

Position Paper

19 February 2008

NO FULL AUCTIONING FOR AVIATION

Climate change and global warming are probably the most worrying challenges of the new century, as they will have far-reaching effects on future generations.

All economic and industrial sectors have a duty to participate in the world's efforts to reduce greenhouse gases.

International aviation, despite its modest contribution to emissions, is actively engaged in the fight against climate change.

The AEA, representing 33 major carriers in Europe, is entirely committed to being environmentally responsible and responsive.

In 2005, together with the other stakeholders of the European Aviation Industry, AEA adopted its 'Emissions Containment Policy' - a multi-action approach based on 4 key pillars: technological progress, infrastructure improvements, enhancement of operational procedures and economic instruments.

In the latter category, the AEA supports an open Emissions Trading Scheme (ETS) which has been recognised by the International Civil Aviation Organisation (ICAO) as the most environmentally efficient and cost-effective mechanism.

Given the fact that the AEA is

- Supportive of the environmental leadership of the EU,
- Determined to assume its rightful share of the burden to reduce emissions along side the other sectors,
- Positively committed to a well-designed, workable, efficient and attractive ETS, which could be endorsed by the international community and even serve as a model,
- Actively involved in the legislative process to include international aviation in the current EU ETS,

The AEA could not accept that, over years, the ETS would be turned into a blunt fiscal instrument, a disguised kerosene tax which would violate the Chicago Convention. The introduction of full auctioning in the aviation scheme, as foreseen within the framework of the revision of the EU ETS Directive 2003/87, will radically change the basic nature of the ETS, without providing any environmental benefits.

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- Aer Lingus
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- Croatia Airlines
- Cyprus Airways
- Czech Airlines
- Finnair
- Iberia
- Icelandair
- Jat Airways
- KLM
- LOT
- Lufthansa
- Luxair
- Malev
- Olympic Airlines
- SAS Scandinavian Airlines
- Spanair
- SWISS
- TAP Portugal
- TAROM
- Turkish Airlines
- Ukraine International Airlines
- Virgin Atlantic Airways

The AEA therefore urges The European Parliament and the Council to reject the principle of full auctioning in the aviation ETS, so as to offer the greatest chance of success for the construction of a coherent, workable and sensible aviation ETS and to ensure the best conditions for fruitful negotiations within and outside the EU.

In this respect, the AEA has identified 10 reasons why full auctioning for aviation will discredit ETS and will not help to achieve environmental targets.

Full auctioning:

- favours carbon leakage and traffic deviation;
- destroys the attractiveness of the EU ETS and makes third countries' acceptance more difficult;
- is in fact a tax and would infringe the Chicago Convention;
- generates costs without providing any environmental benefits, as there is no clear earmarking of auctioning proceeds to aviation;
- does not boost the use of clean energy as this is not yet operational in aviation;
- is a misuse of the 'polluter pays' principle (PPP) as there is no redistribution of the money collected;
- is a misconception of ETS as it distorts the relationship between buyers and sellers within the ETS;
- distorts competition as proceeds could be used to subsidise competing modes of transport;
- is not a good distribution method as it does not reward operators' early action;
- is not needed as a safeguard against windfall profits as these are unlikely to occur in aviation.

For more details please see separate document entitled "10 Reasons why Full Auctioning for aviation will discredit ETS".

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10 REASONS WHY FULL AUCTIONING FOR AVIATION WILL DISCREDIT ETS

1. Full Auctioning favours carbon leakage and traffic deviation

Aviation is an international activity which is exposed to fierce competition at worldwide level. With a geographical scope which encompasses both intra and extra-EU flights, the EU ETS creates the conditions for potential traffic deviation via non-EU hubs. This potential risk will become a certainty if full auctioning is implemented. The end result, in addition to the unavoidable distortion of competition between EU and non-EU carriers, would be significant carbon leakage. This could take several forms:

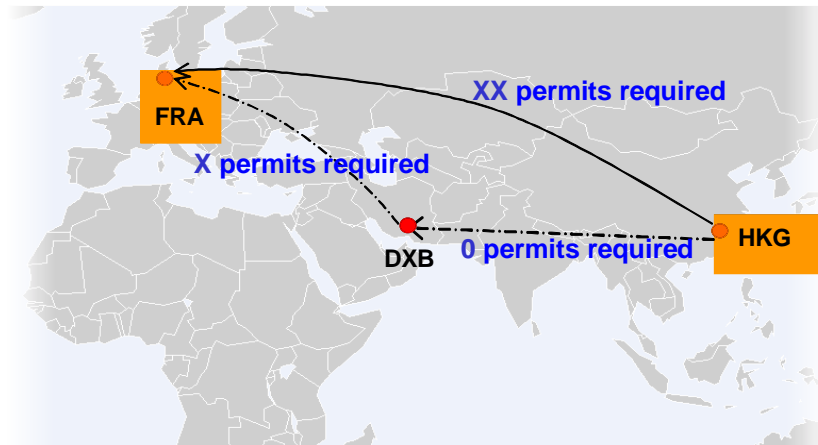
- As shown in the illustration below, trans-continental flights which currently transit through EU airports could well elect to use non-EU hubs. They would then completely avoid EU territory and hence escape the constraints of ETS, but at the same time would continue to use EU airspace and to freely emit CO₂ therein.

Carbon Leakage/Traffic Deviation/Distortion of Competition



- As shown in the illustration below, for trans-continental flights with a final destination in the EU, operators could simply organise an intermediary stop-over at any non-EU airport adjacent to the EU, attributing different flight codes to the different legs. They would therefore only be liable to pay for emissions related to the leg touching the EU. This type of carbon leakage is known in other sectors as 'border effects'.

Carbon Leakage/Traffic Deviation/Distortion of Competition



For mobile sources such as aviation, full auctioning would lead to traffic deviation and hence to carbon leakage. This would have a serious economic impact on EU operators, tourism, and the economy in general (economic 'ripple effect') without providing any environmental benefits. For example, some Member States' economies that are strongly focused on tourism and for which air access is the primary mode of transport, would be more exposed to a serious potential risk of economic decline if a full auctioning ETS is put in place. The EU would be powerless to prevent both traffic deviation and carbon leakage.

2. Full auctioning destroys the attractiveness of the EU ETS and makes third countries' acceptance more difficult

The EU claims leadership on environment and wants to be the driving force in the international arena. To be successful the EU should design an ETS which is acceptable to third countries and which could serve as a model and an example to be followed. The ETS should be simple, manageable, attractive, and above all should comply with ICAO recommendations. This means that the design elements should be fair and reasonable. In this respect, full auctioning is perceived by third countries as a disguised fiscal instrument to impose a kerosene tax on their carriers (cf Point 3). Moreover, the proposal to use auctioning revenues to finance the railways could be seen as a provocation. Third countries fail to understand why, through ETS, they should cross-subsidise the TGV in Europe (cf Point 8).

Unilateral imposition of an EU ETS has been rejected by the world aviation community. A full auctioning will definitely discredit the scheme. It will seriously complicate the current negotiations and will undermine the construction of a coherent, workable and sensible system for aviation.

3. Full auctioning is in fact a tax and infringes the Chicago Convention

Initially, auctioning was conceived to cover only the administrative costs of ETS, but it has progressively been turned into a fiscal instrument. Moving from 3% to 100% auctioning is not a change in level but a change in nature. Those who support full auctioning are in fact trying to introduce a kerosene tax which otherwise could not be imposed on international aviation as it would contravene Article 24 of the Chicago Convention.

Full auctioning is a tax because airlines would be obliged to buy permits to cover not only their emissions above the baseline (which is the rationale of a cap and trade ETS), but also their historical emissions (below the cap). Auctioning will then have the same effect as a kerosene tax by affecting airlines' financial and economic performance without any direct impact on emissions.

Full auctioning may have a different financial impact on airlines depending on their respective financial situation, making it a blunt instrument which would potentially force some operators out of business.

4. Full auctioning generates costs without providing any environmental benefits as there is no clear earmarking of auctioning proceeds to aviation

Applying full auctioning to historical emissions will not bring any additional environmental benefits beyond the cap. The main consequence will be a further deterioration of the profit margins of European airlines and a potential loss of competitiveness. The Commission stated that the proceeds of auctioning should be used to mitigate greenhouse gas emissions. In the aviation sector the most effective way to mitigate gaseous emissions is through infrastructure improvements, in particular the speedy implementation of the Single European Sky policy. An efficient organisation of European airspace would reduce airline emissions by 12 million tonnes of CO₂ per year. The AEA members already have one of the most modern fleet, consisting on average of aircraft which burn 4 litres of fuel per 100 kilometres and per passenger flown. Increased investment into even more efficient engines/aircraft and bio fuels is crucial if further emissions reductions are to be achieved.

The absence of a clear earmarking of auctioning revenues to aviation is a cause for concern, but even more worrying is the failure of both the EU and Member States to make any firm budgetary commitment to finance the implementation phase of the SESAR Programme.

5. Full auctioning does not boost the use of clean energy as this is not yet operational in aviation

Despite ambitious research programmes and some encouraging pilot projects on bio fuel-powered engines¹, aviation does not yet have a realistic alternative to kerosene in the short and medium term. The idea of accelerating the shift from fossil fuels to renewable energies through full auctioning simply would not work for aviation. The money spent on buying an excessive number of permits would not be available for investment in new technologies and fleet renewal.

6. Full auctioning is a misuse of the 'polluter pays' principle (PPP) as there is no redistribution of the money collected

Since aviation is a mobile source, an international operator (regardless of nationality) emits CO₂ all over the world. The fact that he is obliged to pay for the CO₂ emitted by his aircraft is perfectly consistent with the PPP. Furthermore, the PPP implies that the polluter should pay for the damage he has caused and the money collected should go to those affected by the said damage. However, if the payment is made through auctioning to the authorities of one single country/region, whilst the emissions affect other countries/regions, there is a misuse of the PPP. For example, why should an airline flying from Sydney to London be obliged to pay the EU authorities for its total emissions when only a portion of the flight takes place in European airspace? It would be acceptable if the European authorities could guarantee that the money would be either redistributed to all the countries overflowed, in proportion to their airspace, or invested in international funds. In the absence of such a guarantee, one might consider that the EU authorities had appropriated the auctioning revenues and, by so doing, had violated the 'polluter pays' principle.

7. Full auctioning is a misconception of ETS as it distorts the relationship between buyers and sellers within the ETS

The rationale behind the ETS is that the overall emissions reduction target should be achieved in the most cost-effective manner. In practical terms, sources which are able to reduce their emissions beyond their specific targets can sell the surplus to the market. Sources which cannot achieve their reduction targets must buy permits. By doing so, the buyers are 'rewarding' the sellers' efforts and are in fact contributing financially to the sellers' efficiency. If an important part of the buyers' financial resources is taken up by auctioning, the market could be distorted as there would be more sellers than buyers.

¹ In an article entitled 'Boeing believes in "second generation" biofuels', Boeing stated that it is "upbeat on its progress with what it terms 'second generation' biofuels and believes regular commercial services could be operating within five years". (ATW Daily News, February 11, 2008).

In a buyer's market when the carbon price is very low, potential sellers would not be financially motivated to achieve a carbon surplus. They would delay or even cancel the necessary investments to cut or to further reduce their emissions.

If the money is spent by airlines in the ETS market, it will benefit the sources which are reducing their emissions. If the money is spent on auctioning, it will go directly to Member States' treasuries. Full auctioning would affect the effectiveness of the ETS and distort the carbon market, as money spent on auctioned permits cannot be used to purchase emission reductions from the other sectors.

8. Full auctioning distorts competition as proceeds could be used to subsidise competing modes of transport

Member States could use revenues derived from auctioning in different ways; some would recycle them within the aviation sector, but some would not. This may create distortions of competition between airlines. Moreover, using auctioning proceeds to further support the railways, as proposed by the European Parliament, would exacerbate the already unequal treatment afforded to the different modes of transport. If the train is already 'environmentally friendly' why does it need further financial support, since no additional environmental benefits could be expected? In reality this kind of contribution will not be used to make the train 'greener' but to help lower ticket prices in order to attract and divert more traffic from aviation. It could also finance the building of new tracks and rolling stock. The money is not spent on mitigating emissions but on financial support for a particular mode of transport. In that case it constitutes a subsidy or a State aid that would distort the functioning of the Internal Market and would contravene European competition laws.

9. Full auctioning is not a good distribution method as it does not reward operators' early action

Full auctioning has been presented as the simplest method for distributing permits among operators, thus avoiding sophisticated benchmarking, special provisions for new entrants, etc. The main objection to this is that auctioning completely ignores, and hence does not reward, operators' early action to reduce their environmental impact.

Some may argue that airlines which have undertaken early actions would be rewarded, as they would need fewer auctioned allowances. This is not correct, for two reasons:

- For airlines which have taken early action, the financial benefits gained from purchasing fewer auctioned allowances would always be outweighed by the cost of investing in fleet renewal.

- Airlines which have not taken any early action would not have the financial capacity to invest in fleet renewal, because their financial resources would be largely absorbed by purchasing auctioned allowances.

In the first case full auctioning would limit airlines' financial means to buy permits to cover their growth. In the second case full auctioning would delay fleet renewal.

By contrast a properly designed benchmarking would differentiate between operators, allocating more free permits to airlines which have undertaken early actions, whilst sanctioning those with poor performance. A good benchmarking system would allow proactive airlines to grow but would oblige the others either to invest in fleet renewal or to limit their growth. This is the true rationale of an ETS.

A distribution method should not be selected just because it is simple; it should also be fair and equitable. Full auctioning fails to meet these requirements.

10. Full auctioning is not needed as a safeguard against windfall profits as these are unlikely to occur in aviation

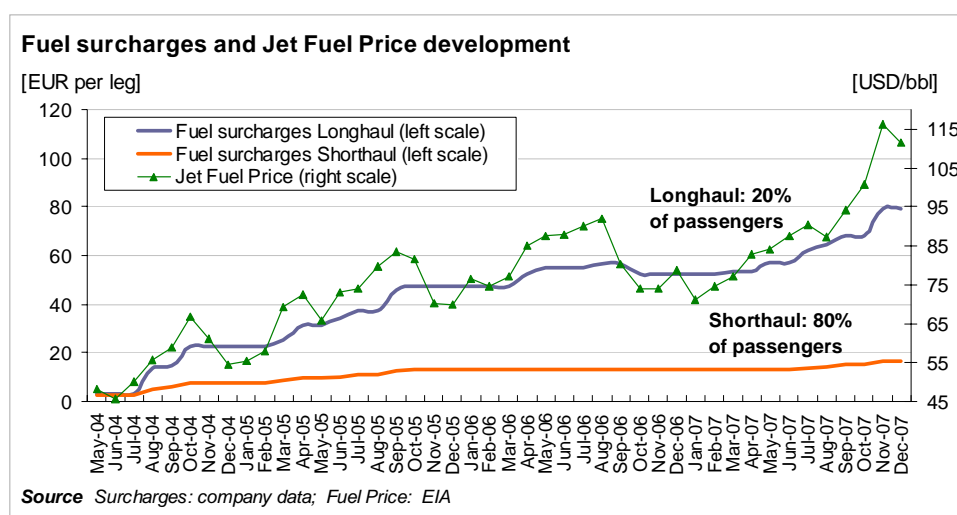
One of the Commission's main justifications for imposing auctioning is that sectors which receive free permits could make windfall profits. This has been the case in the power sector. Windfall profits could occur in two situations: the trading entity sells its surplus permits and/or passes the 'opportunity' cost of its free allowances on to the consumer. Neither of these scenarios applies to aviation.

- It is widely accepted that the aviation sector will be a net buyer and hence will not have any surplus permits to sell.
- With regard to airlines' ability to pass on the cost of permits to their passengers, the impact assessment conducted by Ernst & Young and York Aviation² for the European aviation industry clearly concluded that *'the proportion of additional cost that airlines will pass on to their passengers will vary according to the airline business model and according to the level of competition on a given market. We estimate that on an average basis, the pass through of cost to consumers will not exceed one third of the cost of allowances'*.
- More interesting is the statement by CE Delft, the consultancy which conducted several studies for the Commission on the inclusion of aviation in the ETS. In a recent publication, despite advocating the use of a high level of auctioning in aviation to prevent windfall profits, CE Delft also felt obliged to admit that *'this study agrees with Ernst & Young (2007) that **there are no windfall profits in the aviation sector** (...). In the case of updated benchmarking, the opportunity costs of allowances in possession are cancelled by the opportunity benefits of allowances to be earned for the next period. Therefore, ticket prices do not rise due to free allowances and no windfall profits occur'*.³

² 'Analysis of the EC Proposal to include aviation activities in the Emissions Trading Scheme'. Ernst & Young/ York Aviation, June 1st, 2007, page 5

³ 'Allocation of allowances for aviation in the EU ETS - The impact on the profitability of the aviation sector under high levels of auctioning'. CE Delft Final report, June 2007, page 60.

- The Auctioning Sub Group of the UK Emissions Trading Group (ETG) also recognised that ***‘the nature of competition within sectors may limit the extent that particular actors can pass on the costs of purchasing allowances. Sectors whose products are traded internationally and beyond the EU are generally unable to pass on extra EU or country-specific costs’***.⁴
- Aviation is precisely the type of sector which is exposed to strong competition and is not able to pass on all its costs to its customers. The best illustration is airlines’ reaction to fuel price increases. Although all airlines are subject to the same kerosene price rises worldwide, their ability to impose fuel surcharges remains limited, as reported by the media⁵.
- The AEA has closely monitored the link between fuel prices and fuel surcharges from May 2004 to December 2007.



- This review leads to the following observations:
 - Not all airlines have adopted surcharges,
 - Airlines do not immediately react to fuel price increases,
 - When they do, the surcharge is not applied uniformly to the entire network but is determined according to specific markets,
 - The level of surcharge is adapted to the nature of the flight; they are usually divided into two categories - short/medium and long haul;
 - 80% of passengers are affected by short/medium haul surcharges versus 20% for long-haul;
 - The ability to impose/increase fuel charges on short/medium haul sectors (domestic/European) is very limited, or even non-existent, as the level of competition is generally very high;

⁴ UK Emissions Trading Group (ETG) WG 5/6 - Auctioning Sub Group Discussion Paper, Feb 2006, page 5.

⁵ Airlines Retreat on Fuel Surcharge, By Susan Carey 317 words 31 March 2004 The Wall Street Journal D3 English (Copyright (c) 2004, Dow Jones & Company, Inc.). Major airlines just can't get their bigger fuel surcharges to stick.

Oil pressure - Airline Business (Oct 2004, 2212 words) - The uncomfortable answer to high oil prices is for airlines to focus even more closely on costs and fuel efficiency, by Peter Conway in London.

Fuel surcharges meet mixed fortunes - Airline Business (Nov 2004, 414 words). Airlines have had mixed fortunes in their attempts to recover some of the losses from the surge in kerosene prices by adding a fuel surcharge to tickets, by Colin Baker in London and David Field in Washington.

- The level of long-haul surcharges seems to be higher than that of short/medium haul. In fact this is due to the length effect, but on average short/medium and long haul surcharges are identical - namely around 11€ per 1000 km;
 - Some airlines failed to introduce fuel surcharges or were obliged to limit their level because of competition;
 - The review confirms that **extra fuel costs have not been passed on in full to passengers;**
 - Airlines have absorbed part of the extra costs, which have been recovered through other productivity gains.
- In addition to the AEA review, some interesting information has been provided by the IATA BSP (Billing and Settlement Plan). For example, the Finnish IATA BSP revealed that the average fare, including all taxes and surcharges, collected from the passenger has grown only marginally (by 1.7%) from 2005-2007, while the fuel price increased significantly (by 62.3%) over the same period.

In light of the above, the Commission's statement that '*the aviation industry was expected to be able to pass on, to a large extent or even in full, the costs of participating in the system to their customers*' is not only unfounded but misleading, since it serves as a justification for the misguided proposal to impose up to 100% auctioning in the aviation sector.

CONCLUSION

For all the reasons mentioned above, **the AEA strongly objects to the imposition of full auctioning on aviation.** The level of auctioning should remain modest since its original purpose is to cover the administrative costs of the ETS and to ensure that ETS functions as a market mechanism and not as a fiscal instrument.

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