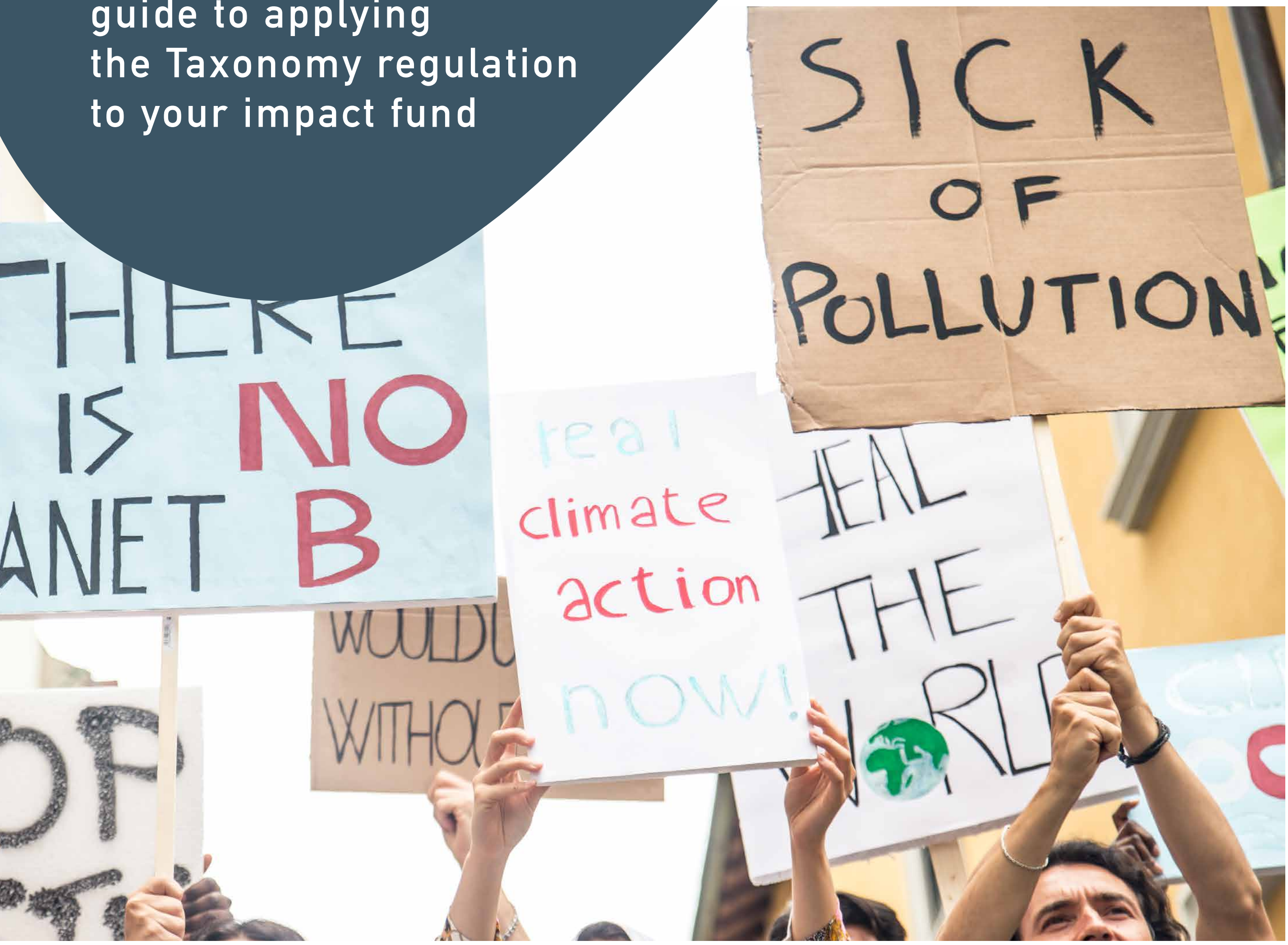
EU ENVIRONMENTAL TAXONOMY

ELIGIBLE, ALIGNED, OR JUST OVERWHELMED?

A quick, practical guide to applying the Taxonomy regulation to your impact fund



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TAXONOMY ELIGIBLE? ALIGNED? START HERE IF YOU'RE JUST OVERWHELMED

Even the most experienced impact fund managers find it daunting to apply the EU Taxonomy to their funds. Many impact finance actors are frustrated by the "impossible" standards set and feel that the regulation is overly complicated. But the impact finance community should shift its perspective to see the regulation for what it is: a roadmap for progress.

At its heart, the EU Taxonomy is a disclosure regime. It does not insist on perfection as so many fear and assume, but it does set a standard for investments with environmental objectives that need to be reported against. It combats greenwashing and guides best practices in green finance.

What is the EU Taxonomy?

A unified classificaton system designed to identify environmentally sustainable economic activities

The Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the EU Taxonomy) is one element of the EU Action Plan on Sustainable Finance. Sometimes confused with SFDR (Regulation (EU) 2019/2088 or Sustainable Finance Disclosure Regulation), the EU Taxonomy is a self-contained regulation that – though related to SFDR and other regulations – has its own requirements.

Like SFDR, the EU Taxonomy requires financial market participants to consider adverse (negative) impacts as well as positive impacts and to disclose how both elements are considered. Unlike SFDR, the EU Taxonomy is limited to environmental objectives and provides robust guidance and science-based criteria to assess investments against.

Financial market participants and products must declare the percentage of sustainable investments in their portfolio and the percentage of those aligned with the EU Taxonomy.

Investments	
% Not sustainable	% Sustainable
% Social	% Environmental
% Other	% Taxonomy Aligned

SUSTAINABLE INVESTMENTS
Sustainable investments under the EU Taxonomy cross-references the SFDR definition.* Taxonomy declarations should therefore be consistent with SFDR disclosures.

ENVIRONMENTAL INVESTMENTS
Environmental investments are in activities contributing to one or more of the six EU Taxonomy objectives. These are defined as **Eligible Activities**.

ALIGNED INVESTMENTS
Aligned investments are Eligible Activities that fulfil all technical screening criteria established for the activity.

An aligned activity must positively and significantly contribute to one of the six objectives laid out by the EU Taxonomy if it is marketed as environmental.

The same activity must also demonstrate that it (i) does not significantly harm any of the other objectives in the regulation, and (ii) complies with the minimum social and governance safeguards.

* "An investment in an economic activity that contributes to an environmental objective or an investment in an economic activity that contributes to a social objective, provided that such investments Do Not Significantly Harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance" (SFDR).

Who cares?

European financial market participants and financial products being marketed within the EU

EU FINANCIAL MARKET PARTICIPANTS

- Insurance undertaking providing insurance-based investment products
- Investment firms / credit institutions providing portfolio management
- AIFMs
- ManCos of UCITS
- Managers of European venture capital or social entrepreneurship funds
- Institutions for occupational retirement provision
- Manufacturers and distributors of pension / personal pension products

FINANCIAL PRODUCTS

- A managed portfolio
- Alternative Investment Funds
- Insurance-based investment products
- Pension / personal pension products / schemes
- UCITS

Unlike other European Union (EU) financial regulations, **there are no criteria that could enable any of the above participants or products to declare themselves out-of-scope of the regulation.**

How to determine eligibility?

Fundamentally, EU Taxonomy Eligible Activities are environmental investments. However, this designation is not at the determination of the financial market participant but is outlined by the regulation.

First, to be EU Taxonomy eligible, an activity must contribute to at least one of the six environmental objectives laid out in the regulation (see right).

Within each of the objectives, the EU Taxonomy lists activities that are deemed to contribute to the objective. Activities are mapped against NACE codes (NACE – Nomenclature of Economic Activities). These activities are eligible and can be easily navigated in the **EU Taxonomy Compass**.

Investments may be made in companies with multiple business lines and activities, some of which may be eligible while others are not. As such, an investment may only be partially eligible.

1. **Climate Change Mitigation**
2. **Climate Change Adaptation**
3. **Sustainable Use and Protection of Water and Marine Resources**
4. **Transition to a Circular Economy**
5. **Pollution Prevention and Control**
6. **Protection and Restoration of Biodiversity and Ecosystems**

CALCULATION

Three KPIs (Key Performance Indicators) can be used to calculate Taxonomy eligibility and alignment, at the discretion of the entity:

- **Turnover** (static view of the company's contribution to environmental goals)
- **Capital expenditure** - CapEx (capital expenditure in a dynamic and forward-looking view of companies' plans to transform their business activities)
- **Operating expenditure** - OpEx (operating expenditure related to taxonomy-aligned activities)

The choice of KPI should be explained and the same KPI used for all investee companies. The KPI must be taken from historical data. Note also that the EU prefers calculations based on turnover.

Eligible Activities may also include two sub-categories listed in the regulation that require specific disclosure:

- A **transitional activity (t)** is eligible if there are no technologically and economically feasible low-carbon alternatives and it supports the transition to a climate-neutral economy
- An **enabling activity (e)** is eligible if it directly enables other activities to contribute to the objectives

As of June 2023, only the objectives of Climate Change Mitigation and Climate Change Adaptation have a published list of eligible activities associated with it. The activities and technical screening criteria associated with the other 4 objectives are expected to be published in 2023.

The list of Eligible Activities is extensive and spans multiple sectors. Currently, Eligible Activities are especially concentrated in renewable energy generation and distribution; water supply, sewerage, waste management and remediation; and climate adaptive transport and manufacturing.

However, there are several activities that many experts may deem to contribute significantly to the environmental objectives but are not currently reflected in the regulation. The most cited example is sustainable agriculture but other technologies are also excluded as of now – such as many carbon capture and storage technologies, carbon dioxide utilisation, blue carbon sequestration, and elements of a circular economy like durable product design.

CASE STUDY 1 - Eligibility

The Climate Future Energy Fund (CFEF) plans an investment in H1+, an energy company with three lines of business:

- Manufacture of hydrogen
- Construction and safe operation of new nuclear power plants for the generation of electricity and/or heat, including for hydrogen production (t)
- Storage of hydrogen (e)

The EU Taxonomy establishes hydrogen manufacturing as an **Eligible Activity**, operation of new nuclear power plants as **transitional (t)**, and the storage of hydrogen as **enabling (e)**.

If each business line represents ≥33% of H1+'s turnover, then the company is 100% eligible, of which ≥33% is transitional, and ≥33% is enabling.

How to determine alignment?

Eligibility only assesses the nature of the activity. Alignment requires an activity to fulfil certain requirements both (i) determining how substantial its contribution to its environmental objective is and (ii) that it adequately manages negative impacts.

Technical screening criteria for determining both substantial contribution and do no significant harm (DNSH) for all Eligible Activities can be easily navigated in the EU Taxonomy Compass.

SUBSTANTIAL CONTRIBUTION

The technical screening criteria to determine substantial contribution are tailored to each activity and can differ significantly in complexity, technicality, and difficulty to achieve.

For example, electricity generation from wind power has one requirement for substantial contribution to climate mitigation – that the activity generates electricity from wind power. However, for the restoration of wetlands to substantially contribute to climate mitigation it must comply with six specific and highly detailed criteria, such as the establishment and observance of a restoration plan, a climate benefit analysis, and a regular audit, each of which must follow the prescription of the regulation.

DO NO SIGNIFICANT HARM (DNSH)

DNSH criteria must be fully met for an activity to be eligible. The criteria ensure that an activity does not negatively impact any of the other established environmental objectives. Like the substantial contribution criteria, DNSH is tailored to each activity and can vary significantly, but there are basic conditions that apply in most cases, namely:

- Physical climate risks are identified through a robust climate risk and vulnerability assessment
- Environmental degradation risks related to preserving water quality and avoiding water stress are identified and addressed
- The activity does not lead to the manufacture, placing on the market or use of specified pollutants and hazardous materials
- An environmental impact assessment has been conducted

MINIMUM SAFEGUARDS

To be aligned, each investment must comply with the established minimum safeguards (outlined in the listed below), meaning that the underlying companies shall have the appropriate procedures and policies in place; an investor would need to confirm this during their due diligence.

- The OECD Guidelines for Multinational Enterprises
- The UN Guiding Principles on Business and Human Rights
- The Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work
- The International Bill of Human Rights

While an investment may be partially eligible or partially aligned due to differences in business lines, a *single activity* cannot be partially aligned. **Alignment is determined on a pass/fail basis**. This means that even if an activity fulfils all but one criterion, it still cannot be considered aligned.

2

CASE STUDY 2 – Alignment of an activity

To determine whether H1+ is Taxonomy aligned, each business line will be analysed against the technical screening criteria laid out in the regulation. The following summarises the technical screening criteria to determine the eligibility of their hydrogen manufacturing.

SUBSTANTIAL CONTRIBUTION

- The activity complies with the life-cycle GHG emissions of 73.4% of savings requirement
- Life-cycle GHG emissions savings are calculated using the methodology provided by the EU Taxonomy
- Quantified life-cycle GHG emission savings are verified
- Where CO2, that would otherwise be emitted from the manufacturing process, is captured for underground storage, the CO2 is transported and stored underground

DNSH

- The basic conditions listed above are met
- Emissions are within or lower than the emission levels associated with the best available techniques

MINIMUM SAFEGUARDS

- The company complies with all minimum safeguards

H1+'s hydrogen manufacturing fulfils all criteria EXCEPT it does not verify GHG emission savings in line with the details of the regulation. As such, this activity is eligible, but is currently **NOT aligned.**

At the investee level

Portfolio companies in the EU should normally be able to provide their Taxonomy eligibility and alignment as they are also subject to related EU regulations. However, it is still important for fund managers and other financial market participants to understand how eligibility and alignment are calculated so these figures can be verified. Furthermore, for funds investing outside of the EU, portfolio companies may not always be able to provide their calculations. To follow the regulation, the fund managers will need to make a calculation to facilitate their own reporting.

3

CASE STUDY 3 – Alignment of a company

Once each business line has been analysed, the aligned percentage of the company overall can be calculated with one of the three KPIs (turnover, CapEx, or OpEx).

For H1+, we know the hydrogen manufacturing business line is NOT aligned (until they apply a procedure to verify their GHG emissions savings in line with the methodology set forth in the regulation). However, the other two business lines are aligned with the EU Taxonomy.

Using Turnover as the KPI and the above data from their latest financial statements, we can establish that H1+ is:

- 100% eligible (of which 50% is transitional and 20% is enabling)
- 70% aligned (of which 50% is transitional and 20% is enabling)

	Hydrogen Manufacture	**Nuclear Power Plant**	**Hydrogen Storage**	**Total**
Turnover	**30%**	**50%**	**20%**	
CapEx	*25%*	*25%*	*50%*	
OpEx	*33%*	*33%*	*33%*	
Eligible	✓	✓ (t)	✓ (e)	100%
Aligned		✓ (t)	✓ (e)	70%

(t) transitional (e) enabling.

At the fund level

The primary requirement for **financial market participants** and **financial products** is to disclose the degree of alignment at the portfolio level. This is done through a simple calculation based on the portfolio companies' alignment and their weight in the portfolio. Note that all portfolio companies must use the same KPIs to determine alignment.

CASE STUDY 4 – Alignment of a portfolio

Climate Future Energy Fund (CFEF) has a portfolio of four investments as well as cash reserves.

Investee A	Investee B	H1+	Investee D	Cash
0% eligible	100% eligible	100% eligible	50% eligible	0% eligible
0% alignment	10% alignment	70% alignment	50% alignment	0% alignment
20% of the fund portfolio	30% of the fund portfolio	25% of the fund portfolio	20% of the fund portfolio	5% of the fund portfolio

With the above data, we can establish that CFEF's portfolio is:

- **65% eligible**
- **30.5% aligned**

The share of transitional and enabling activities' eligibility and alignment will also need to be calculated.

What is required?

SFDR Pre-contractual Disclosures

- Information on the environmental objectives to which the underlying investments contribute (Art 5 (a) EU Taxonomy)
- **Asset Allocation under SFDR**
- **Intended proportion of Taxonomy-aligned economic activities** of investees in the portfolio (Art 5 (b) EU Taxonomy) through pie chart
  - Need to have reliable data to be able to disclose
  - Even if the investee company itself is not subject to reporting under the EU Taxonomy / NFRD
- Intended minimum share of investments **not aligned** with the EU Taxonomy
- **Nuclear energy and gas-related activities** to be considered environmentally sustainable (SFDR and Commission Delegated Regulation (CDR))
  - Report on the degree to which a company carries out, funds or has exposure to nuclear energy and gas-related activities
- **Intended minimum proportions of transitional and enabling activities** (Art 5 (b) EU Taxonomy)
- Disclose whether compliance of investments with the EU Taxonomy will be **subject to an assurance by auditors** or review by third parties

SFDR Periodic Reporting Disclosures

- **Asset allocation** for the past year and specify economic sectors
- **Percentage of investments aligned with the Taxonomy**
- **Report periodically** on proportion of investments made in Taxonomy-aligned activities
- Share of sustainable investments with an environmental objective **not aligned** with the EU Taxonomy
- Report on the degree to which a company carries out, funds or has exposures to **nuclear energy and gas-related activities**
- Share of investments **made in transitional and enabling activities**
- Percentage of investments aligned with the EU Taxonomy **compared with previous reference periods**
- Specify whether Taxonomy alignment is **measured by turnover, capital expenditure or operating expenditure** and the reason for that decision
  - This requires the selection of one KPI (turnover or CapEx or OpEx – if more representative calculation) as the basis of calculation

The minimum percentage of Sustainable and Taxonomy-Aligned investments are binding commitments of the investment strategy. Failing to meet the minimum commitment represents a breach.

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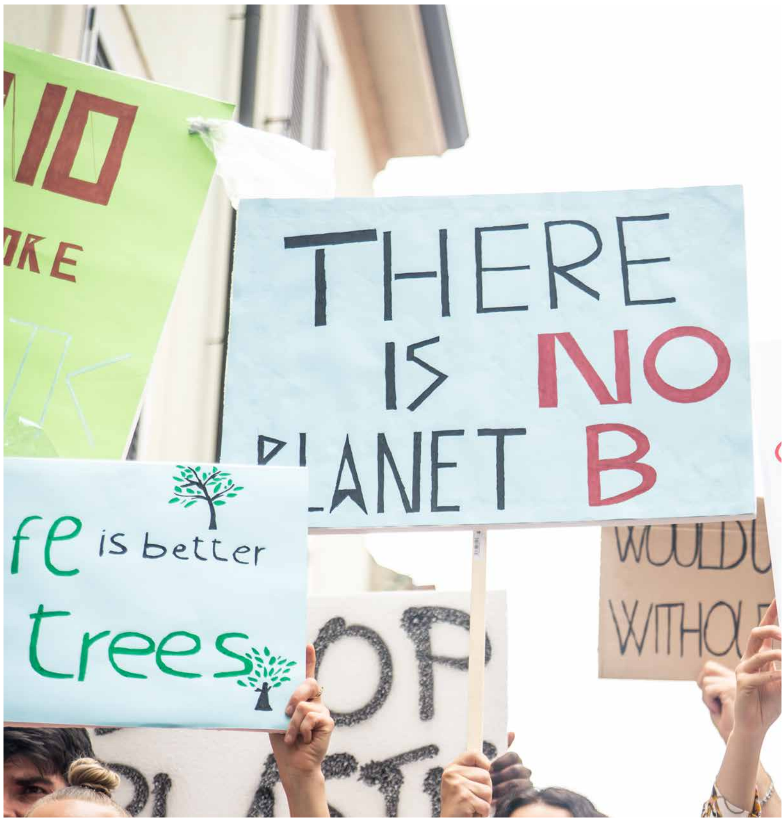
Innpact is a leading impact finance specialist providing advisory and third-party fund management services.

Our team, based in Luxembourg and Mauritius, has unrivalled expertise in designing impact funds and blended finance vehicles.

We work with fund managers, initiators and investors around the world on impact investing projects totaling more than USD 8 bn targeting the Sustainable Development Goals.

We provide our services with motivation and dedication, being faithful to our mission and our values.



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