EXPERT COMMENTARY

When the EU's Sustainability Taxonomy Regulation was adopted in June it did not make front page headlines. Nonetheless, Valeria Rosati, senior partner at Vantage Infrastructure, says it represents a real revolution in sustainable finance

Embracing the EU taxonomy revolution

The European Parliament adopted the Sustainability Taxonomy Regulation on 18 June 2020, but the question is will infrastructure fund managers approach it now mainly as a compliance burden and constraint or as a game changer in sustainable investing? The EU taxonomy was developed to determine the criteria whereby economic activities could be deemed 'sustainable', whilst remaining good corporate citizens. In the works for years, the framework seeks to solve the biggest roadblocks to transitioning the EU into a net-zero, resilient and resource-efficient economy by 2050.

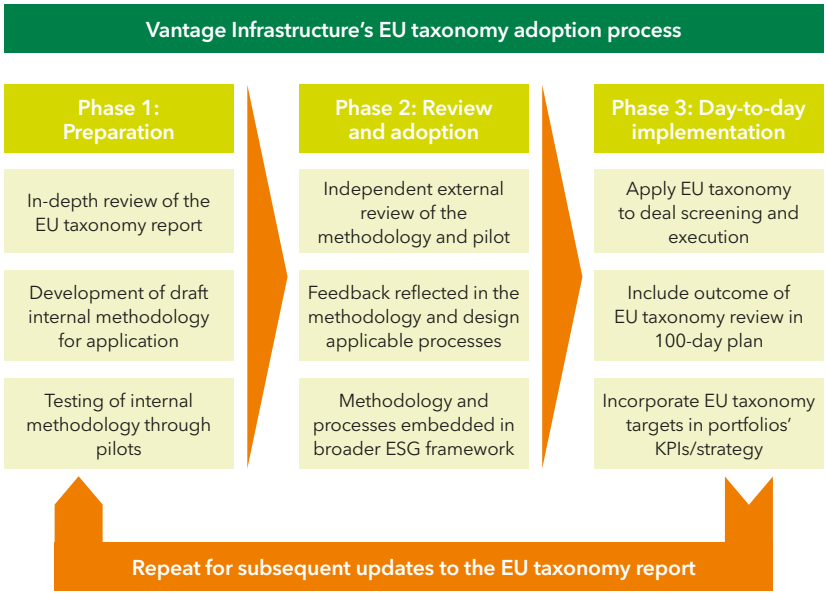
There is a recognition that capital markets will play a crucial role in achieving these policy objectives: the European Commission estimates an additional €260 billion in annual investments will be required to meet 2030 climate targets. Until recently, investors had not had much guidance as to what counted towards fulfilling this investment requirement, aside from renewables. This has now changed, allowing investors and companies to embrace the EU taxonomy revolution.

SPONSOR
VANTAGE INFRASTRUCTURE

For infrastructure managers, the EU taxonomy is especially relevant, as most of the activities falling under the 'mitigation' environmental objective are infrastructure in nature. However, embedding the EU taxonomy in the investment process does bring challenges, and early preparation is advisable. We learned several lessons in an early pilot programme when applying the guidelines to a selection of managed assets and a notional portfolio.

The revolution

Most of the environmental initiatives to date, including the Kyoto Protocol, Paris Agreement and various individual country pledges, have been led by governments or international organisations. Although landmark in nature, those commitments often lacked a clear implementation plan for an economy to achieve their ambitious goals. The EU taxonomy facilitates implementation



Source: Vantage Infrastructure as of October 2020

by clearly defining three main characteristics for a sustainable activity:

– contributes significantly to at least one of six environmental objectives
– does not harm the other objectives
– meets minimum social safeguards

By following the EU taxonomy's guidelines, managers can tailor their strategies and re-orient investment capital towards assets and capex that contribute to 'net zero'.

Secondly, the discussion around sustainability has also been focused on individual companies' behaviour. However, why make costly adjustments to a company's business practices unless the competition does too? Companies have often opted to make small, cost-efficient, incremental improvements to their environmental, social and governance strategy by planting trees, donating to local charities or improving offices' energy efficiency. While ESG-positive, it can be difficult to compare these activities against one another.

The EU taxonomy provides a clear set of guidelines, including technical thresholds and numerical criteria, to determine if an economic activity is sustainable. Therefore, companies can no longer select the cheapest 'green' credential but need to measure sustainability with an identical yardstick.

Lastly, sustainability can be a hard pill to swallow for investors in assets that will not be part of a sustainable economy. However, it is also true that an overly zealous transition agenda not only produces significant system losses but can be counterproductive, as these activities can be a gateway to a lower carbon economy.

The EU taxonomy takes a pragmatic rather than theoretical approach and recognises the role of transition assets. These are not fully compatible with the net-zero target but, in the absence of technological alternatives, the best-in-class transition assets can provide a bridge to net zero.

For example, the EU taxonomy defines stringent targets for diesel trains, a lower-carbon alternative to planes or cars, given the technological and practical impediments to achieving full electrification of the EU's rail system. This keeps a balance between a fully sustainable goal and incentives to invest in incremental changes.

Infrastructure: tool and stick

The EU taxonomy clearly aims at infrastructure investors, with a majority of the 70 economic activities listed under "mitigation" being infrastructure in nature. With this *de facto* enrolment in this revolution, infrastructure managers cannot remain indifferent: the entire sector will be instrumental in the redirection of capital flows towards sustainable activities. This does not need to be limited to renewable investments only, which could create risk concentration for investors, but can encompass a broader range of sustainable sectors to achieve diversification.

In 2019, economic losses from disaster events were estimated to have reached $146 billion globally, with recent climate events including droughts, recurring floods, an ever-increasing number of storms and wildfires. Against this backdrop, and given the climate-related disclosures under the Task Force on Climate-related Financial Disclosures, even before the adoption of the EU taxonomy any infrastructure manager should have been monitoring and managing portfolio exposures to climate and environmental risks. For instance, at Vantage Infrastructure we had already adopted our ESG integration approach, supported by comprehensive processes and tools, to reduce the environmental footprint of our assets over time, support them in the energy transition and drive engagement with stakeholders.

What are other infrastructure managers doing and how? Perhaps it is time for the proverbial shepherd to gather the sheep. This is indeed one of the goals of the EU taxonomy.

By paving the way to decarbonisation, it standardises it for sustainable infrastructure managers such that investors will receive like-for-like disclosures on a manager's sustainable infrastructure investments and practices. Given our early preparation for the EU taxonomy we have already commenced assessing new investment opportunities against their potential alignment with the taxonomy, by embedding the framework's criteria into our own due diligence tool. Furthermore, the EU

taxonomy can also be a useful tool for infrastructure managers to demonstrate both the TCFD compliance of their investments and their contribution to select UN Sustainable Development Goals.

However, the EU taxonomy is not solely a useful 'tool' but also a 'stick' for managers, as it introduces an additional mandatory disclosure requirement that will come into force in 2021. It also plays an important role in the wider regulation on sustainability-related disclosures in the financial services sector.

While SFDR requires disclosure of a manager's risk management process for ESG topics and its integration of sustainability into investment decisions, the EU taxonomy offers an illustration of the sustainability profile of a portfolio. The mandatory disclosure requirements of SFDR and the EU taxonomy will apply to all managers, thus encouraging early adoption.

We have already dedicated resources to understand the link between EU taxonomy and SFDR and identify the impact on our activity. Given the intricacies of certain requirements, embracing the EU taxonomy early on and our strong ESG culture provide us with alignment with the SFDR requirements and a strong foundation.

Lessons learned

We see the benefits of the EU taxonomy as a practical, policy-led tool both to drive investments and for investors to evaluate how sustainable their managers are. So, we made the decision to focus on its introduction early on.

After analysing the draft report in detail in 2019, we commenced work on the practicalities of utilising it for our portfolio companies and future investments. By the time the final report from the Technical Expert Group was issued in March 2020, we were prepared to apply it to a sample of managed investments, spanning a range of renewables and economic infrastructure sectors. These pilots enabled us to learn several lessons:

> *"Infrastructure managers cannot remain indifferent: the entire sector will be instrumental in the redirection of capital flows towards sustainable activities"*

Develop a clear methodology early

Although the taxonomy is meant to be a 'one size fits all' guide, the challenges faced in its application vary depending upon a party's identity (corporate or investor, limited partner or general partner, listed or unlisted, equity or fixed-income). Therefore, a well-defined methodology needs to be specific to the asset class and consistently applied across investments and over time. This will minimise subjective interpretation on an asset-by-asset basis and reduce the time-intensive nature of this exercise. We have developed our own in-house methodology as a 'living' tool because the EU taxonomy itself will evolve. Starting this project early has benefited us, as it takes time to interpret the EU documentation and engage internal stakeholders on the details of methodology and procedures.

An independent review is key

One of the key goals of the EU taxonomy is to enable a definitive answer to be reached: at any given moment, an activity is either taxonomy-aligned or not. However, we found that there is also scope for interpretation, due both to the inherent qualitative nature of certain sustainability objectives and the nascency of this framework. While the quantitative screening criteria are usually straightforward, the qualitative criteria provide more room for interpretation. For example, fulfilling the 'do no significant harm' and 'minimum social safeguarding' criteria can be approached differently. To validate the robustness of our approach, we engaged an independent, third-party consultant to review two of our pilots, in addition to our methodology developed to derive the alignment scores at the activity and portfolio levels.

No substitute for ESG plan

A disproportionate amount of time and resources could be taken up by the evaluation of DNSH and MSS criteria, given lengthy background documents. In the application of these criteria, the spirit of the EU taxonomy needs to be kept in mind. Both standards are meant to ensure 'good citizenship' and 'law-abiding' behaviour.

It should be common sense that any good arising from engaging in a decarbonising activity should not be negated by irresponsible or illegal conduct. However, these qualitative EU taxonomy criteria are neither all-inclusive nor equivalent to a first class ESG programme, which needs to be much more tailored to be effective. Therefore, although we have embedded DNSH and MSS in our in-house EU taxonomy methodology, we also continue to adopt a comprehensive ESG framework.

In conclusion, it is too early to say with certainty that the EU taxonomy revolution will succeed in preventing all 'greenwashing' claims by managers and companies and directing capital only towards truly sustainable investments. However, we believe it provides infrastructure managers with a real opportunity to build environmentally resilient and socially responsible portfolios through the adoption of a common sustainability language. We also view the regulatory 'stick' of the EU taxonomy as a benefit to managers in the long term by prompting them to fulfil their fiduciary duty in a co-ordinated manner. ■


VANTAGE
INFRASTRUCTURE
SUSTAINABLE INFRASTRUCTURE SOLUTIONS
Vantage Infrastructure is an independent infrastructure specialist committed to delivering customised and responsible investment solutions as a long-term partner to our clients.
LONDON | NEW YORK | SINGAPORE | SYDNEY
www.vantageinfra.com
This advert is issued by Vantage Infrastructure (UK) Limited and produced for information purposes only. This advert does not constitute an invitation to engage in investment activity or investment services with Vantage Infrastructure (UK) Limited nor should it be construed as investment advice. Vantage Infrastructure (UK) limited is authorised and regulated by the Financial Conduct Authority in the UK.