

THE EMISSION TRADING SCHEME AND ITS POSSIBLE CONSEQUENCES FOR AIRLINES

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ABSTRACT

The aim of this paper is to analyse the impact of the EU Emission Trading Scheme on the aviation industry. The paper provides an outline of the Scheme and an account of the early years of its implementation.

The ETS has dramatically changed the regulatory framework in which airlines operate, laying upon them a considerable financial burden. This has led to litigation as aircraft operators challenged the legality of the ETS in light of the Chicago Convention and of the Open Skies Agreement between the EU and US.

The far-reaching implications of the Scheme are likely to affect not only the aviation industry but also the Single Market as a whole, calling into question EU Competition and Environmental Law and the respective spheres of competence of European institutions and Member States.

1. THE EMISSION TRADING SCHEME.

The Emission Trading Scheme (henceforth also referred to as “ETS”) is a project launched by the European Union on 1 January 2005 which currently concerns more than 11,000 of Europe’s largest emitting installations and industrial plants (collectively responsible for almost half of the EU’s greenhouse gas emissions)¹.

The scheme was first set up by Directive 2003/87/EC (a.k.a. “ETS directive”)², and due to its far-reaching scope and its extremely ambitious goal, it is now considered to be “*one of the cornerstones of [EU] environmental protection policy*”³.

¹ EUROPA – Emission Trading System- Policies- European Commission, available from:

http://ec.europa.eu/clima/policies/ets/index_en.htm.

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, OJ L 275, 25/10/2003, pp.32-46.

³ Case C-127/07, Société Arcelor Atlantique et Lorraine and others v. Premier Ministre, Ministre de l’Ecologie et du Développement durable and Ministre de l’Economie, des

It can currently boast a trading volume in the region of €29 billion, or approximately 70% of global traded volumes in carbon products⁴, and thus constitutes the main driving force of the global carbon market⁵.

The ETS draws its origins from the Kyoto Protocol, but it is also independent from it, since it was implemented even before the Protocol became legally binding for EU Member States (in February 2005). The European Commission sees this project as essential to its commitment to reduce anthropogenic emissions of greenhouse gases.

The purpose of the ETS is to monitor and collect data on greenhouse gas emissions, setting an annual cap which will be progressively lowered in coming years. On the basis of this cap, each operator is assigned a tradable allowance by the overseeing Authority.

The ETS defines an allowance as the “*an allowance to emit one tonne of carbon dioxide equivalent during a specified period, which shall be valid only for the purposes of meeting the requirements of this Directive and shall be transferable in accordance with the provisions of this Directive*”⁶.

Like other “cap-and-trade” systems, the ETS requires operators to annually surrender allowances equal to the tons of greenhouse gases they emit, but since the EU sets a cap on the number of allowances issued each year, operators whose annual emissions exceed their quotas must purchase extra allowances on the market.

The commodities which can be traded in the carbon market are both allowances (under the ETS system) and credits (under the Kyoto Protocol’s offsetting mechanisms). These units can be traded either for immediate delivery (“spot trade”) or as derivatives based on allowances, such as futures⁷, swaps⁸ and options⁹.

Finances et de l’Industrie, Opinion of Mr Advocate General Poiares Maduro delivered on 21 May 2008, [2008] ECR Page I-09895, para 2.

⁴ SINGH GHALEIGH, Navraj, “*Emission Trading Before the European Court of Justice*”, Working Paper Series, 2009, University of Edinburgh School of Law, p. 1.

⁵ World Bank, “State and Trends of the Carbon Market 2008”, Washington, DC, 2008.

⁶ Directive 2003/87/EC, Article 3.

⁷ A futures contract is a standardized agreement between two parties to exchange a specified asset of standardized quality and quantity for a price agreed today, but with delivery taking place at a specified future date.

For the 2008-2012 trading period, the European Union has allowed operators to use Joint Implementation/Clean Development Mechanism credits up to a percentage determined by National Allocation Plans (henceforth also referred to as “NAPs”) . Unused entitlements can be transferred to the next trading period (2013-2020)¹⁰.

The Aviation industry, like many other economic sectors, has an impact on climate change through the release of carbon dioxide, nitric oxide, water vapour, sulphates and soot particles. The impact of the Aviation industry on the greenhouse effect is admittedly rather modest at present, accounting for barely 2% of global CO₂ emissions and 1,15% of European CO₂ emissions¹¹. However, airlines’ emissions are expected to rise considerably in coming years, reaching 122 mt by 2020.

The Commission’s concern is that this increase will annul the impact of emissions reductions in other industrial sectors, and this is the reason why it deemed necessary to include aviation within the scheme.

The target of the scheme is to set, by 2012, a cap on aircraft operators’ CO₂ emissions which should be 3% lower than in the years 2004-2005. The cap is scheduled to be lowered by an additional 5% for the 2013-2020 trading period.

To this end, on 24 October 2008, the Council and the European Parliament have adopted Directive 2008/101/EC, which amended Directive 2003/87/EC to include air transport in the EU greenhouse emission allowance-trading scheme¹².

⁸ A swap is a particular kind of derivative financial instrument in which two parties exchange certain benefits of one party’s financial instrument for those of the other party’s financial instrument.

⁹ An option is a kind of derivative which establishes a contract between two parties concerning the purchase or the sale of an asset at a reference price. The purchaser gains the right but not the obligation to engage in a specific transaction on the asset, while the seller is bound to fulfil the transaction if requested by the purchaser.

¹⁰ EUROPA – Press Release- Questions & Answers on Aviation & Climate Change, MEMO/05/341, 27 September 2005, available from: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/05/341&format=HTML&aged=0&language=EN&guiLanguage=en>.

Moreover, the implementation of the ETS was followed hard upon by the development of regulations ISO 14064 and ISO 14065, the aim of which is to standardize the monitoring and measurement of greenhouse gas emissions.

¹¹ EUROPA- Press Release- Questions & Answers on Aviation & Climate Change, MEMO 05/341, 27 September 2005. This practice is the so-called “banking” of emission allowances.

¹² Directive 2008/101/EC, OJ L.8, 13/1/2009, pp. 3-21.

Starting from 2012, the ETS will apply to each aircraft operator that lands or takes off from an airport in the European Economic Area.

If an aircraft holds an operating license from a European country, then it will be administered by the competent national authority, while non-EU carriers will be assigned to an administering national authority on the basis of their most frequent European routes.

However, before proceeding with our analysis of the impact of the Emission Trading Scheme on the aviation industry (and of the criticism which has been levelled against it by significant sections of this industry), it is perhaps useful to briefly review the economic implications of the ETS.

2. THE TRADABLE PERMITS APPROACH TO PROTECTING THE ENVIRONMENT: RATIONALE AND IMPLEMENTATION.

The adoption of the Emission Trading Scheme, in and of itself, represented a pivotal moment in the EU's environmental policy: the decision to pursue environmental goals through market mechanisms. The way in which these mechanisms work is by internalising external environmental costs¹³, or externalities (i.e. costs not transmitted through prices¹⁴).

The ETS uses the so-called Coase Theorem (popularized by economist Ronald Coase in his 1960 landmark paper "The Problem of Social Cost") by assigning property rights to clean air to the public and charging private undertakings for the right of polluting.

According to Coase Theorem, the market will solve externalities by itself unless (1) property rights are incomplete (e.g. nobody owns clean

¹³ "A European Community programme of policy and action in relation to the environment and sustainable development", OJ C 138, 17/5/1993, p. 5.

¹⁴ J.J. Laffont, "externalities", The New Palgrave Dictionary of Economics, 2nd Ed., 2008. The effect of externalities on the environment was explained by Nobel laureate Joseph Stiglitz with typical lucidity: "Whenever there are externalities- where the actions of the individuals have an impact on others for which they do not pay, or for which they are not compensated- markets will not work well. Some of the important instances have long understood environmental externalities. Markets, by themselves, produce too much pollution" [STIGLITZ, Joseph, "Managing Globalization", The International Herald Tribune, October 11, 2006].

air) or (2) negotiation and trading are excessively expensive. This model implies that once pollution property rights are assigned, private parties will bargain to achieve the most efficient solution to the externality¹⁵. Therefore, the main advantage of the ETS is that it induces firms to optimally reallocate pollution among themselves through trade.

Moreover, such a scheme allows the regulator to set the amount of pollution at whatever level is desirable; something which could not be achieved through a tax, unless the regulator knew the industry's cost structure exactly.

However, there are some caveats we should keep in mind while talking about the economic underpinnings of the ETS.

The second part of the Coase Theorem postulates that given well defined property rights, low bargaining costs, perfect competition, perfect information and the absence of wealth and income effects, resources will be used efficiently.

It is plain that in the case of the ETS there are considerable “wealth and income effects”, namely the transfer of wealth which occurs when an emitter is awarded an allowance (i.e. a property right). Emission allowances might be used by Member States to circumvent EU legislation on State aid, thus creating market distortions and encouraging rent-seeking behaviors (as undertakings begin to rely on the governments' largesse to balance their books).

Moreover, it is by no means certain that the “economically efficient” amount of greenhouse gas emissions is equal to the “environmentally efficient” one.

¹⁵ Another economic model often considered in relation to cap-and-trade schemes is the so-called “tragedy of the commons”: a dilemma arising from a situation in which multiple individuals, acting independently and rationally consulting their own self interests will ultimately deplete a shared limited resource, even when it is clear that this outcome is not in anyone's long-term interest [see. Harding, Garret, “The Tragedy of the commons”, *Science*, Vol. 162, N. 3859, 13th December 1968, pp. 1243-1245]. These models are usually based on the premise that clean air (just to mention one resource which is relevant to our analysis) is not a “res communis” but a “res nullius” and is therefore used without any regard to the disadvantages resulting, since “those who are in a position to appropriate to themselves the returns [...] do not bother about the later effects of their mode of exploitation” [from von MISES, Ludwig, “*Nationalökonomie: Theorie des Handelns und Wirtschaftens*”, Geneva, Editions Union, 1940, Part IV, Chapter 10, Sec. VI].

Directive 2003/87/EC drew very heavily on the feasibility studies and consultations with stakeholders which ultimately led to the issuance of the Green Paper on Greenhouse Gas Emission Trading within the EU.

The proposal which ultimately led to the ETS Directive was received extremely favourably and through the co-decision procedure the Council and the Parliament quickly agreed on the text of the Directive.

Perhaps the most controversial choice of the legislator (and one which might still be exploited by lobbies and special interest groups to defang the measure), was that of entrusting national authorities with the task of setting the volume of allowances to be apportioned¹⁶ and that of distributing them (through the “NAPs”)¹⁷.

Through the National Allocation Authorities, allowances are allocated to operators who are required to monitor and report their emissions. National Authorities will implement the allowance system by sanctioning non-compliance.

The Commission’s approval of the plans is a pre-condition for the issuance of the allowances to the operators¹⁸.

From the outset, the implementation of the ETS has been subject to serious criticism, since the ETS Directive did not include certain important sectors such as shipping, aviation and a significant part of the chemical industry (all sectors whose contribution to the EU’s total greenhouse gas emissions is still admittedly rather modest)¹⁹.

The implementation of the Emission Trading Scheme has been phased out, pursuant to the Kyoto Protocol compliance period. After the first trial period (2005- 2007), which has been described as a “learning-by-doing phase”²⁰, some of the problems and shortcomings of the ETS

¹⁶ Directive 2003/87/EC, Article 9 (1).

¹⁷ The risk was that the “level of ambition under the scheme risk[ed] being diluted as a result of industry lobbying over their allocations [...] rather than ensuring that negotiation over the distribution [between and within Member States was] a zero sum game with no impact on the environmental integrity of the scheme”, J. Robinson et al., “Climate change Law: Emissions Trading in the EU and the UK”, Cameron May, London, 2007, p. 63 [quoted in SINGH GHALEIGH, Navraj, “*Emission Trading Before the European Court of Justice*”, Working Paper Series, 2009, University of Edinburgh School of Law, p. 6].

¹⁸ Directive 2003/87/EC, Article 9 (3).

¹⁹ COM (2001) 581, OJ C 75E, 26/03/2002.

²⁰ SINGH GHALEIGH, Navraj, “*Emission Trading Before the European Court of Justice*”, Working Paper Series, 2009, University of Edinburgh School of Law, p. 8.

began to surface²¹. The first trading period was in fact characterised by a price collapse in 2006, after the publication of the emission reports by Member States revealed that actual aggregate emissions (and therefore the resulting demand for allowances) were significantly below the quantity of allowances issued to operators by National Authorities. Consequently, prices fell from €30/ ton in January 2006, to €15/ton, falling almost to zero by the end of 2007²².

Plummeting prices also affected the futures markets, contributing in no small part to the turmoil which has riddled the world financial markets.

So far, this market failure has not been repeated in Phase II (2008-2012). On the contrary, evidence suggests that the volatility which characterised the early years of the ETS will not affect it quite so dramatically in the future.

The stabilization of allowance prices was partly due to the drastic measures adopted by the Commission in the aftermath of the price collapse. In fact, the Commission reduced by almost 10% the allocations suggested by Member States, in order to artificially create demand for emission allowances.

Even more serious were the legal problems encountered in implementing the provisions of the Directive concerning the National Allocation Plans.

Article 9 of Directive 2003/87/EC²³ states that Member States must draft national plans setting the total quantity of allowances they intend

²¹ For an in-depth analysis see CONVERY, Frank J. and REDMOND, Luke, "Market and Price Developments in the European Union Emission Trading Scheme", *Review of Environmental Economics and Policy*, Vol. I, No. 1, Winter 2007, p. 88.

²² SINGH GHALEIGH, Navraj, "Emission Trading Before the European Court of Justice", Working Paper Series, 2009, University of Edinburgh School of Law, p. 9. For a conspectus on this topic, see also ELLERMAN, Denny and BUCHNER, Barbara K., "The European Union Emission Trading Scheme: Origins, Allocation and Early Results", *Review of Environmental Economics and Policy*, Vol. I, No. 1, Winter 2007, p. 66.

²³ Directive 2003/87/EC, Article 9: "1. For each period referred to in Article 11(1) and (2), each Member State shall develop a National plan stating the total quantity of allowances that it intends to allocate for that period and how it proposes to allocate them. The plan shall be based on objective and transparent criteria, including those listed in Annex III, taking due account of comments from the public. The Commission shall, without prejudice to the Treaty, by December 2003 at the latest develop guidance on the implementation of the criteria listed in Annex III. [...] 3. Within three months of notification of a national allocation plan by a Member State under

to allocate for each period. The plans must be based on objective and transparent criteria, and must be approved by the Commission.

During Phase II of the implementation, the Commission has rejected several NAPs on the grounds that their allocation criteria lacked transparency and made no reference to past emission levels.

The litigation which ensued produced a string of rulings²⁴ in which all the shortcomings of the National Allocation system came to light as the Court of First Instance was asked to draw the boundaries of the Commission's competence as regards the drafting of the NAPs.

The CFI held that a decision concerning a National Allocation Plan adopted by the Commission finding infringement of the criteria set out by the Directive in circumstances where the Commission limited itself to substituting its own data for those contained in the NAP without in any way reviewing the compatibility of the latter with the criteria set out in the Directive did not comply with the allocation of powers between the Member States and the Commission as defined by the ETS Directive.

The method adopted by the Commission, consisting of comparing the data in the NAPs with the data obtained from its own assessments effectively amounts to allowing the Commission itself to draw up its own reference National Allocation Plan in a totally autonomous manner and to assess the compatibility of the notified NAPs completely disregarding the criteria set out in the Directive²⁵.

While the interpretation of the Directive adopted by the Court of First Instance was doubtlessly correct, it is impossible to deny the shortcomings of this "decentralized" allocation system, which could (and indeed *does*) allow Member States to use their National Plans to

paragraph 1, the Commission may reject the plan, or any aspect thereof, on the basis that it is incompatible with the criteria listed in Annex III or with Article 10. The Member State shall only take a decision under Article 11(1) or (2) if proposed amendments are accepted by the Commission. Reasons shall be given for any rejection decision by the Commission".

²⁴ T-183/97, 23 September 2009, Poland v. Commission of the European Communities, [2009] ECR II- 00395, p. 58; T-263/07, Estonia v. Commission; T-221/07, Hungary v. Commission; T-369/07, Latvia v. Commission; T-368/07, Lithuania v. Commission; T-484/07, Romania v. Commission; T-499/07, Bulgaria v. Commission.

²⁵ T-183/97, 23 September 2009, Poland v. Commission of the European Communities, Summary para. 6 [emphasis added].

partition the Internal Market or to pursue protectionist policies in favour of national airlines.

In its decisions concerning the Polish and Estonian NAPs, the Commission had clearly exceeded its powers of review under Directive 2003/87/EC, however it tried to justify this excessively invasive approach by arguing that an annulment of said decisions would be detrimental to the greenhouse gas emission market, since an excessively high number of allowances would drive down prices, thus undermining the goals ostensibly pursued by the Directive²⁶.

The response of the Court of First Instance, while absolutely irreproachable from a strictly legal point of view, revealed the dramatic design flaws of the ETS.

This is a scheme whose success depends on the stringency of its overall cap and on the number of allowances issued. A decentralized implementation of the scheme would therefore only function if the Member States are sufficiently committed to the scheme and sufficiently homogeneous in their NAPs (which is, quite patently, not the case)²⁷. Until these design flaws are addressed, the ETS regime will inevitably remain more honoured in the breach than in the observance.

Phase III is scheduled to begin in 2013, and the Commission's planning and policies reflect the attempt to address the shortcomings which have riddled the previous phases.

After the 1st of January 2013, allowances will increasingly be allocated by auction (the long-term objective is for *all* allowances to be auctioned), whereas in Phase II free allocation has been the norm²⁸. Phase III will also be characterised by a higher degree of harmonisation and by a longer duration (8 years instead of 5)²⁹. The objectives are

²⁶ We should also keep in mind that the penalties for the violation of one's emission quota are not sufficiently severe (merely 100 € for each tonne of greenhouse gas beyond the allotted quota) to represent a serious deterrent.

²⁷ See DE SEPIBUS, Joëlle, "The European Trading Scheme Put to the Test of State Aid", NCCR Working Paper 34/2007 [Accessed 15 June 2011], Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088716.

²⁸ EUROPA – Emission Trading System- Policies- European Commission, Available from: http://ec.europa.eu/clima/policies/ets/index_en.htm.

²⁹ SINGH GHALEIGH, Navraj, "Emission Trading Before the European Court of Justice", Working Paper Series, 2009, University of Edinburgh School of Law, p. 9.

equally ambitious: the Commission hopes to reduce greenhouse gas emissions by 21% before 2020.

3. THE ETS AND ITS POSSIBLE CONSEQUENCES FOR AIRLINES.

We have explained that during the trial period, the Emission Trading Scheme did not apply to the aviation industry.

However, on 24 October 2008, the Council and the European Parliament adopted Directive 2008/101/EC³⁰ which amended Directive 2003/87/EC to include air transport in the EU greenhouse emission allowance-trading scheme.

All aircraft operators who carry out one of the activities listed in Annex I of the Directive, are included in the EU emission trading system. Unfortunately, the Directive does not provide a consistent definition of “aircraft operator”: a notion which is far from uncontroversial. For example, it is far from clear which airline should be considered the “operator” of a certain flight in case of code-sharing between carriers.

The Commission has consequently issued Guidelines on the detailed interpretation of Annex I³¹ in order to clarify the new scope of the ETS regime.

In accordance with the scope of application of Directive 2008/101/EC, the Commission has produced a list of aircraft operators which have carried out air transport since the 1st of January 2006, assigning each one of them to the administration of a Member State.

From the 1st January 2010, all operators included in the scope of application of the Directive are required to monitor their emissions and file an annual report no later than the 31st March of each year.

The filing of a monitoring plan is a mandatory requirement for the assignation of an allowance pursuant to Article 1.4. of the Directive, and

³⁰ Directive 2008/101/EC, OJ L.8, 13/1/2009, pp. 3-21.

³¹ Guidelines on the detailed interpretation of the aviation activities listed in Annex I to the directive 2003/87/EC of the European Parliament and of the Council (Decision 2009/450/EC).

all amendments to the monitoring criteria must be approved by the competent National Authority.

Pursuant to letter (j) of Annex I to the Directive, a *de minimis* exemption is applicable when a commercial aircraft operator:

- a) Operates fewer than 243 flights per period for three consecutive four-months periods,
- or
- b) Operates flights with total annual emissions lower than 10,000 tonnes per year.

These operators can adopt simplified procedures for the monitoring of their emissions.

The Emission Trading Scheme applies to all inbound and outbound flights, with the exception of the following ones, which are exempted from the scheme³².

As previously indicated, the allowance system will undergo another sea-change in 2013, when auctioning will become the main allocation

³² Directive 2008/101/EC, Annex I, states that the ETS shall not apply to:

“a) Flights performed exclusively for the transport, on official mission of a reigning Monarch and his immediate family, Heads of State, Heads of Government and Government Ministers, of a country other than a Member State, where this is substantiated by an appropriate status indicator in the flight plan;

b) military flights performed by military aircraft and customs and police flights;

c) flights related to search and rescue, firefighting flights, humanitarian flights and emergency medical service flights authorised by the appropriate competent authority;

d) any flights performed exclusively under visual flights rules as defined in Annex 2 of the Chicago Convention;

e) flights terminating at the aerodrome from which the aircraft has taken off and during which no intermediate landing has been made;

f) training flights performed exclusively for the purpose of obtaining a licence, or a rating in the case of cockpit flight crew where this is substantiated by an appropriate remark in the flight plan provided that the flight does not serve for the transport of passengers and/or cargo or for the positioning or ferrying of the aircraft;

g) flights performed exclusively for the purpose of scientific research or for the purpose of checking, testing or certifying aircraft or equipment whether airborne or ground-based;

h) flights performed by aircraft with a certified maximum take-off mass of less than 5.700 kg;

i) flights performed in the framework of public service obligations imposed in accordance with Regulation (EEC) No. 2408/92 on routes within outermost regions, as specified in Article 299(2) of the Treaty, or no routes where the capacity offered does not exceed 30,000 seats per year; and

j) flights which, but for this point, would fall within this activity, performed by a commercial air transport operator operating either:

- fewer than 243 flights per period for three consecutive four-month periods;

Or

- flights with total annual emission lower than 10,000 tonnes per year [...].”

method for emission allowances³³. This reform will be phased in over time, with a view to full auctioning starting from 2027³⁴.

The number of allowances issued to airlines is expressed as a percentage of the sector's mean average annual reported emissions between 2004 and 2006³⁵. In 2012, this percentage will be 97%, albeit the actual amount of the cap for 2012 will be set by 30th September 2011.

Another important measure passed by the European lawmakers is the so-called "Auctioning Regulation"³⁶, the purpose of which is to set out a framework that should ensure the integrity and transparency of the auctions of emission allowances, thus preventing market abuses and other misconducts³⁷.

Throughout the first half of 2011, the Commission will consult stakeholders and seek advice on how to safeguard the transparency and integrity of the carbon market.

To this very end, the Auctioning Regulation prohibits all bids or transactions on the secondary market which give, or are likely to give, false or misleading information with regard to the demand for or price of auctioned products or which could be used by a person or persons acting in collaboration to secure an auction clearing price at an abnormal or artificial level³⁸.

In light of the importance of transparency for the efficient working of the Emission Trading scheme, the Auctioning Regulation clearly states that no person in possession of inside information shall use it by submitting, modifying or withdrawing a bid for an auctioned product to which that information relates³⁹ and that "*all legislation, guidance,*

³³ UK Department of Energy and Climate Change- Aviation in the EU Emission Trading System from 2012, Available from: http://www.decc.gov.uk/en/content/cms/what_we_do/change_energy/tackling_climate/emissions/eu_ets/aviation/aviation.aspx.

³⁴ European Commission Communication, 21/12/2010, COM (2010) 796 final.

³⁵ The number of allowances issued to each airline for the year 2012 will be the airline's share of the total attributed aviation emissions in 2010, and shall be assigned by 31st December, 2012. In 2012, 85% of all allowances will be issued for free.

³⁶ Commission Regulation No. 1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances, OJ L 302, 18/11/2010, p.1.

³⁷ European Commission Communication, 21/12/2010, COM (2010) 796 final.

³⁸ Commission Regulation No. 1031/2010, Article 37.

³⁹ Commission Regulation No. 1031/2010, Article 38.

*instructions, forms, documents [...], any other non-confidential information pertinent to the auctions [...] shall be published on a dedicated up-to-date auctioning web-site maintained by the auction platform concerned*⁴⁰.

Market oversight will be exercised by the competent national authorities⁴¹, which shall be empowered to take all necessary measures to ensure that the provisions set out in the Auctioning Regulation are complied with⁴² and shall be responsible for supervising the auction platform concerned and investigating and prosecuting market abuses⁴³.

4. THE AIRLINES' CHALLENGE TO THE ETS.

Unsurprisingly, the application of the ETS regime to aviation has proved quite controversial. Indeed, in October 2010⁴⁴ the Director General of IATA⁴⁵, Giovanni Bisignani, warned that the goals set by the Kyoto Protocol could not be effectively attained by the EU “flying solo”, and that “*the only effective long-term solution remains a global approach*”.

Perhaps in an attempt to stave off threatened legal actions, the EU agreed to engage in dialogue with third countries during the trial period of the ETS, trying to find an acceptable way to regulate emissions from inbound flights coming from outside the EU. To no one's surprise, on 16th December 2009, the Air Transport Association of America (ATA) and three American airlines, American, Continental and United, challenged the lawfulness of the inclusion of aviation in the Emission Trading Scheme. Other interested parties, such as IATA, joined the lawsuit, which was brought up in the UK since it was the first EU Member State to implement the ETS. The High Court of Justice Queen's

⁴⁰ Commission Regulation No. 1031/2010, Article 60.

⁴¹ Referred to in Article 11 of Directive 2003/06/EC.

⁴² Commission Regulation No. 1031/2010, Article 43.

⁴³ Commission Regulation No. 1031/2010, Article 56.

⁴⁴ At the 37th ICAO assembly in Montreal.

⁴⁵ The International Air Transport Association represents 230 airlines, which account for almost 93% of scheduled international air traffic.

Bench Division (the Court invested with the controversy) consequently made a preliminary reference to the Court of Justice of the EU⁴⁶.

Given the global economic importance of this case, the Court of Justice has been asked to prioritize it, especially since carriers are expected to surrender their allowances effective of 1st January 2012.

It has been argued (albeit not too convincingly) by some critics that the main objective of the claimants is to prevent the EU's unilateral application of an emissions trading scheme to aviation outside of the International Civil Aviation Organization framework⁴⁷.

⁴⁶ The High Court referred to the Court of Justice of the EU the following questions:
“1) Are any or all of the following rules of international law capable of being relied upon in this case to challenge the validity of Directive 2003/87/EC as amended by Directive 2008/101/EC so as to include aviation activities within the EU Emission Trading Scheme [...]:

- a) the principle of customary international law that each state has complete and exclusive sovereignty over its air space;
- b) the principle of customary international law that no state may validly purport to subject any part of the high seas to its sovereignty;
- c) the principle of customary international law of freedom to flyover the high seas;
- d) the principle of customary international law (the existence of which is not accepted by the Defendant) that aircraft overflying the high seas are subject to the exclusive jurisdiction of the country in which they are registered, save as expressly provided for by international treaty;
- e) the Chicago Convention (in particular Articles 1, 11, 12, 15 and 24);
- f) the Open Skies Agreement (in particular Articles 7, 11(2) (c) and 15(3));
- g) the Kyoto Protocol (in particular, Article 2(2))?

To the extent that question 1 may be answered in the affirmative:

2) Is the Amended Directive invalid, if and insofar as it applies the Emissions Trading Scheme to those parts of flights (...) which take place outside the airspace of EU Member States, as contravening one or more of the principles of customary international law asserted above?

3) Is the Amended Directive invalid, if and insofar as it applies the emissions Trading Scheme to those parts of flights (...) which take place outside the airspace of EU Member States:

- a) as contravening Articles 1, 11 and/or 12 of the Chicago Convention;
- b) as contravening Article 7 of the Open Skies Agreement?

4) Is the Amended Directive invalid, insofar as it applies the Emissions Trading Scheme to aviation activities:

- a) as contravening Article 2(2) of the Kyoto Protocol and Article 15(3) of the Open Skies Agreement;
- b) as contravening Article 15 of the Chicago Convention, on its own or in conjunction with Articles 3(4) and 15(3) of the Open Skies Agreement;
- c) as contravening Article 24 of the Chicago convention, on its own or in conjunction with Article 11(2)(c) of the Open Skies Agreement?”- Case C-366/10: Reference for a preliminary ruling from High Court of Justice Queen’s Bench Division (Administrative Court) (United Kingdom) made on 22 July 2010- OJ C 260, 25/09/2010, p. 9-10.

⁴⁷ The most perplexing utterance of this argument came from Nancy Young, ATA Vice-President for Environmental Affairs, who stated that “we will not get a global approach (through ICAO) if we don’t have this lawsuit [...] because the Europeans would have no incentive to come to the table and negotiate about a solution that works for all of international aviation” [from BISSET, Mark and CROWHURST,

4.1. The Sovereignty Principle.

The claimants contend that the obligation to surrender allowances with regard to flights over third countries' airspace and over the high seas is unlawful under international law⁴⁸. In fact, the ETS would require them to forfeit allowances in respect of flights departing from the US and only a small proportion of which takes place over EU airspace.

ATA argues that allowing ETS to regulate airlines operating over US airspace would constitute a serious infringement of US sovereignty. The British Treasury Solicitor countered this claim by pointing out that while all EU Member States are signatories to the Chicago convention, the EU itself is not, and that the requirement that operators give up their allowances for greenhouse gas emissions for flights which take place partly over the airspace of a third country does not mean that the EU is regulating over the territory of that country or that it is infringing its sovereignty⁴⁹.

Moreover, the counterargument raised by the claimants (i.e. that this attitude may increase the risk of multiple or contradictory regulation) does not seem to take into consideration that Directive 2003/87/EC contains a clause which allows the Commission to link up the ETS with other trading schemes⁵⁰.

The objection that the inclusion of Aviation activities in the Emission Trading Scheme would violate the principle of customary international law that each state has complete and exclusive sovereignty over its air

Georgina "Is the EU's Application of its Emissions Trading Scheme to Aviation Illegal?", Clyde&Co, 2011 [Accessed 11 June 2011], Available from: <http://www.clydeco.com/news/articles/is-the-eus-application-of-its-emissions-trading-scheme-to-aviation-illegal.cfm>].

⁴⁸ Article 1 of the Chicago Convention states that each states "has complete and exclusive sovereignty over the airspace above its territory".

⁴⁹ See BISSET, Mark and CROWHURST, Georgina "Is the EU's Application of its Emissions Trading Scheme to Aviation Illegal?", Clyde&Co, 2011.

⁵⁰ Directive 2003/87/EC, Article 25, "Agreements should be concluded with third countries listed in Annex B to the Kyoto Protocol which have ratified the Protocol to provide for the mutual recognition of allowances between the Community scheme and other greenhouse gas emission trading schemes in accordance with the rules set out in Article 300 of the Treaty".

space is sharply at odds with the reality of the extraterritorial application of domestic legislation both in the EU *and* in the US.

Until recently, the US was commonly regarded as one of the main advocates of the extraterritorial effects of domestic legislation. This principle has been reconciled with customary international law thanks to the so-called “effects doctrine”, which argues that jurisdiction can be lawfully asserted on the basis of a conduct occurring within a country but has effects outside that country’s borders⁵¹.

A textbook example of a piece of legislation arrogating extraterritorial jurisdiction was the Sherman Act⁵², as interpreted by US Courts. Indeed, according to the US Second Circuit Court of Appeals, “*it is settled law [...] that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends [...]*”⁵³.

This rather extremist interpretation, clearly influenced by the “effects doctrine”, was later tempered by the principles of reasonableness and balancing of interests⁵⁴, but this did little to dampen the hostility voiced by most foreign nations.

The most controversial application of the principle of extraterritoriality by the US Government was probably the Cuban Liberty and Democratic Solidarity Act of 1996 (the so-called Helms-Burton Act)⁵⁵, a federal law which extended the territorial scope of application of the US embargo to include foreign undertakings which traded with Cuba. This measure encountered strong opposition abroad (especially from the EU) which however did not go beyond the usual diplomatic flurry.

We have seen how the doctrine of extraterritorial application of domestic legislation has been championed for decades by the US. However, in recent years the EU has adopted a similar approach in the field of competition law.

⁵¹ See LAYTON, Alexander and PARRY, Angharad, “Extraterritorial jurisdiction-European responses”, *Houston Journal of International Law*, Winter 2004.

⁵² Sherman Antitrust Act, July 2nd, 1890, ch. 647, 26 Stat. 209. 15 U.S.C. §§ 1-7.

⁵³ *United States v. Alcoa*, 48 F 2d 416 (2d Cir. 1945).

⁵⁴ LAYTON, Alexander and PARRY, Angharad. *Ibid*.

⁵⁵ Pub L. 104-114, 110 Stat. 785, 22 U.S.C. §§ 6021-6091.

Since the late 1960s, the European Commission has steadily pushed towards the extraterritorial application of what are now Articles 101 and 102 TFEU by developing the doctrines of “economic entity” and “implementation”⁵⁶.

The “economic entity doctrine” (first adopted by the European Court of Justice in the *Dyestuff* case⁵⁷) treats the actions within the EU territory of a subsidiary of a non-EU undertaking as actions of the parent company within the EU, thereby attributing EU authorities jurisdiction over it⁵⁸.

Similarly, in the *Wood Pulp* case⁵⁹, the Commission developed the “implementation doctrine”, whereby EU competition authorities are authorized to deal with acts and conducts which originate abroad but are implemented or completed (even in part) within EU territory⁶⁰.

So far, the Court of Justice has refused to acknowledge the applicability of the “effects doctrine”, however the Commission has been able to assert the extraterritorial application of EU competition law by relying on the implementation and economic entity doctrines⁶¹.

It is therefore clear that the notion of the extraterritorial application of domestic legislation is not a novel one on either side of the Atlantic. The claimants in the *ATA* case seem however oblivious of the fact that this principle has been consistently acknowledged by the US judiciary (in spite of strong opposition from the EU, one might add).

While the Court might have misgivings about the “effects doctrine”, in my opinion there is little doubt that the ETS regime is consistent with the dominant European jurisprudence, since both the implementation

⁵⁶ See LAYTON, Alexander and PARRY, Angharad, “Extraterritorial jurisdiction-European responses”, *Houston Journal of International Law*, Winter 2004.

⁵⁷ Case 48/69, 14 July 1972, *Imperial Chemical Industries Ltd. v Commission of the European Communities*, [1972] ECR 00619.

⁵⁸ VAN BAEL & BELLIS (edited by), 2009, “*Competition Law of the European Community*”, 5th edition, Kluwer Law International, p. 151.

⁵⁹ Joined cases C-89/85, C-104/85, C-114/85, C-116/85, C-117/85 and C-125/85 to C-129/85, 31 March 1993, *A. Ahlström Osakeyhtiö and others v Commission of the European Communities*, [1993] ECR I-01307.

⁶⁰ VAN BAEL & BELLIS. *Ibid.*, p. 152.

⁶¹ See GERADIN, Damien, REYSEN, Marc and HENRY, David, “*Extraterritoriality, Comity and Cooperation in EC Competition Law*”, Working Paper, July 2008, [Accessed 11th July 2011], Available from:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1175003&.

and the economic entity doctrine could be invoked to justify the extraterritorial application of the scheme.

4.2. The Chicago Convention.

The claimants invoked Article 11 of the Chicago Convention, which states that “*subject to the provisions of this Convention, the laws and regulations of a contracting State relating to the admission to or departure from its territory of aircraft engaged in international air navigation, or to the operation and navigation of such aircraft while within its territory, shall be applied to the aircraft of all contracting States without distinction as to nationality, and shall be complied with by such aircraft upon entering or departing from or while within the territory of that State*”⁶².

It is the claimants’ opinion that the Emission Trading Scheme falls foul of Article 11 of the Convention since it is to be applied also to flights outside the airspace of the EU. However, while this objection might seem justified in view of the wording of Article 11, in my opinion it misrepresents the rationale of this provision.

It has been pointed out⁶³ that Article 11 should merely be seen as an anti-discrimination provision with a very narrow purpose: that of preventing discriminatory treatment of foreign aircraft.

By this standard, the ETS is unquestionably non-discriminatory, since it treats similarly all flights regardless of their point of departure or country of registration.

However, the argument made by ETS advocates⁶⁴ that Article 11 concerns only laws and regulations relating to the operation and navigation of aircraft and does not apply to environmental legislation, is far less persuasive (indeed the idea of interpreting the words “*laws and regulations [...] relating [...] to the operation [...] of such aircraft*” as including environmental legislation does not seem to be too far-fetched),

⁶² Convention on International Civil Aviation, Article 11 [emphasis added].

⁶³ E.g. BISSET, Mark and CROWHURST, Georgina “*Is the EU’s Application of its Emissions Trading Scheme to Aviation Illegal?*”, Clyde&Co, 2011.

⁶⁴ BISSET, Mark and CROWHURST, Georgina. Ibid.

and will probably be one of the most contentious issues on which the Court will be called to rule.

Another provision invoked by the claimants was Article 12 of the Chicago Convention, which reads as follows:

*“Each contracting State undertakes to adopt measures to insure that every aircraft flying over or manoeuvring within its territory and that every aircraft carrying its nationality mark, wherever such aircraft may be, shall comply with the rules and regulations relating to the flight and manoeuvre of aircraft there in force. Each contracting State undertakes to keep its own regulations in this respect uniform, to the greatest possible extent, with those established from time to time under this Convention. Over the high seas, the rules in force shall be those established under this Convention. Each contracting State undertakes to ensure the prosecution of all persons violating the regulations applicable”*⁶⁵.

Over the years, the International Civil Aviation Organization has adopted a very broad interpretation of this provision, to include within its scope carbon taxes and cap-and-trade schemes. The rationale followed by the ICAO might be that since emissions charges are levied in relation to fuel burn, arguably there could be a conflict between airlines’ navigational activities and the need to save fuel⁶⁶.

Like Article 11, Article 12 requires the signatories to adopt measures to ensure a certain degree of uniformity of flight rules between contracting states.

In my opinion it is highly unlikely that the Court of Justice will find that an environmental regulation such as the ETS falls within the scope of this provision, since it does not affect in any way the flight of aircraft.

The relevance of the last provision of the Chicago Convention invoked by the claimants seems to be much more convincing. In fact, the last sentence of Article 15 of the Convention merely states that *“No fees, duties or other charges shall be imposed by any contracting State in respect solely of the right of transit over or entry into or exit from its*

⁶⁵ Convention on International Civil Aviation, Article 12.

⁶⁶ BISSET, Mark and CROWHURST, Georgina. *Ibid.*

*territory of any aircraft of a contracting state or persons or property thereon*⁶⁷.

While it has been argued that the trading scheme does not levy new “*fees, duties or other charges*”⁶⁸, but merely mandates that aircraft operators monitor and report their emissions and offers them a choice between operating within their allocated allowances or exceed those allowances by buying additional ones at auction or on the market, it is difficult to deny that a fine or the cost of additional allowances do not amount to an additional fee or charge.

We should also keep in mind that the Court’s case law in recent years has undergone a true sea change, to adapt to the dramatic reform which has swept certain fields of EU Law. The spirit of this reform was felicitously described by Commissioner Monti as the shift “*from a legalistic based approach to an interpretation of the rules based on sound economic principles*”⁶⁹. This new doctrine, which has been dubbed the “more economic” (or “effect-based”) approach, has informed much of the recent European legislation⁷⁰.

The more economic approach emphasizes the actual economic effects of a practice (or of a measure) on the internal market⁷¹, and while it was developed in the field of competition law, the same reasoning could easily be applied to the *ATA* case (as indeed *was* implicitly applied by the Commission in its decisions on the first NAPs).

⁶⁷ Convention on International Civil Aviation, Article 15.

⁶⁸ According to the ICAO’s Council Resolution on Taxation of International Air Transport “charges are [merely] levies to defray the costs of providing facilities and services for civil aviation.”.

⁶⁹ MONTI, Mario, “EU Competition Policy after May 2004”, Speech given at the Fordham Corporate Law Institute, New York, 24 October 2003, [Accessed 15 March 2011] Available from:

<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/03/489&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁷⁰ E.g. the “Umbrella regulation on vertical agreements” [i.e. Commission Reg. 2790/1999 on the application of Art. 81(3) to categories of vertical agreements and concerted practices [1999] OJ L 336], the Guidelines on the application of Article 81(3) and the Merger Regulation.

⁷¹ “In applying the EC competition rules, the Commission will adopt an economic approach which is based on the effects on the market; vertical agreements have to be analysed in their legal and economic context”, Guidelines on vertical restraints, [2000] OJ C 291/1.

If the Court were to adopt this approach, I think we can safely predict that it will conclude that the ETS does levy a new fee under the provision at issue.

It has however been convincingly argued⁷² that, even though the ETS must be considered an additional charge, it is not imposed in respect solely of the right of entry into or exit from the EU airspace (and would therefore not fall foul of the prohibition under Article 15).

4.3. The Open Skies Agreement.

The Open Skies Agreement⁷³ is an air transport agreement between the European Union and the United States signed in April 2007 which allows any EU airline and any US airline to fly between any point in the territory of the European Union and any point in the United States.

Article 11(2) (c) of the Agreement, states that “*there shall [...] be exempt, on the basis of reciprocity, from the taxes, levies, duties, fees and charges [...] with the exception of charges based on the cost of the service provided [...] c) fuel, lubricants and consumable technical supplies introduced into or supplied in the territory of a Party for use in an aircraft of an airline of the other Party engaged in international air transportation, even when these supplies are to be used on a part of the journey performed over the territory of the Party in which they are taken on board*”.

In the proceeding before the High Court of Justice Queen’s Bench Division, the Treasury Solicitor has however pointed out that the ETS cannot be construed as one of the taxes, levies, duties, fees or charges from which fuel is exempt.

Even though this view is consistent with ICAO policy (which traditionally distinguishes between taxes and cap-and-trade systems), it is far from certain that the Court of Justice will adopt it.

⁷² E.g. BISSET, Mark and CROWHURST, Georgina. Ibid.

⁷³ Air Transport Agreement, [2007] OJ L 134/4.

In fact, in a similar case in the late 1990s⁷⁴, the ECJ held that a tax on emissions calculated on fuel consumption, levied by the Swedish Government, amounted to a tax on fuel, since “*a domestic tax of that kind, [...] is levied on the consumption of fuel since there is a direct and inseverable link between fuel consumption and the polluting substances emitted in the course of such consumption*”⁷⁵.

This is certainly the most convincing objection raised by the claimants in the *ATA* case, and the outcome of the trial will certainly pivot around the Court’s answer to this question.

It is however important to understand that this argument has very different implications from the other arguments raised by the claimants, since if the former prevails, a ruling would affect only US Airlines (and would consequently be of little consequence for domestic or other foreign operators)⁷⁶.

4.4. The Kyoto Protocol.

The claimants also argued that Kyoto rules require the signatories to enact measures aimed at reducing emissions exclusively within the framework provided by the ICAO. Among the arguments raised by the airlines, this is certainly the weakest, and it is highly unlikely that the Court will pay any heed.

Indeed, while Article 2.2 of the Kyoto Protocol states that parties shall pursue limitation or reduction of greenhouse gases working through the ICAO, the claimant’s argument that under this provision any action undertaken outside of the ICAO framework is therefore

⁷⁴ Case C-346/97, 10 June 1999, *Braathens Sverige AB v Riksskatteverket*, [1999] ECR Page I-03419, cited in Air Transport Association of America, “*The European Union’s Emission Trading Scheme: a violation of International Law*” [Accessed 26 August 2011], Available from:

http://www.airlines.org/PublicPolicy/Testimony/Pages/TheEuropeanUnion%E2%80%99sEmissionsTradingSchemeAViolationofInternationalLaw.aspx#_ftnref5.

⁷⁵ *Ibid.*, Summary Para. 1.

⁷⁶ We should however keep in mind that most bilateral air transport agreements include similar clauses.

prohibited is very difficult to reconcile with the spirit or the wording of the Protocol⁷⁷.

5. EMISSION TRADING SCHEME AND THE INTERNAL MARKET.

Most commentators have taken a rather critical view of the claimant's objections in the *ATA* case (especially with regard to the provisions of the Chicago Convention invoked by them), however we must not underestimate the dangers of a ruling which might exclude US airlines from the application of the ETS.

Moreover, in its upcoming judgment the Court might decide to address some other issues which, albeit lying beyond the scope of the preliminary reference made by the British Court, are intimately linked with the EU Emission Trading Scheme.

In the landmark *Arcelor Atlantique et Lorraine* case⁷⁸, a major steel producing company with installations for the production of pig iron and steel in several European countries sought judicial review of a decision by the French authorities to implement Directive 2003/87/EC in France. The claimant argued, in support of its application, that the ETS Directive infringed its fundamental rights to property and the pursuit of an economic activity, since it constrained its installations to operate under crippling economic conditions thus violating the non-discrimination principle.

Moreover, the applicant argued that the inclusion of its plants in the Emission Trading Scheme constituted a breach of the principle of equality, since other sectors which were in direct competition with the

⁷⁷ Especially after the Committee on Aviation Environmental Protection (CAEP) of the ICAO, in its September 2004 meeting, failed to issue a legal instrument to coordinate emission trading and greenhouse gas reduction through the ICAO framework. For a conspectus of the EU's initiative outside the ICAO framework, see REAGAN, Daniel B., "Putting International Aviation into the European Union Emission Trading Scheme. Can Europe do it flying solo?", *Boston College Environmental Affairs Law Review*, Vol. 35, Issue 2, 2008, pp. 349-384.

⁷⁸ Case C-127/07, 16 December 2008, *Société Arcelor Atlantique et Lorraine and others v. Premier Ministre, Ministre de l'Ecologie et du Développement durable and Ministre de l'Economie, des Finances et de l'Industrie*, [2008] ECR Page I-09895.

applicant (and with greenhouse gas emissions at least comparable with the applicant's) such as non-ferrous metals and chemicals producers were not subject to the new regime.

Therefore the question raised by the Conseil d'Etat had to do "*with whether there is an objective justification for the difference in treatment introduced by the contested directive between the steel sector on the one hand and the plastic and aluminium sectors on the other, even though those sectors are in comparable situations*"⁷⁹.

In a landmark judgment dated 16 December 2008, the European Court of Justice held that the principle of equal treatment did not affect the validity of the ETS "*in so far as it makes the greenhouse gas emission allowance trading scheme applicable to the steel sector without including the chemical and non-ferrous metal sectors in its scope*"⁸⁰.

In fact, the Court argued that the scheme introduced by Directive 2003/87 was a novel and complex scheme the implementation of which could have been hindered by the involvement of too great a number of participants and the objective of which was to reach the critical mass of participants necessary for the ETS to work.

Therefore, "*in view of the novelty and complexity of the scheme, the original definition of the scope of Directive 2003/87 and the step-by-step approach taken [...] in order not to disturb the establishment of the system were within the discretion enjoyed by the Community legislature*"⁸¹.

In reaching this conclusion, the Court drew on its abundant case-law on step-by-step implementation of new policies⁸² ruling, as regards the exclusion of the chemical sector, that the difference in the level of emissions between the steel and chemical industry is so substantial that

⁷⁹ Case C-127/07, *Société Arcelor Atlantique et Lorraine and others v. Premier Ministre, Ministre de l'Ecologie et du Développement durable and Ministre de l'Economie, des Finances et de l'Industrie*, Opinion of Mr Advocate General Poiares Maduro delivered on 21 May 2008, [2008] ECR Page I-09895, para 40.

⁸⁰ *Ibid.*, Summary.

⁸¹ *Ibid.*, Summary.

⁸² E.g. Case 37/83, *Rewe-Zentrale* [1984] ECR 1229, para. 20; Case C-63/89; *Assurances du crédit v. Council and Commission* [1991] ECR I-1799, para 11; Case C-233/94 *Germany v. Parliament and Council* [1997] ECR I-2405, para. 43.

the different treatment of these industries during the trial period of the ETS was justified in light of the enormous difficulties that the EU was likely to encounter in its attempt to implement the new regime.

Even though the claimants in the *ATA* case did not raise the objections raised in the *Arcelor* case, it is likely that the latter constitutes a defining precedent, which will deeply affect future Court rulings on the ETS.

As a matter of fact, the Court might draw on the rationale of *Arcelor* to justify an “elastic” interpretation of the Chicago Convention and of the Open Skies Agreement: one which would not compromise the integrity and the implementation of the Emission Trading Scheme.

The same concerns which were addressed by the Court of Justice of the EU in *Arcelor*, are likely to fuel future debate (and criticism) on emission trading, since by including in its scope of application the aviation industry, while leaving out other competing sectors such as rail or road transport, Directive 2008/101/EC did not merely set up a new environmental policy, but also a new industrial policy, the consequences of which (albeit still hard to quantify) will likely be momentous.

Enforcing stricter emission rules in one particular sector will likely affect the market equilibrium in the whole transport and marine sectors, and the Court will in all likelihood be asked to rule on complex issues such as how to draw the boundary of the relevant market with regard to competition between different means of transport and what should be the extent of the European authorities’ interference in the competitive interplay between different operators.

The literature on competition between air and rail transport is rather limited, however recent studies have emphasized that journey time is the most important determinant of market share⁸³, together with price and

⁸³ See STEER DAVIES GLEAVE, “Air and Rail Competition and Complementarity”, Report prepared for the European Commission DG TREN, August 2006 [Accessed 10th July 2011], Available from:

http://ec.europa.eu/transport/rail/studies/doc/2006_08_study_air_rail_competition_en.pdf.

It is however possible that these results reflect a time in which the price of allowances was at its lowest point, thus neutralizing any effect which the ETS might have had on the aviation and rail market.

frequency⁸⁴. It is therefore likely that a significant non-transitory increase in price might affect market share for short-range journeys (within 500 kilometres), where price is the overriding concern for the user.

The implementation of the Emission Trading Scheme also raised some serious concern with regard to the prohibition of State aid pursuant to Article 107 of the Treaty on the Functioning of the European Union (ex Article 87 TEC). Said provision declares “incompatible” with the internal market any aid granted by a Member State or through State resources which may in any way distort or threaten to distort competition by favouring certain undertakings or industries, in so far as this may affect trade between Member States.

Article 107 TFEU however provides for cases of *de jure* and discretionary derogations to this incompatibility in its second and third paragraphs⁸⁵.

In its early assessments of National Allocation Plans, the Commission has consistently held that the allocation of allowances free

⁸⁴ See ADLER, Nichole, NASH, Chris, PELS, Eric, “High-Speed Rail & Air Transport Competition”, TI 2008- 103/3, Tinberger Institute Discussion Paper, 2008 [Accessed 10 July 2011] Available from:

<http://www.tinbergen.nl/discussionpapers/o8103.pdf>.

⁸⁵ “2. *The following shall be compatible with the internal market:*
(a) *aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;*

(b) *aid to make good the damage caused by natural disasters or exceptional occurrences;*

(c) *aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point.*

3. *The following may be considered to be compatible with the internal market:*

(a) *aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;*

(b) *aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;*

(c) *aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent*

contrary to the common interest;

(d) *aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common*

interest;

(e) *such other categories of aid as may be specified by decision of the Council on a proposal from the Commission” [Article 107 TFEU].*

of charges (a phenomenon known as “windfall profits”) can be considered a measure imputable to the Member States under Article 107 TFEU⁸⁶.

In a string of Decision the Commission has also held that NAPs fulfil all the criteria set out by Article 107, arguing that when allowances are granted for free they do confer a selective advantage to the recipient and are thus liable to distort competition in the internal market⁸⁷.

However, the Commission has so far been very reluctant to use its powers under Article 107, in spite of mounting evidence of the significant economic rents and competitive advantages conferred by the ETS on certain undertakings and industries. The timidity of the Commission was probably prompted by the (reasonable) fear that a strict enforcement of Article 107 would compromise the implementation of the ETS. Another factor might have been the dramatic lack of resources of the Commission, which is quite clearly unable and unwilling to carry out the kind of in-depth analysis which would be necessary.

Moreover, we must not forget that questioning allocation plans based on “expected needs” would force the Commission to take politically sensitive decisions concerning the industrial policy of Member States⁸⁸.

The Commission itself acknowledged that the lack of over-allocation is the crucial factor in preventing the allotment of allowances from becoming a tool to circumvent Article 107⁸⁹.

The timidity of the Commission is a serious concern especially after the *EnBW* case⁹⁰, in which the Court of First Instance rejected an application, brought by the operator of a nuclear plant, to annul the Commission decision on the German NAP (in which the Commission

⁸⁶ See European Commission, Decision on the second Slovakian NAP, 29th November 2006 and Decision on the first Danish NAP, 7th July 2004. For an in-depth analysis of the Commission’s views on this issue, see DE SEPIBUS, Joëlle, “The European Trading Scheme Put to the Test of State Aid”, NCCR Working Paper 34/2007.

⁸⁷ See European Commission, Decision on the first French NAP, 20th November 2004 and Decision on the second German NAP, 29th November 2006.

⁸⁸ See DE SEPIBUS, Joëlle, “The European Trading Scheme Put to the Test of State Aid”, NCCR Working Paper 34/2007.

⁸⁹ See Community Guidelines on State aid for environmental protection, OJ C 82, 1.4.2008, p.1, Section 1.5.11 point 55.

⁹⁰ Case T-387/04, 30th April 2007, Order of the Court of First Instance (Third Chamber), *EnBW Energie Baden-Württemberg AG v Commission of the European Communities*, [2007] ECR II-01195.

held that the allocation plan qualified for derogation under Article 107.3), arguing that the claimant lacked *locus standi*, since it could have no direct interest in the annulment of that measure.

The immediate consequence of the *EnBW* case is that now the Commission is the “sole gatekeeper”⁹¹ of the State Aid provisions and any chance of stopping distortions of competition and rent-seeking behaviours will depend entirely on its will to intervene and to question the industrial and economic policies of Member States.

In spite of serious rounds of consultations with stakeholders throughout the first month of 2011, it is highly unlikely that the new “Guidelines on State aid for environmental protection” will change the current situation. The fear that an additional economic burden on major industries might lead factories to relocate abroad (a phenomenon which has been dubbed “carbon leakage”)⁹² will inevitably lead to serious concessions in the future and to an ever more lenient attitude towards State aid.

The Commission itself has emphasized that the matters which must be addressed in the new Guidelines for the third trading period (starting in 2013) include “*aid for undertakings exposed to a significant risk of carbon leakage for costs related to EU ETS allowance[s]*”⁹³.

Judging from the early years of implementation, I think we can safely conclude that while the Commission’s leniency in its assessment of State aid might shield aircraft operators (and, more in general, emitters) from some of the worst economic repercussions of the ETS, on the other hand it might also become a tool in the hands of the Member States to undermine the scheme.

⁹¹ DE SEPIBUS, Joëlle, *Ibid.*

⁹² Or might provide an advantage for non-EU airlines.

⁹³ Commission non-paper submitted to the European Parliament and the Council on 19 November 2008 (Annex 2 15713/1/08) – “Proposed assessment criteria for state aid to compensate for electricity cost increases due to pass on of CO₂ costs” [Accessed 27 August 2011] Available from:

<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0610+0+DOC+XML+V0//EN>.

6. CONCLUSIONS AND RECENT DEVELOPMENTS.

Clearly, the objections raised by the claimants in the *ATA* case cannot be dismissed out of hand as *chicaneries*, or specious arguments made by an industry eager to protect vested interests and rents arising from its egregious externalities.

On the contrary, the case made by the airlines involved is well-founded, given the implications of a measure which lays an heavier economic burden on their shoulders.

If the Court were to uphold the validity of the ETS, in order to comply with the new regime, airlines would have to either scrap or refit their fleets or continue to operate the ones they have by buying additional allowances at auction or on the market. The costs of both solutions are, needless to say, extremely significant and it is likely that these companies will transfer them onto the consumers through higher air fares.

While the negative consequences of the ETS for airlines are likely to be extremely costly and painful, its considerable benefits will be very difficult to measure (and much less evident to aircraft operators and to the public). Replacement of older aircraft will entail a significant reduction in fuel consumption and maintenance costs.

As already said, the principal merit of the ETS is that of internalising the externalities, the hidden costs, of pollution. This may in turn shift supply and demand for certain services, affect investment patterns and encourage R&D expenditure. In the long term, this scheme might even increase what economists call “dynamic efficiency” (i.e. the optimal use of resources for research and development).

Indeed, the ETS is expected to encourage the development of cleaner engines and the use of bio fuels.

However, as it almost invariably happens, the benefits of increased dynamic competition are going to be spread throughout society, while the immediate pain caused by the implementation of the ETS is going to

hit a very narrow sector of the economy (with immediately visible consequences).

The challenge to the ETS brought by ATA is likely to be only the first obstacle that the EU will encounter in implementing the scheme. Indeed, a few non-EU countries have already expressed their concern with regard to the application of the trading scheme to airlines.

Only a few months ago, Chinese state media announced that three Chinese airlines (China Eastern Airlines, China Southern Airlines and Air China) may be preparing to challenge the EU ETS in Court, claiming that this “carbon tax” will end up costing them millions of dollars a year.

In a press release dated 17th March 2011⁹⁴, these airlines claimed that in 2012 alone the cost of the Emission Trading Scheme for China’s aviation sector will be in the region of 800 million yuan renminbi (i.e. \$ 122 million). According to Wei Zhangzhong, secretary general of the China Air Transport Association, the costs of the ETS for Chinese airlines could hit the staggering figure of three billion yuan per year by 2020. The press release also points out that “the aviation industry is only slightly profitable” and therefore the air companies are very likely to pass the costs on to the passengers.

The China Air Transport Association has calculated that the EU “carbon tax” will likely entail a fare increase of 300 yuan renminbi for each economy flight seat. In the wake of these announcements, Hainan Airlines, another large Chinese carrier, has announced that it may also participate in the litigation, however it is still unclear when and, more importantly, where will these Companies be filing their legal action.

The international opposition to the ETS has been equally successful at gaining support among foreign governments. On 20th July 2011, ten US Congressmen submitted to the House of Representatives a bill which prohibits operators of civil aircraft of the United States from participating in the ETS.

⁹⁴ Flanders-China chamber of Commerce- 31 March 2011- “Chinese Airlines oppose the EU’s Emission Trading Scheme”, Available from: <http://news.flanders-china.be/chinese-airlines-oppose-the-eus-emission-trading-scheme>.

As for the criticism levelled against the ETS by IATA⁹⁵, the need for a “global approach” as “the only effective long-term solution”, it is not, in my opinion, quite so persuasive an argument as it may seem.

In fact, IATA’s objection seems to ignore the fact that while Directive 2003/87/EC allows the Commission to link up the ETS with other trading schemes⁹⁶, the negotiations necessary to build a consensus around a truly “global approach” could be inordinately long and would very likely fall short of the emission cuts required by Kyoto.

Finally, we must emphasize that the debate (in the courtroom or in the forum of public opinion) will be inevitably influenced by the fact that in implementing the Emission Trading Scheme the EU has not simply chosen to address an environmental measure, but has set in motion an overhaul of the European industrial policy in several strategic sectors such as the steel, chemical and airline industries.

⁹⁵ At the 37th ICAO assembly in Montreal.

⁹⁶ Directive 2003/87/EC, Article 25.

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