Addendum to “Applying the EU Taxonomy” – Lessons from the Front Line

The EU plans a historic investment of up to €2 trillion in its economy from 2021. If used wisely, combined with leveraged money from the private markets, this provides a unique opportunity to contribute to the objectives of the Green Deal, while reducing the corresponding investment gap and fighting the post-COVID19 recession. Against this background, it is frustrating that the debate about the right tool to track the climate share revolved around an outdated system (“Rio Markers”), not aligned with the so important private markets, or got lost in minor details and legislative issues. This 2-pager serves as an addendum to the recently published report “Applying the EU Taxonomy” – Lessons from the Front Line. It focuses on the bigger picture and promotes a pragmatic way forward.

(A) In the absence of a taxonomy, financial markets already apply their own definitions of “green” and “sustainable” to both corporates and sovereigns.

While most financial institutions have focused on assessing climate risk at the corporate level, Blackrock has recently launched a sovereign bond exchange traded fund (ETF) weighting countries with respect to their assessed climate risk. As a result, the weight of Germany (high share of coal) and the Netherlands (vulnerable to floods plus low share of renewables) significantly decreased compared to the Eurozone Government Bond Index[1].

Similarly, “ESG” has become the default option for financial institutions starting to incorporate sustainability into investment decisions and this has been happening despite known discrepancies between ESG ratings[2]. With talks about major rating agencies joining forces on ESG rating[3], chances are high that a powerful sustainable standard is already evolving.

> *“‘Even top companies may have very different ratings, depending on who the index provider or rating agent is,’ said Andrew Craswell, head of European ETF relationship management at Brown Brothers Harriman. ‘So I think providers are looking at how they create more of a uniform approach.’” [FT, 14 Sept 2020: ESG surges as investors hunt for better corporate citizens (link)]*

(B) The EU should be in the driving seat and proactively shape these market standards.

As several taxonomies evolve across the globe (already in place in China and India and under development in Canada, Malaysia, New Zealand and Singapore[4]), the EU must be in the driving seat for its capital markets and set scientific standards based upon independent expert consensus. Obliging companies to report in alignment with this EU Taxonomy, and then not applying the same approach to its own budgets undermines policy credibility, coherency and will frustrate green co-investments from the private sector. Relying on an outdated system is a strategic error exactly at the same time when the USA’s new administration has pledged to rejoin the Paris Agreement and will be quickly seeking to define their own taxonomy.

---

[1] Financial Times (2020). BlackRock ETF thrusts climate change into political sphere. (link)
[2] Berg, F., Koelbel, J. F., & Rigobon, R. (2020). Aggregate confusion: the divergence of ESG ratings. *Available at SSRN 3438533*. (link) ; and
[3] Financial Times (23 Sept 2020, p.6). Big Four join forces to unveil ESG reporting framework. (link)
[4] See for example the Annual report of the IPSF 2020, chapter 3a (link)

With the EU Platform on Sustainable Finance[5] to further develop criteria for other environmental objectives; and the International Platform on Sustainable Finance[6] to facilitate a sustainable finance dialogue beyond EU's borders, the right expert frameworks are in place. Leading by example will deliver major benefits.

(C) This report "Applying the EU Taxonomy" - Lessons from the Front Line provides sufficient evidence to show that the EU Taxonomy is already applicable today and can evolve as a dynamic framework.

The report's key components are:

1) Transparency: We have to get the definition of "green" right from the start of the EU Recovery Package: The EU Taxonomy, with its expert TEG-recommended significant contribution thresholds, is the best instrument to achieve this and to avoid significant harm to the EU's Green Deal and economic future.

2) Evidence: The report details the practical application of the EU Taxonomy recommended thresholds for significant contribution to 1,000 shovel-ready recovery projects identified by EY this summer; and to 140 of the categories of EU Structural and Investment Fund investment types identified by the Common Provisions regulation (CPR). It also shows how it was applied to 101 "eco" funds.

The report concludes by recommending that:

- EU Member States can already use the EU Taxonomy to ensure that the climate share of their projects in all EU and co-funded areas will fulfil the European Court of Auditors' call for a credible climate action tracking methodology and to avoid green washing.
- The Rio Markers – the existing climate tracking system used for EU funds – are imperfect, can inflate climate action percentages and doesn't align with the definitions for green increasingly used in the private sector, whose money is required for co-investments.
- No climate tracking system can allow for green-wash, nor can recovery instruments include fossil fuel projects that will quickly become stranded assets as Europe moves to a net-zero emissions economy.

(D) As a second best and temporary solution, the currently proposed "CPR Annex" that defines "climate spending" in the RRF regulation must be adapted in critical categories to avoid harmful lock-in effects and prohibit green washed recovery plans.

The 143 categories of intervention, set out in the CPR Annex and used for Cohesion Policy, are currently proposed as defining the "climate share" of the Member States' recovery plans. This is not recommended and even if adapted to align more closely with the EU Taxonomy, as we describe in Table 1 below, these will not reflect the enormous efforts and power of the EU Taxonomy – a united language for the financing of the European Green Deal. If, given a strict legislative timeline and the need to start spending recovery funds on 1st January 2021, the currently proposed tracking methodology must be adjusted as a temporary solution, we here list the most critical "Rio Markers" with some changes that would align them with the EU Taxonomy, in its current recommended form, in Table 1 below.

[5] EU Platform on Sustainable Finance (link).
[6] International Platform on Sustainable Finance (link).

Table 1 – "Taxonomizing the CPR Annex" - Adding stricter criteria to the currently proposed RRF tracking methodology

The report Annex presents an initial mapping from the draft Common Provision Regulation (i.e. the climate tracking method for Cohesion Policy) to the EU Taxonomy. Cohesion funds constitute the second largest block of climate-related spending (after agriculture) and as this "Rio Marker" system was referenced in RRF debates in Parliament, we translate those key items here:

Dimensions from "CPR Table 1"	Climate Coeff.	Complemented by Condition
022 - Research and innovation processes, technology transfer and cooperation between enterprises focusing on the low carbon economy, resilience and adaptation to climate change	100%	***Research activities are not (yet) covered by the Taxonomy. However, this category needs more details with regard to Taxonomy-aligned products:*** -> Research related to a) key components essential for eligible renewable energy technologies; b) manufacture of low carbon transport vehicles and respective key components; c) products for energy efficient equipment for buildings -> [Others…]
024 - Energy efficiency and demonstration projects in SMEs and supporting measures 025- Energy efficiency renovation of existing housing stock, demonstration projects and supporting measures 026 - Energy efficiency renovation of public infrastructure, demonstration projects and supporting measures	100%	***To prevent that not every energy efficiency investment with minor improvements qualifies as a climate spending, the following thresholds must be met:*** -> For new buildings: Net Primary Energy Demand (PED) must be >20% lower than the NZEB requirement (nearly zero-energy building, national directives); -> For renovation: substantial reduction of PED by >30%.
034 - High efficiency co-generation, district heating and cooling	100%	***Under this system gas qualifies (and even receives a 100% climate coefficient). We suggest the TEG criteria:*** -> Life cycle emissions lower than 100gCO2e/kWh, declining to net-0gCO2e/kWh by 2050. -> Infrastructure for distributing heating and cooling is eligible if it follows the EU Energy Efficiency Directive.
064 - Newly built railways - TEN-T core network 065 - Newly built railways - TEN-T comprehensive network 066 - Other newly built railways	100%	***Threat of a 'blank sheet'. We suggest these categories to be complemented by TEG criteria:*** -> Clear exclusion if infrastructure is dedicated to fossil fuel transport. -> Infrastructure predominantly used by zero direct emission rail (e.g. electric) is eligible. -> Non-electrified infrastructure must have an existing plan for electrification.
073 – Clean urban transport infrastructure 074 – Clean urban transport rolling stock	100%	***Again, threat of a 'blank sheet', which needs to be filled with details:*** -> "Clean urban transport activities" is eligible if it is predominantly used by "Clean urban transport rolling stock". -> The latter is eligible in case of zero direct emissions land transport activities (e.g. light rail transit, metro, tram, trolleybus, bus and rail). Other fleets are eligible if direct emissions are below 50 gCO2e/pkm until 2025.
077 – Alternative fuels infrastructure	100%	***Insert more details from the Taxonomy to prevent harm:*** -> Only infrastructure that is required for zero direct emissions transport is eligible (e.g. electric charging points, electricity grid connection upgrades, hydrogen fuelling stations or electric highways).

To download the full report please click here. For more information, please contact Peter Sweatman (peter@climatestrategy.es) or Malte Hessenius (malte@climcom.de).

About Climate Strategy & Partners

Climate Strategy & Partners is a leading consultant in climate finance, energy efficiency investments and the corporate strategies and Government policies required to up-scale both. For 11 years, the Climate Strategy team has been providing global companies, banks and Governments advice on how to accelerate the economic transition to a low carbon economy. Climate Strategy's chief executive, Peter Sweatman, has authored or co-authored fifteen white papers, is the rapporteur to the G20's Energy Efficiency Financial Task Group (EEFTG) and the EU Commission and UN Environment Finance Initiative's Energy Efficiency Financial Institutions Group (EEFIG). Climate Strategy has supported energy transition policy development in Mexico, France, UK and Spain and continues to implement leading low carbon business solutions for global clients.

More information can be found at www.climatestrategy.com

About Climate & Company

Since the late 1990s the founders of Climate & Company (C&C) have been working primarily on the challenges of analysing, financing and policy design for climate action and sustainable development. Based on a broad and differentiated understanding of policy making, financial market practice and the rigorous analysis of industrial processes, C&C is able to solve complex challenges across sector and country boundaries. The C&C team brings together the right mix of skills, experience and motivation focused on creating a world worth living in for people today and for the future of our children.

More information can be found at www.climateandcompany.com