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Navigating the EU Taxonomy usability challenges

Our experience in addressing the primary obstacles encountered during the assessment

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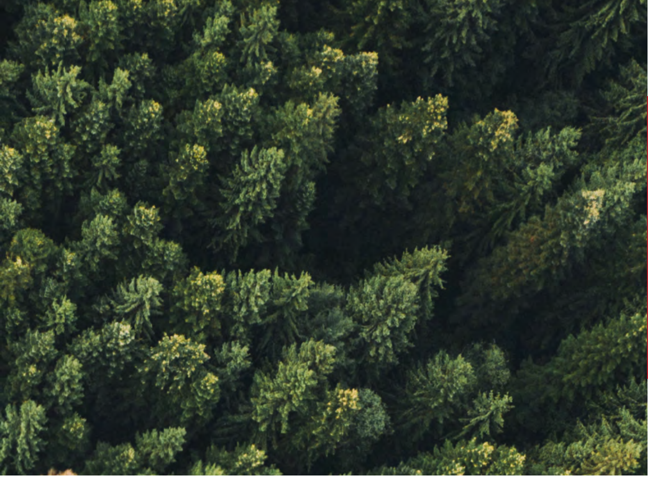


Table of contents

Introduction

What is the purpose and relevance of this report?

In recent years, we have observed a growing challenge faced by clients in the private equity (PE) space when it comes to finding the right balance between ESG integration and value creation. We have witnessed an increasing interest among our PE clients concerning the novel sustainability regulations, with particular emphasis on the EU Taxonomy: They are eager to understand not just how to remain compliant, but how these regulations can serve as catalysts for value creation. Leveraging Strategy&'s strategic foresight and PwC's technical and subject-matter expertise, we have launched a two-part series aimed at addressing these critical concerns.

The first piece, titled "Unlocking the Green Premium in Private Equity," harnesses Strategy&'s strategic capabilities to demonstrate how ESG risks and opportunities can be successfully translated into tangible value. In this context, we also explore the role played by the sustainability regulation landscape, with a particular focus on the EU Taxonomy. Complementing our initial article, in the second piece named "Navigating the EU Taxonomy Usability Challenges" we leverage PwC's extensive technical knowledge in sustainable regulations to highlight the key challenges faced by organisations when assessing their eligibility and alignment with the Taxonomy. By understanding and effectively addressing these hurdles, PEs can leverage the EU Taxonomy to solidify their position as sustainable leaders and generate a green premium.

Why is the EU Taxonomy regulation an important step towards sustainable finance?

Context

Since 2018, the European Commission has been developing a policy agenda on sustainable finance as part of the European Green Deal. This includes the Action Plan on Financing Sustainable Growth, which has resulted in a series of legislative measures on ESG disclosures aimed at enhancing transparency. As part of that action plan, the EU has developed the Taxonomy regulation, which establishes a standardised framework for identifying economic activities that meet the criteria for being environmentally sustainable, providing a common language for assessing investments and ensuring that they align with the defined environmental objectives.

Environmental Objectives

The EU Taxonomy regulation defines six environmental objectives that economic activities must substantially contribute to in order to be considered environmentally sustainable:

Climate change mitigation: Contribute to the reduction of greenhouse gas emissions or enhance their removal

Climate change adaptation: Reduce or prevent the adverse impact of the current or expected future climate change and its risks

Sustainable use and protection of water and marine resources: Achieve and maintain good environmental status for bodies of water and prevent their deterioration

Transition to a circular economy: Increase product durability, reparability, upgradability, reusability and reduce waste production

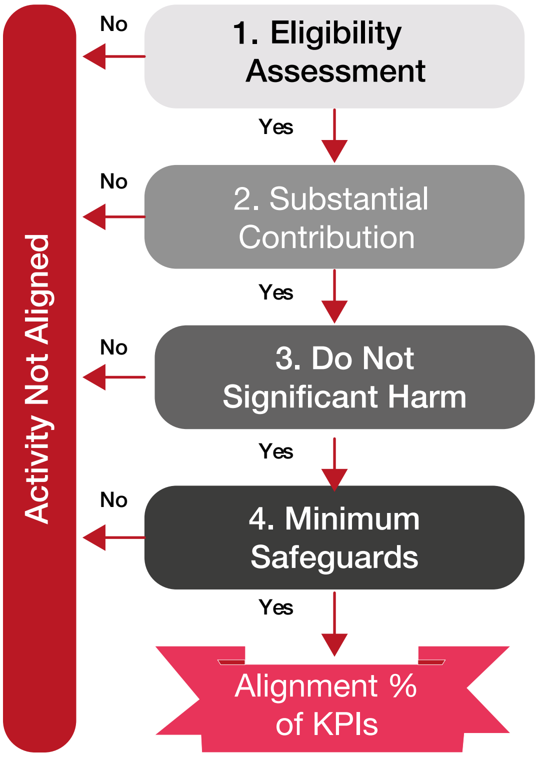
Pollution prevention and control: Prevent or reduce emissions of pollutants other than greenhouse gases into air, water, or land

Protection and restoration of biodiversity and ecosystems: Protect, conserve, or restore biodiversity and ecosystems

To date, the Delegated Acts containing the Technical Screening Criteria (TSC) in relation to climate change mitigation and adaptation have been officially published, which contain around 70 economic activities for each of the two objectives. In June 2023, the Commission approved the Delegated Acts for economic activities substantially contributing to the four remaining environmental objectives.

Overview of the Taxonomy assessment process

The figure below outlines the primary five steps involved in assessing the alignment of an economic activity with the EU Taxonomy:



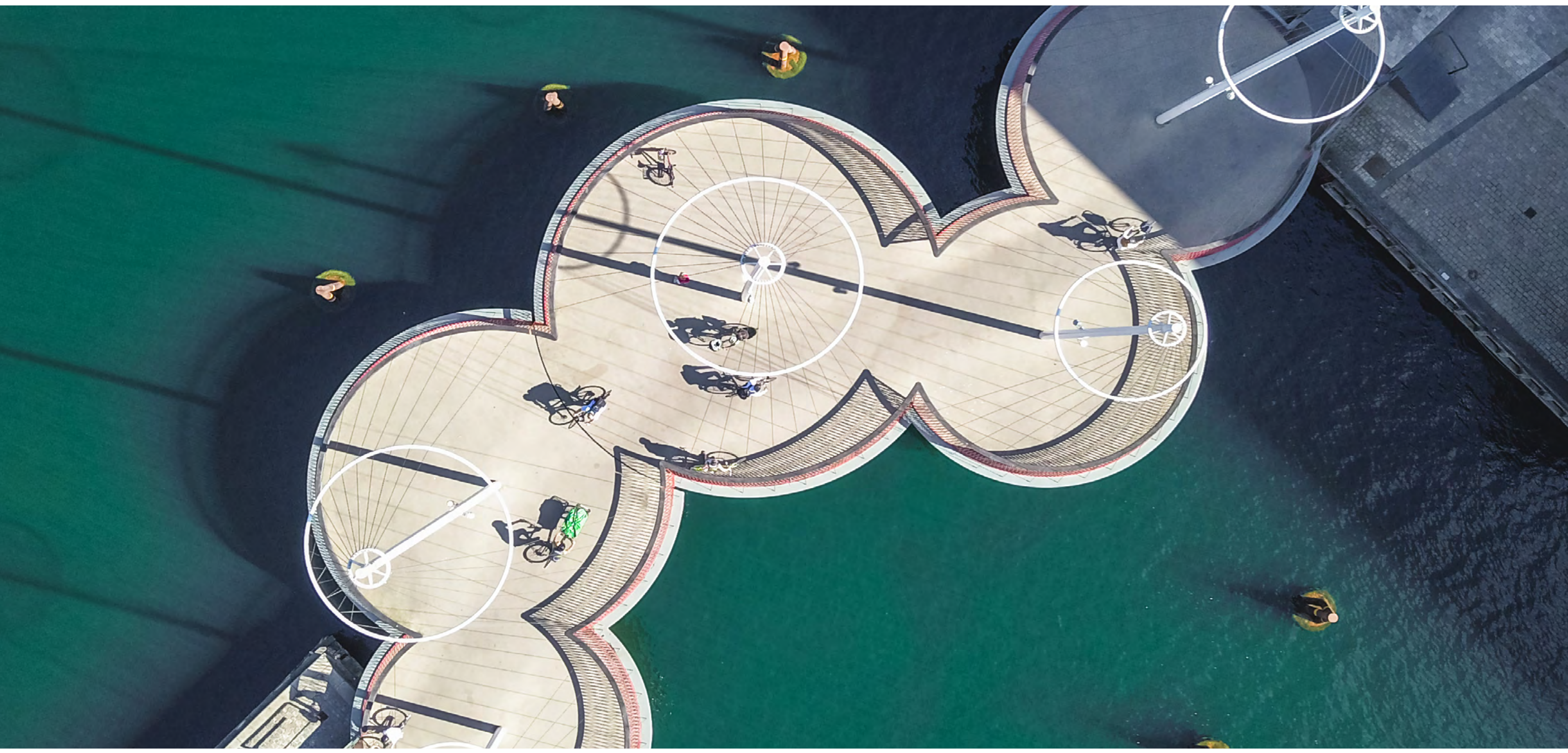
Is the economic activity performed by the company under assessment in scope of the EU Taxonomy, as defined in the Delegated Acts?

Does the activity make “substantial contribution”, meaning that it passes the TSC conditions for at least one of the six environmental objectives?

Does the activity not significantly harm any of the other five environmental objectives, as defined in the Delegated Acts?

Does the company comply with the Minimum Safeguards?

Calculate the three key performance indicators (KPIs) that will determine the percentage of revenue, capital expenditures (CapEx), and operational expenditures (OpEx) that is aligned with the Taxonomy.



What are the main obstacles faced while performing a Taxonomy assessment?

Assessing a company's alignment with the EU Taxonomy can be a challenging task. Numerous public and private organisations, as well as national regulatory agencies, have shared their perspective on the opportunities, challenges, and recommendations presented by the Taxonomy regulation. The most authoritative report describing the challenges of the Taxonomy from a usability perspective is the "Platform Recommendations on Data and Usability as part of Taxonomy Reporting[1]" report issued in October 2022 by the Platform on Sustainable Finance (PSF). Other examples are reports from the Sustainable Finance Advisory Committee of the German Federal Government[2] and the International Capital Market Association (ICMA)[3].

In the subsequent sections, we outline the process-wide challenges as well as specific obstacles faced by users during the Taxonomy assessment process. Our analysis takes into account the key points highlighted in the aforementioned reports, as well as our practical experience in conducting Taxonomy assessments for companies across various industries, countries and sizes.

Process-wide challenges

The Taxonomy assessment process presents several overall challenges that organisations need to navigate. These process-wide challenges of Taxonomy include: (i) complex interpretation and assessment, (ii) difficulties in verifying and acquiring the required data, (iii) resource-intensive and costly implementation, and (iv) strategic-level challenges:

1. Complex to interpret and assess:

All parties involved, from auditors to users, agree that the regulation is ambiguous and lacks clarity due to its evolving nature and its extensive published documentation. This complexity and technicality can pose a significant hurdle to users when trying to understand and interpret the detailed criteria of the regulation text:

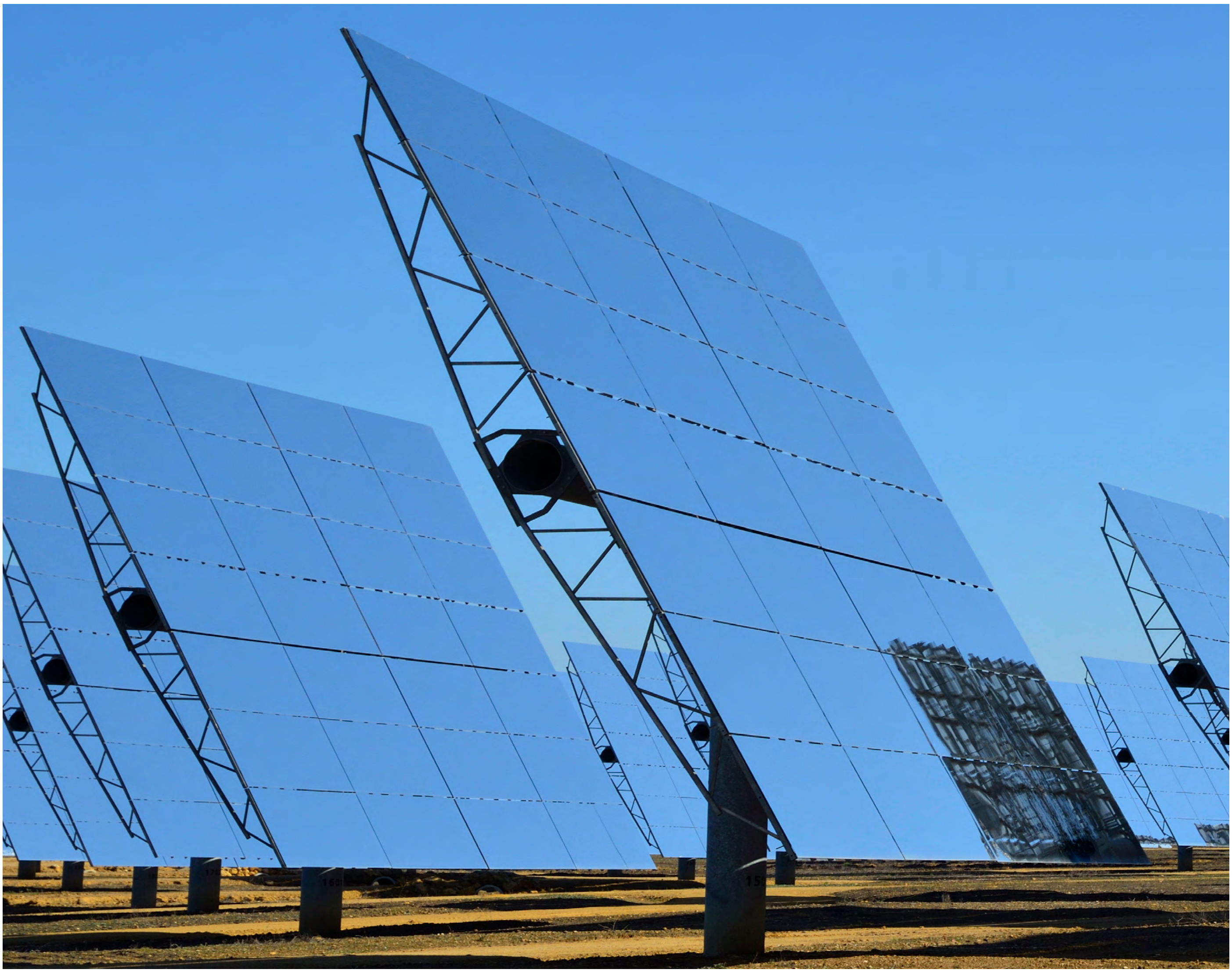
- **Ambiguity and lack of clarity:** While the Taxonomy aims to provide a clear framework for categorising economic activities based on their environmental sustainability, its current text leaves room for subjectivity. For example, mapping the activities of a company with the economic activities defined in the Delegated Acts, or understanding the meaning of substantial contribution pose significant challenges for companies not familiarised with the regulation. Additionally, the Delegated Acts include imprecise terms and definitions such as "best performing" or "comparable information", which involve subjective judgement calls.

1 Platform on Sustainable Finance: *Platform Recommendations on Data and Usability*
2 *The EU Taxonomy: implementation challenges and proposed solutions*, Sustainable Finance Advisory Committee of the German Federal Government
3 *Ensuring the usability of the EU Taxonomy*, ICMA

- **The binary classification problem:** The Taxonomy classifies activities as either "sustainable" or "not sustainable", lacking any in-between classifications. This can potentially result in misunderstandings, with activities not labelled as sustainable being mistakenly deemed as harmful. Additionally, it can also discourage efforts towards sustainability for activities that do not meet the strict "sustainable" classification.

- **Extensive published documentation:** The regulation text is very extensive, containing the Delegated Acts, cross references to other EU Directives, and Technical Expert Group recommendations that need to be fully understood. In addition, the user will need to be familiarised with the required reporting templates and metrics, and potentially consult external sources to fully understand all the requirements.

- **Dynamic and Evolving Framework:** Several elements of the Taxonomy are still being developed. While the timeline for implementation already seems to be defined, the final version of the Delegated Act for the four environmental objectives is still not finalised. The existing TSC for the climate change objectives will probably be adjusted in the future, and it is expected that the number of economic activities in scope will be expanded. In addition, it relies on European legislation, which becomes an obstacle when evaluating alignment with the Taxonomy due to the extensive international operations of European companies.



2. Complicated to verify and acquire the required data:

Many of the companies currently reporting under the Taxonomy expressed difficulties in verifying and obtaining reliable data at the required level of granularity, as well as problems with gathering data from the supply chain, the use of estimates, and systems not adapted to obtain such reliable and accurate data at the activity level:

- **High data granularity required:** Some data required to assess the substantial contribution of an economic activity may not be covered by the existing data collection processes of the company. This problem becomes bigger for PEs trying to obtain ESG data on their portfolio companies. The situation is further complicated for companies with extensive and decentralised value chains, where it may be even more complex to obtain and compare the data from external stakeholders.

- **Need for accurate and reliable data:** The existing data systems may not be aligned with the definition of economic activities in the Taxonomy, making it complex to report the Taxonomy KPIs. In case the required data is not available, its related documentation will need to be created by establishing new processes within the company, which can create a significant burden.

- **Use of proxies and estimates:** The EU Taxonomy allows the use of proxy data, which substitutes for unavailable ESG data, under strict conditions. Essentially, financial market participants (FMPs) can use proxy data, known as “equivalent information,” for portfolio companies that are SMEs or non-EU based and are exempt from the Non-Financial Reporting Directive (NFRD). However, the use of proxy data is not a blanket approval and it can only be used for certain elements of the Taxonomy assessment.

3. Resource-intensive and costly process to implement:

Implementing the EU Taxonomy is a resource-intensive process, as it requires qualified professionals and the integration of new processes within the company, adding burden and costs to the assessment. Also, it may involve the adaptation of existing systems, as well as high coordination efforts:

- **Specialised personnel needed:** The process requires qualified professionals for data collection, analysis, reporting, and external assurance. If companies choose to outsource the Taxonomy assessment process or train their staff, this incurs additional costs and burdens, which can be significant for small and medium-sized enterprises (SMEs) and Private Equity firms who aim to assess Taxonomy alignment at a portfolio level.

- **Integration with existing systems:** Organisations may need to adapt their existing systems and processes to align with the Taxonomy. This adaptation requires significant resources, especially for larger organisations with complex operations. It may involve investing in new technologies and potentially reorganising parts of the organisation.

- **High coordination efforts:** Implementing the EU Taxonomy involves high coordination efforts among various departments, stakeholders, and teams to ensure consistent understanding and implementation of the Taxonomy’s criteria. This includes coordinating data gathering across different units, ensuring effective internal and external communication, and consolidating all information into a single report. In some cases, external partnerships may even be necessary for validation and assurance, which adds another layer of complexity to the process.

4. Challenges at a strategic level:

In our previous report titled "Unlocking the Green Premium in Private Equity", we highlighted the potential long-term value destruction that can arise from neglecting to integrate ESG considerations. The EU Taxonomy's mandatory or voluntary reporting requirements are key in addressing this issue and present numerous strategic challenges:

- **Time constraints for adaptation and reporting:** As time progresses, an increasing number of organisations will need to comply with reporting obligations under the EU Taxonomy. It is crucial for companies to prepare themselves in advance, considering the limited timeframe.

- **Current ESG positioning and market sentiment:** Companies previously known for their sustainability efforts may have to reveal low alignment figures, and will therefore need to explain the reasons behind this to avoid reputational problems. Moreover, adherence to the EU Taxonomy can influence a firm's competitive edge, differentiation in the market and view from investors.

- **Potential external audit required:** As the final report must be audited, it is necessary to create a solid audit trail, which implies gathering a significant volume of supporting evidence. Furthermore, it is essential for companies to ensure they use the mandated reporting templates appropriately. Not complying with the regulation raises risks such as regulatory interventions and reputational damage.

- **Gap assessment and implementation plan to ensure compliance:** Companies seeking eligibility or alignment with the Taxonomy must conduct a gap analysis to identify areas where they currently fall short. Subsequently, they should develop a comprehensive implementation plan to address these gaps and ensure compliance within the established framework. This process can be challenging, particularly for those without prior experience, and may necessitate external assistance from experts.

Step-specific challenges

The following sections present some step-specific challenges that stem from the broader process-wide challenges previously discussed.

Step 1: Eligibility Assessment

The starting point is to analyse whether the activity is part of the scope of the Taxonomy. That means if the activity is in the TSC of the Delegated Acts of any of the six environmental objectives. Some examples of obstacles that a user of the Taxonomy can encounter in this step are:

- **Mapping a company's activities with the economic activities in the Delegated Acts:** Achieving a perfect match between the company's activities and those defined in the Delegated Act can be difficult, as there may be instances where certain activities do not fit neatly into the predetermined economic activities and their associated NACE[1] codes considered in the taxonomy.

- **Incomplete catalogue of activities:** Companies may find that some of the activities they perform are not in the list of activities in the Taxonomy due to these activities being specific to a very particular sector or because they represent emerging practices that the Taxonomy has not yet acknowledged.

- **Activities qualifying for eligibility beyond the core business areas of a company:** A company investing in activities outside its core business can notably enhance its eligibility score. Some examples are the improvement of waste management activities, energy efficiency upgrades or water conservation, which can notably enhance its eligibility score.

Step 2: Substantial Contribution

Once an activity has been determined as eligible, the second step is to verify that the eligible activity actually makes a "substantial contribution" to at least one of the six environmental objectives. This means that the activity needs to do more than just potentially align with an objective, and instead have a substantial positive effect. Some examples of obstacles that a user of the Taxonomy can encounter in this step are:

- **Understanding "substantial" contribution and enabling and transitional activities:** Certain activities inherently contribute substantially to environmental goals, like wind or solar power generation. However, understanding the substantial contribution of enabling and transitional activities, which aid in achieving these goals, can be unclear. Additionally, the complexities of data collection and calculating specific performance thresholds for assessing substantial contribution add to the challenge.

- **Counterfactual scenario analysis:** Assessing the substantial contribution of an activity may require comparing the observed outcomes with a counterfactual scenario where the activity did not occur. Constructing a reliable counterfactual analysis is inherently uncertain and can lead to inaccuracies.

1 Statistical Classification of Economic Activities in the European Community (NACE, for the French term "nomenclature statistique des activités économiques dans la Communauté européenne")

- **Continuous monitoring required:** As technology, scientific knowledge, and societal expectations evolve, the standards and benchmarks defining a substantial contribution can change. This dynamic nature of sustainability standards necessitates consistent monitoring and adaptation of the evaluation process.

Step 3: Do Not Significant Harm

The third step is to ensure that the eligible activity does not significantly harm (DNSH) any of the other five objectives. The Delegated Acts determine the conditions under which the economic activity causes no significant harm to one or more of the other objectives. Some examples of obstacles that a user of the Taxonomy can encounter in this step are:

- **Integration of Life-cycle considerations:** The DNSH assessment may require a full life-cycle assessment (LCA) or at least some life-cycle considerations. Assessing life-cycle considerations can be challenging because it requires an end-to-end examination of the economic activity through the value chain, from raw material extraction to disposal, to identify potential environmental impacts at every stage.

- **Perform a Climate Risk and Vulnerability Assessment:** It involves understanding both the physical risks and transition risks, as well as the ability to predict how vulnerabilities might be exploited by future climate scenarios, requiring the prediction of future climate scenarios and their impacts, which involves considerable uncertainty.

- **Perform an Environmental Impact Assessment (EIA):** Similar to the Climate Risk and Vulnerability Assessments, performing an EIA is a complex process involving assessing the likely environmental effects of a proposed project, which can help identify any potential harm to environmental objectives.

Step 4: Minimum Safeguards

The fourth step is to make sure that the activity is carried out in compliance with the minimum safeguards (MS), which are based on four components: Human Rights, Corruption, Taxation and Fair Competition. These are a set of elementary requirements based on internationally-agreed guidelines and principles, such as the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles, the international bill of human rights and the ILO conventions. Some examples of obstacles that a user of the Taxonomy can encounter in this step are:

- **EU-operating companies compliance with the MS:** The existing status of the MS lacks clarity regarding the extent to which companies operating in the EU and those adhering to state member laws already comply with some of the MS requirements. According to the recommendations of the PSF, the MS requirements should vary based on the nature and scale of the company. For instance, the principle of proportionality should be applied to SMEs, ensuring that requirements align with their risk profile and size without imposing unnecessary burdens. In contrast, larger companies falling under the CSRD (Corporate Sustainability Reporting Directive) face more stringent requirements.

- **Compliance with Human rights requirements:** While for corruption, taxation, and fair competition, companies are only required to have no prior convictions for crimes and to have policies expressing their opposition related to such practices, the requirements for the human rights component are more complex. In this regard, companies need to establish and implement a Human Rights Due Diligence process, including assessing negative human right impacts in their value chains. This can be challenging for companies that have complex and multi-layered supply chains and operations in non-transparent foreign countries.

Conclusion

The EU Taxonomy Regulation plays a vital role in enabling the shift towards a sustainable economy…

The EU Taxonomy Regulation facilitates the transition towards a sustainable economy by providing clarity and consistency in evaluating the environmental impact of a company's activities, establishing a common language and framework for identifying environmentally sustainable activities. It serves as a valuable tool for investors, companies, and policymakers as it brings together standardisation to the reporting of sustainability-related data, motivating businesses to align with sustainable practices, and providing a framework to support compliance with the Paris Agreement.

…although assessing the Taxonomy alignment of a company presents demanding challenges…

Companies undertaking a Taxonomy assessment of their economic activities will encounter numerous challenges. The complex and occasionally subjective interpretation of the regulation, the obstacles in verifying and acquiring essential data, and the resource-intensive nature of the assessment processes pose significant difficulties while assessing a company's eligibility and alignment. These challenges persist at every stage of the Taxonomy assessment and are further amplified for PEs aiming to evaluate the eligibility or alignment of their entire portfolio.

...this could potentially necessitate the involvement of external specialised providers to assist in the Taxonomy assessment journey

Companies may choose to involve external providers for the Taxonomy assessment of their activities due to their specialised expertise and technical capabilities. Engaging external providers offers companies the advantages of an independent perspective, a streamlined process, and extensive regulatory expertise. Furthermore, it helps to mitigate risks by identifying and addressing compliance gaps, thereby safeguarding the company against potential legal and reputational consequences.

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