

The EU Taxonomy

- For Sustainable Activities



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1. Executive Summary

A new regulatory area has evolved in the European Union for environmental, social and governance aspects. The vast amount of new legislation and upcoming proposals is similar to the so called “regulatory Tsunami” in the aftermath of the Financial Crisis. Business leaders are facing new challenges, while adapting their reporting framework with the Taxonomy requirements and other ESG-related requirements.

The EU Taxonomy for Sustainable Activities is a legislative approach to define a common language between finance and sustainability. The overarching goal is that this will reorient capital to sustainable investments and take the European Union one step closer to its ambitious climate objectives, which are (from a legal perspective) defined in the Fit for 55 Package. The aim of the package is to reach the climate targets outlined in the Paris Agreement in 2015. This is done by a set of legal proposals to revise and update EU legislation, which should reduce the EU emissions at least 55% by 2030. The EU Taxonomy is one tool in achieving that goal.

The EU Taxonomy includes six environmental objectives covering the environmental scope. As of March 2023, two out of the six environmental objectives have screening criteria, published in the Climate Delegated Act, which define detailed conditions for business activities to fulfill the Taxonomy requirements. On 5 April 2023 the Commission published a proposal for the four remaining climate objectives.

The process of meeting the requirements include five fundamental steps, which are (1) assessing eligibility, (2) alignment and assuring that the activity under assessment (3) does not cause significant harm to any other environmental objective and that (4) minimum safeguards are met. The final step includes (5) the calculation of key performance indicators and reporting.

The Taxonomy is not all black and white – sustainable or unsustainable. The public discussion seems to make a parallel between having an activity in the Taxonomy and complete sustainability – as it would automatically mean that the activities are purely sustainable, and hence does not harm the environment in any way. In fact, this is not true. The Taxonomy, its details and practical interpretation are much more diverse and complicated. It can be argued that the Taxonomy is an evolving set of definitions that will change over time.

This will create new opportunities and risks, not only regulatory – also risks from transition to physical climate risks that will result in traditional fiscal profitability, capital adequacy and liquidity risks. Both public and private businesses are forced to adapt to these risks.

Knowing the regulatory landscape and understanding essential risks, will give insight for better decision making.

2. Background

The European Union strives to be the first carbon-neutral continent in the world by 2050. During the past 5 years the legal framework, to achieve climate neutrality, has been built at a breathtaking pace in EU. One of the first breakthroughs, from a regulatory point of view, in mitigating harmful actions taken by human beings on the environment, can be seen as the Montreal Protocol, which was designed to protect the ozone layer. The treaty was signed in 1987 and is largely seen as a successful intervention to protect our globe. At the United Nations Conference on Environment and Development (UNCED), commonly known as the Earth Summit, in 1992 held in Rio De Janeiro, it was established that greenhouse gas concentrations in the atmosphere should be stabilized¹. By fast-forwarding back to the 21st century, it can be concluded that the regulatory work on climate change is by no measure a new approach. However, the pace in the European Union of adopting new environmental legislation has taken unprecedented speed. This means that decision makers in both non-financial and financial companies are facing a completely new regulatory landscape, shaped globally by the 2015 Paris Climate Agreement² and in the Union by the European Green Deal³. The goals in the Green Deal are translated into EU laws in the Fit for 55 package⁴, which aims to reduce the net greenhouse gas emissions by at least 55% by 2030 in the Union.

The EU taxonomy framework was published in 2020 and is designed to create a common language between finance and sustainability. The immense interest in sustainable investments has unfortunately led to negative side-effects, such as greenwashing scandals. To tackle greenwashing, and most importantly, to direct capital to sustainable investments, is the backbone of the EU taxonomy. The sustainability discussion has to a large extent been around greenhouse gas emissions – the European Union has broadened the scope to include both social and governance aspects into the legislation. This can be seen in the Taxonomy in Article 18, which connects the EU-legislation to international standards and guidelines, such as the UN Guiding Principles on Business and Human Rights (UNGP) and the OECD Guidelines for Multinational Enterprises.

The EU taxonomy incorporates six fundamental environmental objectives, which covers the ecosystem from pollution prevention to protection of biodiversity. In its essence, the European Union should be prepared to mitigate and adapt to the climate change, protect water and marine resources and transit towards a circular economy. The Taxonomy is one tool, among many, to achieve this. It is linked to number of other regulatory initiatives such as the Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD). Thus far, the focus has been on the objectives to mitigate and adapt to climate change.

From a business perspective, it is irrelevant whether one believes in the power of legislation to change the direction of the European Union towards sustainability. The laws have already been designed and enforced, which means that steering the business forward while abiding to rules and regulations,

¹ <https://unfccc.int/resource/docs/convkp/conveng.pdf>

² <https://unfccc.int/process-and-meetings/the-paris-agreement>

³ <https://www.consilium.europa.eu/en/policies/green-deal/>

⁴ <https://www.consilium.europa.eu/en/policies/green-deal/fit-for-55-the-eu-plan-for-a-green-transition/>

companies and more in general business entities – private and public, will have to adapt to a new regulatory landscape in the forthcoming years.

FCG can help you navigate the regulatory landscape, however it is up to you, as a decision maker, to choose the way forward on how and when to meet the new requirements.

3. The Guiding Principles of the EU Taxonomy

The taxonomy is built upon one overarching regulation (EU) 2020/852 and as of March 2023, of three delegated acts. The regulation itself, consists of only 27 articles and outlines the general principles of the framework. Article 9 defines six environmental objectives:

1. climate change mitigation;
2. climate change adaptation;
3. the sustainable use and protection of water and marine resources;
4. the transition to a circular economy;
5. pollution prevention and control;
6. the protection and restoration of biodiversity and ecosystems.

These objectives form the skeleton of the Taxonomy. Another bearing concept is the substantial contribution criteria, which is defined in article 10 of the Taxonomy. According to the criteria, each business activity needs to contribute substantially to at least one of the six environmental objectives to be classified as Taxonomy aligned. In the climate delegated act combined with the complementary climate delegated act, thirteen (13) sectors have been defined, under which over 100 activities are specified. The sectors are:

1. Forestry
2. Environmental protection and restoration activities
3. Manufacturing
4. Energy
5. Water supply, sewerage, waste management and remediation
6. Transport
7. Construction and real estate activities
8. Information and communication
9. Professional, scientific and technical activities
10. Financial and insurance activities
11. Education
12. Human health and social work activities
13. Arts, entertainment and recreation

The activities under the thirteen sectors are only covering the first two environmental objectives – climate change mitigation (CCM) and climate change adaptation (CCA). The first nine sectors are both climate change mitigating and adapting, while the last four are only considered to be climate change

adaptive. On 5 April the Commission published a draft proposal of the technical screening criteria for the four remaining climate objectives.

The Platform on Sustainable Finance⁵ is an advisory body providing the European Commission information on the implementation and usability of the Taxonomy. The Platform has in total 35 members and 14 observers. 28 members were selected by an open call for application and 7 members from EU agencies and bodies appointed through Article 20 of the Taxonomy Regulation. Nine of the observers are from EU institutions and international organizations and five from the private sector.

The working groups on the Platform have three main tasks:

1. advising on the usability of the EU taxonomy and wider sustainable finance framework
2. advising on the technical screening criteria for the EU taxonomy
3. monitoring capital flows into sustainable investments

The advisory body has divided the workload into three subgroups based on the three main tasks. The activities in the current Taxonomy form, according to the representatives of the Platform, over 90 percent of the greenhouse gas emissions in the Union. It has been highlighted, that the Taxonomy is built on science-based decisions, which seek to find the best solution to tackle climate change. The inclusion of certain nuclear and gas -activities, implemented by the complementary climate delegated act, in the Taxonomy caused turmoil and raised criticism against the framework. For example, Austria being an anti-nuclear country since a referendum in 1978, has filed a lawsuit against the European Commission, arguing that the complementary climate delegated act is unlawful. This certainly raises some questions regarding the objectivity and pure reliance on a scientific-based approach of the development of the Taxonomy. Nonetheless, nuclear and gas energy is considered a less harmful choice compared to coal.

3.1. Transitional and Enabling Activities

The Taxonomy is not all black and white – sustainable or unsustainable. The public discussion seems to make a parallel between having an activity in the Taxonomy and complete sustainability – as it would automatically mean that the activities are purely sustainable, and hence does not harm the environment in any way. In fact, this is not true. The Taxonomy, its details and practical interpretation are much more diverse and complicated. It can be argued that the Taxonomy is an evolving set of definitions that will change over time.

For example, activity 6.5 *Transport by motorbikes, passenger cars and light commercial vehicles*, has a substantial contribution criteria (SC) that up until 31.12.2025 the tailpipe CO₂ are lower than 50gCO₂/km and from 1 January 2026 zero. Followingly, activity 6.5 is considered Taxonomy aligned until the end of 2025, even though, transportation is causing CO₂ emissions, by only considering tailpipe emissions. Transportation, and for example activity 6.5 under it, is a so-called transitional activity, which is defined under article 10 in the Taxonomy. If an activity supports the transition to a climate-neutral economy, *'with a pathway to limit the temperature increase to 1,5 °C above pre-industrial*

⁵ https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en

levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels, and where that activity:

- (a) has greenhouse gas emission levels that correspond to the best performance in the sector or industry;
- (b) does not hamper the development and deployment of low-carbon alternatives; and
- (c) does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.'

Then again, activity 3.5 *Manufacture of low carbon technologies for transport* under the manufacturing sector is an enabling activity, which means that the activity is qualifying as 'contributing substantially to one or more of the environmental objectives set out in Article 9 by directly enabling other activities to make a substantial contribution to one or more of those objectives, provided that such economic activity:

- (a) does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets; and
- (b) has a substantial positive environmental impact, on the basis of life-cycle considerations.'

It is fair to ask, that does not nuclear power plants lock in assets for a very long time – whether those assets, by being invested in nuclear energy, undermines long-term environmental goals can be argued. New nuclear technology, in terms of small modular reactors (SMRs), changes the investment horizon of long-term and large-scale projects to possibly quicker and smaller projects. New innovations and greener technology are welcomed by most politicians. Nonetheless, the legislative process is often lagging the innovations, which is a challenge both for legislators and businesses.

The Intergovernmental Panel on Climate Change (IPCC) published in March 2023 its sixth assessment report on climate change⁶. The report concludes that it is still possible to change the course of global warming towards sustainable levels. However, it requires rapid actions and financing. Legislators face tough decisions on drafting law proposals, which on one hand steers the national economies within the European Union towards sustainability, while not undermining economic competitiveness. A recent example of this is Germany unwilling to accept the proposed law banning combustion engines by 2035. Negotiations are undergoing to allow carbon-neutral synthetic fuels, instead of a total ban. Critics argue that this will undermine the Unions plan for carbon-neutrality by 2050. The need for a level-playing field between businesses is crucial. Additionally, the fast pace of new regulation makes it difficult for capital intense businesses to change the direction towards sustainable activities as the content of law proposals are hard to forecast and sudden changes in draft proposals are possible.

Thus far, the EU Taxonomy has focused on environmental objectives. It is worth noting, that also a social taxonomy has already been considered by the Platform on Sustainable Finance. It can be expected that over time also social and governance related activities will be implemented in the EU Taxonomy or associated regulatory initiatives.

⁶ <https://www.ipcc.ch/report/sixth-assessment-report-cycle/>

4. Implementation of the EU Taxonomy

Despite the known challenges in the path towards sustainability, both financial and non-financial entities⁷, need to follow the current Taxonomy regulation.

The framework includes five fundamental steps, which are (1) assessing eligibility, (2) alignment and assuring that the activity under assessment (3) does not cause significant harm to any other environmental objective and that (4) minimum safeguards are met. The final step includes (5) the calculation of key performance indicators and reporting.

In the first step, eligible business activities are recognized by examining all the activities the entity in question is producing. In its essence, business activities are compared against the list of eligible activities. However, it should be noted that, only scanning through the NACE codes for a business is insufficient. The eligibility assessment requires an in-depth analysis of the business activities – this cannot be achieved, by only determining the eligibility based on NACE codes, even though they are a good attribute supporting the eligibility assessment. One NACE code often entail several activities within a business, thus by only comparing a company's NACE code(s) against the Taxonomy is inaccurate and will cause the second step in the process to fail.

In the second step, the eligible activities are validated against the technical screening criteria set for each activity. At first impression, the task might seem relatively easy. However, it is advisable to note that the technical screening criteria are for many activities linked to several directives and regulations, including detailed thresholds for the activity in question. Practically, for the first time the screening is done, it will most likely include scanning through several national and EU-laws, increasing the burden of the task. The climate delegated act can be seen as a spiderweb of directives and regulations, which will become relevant, when assessing the alignment of the activities.

The third step, assures that an activity being both eligible and aligned, shall not do significant harm (DNSH) to other environmental objectives. An activity under assessment, always falls under one of the six environmental objectives. Hence, the DNSH criteria means that the remaining five environmental objectives shall not be compromised by the activity under assessment to fulfill the Taxonomy requirements.

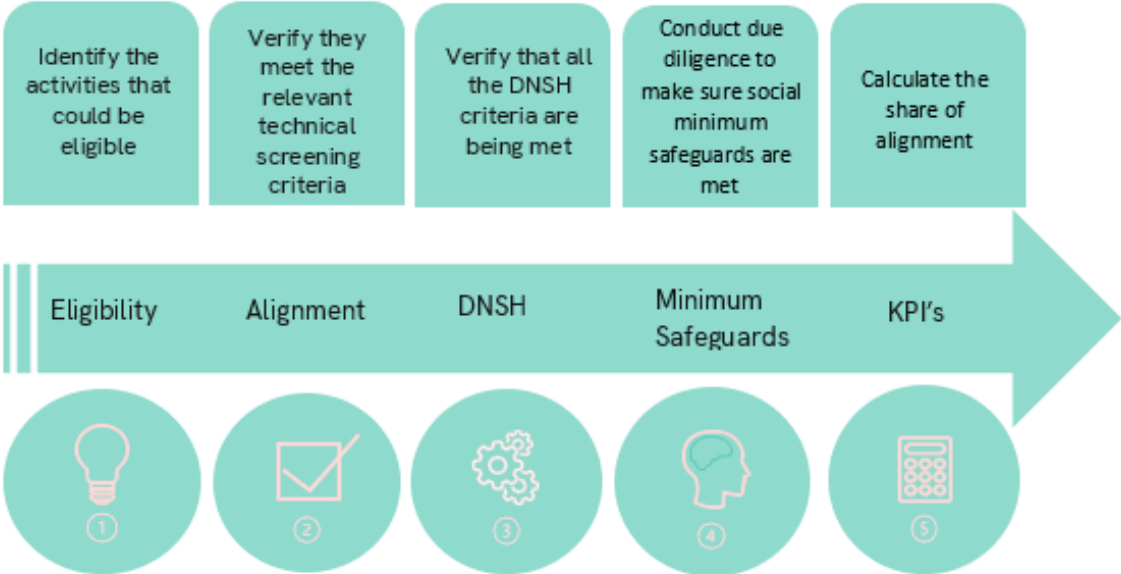
The fourth step takes into consideration the social and governance aspects. An entity conducting business activities shall consider human rights, corruption, taxation and fair competition. For example, a business entity which has been found violating tax laws, does not fulfill the requirements of the Taxonomy. Therefore, no matter how sustainable the business is, none of the activities are considered aligned according to the Taxonomy. From a legal point of view, the minimum safeguards are still a bit vague, as the taxonomy includes only one article (18), which refers e.g., to the UN Guiding Principles

⁷ Public interest entities (PIE)

on Business and Human Rights⁸ and the OECD Guidelines for Multinational Enterprises⁹. However, the EU Platform on Sustainable Finance has published its final report of the minimum safeguards¹⁰.

The final and the fifth step, is to calculate the key performance indicators (KPI's) according to the disclosure delegated act, which include detailed instructions of the requirements for different entities. In addition to the KPI's, the delegated act includes also reporting templates.

Figure 1. The Mechanics of the Taxonomy.



⁸ https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinessshr_en.pdf

⁹ <https://www.oecd.org/corporate/mne/>

¹⁰ https://finance.ec.europa.eu/system/files/2022-10/221011-sustainable-finance-platform-finance-report-minimum-safeguards_en.pdf

5. The Proposed Environmental Delegated Act

On 5 April 2023, the Commission published a draft¹¹ including the technical screening criteria for the four remaining climate objectives – (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, (5) pollution prevention and control and protection and (6) restoration of biodiversity and ecosystems. The draft is on a call for feedback until 3 May 2023.

The proposal introduces three new sectors in addition to the thirteen existing: (1) disaster risk management, (2) services and (3) accommodation activities. Altogether, 35 new activities are proposed in the draft for the environmental objectives 3 to 6, ranging from urban waste water treatment to manufacturing of pharmaceutical products. Consequently, most activities still reside within the first two environmental objectives, covering over one hundred activities.

Besides of introducing new activities for the environmental objectives 3 to 6, amendments are proposed to the Taxonomy Climate Delegated Act covering the first two environmental objectives. The draft includes seven (7) new activities for climate change mitigation (CCM) and six (6) new activities for climate change adaptation (CCA). In addition, amendments are proposed for 10 existing activities under climate change mitigation, which are mainly focused on water transport, rail transport and airport infrastructure¹². Amendments are also proposed for the Taxonomy Disclosure Delegated Act, for the annexes covering both financial and non-financial companies, meaning that the templates designed for giving guidance on how to report the KPI's will be changed, if the proposal is approved.

The proposed entry into force follows a similar phased-in approach as for the first two environmental objectives. Followingly, non-financial companies shall report only eligibility and qualitative information based on the financial year 2023 in the disclosures published in 2024.

Furthermore, for financial companies the proposed entry into force follows also a phased-in approach, where eligibility and qualitative information is reported based on the financial year 2023 in the disclosures published in 2024. In contrast to non-financial companies, the first phase is two years compared to one year. Therefore, the first full disclosure year, including the KPI's, is according to the draft in 2026.

¹¹https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/taxonomy-regulation_en

¹² https://finance.ec.europa.eu/system/files/2023-04/230331-draft-taxonomy-delegated-acts-content-overview_en.pdf

6. Conclusions

The Taxonomy for sustainable activities is still unfinished for all the environmental objectives. However, it is expected that the technical screening criteria for the remaining environmental objectives will be published during 2023. It is very likely, even certain, that the Taxonomy framework will be amended, even after all the technical screening criteria have been published. In fact, the Taxonomy outlines the principles for a review process, which takes place every three years. The process includes e.g. an assessment of the implementation and the effectiveness of the application of the technical screening criteria in channeling private investments into environmentally sustainable activities.

Hence, business decision makers, need to assess the Taxonomy profile of their business entity and adapt their reporting framework to include a new set of requirements.

In due course, the new regulation imposes additional costs on both financial and non-financial entities. Financial institutions faced in the aftermath of the Financial Crisis an exceptional amount of new capital and reporting -requirements. Institutions which were quick in adapting their business models to the new regulatory requirements, were able to price their products more accurately. Once the internal cost allocation mechanisms were in place, financial institutions have been able to monitor how much capital is needed for different products. This in turn gave a competitive advantage for those institutions being able to optimize their capital needs against their desired risk profile. A similar regulatory disruption is undergoing in terms of environmental, social and governance legislation. This will create new opportunities and risks, not only regulatory – also risks from transition to physical climate risks that will result in traditional fiscal profitability, capital adequacy and liquidity risks. Both public and private businesses are forced to adapt to these risks. That is also the justification for, not only the EU Taxonomy, but to all ESG regulatory initiatives.

Knowing the regulatory landscape and understanding essential risks, will give insight for better decision making.