

The European Union Emissions Trading System (EU-ETS)

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The European Union Emissions Trading System (commonly referred to as the EU-ETS) has been in effect since 2005 and has emerged as a major issue and concern for U.S. airlines and private, long-range aircraft operators. It is many operators' first experience with a "cap and trade" tax system, and it is creating international tension by imposing fees on aircraft operations outside the borders of the EU.

How Does the EU-ETS Work?

The EU-ETS is, at its core, an effort to incentivize carbon emitters to reduce their greenhouse gas emission levels by capping the level of carbon that may be emitted without penalty and allowing more efficient emitters to trade (sell) excess allowances. The system allows a carbon emitter a baseline allowance of carbon emissions (free allocation), above which it may purchase carbon credits (measured in tons) to make up the difference.

If a participant emits less than its allowance, it can "bank" its balance or sell (trade) its unused credits to the other emitters who need more credits. Conversely, if an emitter exceeds its "cap," it must buy credits. Thus the name "cap and trade." You are provided a cap of permissible activity and are allowed to trade excess credits. The macro intent is to reduce emissions on an industry-wide basis by allowing industry participants to become more efficient at their own rates, with appropriate costs and rewards for doing so.

Starting January 1, 2012, overall CO₂ emissions of the aviation industry are capped, initially at 97% of 2005 emissions levels, and from 2013 onward at 95% of 2005 levels. Given that aviation-related emissions are expected to increase by 130% from 2005 to 2012, only about 60% of the allowances the sector needs will be issued for "free" in 2012. The costs associated with the 40% difference will almost certainly be spread unevenly, given the very different emission levels of different aircraft.

The EU-ETS was expected to create an active market in carbon credits. Rolled out in Europe in 2005, the system stumbled, with accusations of unjustified windfall profits and a huge scandal in the credit trading markets. Beginning in 2013 the trading exchange (where all credits will change hands) will be consolidated so that credits will trade via a single exchange, rather than multiple EU national exchanges. Ironically, in its earliest iteration, carbon credits were issued based on a polluter's history of emissions and as a result the

largest polluters received the most credits, and were in some cases able to enjoy windfall profits based on carbon reduction efforts that were already in process, or that were the result of economic struggles.

The policy goal of the EU-ETS is to gradually reduce carbon emissions by reducing the allocation of credits on an industry and national scale. Emitters who were ahead of the curve have the financial benefit of being able to sell their credits. An emitter is given a number of “free” credits, which is usually a modest percentage of the emitter's historic emissions. Once up and running, the system allows administrators to tweak the cap to incentivize lower emissions (or generate more revenue).

What Kinds of Flights Are Affected?

EU-ETS covers passenger and cargo flights operated by EU and non-EU airlines that arrive at or originate from an airfield in the EU and non-EU members Iceland and Norway. It also applies to the last leg of international flights between EU and non-EU airports. The amount of carbon subject to the EU-ETS is based on the entire distance of the flight, not just the portion of the flight over EU territory.

Why Is It a Major Issue for Aviation Now?

Since 2005, the EU-ETS has applied to major carbon emitters—power stations and other combustion plants, oil refineries, coke ovens and iron and steel plants operating within EU nations. The allocations initially provided to major emitters were determined on a nation-by-nation and industry-by-industry basis. Obviously, this had no impact on most U.S.-based interests, including airlines. The EU-ETS intruded on aircraft operations beginning in 2009—although until 2012, operators were just gathering data and preparing mandated “plans” to govern their future compliance. Beginning January 1, 2012, however, aircraft operations became subject to EU-ETS compliance. Mechanically, compliance requires the annual surrender of carbon credits in an amount to cover an operator's emissions from the year before. An operator reports to one of the EU member countries that is “assigned” to the operator. For operators with a European operating license, this will be the member state that granted the operating license. Otherwise, the assigned nation is determined by frequency of prior operations. While the EU-ETS is largely consistent from country to country, each administering country has adopted its own governance and enforcement mechanism.

Most importantly, as noted above, the aircraft operations that are subject to EU-ETS compliance include the entirety of any aircraft operation originating or terminating in an EU nation. As such, an aircraft leaving Boston, Chicago or Houston is “consuming” credit allowances from the moment it leaves its U.S. point of origin, until the moment it arrives in Heathrow, U.K.

The EU-ETS provides several options for compliance and several exceptions to its coverage. For example, flights can be exempted from the EU-ETS if the EU recognizes that the country of origin is taking measures to limit aviation emissions from departing flights. Flights involving very small aircraft (with a MTOW of 5700 kg (app. 12,750 pounds) or less) are also exempted from the scheme.

Failing to comply with the EU-ETS requirements can result in penalties of €100 per missing allowance (i.e., €100 per ton of carbon), in addition to having to make up the difference in the following year. Ultimately, an operator that fails to comply can be banned from operating in the EU.

What Is the Status of Efforts to Oppose EU-ETS?

Application of EU-ETS to the aviation sector has been hotly opposed in the United States and many other countries. China and Brazil, for example, have ordered their airlines not to participate in the program. In the United States, both the Secretary of State and the Secretary of Transportation have condemned the scheme. Legislation has been introduced in both the House and the Senate that would prohibit U.S. operators from complying with the EU-ETS or authorize the Secretary of Transportation to prohibit compliance under specific circumstances. Dozens of U.S. industry groups have voiced strong opposition to what is widely seen as a discriminatory system that could cost U.S. carriers and operatives billions of dollars. Some critics point out that the payments made under the EU-ETS may not be applied to greenhouse gas reductions efforts, undermining the argument that this expense will be for the good of the planet as a whole.

Apart from political opposition, an effort also was made to challenge the EU-ETS in the European Court of Justice (ECJ). This effort was not successful, because the ECJ determined that it did not have jurisdiction over a directive issued by the EU and not by one or more individual members (even if the members are responsible for administering the program).

Opponents strongly object to the EU-ETS's coverage of an entire flight, regardless of origination, which disproportionately affects longer flights such as those from the United States. Additionally, opponents argue that the EU was wrong to act unilaterally and that efforts to address aviation-related emissions reductions should take place in the multilateral setting of the UN's International Civil Aviation Organization (ICAO). To date, these protestations have not swayed the EU, which points to its obligations under the Kyoto Agreement and the lack of progress in ICAO despite years of effort.

The EU maintains that the EU-ETS scheme is wholly consistent with international law and the Chicago Treaty. Whether this is true, however, is not entirely clear. International law provides several options to formally challenge the EU-ETS. Chief among them are ICAO's dispute resolution provisions set forth in the Chicago Convention. One or more challenges also appear possible before the World Trade Organization (WTO), under the General Agreement on Trade and Tariffs and the General Agreement on Trade in Services. Both of these agreements contain provisions that may be violated by the EU-ETS.

Thus far, opponents have not challenged the EU-ETS before ICAO or the WTO. The reluctance to proceed before ICAO may reflect a desire to avoid interfering with work to create a comprehensive alternative to EU-ETS, which the EU has indicated would set the stage for EU-ETS to be withdrawn as to the aviation sector. (It bears noting that after years of languishing efforts, as compliance with EU-ETS drew closer, efforts before ICAO have intensified and appear to be showing progress.) Similarly, the apparent reluctance to challenge the ETS before the WTO likely reflects a desire to avoid undermining the authority of ICAO.

As the end of 2012 draws near, aircraft operators are facing the prospect of making their first “payment” for emissions credits under EU-ETS. In the United States, the legislative landscape remains active, as elected officials condemn the ETS and seek to advance bills prohibiting compliance. With several countries such as Russia and China instructing their carriers not to comply, and multiple countries considering other options to respond to the EU-ETS, it appears likely that the EU will be required to deal with fundamental challenges early on. Regardless, as these international intrigues play out, carriers and operators in the United States and other countries will continue to be required to comply with the ETS system.