

Cloudy skies ahead for aviation in the EU ETS

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POINT CARBON ANALYSIS - The EU ETS Directive offers two legal ways out of the current political dispute in the aviation sector: the implementation of a global aviation emission reduction measure, and “equivalent measures” in third countries. We take a close look at the possibility for a global aviation framework within ICAO and an equivalent measure in China, and we conclude that neither of these two options will materialize in the near future. This leaves airlines obligated to comply with the EU ETS in April 2013. Chinese and Indian airlines currently show the highest likelihood of not complying. The resolution of the conflict in the short term will depend on whether negotiations between the EU and third countries find alternative solutions to the current legal framework.

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The inclusion of aviation in the EU ETS has raised an international furor. A coalition of 26 countries has expressed objections to what it sees as a violation of national sovereignty by the EU. The dissenters, which include the US, China, India and Russia, have discussed possible retaliatory measures against EU airlines, threatening to escalate the dispute into a trade war. China and India have showed the staunchest opposition, as the two countries banned their airlines from complying with the EU ETS earlier this year. Their airlines were the only ones not to report their 2011 verified emissions on 31 March, which marked the first breach of EU ETS rules.

The European Commission has stood firm by its legislation, dismissing any pleas by opposing countries or the airline industry that it exclude some or all airlines from the EU ETS. The Commission can however make changes to its regulation under two scenarios: i) Countries implement “equivalent measures”, and ii) A global measure to reduce aviation emissions is implemented. The EU ETS directive allows the Commission to make changes to the list of airlines included in the scheme if other countries implement their own policies to reduce emissions from aviation. Under the second scenario, the Commission can propose an amendment to the EU ETS directive to take away airlines’ obligations under the EU ETS. This scenario has gained some momentum recently and pressure has been mounting on the International Civil Aviation Organization (ICAO) to implement global policies to reduce aviation emissions.

ICAO en route to a global aviation scheme

The Kyoto Protocol of 1997 designated ICAO as the platform where developed countries should develop a global measure to curb aviation emissions. ICAO, an organization of 191 countries, which sets global standards for aviation, has since discussed ways to reduce emissions, but failed to implement specific measures. The ICAO Assembly meeting in 2010 adopted a resolution for an aspirational goal of an annual 2% improvement in fuel efficiency and an aspirational commitment for carbon neutral growth after 2020. The resolution sparked conflict among contracting states of ICAO – a group of developing countries including China, India and Brazil rejected the second aspirational goal. They emphasized that developing countries should not be expected to take measures that impact their growth. This position is consistent with the principle of common but differentiated responsibilities, a concept enshrined in the Kyoto Protocol, which developing countries insist should be a guiding principle for work in ICAO. The resolution also invited the ICAO Council, the executive arm of the organization comprised of 36 states, to study and propose possible global market-based measures to be considered at the Assembly’s next meeting in the fall of 2013.

The political row over the EU ETS has given renewed momentum to efforts at ICAO towards a global scheme. On 2 March this year, the Secretary General of ICAO announced that the goal is to have a final proposal for emission reduction measures by the end of 2012. The ICAO Council at its meeting in March 2012 selected four possible market-based mechanisms (MBM): two types of mandatory offsetting mechanisms and two types of emission trading measures. The secretariat of ICAO now has to assess each option and report back to the Council. Once a mechanism is proposed, it will be negotiated by countries in the Council and later in the Assembly. The Council, composed of the major aviation countries, will seek an agreement on the broad structure of the MBM and define some of its technical and administrative aspects. It will then pass the proposal to the Assembly, where all contracting states of ICAO will negotiate on the specific elements of the scheme and where a final agreement will have to be reached.

Timeline for a global agreement

Figure 1 illustrates the timeline for this process. The first milestone is later this month when the secretariat is expected to present to the Council a progress report of its assessment of the four proposed MBMs. It will then most likely present its results and make a recommendation on an MBM at the Council session in October/November this year. At that point, the 36

members of the Council could start discussing the measure, with a view to have a proposal for consideration at the Assembly meeting in the fall of 2013. This leaves the Council with a very short timeframe to finalize a proposal. We do not expect the Council to achieve significant progress at its meeting in October this year, even if the secretariat manages to finish its recommendations by then. Contracting states may wish to hold back their positions on a global aviation measure before COP 18 in Doha, where they can use it as a bargaining chip, especially in discussions with the EU. Indian and US officials have already warned that the EU ETS conflict could spill over into the international climate talks.

Figure 1: Timeline for a global agreement on aviation in ICAO



The Council could come up with a proposal at its meeting in June 2013. How much the 36 members of the Council manage to agree to before the Assembly meeting will be an important factor in how successful the meeting is. However, the most controversial aspects of the scheme would probably have to be agreed in the Assembly. In some situations, the Assembly can adopt decisions through a simple majority vote, but as a body of the United Nations, ICAO is a forum for cooperation between nations, and cannot require them to reduce their emissions. A global market based measure will only be implemented if major aviation nations support it, and therefore an agreement will have to be reached between these countries.

Achieving such an agreement will thus face challenges similar to those that nations face at the UN Framework Convention on Climate Change. The largest stumbling block will probably be the principle of common but differentiated responsibilities. The reluctance of developing countries to commit to binding emission reduction targets will likely maintain the gridlock between them and developed countries, especially the US, which refuse to take action without the participation of economic competitors such as China and India. One motivation for nations to reach an agreement is the soaring dispute over the EU ETS. States like China and India are perhaps hoping that they can leave the EU scheme for a global measure that will treat them as developing countries and not impose direct costs on their airlines. The concept of common but differentiated responsibilities, however, clashes with the principle of non-discrimination of airlines enshrined in ICAO's constitution, the Chicago Convention. Any policy implemented through ICAO will have to find the balance between these two principles.

Due to these barriers, we find it somewhat unlikely that the Assembly meeting in 2013 will see a global agreement on reducing emissions from aviation. Members of the Council are likely to continue negotiating on various elements of a global market based measure in 2014 and possibly later. The next Assembly meeting will be in 2016; however the Council can convene a meeting of all ICAO states sooner. Therefore, an agreement could materialize in the next few years and be implemented sometime in the second half of this decade. The European Commission could consider amending the EU ETS if the scheme includes targets and measures for all countries and has a comparable level of ambition as EU's cap on aviation, in terms of expected emission reductions. The Commission could start procedures to amend the directive, once a global agreement is made, or even earlier, once it sees that ICAO is showing sufficient progress towards a global treaty. Such an amendment will require a co-decision procedure, which will involve voting in the European Parliament and the European Council, a process that can take up to two or three years.

Equivalent measures in China?

China's strategy towards the inclusion of aviation in the EU ETS has evolved through two stages, as Table 1 below shows:

Table 1 Chinese opposition strategy towards EU ETS's inclusion of Chinese airlines

Timeframe	2009-2010	2011-Present
Main Strategy	non-violent & non-cooperative	official opposition with threat of retaliation

The instruction that the Civil Aviation Administration of China (CAAC) sent out early February this year signaled the culmination of China's opposition. Chinese aviation regulators prohibited mainland Chinese airlines from complying with EU ETS regulation, resulting in eight Chinese airlines not reporting their 2011 emission data to EU in March 2012.

Going forward, there are signs that currently planned aviation regulation in China could be considered an equivalent measure. One Chinese official indicated that China might include aviation sector into its own ETS. In May, two private companies claimed they were drafting proposals on how to cap emissions from aviation. Theoretically, either approach can get EU's recognition as an equivalent measure if it manages to reduce Chinese airlines' emissions. In practice, however, including aviation in the planned Chinese ETS, which is to start in 2015, will not come soon enough to diffuse the current political dispute.

At same time, China has emphasized its own initiatives on aviation sector's emission reduction. In 2008 China set a target for its aviation sector: to reduce both energy consumption and CO2 emission by 15% per ton kilometer in 2015 compared to 2005 level. This intensity-based target aligns with China's 2020 targets pledged in its Nationally Appropriate Mitigation Action (NAMA). Such policies, however, face obstacles for being considered "equivalent measures" as they are based on targets for emission intensity, which are incompatible with EU's absolute cap on emissions. To be considered equivalent, the measures will probably have to be proven to reduce emissions at least as much as the EU ETS, which is difficult because the emission reductions of intensity-based policies depend on future GDP growth.

In our view, it is unlikely that China will implement any additional policies in the near future to be considered as equivalent according to EU rules. China will most likely maintain its current position, as it insists its autonomy in climate adaption and mitigation actions. Beijing however does appear somewhat flexible by supporting a global solution within ICAO's framework, which can be a way for China to save face.

In the meantime: more turbulence expected

Based on our outlook for progress in ICAO and in China, we see it as unlikely that any of these two options will provide an exit out of the current political dispute in the short term. Airlines covered under the European carbon market will most likely have to surrender units for compliance in 2013. This will escalate the current dispute and might result in some airlines not complying. Chinese and Indian airlines have the highest likelihood of not buying units for compliance, as they have been barred from complying by their governments. American airlines are more likely to comply, despite their vocal opposition against the scheme, since they have already started passing on the costs of carbon allowances onto their customers. All other airlines are also showing signs of compliance, as they have reported their 2011 emissions in March.

What will be the consequence for non-compliance? The competent authority for the non-compliant airline will be responsible for imposing charges of €100 for each ton of emissions not covered by allowances or credits. If the fee is not paid, the competent authority can seek the approval of the European Court of Justice (ECJ) to impose an operating ban on that airline. This leaves the EU in a state of dilemma – while it will be cautious not to escalate the conflict further, the EU will also be unwilling to set a dangerous precedent of non-compliance. It should be noted that imposing penalties will take a considerable amount of time, especially if they require the approval of the ECJ, and drag on for a year or more. This will potentially buy time for a global measure to be implemented through ICAO or for equivalent measures to be implemented by other countries. At that time, the obligation of non-compliant airlines could be somehow incorporated within the broader negotiations between the EU and these countries.