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BRIEFING PAPER January 2022

MAPPING OUT A WAY THROUGH THE TAXONOMY CRISIS

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The European Commission's proposals to label fossil gas and nuclear power generation have triggered a crisis. Describing these activities as 'sustainable' for investment purposes is not acceptable to private sector investors. Europe's reputation and climate leadership are also being damaged.

The current proposal can potentially be modified to achieve an acceptable outcome. However, if agreement on suitable modification cannot be achieved then Member States or Parliament should veto the proposed Delegated Act.

The crisis at hand: a damaged taxonomy

The scale of sustainable capital markets is **estimated at \$3.2 trillion** and is growing rapidly. Setting standards to tackle 'greenwashing' (the labelling of unsustainable investments as sustainable) is crucial in a market that is rapidly growing and becoming more complex.

The EU sustainable taxonomy is one of the first legislative attempts to avoid greenwashing. Since it was announced in 2018 the EU's approach has been replicated in more than 20 jurisdictions worldwide.

The EU taxonomy identifies economic activities that are considered to be sustainable, and in its first iteration addresses climate change mitigation and adaptation. Article 10(2) of the **Taxonomy Regulation** provides for the identification of activities which are 'transitional', meaning activities for which "there are no technologically and economically feasible low-carbon alternatives."



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On 31st December 2021, the Commission circulated a draft **Delegated Act** to Member States which proposed new taxonomy criteria for fossil gas and nuclear power generation. While the rationale for including these activities was that they were asserted to be “transitional”, and various time-limited constraints were proposed, the proposed treatment in the taxonomy was to label them as “sustainable”.

The taxonomy is aimed at mobilising private sector financial flows towards sustainable investments. However, the draft Delegated Act received a rapid negative reaction from the institutional investors who are its intended beneficiary. The Institutional Investor Group on Climate Change (IIGCC) **stated** that including fossil gas in the taxonomy “hinders the capacity of our members to align their portfolios with net zero, undermining the whole purpose of the Taxonomy and the substantial work that has been undertaken to develop it.”

Lack of support from investors undermines the EU’s position as a regulator. **Interviewed by Responsible Investor**, the CEO of French investment management company Mirova said: “this creates a two-speed taxonomy [...] with a ‘political’ taxonomy and a ‘practical’ taxonomy. We will ask our data providers for these figures and on our side we will only use the figure without gas and nuclear.”

The draft Delegated Act also undermines European climate leadership, making the EU definition of sustainable investment less climate-friendly than that of **China** or **Russia**. South Korea followed the European debate closely and **weakened its own taxonomy rules** in late December to include fossil gas. Other major economies may now follow the lead set by the EU and South Korea.

The impasse is unlikely to be resolved quickly. Following an initial comment period for members of the EU Platform on Sustainable Finance, Member States will have four to six months to decide whether to adopt the Act. The European Parliament will have a right of veto. And waiting in the wings is the prospect of **legal action against the European Commission led by Austria**.

Overall, the regulatory process around the draft Delegated Act has reflected poorly on the EU’s ability to forge consensus-based democratic decisions. The process has managed to combine delay, inconsistency across policy files, the appearance of deal-making between Member States and the Commission to the exclusion of the Parliament, and limited opportunities for impact assessment or public consultation.



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Mapping a way through the crisis

Given the extent of the concerns raised and the high risk of harming the EU's climate credibility, it is clear that the current proposal should not go forward as it stands. The different options are as follows:

- **The best option at this point would be for the Commission to withdraw the Delegated Act.** To minimise loss of face this moment could be used by Europe to demonstrate its international climate leadership.
- **Failing withdrawal, options to revise the draft Delegated Act should be explored urgently by the Commission and Member States.** The official process for finalising a Delegated Act offers little opportunity for textual amendment at this stage, meaning that this option will be fraught with risks and difficulties. We have outlined options to achieve 'Acceptable' and 'Minimum Viable' outcomes through amendment.
- **If the above options fail, then we recommend that either Member States or Parliamentarians veto the draft Delegated Act.** This would buy time for more thoughtful resolution of the underlying issues. It would also avoid a prolonged legal battle between the Commission and Member States.



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The table below sets out this hierarchy of possible outcomes from the process, ordered by the level to which they address scientific integrity and stakeholder concerns:

Level of acceptability	Description	Scientific integrity and stakeholder support
Desirable	Council and/or Parliament reject the Delegated Act and the taxonomy remains based on the first climate Delegated Act.	Green
'Good Enough'	The draft text of the Delegated Act is modified by putting nuclear and fossil gas into a new 'amber' transitional category with clearly defined progressively tightening thresholds and a sunset clause, derived from a science-based 1.5 degree climate neutrality scenario, and with strong governance.	Yellow
'Minimum Viable'	The Delegated Act's criteria for gas and nuclear energy are modified to reflect the full impact of these activities on climate change and the environment. The criteria are significantly tightened, and governance obligations are strong enough to prevent greenwashing.	Orange
Unacceptable	Nothing changes: the Delegated Act labels fossil gas and nuclear power generation as sustainable and puts in place inadequate governance and safeguards against greenwashing.	Red



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Withdrawal of the Delegated Act

Withdrawal of the Delegated Act would be the best option for the Commission at this point, given the limited flexibility of the Delegated Act process to address major concerns from stakeholders.

The draft Delegated Act was promised in the **Strategy for Financing the Transition to a Sustainable Economy**. This commitment has been kept on the Commission's part, and good faith efforts were made to accommodate the requests and demands of different Member States. Unfortunately, the result does not meet the needs of private sector market actors due to a lack of scientific integrity.

Given this situation, it would be reasonable for the European Commission to withdraw the draft Delegated Act. We recommend that the Commission:

- Makes a prompt public announcement that the draft Delegated Act will be withdrawn in light of stakeholder concerns raised since its circulation, citing the importance of Europe's domestic and international sustainability and climate goals.
- Initiates a period of reflection around the current process to identify lessons learned, with conclusions to be published in six months' time.
- During the reflection period the Commission should seek advice and guidance from the Platform on Sustainable Finance.
- Amendment of the Delegated Act

Amendment of the Delegated Act would enable 'Acceptable' or 'Minimum Viable' outcomes in E3G's proposed hierarchy.

It is by no means clear that significant amendments will be possible at this stage in the Delegated Act process. However, if there were ever a time to test the boundaries of the standard process, this would be the moment.

The key amendments to be made can be separated into those required for 'Acceptable' and those required for 'Minimum Viable' outcomes.

Amendments for an 'Acceptable' outcome

An 'Acceptable' outcome would involve accurate labelling of nuclear and fossil gas power generation. These activities should not be labelled as 'sustainable'. Stakeholder concerns over scientific integrity have been widely expressed in the current debate. In the case of gas, the issue is incompatibility with the EU's 2050



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climate neutrality target, while in the case of nuclear the key issue is incompatibility with the taxonomy's 'Do No Significant Harm' provisions.

It would also be inappropriate to give nuclear and fossil gas generation the label 'transitional'. Transition activities are defined strictly within the Taxonomy Regulation, and these economic activities do not meet the criteria there which are that 'greenhouse gas emissions are substantially lower than the sector or industry average, they do not hamper the development and deployment of low-carbon alternatives and they do not lead to a lock-in of assets incompatible with the objective of climate neutrality, considering the economic lifetime of those assets.'

Therefore, to be consistent with the science-based principles of the taxonomy, and to include these activities, **it will be necessary to create a new time-limited 'amber' category**. This category would cover temporary activities which were not aligned with long-term European sustainability.

Such an approach was already mentioned by Commissioner McGuinness in October 2021, **according to the Financial Times**, which quotes her as saying that "possible compromises included creating an "amber" label for activity that did not win the green label but would still secure a place in the bloc's transition and not discourage private sector investment."

However, despite the statements by Commissioner McGuinness it is not clear that adding such a major change to the draft Delegated Act is legally possible at this stage in the legislative process.

An 'Acceptable' outcome will also need to include strengthened governance provisions. The text of the draft Delegated Act includes (for gas) provisions for an annual third-party emissions verification against a lifetime transition plan and (for nuclear) requires long-term investment in deep storage together with other safeguards. However, the draft Delegated Act has to clarify who will be responsible for enforcing these requirements and what the implications will be of failure to comply with the requirements over time.

This means that it is, for example, possible for a standard gas power plant to attract funding as a 'sustainable' activity and in a few years' time lose this label when the carbon budget set out in the Delegated Act is exhausted, while continuing to operate. Equally it is possible for a nuclear facility to be classed as 'sustainable' between now and 2045, but no mechanism has been identified for notifying investors of a retrospective cancellation of the designation if the deep storage investment requirement is not met at that point.



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Amendments for an ‘Acceptable’ outcome should, if this can legally be done, include:

- Create a new ‘amber’ category;
- Include clearly defined progressively tightening thresholds, and a sunset clause;
- Draw on a science-based 1.5 degree climate scenario for EU climate neutrality by 2050;
- Include a transparent and rigorous governance framework to avoid greenwashing which assigns duties and responsibilities to named institutional actors, including ongoing assessment of projects and solutions to manage retrospective changes to investment status if conditions are not met. This governance framework should be subject to scrutiny and oversight by the European Parliament.

Amendments for a ‘Minimum Viable’ outcome

A ‘Minimum Viable’ outcome would ensure that the full environmental impact of gas and nuclear power generation was recognised and taken into account within the Delegated Act. This would mean that the ‘sustainable’ label would be applied in accordance with the principles of scientific integrity.

Numerous concerns have been raised by investors and civil society that the draft Delegated Act is at present not science-based. A good range of technical arguments is set out in a briefing by the **International Sustainable Finance Centre**. Unfortunately, making substantial textual amendments will be exceedingly difficult at this point in the regulatory process.

In relation to fossil gas and hydrogen, the key issue is that the draft Delegated Act would allow substantial amounts of greenhouse gas emissions with figures **as high as additional 1.4 billion tons of emissions** and would send a market signal that could crowd out investments in clean energy. An Impact Assessment has not been conducted for the currently proposed fossil gas or hydrogen criteria, meaning that there has been no official assessment of their impact on the EU climate neutrality target and the implementation of the Climate Law.

Two points of comparison in the absence of such an assessment are the European Investment Bank’s 2019 Energy Lending Policy agreed in the context of the EIB’s shift to become Europe’s Climate Bank, and the investment framework for the EU Recovery and Resilience Facility. Neither of these frameworks allow fossil gas investments to be labelled ‘sustainable’ raising the question of how the



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Commission can feel confident to apply such labelling in the draft Delegated Act, considering the apparent inconsistencies in EU sustainable finance policy.

For nuclear power generation, the focus of current debate is the constraints which have been placed on sustainable labelling of new investments and whether they are strong enough to meet the taxonomy's Do No Significant Harm criteria. At present assessment, significant impacts have either been classified as out of scope (upstream environmental impacts from uranium mining) and or deferred (the next generation of Europeans is expected to deal with nuclear waste). Even so, **various practical issues with the proposed criteria** have been raised by nuclear industry participants.

Strengthened governance provisions would need to be added to achieve this outcome, for the same reasons that are outlined above for the 'Acceptable' outcome.

Amendments for a 'Minimum Viable' outcome should:

- Draw on a new Impact Assessment for fossil gas, which should now be commissioned by the European Commission and conducted rapidly;
- Draw on inputs from a new public consultation process including investors and industry specialists, as well as civil society;
- Draw on a science-based 1.5 degree climate scenario for EU climate neutrality by 2050;
- Include a transparent and rigorous governance framework to avoid greenwashing which assigns duties and responsibilities to named institutional actors, including ongoing assessment of projects and solutions to manage retrospective changes to investment status if conditions are not met. This governance frameworks should be subject to scrutiny and oversight by the European Parliament.

Veto of the Delegated Act

If the Commission does not decide to withdraw the draft Delegated Act, it will fall to Member States and the European Parliament to decide whether the Delegated Act should be passed into European law.

E3G recommends that the Delegated Act should be vetoed if 'Acceptable' or 'Minimum Viable' outcomes cannot be achieved during the 4-6 month evaluation period, as set out in the table of hierarchies above.

Vetoing the Delegated Act would not have any impact on investment opportunities for new energy projects, as the taxonomy is purely a labelling tool.



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Private sector actors would be able to use the original Delegated Act as a framework to define sustainable investment and would suffer no negative consequences. Meanwhile, the ability of Member States to be able to set their own energy transition pathways would be completely unaffected.

Failing to veto the act would result in enabling a new European regulatory instrument which is not useful to its primary stakeholder group of institutional investors, has inadequate scientific integrity, is causing tremendous damage to the EU's international reputation, and will result in further legal battles.

This will be an extremely important decision for both Member States and Parliamentarians, and the global community will be watching their decision.



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About E3G

E3G is an independent European climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action.

E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

More information is available at e3g.org.

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