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Measuring Carbon Footprints

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INTRODUCTION

Measuring and reducing greenhouse gasses has been a major focus of investor and corporate ESG programs. We note our own observations as well as some articles and academic work on the potential for inaccuracies, inconsistencies, and overall weakness on this increasingly popular environmental reporting. As we have seen in various other areas of ESG, we believe the area of emissions reporting could, over time, come under more scrutiny from regulatory agencies.

There are protocols for reporting carbon footprints, such as the Greenhouse Gas (GHG) protocols, the international ISO 14064 standard, and the Task Force on Climate-related Financial Disclosures (TCFD). It should be noted that there is a part of the process that is based on estimation and extrapolation from these estimates. This combination of varied protocols, significant flexibility in reporting methodologies, confusion on how to report, lack of third-party validation, and heavy use of estimation could produce misleading information. Corporations will have to invest time and resources to provide this data, yet in our opinion, given the challenges previously mentioned, at this time this information may prove to be of little real value to stakeholders. Reporting on emissions for a portfolio of companies where they may use different methodologies, or do not report at all, could provide a misleading sense of precision. This can be the case when reviewing a portfolio of non-public high yield issuers where company disclosure on these metrics is especially weak. While we believe it is better to try to measure carbon footprints than not, there are times when inaccurate work can be less helpful than no work at all.

CO_2 is often used as a "reference" gas as it is one of the largest factors in global warming studies and according to the Environmental Protection Agency (EPA), it accounts for about 80% of the overall warming effect. Therefore, gasses that are measured include CO_2 and outputs such as methane and nitrous oxide which are then converted to a CO_2 equivalent. Several of these emissions other than CO_2 are reported to have a stronger impact but may not be as widespread nor do they last as long in the environment.

The emissions are typically broken down into three "scopes" as outlined by the GHG Protocol:

Scope 1:
Emissions from sources directly within the corporate system (e.g. fuel for company-owned vehicles).
Scope 2:
Emissions that are indirect or that occur as a "consequence" of a corporation's activities but occur at another company such as purchased energy or water (e.g. electricity usage).
Scope 3:
Emissions related to indirect upstream and downstream activities in some places are referred to as "gray emissions". The US EPA describes them as "the result of activities from assets not owned or controlled by the reporting organization, but that organization indirectly impacts its value chain."

When undertaking this work for a particular company, calculations are made using whatever data or estimates are available. For example, if electric consumption is not available estimates are made based on similar industries, facilities, or building square footage. Generally, estimates show that the largest emissions are generated from electric power generation and transportation.

It can be quite difficult estimating upstream and downstream emissions—especially for companies with complex international supply chains and distribution/sales networks. Therefore, this can create a large amount of error. While Scope 3 can entail a higher level of estimation and increases the risk of double counting, we believe it has been included in an attempt to push industry leaders to pressure other parts of the eco-system to focus on emissions.

Another important part of emissions reporting is a company choosing its "boundaries". This can impact which parts of a business get reported on. For large organizations, this can vary based on joint ventures and equity positions in various entities. However, we believe it is another area in emission reporting that gives significant leeway to the companies that choose to report.

Researchers at the University of Vermont have analyzed emission data from corporations that have reported their data to the CDP (formerly the Carbon Disclosure Project), a non-profit reporting platform, and found concerns about inaccuracies in the reporting. Their work highlights issues such as reporters having too much flexibility in reporting on Scope 2 and Scope 3 emissions, where they draw their corporate boundaries and how they account for carbon offset purchases. They also highlighted concerns over how few companies use or require third party verification for their work, and a lack of consequences if the work is wrong or misleading. Additionally, there is the view that too much of the reporting focuses on future "targets" and policy, and that there currently is not the incentive financially for companies to report well. In most jurisdictions, companies also have complete flexibility as to what standard-setting organization they follow including what information they choose to report. While many of the largest companies report in some form on their carbon data, we believe many other companies are wary of reporting data because once they set stakeholder expectations and/or regulations increase, costs and restrictions could continue to spiral. Additionally, a Harvard Business Review article earlier this year highlighted that the increased environmental reporting over the last two decades has not resulted in an improvement in environmental, and specifically, emission statistics.

CONCLUSION

In a somewhat related matter, ESG / SRI designated funds in Europe are facing increased regulatory requirements around Sustainable Finance Disclosure Regulation and that they may not achieve their intended objectives in these funds. The Sustainable Finance Disclosure Regulation (SFDR), appears to require significant data and increased the complexity of complying. This increased scrutiny and regulation could translate to reporting of carbon footprints as well, resulting in an escalation in the examination of the shortcomings within this type of reporting. In our opinion, clear objectives of what companies and other stakeholders want to achieve from measuring carbon footprints can be helpful. We hope to see some development of standards over time that are cost effective, clear, and beneficial to all stakeholders.

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