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Response to EC consultation on additional criteria in EU taxonomy delegated acts

From Morningstar Sustainalytics on 3rd May 2023

Submitted via EU survey

Executive summary

Morningstar Sustainalytics welcome the opportunity to comment on the new EU taxonomy criteria related biodiversity, circular economy, pollution, and water. Our opinion is based on our experience as a practitioner of the EU Taxonomy (data and SPOs) and long-standing ESG research firm.

While we applaud the EC for this proposal, which would enhance the EU Taxonomy, we believe that some important additions and modifications could be considered to further improve the functionality and the usability of these new EU Taxonomy criteria. It's with these two objectives in mind that we are sharing the following recommendations:

- **Raise the level of ambition by prioritizing the most impactful activities**: We strongly encourage the EC to add sectors and their related activities with most impact across the 5 objectives and with clear alternative methods (e.g., Agri-food industry). Omitting these critical sectors for another couple years, while including less impactful ones, undermines the functionality of the EU Taxonomy and stop it from fully contributing to the EU's objectives (e.g., climate-neutrality by 2050, biodiversity by 2030, zero pollution vision for 2050). At the same time, while expanding criteria to broader range of activities, we need to be careful not to cover part of the economies where sustainability outcomes are not evident or questionable (e.g., Road and motorway maintenance).

- **Opt for a holistic approach by recognizing activities' contributions across different objectives:** We understand the need to expand the technical screening criteria to other environmental objectives to increase use cases of the EU Taxonomy and gradually increase the relevancy of alignment figures that needs to be displayed by corporates and investors via advisors and pre-contractual documents. An activity-by-activity approach can lose sight of the bigger picture and interconnections between sectors and their impacts across objectives. Certain activities will significantly contribute to several objectives (e.g., renewable energy: climate and pollution). Allocating each activity to only one objective or look strictly at direct activities (e.g., water criteria) or specific type of actors (biodiversity: public land vs private land) will stop the EU Taxonomy from being a comprehensive and transformative tool. Some safeguards can be put place to avoid double counting in Taxonomy alignment figures.

- **Ensure the usability of the EU Taxonomy by ensuring the applicability of the criteria and managing data gaps**: We would like to highlight that we fully endorse the advice produced by the Platform on Sustainable Finance (PSF) regarding the usability of criteria (e.g., NACE codes, machine readability). In addition, we would like to stress the need for guidance on how to deal with the many references to EU legislations when assessing activities carried outside the EU. This has implications on corporate disclosures, the uptake of the EU GBS, and the relevancy of the EU Taxonomy for EU investors who wants to seize investment opportunities both in and outside the EU. In the absence of detailed guidance or equivalence regimes, the prudent use of estimates should continue to be allowed when looking at non-NFRD companies.

1. Biodiversity

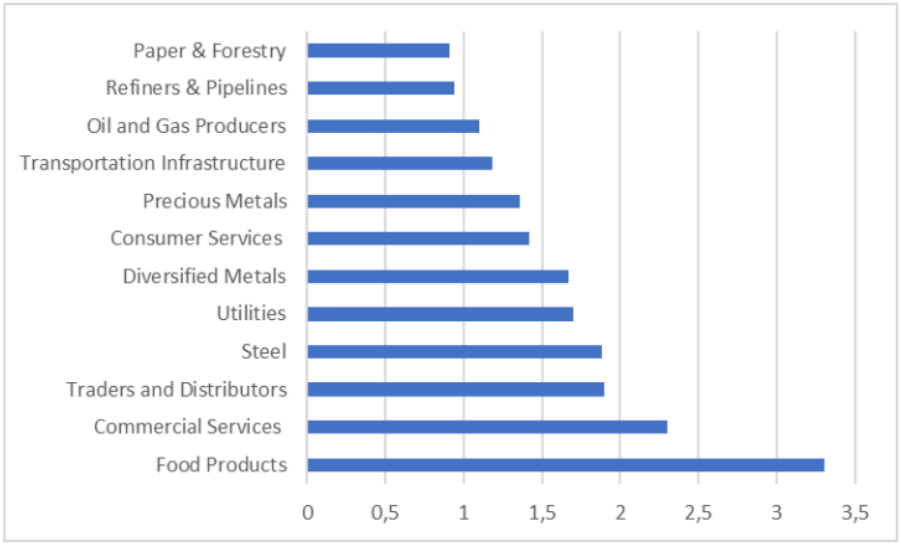
1.1 Suggestions going forward

As highlighted in the EU's Biodiversity strategy, our economies are highly dependent on biodiversity and natural capital. More than half of the world's GDP, equal to USD 44 trillion, is moderately or highly dependent on nature. It is paramount to use all tools available to achieve the objective of having Europe's biodiversity on the path to recovery by 2030. This naturally includes the EU Taxonomy.

To achieve the EU's objective, avoiding biodiversity loss, deforestation, and land use as results of economic activities will be crucial. For the purpose of the EU Taxonomy, this means that the biodiversity objective needs to be well ingrained in each DNHS criteria and that activities with both most adverse impacts and clear alternatives need to be captured.

In that sense, it is disappointing to see that several key activities (e.g., regenerative agriculture and forestry) will continue to be sitting on the side lines of EU Taxonomy. This is a missed opportunity given the rate of biodiversity loss, the impact of these sectors on biodiversity and the linkages between biodiversity and our ability to meet internationally agreed climate targets. We therefore strongly encourage to add and prioritise these sectors and related activities.

Exhibit 1: Land Use & Biodiversity[1]: Unmanaged Risk[2] by Industry



Source: Sustainalytics, data as of December 2022

1.2 Comments on proposed criteria

Regarding the covered activities, we would like to share the following technical observations.

[1] Land Use and BiodiversityBackgrounder_Final_3.pdf (sustainalytics.com)

[2] exposure to ESG risk that is unmanaged (due to management gap and unmanageable risks)

We welcome and support the inclusion of activity 1 on the Conservation, including restoration, of habitats, ecosystems and species. We would encourage the EC to open this activity to non-public land. Under criteria 5, only public land, existing and new conservation areas will be subject for this activity. Likewise, criteria 6.1 could be an effective obstacle for private landowners dealing with biodiversity offsetting (local offsetting could be part of a broader entity level 'net benefit' plan). Given the scale of the issue, private landowners should also be incentivized to change their land use. Finally, we suggest rephrasing reference to the use of pesticides as part of activity 1 DNHS (5) which should not be allowed in conversation/restoration areas.

However, we worry that the current hotel criteria could lead to more pressure on ecosystems. There should be an explicit requirement for an analysis of the carrying capacity of the area. Without this type of safeguard, we fear the criteria could spur the creation of new facilities, infrastructure and traffic volumes in areas best left without additional anthropogenic impacts. Furthermore, we believe the restoration agreement should cover a minimum of 10 years to align with the timeframe necessary to initiate, monitor and conclude conservation outcome (as suggested under activity 1 and the Nature Restoration Law).

2. Circular economy

2.1 Suggestions going forward

In the traditional economic model followed globally, raw materials are collected, transformed into products, used by consumers, and discarded as waste. Product use and manufacturing are responsible for about 45% of global greenhouse gas emissions, and circular economy strategies can cut these by 39%. The circular economy could also generate USD 4.5 trillion of additional economic output by 2030, based on business models that could decouple economic growth and natural resource consumption while driving competitiveness.

The proposal to establish Circular Economy criteria are therefore most welcome and a very positive steppingstone. Several relevant activities seem to be covered but because of the activity-by-activity format of the EU Taxonomy, it sometimes difficult to assess the overall level of ambition for certain key sectors and products like Textiles, the Food industry and EV batteries:

- We would encourage more emphasis on key circular economy sectors and issues, such as deadstock in Textiles. In its current format, it is unclear if real issues, such as deadstock are being included and if so to what extent. Beyond textiles, we encourage the EC to include deadstock in relevant activities (e.g., 2.3, 5.4, 5.5 and 5.6). Otherwise, the remaining unclarity could lead to the greenwashing of overproduction.

- Food waste seems to be only included indirectly and marginally (via waste management software). We see the expansion of the Taxonomy as an opportunity to set clear targets for producers and distributors given that 30%-40% of food waste happens before it reaches markets.

2.2 Comments on proposed criteria

Regarding the covered activities, we would like to share the following technical observations:

- It is unclear to us whether EV, scooters, bicycles batteries are captured by the criteria. The recyclability and lifespan of EV batteries is crucial as EVs will account for 20% cars sold in 2023 and over 60% in 2030, according to International Energy Agency. Also, EV batteries have ample second life options.

- There is a concern that activity 1.1 Manufacture of plastic packaging as currently phrased might potentially classify single use plastic as providing substantial contribution, which with current recyclability rate, would be at odds with other environmental objectives such as pollution prevention.

- There is a concern that Activity 4.2 related to provision of IT/OT data-driven solutions and software might include regular monitoring of operations without clear environmental benefits. In addition, traceability is not always related to sustainable products, inputs or raw materials, and might just be part of regular due diligence.

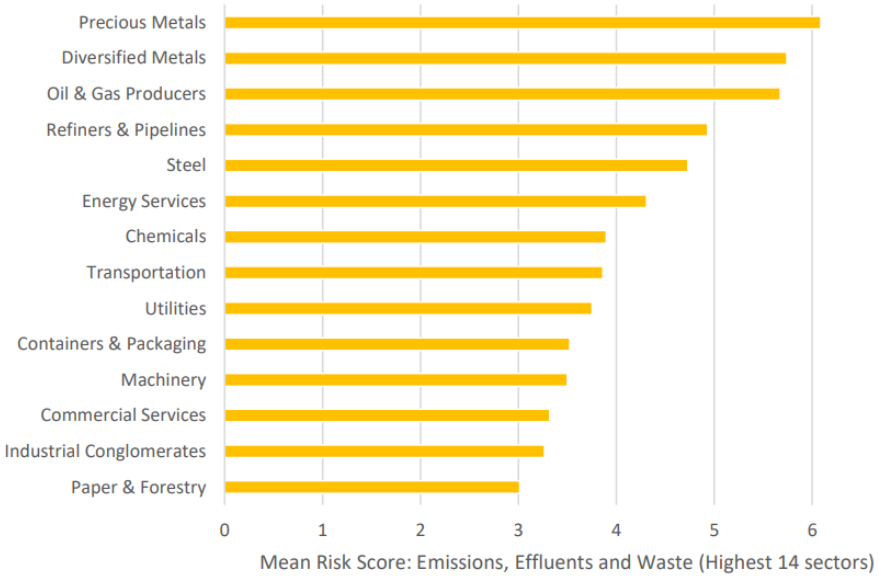
- Finally, we believe activity 3.4 Maintenance of roads and motorways does not fit well under a green Taxonomy. It appears incompatible with the DNHS principle given the significant carbon footprint of road transport in the EU.

3. Pollution

3.1 Suggestions going forward

Like for biodiversity the prioritisation of sectors and related of activities in context of the pollution criteria raises questions. For example, replacing fossil fuel has much bigger positive impact than the issue of pollution arising from manufacture of pharmaceuticals. Renewable energy and the shift to EVs is already covered in The Climate Delegated Act, which can also significantly help to reduce the pollution generated by traditional fossil fuels production and consumption. We strongly encourage the EC to add activities with both the most adverse impacts and clear alternatives.

Exhibit 2: Pollution (Emission, Effluent, Waste):[3] Unmanaged Risk by Industry



[3] Material ESG Issues: Emissions, Effluents and Waste (sustainalytics.com)

The above example raises the question of the treatment of activities contributing to several objectives. As proposed by the PSF, non-financial corporate disclosures ought to reflect a company´s contribution to all six environmental objectives, and when doing so, ensure there is no double accounting. This will be particularly helpful for investors seeking specific environmental outcomes.

3.2 Comments on proposed criteria

Regarding the covered activities, we would like to share the following technical observations:

- Manufacture of pharmaceutical products:
  - DNSH (1): refrigerant leak detection systems should also be required.
  - DNSH (3): this should be enhanced to include for the installation of monitoring wells to allow recovery of groundwater samples to confirm absence of pollution.
- Treatment of hazardous waste:
  - 1.3a: it is not normal practice for a hazardous waste receiving facility to have a laboratory on site capable of detecting the range of potential pollutants. Consideration should be given to rephrasing this to put the responsibility for identification of product toxicity on the waste producer and not the receiver.
  - 1.3d: the quarantine area must be designed to house and contain hazardous wastes (impermeable surface, sealed drainage, interceptors, monitoring routines and access to emergency response spill kits and active evacuation procedures for staff).
- Remediation of legally non-conforming landfills and abandoned or illegal waste dumps:
  - all items should be covered with a provision that all technical assessments and remediation designs must be completed by technically qualified and experienced staff.
  - b.1. receptor vulnerability assessments should be included into the delivery of any risks assessments (adopting the source pathway receptor pollutant linkage model).
- Remediation of contaminated sites and areas: 3.4 include ‘chemical characterisation’ after ‘appropriate.’

4. Water

4.1 Suggestions going forward

Along with flooding and water quality, water scarcity is one of the main water-related challenges of the 21st century. For most of the world's population, Water Stress has risen considerably over the period 2002-2017 and is projected to continue to rise.

The criteria identify economic activities that generate revenue based on direct water supply, leakage control, wastewater treatment, drainage, and so forth. To truly become an impactful and transformative tool the EU Taxonomy needs to cover the full range of economic activities that use and impact water resources and then set related targets (see exhibit 3). Moreover, some sectors direct water related impacts may average low, but are significantly higher in other areas of their product value chain. Similar to Scope 3 emissions, supply chain related water impacts are generated by some industries more than others (see exhibit 4).

Exhibit 3: Resource use (primarily freshwater, excluding supply chain)[4]: Unmanaged Risk by Industry

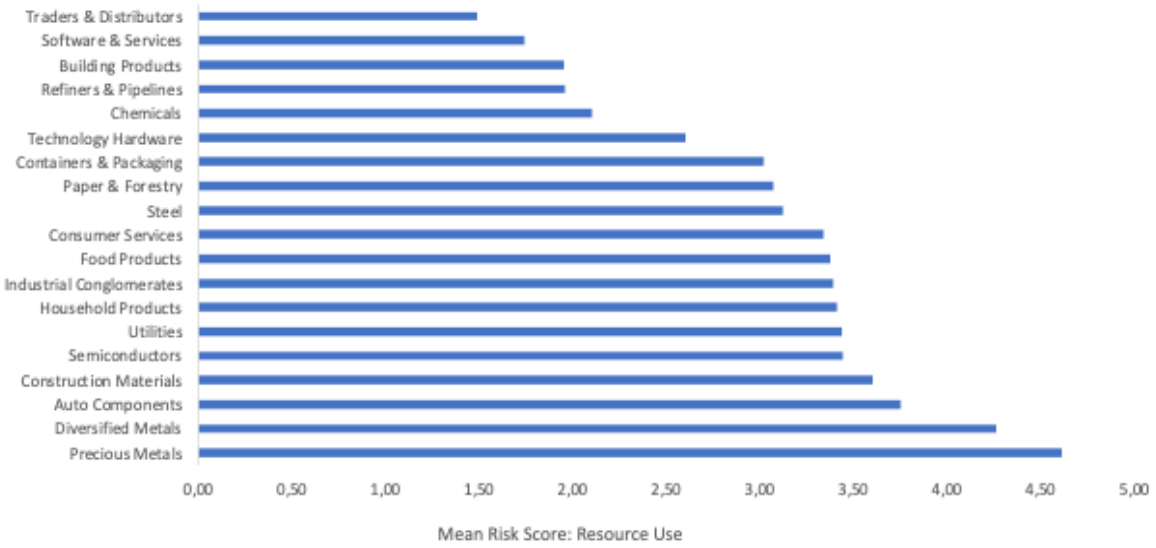
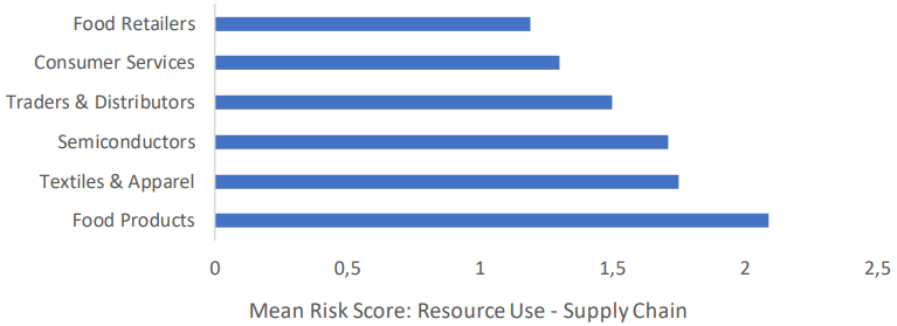


Exhibit 4: Resource use (primarily freshwater, focusing on supply chain)[5]: Unmanaged Risk by Industry



4.2 Comments on proposed criteria

Regarding the covered activities, we would like to share the following technical observations:

- Broaden the scope of water risks from physical risks (which are mapped out in detail) to contextual water risks consistently throughout the criteria. By addressing local water conditions, corporate water risk will be properly accounted for from additional material environmental, social and governance perspectives. Risks such as local governance risks, climate change risks, reputational risk, and social license to operate risk would be relevant to include to reflect localized conditions more accurately.
- The geographic location where such business activities are carried out should be prioritized based on risk assessments using internationally recognized tools such as the World Resource Institute's Aqueduct Water Risk Atlas or WWF Water Risk Filter.

[4] resource-use-backgrounder_final.pdf (sustainalytics.com)
[5] resource-use-backgrounder_final.pdf (sustainalytics.com)

- While leakage reduction is an important measure to mitigate and adapt to climate change, the criteria related to IT/OT data should precise that it should be leveraged to address complex and local water challenges.
- Potential inconsistency with ILI of 2 for existing facility, while climate change mitigation DA has an ILI of 1.5, which might include existing and new facilities.

Conclusion

In summary, Morningstar Sustainalytics support the EC's goal to extend the EU Taxonomy criteria to other environmental objectives. We encourage the EC to consider both our technical comments (usability and applicability of proposed criteria) and more fundamental comments (prioritization of sectors and holistic approach) to improve the relevancy of the EU Taxonomy and make it a transformative tool at the service of the EU's broad sustainability objectives. Should you wish to discuss any aspects of response, please do not hesitate to contact us.

Yours faithfully,

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