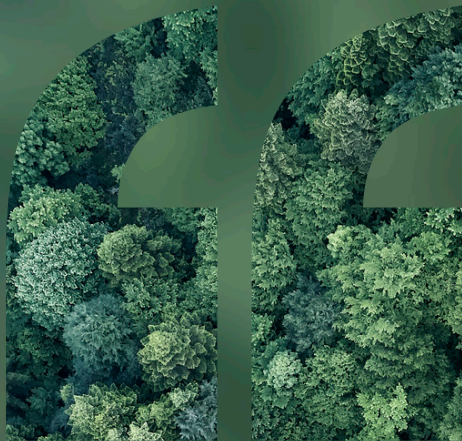
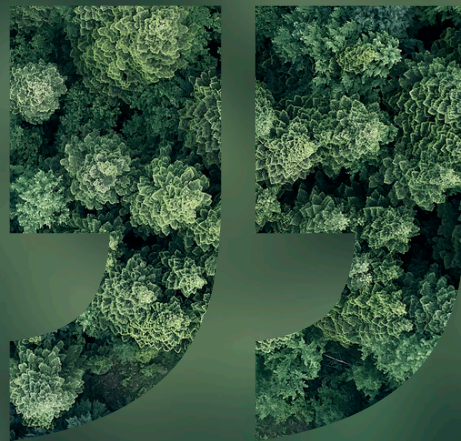


C L I F F O R D

C H A N C E



**ESG: EUROPEAN
COMMISSION FINALISES
TAXONOMY 'TECHNICAL
SCREENING CRITERIA'
FOR CLIMATE
MITIGATION AND
ADAPTATION**



— THOUGHT LEADERSHIP

MAY 2021



ESG: EUROPEAN COMMISSION FINALISES TAXONOMY 'TECHNICAL SCREENING CRITERIA' FOR CLIMATE MITIGATION AND ADAPTATION

The European Commission has finalised legislation containing the Technical Screening Criteria (**TSC**) for climate mitigation and adaptation activities supporting the Sustainable Finance Taxonomy Regulation. While the Commission has broadly retained the approach taken in its November 2020 draft, in some cases its approach to the details of the criteria has differed. This briefing looks at the finalised position.

Key Issues

- The European Commission has finalised a delegated regulation containing Technical Screening Criteria (TSC) for climate mitigation and climate adaptation activities under the Sustainable Finance Taxonomy
- TSC provide thresholds and other criteria for categorising the environmental sustainability of specific economic activities
- The Commission has broadly followed the approach it took in its November 2020 draft TSC but a number of activities (including electricity production from natural gas and agricultural activities) have been removed, and various changes and clarifications have been made to TSC in different sectors
- Nuclear and aviation are still not included in the TSC, pending further consideration

Key changes since the November 2020 draft

- **Natural Gas:** Natural gas activities (as transitional activities) have been removed due to ongoing controversy over whether, and how, they should be included. A final position on natural gas could be included in a complementary delegated regulation later this year.
- **Bioenergy:** Bioenergy is now considered a 'green', rather than 'transitional', activity but the TSC will be subject to review when TSC for substantial contribution to biodiversity and ecosystems are produced.
- **Nuclear activities:** The Commission is still considering whether to include nuclear energy activities in the TSC. However, a recent Commission Joint Research Centre technical report on nuclear energy suggests that concerns over environmental impacts of nuclear energy should not be a major barrier to its inclusion in the Taxonomy / TSC. The report is currently being reviewed for the Commission by two expert groups.
- **Buildings:** For the acquisition and ownership of buildings activity, an additional method of satisfying the climate mitigation TSC (rather than Energy Performance Certificates) has been added based on a building being within the top 15% of Primary Energy Demand nationally or regionally.
- **Manufacturing:** The approach of benchmarking performance against the EU Emissions Trading Scheme has been confirmed although the Commission will continue to consider other approaches.
- **Agriculture activities:** Agriculture activities have been removed due to ongoing CAP negotiations and will be included in a later delegated regulation.
- **Changes to detail:** TSC have been tweaked or otherwise clarified across the sectors.

BACKGROUND

The Taxonomy Regulation EU/2020/852 was published in June 2020. It sets out categories of economic activities that are considered environmentally sustainable. It is a cornerstone of the European Commission's Sustainable Finance Action Plan and will be used in different areas such as regulation, disclosure obligations, sustainability labels and benchmarks (see box below).

The Taxonomy Regulation identifies six environmental objectives and an activity

must significantly contribute to one of these in order to be environmentally sustainable. An activity must also 'do no significant harm' (DNSH) to any environmental objective and comply with minimum social safeguards and with detailed TSC to be published by the European Commission in delegated legislation.

Following advice from the Technical Expert Group (TEG), to advise it on the detailed TSC for climate mitigation and adaptation, the Commission published a

How will the Taxonomy be used?

The Taxonomy Regulation imposes key obligations:

- on member states and at EU level to apply the Taxonomy when regulating how environmentally sustainable financial products or corporate bonds (for example the EU Green Bond Standard proposal) are made available;
- on “financial market participants” (including AIFMs, UCITS managers, investment firms and credit institutions providing portfolio management, insurers which make available an insurance based investment product, as well as providers of certain pension products) to make statements about alignment of investments with the Taxonomy when making available financial products, including when these products are not considered to be environmentally sustainable; and
- on large public-interest entities (including certain EU entities with listed securities, banks and insurers) to include information about how their activities align with the Taxonomy in the non-financial disclosure part of their financial statements. The scope of affected entities would increase under a proposed Corporate Sustainability Reporting Directive (see further our **May 2021 briefing** on the proposal). A separate **Commission proposal** for a delegated regulation has been published for consultation setting out the indicators that will need to be disclosed and how turnover, capex and opex from relevant activities, should be treated (Draft Indicators Regulation).

Market participants will be required to back up their sustainability claims based on the Taxonomy criteria and real data. These obligations are intended to address greenwashing and related reputational risks. It is expected however that the Taxonomy will have broader applications, and perhaps drive improved investor discussion, better expression of investor preferences, and an increase in sustainable financial products such as green bonds and loans. For more information on how the Taxonomy will be used, see our **January 2020 briefing**.

draft delegated regulation containing TSC for those objectives for consultation in November 2020. A large number of responses were made to the consultation, with strong views in a number of areas (e.g. electricity from natural gas) insisting that the TSC are not stringent enough, against others feeling that they are too restrictive and need to be watered down. The College of Commissioners has now achieved political agreement on the delegated regulation which contains, in two annexes, TSC for the climate change and climate adaptation objectives (**Finalised TSC**).

Annex 1 of the draft regulation identifies a list of activities which can make a substantial contribution to climate change mitigation and sets out the DNSH requirements for each activity. Annex 2 of the draft regulation sets out a framework for assessing most of these activities (and some additional ones) against the climate change adaptation objective based on generic principles.

APPROACH

The Taxonomy Regulation provides that the TSC should set qualitative and quantitative thresholds which maintain technological neutrality, use existing EU methodologies and classifications where possible and base the criteria on scientific practices.

The Finalised TSC identify and assess those sectors and activities that bring (or could bring) the most significant contribution to the climate change mitigation and adaptation objectives. In doing so, they adopt the existing NACE industrial classification of economic activities (Revision 2) to classify activities into macro-sectors viewed as priority sectors.

It is worth repeating that the Taxonomy Regulation and the Finalised TSC focus on environmentally sustainable activities, as opposed to investible entities. This allows for the Taxonomy to be used by businesses that pursue both activities that can be classed as sustainable and others that cannot.

Climate change mitigation

Substantial Contribution: activity that contributes substantially to stabilisation of greenhouse gas concentrations by reducing emissions or enhancing removals, through:

- Generating, storing or using renewable energy or climate-neutral energy
- Improving energy efficiency
- Increasing clean or climate-neutral mobility
- Switching to use of renewable materials
- Increasing carbon capture and storage use
- Phasing out anthropogenic emission of greenhouse gases
- Establishing energy infrastructure to enable decarbonisation of energy systems
- Producing clean and efficient fuels from renewable or carbon-neutral sources

The Finalised TSC contain 88 climate mitigation activities and 95 climate adaptation activities. The full list of activities is contained in the Appendix to this briefing.

Climate change mitigation (Annex 1) – what is included?

Article 6 of the Taxonomy Regulation establishes when an activity should be considered to make a substantial contribution to climate change mitigation.

The following 9 sectors are set out in the Finalised TSC:

- Forestry
- Environmental Protection and Restoration Activities
- Manufacturing
- Energy
- Water supply, sewerage, waste management and remediation
- Transport
- Construction and real estate activities
- Information and communication
- Professional, scientific and technical activities

These activities are divided into three types as shown in the table below.

The thresholds chosen for climate change mitigation activities are generally based on levels of CO₂ equivalent emissions (per unit product/power generated/ distance travelled, etc.). In general, the Commission has retained the approach adopted in its November 2020 draft but sometimes it has taken a different route or tweaked the thresholds. Here are a couple of examples:

- In hydrogen manufacture, while the Commission has retained its life-cycle emissions savings approach, the threshold for emissions has been increased from 2.256 tCO₂eq/tH₂ to 3 tCO₂eq/tH₂.
- In relation to the acquisition and ownership of buildings activity, the TEG had recommended that the threshold for pre-2021 buildings be set at the top 15 % of local stock measured by Primary Energy Demand. The Commission initially decided to opt for the EU Energy Performance Certificate (EPC) 'A' rating, but in the Finalised TSC, it decided to provide an alternative threshold for pre-2021 buildings of 15% of national or regional stock (i.e. a refined version of the option proposed by TEG). This will, in particular, be useful for demonstrating performance of building stock outside the EU which would not already have an EPC.

	TYPES OF ACTIVITY		
	“Green” activities	Transitional Activities	Enabling Activities
Features of the activity	Very low and zero emission activities and carbon sequestration	Activities in transition to a low carbon economy	Activities that enable climate change mitigation to take place
Examples	<ul style="list-style-type: none"> • Forestry • Renewable power generation • Zero carbon transport • Carbon capture and storage (CCS) 	<ul style="list-style-type: none"> • Efficient iron and steel manufacturing • Efficient manufacturing of hydrogen • Efficient electricity production from renewable gas / liquid combustion* 	<ul style="list-style-type: none"> • Energy or hydrogen storage • Wind turbine manufacture • Installing on-site renewable generation plant in a building
What “Substantial Contribution” criteria are applied?	Long-term stable criteria based on naturally low or zero emission nature of activities or tied to GHG emission-based thresholds	Criteria tied to GHG emission based thresholds, which are expected to be subject to regular revision down towards zero emission	Criteria generally follow the activities being enabled (i.e. in the boxes to the left) where relevant, or have bespoke criteria

* Non-renewable gas-fired power generation has been removed pending a further delegated regulation setting out relevant TSC (see further below).

Focus on Transition

Under the Taxonomy, an activity that has no “technologically and economically feasible low carbon alternative” but supports the transition to a low carbon economy can be regarded as contributing significantly to the climate change mitigation objective if the activity satisfies certain criteria:

- It has Greenhouse Gas (GHG) emission levels equal to the best performance in the sector or industry;
- It does not hamper the development and deployment of low-carbon alternatives; and
- It does not lead to a lock-in of carbon-intensive assets, considering the lifetime of those assets.

Highlighted in this paragraph are a few examples of the approaches taken in relation to transitional activities in the Finalised TSC. In the Finalised TSC for the manufacturing sector, the EU Emissions Trading System (EU ETS) benchmark has generally been chosen as the threshold for manufacturing sectors in the EU ETS as this represents the top 10% of performance in the relevant sector – the benchmark will reduce over time. Steel, iron and cement manufacturing, for example, are included if this benchmark threshold can be met. Any CO₂ emitted from these manufacturing processes would need to be captured, transported and stored. While the Taxonomy Regulation rules out inclusion of solid fossil fuels in the Taxonomy, the Commission's November 2020 draft included electricity and heat generation from natural gas and liquid fuels in line with the TEG recommendations. For electricity generation, the Finalised TSC retains the general threshold for life-cycle GHG emissions of 100gCO₂e/kWh. However, the Commission has now decided to remove electricity generation from natural gas and other fossil-based liquid fuels from the delegated Regulation given ongoing controversy over if, and how, it should be included. The Commission intends to include natural gas in a future delegated regulation to be published later this year subject to its ongoing review.

Some categories, for example, electricity generation from bioenergy, electrified rail, and zero tailpipe emissions transport are no longer considered 'transitional activities' and qualify as 'green' provided they meet the relevant criteria.

Climate change adaptation (Annex 2) – what is included?

There is an inherent difference in approach between climate change mitigation and adaptation because all sectors need to adapt to become more climate resilient. The adaptation activities are context- and location-specific, so activities will not be subject to hard threshold minimum standards, unlike the climate change mitigation criteria.

With a few exceptions, the Finalised TSC propose a generic approach applicable to each activity to identify whether the activity makes a sustainable contribution to adaptation. This approach is based on:

- A robust climate risk and vulnerability assessment; for activities with lifespans over 10 years, the assessment must be conducted using 'state of the art' modelling under a range of climate scenario projections of 10 to 30 years. For other investments, less sophisticated models can be used; and
- The implementation of physical and non-physical solutions to reduce the most significant physical climate risks relevant to that activity, where those activities:
 - do not affect adaptation efforts of others;
 - favour nature-based solutions or rely on blue or green infrastructure;
 - are consistent with other adaptation efforts;
 - are monitored and measured against pre-defined indicators and remedial action is considered where those indicators are not met; and
 - comply with the DNSH criteria for that activity (in other words, the climate mitigation activities they relate to must themselves not cause significant environmental harm).

Climate change adaptation

Substantial Contribution: activity that contributes substantially to reduction of the negative effects of current and expected future climate change; preventing an increase, or shifting of negative effects of climate change, through:

- preventing or reducing the location and context-specific negative effects of climate change
- preventing or reducing the negative effects that climate change may pose to the natural and built environment within which the economic activity takes place

What is Significant Harm? (Article 12 of Taxonomy Regulation)

Climate change mitigation: activity leading to significant greenhouse gas emissions

Climate change adaptation: any activity leading to increased negative effect on current and expected climate for, and beyond, the natural and built environment within which that activity takes place

Protection of water and marine resources: activity that is detrimental to a significant extent to the good status of EU waters

Circular economy, waste prevention and recycling: activity that leads to significant inefficiencies in the use of materials in one or more stages of the life-cycle of products or activity that leads to a significant increase in the generation, incineration or disposal of waste

Pollution prevention and control: activity that leads to a significant increase in emissions of pollutants to air, water and land

Protection of healthy ecosystems: any activity detrimental to a significant extent to the good condition of ecosystems

The Finalised TSC recognise that activities that contribute to climate mitigation can also contribute to climate adaptation where those activities are made more resilient (for example carrying out flood defence works to a cement manufacturing plant). For that reason, the Commission has also included most of the climate mitigation activities in Annex 2. It should be noted that only costs incurred in implementing adaptation solutions in relation to such climate mitigation activities included under Annex 2 can be taken into account in assessing the environmental sustainability of an investment. In the above example, this would mean only the costs incurred in implementing the flood defence works, not the revenue and opex in operating the adapted manufacturing plant (unless it qualified under the Annex 1 climate mitigation TSC). This is significant when considering the DNSH criteria (see below) which, for example, in the case of cement manufacture, has lower emissions thresholds compared with the thresholds for substantial contribution to climate change mitigation under Annex 1. This is not explained in Annex 2 but rather is dealt with in the Draft Indicators Regulation.

DO NO SIGNIFICANT HARM (DNSH) CRITERIA

Regardless of whether an activity makes a substantial contribution to an environmental objective, no activity will be regarded as sustainable under the Taxonomy if it causes significant harm to any of the environmental objectives. The Taxonomy Regulation establishes principles for assessing significant harm for each of the objectives.

DNSH criteria when considering a climate change mitigation activity

For each climate change mitigation activity, the Finalised TSC flesh out DNSH criteria establishing what would be considered to cause significant harm to the other relevant environmental objectives.

The DNSH criteria for the climate adaptation objective require a robust climate risk and vulnerability assessment

and implementation of adaptation solutions over a maximum 5 year timeline. The baseline for DNSH criteria for the other environmental objectives is generally compliance with relevant EU legislation and standards, with additional qualitative criteria applied as appropriate. For example, for a mitigation project involving "manufacture of equipment for the production and use of hydrogen", not only does the project have to avoid harm to ecosystems by ensuring suitable environmental impact assessment in compliance with relevant Directives (and implement protection measures), but it must also have a water use and protection management plan to prevent water-related impacts, must focus on use of secondary raw materials and component use, must design products for high durability and recyclability, and must prioritise recycling over disposal. A further example of cement manufacture provides that the manufacturing process must meet regulatory 'Best Available Techniques' standards.

DNSH criteria when considering a climate adaptation activity

Similarly, for each climate adaptation activity, DNSH criteria are established for other environmental objectives, and the baseline for these DNSH criteria is also legislative compliance or qualitative criteria. For many activities, DNSH criteria are set for climate mitigation. Significantly, the thresholds contained in DNSH criteria for climate mitigation are not always the same as those contained in the 'substantial contribution' criteria for the same activity when it is considered as a climate mitigation activity.

This is significant for many of the transitional activities mentioned above, and real estate activities. For example, the GHG emissions threshold for manufacture of grey cement clinker is 0.722 tCO₂e per tonne of grey cement clinker as a climate mitigation activity. However, where assessed as an adaptation activity, the DNSH for climate change mitigation for grey cement clinker manufacturing is a softer emissions limit of 0.816 tCO₂e per tonne. As noted above, only costs of the adaptation solution applied to a grey cement clinker

manufacturing plant operating at under the 0.816 tCO₂e per tonne limit can be treated as environmentally sustainable, while revenues from operation of the adapted manufacturing plant could only be treated as environmentally sustainable if it operated below the 0.722 tCO₂e per tonne limit (i.e. if it makes a substantial contribution to climate mitigation under Annex I TSC).

OMISSION OF ACTIVITIES FROM THE TAXONOMY

Certain activities are automatically excluded from the Finalised TSC where DNSH issues made the activities unsuitable for inclusion. An example of these is infrastructure for fossil fuel activities because of the likely lock-in of fossil fuel use for the future.

Natural gas activities have been removed due to ongoing controversy over whether and how they should be included. In particular, a number of Member States have been pushing to have natural gas-fired generation labelled as sustainable under the Taxonomy (rather than being categorised as a transitional activity). The Recitals to the delegated regulation note that a final position on natural gas could be included in a complementary delegated regulation (anticipated later this year) subject to the Commission being comfortable that it meets the strict conditions for transitional activities. A possible silver-lining for the natural gas industry in the Recitals is a note that the Commission will consider specific proposals for financing natural gas reflecting its role in reducing emissions.

Agriculture activities (for example production of crops and livestock) have also been removed due to ongoing CAP negotiations and will be included in a later delegated regulation.

As expected, nuclear energy is not included within the Finalised TSC given ongoing uncertainty over potential harm

to other environmental objectives, including, in particular, concerns over the impacts of long-term waste disposal. The Commission is continuing to consider whether nuclear activities should be included in the TSC. A Commission Joint Research Centre (**JRC**) technical report on the DNSH aspects of nuclear energy published in March 2021 suggests that concerns over the environmental impacts of nuclear energy should not be a major barrier to its inclusion in the Taxonomy / TSC. This report is currently being assessed by two groups who are expected to produce advice by late June 2021: the independent Group of Experts on radiation protection and waste management established under Article 31 of the Euratom Treaty which is looking specifically at radiation-related issues, and the Commission's Scientific Committee on Health, Environmental and Emerging Risks which will consider environmental issues more broadly. The Commission will make its final decision based on the JRC report and advice from the two reviewing groups.

The Commission is considering the inclusion of aviation activities within the Taxonomy. In March 2021 the Commission published a report by external consultants looking at how aviation could be incorporated into the TSC for climate mitigation. The report concluded that inclusion of some aviation-related activities within the TSC would be likely to help develop green finance in this sector.

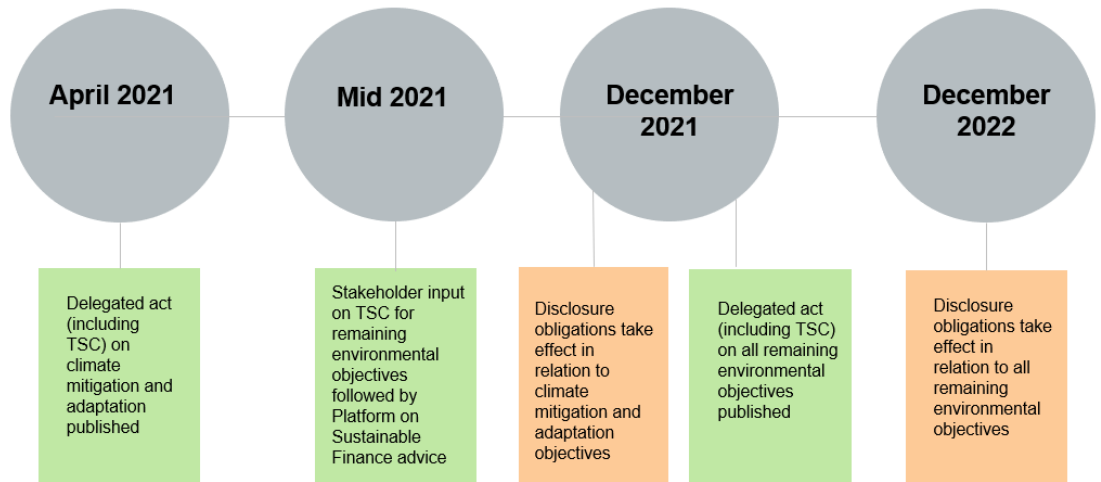
The omission of an activity from the Finalised TSC should not be regarded as meaning the activity is unsustainable. The activity would simply be regarded as not classified (but it could, of course, be classified in the future, e.g. nuclear and aviation). It is difficult to predict whether this will have any impact on investments in such unclassified activities.



NEXT STEPS

Links to the draft regulation and its annexes containing the Finalised TSC can be found [here](#). The text is provisional but there is unlikely to be any substantive amendment. Subject to formal adoption and scrutiny by the Council and European Parliament, the TSC will come into force on 1 January 2022.

A stakeholder consultation exercise on activities to be included in the TSC for the remaining environmental objectives will be launched in 'Mid 2021' and the Platform on Sustainable Finance will then advise the Commission on draft TSC for those objectives. While much of the work will follow on from the DNSH set for the climate mitigation and adaptation objectives, the Commission will need to ensure a clear and a consistent approach given the extent to which the environmental objectives are inter-related.



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APPENDIX – THE MITIGATION AND ADAPTATION ACTIVITIES

NACE Macro-sector	Climate Change Mitigation Activities	Climate Change Adaptation Activities
Forestry	<ul style="list-style-type: none"> Afforestation Rehabilitation and restoration of forests, including reforestation and natural forest regeneration after an extreme event Forest management Conservation forestry 	
Environmental Protection and Restoration Activities	<ul style="list-style-type: none"> Restoration of Wetlands 	
Manufacturing	<ul style="list-style-type: none"> Manufacture of renewable energy technologies Manufacture of equipment for the production of hydrogen Manufacture of low carbon technologies for transport Manufacture of batteries Manufacture of energy efficiency equipment for buildings Manufacture of other low carbon technologies Manufacture of cement Manufacture of aluminium Manufacture of iron and steel Manufacture of hydrogen Manufacture of carbon black Manufacture of soda ash Manufacture of chlorine Manufacture of organic basic chemicals Manufacture of anhydrous ammonia Manufacture of nitric acid Manufacture of plastics in primary form 	
Energy	<ul style="list-style-type: none"> Electricity generation using solar photovoltaic technology Electricity generation using concentrated solar power (CSP) technology Electricity generation from wind power Electricity generation from ocean energy technologies Electricity generation from hydropower Electricity generation from geothermal energy Electricity generation from renewable non-fossil gaseous and liquid fuels Electricity generation from bioenergy Transmission and distribution of electricity Storage of electricity Storage of thermal energy Storage of hydrogen Manufacture of biogas and biofuels for use in transport and of bioliquids Transmission and distribution networks for renewable and low-carbon gases District heating/cooling distribution Installation of electric heat pumps Cogeneration of heat/cool and power from solar energy Cogeneration of heat/cool and power from geothermal energy Cogeneration of heat/cool and power from renewable non-fossil gaseous and liquid fuels Cogeneration of heat/cool and power from bioenergy Production of heat/cool from solar thermal heating Production of heat/cool from geothermal energy Production of heat/cool from renewable non-fossil gaseous liquid fuels Production of heat/cool from bioenergy Production of heat/cool using waste heat 	

NACE Macro-sector	Climate Change Mitigation Activities	Climate Change Adaptation Activities
Water Supply, Sewerage, Waste Management and Remediation	Construction, extension and operation of water collection, treatment and supply systems Renewal of water collection, treatment and supply systems Construction, extension and operation of waste water collection and treatment Renewal of waste water collection and treatment Collection and transport of non-hazardous waste in source segregated fractions Anaerobic digestion of sewage sludge Anaerobic digestion of bio-waste Composting of bio-waste Material recovery from non-hazardous waste Landfill gas capture and utilisation Transport of CO2 Underground permanent geological storage of CO2	
Transport	Passenger interurban rail transport Freight rail transport Urban, suburban and road passenger transport Operation of personal mobility devices, cycle logistics Transport by motorbikes, passenger cars and light commercial vehicles Freight transport services by road Inland passenger water transport Inland freight water transport Retrofitting of inland water passenger and freight transport Sea and coastal freight water transport, vessels for port operations and auxiliary activities Sea and coastal passenger water transport Retrofitting of sea and coastal freight and passenger water transport Infrastructure for personal mobility, cycle logistics Infrastructure for rail transport Infrastructure enabling low-carbon road transport and public transport Infrastructure for water transport Low-carbon airport infrastructure	
Construction and Real Estate	Construction of new buildings Renovation of existing buildings Installation, maintenance and repair of energy efficiency equipment Installation, maintenance and repair of charging stations for electric vehicles in buildings (and parking spaces attached to buildings) Installation, maintenance and repair of instruments and devices for measuring, regulation and controlling energy performance of buildings Installation, maintenance and repair of renewable energy technologies Acquisition and ownership of buildings	
Information and Communication	Data processing, hosting and related activities	
	Data-driven solutions for GHG emissions reductions	N/A
	N/A	Computer programming, consultancy and related activities
	N/A	Programming and broadcasting activities

NACE Macro-sector	Climate Change Mitigation Activities	Climate Change Adaptation Activities
Professional, Scientific and Technical Activities	N/A	Engineering activities and related technical consultancy dedicated to adaptation to climate change
	Close to market research, development and innovation	
	Research, development and innovation for direct air capture of CO2	N/A
	Professional services related to energy performance of buildings	N/A
Financial and Insurance Activities	N/A	Non-life insurance: underwriting of climate-related perils
	N/A	Reinsurance
Education	N/A	Education
Human Health and Social Work Activities	N/A	Residential care activities
Arts, Entertainment and Recreation	N/A	Creative, arts and entertainment activities
	N/A	Libraries, archives, museums and cultural activities
	N/A	Motion picture, video and television programme production, sound recording and music publishing activities

C L I F F O R D C H A N C E

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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