Including aviation in the EU's Emissions Trading System will not put airlines out of business.

by Blog Admin

The EU's Emissions Trading System includes all flights to, from and within Europe as eligible for regulation – something that has faced strong opposition from the US and China. With Airbus's orders from China falling, this pressure has grown from within Europe. **Cameron Hepburn** *argues that for reasons of economic principle, legality and practicality, the EU should stand its ground.*

The inclusion of aviation in the EU Emissions Trading System since 1 January 2012 has faced strong opposition from other nations, particularly the US and China. So far, the EU has held firm in its collective commitment to include all domestic and international flights to and from Europe, regardless of the nationality of airlines, in the cap on greenhouse gas emissions. But could the announcement by Airbus that it will soon have to revise down production targets due to the suspension of orders from China lead to a weakening of resolve within the EU?

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There is some sign that this may already be happening. Following a meeting on 11 September 2012 between Airbus executives and representatives from the governments of Spain, France, Germany, and the UK (where Airbus makes its planes), the UK Minister for Business and Enterprise, Michael Fallon MP, said that there was no doubt that the Chinese threat to cancel orders represents a "clear and present danger to its [Airbus's] order list." At the meeting, the ministers agreed to push for a global solution to aviation emissions pricing when the United Nations International Civil Aviation Organisation (ICAO) meets in September 2013. But this does not fit with the EU's plan that airlines should pay by April 2013 for their 2012 emissions. The ICAO route would require a delay or temporary exemption for non-EU carriers. Indeed, the German Minister for Aerospace, Peter Hintze, has since publically said that he thinks that the deadline for charges for aviation emissions in 2012 should be delayed until September 2013.

So, is now the time for the EU to relax its stance on aviation emissions within the EU Emissions Trading System? Let us begin by reminding ourselves of the details of the EU Emissions Trading System and its context.

Since 2010, airlines have been required by EU law to measure and report emissions from flights to and from the EU. From 1 January 2012, airlines have not only had to report details of their emissions, but also to pay for them by acquiring and surrendering allowances eligible under the EU Emissions Trading System. The deadline for surrendering allowances is April 2013. The law will impose a cap on total emissions from the aviation industry. In 2012, emissions will be capped at 97% of 2005 emissions levels and from 2013 onwards at 95%. The underlying principles are analytically sound: emissions from aviation need to be reduced, emissions trading can deliver that result at minimal cost, and it is sensible to enact policy that covers domestic and foreign airlines equally.

Nevertheless, the Indian and Chinese governments have banned their airlines from participating in the EU Emissions Trading System and the US Senate is considering a similar move in relation to its airlines. China has reinforced its protest by delaying its purchases from Airbus, suspending an order for 35 large planes, although it also recently signed a deal, worth $3.5 billion, for 50 planes during a two-day visit by German Chancellor Angela Merkel.

Countries that oppose the inclusion of non-EU airlines in the Emissions Trading System have argued that the EU had stepped outside its legal jurisdiction by charging for emissions for an entire flight, rather than for just that part of the flight within European airspace. The EU disagrees and recently won the legal argument at the European Court of Justice. The opposing nations, who number 17 including China, India, the US, Russia, and Japan, have since met in Washington where they committed to work on a voluntary scheme with ICAO.

So what is all the fuss about? Does the EU Emissions Trading System impose a heavy cost penalty on participating airlines? Or will increased costs to passengers result in much lower demand for air travel?

It would appear that the answer is “no” to both questions. Like other high-emitting sectors of the economy, airlines will be granted free permits for about two-thirds of their expected emissions between 2013 and 2020, and will thus only need to purchase a third of their allowances. These costs will be largely or entirely passed through to the passengers, including the opportunity costs associated with surrendering allowances that have been given to airlines for free. Recent analysis by researchers at MIT and the Institute for Transport Economics at Muenster University has shown that this could lead to windfall profits for airlines in the US. A report by Vivid Economics for the UK Department for Environment, Food and Rural Affairs (DEFRA) in 2007 came to similar conclusions about windfalls for international airlines as a whole.

The European Commission stresses that the additional cost to passengers will be small. In a recent column for the UK’s Guardian newspaper, the Commissioner for Climate Action, Connie Hedegaard, argued that the additional cost of an airline ticket from London to New York would be less that £2 per passenger, which she believes passengers will barely notice. While slightly higher ticket prices would be expected to lead to reductions in demand and hence profits, analysis suggests that this is not a large effect, and that some of airlines might make extra profits because of the ability to pass on more than the full cost to passengers.

In short, the inclusion of aviation in the EU Emissions Trading System will not put airlines out of business, and could in fact boost profits for some. Concerns about the impact on short-term profits therefore seem to be an unlikely reason for opposition from airlines. A more likely explanation is that airlines have a speculative but deep-rooted fear that being included within the EU Emissions Trading System now is the thin edge of a wedge that will eventually damage their long-run interests.

What does the EU do about the current opposition? As a trading bloc, the EU has real economic clout. In a forthcoming paper, Dieter Helm, Giovanni Ruta, and I argue that trade-related threats of this sort against the EU are unlikely to be credible. The Chinese orders from Airbus are only worth several billion euros — a small proportion of the company’s income. By comparison, in 2011, the EU imported €292.1bn ($381.4 billion) of goods from China, and EU retaliation against Chinese threats could do serious harm, particularly when China’s economy appears to be weakening and it is about to experience the most important political transition of the decade. The simple point is that a trade war is not in anyone’s interests, and economic logic suggests that the EU should simply ignore such threats.

Even if the ‘coalition of the unwilling’ were able to throw enough economic and political weight around to convince the EU to consider softening its position, it is not clear how a change to the aviation emissions directive could be carried out, and at least not quickly. All 27 EU Member States adopted legislation in 2008 and appear to still support the directive. EU legal mechanisms are notoriously slow and offer little wriggle room once a directive has been adopted. So, anything beyond minor tinkering with the application of the directive seems unlikely. Hence for reasons of economic principle, legality and practicality, the EU should stand its ground.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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