

After the Green Taxonomy, a “Good Transition” label?

Note written for EUROFI by Jean-François Pons, Alphalex-Consult

“... Transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050 in keeping with the science...”
(extract from the final declaration of COP28 in Dubai)

The elaboration of an EU “green” taxonomy has taken many years of work and discussions for experts, European political institutions, financial and non-financial corporates, lobbies, NGOs and other interested parties. The result is a very long and detailed list of economic activities which can be considered as “green”, most of them in the condition that they respect pre-defined parameters.

The beginning of the implementation of the green taxonomy in 2024 will show what is the concrete interest of this reform. The “green asset ratio” will probably be under or around 5% for most of the financial actors, but this should not disappoint observers: it will only reflect the part of the economy which corresponds to the list of green activities in the EU taxonomy.

There exists a large consensus today for thinking that the most important challenge related to climate is not a dramatic growth of green activities, but the “transitioning away from fossil fuels in energy systems”, to use the language of COP28. This means a strong and continuous decrease of fossil energy consumption by enterprises, households, States and local authorities, and a strong and continuous decline of fossil energy production. In this regard, the decarbonation of carbon-intensive companies is as important as the growth of green activities.

There are different way of trying to bring transparency in the transition and to make clear to a large public (including small investors) which company is following a “good transition” (aligned with the Paris Agreement):

- Publication of transition plans by corporates, as envisaged by the EU regulation;
- Elaboration of a taxonomy of transition, with two or three colors adding to the green, as it

was envisaged by the Sustainable Finance Platform experts advising the European Commission, or as it has been recently decided in Singapore;

- Creation of a label of “good transition”, on the basis of a framework approved by EU political and supervisory authorities.

This article will comment these options and try to explain why the 3d one should be explored.

1. The publication of transition plans : a medium-term progress but with limits

The EU legal framework foresees the publication of transition plans by large corporates. The Corporate Sustainability Due Diligence Directive (CS3D), which should be finally agreed by the EU political institutions in the coming weeks, would make these publications obligatory. Financial supervisors will also look at the transition plans of the banks and insurances according to the EU regulation on these entities.

This is a welcome progress for transparency in the fight against climate change, but which raises the following difficulties:

- Uncertainties on the development of a transition plan by a company: for instance which baseline scenario(s) (sectoral, national, EU, worldwide) to take into account?
- How to compare transition plans from a company to another?
- How to assess “good transition” plans and “insufficient transition” plans?

These difficulties have for consequence that the large public will probably have no clear indication for at least a number of years on the selection of companies which are on a "good transition" track, and that other indicators would be welcomed to assess which corporate follow a good trajectory of reduction of its greenhouse emissions and which corporate does not.

2. A quadricolor or tricolor taxonomy : a long and complex process

• The project of a EU quadricolor taxonomy

The European Platform on Sustainable Finance, a group of experts advising the European Commission, has proposed a new classification in February 2023. This "transition taxonomy" adds new categories, in addition to green activities listed in the initial regulation. "We realized that we had to look at the economy as a whole, greening is necessary everywhere", said the rapporteur of the platform on this mission. This report responded to a request from the European Commission of January 2021, to determine the means to finance companies in transition. Platform members, without establishing a new list rather, have widened the sectorization of the economy into four categories:

- Green activities as defined by the initial taxonomy, which generates a substantial contribution for climate and do not harm the environmental objectives of the European Union;
- Intermediate activities, of "amber" color, which do not cause environmental damage to the meaning of the "Do no significant harm" (DNSH) criterion of the taxonomy but which also have no contribution significant to EU objectives;
- Harmful activities, red in colour, which must be stopped urgently;
- Activities with low environmental impact, colorless.

The objective of the Platform was to define categories that encourage companies to migrate from red to amber, then to green, and to attract the necessary funding to enable them to make this transition. "It could be used to set targets for our entire portfolio", said an insurer, member of the platform.

But the development of the green taxonomy has shown how complex it is to define a list of green activities under certain parameters, with divergences between experts, between NGOs and representatives of the sectors concerned, and political controversies

which could be very strong. The development of an EU quadricolor taxonomy would be an Herculean task and take many years. We cannot wait as long to know which companies are implementing a "good transition" and which do not.

• The Singapore tricolor taxonomy

On December 3rd, 2023, the Monetary Authority of Singapore launched the Singapore-Asia Taxonomy for Sustainable Finance. It is the world's first multi-sector transition taxonomy, covering eight key sectors to define both green and transition activities. The innovation is that it uses a traffic light system with three colours: "green" for environmentally sustainable activities, "amber" for transition activities and a third category "red" that is ineligible. Transition activities are those that encompass existing infrastructure and activities that fall short of green thresholds but are on a trajectory towards net-zero emissions or which contribute to net-zero outcomes. In order to achieve a trajectory consistent with the goal of restricting global warming to 1.5 degrees Celsius, specific time-bound transition thresholds have been established, each with its own sunset date. Activities are required to either align with the 1.5°C pathway by the designated sunset date or face reclassification into the "ineligible activities" category.

This initiative seems to have avoided some of the difficulties which have just been underlined for the quadricolor proposal of the Sustainable Finance Platform. There are two reasons for this difference :

- It is much easier for a single authority of a single State to define a list of tricolor activities than for an EU legislation for 27 member countries;
- Instead of looking at all the economic activities, Singapore has chosen to focus on eight key sectors, which makes the process simpler but which will not give a full picture of all the corporates which have to transition away from fossil fuels.

It is too early to have an assessment of the remaining complexity and difficulties of the process. Compared to the EU framework, this taxonomy will also be probably less ambitious to take into account Asian specificities.

3. A "Good Transition" label

There are a number of ESG labels in the EU, most of them covering mainly one or a few EU countries.

These labels are useful but they do not provide a precise information on the energy transition.

Thence the idea to create a new label focused on the climate trajectory of large companies. It should in principle provide a very useful and critical information and a powerful incentive for transitioning away from fossil energy consumption and production. This label could complement existing labels which have their usefulness. For the financial sector, besides the green asset ratio, there could be a "good transition asset ratio" based on activities which are really transitioning to net zero.

Difficulties:

The first difficulty is of course how to assess which corporates implement a good transition and which ones do not. And to do it without the complexity of the present framework on the green taxonomy.

A second difficulty is about who is doing this assessment and on which basis.

Possible ways forward :

This assessment should be based on sectoral trajectories which will be themselves based on national transition plans and, if possible, EU transition plans. That supposes some work for national governments and for the EU Commission, in concertation with the interested parties, but this work is more than needed if we want real clarity on the concrete implementation of the Green Deal and the reaching of its targets of -55% of gas in 2030 and net zero in 2050. There exist already scenarios of transition, from the International Energy Agency or from Science Based Targets Initiative (SBTI). Some member States have already published national plans, including sectoral ones, like France.

Then the acid test of "good transition" should be simple: if a corporate is doing as well or better than the trajectory of its economic sector, it will be rewarded by a "good transition" label. And vice versa.

Who should take the responsibility of the assessment? It seems better that it should not be public authorities, because it may create the same kind of difficulty than defining a taxonomy. Labelling institutions, which work generally in cooperation with public authorities and with diverse stakeholders (scientists, NGOs...) and which are already well engaged in ESG labelling, could probably deliver this new label, preferably at the EU level. The governance framework of the Green Bonds is also an interesting example in that regard. To avoid criticism of conflict of interest or greenwashing, the methodology used should be made as transparent as possible.

Conclusion

There is a growing demand, including from a large public, for knowing as clearly as possible on which path of energy transition are the large companies, and amongst them, the financial institutions. The EU "green taxonomy" does not give this information. More extensive taxonomies including transition activities need a very complex work and will at least take many years to be developed.

The publication of transition plans will be a first welcome progress in the coming years, but their evaluation by third parties will probably not be easy and the general public will be probably confused by controversies.

The creation of a "good transition" ratio, preferably at the EU level and based on sectoral trajectories defined under the responsibility of the political authorities, seems a path worth exploring. Recently, the French association *Les Ateliers du Futur* has provided a good example of what this label could look like: it has identified three major European groups, ArcelorMittal, Engie and Schneider Electric, describing them as the "good students" of transition. The criteria considered is that these firms are in the best position to reduce emissions, thanks to their financial resources and the technologies they developed to do so. It is interesting to see that a carbon-intensive company like ArcelorMittal can be considered a "good student" thanks to its committed strategy to decarbonize. This example illustrates the added value that a "good transition" label could bring in the sustainable reporting framework ¹.

1. <https://www.lesechos.fr/industrie-services/energie-environnement/engie-schneider-electric-et-arcelormittal-bons-eleves-du-climat-2074860>