AFME position on the Taxonomy Report by the EU Technical Expert Group on Sustainable Finance

13 September 2019

Summary

Developing a unified classification system on what activities can be considered environmentally sustainable is the key initiative of the European Commission's Action Plan on Financing Sustainable Growth ("Action Plan") and is now seen as the cornerstone of further mainstreaming the sustainable finance agenda not only at the EU but also at the international level. AFME has been fully supportive of the initiative from its outset via advocating for a practical, scientific-based, flexible, progressive and proportionate taxonomy that would promote convergence at the global level[1] and truly shift capital flows towards sustainable investment. AFME fully appreciates the complexity of the undertaking and welcomes the progress made by the Technical Expert Group (TEG) on the taxonomy, as outlined in its Technical Report (Report).

AFME generally supports the principles underlying the taxonomy approach, which requires an economic activity to make a substantial contribution to at least one of the six environmental objectives[2] and cause no significant harm to the other objectives in order to be eligible for being considered environmentally sustainable. We believe that establishing quantitative criteria, as demonstrated for climate change mitigation, is very important to set consistent standards and prevent greenwashing. We broadly agree with the principles underlying the "Do No Significant Harm" (DNSH) criteria and those for climate change mitigation, however, we perceive some important issues in relation to some of the approaches and thresholds proposed, including the ability of finance providers to assess compliance of investees with such criteria. We outline our considerations in more detail in this paper. We note that several specific points, as indicated further in the paper, have been endorsed by the International Swaps and Derivatives Association (ISDA). Unless mentioned in specific parts of the position that other trade associations, such as ISDA, are endorsing the points made, the paper should be read as reflecting only AFME's position.

We strongly support that the Report acknowledges the need to recognise not only the activities that are already "green" but also the **activities that contribute to the transition** to a zero net emissions economy in 2050 yet not currently operating at that level, including "enabling" activities. We also agree with the overall approach to assess activities in isolation rather than attempting to evaluate the full supply chain, which would significantly increase the complexity of the assessment and narrow down the array of compliant activities. For example, we understand that an investment in construction activity would comply with the taxonomy provided that all construction and operations comply with the emission thresholds, rather than also extending this assessment to the sources of the building materials or the carbon effect from the transportation of the materials. We agree that this is a reasonable and fair approach.

[1] Refer to AFME material produced:
- AFME position on the EU Taxonomy Regulation
- AFME comments on European Parliament's Report on Taxonomy Regulation
- AFME's feedback on TEG's Taxonomy [interim] report

[2] (1) Climate change mitigation; (2) climate change adaptation; (3) sustainable use and protection of water and marine resources; (4) transition to a circular economy, waste prevention and recycling; (5) pollution prevention and control; (6) protection of healthy ecosystems

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We believe that the taxonomy sets up a solid foundation for developing a classification system of environmentally sustainable activities for investors such as portfolio managers, UCITS funds, alternative investment funds (AIFs), providers of insurance-based investment products (IBIP), pension products and pension schemes. We believe that the taxonomy can also be used by banks to structure "labelled" environmentally sustainable products. We note, however, that the taxonomy, as currently designed, is not fit to be used for banks' whole portfolio and we would like to provide additional recommendations on the **use of the taxonomy across various asset classes** (as set out in more detail in Section 3 below and Appendix I), in particular banks' loan and guarantee portfolios, green bonds, project finance and public equity. AFME agrees that the taxonomy will need to be reviewed at regular intervals to adjust the criteria toward the 2050 carbon neutrality goal, taking into account technological progress and further development of "green" infrastructure. We believe however that the three-year cycle of review, as currently envisioned, should be more frequent – at least in the initial stages. We recommend considering a review annually or every two years, as we expect that a significant amount of feedback would be available from the industry and the investment community during the first stages of the taxonomy implementation and integration into business-as-usual operations.

Finally, we believe that the taxonomy should reflect a holistic and flexible approach that takes into consideration different stages and pace of development in the EU jurisdictions as well as in the third countries. We stress that complying with many requirements, if transposed mechanically to emerging countries, would be extremely challenging, if not impossible within a short period of time. For that reason, we believe that the taxonomy should be locally-adapted - at least until reaching some degree of convergence between advanced and emerging economies in the sustainable finance arena.

1. Financing transition activities

AFME believes that the taxonomy should be ambitious and seek to drive measurable changes in investment behaviour. We also acknowledge that certain barriers should be in place for activities to be taxonomy eligible to avoid greenwashing and subjectivity, which arguably could negate the point of the taxonomy. However, we believe that the definition of transition activities, according to the Report, can be too restrictive. Phase-in thresholds for certain activities are too ambitious and discourage the use of the taxonomy by market participants across all EU jurisdictions – and prove even more challenging for participants in other regions, especially less developed markets (please refer to Appendix I of this paper for respective examples and additional details). This might hinder the stated objective of the EU taxonomy becoming a tool to stimulate international coordination and convergence in facilitating the shift to a low carbon economy.

We note that, as acknowledged in Recital 28 of the EU Taxonomy regulation EU/2018/0178, when *"establishing technical screening criteria, the Commission shall assess whether adoption of the criteria for environmentally sustainable activities would give rise to stranded assets or deliver inconsistent incentives, and whether it would have any negative impact on liquidity in financial markets."* AFME and ISDA think that it is crucial to maintain this principle when establishing the final set of the screening criteria as we envision an essential direct impact of the taxonomy proposal, as it currently stands, for market participants - mainly on their corporate treasury/finance activities. The general risk is that it will become more difficult for firms to attract investment capital for activities that are not sustainable, yet vital to the near-term transition process, and this could adversely impact the liquidity of such companies. As a result, trading in commodities and commodity derivatives could be affected as well, if the underlying assets are not deemed sustainable, which could also have an negative impact on the liquidity of financial markets.

We strongly believe that the funding of transition activities is vital to achieving the overall aims of the taxonomy. There is a danger that the exclusion of activities that are considered "brown" as well as any hard thresholds could disincentivise funding of activities that would enable a transition from "brown" to "green". For example, as the taxonomy stands, a Transition Bond[3] would not be considered sustainable. There is a genuine risk that emission-intensive industries (e.g. fossil fuels industry), intended as a primary target for the transition – will be excluded altogether from the pool of capital available to finance such transition or pushed to other jurisdictions. In order to avoid this counterproductive outcome, we suggest the inclusion of a concept of "additionality" demonstrating, against the current baseline, that funding is designed to enable transition toward the relevant thresholds in a given time. This could, for instance, be included as an additional criterion in a mitigation report. We also suggest considering introducing in the taxonomy a concept of *portfolio effect*, along with the hard thresholds at an asset level, allowing a finance provider to meet the targets by averaging multiple assets.

We acknowledge that there may be extra safeguards necessary to ensure that greenwashing does not become hidden in the complexity of some investment products, especially those involving "green" equity investments. We also think that with the implementation of the EU Disclosure regulation and updated EU Benchmark regulation it would be easier to establish additional safeguards to prevent greenwashing through enhanced disclosures around ESG indices and products.

2. Use of Taxonomy for banks

We believe that the taxonomy approach described in the TEG's Report can generally be applied by banks to structure "labelled" environmentally sustainable products for their clients though certain types of financial instruments, such as green bonds, green covered bonds and green securitisations. The taxonomy can also be used for bank's own issuances of green market instruments. As mentioned above, we also believe that the taxonomy can be used when loans are structured in a way where the use of proceeds is dedicated to a specific green investment. However, when it comes to more general lending activities, the use of the taxonomy is not so obvious, and we stress that the vast majority of banking products are not dedicated to specific investments (treasury loans, working capital financing, export trade, retail loans, etc.).

For loans to companies for general use, it is going to be very data-challenging and operationally complex for banks' systems to segregate and weigh each borrowing companies' activities, with the exact same taxonomy's classification format based on revenues or expenditures. Hence, the taxonomy cannot be used effectively for a large spectrum of financial products and on a broader scale in general, for example, to assess the climate-related risk of the overall balance sheet. Furthermore, we identify additional problems in data gathering (further discussed in Section 5) that could potentially represent a significant barrier for adoption of the taxonomy by SMEs and respective reporting due to its complexity. Therefore, it would be extremely important to simplify the metrics to avoid creating unjustified competitive disadvantage for SMEs.

[3] The same issue would be pertinent to the SDGs- linked bonds. For example, ENEL has recently issued such bonds, which was a relatively new product designed in response to demand asset managers had expressed over the past couple of years, stating that there is need for bonds that would go beyond 100% green bonds and thus enable companies that cannot issue green bonds to perform transactions that would support their transition to the low carbon operations.
Source: https://renewablesnow.com/news/enel-issues-usd-15bn-sdg-linked-bond-668049/

3. Activity-based approach

We generally support that the TEG has chosen to focus on the classification of "activities" and not the specification of types of "entities" in which the sustainable investments may be made. This approach allows any organisation to use the taxonomy to specify the proportion of its activities that substantially contribute to environmental objectives. We also understand and appreciate the approach taken behind identifying the key or high priority sectors for the taxonomy. However, we highlight that this approach would scope out other sectors, including a large array of activities by higher carbon-emitting companies without any distinction.

We believe it would be critical to stimulate the allocation of capital to the transition of high-emitting companies to environmentally sustainable business models, subject to such companies being able to demonstrate their commitment to the transition and provide robust information on the progress made (e.g. increasing share of renewable energy in the overall energy mix, setting and meeting decarbonisation targets, increasing investments in R&D aimed at the reduction of carbon footprint, optimising non-renewable energy consumption, using Carbon Capture and Storage, reforestation, etc.). We thus appreciate and support the approach (as noted in the project finance/green loans section of the Report) whereby, for example, a high emitting company could aim to reduce its carbon footprint through attracting taxonomy eligible financing aimed at reducing carbon emissions. However, we are concerned that the taxonomy, as currently stands, would not be able to capture all important mechanisms of "greening" high-emitting sectors. Recital 23 of the European Commission's proposal on the taxonomy Regulation rightly conveys this concern: "*Some economic activities have a negative impact on the environment, and a substantial contribution to one or more environmental objectives can be achieved by reducing that negative impact. For those economic activities, it is appropriate to set out technical screening criteria that require a substantial improvement in environmental performance compared to, inter alia, the industry average. Those criteria should consider also the long-term impact of a specific economic activity.*"

We believe the taxonomy should recognise, where technically possible, companies' proven and measurable engagements in sustainable practices, including by companies in sectors that cannot be classified as environmentally sustainable *per se*. We note that many companies have already adopted "science-based targets" to signal their commitment to reducing greenhouse gas (GHG) emissions.[4] We are therefore concerned that, as it currently stands, the taxonomy would in many cases exclude investments in companies engaging in activities contributing to climate change mitigation as such investments would fail to meet the technical screening criteria proposed. To illustrate this point, we have provided the following example.

A bank grants a 5-year loan to a company operating in cement manufacturing. Currently, the company has greenhouse gas emissions of 0.8tCO2e/t of cement. The taxonomy includes the following criterion for when cement manufacturing is considered to have a substantial contribution to climate change mitigation: 0.498 tCO2e/t of cement. Hence, the taxonomy is binary: not taxonomy eligible when above the thresholds or eligible when already below the thresholds. For a banking institution granting a loan it would be essential to be able to conclude that the loan being granted would be taxonomy compliant when there is a proof that the investee company has taken credible commitments (e.g. sustainability performance targets / Key Performance Indicators with quantitative thresholds, etc.) to meet the thresholds proposed by the Report within the time frame of the Paris agreement. We further illustrate our arguments in the following table, demonstrating that the binary approach of the taxonomy, as currently stands, can prove counterproductive.

[4] The Science-Based Target Initiative (SBTI) lists a series of relevant case studies and proposes a standardised approach for corporations to meaningfully decarbonize their activities[4]. According to the definition proposed by the SBTI, for targets to be considered "science-based", they must align with the goals set out by the Paris Agreement – that is, to limit global warming to 1.5°C above pre-industrial levels, or less. In order to mitigate the risk of greenwashing, science-based targets proposed by companies undergo a rigorous assessment process by SBTI. https://sciencebasedtargets.org/

Screening criteria	Company commitment	Time horizon: origination date	Time horizon: Loan 5/y maturity	CO2 emissions reduction
greenhouse gas emissions < 0. 498tCO2e/t of cement at loan origination date	N/A	Complies with the taxonomy	Complies with the taxonomy	0
greenhouse gas emissions of 0.8tCO2e/t of cement at loan origination date	Loan with use of proceeds, aiming at funding the new technology to meet in 3 years greenhouse gas emissions of 0. 4tCO2e/t of cement	Complies with the taxonomy	Complies with the taxonomy	**0.4**
greenhouse gas emissions of 0.8tCO2e/t of cement at loan origination date	Loan with no use of proceeds, but company commitment to invest in new technology to meet in 3 years greenhouse gas emissions of 0. 4tCO2e/t of cement	**Does not comply with the taxonomy**	**Does not comply with the taxonomy (3 years)** Complies with the taxonomy (2 years if met)	**0.4**
greenhouse gas emissions of 1.2tCO2e/t at loan origination date	To invest in new technology to meet in 5 years greenhouse gas emissions of 0. 6tCO2e/t of cement	**Does not comply with the taxonomy**	**Does not comply with the taxonomy**	**0.6**

In this example, under current practice, three loans would be considered by banks as such that contribute to climate change mitigation objectives. The taxonomy, however, omits two major dimensions: the **customer commitment to decrease its carbon emissions and the dynamic approach to the time horizon to meet this objective.**

Therefore, AFME believes that the taxonomy should allow for the financing granted to a company for its energy transition to be considered taxonomy compliant when the company sets a clear and consistent strategy to reach this objective and not only when the objective has been reached already. In other words, we believe that the taxonomy should account for different degrees of sustainability, possibly through the introduction of different categories within the taxonomy, which would recognise companies who already meet the C02 emission thresholds as well the companies who are committed to the transition. We note, however, that the "eligibility" of the loan benefitting from the use of proceeds, for example, might not be classified in the same sustainability category as the loan to a company already meeting the technical thresholds. We also acknowledge that monitoring companies' commitments would be crucial, and the monitoring processes and mechanisms would need to be further strengthened and developed.

AFME notes that the transition is a dynamic process that must be reflected in the classification system in order to ensure that adequate incentives can be put in place. With its static approach, the current taxonomy cannot perform this task. Therefore, AFME finds it essential for an ongoing feedback mechanism to be established, allowing to consider the inclusion in the taxonomy of activities found to be, for example, reducing a company's emissions but currently not included under the taxonomy. We understand that this will be handled through establishing the EU Platform on Sustainable Finance, and therefore we welcome this initiative and stress the importance of its future role as a forum for facilitating exchanges and, where appropriate, coordinating global efforts in this area.

4. Technical complexity and overly ambitious metrics

AFME appreciates the amount of detail and comprehensiveness of analyses that shaped the technical screening criteria. However, we would like to highlight their complexity, which could impede the uptake of the taxonomy by market participants.

AFME believes that, from the outset, a consistent structure and methodology is required for the taxonomy to be successful. We note that the approach starts with the identification of high-priority sectors based on the NACE code identification and then moves into new sub-categories of activities for which there is no unified classification or identification, which in our view could cause lack of harmonisation as to what activities might fall into those categories. We think that subjectivity in the taxonomy should be avoided as it could potentially lead to different companies classifying activities differently – thus negating the objectives of the taxonomy and its positive impact.

Additionally, we note that industry classifications, such as NACE, generally have limited use in describing the economic activities that a company is engaged in (i.e. what a company actually does). For example, a company's NACE code might say that a company operates in the power generation sector, but it does not say how much of that power is renewable, or indeed whether the company also manufactures plastics as well as generating power.

Investee companies will need to disclose a breakdown of their activities according to the taxonomy before financial institutions can start using that information to assess their portfolios. We further note that the technical assessment of these subcategories' performance is highly complex and the level of skill or data available within the industry or market more broadly is not sufficient to be able to appropriately perform the assessment. Notably, banks and companies will need the criteria to be codified in IT systems in order to automate the assessment processes.

We further note that the approach proposes very ambitious metrics and thresholds for many activities that could be difficult to achieve in the near future. Appendix I to this letter provides examples of such activities as well as our comments on other matters that we believe would require further improvement and/or clarification. We note that if the taxonomy criteria are too strict, or the scope is too narrow, it would be challenging to identify eligible investment opportunities, or it may leave certain sectors unable to attract investors. There is a risk that a portion of European companies, actively committed to their sustainability objectives, would not be able to signal their pledge as active supporters of the much-needed transition towards a more sustainable economy.

We are also concerned that the Do No Significant Harm (DNSH) requirements and the minimum social safeguards, as currently stated, would restrict the financeable universe for firms - mainly geographically. As it currently stands, the framework lacks clarity on some important aspects to enable users to undertake this

assessment. In particular, it is not clear what and how the EU environmental laws should be considered. If there is an aspiration for the taxonomy to be applied globally, there is a limitation of having only EU laws as a reference. We think that it may be necessary to begin with EU laws as a reference and then translate them across different jurisdictions on the basis of equivalent frameworks, where possible. Requiring areas outside the EU to comply with EU laws would hinder the global uptake of the taxonomy. AFME believes that a practical solution to this issue would be to use the local laws as a reference point in the respective jurisdictions. At the same time, we believe that as soon as a third-country financial institution engages in business relationships with a client based in the EU, the EU taxonomy should apply.

We would like to highlight that the existing due diligence practices have not been developed to the extent enabling firms to adequately assess compliance with the DNSH criteria, and it will take time to develop such practices. In some cases, assessing these criteria for a single asset would require a full environmental impact assessment, which could take a number of months to complete depending on the complexity of the economic activity. The bank would either have to review the impact assessment for every asset in, for example, a green bond to confirm that all assets meet the criteria, or appoint a third party to do it – both situations would result in a significant transaction cost potentially discouraging such "green" issuances. We note that more industry guidance could be published to support the establishment of effective due diligence processes to help accelerate the uptake of the use of the criteria. We understand that the TEG will continue to work on the DNSH criteria until the end of its mandate in December 2019, therefore we would welcome further developments addressing the above-mentioned issues.

We fully support the principle of the minimum social safeguards, but we are concerned that the range of financeable investments could be limited by the obligation for market participants to carry out due diligence on the investee/borrowing companies' compliance with the minimum social safeguards – specifically in emerging markets, where governance and social indicators are not widely available or these principles have not been clearly defined yet. This might work against the need to keep up with rapidly increasing needs for sustainable investment in emerging markets. We thus encourage the TEG to consider how these requirements would be applied in the context of such markets to prevent the taxonomy from disincentivising critical investments for their sustainable development.

5. Data gap

As noted in our position paper on the EU Taxonomy Regulation (referred to on page 1 of this paper), a conclusion on whether financial products qualify as environmentally sustainable investments can only be reached using the information from the issuing investee companies based on the assessment of their sustainable economic activities and/or practices. Notably, there is an increased number of reliable ESG data providers in the market and significant progress in the quality of corporate ESG reporting has been achieved over the past few years. However, there is still a lack of availability of robust and reliable ESG data for a wide array of investee companies' activities and/or practices at the level of granularity matching the proposed screening criteria. Additionally, as we mentioned above, it is unclear how the proposed approaches would be implemented by smaller companies and SMEs without imposing on them a significant operational burden, thus discouraging both investors and investees from applying the taxonomy in assessing sustainability of investee activities and respective investments. If companies are not in a position to provide the data required by the taxonomy, and, as a consequence, this information will not be available to banks, there is a risk of under-representation of the environmentally sustainable sectors only due to an information gap – this risk appears particularly relevant for lending businesses.

The current state of play will lead to a situation where financial institutions have to collect data from third-party providers. This poses a series of issues such as lack of comparability among ESG products, due to transparency issues on the different methodologies used by data providers. Moreover, in a context of constant increase in data prices, increasing the dependency on third-party data providers is likely to favour big institutions to the detriment of small banks.

Concluding remarks

Overall, AFME believes the taxonomy approach proposed in the Report represents a good starting point, conditional on its future developments and iterations. We generally agree with the conceptual principles outlined in the Report for climate change mitigation and adaptation and highly value the scientific basis underlying the approaches, but stress the need for more industry guidance to be issued in the future for implementation and use of the taxonomy across a range of different stakeholders including SMEs, large corporates, banks, investors, etc. We think, however, that the approach might be too rigid and complex in defining environmentally sustainable activities. Considering that most companies are at different stages in their transition journey towards low-carbon and sustainable activities, it would be extremely important to allow for some degree of flexibility in applying the taxonomy. We would also recommend that the TEG remain cognisant of ongoing work and existing principles and guidelines at the international level (e.g. Green, Social and Sustainability bonds principles by the ICMA) as well as the ultimate need to reach a coordinated framework at global level recognising that the European financial system cannot work in isolation.

We stress that industry-wide understanding of and adherence to the classification criteria will be the key factor and the condition necessary to the intended change within the banks' decision-making processes and business models towards a committed and effective engagement in environmentally sustainable banking.

We would be pleased to discuss the content of this paper or to provide any further clarity with regard to the statements made.

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About AFME

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.

Appendix I – AFME feedback on specific matters of the Report

USABILITY OF THE TAXONOMY
1. Do you expect to use the Taxonomy in your business activities in the short term (1-3 years) or long term (4 years or more)? If yes, please indicate when (short term or long term) and specify the activities for which you will use the Taxonomy.
AFME members expect to use the taxonomy for project finance activities in the short term.
3. Can the Taxonomy be made more useful for your investment decisions in different asset classes? Yes **Which asset class(es) did you have in mind?** • Project finance • Green bonds • Green loans • Public equity
How could Taxonomy be made more useful for green bonds:
Although we believe that the taxonomy is generally a useful tool for those issuers who have already issued green bonds, we see some room for improvement of the taxonomy for the so-called "hard to abate" industries, for example, companies exposed to fossil fuels or operating in the steel production industry. Companies operating in the mentioned sectors would be able to issue green bonds to finance very distinct, specific, mostly already "green" projects, whereas companies who intend to change their operations to reduce carbon emissions would find the taxonomy's application limited. Notably, entities are now exploring new instruments, such as "transition bonds" with characteristics that would not allow them to meet the definition of "green" at the given stage, but which would still support the transition from "brown" operations to more sustainable and low carbon models. We believe that including such instruments in the taxonomy would boost new bond issuances whilst excluding them would significantly limit the market potential. We would thus encourage the TEG to consider exploring ways to include transition bonds in the taxonomy.
How could Taxonomy be made more useful for project finance:
In AFME's view, taxonomy would enable debt and equity investors to form a more informed view about the investment and thus allocate different proportions of funds to taxonomy compliant project finance vs traditional project finance. The ability to define deals as taxonomy compliant could potentially also improve secondary sales activities by banks and allow securitisation of taxonomy compliant asset pools to different debt investors with a sustainability focus. As there are a number of transition and enabling projects already existing and would need to grow in the future (Carbon Capture & Storage, gas-fired CHP, Waste to Energy), a clear classification as environmentally sustainable activities would help to enable such projects to benefit from such a classification.

AFME would advise against a very prescriptive and granular approach, where, for example, the eligibility of each component of the project would need to be verified for the eligibility with the Taxonomy. We think that a more holistic approach, which would allow the classification of the entire project as "green", would encourage the use of the taxonomy by creating less complexity for the parties involved in the project finance transaction, thus potentially allowing for a smoother securitisation process, decreasing the cost of financing and ultimately benefiting the investors and boosting investment volumes.

How could Taxonomy be made more useful for green loans and guarantees:

As outlined in Section 3 of this paper, AFME thinks that it would be essential if the taxonomy allowed for an approach where a loan could be considered green-based not only on the use of proceeds to invest in already "green" activities but also in activities that would support companies' transition to low carbon operations. Such transition commitments could be established via KPIs and/or Science-Based Targets and a monitoring process should be established to track the progress and ensure the adherence to set criteria by the borrowing companies or guarantee holders.

How could Taxonomy be made more useful for public equity:

AFME and ISDA note that there could be a potential negative impact on wholesale equity trading as derived from the taxonomy's use of "share of revenue" (turnover) when an investor is measuring a company's 'greenness'/share of sustainable activities. We are concerned that the main challenge an equity investor might face is to identify the percentage of revenues or turnover derived from taxonomy-eligible activities and, in some cases, to verify the technical criteria for those activities. For example, many utilities often have a quite high turnover in less green activities (often having small margins = small earnings despite a high turnover) even in cases with high investments in green technologies. Obviously, the turnover is influenced by the (churn) level of wholesale trading. Hence, companies may have an incentive to trade/re-trade their portfolio less to the detriment of the liquidity. However, the potentially unfortunate use of 'share of revenue' (turnover) could be to some extent mitigated by using earnings instead, e.g. by using EBITDA as background for a breakdown of taxonomy-related activities. An EBITDA based assessment will generally lead to a fairer representation of the level of "greenness" for utilities as earnings compared to the related turnover much better represent the return on green products. We think that EBITDA could be proposed as a supplemental measurement instrument due to the fact that there is a risk of ending up with counterintuitive results in case of companies having made unfortunate investment in (green) activities resulting in negative earnings. This more "backward looking" measure could be complemented with the use of planned investments or investments in the preceding year, as a basis for the evaluation of portfolios of taxonomy-eligible and non-eligible activities since this would give a more accurate picture of how sustainable a company or an activity is. Using a company's yearly level of investment as an additional measurement instrument would show if the company is actually on a path to sustainable transformation. It would thus seem logical to look at the balance sheet of the company instead of only the 'share of revenue' (turnover) stemming from profit and loss account as a supplemental measurement instrument given that it would give such companies an incentive to further increase their green investments. With regard to wholesale trading, more focus on the balance sheet measuring instruments would also remove (or reduce) the potential negative impact on the trading level turnover based measuring instruments have, i.e. avoiding a negative impact on liquidity.

TECHNICAL SCREENING CRITERIA

Agriculture

AFME notes that GHG emissions in the metric require a "specific trajectory over time" but this trajectory is not specified, nor how this would work in practice. There is a similar issue with the carbon stocks metric which requires them to "be increased progressively over a minimum 20-year period", where the practical application is unclear. We would encourage the TEG to include additional application guidance and examples in the final report.

Production of electricity from Hydropower

The progressive reduction of the maximum life cycle GHG emissions threshold for the production of electricity from Hydropower starting below 100gCO2e/kWh and declining every 5 years to 0gCO2e/kWh by 2050 seems unpragmatic for the following reasons mainly:

- Measuring the level of GHG emissions for this activity on a life-cycle basis would add a severe layer of complexity in the assessment of each new hydropower facility and existing ones outside of the EU, given the variability of parameters to take into consideration.
- The proposed taxonomy exempts other renewable energy sources from performing a life cycle GHG emission assessment. It therefore unduly favours certain renewable technologies over others. For example, Solar PV and wind power generation do not emit direct emissions, but (indirect) emissions arise from the manufacturing and transport of those renewable systems. In fact, as reported in the IPCC report in 2018, the median and maximum values of life cycle GHG emission of Solar PV and wind energy are higher than that of hydropower[6]:
- As hydropower remains one of the best alternatives to coal from a significant emission-reduction perspective[7], and as it will be challenging to significantly reduce societies' electricity needs in the future, production of electricity from hydropower should be encouraged and therefore automatically eligible, without any thresholds.

Production of electricity from gas combustion

The level of the maximum GHG emission threshold for the production of electricity from gas combustion translates into a de facto exclusion of this activity. This is because the TEG recommended an approach for the different types of production of electricity that should all be below 100gCO2e/kWh, declining every 5 years to 0gCO2e/kWh by 2050.

We believe instead that a threshold should be set around 350-420 gC02/kWh on a lifecycle GHG emission basis for all fossil-fuel power plants (except bioenergy plants). This threshold is set at a level that is just above the lifecycle GHG assessment of all renewable technologies. With such threshold, only the very most efficient gas power plants will be eligible, together with some gas and coal power plants with Carbon Capture and Storage (CCS). These technologies have a pivotal role: some are needed to provide stability to

[6] https://www.ipcc.ch/site/assets/uploads/2018/03/SRREN_FD_SPM_final-1.pdf

[7] To quote the IPPC report summary for policymakers : "Limiting global warming requires limiting the total cumulative global anthropogenic emissions of CO2 since the preindustrial period, that is, staying within a total carbon budget":
https://www.ipcc.ch/site/assets/uploads/sites/2/2018/07/SR15_SPM_version_stand_alone_LR.pdf

the power grid, but their deployment should be limited to maintain the EU's GHG emissions level consistent with the Paris Agreement. We would recommend that for gas, the exact threshold should be measured against 2°C scenarios, which suggest gas generation be set to decrease but installed capacity be set to increase. This is likely to be the result of the increasing need for peaking capacity of gas power plants.

General comments on the use of carbon capture and storage (CCS) for energy production

With regards to CCS activity, the TEG's proposal is that coal-fired and gas-fired power may qualify as green if CCS is used and if GHG emissions are below 100 gCO2/kWh (pages 253-254). We are particularly worried that by setting the initial threshold at 100gCO2e/kWh without providing guidance on how to measure it consistently and without defining the scope of measurement would open the door to a lack of confidence and transparency on the results achieved. **This could divert the use of CO2 storage technology to enhance CO2-emitting activities such as CCU (Carbon Capture and Utilisation) or EOR (Enhanced Oil Recovery).**

Indeed, for calculating emissions of CCS activity, reference is made to life cycle emissions (LCE) methodology that does not yet exist and remains to be developed.

In order to avoid any misuse of the CCS technology and avoid any risk of considering as eligible an activity with a net negative impact on the climate and the environment at large (CCU or EOR for example), we believe that the future LCE methodology for CCS must include at least:

- the direct and indirect emissions as defined in ISO 14064 in development
- all GHGs listed in the Kyoto Protocol in addition to CO2, including methane (the threshold value should be expressed in CO2 equivalent)
- the overall scope of the value chain (capture, transport, storage) including any downstream use of CO2 such as CCU or EOR activities
- the reference period needs to be taken into account for calculation
- the analysis of other environmental impacts such as eutrophication, acidification, oxidation

As a result, we recommend that, for CCS activity in particular:

- In the absence of a clear, reliable and complete methodology, it is imperative to refer to the specific guidance on LCE methodologies based on ISO 14025, 14044 and 14067 standards as quoted by the TEG (currently being developed) and also to the ISO 14064 standard on the quantification of GHG emissions for a standardised measurement of GHG emissions (also currently being developed).
- The investment in CCS for downstream use of EOR should be specifically excluded from the scope of eligible activities under the taxonomy.

Production of electricity from nuclear power

According to the IEA Sustainable Development Scenarios, in 2040, the EU's electricity generation grid should be composed of 67% of renewables, 21% of nuclear (vs. 18% under current policies scenarios), 10% of gas and 1% of oil & coal power generation; and for the World of 66% of renewables, 13% of nuclear (vs. 9% under current policies scenarios), 14% of gas and 6% of oil & coal power generation.

- With these scenarios in mind, we believe that nuclear power might be considered as a viable option to support the reduction of GHG emission in the near- to mid-term, in combination with continued efforts to increase the production capacity from other renewable energy sources and subject to strict controls, territorial stability conditions, recognised technological know-how and positive developments in terms of nuclear waste recycling,
- We welcome the precautionary approach adopted in the TEG deliberation on nuclear energy. It is, however, unclear whether the TEG leaves the door open to a review of the DNSH principles in the near future, in line with the IEA Sustainable Development Scenarios.

Transportation

AFME believes that the increasing use of hybrid vehicles should definitely be part of the transition to a net-zero carbon economy by 2050. However, it would be inefficient to classify hybrid passenger rail and public transportation vehicles taxonomy-eligible until 2025 only to rule them out as early as 2026, which we would welcome further justification on from the TEG. Passenger rail and public transportation, even emitting moderately with hybrid trains and buses, represent a significant emission-reduction opportunity, if it becomes the best alternative to individual cars. This approach does not seem to take into account either the time needed to invest in and develop electrified railways (only 57% of railways are electrified in France, 53% in Germany, 64% in Spain, 55% in Finland, 24.5% in Denmark[8]). Also, this seems counterproductive to the fact that one of the key public sustainability priorities, worldwide, is to develop sustainable public transport infrastructures[9].

Regarding the infrastructure for low carbon transport and construction of water projects, we note that the report states that it is the infrastructure that is "fundamental" to the operation of the transport service would be taxonomy compliant, however, we note this can be quite subjective and examples of what would qualify in this case would be helpful.

Manufacturing

We expect that the combination of the BTS benchmark thresholds for GHG emissions (top 15%) and the strict DNSH principles for the manufacture of Cement, Aluminium, Iron and Steel would only allow companies in a far lower percentile of the top 15% to be eligible. We are also concerned that the cement clinker threshold may imply a clinker rate which is inconsistent with the minimum French norm.

Water

We note the TEG recommends a very uniform front-to-end cycle 0.5 Kwh/m3 threshold for water collection, treatment and supply which does not take into account territorial physical aspects (i.e. mountains as opposed to flat territories). Also, there is no recommended threshold for the different phases of water collection, treatment and supply whereas investments/financing are merely on specific phases rather than the whole front-to-end cycle.

[8] https://ec.europa.eu/transport/facts-fundings/scoreboard/compare/energy-union-innovation/share-electrified-railway_en

[9] UN Sustainable Development Goals – Number 11: "Make cities and human settlements inclusive, safe, resilient and sustainable: "*By 2030, provide access to safe, affordable, accessible and sustainable transport systems for all, improving road safety, notably by expanding public transport* »

Additionally, for water collection, treatment and supply, the Report proposes a metric to decrease the average energy consumption of the system by at least 20%, however, we note that this could be very difficult to prove for a whole system. We would welcome examples demonstrating the practical application of the metric.

The Report does not give any guidance on threshold for water efficiency/water consumption improvements in the context of green buildings and/or manufacturing operations. We understand this is to be tackled in detail under EU Objective #3, but some initial guidance (e.g., best practice % improvements in water efficiency) would be welcome and particularly useful in the context of issuing green bonds.

Regarding centralized wastewater treatment systems, we think that the meaning of the statement "the new wastewater treatment substitutes the untreated discharge of wastewater to the water bodies or more GHG emission-intensive wastewater treatment systems" lacks clarity, thus adding relevant examples to the final Report would thus be appreciated.

Buildings

The report mentions on p367 that "*If an alternative scheme, such as a commercial sustainability certification scheme or a similar national regulation or requirement in countries outside EU proves the respective scheme meets the performance criteria set in the Taxonomy in a defined location, eligibility for the alternative scheme is accepted as a means to prove eligibility for the Taxonomy criteria.*"

AFME notes it would be helpful to provide further clarity on the criteria to assess the eligibility of such proxies.

Relative thresholds

The taxonomy uses some relative thresholds, for example in green buildings (top 15% of national building stock) or transmission networks (top 10% in their category for energy efficiency). AFME notes that additional clarity on how eligibility vs these relative thresholds is assessed would be very helpful.

In particular, in the case of transmission networks, it is unclear how the top 10% proposed threshold would be calculated given the nature of the operators' business (whether it would be at the national level, at EU level, using different thresholds depending on the source of energy). We would advise the TEG to take these points into consideration as they complete their work on this type of activities by December.

In the case of green buildings, we understand that the technical screening criteria are based on national rules at this stage. We therefore note that it creates an unlevel playing field within the EU as today there are no comparable "levels of stringency" between EU Member States. For example, in France, the réglementation thermique RT2012 which captures the top 15% performers is currently being revised into the réglementation environnementale 2020 (RE2020) that is meant to be aligned with a carbon neutrality objective and is expected to translate into more stringent norms than in other Member States. The TEG explicitly recognizes this limit but, given the respective burdensome national building legislations and disparities amongst Member States, developing absolute thresholds for energy and carbon performance based on the level of performance of the top 15% would be very ambitious.

OTHER COMMENTS

Purchasing Costs

The proposed EU Green Bond Standard excludes purchasing costs from eligible expenditures, unless included in the taxonomy for a specific activity. This is very challenging to check at the moment, given many purchasing costs relate to sustainable sourcing - which would fall under EU objective #4 (transition to a circular economy), to be addressed in the future.

AFME notes that the implications for Renewable Energy Power Purchasing Agreements (PPAs) because of the above are not clear. We believe it would be crucial to ensure this exclusion would not apply to PPAs for renewable power, which have so far been an important category of eligible projects under green bond issuances, and which contributes to a transition to lower-carbon buildings and operations.

Additionally, further clarification would be necessary on how, in the interim, the use of proceeds around procurement of recycled plastics would be treated. For example, Philip's Green & Sustainability Innovation Bond Framework[10] notes the minimum thresholds for recycled content in assets to be financed by its Green Innovation Bond proceeds, "*Purchase of recycled plastic used for products with a recycled plastics content of >25% by total weight of eligible plastics*".

Air conditioning supply

We note that air conditioning activity has been mentioned in the Report but the treatment of it under the taxonomy is not clear. Specifically, it is not clear whether this activity is to be analysed by the electrical energy consumed (indirect emission) or by the refrigerant gases that make up this activity under the Kyoto Protocol for GHGs (and the Montreal Protocol for the protection of the O3 layer). Therefore, we would welcome further clarification by the TEG on this matter.

Measurement of CO2 transition

We would welcome more clarity on how the commitment to the 2050 net zero-carbon emissions will be measured along the journey and how the ongoing measurement will be reflected in the taxonomy's technical screening criteria.

Climate change adaptation criteria

We appreciate the principle-based approach considering contextual environment. However, we would welcome application guidance and screening criteria for a broader range of activities.

[10] Page 3 https://www.sustainalytics.com/sustainable-finance/wp-content/uploads/2019/05/Philips-Green-and-Sustainability-Innovation-Bond-Frame-Second-Party-Opinion-08052019.pdf