

Environment and Carbon Law

23 December 2011

Airlines EU ETS Update

As expected following the Advocate General's Opinion, delivered on 6 October 2011, the European Court of Justice (ECJ) ruled on Wednesday 21 December 2011 that the application of the EU Emissions Trading Scheme to airline operators flying in and/or out of the EU was lawful. The ECJ rejected the objections of US and Canadian airline operators that the imposition of the EU ETS infringed a number of principles of customary international law and various international agreements. According to them, the directive infringes, first, the Chicago Convention, the Kyoto Protocol and the Open Skies Agreement (in particular because it imposes a form of tax on fuel consumption), and second, certain principles of customary international law in that it seeks to apply the allowance trading scheme beyond the European Union's territorial jurisdiction.

In its judgment, the ECJ confirmed the validity of the directive (2008/101/EC) that includes aviation activities in the emissions trading scheme (2003/87/EC).

First of all, the ECJ established that only certain provisions of the Open Skies Agreement and three principles of customary international law (namely the sovereignty of States over their airspace, the illegitimacy of claims to sovereignty over the high seas and freedom to fly over the high seas) may be relied upon for the purposes of examination of the directive's validity. Of the principles and provisions mentioned by the High Court, they alone fulfil the criteria laid down by the ECJ's case-law.

In particular, the ECJ establishes that the EU is not bound by the Chicago Convention because it is not party to that convention and also has not hitherto assumed all the powers falling within the field of the convention. As regards the Kyoto Protocol, the Court observes that the parties to the protocol may comply with their obligations in the manner and at the speed upon which they agree. In particular, the obligation to pursue limitation or reduction of emissions of certain greenhouse gas ("GHG") emissions from aviation fuels, working through the International Civil Aviation Organisation (ICAO), is not conditional and sufficiently precise to be capable of being relied upon.

Whilst the ECJ agrees to examine, within the limits of review as to a manifest error of assessment, the validity of the directive in the light of the three principles of customary international law relied upon, it found however, in the case of the fourth

principle, that there is insufficient evidence to establish that the principle that a vessel on the high seas is governed only by the law of its flag could apply by analogy to aircraft.

The ECJ then examined whether the directive is compatible with the principles of customary international law and the Open Skies Agreement.

The ECJ observed that the directive is not intended to apply as such to aircraft flying over the high seas or over the territory of the Member States of the EU or of third States. It is only if the operators of such aircraft choose to operate a commercial air route arriving at or departing from an airport situated in the EU that they are subject to the EU ETS.

With that in mind, the application of the EU ETS to aircraft operators does not infringe the principle of territoriality or sovereignty of third States, since the scheme is applicable only when aircraft are physically in the territory of one of the Member States of the EU and thus subject to the unlimited jurisdiction of the EU. The application of EU law does not affect the principle of freedom to fly over the high seas since aircraft flying over the high seas are not subject, in so far as it does so, to the EU ETS.

The ECJ pointed out that EU environmental policy aims to provide a high level of protection and the principles of customary international law do not call into question the full applicability of EU law in territory outside of the EU, including the application of the EU ETS to the whole flight.

The ECJ refuted that the EU ETS constituted a tax, fee or charge in breach of the Open Skies Agreement as the defining feature of the EU ETS is that there is no direct and inseverable link between the quantity of fuel held or consumed by an aircraft and the pecuniary burden on the aircraft's operator in the context of the EU ETS' operation.

This means that from the 1 January 2012 airlines will be charged under the EU ETS¹ on GHG emissions created by flights to and from the twenty seven EU Member States no matter where the operator is based in the world. The European Commission estimated that the EU ETS could increase the cost of a single trip ticket by between €2 and €12 (US\$2.60 and US\$15.70) depending on the flight length. Thomson Reuters forecasted a €9 billion (US\$11.8 billion) addition to airlines' cost by 2020.

¹Under the Aviation Emissions Directive (Directive 2008/101/EC) amending (Directive 2003/87/EC) so as to include aviation activities in the EU ETS.



Airline operators will have to surrender 1 allowance per tonne of carbon dioxide emitted on a flight into and from (and within) the EU. Non-complying operators face a penalty of €100 per missing allowance, on top of the obligation to procure and surrender missing allowances.

Carbon dioxide emissions from the aviation industry will be capped at 97% of the average 2004 to 2006 emission levels for 2012, and 95% of the average 2004 to 2006 emission levels from 2013 onwards. Any aviation emissions above these levels will need to be matched by equal reductions in other sectors subject to the EU ETS.

The quantity of EU Aviation Allowances (EUAs) to be auctioned will be much smaller than the number of EU Allowances (EUAs) to be auctioned under the EU ETS. The EU will distribute 85% of the EUAs for free and many commentators anticipate that potential hedging needs (for airlines to purchase the remaining allowances that they will need to surrender) can be satisfied by supply of EUA forwards and futures.

From an all time low of €6.45 on the 14 December, the price of EUAs rose with the announcement that the European Parliament's environment committee voted to cut the supply of allowances by 63% for phase three (2012 to 2020) to a high of €9.75, a 32% increase, at close on the 19 December 2011. On the day of the ECJ judgment (21 December 2011), the EUA price fell 6.5 percent to €8.33 and at the date of the article (23 December 2011) the price of EUAs stands at €8.27; still significantly above the 14 December all time low.

Response to the ECJ findings have been swift and strong. The US warned that the ruling had not resolved Washington's "strong objections" to the EU plan. US Secretary of State, Hilary Clinton, told her European counterparts that Washington will

be "compelled to take appropriate action" if the EU did not reconsider its plans. Lawmakers in the US are pushing bills that would ban US airlines from complying, and Airlines for America, the US aviation trade industry association, said it was reviewing its options for a further challenge before London's High Court. Separately, China said it could take Brussels to court and hinted that the scheme could adversely impact on Airbus jet orders. Experts have warned that the ECJ ruling could spark an international trade war.

There are also worries that the EU's action could hamper the on-going deregulation of the industry.

The Fitch ratings agency warned of a global trade dispute stating "We believe threats of trade retaliation over the EU's cap-and-trade system will pose a growing threat to access to aviation market in both developed and emerging markets next year," adding that counter-measures could include changes in slot allocations at airports and authorising routes, particularly in developing countries.

Burges Salmon has been advising a number of companies, including airlines, through the complex web of negotiations involved in emissions trading. To assist airline operators we have produced a useful guide which is available from:

http://www.burges-salmon.com/Practices/environment_and_health_and_safety/emissions_trading_and_carbon_law/Publications/Airlines_Are_you_ready_for_the_EU_Emissions_Trading_Sch.pdf

The guide raises a number of questions we suggest airlines consider as a matter of priority and explains how Burges Salmon could in this process.

If you would like to discuss how the EU ETS will affect your business and what you can do to mitigate its impact, please contact:



Georgie Messent
Partner

T: 0117 902 7732
E: georgie.messent@burges-salmon.com



Esther Kiddle
Solicitor

T: 0117 307 6811
E: esther.kiddle@burges-salmon.com

Burges Salmon LLP, One Glass Wharf, Bristol BS2 0ZX Tel: +44 (0) 117 939 2000 Fax: +44 (0) 117 902 4400
Chancery Exchange, 10 Furnival Street, London EC4A 1AB Tel: +44 (0) 20 7685 1200 Fax: +44 (0) 20 7685 1266

www.burges-salmon.com

Burges Salmon LLP is a Limited Liability Partnership registered in England and Wales (LLP number OC307212) and is authorised and regulated by the Solicitors Regulation Authority. A list of members, all of whom are solicitors, may be inspected at our registered office: One Glass Wharf, Bristol BS2 0ZX.

© Burges Salmon LLP 2011. All rights reserved. Extracts may be reproduced with our prior consent, provided that the source is acknowledged. Disclaimer: This briefing gives general information only and is not intended to be an exhaustive statement of the law. Although we have taken care over the information, you should not rely on it as legal advice. We do not accept any liability to anyone who does rely on its content.

Data Protection: Your details are processed and kept securely in accordance with the Data Protection Act 1998. We may use your personal information to send information to you about our products and services, newsletters and legal updates; to invite you to our training seminars and other events; and for analysis including generation of marketing reports. To help us keep our database up to date, please let us know if your contact details change or if you do not want to receive any further marketing material by contacting marketing@burges-salmon.com.