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One Hand Giveth, the Other Taketh Away: Emissions Trading Schemes & Barriers to Expansion in a Liberalized Aviation Market

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This paper examines the seemingly paradoxical relationship between the soon to be implemented liberal aviation marketplace between Canada and the European Union and the EU's intention to integrate global aviation into its emissions trading scheme from 2012. This will necessitate an overview of the EU's proposals with respect to international aviation emissions and an examination of whether this contradicts the goal of liberalizing the sector through the recent opening of the skies. The paper, includes an assessment of the framework on environmental regulation contained in the 2009 bilateral air services agreement and a comparison of this framework with that contained in the comparable bilateral agreement inked by the EU and the United States in 2007. The piece concludes by urging Canada to be cautious of submitting to European public interest policies.

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I. The EU Legislation on International Aviation and Emissions Trading

Directive 2008/101/EC[1], which took effect in early 2009, amended Directive 2003/87/EC[2] on establishing a scheme for greenhouse gas emission allowance trading within the European Union so as to integrate thereinto provisions extending the application of the emissions-trading scheme to the aviation sector. This represents the legislative enforcement of a proposal supported throughout the European institutions but greatly criticized outside the boundaries of the European Union. From 2012 it will become mandatory for all airlines with operations into and out of the European Union to hold carbon allowances for the emissions resulting from their operations into and out of the EU.

This issue has been highly contentious. During the drafting of legislation, and at the time of the last International Civil Aviation Organization (ICAO) Assembly in 2007 a number of States proclaimed that such a requirement would be illegal under international law as an intrusion into the sacrosanct sovereignty over airspace above the territory of third States as protected by the International Convention on Civil Aviation to which all members of the European Union are party.[3] This led to the ICAO Assembly issuing a Resolution dissuading Contracting States from extending emissions trading schemes to airlines not subject to their jurisdiction.[4] However, in retort the European Union identified the right of Member States to make entry into their airports conditional upon the respect of local laws and regulations, and thus filed a Reservation to the Resolution.[5]

Directive 2008/101 articulates the aviation emissions trading scheme conceived by the Commission. The year 2010 shall be used as a monitoring year which will be used to determine emissions allowances both for 2012 and the following period 2013-2020.[6] For 2012 total aviation emissions allowances will represent 97% of the emissions in the reference year 2010,[7] and in 2013-2020 this will drop to 95% of the 2010 emissions.[8]

Allowances will be calculated on the basis of tonne-kilometres. Of the total number of tonne-kilometres, 82% of these will be allocated to airlines gratuitously on the basis of their reference period operations,[9] thus for 2013, operators will be able to operate 79.54% (82% of 97%) of their 2010 tonne-kilometres into, out of or within the European Union using their free allowances. A further 15% of the permissible total emissions will be auctioned,[10] and the remaining 3% of permissible emissions will be reserved for entrant airlines or airlines which have increased operations by at least 18% annually from the monitoring year through to the second year of the reference period.[11] Any of the last category of allowances which are unused are to be auctioned.[12] Any airline with a surplus of permits may sell their quotas.

II. Liberalization and Barriers to Entry and Expansion

As has been discussed in earlier policy papers,[13] a new "bilateral" agreement on air transportation services was concluded by the Commission of the European Union on behalf of its Member States and Canada on 8 December 2008.[14] The agreement underlines in its preamble that it seeks to foster a competitive aviation industry in view of the resulting benefits.[15] The issue thus remains whether it is possible to reconcile the goals of the liberal air services agreement with the European Union's new environmental legislative measures.

The Directive does fortunately create a provision for new entrant airlines and one for airlines with expanded service. Initially these provisions were not included.[16] For entrant airlines the provision is critical since otherwise the obligation for an entrant airline to purchase permits which competing incumbents had largely received gratuitously would have constituted a serious barrier to entry. The 3% of total allowable emissions reserved for entrant and expansionary airlines is a sizeable quantity given that the 3% is based on system-wide data. While growth in the sector is negative especially in the western hemisphere, it is not foreseeable that entrant airlines will in any year assume 3% of the total market. Thus entrant airlines are unlikely to be harmed by these provisions. It is rare for a new airline to be established, particularly for transatlantic services.

It is to be questioned whether the provisions for expansion of existing operators will be sufficient to counter the risk of discouraging expansion of air services to Canada. In order to qualify for additional gratuitous permits an airline would have to expand 18% per year every year from the monitoring year through to the second year of the reference period. Thus over four years, the airline would have to almost double total service to qualify for bonus free permits. It is currently inconceivable that either of the Canadian transatlantic carriers; Air Canada or Air Transat, would be able to double their services into the European Union. The threshold is even more unattainable for European airlines since presuming that the vast majority of their flights commence or end in the European Union, they would have to effectively double their system-wide tonne-kilometres which for any mature operator is effectively impossible.

Thus any expansion of service - and indeed maintaining the 20.46% of previous service levels not provided with gratuitous permits - into and out of the European Union is now going to be costly for incumbent airlines. The tonne-kilometre based scheme fails to provide an incentive to migrate to an upgraded "green" fleet, since actual emissions are not a criterion in determining allowances.

Air service between the European Union and Canada has been in decline in recent years, most prominently through the collapse of a significant Canadian transatlantic carrier, Zoom Airlines[17] and the even more recent insolvency of seasonal low cost operator FlyGlobespan.[18] These failures will dissuade potential new entrants into the transatlantic market, and also serve notice of the difficulty of operating profitably on such routes. If transatlantic routes have proven unprofitable in the past, the addition of a new charge to purchase the required emissions trading in order to add or reintroduce service to Canada makes it more likely such services would be in the red on their resumption. For Canadian airlines, the new charge, in addition to the wealth of asymmetric

environmental taxes and charges imposed as departure taxes from European airports,[19] represents an incentive to direct any new capacity outside of the EU since all additional charges must eventually be encompassed into the fare and thus would serve to stifle demand. This leads to the conclusion that Directive 2008/101/EC does run contrary to the purposes laid out in the EU-Canada Air Transport Agreement as the Directive risks hampering expansion or introduction of Canadian services by existing airlines, irrespective of whether they already serve Canada.

III. Bilateral Framework on Environmental Regulation

The European Union has not been unaware of the controversy caused by its expansion of emissions trading to the aviation sphere. Thus, in concluding bilateral agreements with the United States and Canada in 2007 and 2008 respectively, special provisions were inserted with respect to environmental measures.

In the US-EU bilateral agreement the parties recognized the need to weigh the costs and benefits of environmental measures with the development of international aviation policy,[20] and urged that the parties take measures to mitigate any adverse effects of environmental policy on the exercise of air transport rights.[21] The parties agreed to apply ICAO Standards[22] and to form a meeting of the Joint Committee to discuss concerns over the relationship between application of environmental norms and the implementation of the agreement.[23]

In the EU-Canada agreement however the environmental stipulations lean more towards protecting the EU's policies. The first significant difference from the US Agreement is that Article 18 on the environment opens with a broad recognition of the importance of protecting the environment.[24] The following paragraph asserts the right of each party to apply "within its own sovereign jurisdiction….appropriate measures to address the environmental impacts of air transport provided that such measures are applied without distinction as to nationality."[25] Article 18 goes on to repeat clauses found in the US agreement on mitigation of environmental policies on the air transport rights granted,[26] and the application of ICAO Standards.[27]

The sixth and final paragraph of Article 18 dealing with consultation between the parties on matters of the environment is interesting in view of the weak enforcement language employed. Parties agree only to "endeavour to consult each other" on "measures likely to have a significant effect on the international air services covered by this Agreement."[28] The term "endeavour" is unusual in any agreement between parties, since the extent of the obligation is unknown. The clause would be far more coherent and unambiguous if it simply stated that "the parties shall consult each other". Given that the clause refers to the articulation of policies likely to have a significant effect on the outcomes of the Agreement, it would not be unreasonable to expect a firm undertaking to consult the other Contracting Party.

The EU-Canada bilateral agreement thus clearly had in mind the introduction of an aviation emissions trading scheme by the European Union, and the terms of the agreement imply that Canada will not object to this. The reference to the sovereign right to apply environmental

measures within the home jurisdiction underlines the apparent submission of Canada to the EU's intentions. Moreover the obligation for any measure to be implemented in a manner independent of nationality creates an obligation for the EU to apply the measures to Canadian airlines.

European Public Interest Policies in Canada

The European Union has developed broad protective public interest policies which are now being refined into precise obligations applied to specific fields. The proposed application of the emissions trading scheme to all aircraft operations into and out of EU airports is an intrepid approach. The EU could have restricted the application to operations while above EU airspace, or to operations out of an EU airport and to EU airlines flying into an EU airport in the same way it applied its passenger rights policy[29] despite the resulting slight distortion of competition against its own carriers. However, the EU has preferred to test the international community's resistance to its own conception of its sovereign powers.

The issue is not whether or not the environment needs to be protected, but whether Canada should be prepared to accept that a Canadian airline, while flying over Canadian airspace en route to or returning from the EU must partly offset its emissions with allowances purchased in the EU, where the proceeds will be used to protect the environment in a manner convenient to the EU pursuant to a scheme creating jobs within the European Union.

The EU's emissions trading policy in aviation would perhaps be more legitimate;

- if it had first exhausted all of the other ways to reduce emissions, including improvements to air traffic control over European airspace which could cut emissions by 12%,[30]
- if it had first pursued vigorously a global agreement on emissions through ICAO – the agency mandated to drive emissions cuts under the Kyoto Protocol,[31]
- if it had introduced a single aviation environmental policy which overruled the prevailing charges applied by Member States,
- or even if the final scheme rewarded fleet renewal with lesser-emitting aircraft which would in turn provide a strong incentive to aircraft and engine manufacturers to pursue ever more dynamically the ultimate environmental aircraft.

The European Union has done none of the above, but rather prematurely adopted a scheme which pushes further than ever the limits of its territorial jurisdiction. Canada should be cautious of the seeping in of European policies into domains over which it can claim authority, for the European modes of tackling incontrovertibly serious issues are neither necessarily flawless nor adept to the Canadian context.

[1] 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, 52 O.J. (L8) 3 [hereinafter Aviation ETS Directive 2008].
[2] 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.
[3] Convention on International Civil Aviation, 7 December 1944, 15 U.N.T.S. 295 ICAO Doc. 7300/6 Art. 1.
[4] Resolutions adopted by the 36th Session of the Assembly of the International Civil aviation Organization (Provisional Edition) available online: International Civil Aviation Organization < http://www.icao.int/icao/en/env/A36_Res22_Prov.pdf>. Resolution 36-22 Appendix L 1 (b) reads "The Assembly urges Contracting States not to implement an emissions trading system on other Contracting State's aircraft operators except on the basis of mutual agreement between those States [emphasis copied from source].
[5] European Union, Written Statement of Reservation on behalf of the Member States of the European Community and the other States Members of the European Civil aviation Conference [42 States altogether], Doc. Memo/07/391 (Oct. 2 2007).
[6] Aviation ETS Directive 2008 Art. 3d 3.
[7] *Ibid*. Art. 3c 1.
[8] *Ibid*. Art. 3c 2.
[9] *Ibid*. Art. 3e.
[10] *Ibid* Art. 3d 2. This percentage may be subject to increase in the future.
[11] *Ibid* Art. 3f 1 a&b.
[12] *Ibid* Art. 3f 8.
[13] Mark Glynn, The EU-Canada Air Services Agreement: A plea for rapid implementation (April 2009), available online at http://www.carleton.ca/europecluster/publications/2009-04-AirServicesAgreement(Glynn-deMestral).pdf and Mark Glynn, Policy considerations in the negotiation of a new air services agreement between Canada and the European Union (December 2008) available online at http://www.carleton.ca/europecluster/publications/2008-12-18-AirServicesAgreement(Glynn).pdf.
[14] Agreement on Air Transport between Canada and the European Community and its Member States [subject to linguistic review], available online: European Commission Air Transport Portal <http://ec.europa.eu/transport/air/international_aviation/country_index/canada_en.htm> [hereinafter EU-Canada Open Skies Agreement].
[15] *Ibid*, Preamble. The Agreement thus removes regulatory barriers to free market access relating to capacity, pricing, designation, frequencies etc.
[16] Aviation ETS Directive 2008 Art. 3f 1a&b.
[17] See previous Strategic Knowledge Paper, Policy considerations in the negotiation of a new air services agreement between Canada and the European Union, available online: Carleton University <http://www.carleton.ca/europecluster/publications/2008-12-18-AirServicesAgreement(Glynn).pdf>.
[18] Brent Jang "Flyglobespan folds up its wings" Globe and Mail (18 December 2009), online: Globe and Mail <http://www.theglobeandmail.com/report-on-business/flyglobespan-folds-up-its-wings/article1404872/>.
[19] An example of these is a £45GBP/$79CAD tax on each departing passenger from the UK to East Coast Canada, and £50GBP/$88 CAD tax departing to the West coast Canada under its Air Passenger Duty charges. See online: Her Majesty's Revenue & Customs <http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageExcise_InfoGuides&propertyType=document&id=HMCE_CL_001170>.
[20] EC, Air Transport Agreement, [2007] O.J. L. 134/4 Art. 15.1.
[21] *Ibid* Art. 15.2.
[22] *Ibid* Art 15.3.
[23] *Ibid* Art. 15.4.
[24] EU-Canada Open Skies Agreement Art. 18.1, this general provision lacking substance is more suited to the Preamble of the Agreement and indeed a similar provision is found in the Preamble both of this Agreement and that with the United States.
[25] *Ibid* Art. 18.2.

[26] *Ibid Art. 18.3*
[27] *Ibid.* Art. 18.4.
[28] *Ibid* Art. 18.6.
[29] Regulation (EC) No 261/2004 of the European Parliament and of the Council of 11 February 2004 establishing common rules on compensation and assistance to passengers in the event of denied boarding and of cancellation or long delay of flights, and repealing Regulation (EEC) No 295/91 47 O.J. L46 1 Art. 3.1.
[30] Single European Sky: Towards Greener Air Travel, Online Euractiv < http://www.euractiv.com/en/transport/single-european-sky-greener-air-travel/article-173593>.
[31] Protocol to the United Nations Framework Convention on Climate Change, signed Dec. 11 1997 U.N. Doc. FCCCCP/1997/1/Add.1 [entered into force Feb. 16, 2005] Art. 2.2. Note however that in EU-Canada Open Skies Agreement Art. 18.4 the Parties *prima facie* agree to work within the multilateral framework.