the basis of the impacts that are directly linked to the undertaking's products and services through its business relationships"). In addition to ensuring relevant and faithfully represented information, this requirement to only allow the operational control approach ensures the comparability of reported Scope 1 and 2 GHG emissions across reporting undertakings.

BC105. Paragraph AR 41 (c) builds on the GHG Protocol, which requires that CO2 emissions arising from biogenic sources (i.e., biomass combustion) should be reported independently from the "scopes".

BC106. Paragraph AR 41 (d) requires, in accordance with the GHG Protocol, the disclosure of Scope 1 GHG emissions in gross terms, excluding any purchased, sold or transferred carbon credits or GHG allowances. This is due to two main limits associated with offsets. First, they are a source of greenwashing if they do not fulfil stringent quality criteria, and even by the best standards, there are still uncertainties related to the temporal aspects of nature- and technology-based carbon sequestration, the potential risks of carbon release through deforestation, fire, disease and drought. Second, they can lead to disguising the need for GHG reductions in the undertaking's own operations and value chain and lock-in high-carbon infrastructures. Indeed,

offset schemes make it difficult to see the evolution of the actual greenhouse gas emissions over time, and this can give a false impression that climate risks can be easily eliminated.

BC111. Paragraph 46 (a) and (b) and the related paragraph AR 43 (d) allow ESRS to be aligned with the GHG Protocol Corporate Standard and Scope 2 Guidance and the GRI 305 (Emissions 2016) that require both location-based and market-based values. Moreover, both approaches have inherent advantages and drawbacks and a choice by the preparer in favour of one or the other could undermine comparability. The location-based method reflects the average emission intensity of the grids from which the electricity is taken. The market-based method reflects the emissions from electricity that companies have chosen (or not) on the market. Contractual instruments used include energy Attribute Certificates (RECs, GOs, I-RECs, …), direct contracts, supplier-specific emission factor, and emission factors representing energy and emissions not tracked or unclaimed (residual mix).

BC112. Paragraph AR 43 (a) and (g) acknowledges that the principles and provisions of the GHG Protocol Scope 2 Guidance are widely used by undertakings and are generally accepted.

BC115. Paragraph AR 43 (e), in accordance with the GHG protocol, requires the undertaking to disclose biogenic emissions of CO2 from the combustion or biodegradation of biomass separately from the Scope 2 GHG emissions.

BC122. Paragraph AR 44 (a) acknowledges that principles and guidance provided by the GHG Protocol are widely used by undertakings and generally accepted.

BC123. Paragraph AR 44 (b) considers that the GHG Accounting and Reporting Standard for the Financial Industry from the Partnership for Carbon Accounting Financial (PCAF) is the most appropriate accounting and reporting framework for financial institutions in line with the recommendations of the European Banking Authority (EBA). PCAF Standard forms an extension to the GHG Protocol Corporate Value Chain which refines and expands the GHG Protocol's accounting rules for Scope 3, category 15 (investments), and replies to the need of FIs to measure the absolute emissions of their loans and investments.

BC124. Paragraph AR 44 (c) and (d) suggest that not all 15 categories identified in the GHG Protocol have to be part of Scope 3 reporting in order to reach a reasonable cost-benefit balance. It is suggested to refrain from a fixed threshold and rather to follow a criteria-based approach as developed by the GHG Protocol ISO 14064:2018. With regard to the quantitative significance of total Scope 3 emissions, TCFD recommendations refer to a 40% threshold and the SBTi11 states that "if Scope 3 emissions compose over 40% of total Scope 1, 2, and 3 emissions, companies shall develop ambitious Scope 3 targets that collectively cover at least two-thirds Scope 3 emissions".

BC125. Paragraph AR 44 (e) acknowledges that Scope 3 information is expected to mature over time. Rough estimates are therefore legitimate and acceptable from the start.

BC127. Paragraph AR 44 (g) aims to encourage the use of the most accurate data by requiring the undertaking to disclose the share of emissions calculated using primary data. The GHG Protocol Scope 3 Standard allows the choice of input data including supplier specific data, country or sector or product averages, and proxies. However, to increase the accuracy of the data applied, it is recommended to use data in the following order of merit: 1) tier 1 supplier-specific data; 2) an average of country before an average of sector or product; 3) proxies based on spend (nature of purchased goods and services). Moreover, despite GHG Protocol sectoral guidance, more sector-specific definitions are needed to improve the comparability of Scope 3 disclosures.

BC129. Paragraph AR 44 (j), in accordance with the GHG protocol, requires undertakings to disclose biogenic emissions of CO2 from the combustion or biodegradation of biomass that occur in its value chain separately from the gross Scope 3 GHG emissions.

BC136. The SFDR requires financial market participants to disclose the GHG intensity per revenue of their investee companies. It is, therefore, necessary that undertakings pursuant to the CSRD

report that information through the ESRS. Indeed, preparers/investee companies have an insight position (knowledge of GHG emissions and revenues details) allowing to finetune the calculation of the GHG per revenue ratio (adjustment of the perimeter for both numerator on GHG emissions and denominator on revenues) and are better positioned to do this than the financial market participants (investors or analysts) themselves.

BC146. The [Draft] ESRS E1 recognises that to date there are no comprehensive consensus methods for accounting and reporting on GHG removals and storage. For this reason, Disclosure Requirement E1-7 aims to provide the necessary transparency on the assumptions made and methodologies and frameworks applied by the undertaking in accounting for GHG removals (cf. paragraph 55 (b)). More advanced methods for accounting of GHG removals are currently being developed, notably the planned EU regulatory framework for certification of carbon removals, but also the Land Sector and Removals Guidance under the auspices of the GHG Protocol, and the Forest, Land and Agriculture Science-Based Target Setting Guidance by the SBTi. To take account of these developments, the [Draft] Standard includes a dynamic requirement to apply consensus methods as soon as they are available.

BC150. Since it is not possible for most undertakings to eliminate all GHG emissions associated with their activities, products and services right away, an increasing number of undertakings use carbon credits from GHG reduction or removal projects with the aim to balance or compensate their GHG emissions or claim “carbon neutrality”. However, this trend in market practice is observed with caution as carbon credits and offsetting practices are limited in their effectiveness in many ways. First, they can be a source of greenwashing if the climate change mitigation project behind a carbon credit does not fulfil the stringent and verified quality criteria. Secondly, offsetting practices can lead to disguising the need for deep GHG emission reductions in the undertaking’s own operations and value chain to achieve EU and global climate goals and avoid a lock-in in high-carbon infrastructures (also known as mitigation deterrence). Thirdly, GHG emissions by far exceed the amount of carbon credits potentially available. Hence, the concept of purchasing carbon credits to offset emissions cannot be considered as a viable solution on a large scale. Fourth, double counting of mitigation outcomes (towards national or EU climate targets and at the same time towards an undertakings’ GHG neutrality claim) may lead to less overall climate action and can therefore be perceived as a risk for environmental integrity. Overall, in developing this [Draft] Standard it has been noted that undertakings should prioritise GHG emission reduction over offsetting and compensation practices. This principle is reflected throughout the [Draft] Standard. Disclosure Requirement E1-4 does require reporting of GHG emission reduction targets and the progress made to achieve them but excludes the use of carbon credits to claim target achievement. Disclosure Requirement E1-6 requires reporting on gross Scope 1, 2, 3 and total GHG emissions and do not allow netting of emissions with carbon credits. Nevertheless, it is recognised that the purchase and use of carbon credits have become common market practice and reporting standards should create the necessary transparency on, if and to which extent the undertaking’s climate-related policies rely on carbon credits and offsetting and whether the carbon credits purchased and cancelled by the undertaking fulfil certain quality criteria. This approach is in line with GRI 305-5 (Emissions 2016) and the GHG protocol corporate standard and Scope 3 standard.

ESRS E2 and E4

3. E2 and E4 have no references to operational control or the GHG Protocol.