

Methodology

EU Taxonomy Revenue Share

CONTACT US

The Americas
+1 800 402 8774

**Europe,
Middle East & Africa**
+44 20 7160 9800

Asia-Pacific
+852-2533-3565

trucostinfo@spglobal.com

ABOUT TRUCOST

Trucost, part of S&P Global is a leader in carbon and environmental data and risk analysis. Trucost assesses risks relating to climate change, natural resource constraints, and broader environmental, social, and governance factors. Companies and financial institutions use Trucost intelligence to understand their ESG exposure to these factors, inform resilience and identify transformative solutions for a more sustainable global economy. S&P Global's commitment to environmental analysis and product innovation allows us to deliver essential ESG investment-related information to the global marketplace. For more information, visit www.trucost.com.

THE EU TAXONOMY

In March 2018, the European Commission adopted an action plan on sustainable finance as part of a strategy to integrate environmental, social and governance considerations into its financial policy framework and mobilize finance for sustainable growth. In May 2018, the Commission released the first legislative package under the action plan and established a Technical Expert Group on Sustainable Finance (TEG) to inform its development. One of the proposals under the legislative package is the development of a unified EU classification system or 'EU Taxonomy' ('Taxonomy') that would define which economic activities are environmentally sustainable. In March 2020, the TEG published its final report outlining its recommendations on the design and implementation of the Taxonomy.

The Taxonomy is essentially a tool that will help companies and investors navigate the transition to a low-carbon, resilient and resource-efficient economy. It sets performance thresholds for economic activities that make a substantive contribution to one of six key environmental objectives (outlined in Table 1 below), do not negatively affect the other five and meet minimum safeguards. To date, the Taxonomy considers economic activities that contribute to climate change mitigation and/or adaptation objectives with the TEG planning to address the other environmental objectives in future iterations. However, financial market participants in the region will be required to complete their first set of disclosures against the Taxonomy, covering climate change mitigation and/or adaptation, by the end of 2021. Companies will be required to disclose in the course of 2022.

In the transition to a low carbon economy, certain activities can be identified as greater contributors to climate change or mitigation thereof. These activities are either prone to shift their technologies towards low emission solutions or are mitigating the effects of climate change by default thanks to their activities.

They correspond to 'transitional' and 'enabling' activity categories of the EU's Taxonomy, according to its Technical Expert Group on Sustainable Finance.

Table 1: Six environmental objectives of the Taxonomy:
1. Climate change mitigation;
2. Climate change adaptation;
3. Sustainable and protection of water and marine resources;
4. Transition to a circular economy;
5. Pollution prevention and control;
6. Protection and restoration of biodiversity and ecosystems

Source: EU Taxonomy: Final Report on the Technical Expert Group on Sustainable Finance, March 2020

The Taxonomy is one of the most significant developments in sustainable finance and may have wide-ranging implications for financial institutions (notably pension funds, insurers, banks and asset managers) and issuers working in the EU, and beyond.¹ In response to these developments, Trucost has launched an EU Taxonomy Revenue Share dataset that will help financial institutions start the process of disclosure by identifying companies with business activities that have the potential to make a substantive contribution to climate change mitigation and/or adaptation objectives.

TRUCOST'S APPROACH

The Taxonomy outlines 67 business activities linked to seven NACE macro sectors. The business activities include those that have a direct carbon mitigation potential (for example, renewable energy) as well as those that are relatively carbon intensive *but* have significant potential to reduce their carbon emissions (for example, steel manufacturing).

The seven NACE macro sectors covered by the Taxonomy are:

- Agriculture, forestry and fishing
- Manufacturing
- Electricity, gas, steam and air conditioning supply
- Water, sewerage, waste and remediation
- Transportation and storage
- Information and Communication Technologies (ICT)
- Buildings (Construction and real estate activities, with application to other sectors where appropriate)

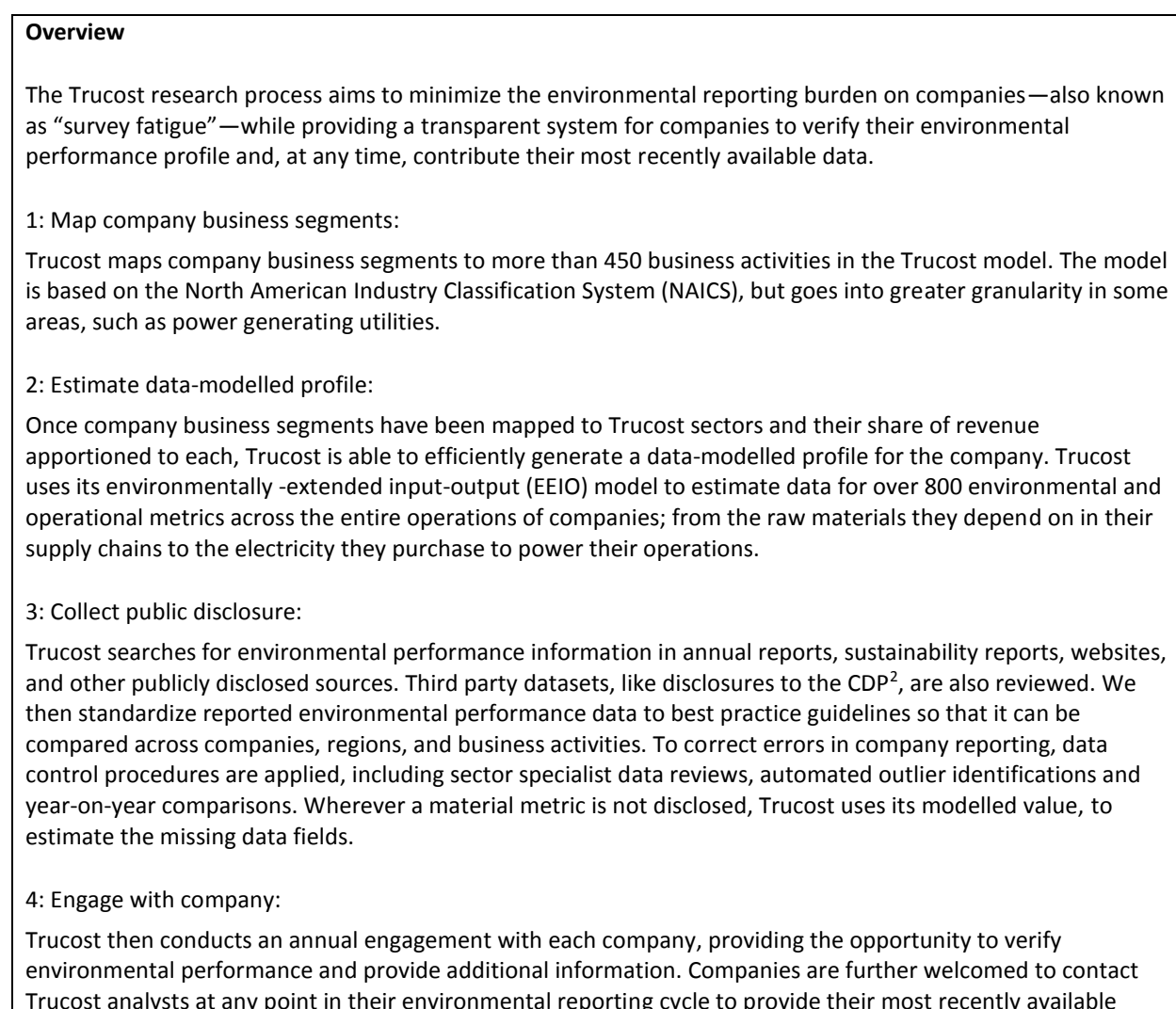
Trucost's EU Taxonomy Revenue Share dataset provides an assessment of the proportion of company revenues linked to the 67 business activities outlined in the Taxonomy. In this first iteration, Trucost only examines revenue exposure; the performance thresholds (for example, tCO2e/unit of production) are not included. However, Trucost splits the business activities in two sub-categories of substantial contribution to climate change mitigation:

¹ EU Technical Expert Group on Sustainable Finance (TEG), (2020), *Taxonomy: Final Report of the TEG*.

transitional and enabling activities. The dataset covers 15,000+ listed companies in Trucost’s Core Plus universe. Trucost also offers historical data for each company.

Trucost uses a blended approach to assess the alignment of company revenues with the Taxonomy. Firstly, Trucost has conducted a direct mapping between the 464 business activities in its proprietary sector classification system with the 67 business activities mentioned above. The Trucost proprietary sector classification system is based on the North American Industry Classification System (NAICS), which is similar to the European NACE system. The entire economy’s activities are split into 464 business activities. Any business activities not mapped directly through this process are reviewed using a bottom-up assessment of their alignment with the objectives of the Taxonomy. During this step, Trucost reviewed company reported revenues and emissions data from its Core Plus universe. Companies in this universe are analysed using Trucost’s company research process outlined in Figure 1. This step in the process ensures that only business activities that have a carbon mitigation and/or adaptation potential are included in the dataset. Any business activities remaining after this step are not considered to be eligible to the Taxonomy.

Figure 1: Trucost’s company research process



² CDP is a not-for-profit charity that surveys companies on Climate, Water, and Forestry issues and aggregates the collected disclosures. For more information see: <https://www.cdp.net/>

data. This supports Trucost’s efforts to utilize the most up-to-date company information and to maximize data quality.

Companies in the Trucost’s Core Plus universe are analysed by a dedicated team of research analysts who carefully review company financial statements, sustainability reports and other publicly disclosed information on an annual basis. The team uses proxies to allocate revenue per business activity when the company does not disclose the revenues for that activity. By way of example, Table 2 outlines the list of proxies Trucost uses to break down revenues for the power generation sector.

Table 2: Example of data hierarchy to proxy activity breakdown in the power generation sector

Hierarchy	Data	Action
1	Revenue split by power generation/purchased power, and by generation energy sources	Use to split sectors
2	Revenue split by power generation/purchased power	Use to spill out purchased power sector, proceed with hierarchy for power generation sectors
3	Power (in KWH/MWh/GWh, or % breakdown and total) split by power generation/purchased power, and by generation energy sources	Use to split sectors
4	Power generation (in KWh/MWh/GWh, or % breakdown and total) split by generation energy type (e.g. ‘thermal’ and ‘renewable’)	Use to split out generation energy type, proceed with hierarchy for power generation sectors
5	Energy use for power generation by source	Convert energy use to KWh to standardise. Use to split sectors
6	Capacity mix for power generation by source	Use to split sectors
7	Country of operation generation mix	Use to split sectors, splitting at a country level

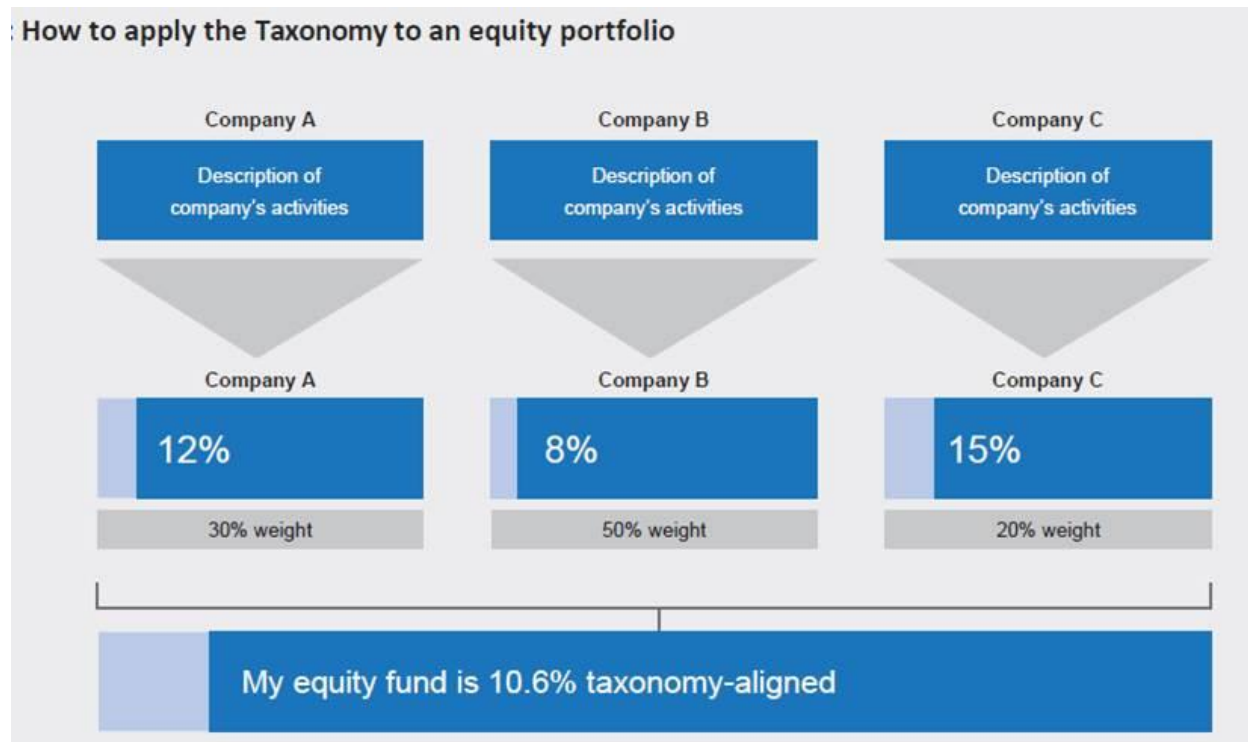
Out of the 464 business activities in the Trucost proprietary sector classification system, 117 have been mapped to the 67 business activities highlighted in the Taxonomy. Trucost paid close attention to the objectives of the Taxonomy throughout the mapping process. For example, glass product manufacturing is currently excluded from the Taxonomy and is therefore not included in the list of 117 business activities.

Once mapped, the 117 activities are split into two sub-categories of contribution to climate change mitigation as outlined in the Taxonomy. Transitional activities are defined by the Taxonomy as those that are, (1) contributing to climate change mitigation based on their capacity to improve their emissions intensity, and (2) those that are directly mitigating the impacts of climate change. Enabling activities are defined by the Taxonomy as those that are providing products and services that improve emissions intensity of other activities and are indirectly mitigating the effects of climate change.

APPLICATION TO PORTFOLIO ANALYSIS

Trucost's EU Taxonomy Revenue Share dataset can be applied at the portfolio-level to help financial institutions understand the carbon mitigation and/or adaptation potential of their portfolio holdings versus the benchmark and comply with reporting requirements. This can be done using a weighted average approach by summing the product of each holding's weight in the portfolio with the company-level revenue alignment metrics (see Figure 2 below).

Figure 2: Example portfolio-level calculation



Source: EU Taxonomy: Final Report on the Technical Expert Group on Sustainable Finance, March 2020

This approach can be applied to any portfolio of companies (equities, corporate bonds, convertible bonds or even corporate loans covered by Trucost). This provides the overall share of portfolio revenues currently aligned with the Taxonomy and is a useful starting point in identifying companies that have the potential to contribute significantly to the low carbon transition. Other metrics, such as the value of holdings with a carbon mitigation and/or adaptation potential can also be presented as part of the portfolio analysis. Trucost data can also be used to calculate the revenue exposure for each NACE macro sector and, thus, indicate whether a portfolio's specific NACE macro sector exposure is higher or lower, versus the benchmark.

In order to perform a portfolio audit, the following data points are required:

- Company identifiers (e.g. ISIN)
- Value of holdings, or weights and the total value of holdings

LIMITATIONS

The first iteration of Trucost's EU Taxonomy revenue share dataset covers the 67 business activities currently outlined in the Taxonomy. Over the coming years, the Taxonomy will continue to evolve as the TEG considers approaches to the other environmental objectives. There are also certain topics within carbon mitigation and adaptation (such as extractives or glass, pulp and paper) that are not currently addressed but will likely be covered in future releases. As such, Trucost will look to expand its coverage of business activities as the Taxonomy evolves.

In addition, Trucost only examines revenue exposure. The performance thresholds (for example, tCO₂e/unit of production) are not included. Trucost will look to incorporate performance thresholds for each business activity in the future so that the resolution of the revenue alignment metrics at the sector-, company- and portfolio-level can be increased.

REFERENCES

- 1) NACE sector classification, (2020). Available at: [https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Statistical_classification_of_economic_activities_in_the_European_Community_\(NACE\)](https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Statistical_classification_of_economic_activities_in_the_European_Community_(NACE)).
- 2) EU Technical Expert Group on Sustainable Finance, (2019), Taxonomy Technical Report. Available at: https://ec.europa.eu/info/publications/sustainable-finance-teg-Taxonomy_en

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