

## **An innovative approach: The German use of ETS revenues for national and international climate financing**

### **Introduction**

Especially after the failure of the Climate Conference in Copenhagen in December 2009 it has become an essential question, how an appropriate and predictable financing of climate-related issues can be ensured. Climate financing is a key issue within the framework of international climate negotiations and works as a crucial trust building element between industrialised and developing countries. The expectations are high: Developed countries committed in Cancun 2010 to jointly mobilise 100bn USD per year by 2020. Until that point, the amount should increase gradually. According to the AGF-report it will be “challenging but feasible” to meet this goal.<sup>1</sup>

It is estimated that about one third of the amount must be provided by the European Union per year by 2020 (coming from public and private sources). Therefore, in times of financial crisis, it is necessary to identify innovative finance sources to meet this share. The largest innovative finance source in the EU could be the revenue from the auction of emissions allowances under the EU Emission Trading System (ETS): By 2020 these auctions could potentially deliver revenues of more than 20bn Euro per year within the European Union.<sup>2</sup>

Germany is *currently* showing how the use of this innovative finance source can be shaped for national and international climate financing. In our point of view, the “German model” of earmarking the full ETS-revenues (including the revenues from the aviation sector) for climate-related issues - a meaningful part for international climate financing - constitutes a very sensible, appropriate and innovative approach, which could work as a precedent for other EU Member States. Finally, the ETS-revenues may become increasingly important as an innovative finance source, because from 2013 *at least half* of the total number of allowances within the European Union will be auctioned, and corresponding to the level of auctioning, more funds will be generated.<sup>3</sup> In this respect it would certainly be a step in the right direction within the European Union if these funds would be increasingly earmarked for climate financing (at the beginning one third and not later than 2020 50% for international climate financing).

### **The establishment of the “Special Energy and Climate Fund”**

In 2010, the German government established a separate budget structure, the so called ‘Special Energy and Climate Fund’, to finance national and international climate-related expenditures. Originally, it was supposed that approximately 20 percent of the new fund’s revenue should be provided by the nuclear power sector and 80 percent of the amount should be raised from the ‘auction revenues’ of the European Union Emission Trading Scheme (ETS revenues). In the course of the energy shift with nuclear power phase-out in 2011 the income concept of the new fund was revised in order to compensate the shortfall of revenue from the nuclear power sector.

After this revision, beginning 2012, the ETS auctioning revenues of the European Union Emission Trading Scheme will flow completely into the ‘Special Energy and Climate Fund’. The nearly<sup>4</sup> complete appropriation of the ETS revenues for climate-related purposes, in our view, can be considered as an important - although not sufficient<sup>5</sup>- step towards a reliable German contribution to international climate financing.

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<sup>1</sup> Report of the Secretary-General's High-level Advisory Group on Climate Change Financing ('AGF-Report'), 5 November 2010

<sup>2</sup> EU Commission Staff Working Document: Scaling up international climate finance after 2012. SEC(2011) 487 final (Brussels 8.4.2011) [http://ec.europa.eu/economy\\_finance/articles/financial\\_operations/pdf/sec\\_2011\\_487\\_final\\_en.pdf](http://ec.europa.eu/economy_finance/articles/financial_operations/pdf/sec_2011_487_final_en.pdf), page 4.

<sup>3</sup> European Commission, DG Climate Action, Emission Trading System, Auctioning, 3rd trading period (01/2011). See: [http://ec.europa.eu/clima/policies/ets/auctioning/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/auctioning/index_en.htm)

<sup>4</sup> Only the “German Emissions Trading Authority” will receive a small share of the ETS revenues (42.7mio.Euros).

<sup>5</sup> From the point of view of German NGOs (Bread of the World, WWF, Oxfam and Germanwatch) the German contribution for international climate financing should increase to 7 to 10bn Euros by 2020. Therefore it is necessary to identify more finance sources.

## The appropriation of the ETS revenues for climate-related purposes in Germany

In Germany, it is only permitted within the framework of a separate budget structure, the so called 'special fund' or 'extra-budgetary fund' (in German: 'Sondervermögen'), to appropriate revenues. This, of course, applies also for the ETS revenues. For that reason the establishment of the "Special Energy and Climate Fund" was a necessary step not only for *earmarking the ETS revenues*, but also for *bundling climate-related expenditures*.

The earmarking of the ETS revenues is a significant progress in German climate policy. The key reason for that is the pioneering financing mechanism of the "Special Energy and Climate Fund" which is based on the "polluter pays principle". The money generated by auctioning the "pollution rights" within the emission trading scheme is used appropriately– namely for climate-related issues. This can be considered as a very innovative approach because the use of the ETS revenues illustrates a way to fund the *transformational change* (which means, the move away from nuclear power and fossil fuels towards the promotion of renewable energies and energy efficiency). Furthermore: as ETS revenues are generated additionally, this financing mechanism works without burdening the national budget.

The implementation of this innovative financing mechanism in Germany – with the aid of a new budget structure - might be considered as a role model within the European Union. The German example sets a precedent, particularly considering that the Emission Trading Scheme Directive<sup>6</sup> recommends using *at least 50 percent* of the ETS revenues for national and international climate action. The German approach goes even further by using 100 percent of the ETS revenues for climate action.

### The ETS revenues: A reliable source of funding?

From the third emission trading period starting in 2013 the auctioning of allowances in the European Union will become the rule. For electricity production there will no longer be free allocation, only sectors with a high risk of carbon leakage will receive allowances for free. From 2013 *at least half* of the total number of allowances within the European Union will be auctioned.<sup>7</sup>

Corresponding to the rising level of auctioning of ETS allowances, the ETS revenues will increase, but not as significantly as expected a year ago. Due to the falling certificate price, the German government is expecting ETS- revenues of about 2.2 bn Euro in 2013 (on the basis of a certificate price of 10 Euro per t/CO<sub>2</sub>) . Last year the German government assumed, that the ETS-revenues for 2013 would be 1 bn. Euro more (on the basis of 17 Euro per t/CO<sub>2</sub>) . Against this background, for the 'Special Energy and Climate Fund' the German government assumes the following amounts of finance coming from the ETS revenues:

**Expected ETS revenues for the Energy and Climate Fund<sup>8</sup>**

2013	2014	2015	2016
<b>Mio. €</b>			
<b>2.18</b>	<b>2.4</b>	<b>2.5</b>	<b>2.6</b>
<b>10 €/tCO<sub>2</sub></b>	<b>11.2€/tCO<sub>2</sub></b>	<b>11.8 €/tCO<sub>2</sub></b>	<b>12.4 €/tCO<sub>2</sub></b>

<sup>6</sup> DIRECTIVE 2003/87/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC

<sup>7</sup> European Commission, DG Climate Action, Emission Trading System, Auctioning, 3rd trading period (01/2011). [http://ec.europa.eu/clima/policies/ets/auctioning/index\\_en.htm](http://ec.europa.eu/clima/policies/ets/auctioning/index_en.htm)

<sup>8</sup> Federal budget draft 2013, Federal Ministry of Finance, [http://www.bundesfinanzministerium.de/nm\\_3378/DE/Wirtschaft\\_und\\_Verwaltung/Finanz\\_und\\_Wirtschaftspolitik/Bundshaushalt/Bundshaushalt\\_2013/](http://www.bundesfinanzministerium.de/nm_3378/DE/Wirtschaft_und_Verwaltung/Finanz_und_Wirtschaftspolitik/Bundshaushalt/Bundshaushalt_2013/)

Certainly, there is no guarantee that even these expected amounts can be obtained. The revenue of the 'Special Energy and Climate Fund' solely depends on the development of the price of ETS certificates. If the certificate price is still decreasing there will be less money for the fund.

Nevertheless it is necessary to face up to the volatility risk regarding the certificate price. Many factors may have an impact on the development of the certificate price. And due to the new economic crisis within the EU new uncertainties arise. But above all, a binding European reduction target for greenhouse gas emissions is essential for the development of the certificate price. If the European reduction target for 2020 could be intensified to 30 percent (instead of 20 percent) it would not only be an import improvement for the climate and the international climate negotiations, but also a significant factor for stabilising the certificate price.

But apart from this, it would make sense to enlarge the possibilities of revenues for the 'Special Energy and Climate Fund' in general. Especially eligible are those financing instruments which refer to the "polluter pays principle".

## The allocation of funds for international climate financing

In the case that funding for the 'Special Energy and Climate Fund' is generated by an innovative finance mechanism based on the "polluter pays principle", it is important that the revenues are allocated properly. There is no doubt, that the national and international use of these revenues is coupled with high expectations regarding climate-relevance. Currently the national allocation side is being debated and criticised. One criticism, for example, arises because the German government is going to spend revenues to compensate companies with high energy consumption for higher energy prices - using competition arguments (expected to start 2014)..

There are certainly also high expectations concerning the international allocation of the fund. Approximately 15 percent of the revenues will be provided for international climate financing, starting 2013.<sup>9</sup> The amounts will be channelled through the Federal Ministry of Environment, Nature Conservation and Nuclear Safety (BMU) (45 percent) and through the Federal Ministry for Economic Cooperation and Development (BMZ) (55 percent). In close cooperation, both ministries have been developing plans for the allocation. The amounts will be spent as follows<sup>10</sup>:

- **23 %** for forest protection and biodiversity,
- **45 %** enhancement of exiting climate-related activities (BMZ focuses on adaptation; BMU e.g. enhances the International Climate Initiative),
- **32 %** for a new instrument: the German climate technology initiative (German: "Deutsche Klimatechnologieinitiative" - DKTI)

Especially noteworthy is the last mentioned climate-related instrument: the German climate technology initiative (DKTI), which has been developed by the German implementation agencies KfW and GIZ. The DKTI is pursuing the following aims:

- Promote technology cooperation for mitigation
- Create basic conditions for international markets, remove investment entry barriers
- Provide bilateral financing channels for Nationally Appropriate Mitigation Actions (NAMAs)/ transformation programmes and activities of international technology cooperation

The concept of the DKTI intends to merge science and private sector more strongly than previous instruments of the development co-operation. For that reason as well, the DKTI has got the potential to become an important and effective instrument of German climate financing.

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<sup>9</sup> However, it's worth mentioning, a portion of the money has been blocked by the budget committee.

<sup>10</sup> Budget Committee, German Bundestag - Committee Bulletin (Ausschussdrucksache) 3081, 17. Legislative periode.

## Conclusion

The earmarking of the ETS revenues for climate-related issues in Germany can be considered as a significant progress for climate financing, even though these efforts are not sufficient and it can only be *one important* component of a coherent strategy for international climate financing.

The specific advantages of this approach are the following:

- One main advantage regarding the establishment of the “Special Energy and Climate Fund” is first of all **the signal effect** for the international climate negotiations. As mentioned above, climate financing has become a **crucial source for transformative climate action and a central trust building element** between industrialised and developing countries. The ETS revenues are a finance source with a certain measure of predictability. In terms of **predictability**, the *earmarking of the ETS revenues and bundling of climate-related expenditures* is a very significant factor.
- Predictability is closely related to the **transparency** aspect. As long as there is no global system for measuring, reporting and verification (MRV)<sup>11</sup> of international climate finance it is important for the further progress in this regard to have forerunners, who show possibilities for how transparency can be guaranteed. The establishment of the “Special Energy and Climate Fund” is comparatively transparent for the international community regarding the identification of amounts of revenue which are provided for international climate financing (compared to the general budget plans with climate-related expenditures).
- Apart from the above mentioned factors (whose importance are especially given within the international context), the ETS revenues are particularly an innovative finance source, because this finance mechanism works on the basis of the “**polluter pays principle**” – therewith constituting a very innovative and pioneering approach. This sets the right incentive structure and it leads to self-financing climate regime. Other innovative financing mechanisms should be identified and used for international climate financing not only in the EU, (e.g. like “bunkers” - the revenues from a levy or ETS on bunker fuels of the international aviation and maritime sectors).

Within the European Union the establishment of the “Special Energy and Climate Fund” in Germany could work as a role model for other member states. Already at the beginning of the third emission trading period (2013) the auctioning money will increase, and then (2013 to 2020) the level of auctioning will increase in a linear manner with a view to reaching 100 percent. Corresponding to the auctioning level, the ETS-revenues will substantially rise, which means the generated revenue is available additionally in the European Union.

Given that about one third of pledged amount of 100bn USD for international climate financing must be provided by the European Union by 2020 per year (coming from public and private sources), it seems to be necessary to establish appropriate budget structures for implementing innovative finance mechanisms. Starting with earmarking of ETS-revenues for climate-related issues could be an important step in the right direction – but in the long run other innovative finance sources must follow (like a global pricing scheme for the shipping and aviation sector). However, in this regard also Germany has to improve its efforts; one innovative approach is not enough.

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<sup>11</sup> On this topic, see also Griefhaber, Linde, 2011a: Transparenz in der internationalen Klimafinanzierung, Stand der Diskussion und Anforderungen an einen MRV-Mechanismus, Germanwatch (Edit.), , Griefhaber, Linde, 2011b: Reporting on the Use of Auctioning Revenues of the EU Emissions Trading Scheme, Suggestions on Reporting Requirements with a Focus on those Potentially Used for International Climate Finance. Germanwatch (Edit.),