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Directorate B – Growth and Innovation
Circular Economy and Industrial Leadership

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EU Ecolabel criteria for retail financial products

JRC discussion paper ahead of the 1st sub-group meeting

Introduction

The main objective of organising an expert sub-group meeting is to reflect on how thresholds in criterion 1 ("investment in green economic activities", as presented during the 2nd AHWG web-meeting) can be further developed, and how such thresholds could affect market uptake and the perception of the EU Ecolabel. It will also address other important aspects of the setting of criterion 1 – including any sub-criterion on companies in transition, how bonds are treated and options for enhancing investor impact.

The sub-group is composed of registered stakeholders who actively shared their expertise by commenting on criterion 1 and who represent a balanced cross section of registered stakeholders. This document aims at guiding on the specific discussion points to be addressed by the sub-group members. A summary of the sub-group is provided in the box below.

Sub-group formulation to review criterion 1 ambition level and requirements on transition

Aims and objectives*:* to review and discuss the evidence and analysis gathered to date by the JRC, as well as the options available to improve the criteria, in order to provide feedback/input on the possible final criterion and ambition level.

Scope: It is proposed to mainly focus on equity funds and to address:

- the thresholds for EU Taxonomy compliant green economic activities;
- data on the possible uptake of the label, the potential to obtain EU Taxonomy compliant equities, application of the exclusions and further sensitivities that could be applied/analysed (e.g. size of the capitalisation of the companies, risk associated to the EU Ecolabel portfolio);
- the pocket approach and the associated value of assets under management (AuM) and company revenues;
- the contribution of companies in transition and how to set any sub-criteria that specifically target them.

Composition: 17 initial members with representation from fund managers, data providers, existing label operators and NGOs

Transparency: All meetings will be minuted in order to keep other stakeholders informed.

Context and Rationale

Feedback received on the second proposal for criterion 1 highlighted contradictory opinions in terms of the criterion's ambition level. According to some stakeholders, the potential label uptake could be insufficient, due to the immaturity of the market and the ambitious restrictions set on the investable universe. In fact, not enough green assets are considered to be currently available to compose EU Ecolabel portfolios. Moreover, the legal requirement for UCITS funds (which represent the main financial product targeting non-professionals) to practice risk diversification make it difficult to concentrate investments in the currently small number of green activities available to invest in. On the other hand, other stakeholders highlighted the potential risk of compromising the reputation of the EU Ecolabel. Indeed, current thresholds are not considered strict enough, whereas the EU Ecolabel should stand for environmental excellence in the market.

Other aspects that needs evaluation, in connection with the ambition level of the criterion, include:

- Whether the pocket approach really supports green activities, including front runners, and the extent to which the green activities of large capitalisation companies are given any weighting in the current criteria proposal;
- The use of metrics such as Capital Expenditure (Capex) to support companies in transition;
- Evidence of impact that EU Ecolabel investors would have on the companies invested in and on their environmental performance.

Criterion 1 requirements for equity funds

Criterion 1 for equity funds as defined in the TR2.0 splits the portfolio into three pockets. It comprises a pure green pocket that requires more than 50% of green revenues, a transition pocket with green revenues between 20-50% and a diversification pocket that does not require any greenness of the AuM. Nevetheless, the underlying assets are subject of compliance with environmental and social exclusions. The green revenues are revenues from environmentally sustainable economic activities as defined in the EU Taxonomy Regulation. The greenness requirements for equity investment funds are outlined in criterion 1.1 as follows:

A. Equity funds

At least 60% of the total portfolio value in terms of assets under management (AuM) shall be invested in companies whose economic activities comply with the following threshold:

i. At least 20% of AuM shall be invested in companies deriving at least 50% of their revenue from green economic activities.

ii. The remaining proportion of AuM (0-40%) shall be invested in companies deriving between 20% and 49% of their revenue from green economic activities.

The remaining proportion of the total portfolio shall consist of:

- companies deriving less than 20% of their revenue from green economic activities and not excluded by criteria 2 or 3, or
- other assets or cash

Key discussion points

During the two sub-group meetings envisaged, the subgroup members shall advise the JRC on appropriate finalisation of criterion 1. In this context, the subgroup shall review and provide guidance as to the following thematic areas:

- A: Ambition level of the greenness criterion;
- B: Qualification criteria for companies investing in a transition;
- C: Requirements for bonds;
- D: Assessment and verification issues of the points A-C.

The first sub-group meeting, scheduled for 28th July 2020 via the Webex, will address points A and B.

Following the results of the analysis so far, the outcomes of the consultation phase, the position of different stakeholders and those of the EUEB members, the JRC has identified the following aspects for consideration.

- The thresholds for EU Taxonomy compliant green economic activities and their effect on the investible universe and the take-up of the EU Ecolabel;
- Data from the DG FISMA study and other analysts on the possible uptake of the label, the potential to obtain taxonomy compliant equities (and bonds), application of the exclusions and further sensitivities that could be applied/analysed;
- The pocket approach and the associated value of assets under management and company revenues;
- The role of small, mid and large capitalisation companies in growing the green economy and how they contribute to the green economic activity thresholds;
- The contribution of transitional activities and how to set any sub-criteria;

A: Ambition level of the greenness criterion for equites

The ambition level of the greenness criterion shall be reviewed, taking into consideration concerns for low uptake, legal requirements for risk diversification, the need to achieve investor impact, retail investor perceptions and for preserving the reputation of the EU Ecolabel.

JRC has considered the outcomes of four analyses, which differed in terms of scope, methodology, data, and association conducting the study. However, all analyses investigated the size of the investment universe eligible for the EU Ecolabel under the current version of criterion 1. The four analyses are detailed below:

A1: The study '*Testing Draft EU Ecolabel Criteria on existing UCITS equity funds*[1]' performed by the Climate & Company and the Frankfurt School's UNEP Collaborating Centre and commissioned by DG FISMA;

[1] https://susproc.jrc.ec.europa.eu/Financial_products/documents.html

A2: The EU Taxonomy analysis performed by MSCI on the compliance of companies with the EU Ecolabel criteria;

A3: The equity analysis performed by FIDEAS on the compliance of equity funds with the EU Ecolabel criteria;

A4: An analysis provided by Sustainalytics based on their experience regarding the eligible assets universe and the ambition level of criterion 1.

The scope and outcomes of these independently performed analyses is summarised below, and represent a starting point for discussing and reviewing the ambition level.

A1: Supporting DG FISMA report '*Testing draft EU Ecolabel criteria on existing UCITS equity funds*'

The objective of this study was to test the application of criterion 1 to a sample of 101 "green" UCITS equity funds domiciled in the EU27. Focused on the EU environmental objective "climate change mitigation", the study analyses the share of EU Taxonomy aligned revenues of these funds' constituents and hence provide insights into the potential qualification of the equity funds under the current proposal for criterion 1.

Study outcomes

- More than 50% of the revenue-weighted activities are not covered by the EU Taxonomy's climate change mitigation criteria;
- Only 3 out of 101 (3%) funds would qualify for criterion 1, having a sufficiently large share of EU Taxonomy aligned and green (i.e. falling into the "green" or "transition" pocket) activities; This number remains unchanged even if it is assumed that 11% (i.e. the average "green" share in the sample) of the "non-verifiable" share per company was green as per EU Taxonomy;
- Two further sensitivity analyses with a less strict application of the EU Taxonomy. The results suggest that in total a maximum of 6 out of 101 funds are complying with criterion 1. Reasonable assumptions and proxies were considered to broaden the evaluation;
- The results also show that currently due to data constraints (in particular limited reporting) and the limited coverage of the EU Taxonomy, the evaluation of funds against criterion 1 is constrained. This may pose a challenge for verifying products until the market has responded to the new disclosure requirements;
- It is difficult to evaluate fund greenness comprehensively, based on available data from the major ESG data providers. The lack of disaggregated company data, such as (but not limited to) product-specific data on energy efficiency equipment, limits a comprehensive evaluation;
- The relevance of non-EU companies poses an issue as mandatory disclosures will apply to EU companies only;
- The manufacturing and energy sector is of particular importance within the underlying assets of the funds analysed.

Limitations

- Only UCITS equity funds were investigated, although the EU Ecolabel targets a wider scope of retail financial products;
- Data availability placed a constraint on the verification of the compliance with the EU Taxonomy (and mapping of companies' economic activities to the EU Taxonomy);
- Only climate change mitigation was considered in this study;
- DNSH criteria, social safeguards and other provisions of the draft Ecolabel proposal and the underlying, corresponding EU Taxonomy proposal were not addressed (outside the scope of this study).

A2: MSCI analysis

An analysis made by MSCI took a different approach to A1 by seeking to determine which part of the screened securities universe could currently be available to portfolio managers as a selection universe for active management or as the basis of an indexed solution. The sample contains 9000 companies, which have been checked against proxy EU Ecolabel criterion 1 requirements, as well as the exclusionary criteria 2 and 3. The analysis for criterion 1 was based on a climate change proxy addressing all six EU Taxonomy environmental objectives

Study outcomes

- Eligible companies, based on the climate change mitigation and adaptation objectives, would represent between **3.9%** and **5.7%** of the market, depending on whether large+mid cap or small cap companies are considered, as detailed in Table 1 and Table 2, respectively. The outcomes can therefore be used to examine how the investment universe is affected by how the thresholds are configured.
- Applying the environmental and social exclusions could further reduce the investment universe by almost 40% (large+mid-caps). However, applying these exclusions require a large number of assumptions and proxies to currently be applied.
- An Evolutionary approach to thresholds (whether % of AUM or % of revenue) may be required because of the dynamic situation in the market. Thresholds would be adjusted year-on-year to reach the ideal threshold. This approach might encourage companies to transition to a greener economy, and/or increase their green economic activities. Based on a sensitivity analysis the eligible pool of companies increases by a factor of two (small caps) to almost three times (large+mid caps).
- A differentiated approach to thresholds may be required because of the difference in eligible stocks by capitalisation. Given that most pure-play green companies are smaller, differentiating thresholds could credit large companies with smaller % from green economic activities but that derive more in absolute revenue. Based on a sensitivity analysis the eligible pool of companies increases by a factor of nine (*large caps*), whereas the eligible pool for small and mid-cap companies is not affected.

Table 1 Eligible universe based on EU Ecolabel criterion 1 on equities (large and mid-cap companies)

		0%	<20%	20%-50%	>=50%
Climate change	Weight	69%	27%	3.2%	0.7%
	After exclusions		15%	1.8%	0.6%

Table 2 Eligible universe based on EU Ecolabel criterion 1 on equities (small cap companies)

		0%	<20%	20%-50%	>=50%
Climate change	Weigh	76%	17%	3.1%	2.6%
	After exclusions		14%	2.7%	2.3%

Limitations

The currently adopted screening proxies can be applied in a scalable way – since detailed and relevant corporate disclosures may not appear until 2022 within the EU, and it will be even harder to obtain for companies domiciled outside the EU.

A3: Fideas Asset Management analysis

An analysis was made by fund manager and analysts FIDEAS of both potential uptake by funds and the underlying investable universe of equities. They examined a sample of 3707 EU equity funds and 300 stocks (large, mid and small capitalisation) for eligibility with the EU Ecolabel criterion 1, using Morningstar and Trucost data. A number of ecolabelled portfolios were designed and their performance and characteristics modelled and analysed in comparison to a benchmark fund.

Study outcomes

- Only 57 funds were compliant with EU Ecolabel criterion 1 requirements, meaning that only **1.54%** (Nr. of funds) or **1.25%** (AuM) could qualify;
- UCITS funds represent 74% of the fund sample;
- Assigning the companies into different pockets according to their green revenues[2] gave the results in Table 3. The table suggests that more than 50% of the companies have less than 20% green revenues, and therefore would not qualify for the green and transition pocket;
- The main constraint identified was the size of the investable universe of green activities – the green economy at this point in time;
- The active risk of an ecolabelled fund although greater is deemed 'acceptable' compared to a benchmark fund (+23%). At higher levels of compliance (80% and 100%) based on the

[2] Green revenues were computed using Trucost data; activities are defined as green using EU Taxonomy eligibility only

2nd proposed criterion 1 design, the active risk becomes significantly higher – +43% and +63% on average.

- The tracking error for the ecolabelled portfolios that were modelled was relatively small (1.28 – 2.91%), which is relatively small compared to the corresponding risks.
- In order to compose an ecolabelled fund an overweighting compared to benchmark is required in the sectors of automobiles & components, capital goods, materials, real estate, utilities and telecommunication services. Care needs to be taken not to overweigh sectors with only a marginal impact on climate change or to underweight key sectors that need to make a transition.
- The relative importance of sales volumes, for example of electric vehicles, versus revenues was highlighted.

Table 3: Allocation of companies, based on their green revenues, in three pockets

		Exclusions	<20%	20%-50%	>=50%
Aggregate green	With exclusions	11.7%	52.4%	6.6%	29.6%
	Without exclusions		62.1%	6.9%	31%

Limitations

- Only EU based equity funds have been included in the sample;
- There is uncertainty relating to the fund analysis since it is based on Morningstar categories or using the name of the fund itself. Therefore, it does not map directly on the proposed EU Ecolabel criteria;
- The pool of stocks used to put together portfolios was relatively small.

A4: Sustainalytics screen

Sustainalytics carried out a proxy screen of the Ecolabel criteria on their global universe (12000 companies) and on a portfolio of some 600 of the largest European stocks. The proxy screen does not ideally match with the Ecolabel criteria, but the order of magnitude of the outcomes may still be representative of the current reality.

Screening outcomes

- The results of the proxy screen on the 12000 companies revealed that approximately **6.5%** of these companies would meet the exclusionary screens and have at least some revenue from EU Taxonomy aligned activities. However, if a revenue threshold of >20% is applied, then less than 4% meet the criterion;
- The results of the proxy screen on the 600 European stocks revealed that approximately 65 would meet the exclusionary screen and have at least some positive revenue from EU Taxonomy aligned activities;

- In a real-world setting, there is a significant risk that the limited number of companies that meet the criteria may create an asset bubble in the market;
- While the exclusion rules reduce the eligible universe, the proposed requirement with respect to greenness act as a far stricter filter. The reason being that there are very few companies that meet the proposed EU Taxonomy aligned revenue thresholds;
- Several factors will influence any increase of the investable universe in the foreseeable future, including how fast the outstanding EU Taxonomy objectives will be developed and adopted and corporate disclosures with respect to EU Taxonomy alignment not only in Europe but globally. Likely most important is however the speed at which economies will transition and companies generate more revenues from EU Taxonomy aligned activities.

Limitations

The screening is made up of a green proxy using Sustainalytics Sustainable Products Research, and a set of exclusionary screens on nuclear, oil & gas, tobacco, weapons, adult entertainment, and Global Compact Compliance.

<u>A5: Summary of the analyses findings and further options for criterion 1</u>

The results of all four analyses suggest that the eligible universe under the current criteria proposal would not currently be sufficient to compile EU Ecolabel eligible funds that correspond to the 10-20% of the best performers in the market, although one shall bear in mind that:

- The studies only assess climate change mitigation compliance – the eligible pool might increase once the criteria for all EU Taxonomy environmental objectives will be defined and adopted, although there may be some overlap as companies seek to fulfil multiple objectives;
- The adoption of the EU Taxonomy is expected to improve the granularity and quality of data disclosed by European companies, but this will have a lag time as the market familiarises itself with the final criteria and data is compiled and disclosed;
- The analysed sample only contains equities. It is expected that the inclusion of green bonds will enhance the greenness of the portfolio.

Based on the analyses, three key factors can be identified that may need to be taken into account when seeking to revise the criterion:

- *<u>Capitalisation</u>*: The eligible universe varies depending on the capitalisation of the companies, and the pure players tend to fall into the small-cap category. The majority of the underlying assets of UCITS are composed of large and mid-cap companies;
- *<u>Revenue</u>*: The percentage of green revenues alone may not be a good indicator for the scale of impact. For example, 10% green revenue for a large-cap company may have a greater effect than a 50% green revenue from a small-cap company;
- *<u>Companies in transition</u>*: Although not directly identified by the analysis, an option suggested by stakeholders for expanding the eligible universe could be to explore the provision in the EU Taxonomy to support companies in transition.

Three options for a revised version of criterion 1 were formulated by JRC, considering the outcomes of the analyses and the stakeholders' views on the subject matter. These options are provided below, and open up to some overall questions that need to be addressed (see box below). The sub-group should bear these questions in mind when evaluating the three alternative options for criterion 1.

Related questions for discussion

Criterion design

1. What are the main parameters that should be taken into account or incorporated into the design of the criterion?
2. Should the current (v2 proposal) pocket approach based on % green revenues be changed in any way?

Fund type and composition

3. Should the ambition and thresholds be set/varied based on distinct types of equity fund and/or equity fund compositions?
4. To what extent do choices/priorities relating to the underyling composition of the fund influence the ability to set the threshold for green economic activities?
5. To what extent would setting a higher green economic activity thresholds for a UCITS limit in any way affect the retail investors to whom it could be offered?

Companies in transition

6. How should we adapt the EU Taxonomy definition of 'transition' for the purpose of the EU Ecolabel?
7. To what extent should the equities of 'companies in transition' be possible to use to meet certain thresholds?
8. To what extent should compliance with criterion 1 also be linked in some way to criterion 2 environmental exclusions and criterion 4 engagement?

Current option – 2nd criterion proposal

The outcome of the consultation during and after the 1st AHWG meeting revealed that stakeholders could not agree on a quantitative threshold for green revenues at the company level. Some debated that it should be kept high in order to include only companies with a high share of green activities ('green companies') and thus preserve the credibility of the label. Others said it should be lowered to capture highly diversified companies engaged in the development of new environmental technologies ('companies in transition'). The stakeholders also argued that failing to capture such companies would make it challenging for fund managers to comply with risk diversification requirements for retail products. However, it was pointed out that a lower threshold would not adequately distinguish between companies with a high share of green activities and companies in transition.

Some stakeholders argued that having two thresholds at company level similar to the approach adopted by the French Greenfin label would provide a better distinction between these two types of companies, on top of facilitating compliance with the risk diversification requirements, and thus possibly leading to a higher EU Ecolabel uptake.

The potential for adopting this approach was assessed by analysing the (limited) data provided by asset managers (six funds). The outcome of the analysis led to the three-pocket approach (as proposed in TR2.0), which allows for improvement of greenness through green revenues increase from both green companies (>50% green revenues) and companies in transition (20-49% green revenues). Moreover, the diversification pocket, which can include companies with less than 20% green revenues, increases the eligible assets universe and facilitates fund managers in managing risk.

Nevertheless, the ambition level of the thresholds was criticised: asset managers and data providers judged it to restrict the eligible pool of companies considerably under the current market situation, whereas NGOs judged the threshold to be not ambitious at all, and therefore potentially compromising the credibility of the EU Ecolabel.

Considering the pros and cons of a pocket approach and the diverse stakeholder arguments and proposals on the ambition level of the equities threshold, the JRC has developed three alternative options for equity fund requirements as follows:

<u>Alternative option 1 – Thresholds geared to market capitalisation and the investable universe</u>

The size of the eligible companies appeared as a potential factor to consider in setting thresholds. The majority of UCITS equity funds are understood to be composed of large and mid-cap holdings, which are more difficult to achieve a high green threshold, whereas small-cap equity funds and AIFs are more readily composed of SMEs and pure players with high green percentage.

This option, therefore, treats these different types of equity funds as distinct sub-categories/sub-products and tailors the thresholds according to the individual characteristics of the funds. Since the majority of large-cap equities have a low green percentage, but a potentially significant impact, it is proposed to increase their ambition level by allowing for transition revenues to be used to meet a threshold (see table below). The ratio represents the balance of contribution towards meeting the portfolio threshold

Large-cap UCITS equity fund (to be defined)	x% portfolio threshold = can be achieved by a combination of green and transition revenues (indicatively 1:4)
Mid and small-cap UCITS equity fund (to be defined)	y% portfolio threshold = can be achieved by a combination of green and transition revenues (indicatively 2:1)
Private equity retail AIF fund (to be defined)*	z% portfolio threshold = can be achieved by a combination of green and transition revenues (indicatively 3:1)

* there are AIFs that follow UCITS strategies, so maybe we should only refer to the composition

The portfolio threshold can be geared to what we deduce is feasible and then different ratios of green:transition would be allowed in order to meet the threshold. These ratios could be adjusted over time as the green economy grows and data improves. Linked to this, it is to be discussed to what extent and in what form we keep the link between the value of the assets under management (i.e. the value of shares held) and the revenues of the company. The challenge for the transition revenues is how to define a timeframe and to understand what a realistic rate of change in transition revenues could be.

Alternative option 2 – A combination of Green revenues and Capex as a metric

Option 2 refers to equity funds and entails a combination of green Capex and green revenues as an indicator for greenness. This version of criterion 1 does not contain different pockets anymore. Instead, there is a requirement for the weighted average of green Capex and green revenues to be more than 50%. Additionally, companies with green revenues below 5% shall be excluded.

A simulation of alternative option 2 for a portfolio of six companies and with equal AuM for each company is provided in Table 4 below. There are four indicative combinations of weighting factors that range between 50%/50% and 80%/20%.

The use of Capex as a metrics for green revenues and companies in transition is further discussed in section B, in which hypothetical examples are contrasted.

Table 4. Option 2 simulation for a portfolio of 6 companies

	Green revenues	Green Capex	Average with weight revenues 50% / capex 50%	Average with weight revenues 60% / capex 40%	Average with weight revenues 70% / capex 30%	Average with weight revenues 80% / capex 20%
Company A	2%	20%	excluded	excluded	excluded	excluded
Company B	2%	80%	excluded	excluded	excluded	excluded
Company C	10%	40%	25%	22%	19%	16%
Company D	25%	50%	38%	35%	33%	30%
Company E	50%	75%	63%	60%	58%	55%
Company F	75%	100%	88%	85%	83%	80%
Overall average at fund level			53%	51%	48%	45%

As it can be seen, the weighting factors and the composition of the portfolio are the parameters that influence the eligibility of the fund. In addition, this approach can also incorporate cut-offs for green Capex to boost transition. As Table 4 shows, companies with more than 5% of revenues could qualify for inclusion and they can contribute to the overall greenness if they have an ambitious green strategy and a commitment to transition. A key challenge in using Capex is the scope of activities covered, the scale of investment and the rate of change associated with the reported percentage. Without relating this to the change in green revenues of a company, it is difficult to understand to what extent the company is in transition.

Alternative option 3: Dynamic thresholds for green revenues

The third option elaborates a green revenues dynamic criterion. It establishes a 5 years' period for improving green revenues and sets different requirements for large/mid and small-cap companies. Table 5 shows indicative minimum thresholds for green revenues, differentiated for large/mid-cap and small-cap companies, while adopting a forward-looking approach. The dynamic rate of change of green revenues can be modified according to the feasibility to achieve this increase. The weighting of the large and mid capitalisation companies in the fund is for the moment assumed to be equal. The same applies for the importance of green revenues sourced from pure green companies and companies in transition.

Table 5: Dynamic threshold change for large/mid and small-cap companies

Large/Mid-cap companies				
Portfolio percentage contribution	Transition pocket I 20%	Transition pocket II 30%	Front runner pocket 20%	
Company's Green revenues by pockets	<20%	>=20% & <50%	=>50%	Total[a]
Rate of change in green revenue (per year)	15%	10%	2%	
Year 1 green revenues	10%	20%	50%	18%
Year 2 green revenues	12%	22%	51%	19%
Year 3 green revenues	13%	24%	52%	20%
Year 4 green revenues	15%	27%	53%	22%
Year 5 green revenues	17%	29%	54%	23%
Small-cap companies				
Portfolio contribution		Transition pocket 40%	Front runner pocket 20%	
Company's Green revenues by pockets		>=20% & <50%	=>50%	Total[b]
Rate of change in green revenue (per year)		10%	5%	
Year 1 green revenues		33%	60%	22%
Year 2 green revenues		36%	63%	24%
Year 3 green revenues		40%	66%	25%
Year 4 green revenues		44%	69%	27%
Year 5 green revenues		48%	73%	29%

[a,b] Numbers are rounded up

This approach would potentially allow more funds to achieve the thresholds. The challenges are to define pragmatic rate of change in terms of green revenues and a reasonable timeframe. It assumes that annual achievements need to be communicated to the EU Ecolabel competent bodies. There is also the need for the sake of the credibility of the label for a look back period, in which companies in transition should already demonstrate that they are increasing their share of green revenues.

B: Qualification criteria for companies investing in a transition

The 2nd criteria proposal for the EU Ecolabel introduced under criterion 2 the concept of transition – namely that as well as verifying based on the EU Taxonomy economic activities considered to be 'green' there is also the potential to verify companies that are investing in a transition towards a higher proportion of green revenues on their balance sheet. The concept can have two potential benefits for the EU Ecolabel:

1. **Investor impact:** It would recognise and support the investment being made, particularly by large capitalisation companies, to contribute towards meeting EU Taxonomy environmental objectives. It therefore contrasts with capital allocation to support SMEs with a high proportion of green economic activities, where the objective would be growth rather than transition.
2. **Investable universe**: It could expand the investable universe because current analyses (see Section A) suggest that at the moment the size of the green economy may constitute a major constraint on putting together an EU Ecolabel compliant portfolio. Moreover, although substantial investment is being made by mid to large capitalisation companies, particularly in the utility sector, their green revenue share tends still to be low. The recent analysis carried out for FISMA by Climate Company and the Frankfurt School of Finance and Management, as well as findings presented by MSCI, suggests that the manufacturing sector in particular would merit attention, being the most significant economic activity within UCITS equity holdings.

This overall concept was discussed at the 2nd Ad-Hoc Working Group meeting and the JRC is now exploring how this could be applied in practice and to what extent it should be incorporated into the EU Ecolabel criterion proposal. It also forms part of proposals received by stakeholders for the configuration of the equity fund component of criterion 1, so requires a solution.

Transition under the EU Taxonomy Regulation

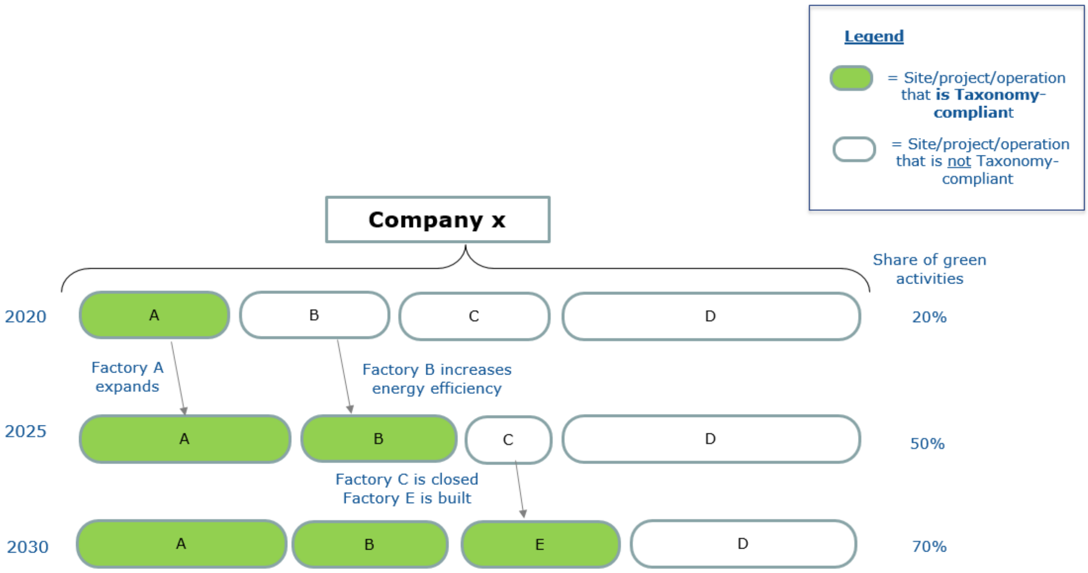
The EU Taxonomy Regulation was adopted on the 1st April 2020. It includes provision for 'transitional activities' that can make a substantial contribution towards the environmental objectives, and defines these activities under Article 10, clause 2 as:

> *'….an economic activity for which there is no technologically and economically feasible low-carbon alternative shall qualify as contributing substantially to climate change mitigation where it supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1,5 ^{o}C above pre-industrial levels, including by phasing out greenhouse gas emissions, in particular emissions from solid fossil fuels, and where that activity:*
> *(a) has greenhouse gas emission levels that correspond to the best performance in the sector or industry;*
> *(b) does not hamper the development and deployment of low-carbon alternatives; and*
> *(c) does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets.'*

In this respect, the EU Taxonomy enables companies to invest in transition by defining green economic activities rather than green companies. Companies can therefore transition by gradually increasing their share of green economic activities. This approach is illustrated in figure 1. Whilst this example refers to factories, it could also apply to energy plant or any other site that contributes towards green revenues generation. Note, however, that the example in Figure 1 wouldn't allow for achievement of intermediate thresholds for performance on the unit of measurement in the EU Taxonomy technical screening criteria.

Moreover, the EU Taxonomy Regulation refers to the disclosure of Capital Expenditures (Capex) related to EU Taxonomy compliant activities. This has the potential to be used as a metric for reporting on the investment being made in transitional activities.

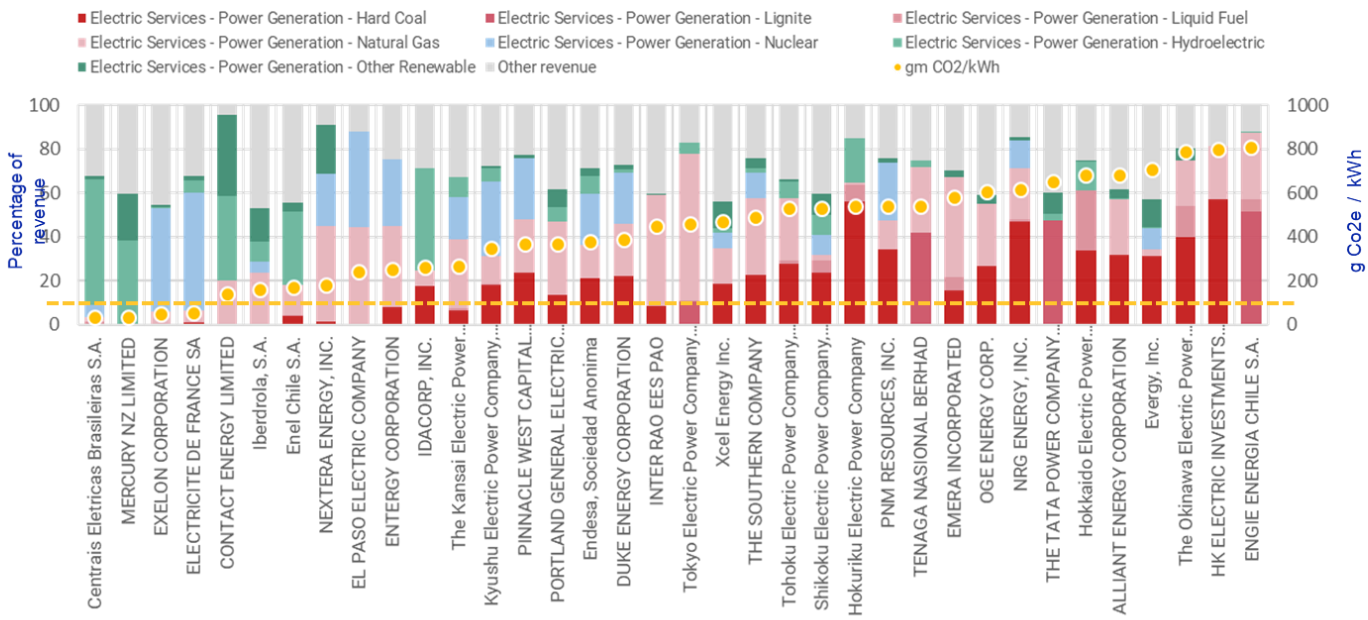
Figure 1. How the EU Taxonomy enables companies to transition



Estimates of Taxonomy compliance for utilities with power generating assets by MSCI illustrate a potential need for a transitional approach. Figure 2 presents the result of an analysis of electric utilities with at least 50% of the revenue from power generation. Of the 37 power producers that report emissions data tied to generation, the majority do not currently meet either the TEG recommended threshold (100 g CO_2eq/kwh) or an IEA recommended threshold (220 g CO_2eq/kwh).

Utilities are understood to be an important asset within UCITS funds and whilst such an approach requires further development, in principle it would serve the dual purpose of supporting risk diversification whilst reducing the environmental impacts of one of the major contributors towards EU and international greenhouse gas emissions that has been prioritised for inclusion in the EU Taxonomy.

Figure 2. CO_2 emissions and power generating assets for a sample of major international utilities



Source: MSCI (2020). Notes: TEG recommended threshold for utility: < 100 gCO_2e /kWh; Based on the set of Electric Utilities with >50% of revenue from power generation.

Precedents and existing examples of criterion on companies in transition

Some initial precedents for this type of criteria were explored in the TR2.0 , published in December 2019. These included a criterion from the Belgian Febelfin label linked to power station CO_2 emissions and exemption criteria set by the Nordic Swan for fossil fuel related activities (see the box below). The latter were cited as an example in the 2nd AHWG. Feedback suggested that it may be difficult to communicate to retail investors the concept of derogations or exemptions from exclusions. Please note that the Nordic Swan label is awarded on a point-basis, whereas the EU Ecolabel is a pass-or-fail label.

Nordic Swan

Investment funds criteria, v1.0.
Exclusion criteria, 5. Extracting and refining fossil fuels

The fund may not invest in companies which themselves or through entities they control derive 5% or more of their revenue from extracting coal (all sorts of thermal coal, e.g. lignite or anthracite), natural gas, crude oil or uranium, and/or from refining coal, natural gas, crude oil or uranium for fuel. Companies that fulfil all of the following criteria are exempt and may be included in the fund.

- At least 75% of the company's energy sector investments on average for the last three consecutive years are in the renewable energy sector.
- Revenue from renewable energy comprises at least 50% of the company's total revenue. This ratio may be calculated on average over the course of 1, 2 or 3 of the last financial years.
- The company has less than 0.1% revenue from tar sand, shale oil or shale gas, or other fracking activities and/or mining of oil shale.

The JRC also put forward a practice-based criterion proposal (in the current version of the technical report, TR2) for vehicle emissions, which has the potential for dynamic change. The proposal is linked to both the EU Taxonomy thresholds and legislation on passenger car and commercial vehicle performance (see the box below).

Extract from proposed EU Ecolabel criterion 2. Environmental exclusions

2.1.2 Transitionary exclusions
Transportation

Production, distribution and sale of new passenger cars and light commercial vehicles, unless the company undertaking the activity complies with the following requirements:

- For new passenger cars: Manufacturers shall have made available to consumers at least one zero- and low-emission vehicle (ZLEV) model with tailpipe emissions of <50 g CO_2/km and the average tailpipe emissions of all models that they have registered in the last calendar year shall be 5% lower than the respective EU target applicable at the time.
- For light commercial vehicles: The average tailpipe emissions of all models that a manufacturer registered in the last calendar year shall be 5% lower than the respective tailpipe CO_2 emissions target.

The JRC has also identified increasing evidence of the verification and issuing of so-called 'transition bonds' which could provide some transferable concepts for application to equities. Axa provides an example of the guidance and expectations for companies investing in transition, which could offer a further precedent for the EU Ecolabel (see the box below). Data providers such as Sustainalytics are also starting to provide Second-Party Opinions for transition bonds, including assessment on:

- the alignment of the issuer's transition strategy and commitments with internationally established decarbonisation pathways,
- the alignment of the use of proceeds with decarbonisation pathways.

Axa investment managers

'Transition bond' definition and guidelines 3

Transition bonds are intended for companies:

- in greenhouse gas-intensive industries such as materials, extractives, chemicals and transportation
- in industries which currently do not (and for the foreseeable future may not) have sufficient green assets to finance but do have financing needs to reduce their greenhouse gas footprint of their business activities, as well as their products and services

Transition bond issuers should clearly communicate what climate transition means in the context of their current business model and their future strategic direction. Senior management and board directors should make a commitment to align their business with meeting the COP21 Paris Agreement goals.

The issuer's transition strategies should be intentional, material to the business and measurable. The Transition Bond must fit into a broader transition strategy. This should be defined by quantified short and long-term environmental objectives. Transition Bonds should be a tool to principally finance a share of the issuer's spending necessary to achieve targets.

Bond issuers are increasingly announcing environmental targets for 2030 or even as far in the future as 2050. While long-term objectives are welcomed, we ask for quantified shorter targets to assess the issuer's progress against its own transition pathway. We also encourage issuers to explain their board and senior management's strategic decision-making process and the Capex needed to meet these targets. Issuers should ensure that their broader sustainability practices, such as policies and programmes, are capable of helping achieve the objectives.

[3] Axa, Financing brown to green: Guidelines for Transition Bonds, https://www.axa-im.es/content/-/asset_publisher/qxx9OlkAqLWg/content/financing-brown-to-green-guidelines-for-transition-bonds/23818

Options and considerations for setting transitional criteria

As has been illustrated by this paper, a number of options exist that could provide a basis for such a criterion. Each has its strengths and weaknesses, which we propose to evaluate with the input of sub-group members. While the formulation of such a criterion, and how it would relate to criterion 1, 2 and 4, has not been decided, the options listed provide a good starting point for discussion. They are as follows:

B1: Capital expenditure: As a metric to disclose the investment priorities of a company. Below we discuss further the specific challenges relating to this metric (see the box below for a discussion based on hypothetical examples).

B2: Share of Taxonomy compliant 'green' revenue: As a metric to disclose how the revenue base for the company is changing, or is planned to change.

B3: Practice-related performance thresholds: As technology neutral thresholds for measuring progress. Although these can be linked to technical screening criteria of the EU Taxonomy, the economic activity would also need to meet the other criteria, such as the Do No Significant Harm (DNSH).

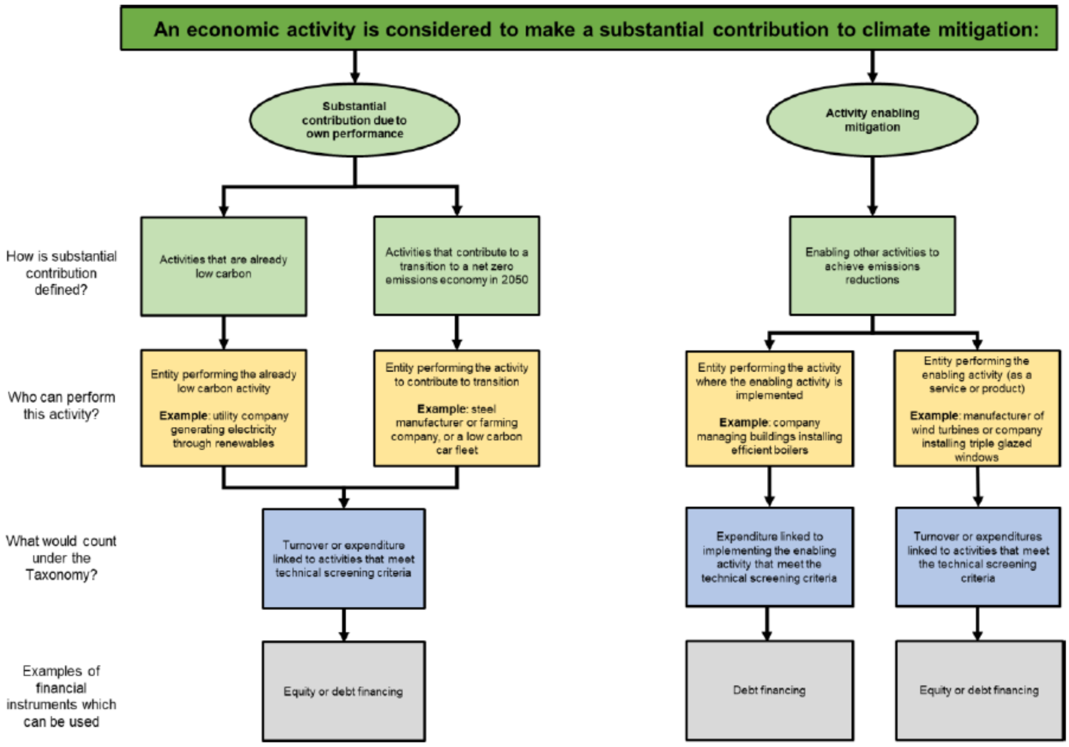
B4: Phase out and divestment: As a demonstration of commitment to the new pathway. However, care needs to be taken to ensure additionality and that divested assets do not simply change hands.

Based on the JRCs analysis to date there also appear to be a number of accompanying questions that would need to be addressed in order to set transition criteria:

- What should be the scope of eligible activities?

  Evidence from the analysis to date of funds and equities suggests that initial criteria are needed that recognise transitions underway in the energy and manufacturing sectors. Whilst the EU Taxonomy provides the main starting point, with companies either investing to increase their revenue from, initially, low carbon activities and/or enabling activities, there may also be intermediate thresholds and practices that the EU Ecolabel could support e.g. intermediate vehicle emission targets. A related issue is the extent to which some activities or technologies that may be excluded by criterion 2 (environmental exclusions) should be permitted as long as the company can show that they are in transition e.g. natural gas or coal power generation revenues at >5%.

Figure 3. Economic activities considered to make a substantial contribution towards taxonomy objectives



Source: *EU TEG on sustainable finance (2020)*

- What is the definition and scope of Capex?

  There is the need to define the scope of investments that qualify under Capex disclosures. In some definitions it is understood to include activities relating to extension of the life span of green assets rather than investment in new green assets.

- Should there already be evidence of transition?

  To provide assurance to retail investors there may be for 1) a minimum initial % of green revenue and/or 2) the need to have a look back period for transition during which a shift in investment and green revenue can be shown. The aim would be to ensure that companies can demonstrate that initial progress made.

- What should be the scale and rate of transition?

  To provide further assurance to retail investors, it will be important to have a look forward period for transition. This would comprise the forward strategy for change and investment, including milestones in time. There is the need for the EU Ecolabel to define what the qualifying scale of transition, rate of change/growth and associated time frames would be. Depending on the metric chosen, this would have a differing definition.

The JRC has been analysing examples from the energy sector such as Drax Power, Orsted and Iberdrola in order to understand and inform potential time frames and rates of transition, but it is to be discussed how far the parameters for transition can be defined on a generic basis. As such, a criterion would need to cover a range of energy and manufacturing related activities. It is understood that ADEME, the French Environment Agency, is currently analysing transition pathways for different sectors as part of the ACT programme and the LIFE funded FinanceClimAct project, and have therefore been invited to contribute.

Further hypothetical discussion on the use of Capex

To date in discussion with EU Ecolabel stakeholders, the potential to include a criterion on companies in transition has focused mainly on the potential to use the metric of Capex. Discussions with data providers suggest that Capex is a relatively new metric for which there is limited current reporting in the frame of ESG or environmental performance. The sector in which it is understood to be most commonly reported is the oil and gas sector, as evidenced by a recent study carried out by the IEA on the potential to shift investment. There appears to currently be a lack of a common definition and scope to delineate between Capex and Opex.

The hypothetical case of three power plant operators that all have some renewables assets that generate 10% of their revenue from green economic activities illustrates some of the issues to take into account when using Capex:

- Company x is currently making minimal planned investment over 2-3 years in the upgrading of its existing renewables plant to extend their lifespan and this represents 100% of Capex. Their remaining fossil fuelled plants from which it derives 80% of its revenue will continue operating.
- Company y plans to replace major parts of all its fossil fuelled plant over 5-6 years in order to become 50% taxonomy compliant.
- Company z is in the process of replacing all the major parts of all its fossil fuelled plant over 5-6 years in order to become 100% taxonomy compliant.

Contrasting the three cases: company x's performance is static, verification of company y's performance relies on its forward strategy and company z already has some evidence that it is on a path to transition and is now aiming to become a pure player. In all cases 100% of the Capex being made would be Taxonomy compliant but this on its own does not provide enough information about the nature of the transition being made, if at all.