

Insight: Asset Finance

March 2013

High Hopes for Regulating International Aviation Emissions

*"Application of the [EU] emissions trading scheme to aviation infringes neither the principles of customary international law at issue nor the Open Skies Agreement."*¹

This was the judgment of the European Court of Justice ("**ECJ**") in December 2012, in response to the landmark case brought by certain US airlines, the Air Transport Association of America (now, A4A) and the International Air Transport Association ("**Applicants**").² The Applicants challenged the validity of applying the European Union ("**EU**") Emissions Trading Scheme ("**EU ETS**") to non-EU airlines and aircraft.³ Starting on 1 January 2013, all flights into, out of, or within the EU would be required to comply with emissions monitoring and reporting obligations. Starting on 1 April 2013 those aircraft operators or owners⁴ covered by the EU ETS must surrender their allocated carbon emissions allowances (and potentially buy credits if they exceed their allocated allowances).⁵ Non-compliance with the EU ETS will result in penalties, including the ability of the designated regulators in Member States to detain and dispose of aircraft for continued non-payment of fines (similar to the approach taken with Eurocontrol charges).⁶

As expected, the decision was not easily swallowed by the Applicants. No sooner had the ECJ ink dried, did the US propose its own decision – to craft a bill to protect its airline industry from the long arm of the EU law⁷ and, quite significantly, encourage US airlines to defy EU law by prohibiting operators of US civil aircraft from participating in the EU ETS.

The US government stressed its commitment to reducing carbon emissions from civil aviation, and agreed that the right approach would be through a global solution under the United Nations International Civil Aviation Organisation (ICAO).⁸ To emphasise that the EU approach was misguided, the bill implicated the EU by stating that

*"The European Union's action undermines ongoing efforts at the International Civil Aviation Organization to develop a unified, worldwide approach to reducing aircraft greenhouse gas emissions and has generated unnecessary friction within the international civil aviation community as it endeavors to reduce such emissions."*⁹

Other countries threatened legal action against the EU ETS and, in the case of India and China, have gone so far as to pass legislation requiring their airlines not to comply with the EU ETS.

For the EU, in the wake of this threatened breach of their laws and the seeming openness to a broader solution for aviation emissions, a new tack had to be taken. The European Commission started sending out sound bites on the need for a global agreement to effectively tackle aviation emissions. At the beginning of November 2012, as a "gesture of



Tallat Hussain Environmental Counsel, London

+ 44 20 7532 2376
thussain@whitecase.com

Adrian Beasley Partner, London

+ 44 20 7532 2312
abeasley@whitecase.com

goodwill in support of an international solution” the EU proposed to “stop the clock” on international compliance with the EU ETS aviation provisions, to allow more time for the ICAO to develop a “global market-based approach to regulating greenhouse gases from aviation.”¹⁰ The EU solution was to allow a derogation from Article 16 of the EU ETS Aviation Directive (“**Derogation Decision**”)¹¹, which requires (i) Member States to establish the rules on penalties for infringement of the national legislation on aviation emissions, and (ii) publication of the names of operators who are in breach of requirements to surrender allowances correlating to their actual emissions, as well as a fine of €100 per tonne of CO₂.

The Derogation Decision states:

“Member States shall take no action against aircraft operators in respect of requirements set out in Article 12(2a) and Article 14(3) of Directive 2003/87/EC arising before 1 January 2014 in respect of activity to or from aerodromes in countries outside the European Union that are not members of EFTA, dependencies and territories of EEA Member States or countries having signed a Treaty of Accession with the Union, where such aircraft operators have not been issued free allocations for such activity in respect of 2012 or, if they have been issued such allowances, have returned a corresponding number of allowances to Member States for cancellation.”¹²

This moratorium on enforcement of the EU ETS applies to all flights coming from or going outside of the EU that land in or take off from Europe. It will be effective for one year, until after the ICAO General Assembly meeting in Autumn 2013. However, the EU ETS legislation will continue to apply to all flights within and between the European countries covered by the EU ETS.¹³

On cue, on 27 November 2012, the proposed US bill (aptly named the “European Union Emissions Trading Scheme Prohibition Act of 2011”) became law.¹⁴ Under the new US law, the Transportation Secretary would be allowed

to prohibit compliance by US airlines with the EU ETS, if it is considered to be “in the public interest.” That is, by taking into account:

- (i) economic, energy and environmental security considerations;
- (ii) the impact of non-compliance on US consumers, carriers and aircraft operators; and
- (iii) the effect on US foreign relations, including international commitments.¹⁵

The Transportation Secretary would not need to dig very deep to reach such a conclusion. After establishing the need for a prohibition, the Transportation Secretary would be required to hold a public hearing at least 30 days before imposing any prohibition. Interestingly, the US legislation moved forward despite the moratorium on compliance with EU ETS requirements for non-EU flights. With the moratorium in place, there should be no need to invoke this provision; however, it was noted by US lawmakers that the “overreach” of the EU “still warranted the move.” The new legislation states quite clearly that revision of the EU Aviation Directive would be sufficient to revisit the need for a US prohibition on compliance.¹⁶ But the EU wants an international agreement which will:

1. deliver aviation emissions reductions at least as much as the EU;
2. be non-discriminatory for all airlines; and
3. contain targets and measures for ICAO member countries.¹⁷

The European Commissioner for Climate Action, Connie Hedegaard, has made it clear that if the 2013 ICAO General Assembly fails to make the necessary progress, the EU ETS legislation would be applied in full to all flights to and from non-European countries from 1 January 2014 onwards.¹⁸ On 26 February 2013, the European Parliament accepted the proposal to temporarily suspend the EU ETS for intercontinental flights in order to promote a solution through the ICAO.

In addition to prescribing that the exception for intercontinental flights should apply for a maximum of one year, the European Parliament clarified that this could be extended if “clear and sufficient progress” is made by the ICAO for a global system with a realistic timetable for its application.¹⁹

In the light of the timing and levels of uncertainty relating to the Derogation Decision, the UK, which was the first Member State to start incorporating the EU ETS Aviation Directive into national legislation, took an early stand.²⁰ The Department of Energy and Climate Change declared at the end of December 2012 that the “Government will defer a decision on whether to include international aviation [and shipping] emissions in carbon budgets until the setting of the fifth carbon budget in 2016, by which point there should be more clarity on how aviation emissions will be tackled at an EU and global level!”²¹

Although technically compliance with the reporting requirements is not required throughout the moratorium, the exempted non-EU airlines have the option to continue to monitor and report their emissions. This raises some practical issues for aircraft operators to consider. If exempted airlines do not report emissions during the moratorium period, there will be a cost (both in time and resources) to ramping up for compliance in 2014 when the EU ETS would be applicable again. If exempted airlines do continue to comply with their monitoring and reporting requirements, either as part of their corporate policies or for reputational reasons, the cost (both in time and resources) might not be justifiable if the Aviation Directive ceases to remain in existence or if an international agreement comes into effect that has different requirements. If the costs are passed down to consumers, there may be impacts on competitiveness. Another complication to consider is whether continued compliance is even optional for some aircraft operators. Since inter-EU flights remain covered by the EU ETS, the emissions from those portions of flights must still be monitored and reported. Surely excluding information for

one flight by an aircraft and including information for another flight by the same aircraft will pose administrative requirements that are disproportionately burdensome and make the Derogation Decision impractical.

The new US legislation does go further than merely countering the EU law. It contains provisions for facilitating a global solution through the ICAO including instructing the Transportation Secretary, the Administrator of the Federal Aviation Administration and other "appropriate officials" of the US government to "use their clout to engage in international negotiations aimed at establishing a global mechanism to address aircraft emissions – including the environmental impacts."

On paper, this is encouraging indeed. The potential scope of US engagement on aviation emissions is as broad as the language of the provision. It potentially opens the door to innovation (and innovative funding using market-based mechanisms) to address aviation emissions (e.g., clean fuel technologies, more efficient aircraft and lighter materials). Inadvertently perhaps, the EU and US may have turned this into an opportunity to apply a sector-based approach to emissions reductions on a global scale.

Engaging the UN countries (through the ICAO membership) means that negotiating an aviation industry solution can be left to those who understand the business of aviation, its impacts and what it needs to progress in the future. For example, a

sector-based cap and trade programme designed specifically for the aviation industry, taking into account the practical and commercial nuances spanning the industry and amongst various ICAO party countries, could result in the creation of a well-developed and implementable global system. This would achieve something the Kyoto Protocol's "one size fits all" approach has not been able to achieve – effectively not being able to fully address the EU priorities, the needs of the aviation industry and the complexities of accounting for emissions that are "deposited" around the world.

But delivering up what the EU wants and balancing it against the needs of the aviation industry and the policies of sovereign nations around the world is no small task. The ICAO member countries include the same countries that are party to the Kyoto Protocol, many at different stages of development with differing perceptions of their contributions to climate change (including through transportation) and none with the policy drivers or ability to deliver the same level of aviation emissions reductions as the EU.²²

The obvious question arises as to what then happens if the ICAO cannot close the deal. In the past 15 years a global agreement on aircraft emissions has not been reached (despite being lead by an international organisation such as the ICAO and despite recognition in the Aviation Directive that a global solution is required).²³ The EU has admitted that the negotiations have "been tough" in the past

(although progress on market-based solutions is being made). The Kyoto Protocol has only nominally been extended past the first phase and no internationally agreed carbon emissions reduction and trading system looks likely within this decade, although a 2015 deadline has been set for negotiating the successor to the Kyoto Protocol.

So if the EU ETS will re-apply in full to the aviation industry effective January 2014, what message will that send to those participating in the development of a draft international agreement? Will the US, China, India and other countries continue to flout EU law and test the enforcement mechanisms (such as the power of Member States to ground and dispose of aircraft for continued non-payment of fines for non-compliance)? As other countries join in the battle against the EU, will continuing the application of the EU ETS to EU airlines cause EU airlines to be at such a competitive disadvantage that the whole application of the EU ETS to aviation emissions is threatened?

The ICAO parties should recognise this opportunity to find an industry-based approach which in turn could provide a positive example to other industries grappling with similar carbon-reduction issues.

Endnotes:

- 1 Premised on the concept of open skies (the liberalisation of the international aviation industry), the purpose of the 2007 EU/US Open Skies Agreement is to promote and increase international air transport, open access to the global aviation market and facilitate competitive pricing, as well as encouraging environmental and consumer protection in the industry. The full text of the Agreement can be found at <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:134:0004:0041:EN:PDF>.
- 2 *Air Transport Association of America, American Airlines Inc., Continental Airlines Inc., United Airlines Inc. v Secretary of State for Energy and Climate Change (Case C-366/10)*, addressing the challenge to the inclusion into the EU ETS of non-EU airlines and flights, on the basis that it breaches the Chicago Convention and international law through the extra-territorial reach of the EU ETS. This has significant cost consequences for compliance (considered by some as a distorting "tax") and has an opportunity cost of technological and infrastructure improvements that could make a greater contribution to aviation emissions reductions. The full text of the decision can be found at <http://curia.europa.eu/juris/document>
- 3 See *Directive 2008/101/EC of the European Parliament and of the Council of 19 November 2008 amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community* (also known as the EU ETS Aviation Directive) at http://ec.europa.eu/clima/policies/ets/documentation_en.htm
- 4 Defined in Part 3, Section 1 of the *UK Greenhouse Gas Emissions Trading Scheme Regulations 2012* as a person carrying on aviation activities and in the case of a UK administered operator means "(subject to regulations 22 to 25) a person who is (a) identified in the Commission list, and (b) specified in that list as an aircraft operator to be administered by the United Kingdom". See <http://www.legislation.gov.uk/ukxi/2012/3038/part/3/made>
- 5 The penalty for failure to surrender allowances is €100 per tonne of carbon emissions in excess of the allocated amount given to the covered operator.
- 6 For example, under the UK Regulation, the regulator has the authority to detain a regulated aircraft for continued non-payment for over 6 months of a civil penalty (such as for non-compliance with an emissions monitoring plan, not paying the fine of €100 per tonne of carbon dioxide equivalent for the volume of allowances exceeding the operator's allocation) or where there is an EU operating ban under Article 16(10) of the EU ETS Directive. See *UK Greenhouse Gas Emissions Trading Scheme Regulations 2012*, Part 5. Instead of challenging the ECJ Decision, the US government (on behalf of its airline industry) decided to use the legislative powers it has available to it. See 3 Chapter 5, Section 39(1) at <http://www.legislation.gov.uk/ukxi/2012/3038/part/5/made>
- 7 S.1956 introduced to the 1st Session of the 112th Congress by Mr. Thune on 7 December 2011, as *A Bill to prohibit operators of civil aircraft of the United States from participating in the European Union's emissions trading scheme, and for other purposes*, cited as the "European Union Emissions Trading Scheme Prohibition Act of 2011". See <http://www.gpo.gov/fdsys/pkg/BILLS-112s1956enr/pdf/BILLS-112s1956enr.pdf>.
- 8 *Ibid*, Section 2 para. 5
- 9 *Ibid*, para. 4
- 10 See EU commentary on "'Stopping the clock' to allow more time for a global solution", at http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm
- 11 *Proposal for a Decision of the European Parliament and European Council derogating temporarily from Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowance trading within the Community* at p.1. See the full text of the decision at http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm On April 15, ICAO plenary meetings are scheduled to commence....
- 12 Decisions under EU law are directly applicable to Member States and become effective without the need to be transposed into national legislation. Article 1 of the EU ETS Derogation Decision at http://ec.europa.eu/clima/policies/transport/aviation/docs/com_2012_697_en.pdf.
- 13 According to the EU Derogation Decision, "The Directive continues to apply in full in respect of flights between aerodromes in the EU and closely connected areas with a shared commitment to tackle climate change. Consequently, all aircraft operators which have performed aviation activities falling within the Directive between such aerodromes in 2011 and in 2012 are required to comply with monitoring, reporting and verification requirements. By 30 April 2013, all aircraft operators which operated such flights in 2012 are required to surrender allowances or international credits in respect of emissions from those flights." See http://ec.europa.eu/clima/policies/transport/aviation/docs/com_2012_697_en.pdf. The countries included are the 27 Member States of the European Union and Norway, Iceland and Lichtenstein.
- 14 European Union Emissions Trading Scheme Prohibition Act of 2011 bill was passed by Senate on 22 September 2012 and passed by the House of Representatives on 13 November 2012. It was signed by US President Obama on 27 November 2012. The full text can be read at <http://www.govtrack.us/congress/bills/112/s1956/text>
- 15 "European Union Emissions Trading Scheme Prohibition Act of 2011"; Section 1
- 16 *Ibid*. Section 3. Under section 2 (2), the Secretary shall reassess such a determination after (a) any amendment by the European Union to the EU ETS Directive; or (b) the adoption of any international agreement pursuant to international negotiations to pursue a worldwide approach to address aircraft emissions; or (c) enactment of a public law or issuance of a final rule in the United States to address aircraft emissions.
- 17 See http://europa.eu/rapid/press-release_MEMO-12-854_en.htm
- 18 See the official Press Release from the European Commissioner at http://europa.eu/rapid/press-release_MEMO-12-854_en.htm where the Commissioner states: "**But let me be very clear: if this exercise does not deliver – and I hope it does, then needless to say we are back to where we are today with the EU ETS. Automatically.**" See also commentary on the moratorium and the Commissioner's statement at http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm
- 19 The Environment Committee also wants to see revenues from EU ETS aviation provisions to be applied for mitigation of climate change impacts. A formal decision on the proposal for an exemption from Directive 2003/87/EC must be reached by the European Council and published in the EU Official Journal before 30 April 2013 in order to be effective.
- 20 The UK has just issued a consultation, ending on 1 April, on its decision to give effect to the EU Derogation Decision in UK legislation. See http://www.decc.gov.uk/en/content/cms/news/pn12_168/pn12_168.aspx
- 21 See DECC Press Notice 12/168, 19 December 2012 at http://www.decc.gov.uk/en/content/cms/news/pn12_168/pn12_168.aspx
- 22 The EU ETS Directive places an annually declining cap on carbon emissions with the ultimate goal of 20 per cent reductions by 2020 (as compared with 2005 levels).
- 23 See <http://www.transportenvironment.org/press/ngos-cautiously-welcome-icaos-decision-speed-work-global-measure-reduce-aviation-emissions>