vigeoeiris

Taxonomy Alignment Screening

INTRODUCTION

Our teams at Vigeo Eiris (V.E) have carefully followed the European Union's (EU) Taxonomy project since the European Commission's (EC) action plan on financing sustainable growth was released in March 2018. Since then, the Technical Expert Group (TEG) has released multiple reports and consultations to refine the Taxonomy, generate buy-in from the affected market participants and position the initiative for take-off. Within its June 2019 report, the TEG identified the key role for ESG data providers whom they consider will "play an important role by standardising information from different sources and jurisdictions to provide financial institutions with comparable global datasets for capital allocation decisions"[1] . With those responsibilities in mind, we are pleased to have released the beta-version of our EU Taxonomy Alignment Screening. Over the coming months and using the feedback from the market, we will continue to refine our solution to ensure that we are supporting market participants with comprehensive, transparent and decision relevant data that helps them navigate the changing landscape.

WHAT IS THE EU TAXONOMY?

At its core, the Taxonomy is a tool to help investors to understand whether an economic activity is environmentally sustainable. It has been designed to provide a common language for all market participants and introduce standards that align with the ambitions of the European Commission's Sustainable Finance Action Plan. The Taxonomy defines the conditions and reference points (i.e. criteria and thresholds) under which a given list of activities can be considered as sustainable, from a climate mitigation and adaptation point of view. The Taxonomy is set to become the basis of a new regulatory landscape that is already taking shape in the EU. This Taxonomy is likely to influence investment decisions in the years to come, especially on project finance, the green/sustainable bonds market and in portfolio management. It will help investors to design pan-European financial products and to benchmark their investments against recognized reference standards.

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[1] TEG Taxonomy Report — Published June 2019, p77

The Taxonomy defines three criteria required for an economic activity to be eligible. It must:

1. **Substantially contribute** to one or more of the six environmental objectives in compliance with the technical screening criteria (climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control; protection and restoration of biodiversity and ecosystems).
2. **Do no significant harm** to any of the six environmental objectives.
3. **Comply with minimum social safeguards** (derived from the ILO core labor conventions).

HOW WILL IT BENEFIT MARKETS?

We have identified four likely overarching benefits. Firstly, the Taxonomy provides market clarity by defining a common language and a common understanding of what is environmentally sustainable amongst investors, issuers, policymakers, regulators, scientists and broader stakeholders. Investors can use the Taxonomy and refer to the environmental performance criteria to express their expectations for their investment decisions and financial products. Companies and project developers can directly refer to it to plan and raise finance, developing a pipeline of sustainable investment opportunities.

Secondly, in the way in which it has been established, the Taxonomy places environmental data in context. Investors need to understand which companies are contributing to the low-carbon transition and building resilience to climate change. The information that they require goes beyond a simple carbon footprint analysis. By defining clear thresholds for impactful activities, the Taxonomy forces the disclosure of wider and more precise environmental and operational efficiency data for all covered activities. Over time, the improved disclosures that the Taxonomy will facilitate are expected to build greater confidence in the robustness of the sustainable finance market.

Thirdly, the Taxonomy contributes to the management of reputational risks for investors. By screening out economic activities that undermine broader environmental, climate and social objectives, investors can avoid reputational risks and to some extent their transaction costs. The Taxonomy is a tool that will help them ensure that their strategy is robust and backed against this EU-wide classification. Therefore, investors will be encouraged to explain in the marketing of sustainable funds if and how they have used the Taxonomy as well as the

percentage of their funds invested in Taxonomy eligible activities.

Finally, as a science and evidence-based framework defining what is environmentally sustainable, the Taxonomy provides companies with clear direction as well as incentives to adopt or reorient their transition strategies and to invest further in low carbon technologies and R&D. It will benefit innovative companies by allowing access to finance for R&D (e.g. green loans) and reward those undertaking environmentally sustainable activities or setting up specific environmental projects.

MEASURING TAXONOMY ALIGNMENT.

Vigeo Eiris has established a specialist team and research methodology to screen companies for Taxonomy alignment. We have structured our approach around the three criteria outlined by the European Commission:

1. Substantially contribute to one of the six environmental objectives,
2. Do No Significant Harm to the other environmental objectives,
3. Comply with minimum social safeguards

As of today, we are able to provide an assessment that covers:

- ✓ Taxonomy alignment at activity level,
- ✓ Taxonomy alignment at company level,
- ✓ Taxonomy alignment at portfolio level

Substantial Contribution

The first step is to identify activities that could be considered as Taxonomy eligible. This is done via a screening of the issuer and its activities. The screening is conducted using public information as well as by leveraging our own existing internal datasets on company activities.

For each activity that is identified, we assess whether the company meets the relevant screening criteria for substantial contribution as defined by the EC. Given the level of technical detail for each of these criteria (as well as the fact that these are new criteria), the volume of public

information to affirm alignment is low (but expected to rise in time). Where public information is lacking, robust assumptions based on available scientific literature are made to define whether the activity satisfies the criteria or not.

For example, for the activity of electricity generation, the screening criteria is set at <100g CO_2/kWh (life cycle). When the life cycle emissions intensity per kWh generated is not disclosed by the company, as proxy we use the Intergovernmental Panel on Climate Change[2]. Technology-specific Cost and Performance Parameters report to make a robust assumption per each technology. In cases where the company does not disclose the necessary information related to the screening criteria and well-founded assumptions are not possible, the activity is marked as not aligned.

Do No Significant Harm (DNSH)

The second step is to apply the DNSH criteria to ensure that the activities of the company do not negatively impact the six environmental objectives outlined by the European Commission. In order to do this, our teams conduct a controversy screening. This applies the methodology of Vigeo Eiris' Controversy Risk Assessment product. Where companies are found to have controversies of a "High" or "Critical" severity on the associated criteria, they are excluded from being considered as Taxonomy eligible.

Table 1: The EU Taxonomy Environmental DNSH Principles

6 EU Environmental Objectives	Vigeo Eiris Controversy Screening
Climate Change Mitigation	Energy Atmospheric Emissions Water Waste Management Accidental Pollution Prevention & Control Biodiversity
Climate Change Adaptation	
Protection of Water and Marine Resources	
Transition to a Circular Economy	
Pollution Prevention and Control	
Protection and Restoration of Biodiversity	

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[2] Schlömer S., T. Bruckner, L. Fulton, E. Hertwich, A. McKinnon, D. Perczyk, J. Roy, R. Schaeffer, R. Sims, P. Smith, and R. Wiser, 2014: Annex III: Technology-specific cost and performance parameters. In: Climate Change 2014: Mitigation of Climate Change. Contribution of Working Group III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change [Edenhofer, O., R. Pichs-Madruga, Y. Sokona, E. Farahani, S. Kadner, K. Seyboth, A. Adler, I. Baum, S. Brunner, P.Eickemeier, B. Kriemann, J. Savolainen, S. Schlömer, C. von Stechow, T. Zwickel and J.C. Minx (eds.)]. Cambridge University Press, Cambridge, United Kingdom and New York, NY, USA.

Comply with minimum social safeguards

The final step also leverages our Controversy Risk Assessment research to determine whether or not companies are in breach of the minimum social safeguards as outlined by the European Commission.

Table 2. EU Taxonomy Minimum Social Safeguards Principles

Area	Principle	Vigeo Eiris Controversy Screening
Human Rights	**Principle 1:** Businesses should support and respect the protection of internationally proclaimed Human Rights; and **Principle 2:** make sure that they are not complicit in Human Rights abuses.	• Fundamental Human Rights • Non-Discrimination • Supply Chain Labour Standards
Labour	**Principle 3:** Businesses should uphold freedom of association and the effective recognition of the right to collective bargaining; **Principle 4:** the elimination of all forms of forced and compulsory labour; **Principle 5:** the effective abolition of child labour; and **Principle 6:** the elimination of discrimination in the respect of employment and occupation.	• Fundamental Labour Rights • Child and Forced Labour • Supply Chain Labour Standards
Anti-Corruption	**Principle 10:** Businesses should work against corruption in all its forms including extortion and bribery.	• Corruption

DATA AT ACTIVITY LEVEL

At activity level, five datapoints are systematically provided per company:

1. Whether there is Involvement (Yes/No) in the activity

2. Whether the technical criteria for the activity are met (Yes/No)

3. What the level of incorporation is for this activity. This is a measure of the share of revenues related to this activity. This information is provided on a 0-100% scale.

4. What the scale of incorporation is for this activity. This is an approximate measure of the share of revenues related to this activity. This information is provided within a set of 10 thresholds.

- None

-]0-10%[

- [10-20%[

- [20 -30%[

- Etc.

5. The sources of information for this data.

Table 3: Example of Data provided at Activity level (*example of growing of perennial crops*).

ACTIVITY 1 - Growing of Perennial Crops					
	Involvement – Growing of Perennial Crops	Technical Criteria Met	Reasonable Estimation of Incorporation – Growing of Perennial Crops	Scale of Incorporation – Growing of Perennial Crops	Sources of Information
OPTIONS	YES/NO	YES/NO	FROM 0 -100%	THRESHOLDS	SOURCE OF INFORMATION
Company X	YES	YES	11%	[10-20%[	Annual Report – Company X 2020 – pg 132
Company Y	NO	NO	0	NONE	-
Company Z	NO	NO	0	NONE	-

This data can support investors in identifying their existing level of exposure to companies with activities that are considered as being Taxonomy aligned. The data also supports an understanding of the nature of those activities and can facilitate the identification of new investment opportunities in companies with Taxonomy aligned activities.

DATA AT COMPANY LEVEL

At company level, five datapoints are systematically provided per issuer:

1. Whether there is Involvement (Yes/No) in Taxonomy activities,

2. What the scale of incorporation is for this issuer respecting the criteria defined by the Taxonomy. This is an approximate measure of the share of revenues related to this issuer. This information is provided within a set of 10 thresholds.

    a. None

    b.]0-10%[

    c. [10-20%[

    d. [20 -30%[

    e. Etc.

3. What the scale of incorporation is for this issuer with insufficient information related to the criteria defined by the Taxonomy. This is an approximate measure of the share of revenues related to this issuer. This information is provided within a set of 10 thresholds.

    a. None

    b.]0-10%[

    c. [10-20%[

    d. [20 -30%[

    e. Etc.

4. Whether the company is in alignment or not with the Do No Significant Harm principles (Yes/No)

5. Whether the company is in alignment or not with the Minimum Social Safeguards principles (Yes/No)

	OVERALL LEVEL				
	Taxonomy Activities	**Overall Scale of Incorporation – Respecting the technical criteria as defined by the EU Taxonomy**	**Overall Scale of Incorporation – with insufficient info related to the technical criteria as defined by the EU Taxonomy**	**DNSH**	**Minimum Social Safeguards**
OPTIONS	YES/NO	THRESHOLDS	THRESHOLDS	YES/NO	YES/NO
Company X	NO	NONE	NONE	NO	NO
Company Y	YES	]0-10%[	]0-10%[	YES	YES

RESULTS SNAPSHOT

Below we have outlined some of the initial findings from our EU Taxonomy research:

- Many companies screened so far do perform one of the 72 Taxonomy activities.
- However, the majority do not visibly meet the technical criteria or those activities represent a limited share of their total revenues.
- Revenue attributable specifically to each activity was rarely reported in the detail required to make a precise assessment.
- Concerning Do No Significant Harm and Minimum Social Safeguards criteria we found that, out of the total number of companies found with some substantial contribution, 9% of those were involved in an environmental controversy and 21%, a social related controversy thus ultimately considered as non-Taxonomy aligned.

Share of Companies with Taxonomy Aligned Revenues per Sector
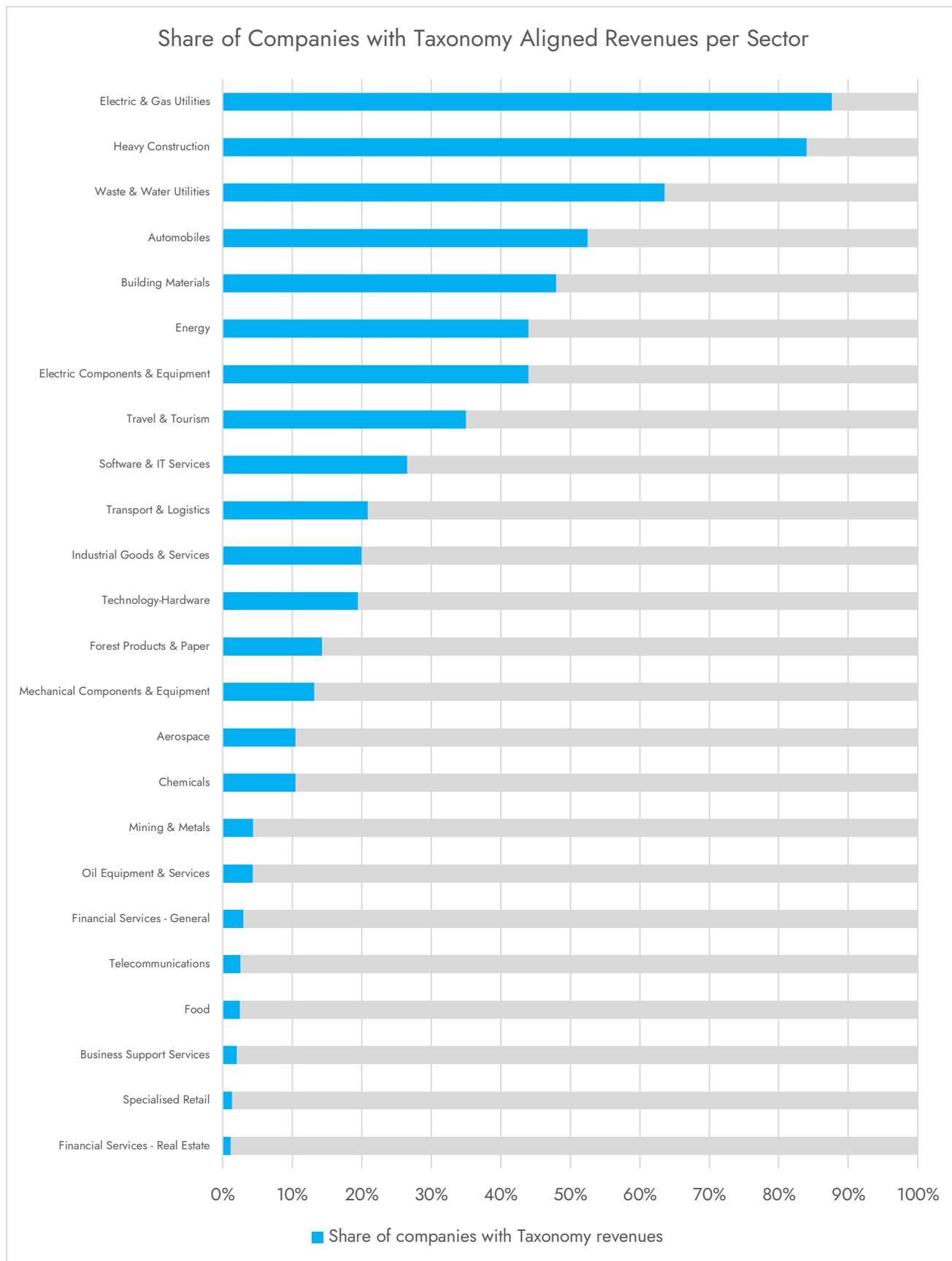
CONCLUSIONS

The Taxonomy is being progressively incorporated across our products and services. As of today, a total of 1587 European issuers have been screened against the EU Taxonomy criteria. This data has been released in a beta version of the product and following feedback from the market, we will refine and expand the coverage of this service in 2021. For any questions related to our EU Taxonomy Alignment Screening we encourage you to reach out to the authors listed below.

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ABOUT

Vigeo Eiris is a global leader in ESG assessments, data, research, benchmarks and analytics. Leveraging our extensive proprietary database, we equip market players with the ESG insight they need to manage risks and better understand and address their social and environmental impact. With a team of nearly 300 experts of 30 different nationalities, Vigeo Eiris is present in Paris, London, Brussels, Casablanca, Hong Kong, Milan, New York, Rabat and Santiago. Since 2019, Vigeo Eiris has been an Affiliate of Moody's Corporation.

For more information: vigeo-eiris.com