

THE EU TAXONOMY FOR SUSTAINABLE INVESTMENTS – TRANSPORT

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- 1) The Taxonomy Regulation and its objectives
- 2) Scope of the taxonomy
- 3) How is “environmentally sustainable” defined?
- 4) The Technical Screening Criteria (“TSC”): Overview
 - TSC: Transport: Maritime
 - TSC: Transport: Aviation
 - TSC: Transport: Rail
- 6) Disclosure obligations
- 7) Extra territorial effect
- 8) Conclusion

THE TAXONOMY REGULATION AND ITS OBJECTIVES

Regulation (EU) 2020/852 of the European Parliament and EU Council (the ‘Taxonomy Regulation’)¹ came into force on 12 July 2020, although it will not start applying until 1 January 2022 at the earliest. It represents a key step towards the EU’s objective of achieving a climate neutral union by 2050.

"The taxonomy is likely to be a key tool in assessing any green supporting factors under banks' prudential rules (e.g. capital adequacy treatment)."

The Taxonomy Regulation provides uniform criteria for companies and investors to determine whether an economic activity is “environmentally sustainable”. It is a classification system (known as a “taxonomy”) which will help investors identify what is, or is not, sustainable. Its aims include²:

- To re-direct capital flows to sustainable investment and to companies engaged in or transitioning to more sustainable activities;
- To limit market fragmentation in the classification of green activities and investment projects, which will in turn facilitate cross-border sustainable investment in the EU;
- To increase transparency thereby enhancing investor confidence and awareness of the environmental impact of financial products/corporate bonds; and

- To create visibility and address concerns about “greenwashing” (that is, the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact, basic environmental standards have not been met).

Further, the taxonomy is likely to be a key tool in assessing any green supporting factors under banks’ prudential rules (e.g. capital adequacy treatment). For example, the European Banking Authority has a mandate to assess the need for a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and /or social objectives, which will use the new EU taxonomy³.

SCOPE OF THE TAXONOMY REGULATION

The Taxonomy Regulation applies to:

- measures adopted by Member States or by the EU that set out requirements for financial market participants (“FMPs”) or issuers in respect of financial products (which includes investment funds, pensions and UCITS) or corporate bonds that are made available as environmentally sustainable, for example Green Bonds (FMPs include insurance undertakings, investment firms, pension providers and fund managers);
- FMPs that make available financial products; and
- undertakings which are subject to the obligation to publish a non-financial statement or a consolidated non-financial statement pursuant to the Non-Financial Reporting Directive (see below).

"The TSC are uniform criteria which will be used to determine whether economic activities "contribute substantially" to each environmental objective, and therefore can be considered sustainable."

THE DEFINITION OF “ENVIRONMENTALLY SUSTAINABLE” UNDER THE TAXONOMY

There are **four criteria** under the Taxonomy Regulation which an economic activity must meet in order to qualify as “environmentally sustainable⁴”:

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As mentioned above, the Taxonomy Regulation sets out **six environmental objectives**⁵:

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

Each of the objectives is defined in the Taxonomy Regulation.

TECHNICAL SCREENING CRITERIA: OVERVIEW

The **Technical Screening Criteria** (the “TSC”) are uniform criteria which will be used to determine whether economic activities “contribute substantially” to each environmental objective, and therefore can be considered sustainable⁶. The TSC will also determine whether any of those economic activities cause significant harm to any of the other environmental objectives (in accordance with criteria (2) above). The TSC will therefore be used as a basis for establishing an actual list of environmentally sustainable activities and will be implemented pursuant to the Taxonomy Regulation through delegated acts which are to be adopted in two sequences⁷.

The draft TSC covers the following 13 sectors:

"This first delegated act was expected to be adopted by 31 December 2020 with the intention that the taxonomy would apply from 1 January 2022."

- 1) Agriculture and forestry;
- 2) Environmental protection and restoration activities;
- 3) Manufacturing;
- 4) Energy;
- 5) Water supply, sewerage, waste management and remediation activities;
- 6) Transport (including maritime);
- 7) Construction and real estate;
- 8) Information and communication;
- 9) Professional scientific and technical activities;
- 10) Financial and insurance activities;
- 11) Education;

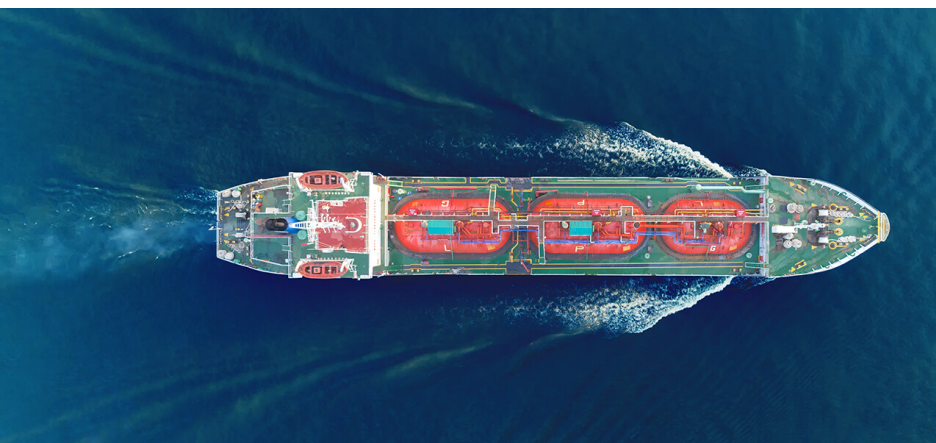
12) Human health and social work activities; and

13) Arts, entertainment and recreation.

Work has commenced on elaborating the TSC for the first two environmental objectives (*climate change mitigation and climate change adaptation*). This first delegated act was expected to be adopted by 31 December 2020 with the intention that the taxonomy would **apply from 1 January 2022⁸**. However, the regulation is still in draft form and will be adopted as soon as possible after the evaluation of the stakeholder feedback. The feedback period closed on 18 December 2020, so we expect more information from the EU on the timetable for implementation in due course.

For the four other environmental objectives (*water; circular economy; pollution control and biodiversity*), the taxonomy is intended to be established by the end of 2021 so that the taxonomy can start to apply to those objectives from **1 January 2023⁹**. This gives those affected by the Taxonomy Regulation a year to familiarise themselves with the TSC and to prepare for their application¹⁰.

The annexes to the delegated acts are where the TSC are set out in detail, together with very technical industry specific tests for various sectors and economic activities. Investors will need to use these annexes when determining whether or not the economic activity is sustainable.



"A COMMON DISQUALIFIER FOR MARITIME TRANSPORT IS WHERE ECONOMIC ACTIVITY IS CONCERNED WITH VESSELS DEDICATED TO THE TRANSPORT OF FOSSIL FUELS."

The **Technical Expert Group** (the “TEG”) was set up by the Commission to provide technical input and establish the TSC for each environmental objective. The TEG has now been replaced by the **Platform on Sustainable Finance** (the “Platform”), comprising of a broad range of experts from both the public and private sectors, who will be responsible for establishing and updating the TSC going forward¹¹. The Platform will therefore develop the TSC for the remaining four environmental objectives.

The Commission will review the TSC, based on the advice it receives from the Platform in line with scientific and technological developments, and where appropriate amend the delegated acts¹². This means that, in the case of tightening criteria for certain economic activities, it is possible that some activities that were previously considered taxonomy-aligned would lose their eligibility¹³. It is also envisaged that the scope of the taxonomy is extended beyond environmentally sustainable economic activities so that it covers other sustainability objectives, including **social objectives**¹⁴, and criteria for a “**brown**” taxonomy¹⁵.

TECHNICAL SCREENING CRITERIA: TRANSPORT

MARITIME

The draft delegated regulation recognises the importance of shipping in the transition to a low-carbon economy given the sector’s potential to reduce its greenhouse gas emissions. Separate studies are being conducted to assess sustainable financing criteria for maritime shipping and establish relevant TSC where appropriate.

The current draft TSC in respect of maritime transport (including related infrastructure) is comprised of seven categories:

- Inland passenger water transport;
- Inland freight water transport;
- Retrofitting of inland water passenger and freight transport;
- Sea and coastal freight water transport;
- Sea and coastal passenger water transport;
- Retrofitting of sea and coastal freight and passenger water transport; and
- Infrastructure for water transport.

References to maritime transport are also contained in the section concerned with the TSC for the manufacture of low carbon technologies for transport. Some of the TSC for maritime transport are considered below.

"A key TSC applicable to all maritime transport is that vessels have zero direct (tailpipe) carbon dioxide emissions."

Fossil fuel disqualification

A common disqualifier for maritime transport is where economic activity is concerned with vessels dedicated to the transport of fossil fuels. This applies under a number of heads including the manufacture of low carbon technologies for transport¹⁶, inland freight water transport, sea and coastal freight water transport¹⁷, retrofitting of inland water passenger and freight transport¹⁸, retrofitting of sea and coastal freight and passenger water transport¹⁹ and infrastructure for water transport²⁰. The effect of this will be to disincentivise investments in tonnage and infrastructure that are dedicated to the transport of fossil fuels. Whilst this is no doubt the intention, such a blanket disqualifier is potentially problematic for the transitional period; there are a range of fossil fuel types, some of which produce fewer emissions than others. For example, this could redirect capital away from transition fuels and infrastructure that some stakeholders are looking to develop as intermediate steps to a zero-carbon emissions future (e.g. the use of LNG as a fuel with vessels retro-fitted with carbon capture systems). Where existing technologies are improved, and new innovations encouraged, the potential pathways to a zero-carbon emissions future will increase; important solutions may be at risk of being lost if access to capital is made more difficult.

CO2 emissions

A key TSC applicable to all maritime transport is that vessels have zero direct (tailpipe) carbon dioxide emissions²¹. However, there are certain exemptions which apply²²:

"It should also be noted that where exhaust gas cleaning systems are being used, the TSC currently contemplate that such systems will need to be of the closed-loop type."

- passenger water transport vessels will qualify until 31 December 2025 which are (i) hybrid vessels which use at least 50% of zero direct (tailpipe) CO2 emission fuel mass or plug-in power for their normal operation or, (ii) in the case of sea and coastal passenger vessels only, have attained an Energy Efficiency Design Index (the "EEDI") value of 10% below the EEDI requirements applicable on 1 January 2022;
- inland freight water transport vessels, which are not dedicated to transporting fossil fuels, will qualify until 31 December 2025 where the vessels have direct (tailpipe) CO2 emissions per tonne kilometre, calculated (or estimated in case of new vessels) using the Energy Efficiency Operational Indicator, of 50% lower than the average reference value for CO2 emissions defined for heavy duty vehicles under Article 11 of Regulation (EU) 2019/1242 (the "Heavy Duty Vehicle Regulation"); and
- sea and coastal freight water vessels, which are not dedicated to transporting fossil fuels, will qualify until 31 December 2025 where they are (i) hybrid vessels that use at least 50% of zero direct (tailpipe) CO2 emission fuel mass or plug-in power for their normal operation or (ii) where it can be proven that the vessels are used exclusively for the provision of coastal services designed to enable modal shift of freight currently transported by land to sea, where the vessels have zero direct (tailpipe) CO2 emissions, calculated using the EEDI, of 50% lower than the average reference CO2 emissions value defined for heavy duty vehicles (5-LH) under the Heavy Duty Vehicle Regulation or (iii) where the vessels have attained an EEDI value 10% below the EEDI requirements applicable on 1 January 2022.

EU laws

The TSC for maritime transport cross-refer into other EU laws, including Regulation (EU) No 1257/2013 concerning ship recycling. The TSC also cross-refer into international conventions making compliance a requirement; for example, Regulation 14 (Sulphur oxides) of Annex VI to the IMO MARPOL Convention. It should also be noted that where exhaust gas cleaning systems are being used, the TSC currently contemplate that such systems will need to be of the closed-loop type. This may have investment implications depending on bunker spreads at the applicable time.

AVIATION

As of the date of writing, no TSC (draft or otherwise) exist in relation to aviation (except in the limited example of low carbon airport infrastructure, essentially on-airport vehicles, for example, pushback tugs, catering trucks, airstairs, apron buses, refuelling trucks and baggage transporters). However, aviation has been noted as an area that should be prioritised, with the Commission targeting its adoption by the end of 2021. The Commission has ordered an ongoing external study by Steer, a global business consultancy, on 'the development of a methodology to assess the 'green' impacts of investments in the aviation sector and projects' for the purposes of preparing draft TSC. As part of our wider instruction by the Aviation Working Group (a not-for-profit body comprised of major aviation manufacturers, leasing companies and financial institutions) in relation to ESG matters in aviation, we are liaising with Steer and the Commission on the study and the development of TSC for aviation.

RAIL

Rail transport has been divided into the following categories:

- Passenger interurban rail transport;
- Freight rail transport; and
- Urban, suburban and road passenger transport (which includes underground and elevated trains).

"There is a requirement that freight rail transport is not dedicated to the transport of fossil fuels."

The following points will be of interest to rail sector participants:

CO2 Emissions

With respect to both passenger interurban and freight rail transport, it is required that the rolling stock has (i) zero direct (tailpipe) CO2 emissions and/or (ii) zero direct (tailpipe) CO2 emissions when operated on a track with necessary infrastructure, and uses a conventional engine where such infrastructure is not available (bimode).

With respect to urban, suburban and road passenger transport, it is required that the vehicles have zero direct (tailpipe) CO2 emissions.

Transport of Fossil Fuels

There is a requirement that freight rail transport is not dedicated to the transport of fossil fuels.



"ORGANISATIONS COVERED BY THE NFRD WILL HAVE TO START DISCLOSING AGAINST THE FIRST TWO CLIMATE OBJECTIVES IN THE COURSE OF 2022."

Purchasing

With respect to urban, suburban and road passenger transport, the *climate change adaptation* objective requires that the relevant activity does not include purchasing vehicles with CO2 emissions which are higher than average for the category.

Other Requirements

There are also specific requirements relating to emissions limits and the management of waste, in particular during maintenance. For battery-operated vehicles, this includes a requirement for measures to deal with the reuse of batteries, electronics and the critical raw materials contained therein.

DISCLOSURE OBLIGATIONS

The Taxonomy Regulation is closely linked with the Disclosure Regulation (defined below) and the Non-Financial Reporting Directive (the “NFRD”) and introduces new disclosure obligations for a range of entities. We set out what this will mean for both reporting companies and FMPs below.

REPORTING COMPANIES

Article 8 of the Taxonomy Regulation requires **financial and non-financial organisations** covered by the NFRD to include information in their non-financial information statements on how, and to what extent, their business activities (turnover, CapEx and OpEx) align with the Taxonomy Regulation²³. They will have to start disclosing against the first two climate objectives (*climate change mitigation and climate change adaptation*) **in the course of 2022** (covering the financial year 2021) and all six environmental objectives **in the course of 2023** (covering the financial year 2022²⁴).

"Companies within the scope of the NFRD will have to disclose even if there are no specific criteria (yet) available to their activities/sector."

Currently the NFRD applies only to EU-incorporated **large public interest entities** (“PIEs”), which can include organisations in the financial and non-financial sectors with securities traded on a regulated market, in each case if they have more than 500 employees. However, the Commission has announced a review of the NFRD and one issue being considered is whether it is amended to include all listed companies (including SMEs) and/or set the bar precisely at SME level (i.e. above 250 employees²⁵). If the scope of the NFRD was extended, this would in turn have a knock-on effect on which organisations need to comply with the disclosure requirements in Article 8 of the Taxonomy Regulation.

Another important point to note is that that companies within the scope of the NFRD will have to disclose even if there are no specific criteria (yet) available to their activities/sector²⁶. The content and presentation of the information to be disclosed under Article 8 will be further specified by the Commission by 1 June 2021 through a delegated act²⁷.

FINANCIAL MARKET PARTICIPANTS

Articles 5-7 of the Taxonomy Regulation introduce new disclosure requirements for entities covered by EU Regulation 2019/2088 (the “Disclosure Regulation”), which includes insurance undertakings, investment firms, pension providers and fund managers²⁸. Such entities will need to disclose how and to what extent their portfolios align with taxonomy objectives. More specifically:

1. **Sustainable products (as defined by Disclosure Regulation):** entities will need to set out the percentage of their portfolio that is EU Taxonomy-aligned²⁹;
2. **Products with ESG characteristics (as defined by Disclosure Regulation):** as above, entities must set out the percentage of their portfolio that is EU Taxonomy-aligned; and include a statement that the “do no significant harm principle” only applies for the investments underlying the product that consider the EU taxonomy³⁰; and
3. **Mandatory statement products with no ESG characteristics:** the following statement must be included in their disclosures: the “product does not consider the EU Taxonomy”³¹.

These disclosures will need to be made in a company’s pre-contractual documents, websites and periodic reports³². The first set of disclosures against the taxonomy, covering activities that substantially contribute to climate change mitigation and adaption, need to be made from 1 January 2022. Disclosures in relation to all six environmental objectives will need to be made from 1 January 2023³³.

EXTRA TERRITORIAL EFFECT

The disclosure obligations for FMPs in the Taxonomy Regulation (as set out above) apply to anyone offering financial products in the EU **regardless of where the manufacturer of such products is based**. In addition, the disclosure obligations pursuant to Article 8 of the Taxonomy Regulation (as set out above) apply to entities subject to the NFRD and to all their activities **regardless of their location**³⁴.

"The disclosure obligations for FMPs apply to anyone offering financial products in the EU regardless of where the manufacturer of such products is based."

Furthermore, the TEG has suggested that investors in third countries could use the taxonomy criteria to benchmark or compare the environmental performance of local economic activities in those countries. In cases where a locally relevant threshold has been used to assess the environmental performance of an economic activity, it is also suggested by the TEG that companies and investors may wish to provide an additional second disclosure setting out the details and rationale for variation from the TEG standard³⁵.

The UK’s approach with respect to taxonomy-related disclosures post-Brexit is not yet clear. In June 2020, it was confirmed that the UK would retain the taxonomy framework, including the **six environmental objectives**. However, as the details are to be set out in the future delegated acts which are not yet finalised, the UK government could not confirm at that stage the extent to which UK law will align with EU law here.

VERIFICATION AND ASSESSMENT OF TAXONOMY ALIGNMENT

The Taxonomy Regulation does not explicitly require any formal verification of whether activities comply with the TSC. However, as set out above, compliance with the taxonomy **disclosure obligations** will be monitored by national supervisors. In addition, as good practice, FMPs are encouraged to seek external assurance on their taxonomy-related disclosures.

"It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways."

Disclosures made under the NFRD do not, as a baseline, require verification (although this may vary based on the transposition by Member States). However, this may be subject to change depending on the outcome of the currently on-going review of the NFRD³⁶.

CONCLUSION

The Taxonomy Regulation is likely to have a significant impact on reporting obligations for FMPs and a broad range of other companies, although understanding the level of additional work required will depend on the detailed criteria set out in the TSC. It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways. We

therefore suggest that FMPs and other entities follow its evolution closely, and in particular:

- identify any disclosure and data requirements and establish reporting procedures;
- consider the impact of the Taxonomy Regulation on their investment and access to financing, particularly as this may enable investors to better target “green” investments; and
- consider their existing compliance with the criteria, and whether/how to take it into account in their future financing decisions.

This is part of a series of articles on the EU Taxonomy. Follow the links to see our guidance on how it affects the real estate, energy and mining sectors.

- [1] For the text of the Taxonomy Regulation as published in the Official Journal, click here.
- [2] Taxonomy Regulation, Recitals 6-14
- [3] Frequently asked questions about the work of the European Commission and the Technical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard (the “**TEG FAQs**”), p.8. For the text of the TEG FAQs, click here.
- [4] Taxonomy Regulation, Article 3.
- [5] Taxonomy Regulation, Article 9.
- [6] See requirements as set out in the Taxonomy Regulation, Article 19.
- [7] Taxonomy Regulation, Recital 54.
- [8] Taxonomy Regulation, Articles 10(6) and 11(6).
- [9] Taxonomy Regulation, Articles 12(5), 13(5), 14(5) and 15(5).
- [10] Taxonomy Regulation, Recital 57.
- [11] Taxonomy Regulation, Article 20 and TEG FAQs, pp. 6.
- [12] Taxonomy Regulation, Article 19(5).
- [13] TEG FAQs, p.7
- [14] Taxonomy Regulation, Recital 59.
- [15] TEG FAQs, p. 8.
- [16] See further Annex 1 and Annex 2, Section 3.3 (Manufacture of low carbon technologies for transport).
- [17] See further Annex 1 and Annex 2, Sections 6.8 (Inland freight water transport), 6.10 (Sea and coastal freight water transport).
- [18] See further Annex 1 and Annex 2, Section 6.9 (Retrofitting of inland water passenger and freight transport)
- [19] See further Annex 1 and Annex 2, Section 6.12 (Retrofitting of sea and coastal freight and passenger water transport).
- [20] See further Annex 1 and Annex 2, Section 6.16 (Infrastructure for water transport).
- [21] See further Annex 1 and Annex 2, Section 3.3 (Manufacture of low carbon technologies for transport).
- [22] Ibid
- [23] Taxonomy Regulation, Article 8(1) and (2).
- [24] Taxonomy Regulation, Article 27(2).
- [25] TEG FAQs, p. 16.
- [26] TEG FAQs, p.13.
- [27] Taxonomy Regulation, Article 8(4).
- [28] Disclosure Regulation, Article 2(1). For the text of the Disclosure Regulation as published in the Official Journal, click here.
- [29] Taxonomy Regulation, Article 5.
- [30] Taxonomy Regulation, Article 6.
- [31] Taxonomy Regulation, Article 7
- [32] The TEG Final Report on the EU Taxonomy (the “**TEG Final Report**”), paragraph 3.3.1. For the text of the TEG Final Report, click here.
- [33] Taxonomy Regulation, Article 27(2).
- [34] TEG FAQs, p. 10.
- [35] TEG FAQs, p.18.
- [36] TEG Final Report, paragraph 3.2.8 and TEG FAQs, p.11.

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