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Sustainable Taxonomy of Mexico



Legal analysis and main implications.

Mexico's Sustainable Taxonomy (the "<u>Taxonomy</u>"), a classification tool created through a broad, participatory, and coordinated three-year process to identify and define activities with positive effects on the environment and society, following technical criteria and international standards was presented on March 16, 2023 by Gabriel Yorio, assistant secretary of the Ministry of Finance and Public Credit "Secretaría de Hacienda y Crédito Público" ("<u>SHCP</u>") within the framework of the 2023 Banking Convention.

The promotion of investment in economic activities that contribute to closing socio-economic gaps and protect the environment is the purpose of the Taxonomy. The SHCP worked on it with the assistance of over 200 technical experts from public, private, financial, academic, and civil society institutions, as well as international organizations, ensuring the technical soundness and relevance of this tool to address sustainable development challenges in Mexico.

SUSTAINABLE TAXONOMY

The Taxonomy is a globally unique tool, as it incorporates environmental and social dimensions in its core design, allowing a comprehensive approach to sustainability as it promotes the integral well-being of individuals and the environment, with 124 activities (to mitigate and adapt to climate change) distributed in six economic sectors: (a) agriculture, livestock breeding, forestry, and logging; (b) generation, transmission, distribution, and commercialization of electric power and supply of water to the final consumer; (c) construction; (d) manufacturing industries; (e) transportation; and (f) waste management and remediation services.

To align such economic activities, the following aspects must be met: a) eligible activities must be included in the Taxonomy, b) such activities must be classified under various metrics and thresholds, c) Non-Significant Harm ("<u>NSH</u>") criteria must be met, and d) maintain minimum safeguards. The Taxonomy also establishes cross-guidelines to identify activities to ensure compliance with gender equality.

The Taxonomy is the beginning to disseminate and implement activities to contribute the development of a sustainable financial market, resulting in: (a) promoting actions to train authorities and entities in the financial sector, (b) developing corresponding regulation, and (c) preventing the attribution of environmental or social benefits lacking foundations, better known as 'greenwashing'.



What the Taxonomy represents in terms of ESG compliance.

The use of the Taxonomy will require an ethical behavior from organizations that intend to communicate to their stakeholders that their economic activity is sustainable, according to criteria of legitimacy and based on science.

The document that publicizes the Taxonomy notes that it seeks to reduce the risk of "green and social washing". This implies that the preparatory work of the Taxonomy considered the negative effects of unethical behavior and strategies of a company or institution, aimed at making society believe that the corporation take more actions to protect the environment or human rights than it does. This awareness of ethical misconduct and its relation to the regulatory content of the NSH represents a call for ESG Compliance ("C-ESG"). C-ESG shall be responsible for ensuring that companies, organizations, or entities use the new Taxonomy ethically and in accordance with applicable laws, regulations, standards, and practices. This is a relevant issue for Compliance Officers, who must identify the inherent risk scenarios that green and social washing will generate for the company, as well as to adjust the control environment to ensure the application of NSH principles and promote the transparency that allows the financial sector and different stakeholder groups of organizations to have confidence in the classification and sustainability rating of business activities.

Finally, the Taxonomy could have positive regulatory and even procedural implications by contributing through NSH criteria to the content of the sustainability concept referred to in Mexican environmental legislation, in aspects as relevant as 'environmental compensation' provided for in Article 14 of the Federal Environmental Responsibility Law.

SEMARNAT's intervention in the Taxonomy.

Notwithstanding that the Taxonomy has no direct regulatory objectives, which means it is beyond compliance vis a vis environmental regulations and legislation protecting human rights, its purpose is to provide certainty and transparency to financial markets and investment in sustainable activities.

Having said that, the federal environmental sector had a significant participation in the alignment of the Taxonomy with current environmental regulations. The National Institute of Ecology and Climate Change collaborated in the process to ensure that the Taxonomy considered the nationally determined contributions ("<u>CDN</u>"), which translate into the commitment that the Mexican government assumed on climate change and that has its regulatory reflection in Mexico's General Law on Climate Change. SEMARNAT's participation is reflected in various aspects of the Taxonomy, among which the figure of the NSH stands out.



Concept of Non-Significant Harm.

The concept of NSH is one of the most important concepts contained in the Taxonomy which is worth highlighting being one of the elements of the Technical Evaluation Criteria ("<u>TEC</u>") to identify economic activities as sustainable. The other three elements are: (a) the main parameter or thematic criteria from which the sustainability of an economic activity is evaluated, (b) the substantial contribution of such activity to sustainability based on metrics and thresholds, and (c) the minimum safeguards. The NSH is composed of a series of environmental criteria ensuring that a specific economic activity does not have negative effects on any of the other objectives of the Taxonomy preventing that progress in some objectives is not made at the expense of other environmental objectives.

The NSH criteria is based on existing legislation, regulation, norms, and standards governing a given sector and suggest certain regulatory aspects applied to the Taxonomy. Thus, companies seeking to disclose their degree of alignment to sustainability should verify that their activities are considered in the Taxonomy, identify the cases in which the established metrics and thresholds are met, the compliance with minimum safeguards, as well as the NSH criteria that include regulatory aspects.

An example of applied NSH, in the case of the construction sector, will imply that the corresponding activities must comply, among others, with the Mexican Official Standard NOM-001-SEMAR-NAT-1996, which establishes the maximum permissible limits of pollutants in wastewater discharges into national waters or property. In the case of the generation, distribution, and commercialization of electricity from hydraulic sources, the companies must follow the guidelines of the National Water Law and include, if applicable, the concession title issued by the National Water Commission and the duly recorded wastewater discharge permit.



Gender equality within the Taxonomy.

Gender equality, as a social objective within the Taxonomy, becomes a fundamental factor to watch within organizations, since it will enable, through the metrics proposed in the Taxonomy, the identification and promotion of investments that contribute to closing the existing gender gaps, allowing potential users of the Taxonomy to be guided by it to generate actions to contribute to gender equality.

The Gender Equality Index ("<u>IIG</u>") will be the indicator to measure the degree of participation and commitment of an organization through three pillars, as detailed in the Taxonomy: (a) dignified work, (b) well-being, and (c) social inclusion. Based on these 3 pillars, metrics will be established to address specific aspects within the organizations to evaluate actions or commitments, such as those related to equal pay, health from a gender perspective, social participation of women, among others, to assist organizations to strengthen their contribution to gender equality.

Through a questionnaire - composed of three levels - revealing the evolution of the organizations on gender equality - consisting of questions related to policies in place to promote gender equality and actions to comply with such policies, as well as the mechanisms in place to amend situations that hinder or distance companies from such goals aimed at achieving gender equality the IIG will be obtained.

The Taxonomy establishes that even when organizations contribute to close the gender equality gap, they must demonstrate not generation of negative effects in the environment (climate change, pollution, and water resource management); and compliance with the NSH criteria or (if applicable) compliance with national standards or regulations, specialized certifications or other criteria detailed in the Taxonomy.



Although there have been actions to close the existing gap over the years in terms of gender equality, contemplating and including this objective within the Taxonomy will allow organizations to strengthen and mobilize actions and commitments aimed at this important issue and, with such commitments, be able to access financing mechanisms that, given the importance that this represents today, are aimed at activities contributing to social welfare and the environment. An organization will be considered aligned with the Taxonomy if it can prove that meets the IIG, NSH criteria, and minimum social and governance safeguards.

Alignment of the eligible economic sectors with the Taxonomy, key examples.



1) Agriculture, animal husbandry and forestry land-use.

The main parameter is to contribute to the mitigation of greenhouse gases and compounds (GHG&C), using metrics such as CO2e emission reduction and carbon capture. For the evaluation of the NSH, all the activities of the subsectors under this activity, for example, agriculture sector, must use renewable energy sources, not use pesticides with yellow or red labeling, according to the sanitary registration of pesticides issued by COFEPRIS, and promoting rainwater harvesting and water reuse in their facilities, among others.





2) Generation, transmission, distribution and commercialization of electricity and water supply to the final consumer.

Since it is an essential activity for the population and for the performance of very productive activities of other economic sectors, in order to contribute to the mitigation of GHG&C, the purpose is that one of the metrics that will be used in emissions for power generation: kgCO2e/MWh - with a power per unit area higher than or equal to 5W/m2 - can be directly eligible and exempted from submitting the life cycle report of a product, including the evaluation of its carbon footprint. It is worth noting that power generation from fossil fuels is excluded.



3) Construction.

The traditional processes of this sector use fossil fuels and high energy demand, therefore, it generates high emissions of CO2, negatively impacting the environment. In the case of the construction of industrial buildings and plants, under the GHG&C mitigation parameter, the metric that will be used is the primary energy demand expressed in kWh/m2 per year, and therefore various parameters must be met for such activity to be considered as sustainable, however, projects with construction certifications will be directly eligible.



4) Manufacturing industries.

The steelmaking activity (primary smelting of crude iron and the manufacture of steel, ferroalloys, finished products, such as pipes, poles, rods, among others) is one of those included within this sector for the GHG&C mitigation, so the metric to be used will be GHG emissions per unit of production expressed in tCO2e/per product, for example, for aluminum manufacturing to be considered sustainable, the direct GHG emission associated with the primary aluminum production process must be equal or less than 1.5 tCO2e/t.



The transportation sector in Mexico is one of the main sources of GHGs emissions and atmospheric pollutants, contributing to global warming and generating significant negative impacts on human health. Therefore, all economic activities in the transportation sector must develop risk management and climate change adaptation criteria during the design, construction, reconstruction, rehabilitation, and maintenance of transportation infrastructure, in addition, they must hold an environmental impact assessment ("MIA") or a preventive environmental report, authorized by the environmental authority, with their reporting obligations for compliance of environmental conditions. The MIA must contain the significant environmental impacts of such works and/or activities and their mitigation measures.



6) Waste management and remediation services.

This sector includes various activities for the handling of hazardous waste, special management waste, and urban solid waste, focusing on recovery activities and environmentally sustainable management. Precisely, waste recovery activities by the private sector involve the recovery of usable materials from waste, such as used PET bottles, used aluminum cans, used cardboard, used paper, used glass, old iron, used textiles, electronic scrap, and other recyclable materials. They will be considered sustainable when secondary raw materials or by-products are suitable for the substitution of primary raw materials in another production processes. The recovered waste (by-products) must have a traceability system for rapid identification and handling, in accordance with the principles for waste management set forth in the General Law for the Prevention and Integral Management of Waste.

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SUSTAINABLE TAXONOMY

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