PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL AMENDING DIRECTIVE 2003/87/EC TO ENHANCE COST-EFFECTIVE EMISSION REDUCTIONS AND LOW-CARBON INVESTMENTS

OPINION OF RWE

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VORWEG GEHEN

Amended ETS-directive provides needed long-term framework

The European Emission Trading System (EU ETS) is the central pillar of European climate policy. It has brought the included sectors on track of a reliable carbon reduction path so that EU's climate target for 2020 will be met. Therefore it is very disappointing that we have seen a tendency to implement additional national instruments (e.g. UK carbon floor price, Dutch coal tax, German "national climate instrument"), since these distort the market, undermine the price signal and reduce the efficiency of the ETS. A strengthening of the EU ETS is a considerable step to set a counterbalance – signaling Member States that the only meaningful approach to tackle climate change is a common European one – and to provide the market with a desired stable long-term framework for emission reductions.

The European Council has already taken the first important step by setting ambitious climate targets for 2030: Overall, the EU shall reach at least 40 % CO_2-reduction. And the ETS sectors have to deliver 43 % CO_2-reduction (compared to 2005) by the end of the next decade. The present proposal for an amended ETS-directive provides the necessary legal framework on how this target shall be achieved.

Following the adoption of the Market Stability Reserve, RWE welcomes this proposal as a further improvement of the EU ETS, as a positive signal to the market and as a contribution of the EU to COP 21 in Paris. We appreciate the opportunity to share our views on the proposal with the EU Commission and to deliver first input at an early stage of the legislative process.

One single instrument for emission reductions in all relevant sectors

The underlying idea of the ETS is cost-efficient emission reductions. While the overall reduction path is set in advance, realised reduction options are determined by a market mechanism ("cap and trade"). This approach works more efficiently the more emitters are covered by the ETS. RWE therefore highly appreciates the EU Commission's proposal which keeps one single ETS – for both the power sector and the industry – and establishes an overall balance between the different needs of both. Industry and utilities will work collaboratively to decisively reduce emissions and will jointly ensure meeting the ETS' goals. In the future, effectiveness and efficiency of the ETS and the European emission reduction efforts in general could be further improved if more sectors would be included.

Auctioning share should not fall short of 57%

We consider it positive that the share of free and auctioned allowances will be explicitly laid down in the next phase for the first time. This increases planning security for all emitting installations. In particular all companies which must cover their hedging needs by buying CO_2-

certificates still have access to allowances safeguarded in the auctioning rounds in the future. Nevertheless, we deem it useful to point out that a 57% auctioning share on average is less than the share at the end of the current trading period. Even if the shares of free allocation are equal in the third and fourth phase on average, the auctioning share is continuously ascending in the third phase to more than 60% in 2020. Thus, during the transition from 3rd to 4th phase free allocation is to some extent fluctuating, which amplifies uncertainty of decision making for the industry and may provide unstable incentives for emission reductions. In the long-term, it should be kept in mind that free allocation may interfere with efficient allocation of reduction measures barring the way to the lowest cost path to achieve the EU's targets.

Targeted carbon leakage protection by free allocation and financial compensation from auctioning revenues

Measures to mitigate carbon leakage are key, as long as no international agreement on climate action is in force which would to lead to at least similar cost burdens from emissions reductions for competitors in the leading economies of the world. Free allocation to compensate for direct carbon costs has been proven to be effective, even if some recipients seem to have been overprotected in the past whereas others had to cope with an insufficient protection. RWE therefore welcomes the intention of the EU Commission to revise the rules and to come to a more targeted approach. In contrast to dynamic or ex-post allocation, the present proposal represents a well-balanced compromise between protecting companies from undue costs and keeping incentives to pursue additional emission reductions. The carbon leakage rules ensure greater flexibility whilst ensuring certainty over the allocation of allowances is not undermined. However, we are concerned that – in contrast to the currently valid rules of the ETS directive, industries *not* endangered by carbon leakage are still qualified for free allocation (at least up to 30%) throughout the whole phase.

Free allocation is no remedy to deal with burdens induced by indirect carbon cost. We agree with the EU Commission's approach being that national governments should address this topic by using auctioning revenues for financial compensation of indirect carbon costs.

From an overall economic perspective, full auctioning is required to ensure that the transition to a low carbon economy is at the lowest cost to society. This would imply that an increasing proportion of emissions are covered by auctioned allowances, at least in the long-term. As a consequence, the costs of carbon leakage must then be met by means other than free allocation, which could include using some of the revenues from auctioned allowances.

Transparency still needs to be improved further

The proposal provides more clarity and predictability for all market participants, which is highly appreciated. A stable and reliable framework is decisive for the needed investments in emission reduction measures. Nevertheless, the EU Commission's proposal increases complexity of the

EU ETS at the same time – resulting in additional demand for information. It is for example unclear how new as well as revised funds and the Market Stability Reserve interact with one another. Uncertainty for market participants originates also from the fact that some parts of the future ETS design are not determined right now but shall be detailed in delegated acts. And it is still open how and to what extent allowances can be used to meet emission reduction goals in non-ETS sectors.

The EU Commission should provide as much clarity as possible to market participants. In particular, RWE would welcome clear and transparent rules regarding the timing and monetisation of allowances to be used for the Innovation Fund and the Modernisation Fund as soon as possible. And it would be helpful if the EU Commission could share further estimates on the impact of the future carbon leakage rules, e. g. the level and share industrial emissions likely to be covered by free allowances, or the estimated use of the cross sectoral correction factor.

Access to International allowances and credits should be considered

The proposal for an amended ETS directive is silent on the issue of access to international carbon allowances and credits. While the outcome of the COP 21 negotiations in Paris remains to be determined, the aspiration is for a strong binding international agreement which makes substantial progress towards achieving the 2 degree climate change target. Putting a global price on carbon, preferably through a market based instrument, will be a key element of any meaningful agreement. A considerable number of fledgling carbon emission trading schemes are emerging around the world and it will be important for the EU to be seen to recognize and support these if significant progress is to be achieved in Paris. This approach would include allowing access under the ETS to international allowances and credits. If designed in the right way, such a mechanism could mitigate the impacts of carbon leakage on EU competitiveness while EU climate targets remain more ambitious than those of other parties to any international agreement, and could facilitate the transition to a global carbon market.

Utilities to shoulder considerable share of the reduction efforts

Reform of the ETS-directive is a decisive and important step to bring the reduction path in line with the EU's long term climate objectives. The current proposal reflects the needs of both, the industry and utilities, and makes the EU ETS fit for its further tasks. The future framework for future emissions reduction investments becomes much more visible, even if additional information and more clarity regarding the planned changes is desirable. All in all, the proposal represents a balanced compromise in the light of stakeholders' very diverging interests, but – this has to be recognized – puts a considerable share of the burdens on utilities' shoulders. If amendments are considered, economic capability of the energy sector should be always kept in mind – especially, as its business models are currently challenged by the energy transition.

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Contact details

Corinna Grajetzky
+32 (0)2777 08 51
corinna.grajetzky@rwe.com

Jens Wiggershaus
+49 (0)201 12 15593
jens.wiggershaus@rwe.com

RWE AG

Opernplatz 1
45128 Essen

Germany

T +49(0)201-1200
I www.rwe.com