The EU Taxonomy impacts on other environmental policies

A preliminary & qualitative analysis on how the EU Taxonomy will affect and interact with other (selected) environmental policies

The EU Taxonomy Regulation and the Technical Screening Criteria (TSC) set in its delegated acts will have 2 main types of (direct & indirect) impacts. Firstly, on other Sustainable Finance (SF) policies. Secondly, on other environmental and climate policies, such as the ones included in the *"fit for 55"* package, as well as public funding or aid schemes like the Recovery and Resilience Facility, the Cohesion policy, Invest EU, the revised Climate, Energy and Environmental Aid Guidelines (CEEAG), etc.

If the impact on other SF policies was somehow previously considered by policy makers[1], the one on the other policies is still unknown, also because the *fit for 55* package will be published on the 14 July 2021.

Questions to panelists:

- *How will the EU Taxonomy Regulation impact other EU Sustainable Finance policies?*
- *How will the EU Taxonomy Regulation impact the policies in the "fit for 55" package?*
- *How will the EU Taxonomy Regulation impact the overall functioning of the economy and the balance between the roles of markets and regulation?*

Background information

1. The EU Taxonomy impacts on the Sustainable Finance (SF) policies

- *The EU Green Bond Standard (EU GBS) & the EU Ecolabel for financial products*

The EU Taxonomy Technical Screening Criteria (TSC) defined in the climate delegated acts (DA) will likely be the reference for issuing an EU Green Bond (EU GBS)[2]. The TSC will therefore shape the financing mechanism of companies that will intend to issue a bond under the upcoming (6 July 2021) European Standard (which will be voluntary). To be noted that green bond issuers can also be public entities, and therefore also Member States will have the opportunity to issue EU green bond compliant with the Taxonomy TSC.

[1] COMMISSION STAFF WORKING DOCUMENT, IMPACT ASSESSMENT REPORT (2021): https://data.consilium.europa.eu/doc/document/ST-9801-2021-INIT/en/pdf?utm_source=Associate+Members&utm_campaign=4cc64ada7f-EMAIL_CAMPAIGN_2018_11_07_05_13_COPY_01&utm_medium=email&utm_term=0_00bf999edc-4cc64ada7f-246002533

[2] TEG recommendation: *"proceeds from EU Green Bonds should go to finance or refinance projects/activities that (a) contribute substantially to at least one of the six Taxonomy Environmental Objectives, (b) do not significantly harm any of the other objectives and (c) comply with the minimum social safeguards. Where (d) technical screening criteria have been developed, financed projects or activities shall meet these criteria, allowing however for specific cases where these may not be directly applicable"*

Moreover, it is still unclear, in the context of the EU GBS, if and how "low-carbon" and "transitional" bonds will be defined, and how they will be linked with the definition of transitional activities under the Taxonomy Regulation.

- *The Climate Benchmarks (a definition of transition at company level?)*

The Taxonomy Regulation (TR) provides Technical Screening Criteria (TSC) for economic activities, and therefore does not specify performance thresholds at corporate level[3]. Climate benchmarks, instead, might be a policy to be potentially explored for finding a generally accepted definition of "transitional" business.[4] However, it should be noted that the Climate Benchmarks is a tool designed for financial portfolios and not for companies. There are possible links (and inconsistencies) with Climate Benchmarks in the definition of "transitional activities". The 2 definitions of "transition" might differ as the Taxonomy refers to economic activities whilst the benchmark to companies; this can cause confusion and issues among stakeholders.

In terms of direct impact of the Taxonomy Regulation (TR) on Climate Benchmarks, (which are of 2 types: Paris-aligned (PABs) & transitional (CTBs)), administrators of EU PABs (the more "ambitious" benchmark in terms of sustainability performance) shall exclude companies that are found to significantly harm one or more of the environmental objectives of the TR; whilst administrators of EU CTBs shall comply with the same rule by 31 December 2022.[5]

- *The Sustainable Finance Disclosure Regulation (SFRD)*

    - The "do not significant harm" (DNSH) principle is present in both legislations, but SFRD definition of "sustainable investment" is broader and overarching (including also social aspects) whilst the EU Taxonomy goes into detail and requires a "substantial contribution" (and not only "contribution", as in the SFDR) to an environmental objective[6] (i.e. not focusing on social aspects, so far). The 2 definitions therefore differ between each other and which one will be considered by the market is still unclear.
    - Under the SFDR, financial market participants are required to disclose the extent to which their financial products are environmentally sustainable and address adverse sustainability impacts. Regulatory Technical Standards (RTS) for the SFRD will specify the technicalities for disclosing the taxonomy-alignment of financial products.

[3] A corporate can be the "sum" of more than 1 economic activity listed in the NACE code

[4] That would be: 1) being on a decarbonisation trajectory (defined as "measurable, science-based and time-bound trajectory towards alignment with PA objectives by reducing Scope 1, 2 and 3 carbon emissions") OR 2) by publishing GHG emission reduction targets and reaching a (-7%) for 3 years in a row

[5] Furthermore, in the Benchmark Regulation there is a review clause requiring that by 2022, the minimum standards on both EU CTBs and EU PABs are reviewed to ensure that the selection of the underlying assets is coherent with environmentally sustainable investments as defined in Taxonomy

[6] Moreover, there are some *horizontal issues across EU policies in the definition of sustainability reporting (e.g. definition of "sustainable" & "green" differs between Taxonomy & SFDR. Moreover, there is a potential lack of coherence among CSRD, SFDR & Taxonomy with regard to reporting obligation in line with the double materiality*

- *The Corporate Sustainability Reporting Directive (CSRD) & The Corporate Governance Initiative*

The "legal" influence of the EU Taxonomy Regulation (TR) to the future CSRD stands in TR Article 8, which requires companies under the scope of the CSRD to disclose the undertaking's taxonomy-alignment with: 1) Turnover; 2) Capex; & 3) Opex (i.e. disclosing information about companies' investment strategies).

Taxonomy "non-legal" influence will likely shape businesses' environmental risk management[7]. The disclosure of businesses' sustainability impacts & risks (double materiality) is required by the new CSRD, and according to the Commission proposal, reporting standards will likely be based on the 6 Taxonomy's environmental objectives. Therefore, the corporate environmental risk management activities will be influenced by the environmental Taxonomy "categorization", which was initially designed for financial markets labelling purposes and not for supporting a functional business transition (i.e. able to take into account the sectoral nuances, the transition challenges and the geographical context).

2. The EU Taxonomy impacts on the "fit for 55" package & EU public funding

- *The Emission Trading System & The Carbon Border Adjustment Mechanism*

The Taxonomy will likely (negatively) impact the technological neutrality principle of the EU ETS, with the risk of creating green bubbles with inefficient overallocations of capital on certain activities (and thus leading to inflated & unstable asset prices).[8]
Furthermore, the Taxonomy will likely have an effect on carbon prices in the EU, due to an increased decarbonization process partly enhanced by the Taxonomy itself. There will thus be more allowances in the system and less demand. Are the Linear Reduction Factor (LRF) & the Market Stability Reserve (MSR) of the EU ETS 'fit for purpose' to deal with this possible issue?
To conclude, the carbon price-effect might be trickled down from the industry to the consumers (thus affecting more the lower income groups), because of increased industry & energy costs. Is there a EU solidarity mechanism that is going to implement the needed transfers for ensuring a just transition?
CBAM will be linked to all these considerations via its interlinkage with the EU ETS, which is currently under examination by ERCST under a separate work-stream.

The Energy Taxation Directive (ETD) & the revised Climate, Energy and Environmental Aid Guidelines (CEEAG)

The revised ETD will likely interact with the ETS[9] carbon leakage governance, with a similar effect of the Taxonomy in increasing carbon leakage risks. Thus, there is the need to consider the impacts on the most affected industries (also on the base of their trade exposure). The reform of the ETD in environmental terms, the EU Taxonomy & the new CEEAG could have a

[7] The results from the consultation on the Renewed Sustainable Finance Strategy indicate that a high degree of use can be expected at least among economic operators that consider themselves sustainable. Among these companies, two thirds indicated a high or very high likelihood of using the EU Taxonomy in business decisions
[8] European Central Bank website (2020): https://www.ecb.europa.eu/press/inter/date/2020/html/ecb.in201121~f7ef8bb05d.en.html
[9] Risk of double taxation between the EU ETS, which is seen as the main carbon pricing instrument at the European level, and the ETD, if this will be revised to tax fuels based on their carbon content

self-reinforcing effect: Member States will be likely allowed to support certain projects & technologies, without this support being qualified as State Aid, and therefore not being subject to the same legal constraints.

- *The Renewable Energy Directive (RED) & The Energy Efficiency Directive (EED)*

Taxonomy will likely reinforce the current & revised RED (increasing RES in the energy mix) as well as the current & revised EED (improved energy efficiency) objectives. Another element to be considered in the EED context is that there might be a risk that as money are channelled towards green technologies and a favourable legal framework is created, the energy consumption could be more than the optimal level, going against the objectives of the energy efficiency directive of reducing energy consumption.

- *The Recovery & Resilience Facility (RRF); Cohesion Policy Regulation*

The "do not significant harm" (DNSH) principle is required to all MSs designing their RRF plans (with a technical guidance document issued by the EU Commission, which is not in line with the TSC defined in the climate delegated act but follow *ad-hoc* principles, i.e. only the DNSH "principle" was exported and not the TSC). Cohesion Policy Regulation and InvestEU also require its funds to be DNSH compliant for the 2021-2027 programming period.