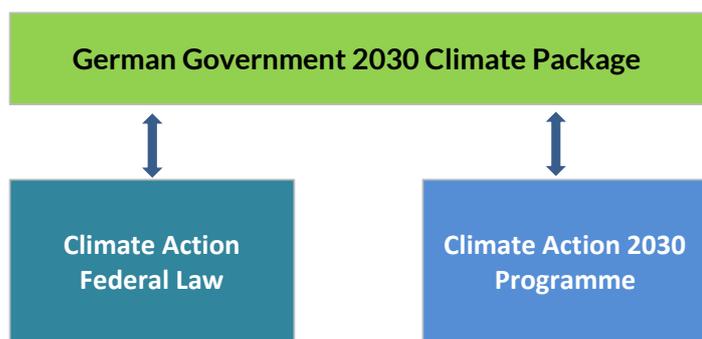


German 2030 Climate Package May Become a Blueprint for National Environmental Regulations

Sector impact will vary, with requirements for energy, transport and buildings most demanding, while rail will receive most direct investments



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If successfully implemented, the German federal government's sweeping package of climate policy reforms may become a blueprint for an intermediate climate action step for many nations aiming to achieve their commitments on carbon neutrality by 2050. The German government has maintained its commitment not to raise new debt to finance this package.

Any specific credit impact of this climate policy reform on rated entities will become clear when detailed information on sectoral and regional legislation, programmes and policy decisions becomes available.

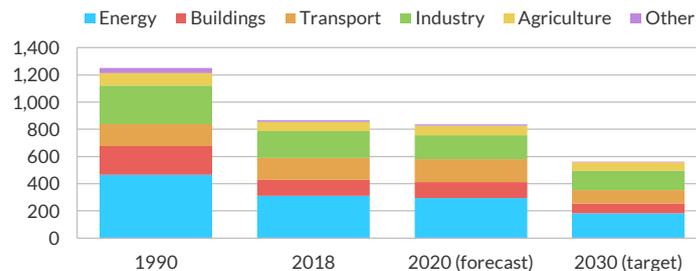
The reforms, approved at the end of last year, target multiple sectors and aim to reduce the country's greenhouse gas (GHG) emissions by 55% by 2030 compared to 1990 levels.

The package combines a new carbon pricing-and-trading system with a wide range of restrictions and incentives. It includes the first comprehensive federal law, which created the framework and legally binding sector targets, and the Climate Action Programme 2030, which prescribes measures and support programmes that later will be legislated in sector-specific and regional laws.

The package identified emissions reduction targets for six sectors: energy, buildings, transport, industry, agriculture and "other". The first three will be most affected by demanding decarbonisation requirements. Therefore companies in those sectors are likely to bear the largest impact on their credit profiles. Rail transport is likely to receive most direct investments as part of the package. All sector emissions reduction targets in the package arise from Germany's Climate Action Plan 2050.

German Greenhouse Gas Emission Reduction Targets

Million tonnes of CO2 equivalent



Source: Fitch Ratings, Clean Energy Wire, BMU

Aim to Be Budget Neutral

Full costings for this package are not yet available, but news reports suggest they will be "a three-digit billion euro sum" by 2030. However, the government is committed to keeping the plan budget neutral, with no new debt to be raised to finance the programme.

Germany's Energy and Climate Fund will be the central financing tool. The Fund receives relevant revenues from the EU Emissions Trading System (ETS) and will be further boosted by receipts from Germany's own emissions trading system. Furthermore, redistributions between tax increases for polluters and tax cuts for greener initiatives should help to fund the measures.

German Carbon Cap-and-Trade System to Coexist with ETS

The new package introduces a national emissions pricing-and-trading system for sectors and companies not covered by the ETS. Revenues generated by this system will be transferred to the Energy and Climate Fund.

Transportation and heating, along with smaller power plants and installations excluded from the ETS, are likely to be most affected by the system.

Prices will be fixed for 2021-2025 (EUR25 per tonne of CO₂ equivalent in 2021 with incremental increases to reach EUR55 in 2025). After that the price will be determined in auctions in 2026 with a corridor of EUR55-EUR65 and based on market prices from 2027 (with an option for price corridors that will be decided in 2025).

The new system appears to become costlier for its participants than for those covered by the ETS. The current market price of ETS allowances is under EUR25 per tonne, which is close to the maximum of the past 10 years. It remains uncertain how successful the implementation of this new system will be and how well it could coexist with the ETS.

A degree of compensation and free allowances under the new system is also key. Energy cost compensation to energy-intensive industries averages EUR300 million annually in Germany, while free allowances typically cover 80%-90% of emissions for industrial sites falling under the ETS.

Energy Decarbonisation Is Cornerstone of New Package

We expect the energy sector to be the most affected: it needs to cut over 40% of GHG emissions by 2030 (compared to 2018) and support electrification of other sectors, i.e. road transport and heavy industries. The two key pillars of this strategy are coal being phased out by 2038 and a rapid expansion of renewables.

The government compensation package for the coal phase-out is worth EUR40 billion and includes both direct payments to utilities and benefits in kind for affected coal-producing regions, such as a transfer of government institutions and military assets to those regions in a bid to create jobs and generate revenues.

The amount of renewable power capacity connected to the grid needs to almost double over the next decade, from 118 gigawatts in 2018 to 200 gigawatts by 2030.

The government plans to gradually reduce the country's renewables surcharge and possibly offset some other policy-related components of the power price, such as grid fees, to reduce financial pressures from potentially higher energy prices on both corporates and the general public.

Rail Transport Will Benefit from Major Investments

The government emphasises public transport development to tackle emissions, with rail the main recipient of investments. The aim is to double the number of train passengers by 2030.

The federal government will contribute EUR62 billion to the national rail operator Deutsche Bahn's expansion and modernisation programme. The company will contribute a further EUR24.2 billion to this 10-year plan. Moreover, the government's annual payments to Deutsche Bahn will be increased by EUR1 billion by 2021 and by EUR2 billion by 2025. The package also entails value-added tax cuts on long-distance travel, lowering ticket prices by 10%.

Funding for Electric Vehicle Charging Infrastructure and Incentives May Help Automakers

Electrification of road transport is among the key priorities of CO₂ reduction policies. However, the importance of the auto industry in Germany requires a balanced approach through extending stimuli for consumers to switch to electric vehicles (EVs).

Automakers are under significant strains from more demanding EU-wide emission standards, on top of other industry pressures, including weakening demand, technological shifts and reducing profitability and cash flows. A recent government-sanctioned report concluded that 400,000 jobs are at risk in Germany in the coming years chiefly because of the shift to EVs.

The new package appears to be designed to assist the transition to cleaner cars without exerting additional compliance pressures on automakers. It provides for public funding to increase the number of public EV charging points to one million by 2030 (a 50-fold increase). Construction of charging points on private or company premises will also be supported and regulatory hurdles removed. The increased EV charging network should ease potential customers' range anxiety and stimulate sales.

Considerations for EV purchases are often price driven, so the package aims to reduce costs for buyers. The government will co-finance EV and plug-in hybrid subsidies worth several thousand euros per vehicle. The package will target corporate purchases by prolonging allowances for company cars with batteries or plug-in hybrid engines until 2030 and reducing taxes for pure EVs.

In addition, the motor vehicle tax will be based on emissions per kilometre for new registrations by 2021, to the advantage of cleaner vehicles. Combined, these measures aim to increase the

number of EVs on the road to 7 million-10 million by 2030, from a total of 285,000 EVs purchased between January 2010 and October 2019.

Less Friendly Skies for Aviation

The package recognises that so far the most efficient way to reduce airline emissions is to reduce air traffic. This is expected to be achieved by higher air ticket prices, combined with lower train fares and an improved railroad network.

The air traffic tax will be increased by at least 40%. New regulations will also require that air tickets cannot be cheaper than the combined costs of applicable taxes, surcharges and other fees, in order to avoid super-low-cost air fares inducing customers to fly.

Low-cost carrier (LCC) customers are more price sensitive than business or leisure travellers on network carriers. LCC ticket prices are relatively low, so additional charges related to CO2 emissions are likely to be more visible as a share of the ticket price and may have some impact on demand. However, ultra-low cost carriers, such as Ryanair, benefit from very low cost structures, geographical diversification and a high share of ancillary revenue, which should support their competitiveness.

Retrofits Encouraged in Buildings

Stricter construction standards are already leading to reduced emissions from new buildings. However, the package introduces a range of incentives for retrofits to encourage further improvements.

Energy-efficient retrofitting of buildings will become tax-deductible by 2020, reducing installation costs by up to 20%. The government will reimburse up to 40% of the costs of swapping oil-fired heating systems for more efficient ones. In addition, installations of new oil-fired heating systems will be banned from 2026, if more climate-friendly alternatives are available.

The plan proposed to hold public buildings to higher efficiency standards and require climate-friendly technology solutions if possible.

Production Optimisation to Drive Emissions Cuts in Industrial Sector

The package expects the industrial sector to shed about a quarter of emissions and generate a maximum of 143 million tonnes of CO2 by 2030. The focus will be on more efficient production methods to cut emissions, particularly for hard-to-tackle industrial processes, like the production of cement and steel. Many German industrial sectors are already affected by the EU ETS.

In steel, one of the options is wider use of electric arc furnaces instead of more polluting blast furnaces. However, this switch is time consuming and requires significant investments from steelmakers. So far the government's package outlines only streamlined support and counselling for companies, without any indication of financial commitments.

The government will also aim to increase the use of renewables in industrial production and reduce industrial heat waste by integrating industrial facilities into district heating systems.

Furthermore, industrials may be indirectly affected by the package due to changing demand patterns forced by new regulation. For example, due to new construction and retrofit requirements for buildings, demand for construction materials and systems is likely to shift toward more eco-friendly options. Similarly, changes in agricultural regulation may cause transition to fertilisers with less potential to release nitrous oxide emissions, which would affect chemical producers.

Farmers' Margins May Come under Pressure

The new measures may increase farming costs, which the sector may not be able to fully pass on to consumers due to pricing pressures from the retail sector and competition from farmers in other EU countries.

The package requires a reduction of over 10% in agricultural emissions in Germany by 2030 to 58 million-61 million tonnes of CO2 equivalent. The package introduces new regulations on the use of fertilisers aiming to reduce the levels of nitrogen, the cause of agriculture's high nitrous oxide emissions. Other measures to control nitrous oxide emissions outlined in the package include gas-tight liquid manure storages and low-emission spreading technology. There will also be increased support for organic farming.

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