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'Competitive distortions, carbon emissions efficiencies, or the green ultimatum?'*

Abstract

The transatlantic air transport sector is experiencing a unique double entente: the freeing up of markets under the Open Skies Agreement and the increasing environmental onus on airlines under 'green' tax and emissions trading scheme initiatives. On the balance of benefits and burdens under the likely inclusion of airlines in the EU Emissions Trading Scheme, as influenced by the Kyoto Protocol, the system European system appears to be the best suited to achieve efficient reductions in carbon emissions, whilst establishing a framework for future *transatlantic* carbon allowance trading.

Background

The transatlantic air transport sector has been transformed in a number of aspects over the past year, particularly evident in the opening of the transatlantic market alongside the attention of regulators focussing on the industry's environmental costs.

The Open Skies Agreement came into force in late-March of this year, sparking the biggest industry shake-up in 30 years. Under the first phase of the working agreement, previous limits imposed on flights between specific EU and US airports through bilateral agreements have been lifted. Any airline that is registered in the EU or US may now fly to any airport within the other's borders, subject to the availability of takeoff and landing slots on both ends of the proposed route. If insufficient progress is made toward the second phase of the agreement, by 2010, these 'open' flights may be limited or suspended from 2012.

Parallel to the opening of the transatlantic airspace is the issue of climate change through greenhouse gases emitted by commercial aircraft. In the air transport sector, carbon dioxide is discharged during fuel burn. The UN Framework Convention on Climate Change took place in Kyoto, Japan in 1987, resulting in the 'Kyoto Protocol'. In short, parties have agreed to reduce their national carbon emissions by five percent from 1990-levels by 2012. It should be noted that the US have not endorsed the Kyoto Protocol.

In the absence of a global system for greenhouse gas emissions reduction, such as a regulatory levy or market-based trading scheme, some states who are signatories to the Kyoto Protocol are initiating their own National Allocation Plans (NAPs).[1] The NAPs do not set

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[1] Article 9, EC Directive 2003/87

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new targets on emissions, but create a system of 'carbon credit' registration at the national-level.[2]

With a view of reducing carbon emissions in the EU, the European Commission is working to include all airlines which fly into and out of the EU, including US airlines, in its Emissions Trading Scheme (ETS) from 2012. Under Article 25, EC Directive 2003/87[3], flights from third countries arriving in the EU will only be exempt from the ETS if there are comparable provisions in that third country for emissions reduction. All intra-EU flights, irrespective of flag, will be subject to the EU ETS from 2011. The EU ETS provides a *de minimis* exemption for airlines operating fewer than 243 flights per designated period, helping third countries which may carry the 'lesser developed' designation and those with weaker connections to the EU.

The common position to include aviation in the EU ETS was adopted by ministers on 18 April 2008, with the first positive vote on 27 May 2008. It is estimated that the full House should take a vote on 7 July 2008.

The issue

US commercial airlines, supported by various agencies of the US Government, refuse to join the EU ETS and have made little progress implementing a scheme that includes airlines.

The US argues that the EU's imposition of the ETS on US carriers violates the Open Skies Agreement. The US Federal Aviation Administration (FAA) dislikes the unilateralism of the EU ETS, but has petitioned for the US Environmental Protection Agency (EPA) to invent a similar scheme. The US currently has a system of regulatory controls on sulphur dioxide emissions in electric utilities, and restrictions on the type of equipment used on aircraft engines to limit carbon dioxide emissions. Marketable emission permits have been in place in the US since the 1970s, for aircraft noise.

Arguments against ETS

Environment-related levies are another option. In the UK, the Treasury claims that since the aviation industry is not meeting its environmental costs, the UK Air Passenger Duty (APD), a government-imposed, environmental tax, should be imposed. The UK APD doubled in February 2007, to £10 for short-haul economy class, £40 for long-haul economy class, and the double for first/business fares.

The Netherlands has levied various environmental taxes since 1988, including on utilities such as electricity, coal and natural gas. From this year, carbon emissions from commercial aircraft are also taxed, EUR 11.50 for flights within the EU and EUR 45 on flights departing the Netherlands for international destinations.

[2] As set out in EC Decision 2002/358
[3] 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

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According to the International Air Transport Association (IATA), some 170 affected countries oppose the EU ETS. Giovanni Bisignani, IATA's chief executive, argues that regional solutions like ETS will not work, due to the global nature of the industry. He intimates that a global solution is needed. As the reduction of carbon emissions is a global goal, it seems clear that the solution must be a one that functions cross-border. Otherwise industries and consumers may chose to move to or fly from another country where there is no regulatory structure in place. From an international perspective, an environmental tax would appear to be easier to implement and enforce than the cap-and-trade system.

There also exists the risk that the amount of marketable rights, on distribution, are not necessarily set by the market, but by governments. The NAPs in the EU are clearly linked to the quotas established by the 1990-emission levels in the Kyoto Protocol. However, there is a risk that the allocation of the allowances in some jurisdictions may be influenced by political rather than economic models and motives.

It may be argued, however, that environmental taxes are nothing more than a licence to pollute. It is not entirely clear where the collected taxes go, whether to anti-pollution initiatives or the national treasury toward general government spending. Furthermore, Article 15, Chicago Convention on International Civil Aviation 1944, states, "No fees, due or other charges shall be imposed by any contracting State in respect of the right of transit over or entry into or exit from its territory of any aircraft of a contracting State or persons or property thereon." Therefore, any environmental tax imposed by (signatory) governments appears *inter alia* to be in breach of the Convention and International Civil Aviation Organisation (ICAO) resolutions. So, ICAO vis-à-vis the Chicago Convention, opposes a government-imposed tax of this type, but it is unclear what it suggests. Secretary of State for Transport, Ruth Kelly, blames ICAO, for failing to set up a global emissions scheme for airlines.

It should be borne in mind that many of the air transport sectors' emissions occur in international airspace. If there is to be consideration for a global approach, ICAO, as the UN body overseeing global civil aviation, would likely be the most effective global framework. The ICAO is due to hold a workshop on the subject from 18-19 June 2008.

Arguments for ETS

According to basic economics, governments create a certain number of saleable rights to engage in some undesirable conduct, in this case carbon dioxide pollution. This system is sometimes referred to as the 'cap-and-trade' approach. These marketable rights are a type of substitute for regulation, based on market principles, rather than through taxes as a licence to pollute, based on rules. The ETS creates a market system of nationally allocated rights across the EU based on the proportion of industry in each member state, which may be bought and sold. The EU ETS is an open trading scheme, with 'carbon credits' traded freely on the market, irrespective of industry. Under each NAP, individual emissions quotas are set, encouraging each entity to choose the least costly option to meet their respective quota.

Economic theory thus suggests that buyers and sellers in an emissions trading market capped by (Kyoto) quotas are likely to encounter a 'win-win' situation. Buyers of carbon credits are

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better able to meet their emissions obligations at a lower cost, whilst sellers who take additional steps to reduce their own emissions may profit from the sale of their excess allowances.

Proponents of the 'cap-and-trade' approach argue that a regulatory system such as imposing an environmental tax on carbon leaves too many unknowns. Under a tax system, for instance, the amount of pollution is unknown in advance. A tax is imposed on carbon at the top end of the supply chain, subsequently passed to the final consumer to discourage the activity (i.e. purchasing petrol, travelling by air, burning coal for heat). Under a market-based system, the amount of pollution is known, but the price of pollution is unknown, as it is determined by the amount of supply and demand on the market.

Not surprisingly, the market-based approach wins the support of airlines. Environmental taxes threaten to price passengers out of the market, by increasing the cost of each passenger's air ticket. The EU ETS would not price passengers out of the market, but encourage individual airlines to take necessary steps to reduce emissions, the cost of which could be passed to consumers but within a more reasonably estimated margin, as determined by the airline, but ultimately, the market.

ETS cross-border and beyond

The Chicago Climate Exchange (CCX) launched in 2003 as the world's first and North America's only self-regulatory trading system to reduce emissions of six major greenhouse gasses. CCX is the only operational cap-and-trade greenhouse gas system in the US. In 2005, CCX launched the European Climate Exchange (ECX), which is a similar pan-European exchange platform. The CCX was principal in setting up the first sulphur dioxide allowance trade recorded. An ECX member, Baxter Pharmaceuticals, was the first member to transfer carbon allowances (100 metric tons) from the EU ETS to its US CCX registry account. Baxter transferred the credits it earned through conservation efforts in Ireland and apply them to its efforts in North America.

Looking forward, the Montreal Climate Exchange (MCeX) is due to begin trading of futures contracts on Canadian carbon dioxide from end-May 2008, subject to regulatory approval.

It appears that the international trade of carbon allowances is possible. Perhaps the main hindrance to full cooperation is the issue of how quotas will be determined, whether by individual states or the Kyoto Protocol, and whether influenced by politics or economics. The cap-and-trade system is in place in the US, so the onus is shifted to the FAA and EPA to subject the US air transport sector to it and reduce carbon emissions at home, or leave impacted US carriers to be liable under the EU ETS. If the US includes aviation in its carbon emissions scheme, the EU will exempt the US carriers from the EU ETS.

The European approach to including the aviation sector and presuming its exterritorial effect of the ETS seems reasonable. Without a common system in place to reduce carbon emissions, on a cross-border basis, competition on the affected markets will be distorted, as air ticket prices otherwise will undoubtedly be higher in EU countries. This might be viewed as

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punishing EU airlines for improving the negative impact of carbon on the environment, whilst albeit indirectly, US airlines are incentivised to do nothing. This is clearly not the aim of the Kyoto Protocol, or the general green initiative.

One thing is certain, the US must move relatively quickly. With the EU's review of the efficiency of the Open Skies Agreement soon expected, and given the US's recent rebuttal of the EU ETS, it is likely that no action taken toward reducing carbon emission by the US industry and government will mean serious implications on the attempted opening of the transatlantic market, and both the EU and US air transport sector. This leaves the US industry and government with the green ultimatum.