INFORMATION FOR INVESTMENT PROFESSIONALS

Your success. Our priority.

EU's 'Fit for 55' strengthens sustainable outcomes focus

European equities | July 2021

Andrea Carzana
Portfolio Manager,
Sustainable Outcomes
Pan European Equities

Natalia Luna
Senior Thematic Investment
Analyst, Responsible
Investment

The European Commission has unveiled its Fit for 55 roadmap[1] setting out the transformation to deliver the European Union's 2030 target of reducing net greenhouse gas emissions by at least 55% by 2030. This is a vital step to ensure the EU is on the way to becoming climate-neutral by 2050.

The package brings granularity and detail as to how these reductions might be met. It will be debated and voted on by the European parliament and member states before adoption, so not all the proposals may ultimately become law – nevertheless, it is a solid starting point.

It is also interesting to look at what has been announced and, in this case, show how the proposed framework will benefit the sustainable themes targeted by the Threadneedle (Lux) Sustainable Outcomes Pan European Equity (SOPEE) Fund.

Carbon border tax

The carbon border adjustment mechanism (CBAM) will initially apply to cement, fertilisers, iron and steel, aluminium and electricity generation, as well as to Scope 1 direct emissions. Importers will be taxed on the carbon emission embedded in their goods based on the EU carbon price. This will be implemented over three years from 2023 and could be extended to other sectors after 2026. Free allowances will be phased out for these subsequent sectors by 2035, declining 10% per annum, at which point it will reach zero. This is a positive factor for the construction industry, and a holding in the SOPEE fund such as building materials business CRH[2], as the carbon-free allowance might have been removed as soon as 2023. But the proposed date means the industry will only have to bear the full incremental carbon cost by 2035, allowing more time to accelerate emissions reductions plans and adjust pricing to a higher level.

[1] https://ec.europa.eu/commission/presscorner/detail/en/ip_21_3541

Mention of specific stocks within this document is not a recommendation to buy

The most positive and impactful aspect of the CBAM is that it is a starting point, heralding much more stringent carbon regulations globally. The delayed implementation could see the CBAM become a powerful tool to push the acceleration of decarbonisation plans by other countries, stimulating increased debate around global decarbonisation and climate ambitions.

Aviation and maritime

The EC is proposing that over the next few years sustainable aviation fuel (SAF) be blended into jet fuel on flights from any EU airport in order to drive emission reductions – a topic we covered in a recent viewpoint.[3] The proposal now is for a 2% SAF blend by 2025, 5% by 2030 and 25% by 2035, up from a current level of around 0.1%.

The aviation sector has also been added to the EU emissions trading scheme (ETS). Sectors covered by the revised EU ETS – which will see further tightening of the market in support of higher carbon prices – will need to reduce their greenhouse gas (GHG) emissions by 61% by 2030 versus 2005 levels. This will see the sector's free credit allocation, based on 2010 flying levels, wind down by 4.2% per year.

These proposals will impose additional costs on the aviation industry, so there will be winners and losers. Airlines will have to factor in SAF adoption and buying carbon certificates, and their success will depend on their ability to pass on costs to customers. For a company such as Neste – the world's largest producer of renewable diesel and sustainable aviation fuel refined from waste and residues, and which we hold within SOPEE – this is very supportive as Neste grows SAF production from around 0.1 Mtpa today to close to 1.5 Mtpa by 2024.[4]

The maritime sector has also been added to the EU ETS, and this will affect intra-EU voyages, 50% of emissions from extra-EU voyages and emissions occurring at berth in an EU port. The industry will need to reduce its GHG intensity (versus a reference value yet to be set) by 2% by 2025, 6% by 2030, 13% by 2035, 26% by 2040, 59% by 2045 and 75% by 2050.

Neither the kerosene used in the aviation industry nor heavy oil used in shipping will be fully exempt from energy taxation for intra-EU voyages. Over 10 years the minimum tax rates for these fuels will increase, while sustainable fuels will benefit from a zero rate which will boost its acceptance and uptake.

Electric vehicles

EU car manufacturing is to be fully electric by 2035. Fit for 55 proposes a 55% reduction in emissions of new cars by 2030 and 100% by 2035. This implies a phase-out of internal combustion engine vehicles by 2035 – a faster emissions reduction than anticipated – which will require faster growth of electric vehicles (EVs). However, these targets could pose a challenge for automakers and will also require acceleration in the rollout of EV infrastructure, including an increase in the number of charging points to a million by 2025 and 3 million by 2030.

[3] Sustainable aviation fuel is ready for take-off, May 2021

[4] https://www.neste.com/about-neste/who-we-are/business#9507dabd

This is very positive for semiconductor firms, which are key to this rollout. Infineon, which we hold is the market leader in the power semiconductor segment, a market that should see tremendous growth as these proposals mean the number of EVs on the road simply has to go up. Electrical equipment companies like Schneider will also benefit, as they are critical to the implementation of the charging network.

Building renovations

The roadmap has increased the energy efficiency savings target to 36% by 2030, up from 32.5%. There is also a new binding target of a 1.1% annual increase in renewables used in heating and cooling, with renewables to account for 49% of energy use in buildings by 2030.

We previously covered this topic in a viewpoint at the end of 2020[5], but the proposals now go further. Previously the requirement was purely for government buildings to be upgraded, but now the public sector will be required to renovate 3% of its buildings each year, to include schools and hospitals. However, to achieve these efficiency targets further supportive policies will be needed in terms of funding, incentives and other regulations.

While carbon regulation is still a near-term headwind for the construction industry, in the long term the new EU rules are a positive factor and could benefit the decarbonisation leaders with greater access to capital and potentially a lower relative cost base. For firms such as Belimo, SIKA and Schneider that we hold in SOPEE this should result in a sustained high level of organic growth with strong pricing power. Electrical companies will also benefit as commercial and residential buildings will be instrumental to energy transformation across the grid.

Fit for 55 in summary

Sector	New 'Fit for 55' policy	Implications	Sector impact
Emissions	• 55% reduction by 2030 versus 1990 levels		• Sectors covered by the revised EU ETS must reduce emissions by 61% by 2030 versus 2005
Emissions Trading Scheme (ETS)	• Lower supply and free allowances • Aviation and shipping sectors to be included under the scheme • Separate ETS for transport and buildings	• Incremental demand and reduced supply will support higher carbon prices	• Incremental carbon costs for heavy industry, industry, oil and gas • Aviation and shipping decarbonisation will be kick-started • Incentivise building owners and developers to invest in energy efficiency and fuel switching
Carbon border tax	• Gradual phase in from 2023-2026 • Importers will be taxed on the carbon emission	• Free allowance wind down over 2026-2035 reduces the potential tail risk and provides incentives for	• Relative good news for sectors like steel and cement as the worst case scenario of an immediate

[5] Riding Europe's building renovation wave, December 2020

	embedded in their goods based on the EU carbon price	companies to invest in decarbonisation • Push uptake of global carbon pricing and climate goals	removal of free allowance is gone
Renewables	• Raises renewables target to 40% of the energy mix by the end of the decade from existing 32% goal	• Require twice the renewable capacity versus today	• Positive for the organic growth of renewables producers
Road transport	• Emissions from new cars to fall by 55% from 2030 and drop to zero from 2035 • Boost electric vehicle (EV) infrastructure	• Effective ban on new sales of ICE cars/vans from 2035 • Acceleration of EV penetration	• Slightly tougher regulation could be a headwind for original equipment manufacturers (OEMs), but most OEM strategies have started to anticipate EV adoption targets
Aviation	• Officially enters the ETS • Free allocation of credits phased out in 2027 • Mandate quotas of Sustainable Aviation Fuels (SAF)	• Pay for carbon credits • Meet SAF requirements	• Additional cost burden for EU airlines from SAF quotas, fuel tax and ETS compliance • Positive for SAF suppliers: Neste
Shipping	• Included in the ETS • Greenhouse gas intensity of the energy used by a ship should be reduced by 6% by 2030, falling by 75% by 2050	• Pay for carbon credits • Push and acceleration of biofuels	• Incremental costs for shipping companies
Buildings	• Renovate 3% of all public buildings each year • Binding target of 1.1% annual increase in renewables used in heating and cooling		• Positive for electric equipment (Schneider); heat pumps (Belimo); buildings materials (Kingspan, Sika, Rockwool)

Energy tax	• Fuels to be taxed based on their energy content and environmental performance compared to the previous model based on volume	• Polluting fuels taxed most • Certain exemptions phased out: kerosene fuel used in aviation and heavy oil used in maritime for intra-EU voyages over 10 years • SAF incentivised with a zero minimum tax rate	• More headwinds for the traditional fossil refiners and oil majors • Increase costs for aviation and shipping

Important Information: For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients). This is an advertising document.

This document is intended for informational purposes only and should not be considered representative of any particular investment. This should not be considered an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. **Investing involves risk including the risk of loss of principal. Your capital is at risk.** Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. The value of investments is not guaranteed, and therefore an investor may not get back the amount invested. **International investing** involves certain risks and volatility due to potential political, economic or currency fluctuations and different financial and accounting standards. **The securities included herein are for illustrative purposes only, subject to change and should not be construed as a recommendation to buy or sell. Securities discussed may or may not prove profitable.** The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Threadneedle Investments (Columbia Threadneedle) associates or affiliates. Actual investments or investment decisions made by Columbia Threadneedle and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. **Past performance does not guarantee future results, and no forecast should be considered a guarantee either.** Information and opinions provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. This document and its contents have not been reviewed by any regulatory authority.

In the UK: Issued by Threadneedle Asset Management Limited, registered in England and Wales, No. 573204. Registered Office: Cannon Place, 78 Cannon Street, London EC4N 6AG. Authorised and regulated in the UK by the Financial Conduct Authority.

In the EEA: Issued by Threadneedle Management Luxembourg S.A. Registered with the Registre de Commerce et des Sociétés (Luxembourg), Registered No. B 110242 44, rue de la Vallée, L-2661 Luxembourg, Grand Duchy of Luxembourg.

In the Middle East: This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA).

The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Market Counterparty and no other Person should act upon it.

In Switzerland: Threadneedle Asset Management Limited. Registered in England and Wales, Registered No. 573204, Cannon Place, 78 Cannon Street, London EC4N 6AG, United Kingdom. Authorised and regulated in the UK by the Financial Conduct Authority. Issued by Threadneedle Portfolio Services AG, Registered address: Claridenstrasse 41, 8002 Zurich, Switzerland.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.