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To: Financial Services Attachés
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Subject: Sustainable finance (Taxonomy Regulation) - Commission non-paper on the TEG's approach towards transition activities and enabling activities, in view of trilogue on 20 November 2019

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Non-paper on the TEG's approach towards transition activities and enabling activities

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During the second trilogue on the proposal for a Regulation on the establishment of a framework to facilitate sustainable investment (hereinafter: the 'Taxonomy proposal') in Brussels on 6 November 2019, Members of the European Parliament and the Council Presidency called in view of the next trilogue for a non-paper clarifying the approach of the Technical Expert Group on Sustainable Finance (TEG) towards transition activities and enabling activities. The purpose of this non-paper is to provide these clarifications.

1. Defining substantial contribution to climate change mitigation

Article 3 of the **Taxonomy proposal** states that an economic activity is environmentally sustainable when it:

- a) makes a substantial contribution to an environmental objective;
- b) does not significantly harm any environmental objective;
- c) respects minimum social safeguards; and
- d) complies with technical screening criteria.

The technical screening criteria will specify under which conditions an economic activity can be considered as (1) making a substantial contribution to an objective (criteria for 'substantial contribution'), while (2) not doing significant harm to the other objectives (criteria for 'do no significant harm').

The TEG was tasked with developing recommendations on criteria for substantial contribution to two of six environmental objectives (climate change mitigation and climate change adaptation), and criteria for 'do no significant harm' to the other environmental objectives.

For climate change mitigation, this entailed identifying the sectors in which economic activities can *potentially* make a substantial contribution to that objective (e.g. 'electricity production'). Once the relevant sectors were identified, the TEG developed criteria to specify under which conditions a given economic activity (e.g. production of electricity from hydropower) *effectively* makes a substantial contribution (e.g. greenhouse gas emissions must be less than 100g CO₂e per kWh of electricity produced). The TEG also developed criteria defining under which conditions the economic activity does not significantly harm the other environmental objectives.

In defining substantial contribution to climate mitigation, the TEG found it helpful to develop a conceptual framework (based on Article 6 and 14 of the Taxonomy proposal). The TEG interprets Article 6, which defines substantial contribution to climate change mitigation, to mean climate neutrality (i.e. net zero emissions) by 2050.

The TEG considered an economic activity can make a substantial contribution to climate change mitigation in **three ways**:

- a) by having low GHG emissions in an absolute sense (**‘low-carbon activities’**);
- b) by having significantly lower GHG emissions than the sector or industry average, where the activity itself does not undermine climate change mitigation objectives and avoids lock-in to carbon intensive assets or processes (**‘transition activities’**); or
- c) by enabling a reduction of GHG emissions in another sector (**‘enabling activities’**).

2. Low-carbon activities

Low-carbon activities would include activities that are already very low-carbon or zero-carbon (e.g. production of electricity from wind power), as well as activities that lead to GHG emissions sequestration (e.g. restoration and rehabilitation of forests).

The TEG defined criteria to specify under which conditions an economic activity is effectively low-carbon. For example, the criteria for the activity ‘restoration and rehabilitation of forests’ specify the practices that need to be implemented to allow the forest to act as a carbon sink. The TEG indicated that such criteria are likely to be **long-term**, i.e. not needing revision over time.

3. Transition activities

A **transition activity** would be defined as an economic activity that is not low-carbon, but is critical to the economy and can contribute to the transition to a net-zero carbon emissions economy by substantially reducing its GHG emissions. The TEG has recognised that these activities can make a substantial contribution if they operate at much lower GHG emissions than sector or industry average, while avoiding lock-in to carbon intensive assets or processes. For example, cement manufacture using an advanced production technology that results in significantly lower GHG emissions than traditional production technologies would be considered a substantial contribution to climate change mitigation, even though the production process still results in significant GHG emissions.

The TEG’s **rationale** for recognising transition activities in the Taxonomy is the following. Some sectors with significant GHG emissions (e.g. cement manufacturing) are critical to the economy and require urgent decarbonisation, yet there are currently **no low carbon technologies**. In other words, technologies that would allow economic activities within that sector to be low carbon do not exist or are not commercially available. For example, cement manufacturing is a significant source of GHG emissions, but there are currently no commercially available technologies or production processes that allow cement manufacturing to be nearly zero carbon. However, moving to a net-zero carbon emissions economy requires such sectors to lower their emissions.

Setting a threshold to capture only low-carbon activities in such sectors would mean no economic activities would be considered as environmentally sustainable. This approach would not incentivise operators to lower the GHG emissions of their economic activities as much as possible with the best technologies and management practices that are available.

Instead, when the TEG identified a sector that is high emitting and for which there are no low-carbon technologies available, it has set a **threshold for substantial contribution that corresponds to the highest environmental performance within an industry or sector** (e.g. emissions from cement production processes are less than 0.498 tCO₂e per tonne of cement).

The TEG indicated that such criteria are likely to be **short term**, i.e. subject to regular revision, tending towards zero emissions over time. This allows economic activities that lead to a substantial

reduction in GHG emissions to make a substantial contribution, but only until better performing technologies or processes emerge.

At the same time, the TEG recognised that such a ‘transition category’ could lead to the inclusion of activities that undermine the objective of climate change mitigation. It therefore developed **additional safeguards**¹:

1. The ‘transition’ category does not apply to sectors where low carbon technologies are commercially available;
2. The transition activity must lead to substantial reductions in GHG emissions compared to sector or industry average;
3. The threshold is strengthened over time and tends to net-zero by 2050 (short-term criteria);
4. Transition activities must not result in lock-in into carbon intensive assets or processes².

4. Enabling activities

Enabling activities would be defined as economic activities that enable substantial improvements of environmental performance in other economic activities. These activities are mostly part of the ‘neutral’ sectors, i.e. their environmental footprint is not significant, but they are prioritised because they enable sectors with a substantial negative environmental impact to improve.

The TEG has developed both substantial contribution criteria and do no significant harm criteria for enabling activities to ensure that the benefits of the enabling activity’s output (product/service) outweigh its environmental footprint. It indicated that the criteria for enabling activities are either **long term or short term**, depending on whether they enable low carbon activities or transition activities.

Examples of enabling activities identified by the TEG are:

- manufacturing of wind turbines, which enables substantial GHG emissions reductions in the sector ‘electricity production’.
- installation of highly efficient boilers in buildings, which enable GHG emissions reductions for the remaining operational phase of existing buildings.

It is important to note that enabling activities by themselves do not necessarily result in the ‘enabled’ economic activity meeting the technical screening criteria. For example, the installation of a highly efficient boiler does not necessarily make a building compliant with the substantial contribution criteria for the activity ‘renovation of existing buildings’. To achieve this, other renovation measures – like the installation of additional insulation or energy efficient windows – might be necessary as well.

¹ See also figure 7 - Decision tree for the inclusion of economic activities in the EU Taxonomy – on page 32 of the TEG’s technical report.

² For this last safeguard, the TEG gives the following justification: “the transition to a low carbon economy will involve phase-out of some economic activities, such as unabated fossil fuel-based power generation. While there may be some short-term advantages to reducing the environmental harm caused by these activities, the TEG considers that these cannot be considered to make a ‘substantial’ contribution to climate change mitigation. The EU Taxonomy should therefore exclude activities which would ultimately undermine climate change mitigation objectives if their operation was locked in for the long term. Including such activities in a sustainability-oriented Taxonomy would send inappropriate signals regarding their long-term contribution to climate objectives. Activities that were identified as failing this principle in the TEG work to date include renovations to transport facilities or buildings (including storage) that are dedicated to fossil fuels and may create lock in of these assets for fossil fuel purposes.”

In this case, the TEG recommends that the expenditure (i.e. the cost of the boiler) should be considered taxonomy-eligible for financing purposes, but the overall building would not be unless it met the criteria for substantial contribution.

To sum up, the TEG’s approach considers three kinds of activities that can make a substantial contribution to climate change mitigation:

Type of activity	Technical screening criteria	Examples
Low-carbon activities	Likely to be stable and long term.	<ul style="list-style-type: none"> • Zero emissions transport (e.g. electric cars or trains); • Near to zero carbon electricity production (e.g. solar power); • Restoration of forests.
Transition activities	Likely to be subject to regular revision, tending towards zero emissions over time.	<ul style="list-style-type: none"> • Building renovation; • Busses for interurban transport <50g CO2/km; • Cement manufacture <0.498 tCO2e/t of cement.
Enabling activities	Likely to be stable and long term (if enabling activities that are already low carbon), or subject to regular revision tending to zero (if enabling activities that contribute to transition but are not yet operating at this level).	<ul style="list-style-type: none"> • Manufacture of wind turbines; • Manufacture of household appliances rated in the highest energy label class (e.g. A+++); • Installing efficient boilers in buildings.

5. The Taxonomy encourages the transition in other ways

Aside from the recognition by the TEG of transition and enabling activities, the Taxonomy also encourages the transition to a low-carbon economy (and more broadly an environmentally sustainable economy) through other means.

First, the Taxonomy defines ‘environmentally sustainable’ (or ‘green’) at the level of the economic activities, not at the level of the companies. This enables companies to transition by gradually increasing their share of green activities. Companies can:

1. upgrade their existing economic activities to make them compliant with Taxonomy criteria,
2. expand those of their existing economic activities that are already Taxonomy-compliant.
3. stop economic activities that are not Taxonomy-compliant by selling or closing related assets.

Such a framework would not blacklist any particular company. Instead, it would allow companies to describe the performance of part of their activities as Taxonomy-compliant. Companies could also describe the share of their own capital expenditure in Taxonomy-eligible activities even though their current share of Taxonomy-compliant activities may be low .In this way, companies can show investors that they are serious about the transition. Thus, the framework would provide an incentive to reallocate capital within a business over time and may help issuers access “green” capital more readily.

Second, even for companies undertaking activities that are not in line with the Taxonomy criteria, the Taxonomy could serve as a clear framework for companies to disclose their environmental performance to investors. Indeed, for each activity, the Taxonomy would provide a metric – which gives a common unit of measurement for that activity – and a threshold – which give a clear reference point against which to compare performance. In other words, companies will be able to describe their progress towards meeting criteria in a consistent way.

For example, a utility company could claim that by switching, for part of its activities, from coal to gas in its electricity production, it is reducing its GHG emissions from 900g CO₂/kWh to 400g CO₂/kWh, and therefore reducing harm to the objective of climate change mitigation. These activities would still not be ‘green’ or ‘environmentally sustainable’ (given the threshold of 100g CO₂/kWh for electricity production to make a substantial contribution to climate change mitigation). However, it is useful information for the investor, who can understand the reduction in harm more clearly. Using the metrics given in the taxonomy for the specific economic activity (rather than other more general indicators, such as absolute GHG emissions or GHG emissions per euro of turnover) makes the information provided to the investor more relevant and meaningful. It also allows understanding the scale of the gap to the level of performance considered “environmentally sustainable” that is defined by the threshold.