ETS for aviation: Financial Risk or Regulatory Benefit?

International Conference on Contemporary Issues in Air Transportation, Air Law & Regulation
New Delhi, India

By
Martine De Serres
April 24, 2008

Aviation's situation

- Fastest growing contributor to climate change (3.7-6.6% annual traffic growth)
- 5% contribution by 2050
- Zero footprint by 2050 is science fiction
- Technological and managerial improvements cannot account for growth

Unmanageable growth

A time to act

- Kyoto Protocol goals insufficient
- Kyoto Protocol ignored
- Stern Review: inaction is economically unsound
- Rise of climate change litigation
- Growing pressure from public opinion on
  - On industries
  - On governments ⇨ Regulation expected

Unilateralism or duty to act?

- Increasing litigation to force regulators to take action, in the US and Canada:
  - *Friends of the Earth* v. *Canada*
  - *Massachusetts* v. *EPA, etc.*
- Do States have Kyoto obligations in light of ICAO inaction?
- Duty of care?

What's the best solution?

TAXES:

- Low price elasticity of demand
- Little political support for high taxes
- Competition distortion unless applied on international scale
- ICAO recommends against

ETS: the best solution

- ETS more **dynamically efficient** than taxation
- ETS **self-adjusts** to economic growth
- If well-designed, can avoid many **competition distortion** effects
- Creates abatement incentive for industries with lower abatement costs

⇨ **Finance reductions**

for aviation industry

Design elements of an ETS

- **Auctioning** most credits may dampen competition distortion effects
- **Downstream** ETS that includes other GHG than CO_2 will efficiently reduce all aircraft emissions
- **Open ETS** can finance reductions in other sectors & compensate for air travel
- **Large spatial scope** and coverage will strengthen flexibility of an open ETS
- **Banking** could promote early action and protect against price fluctuations

Overview of EU ETS

- Mostly grandfather rights
- Only CO_2 covered for now
- Downstream system (5 major industries covered, expansion underway)
- Unrestricted transactions (banking ok)
- Penalty for failure to purchase allowances

Is EU ETS well-designed?

- Auctioning **NO**
- Downstreaming **YES**
- Open ETS / large scope **YES** and expanding
- Banking **YES**

Shortcomings of EU ETS

- Trading period (5 years) may be too short for adequate financial planning
- More auctioning needed
- Allowance price is too low to efficiently promote reductions; too many sellers

Need emissions buyers

EU proposal to include aviation

- Foreign airlines included by 2011
- Allocation based on historical emissions from 2004-2006
- No double-counting: EU will negotiate with states with equivalent requirements

⇨ **Invitation to create international ETS**

Business risks

- Uncertain regulatory requirements
- Increased insurance costs
- Possible climate change litigation (tort law – duty of care)
- Uncertainty of carbon footprint
- ETS quota price fluctuations
- Financial disclosure of risks

Managing risks

- Support ETS to avoid taxes
- Self-assess risks
- Create climate change funds
- Self-assess footprint
- Seek ETS credit (green technologies)
- Understand carbon accounting
- Environmental risk insurance
- Bank credits