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SUBJECT: Distortion of aviation competitiveness and carbon leakage risks linked to “Fit for 55” measures

Introduction

The “Fit for 55” legislative package expected by the European Commission in July 2021 plans to fundamentally overhaul the EU’s climate policy architecture and put the EU on track to deliver on its 2030 climate target of at least 55% net greenhouse gas emission reduction compared to 1990.

In parallel, European aviation’s **Destination 2050** decarbonisation roadmap¹ sets a clear pathway for the sector’s contribution to fight climate change and contribute to the objectives of the COP21 Paris Agreement. The roadmap identifies a detailed set of actions that would enable aviation to help meet Europe’s 2030 and 2050 climate goals without compromising its ability to continue delivering social and economic benefits globally.

Fit for 55 policies, and in particular the revision of the EU Emissions Trading System (ETS); the introduction of a tax on aviation fuels through a review of the Energy Tax Directive (ETD); and the implementation of an EU Sustainable Aviation Fuel (SAF) blending mandate must all be designed in a way which avoids distorting competition between European stakeholders within the single aviation market -- as well as between European and non-European aviation stakeholders -- and leads to an efficient reduction of emissions.

Fit for 55

Different options for the three above-mentioned policy measures have been considered. While the actual details of these policies are likely to remain unknown until their final adoptions by the European co-legislators, some **high-level assumptions** can nevertheless be assessed regarding the future reform of the EU ETS and the implementation of CORSIA into EU law, the impact of the review of the Energy Taxation Directive and the implementation of an EU-wide SAFs blending mandate.

Based on these assumptions of price and policy scenarios, we assess that **the cost of compliance to the identified measures could reach €4.5 bn in 2025 and €9 bn by 2030.**

Air traffic is not expected to recover before 2024 or 2025². Based on recognized assumptions of price and policy scenarios and pending further analysis, we assess the cost of compliance to the identified measures could reach €5 bn in 2025 and over €10 bn by 2030. For example, for the EU ETS compliance year 2019, A4E airline members purchased CO2 certificates for around 60% of their emissions. For that year, the value of these purchases under the ETS neared €650 million, which equals app. €800 million for

¹ <https://www.destination2050.eu/>

² EUROCONTROL Forecast Update 2021-2024, May 2021

all aircraft operators covered by the measure. This is a significant contribution to the EU's decarbonisation effort coming from an industry currently experiencing one of its worst crises in modern times.³ Taking the current average price projections for CO₂ under the EU ETS, between 2019 and 2025, the cost of compliance to the ETS for all aircraft operators covered could quadruple, reaching €4.6 billion and then €6.5 billion in 2030.

Impact on European airline competitiveness

As one of the sectors hardest hit by the pandemic and with an essential role in kick-starting societal and economic recovery – future policies need to guarantee and support the competitiveness of the European aviation sector. The latest industry data shows a deepening crisis in the sector, with air traffic in a continuing downward spiral and not appearing to recover to 2019 levels until 2024-2025⁴.

The European aviation sector has been hit first and indeed the hardest by the COVID-19 crisis, leaving an unprecedented and devastating impact. Urgent action is needed to help stabilise the sector and put it back on its path towards a sustainable future, operationally, financially, socially and environmentally. The impact of the pandemic will be long-lasting, affecting aircraft operators' capacity to embrace and accelerate their sustainable transformation. The sector's decreasing resources, and its competitiveness challenges are major obstacles to achieving its transformation goals. This brings particularly acute risks with regards to achieving its decarbonisation ambitions, as it could result in current carbon-intensive technologies and practices becoming "locked-in". Potential carbon lock-in would inhibit the sector's transition towards higher energy efficiency improvements or emissions reductions options.

The Fit for 55 policies risk affecting the competitiveness of the aviation sector, Europe's tourism industry and the wider EU economy. Such a loss of competitiveness could stem from consumer, airlines, and investor responses, including switching of carriers⁵, switching of routes⁶, shifts in demand⁷, investment

³ Out of the total of c. 68 million tonnes of CO₂ produced by aviation activity in 2019, c. 30 million were allocated to airlines for free, c. 6 million were auctioned (adding up to the aviation ETS cap of c. 36 million allowances) and the remaining 32 million allowances were purchased from other sectors.

⁴ Eurocontrol data May 2021.

⁵ Higher prices could result in passengers choosing to avoid the airlines affected by the measures and instead fly between the same origin/destination but with other airlines. This response depends on carrier's choices about fares, as well as other aspects of their flight offerings. The extent of any differences between ticket prices also depends on the on the specific route.

⁶ Higher prices for intra-EEA travel will make EU destinations relatively less attractive to visitors from within the EU. EU travellers may opt to travel to non-EU destinations to avoid some of the policy costs, for example holiday destinations outside the EU. This applies both for direct flights going EEA to non-EEA as well as flights from the EEA to non-EEA where one leg of the journey is intra-EEA.

⁷ Higher prices for travel to and from the EU will make EU destinations less attractive to visitors – both visitors from within the EU, and from outside it. EU residents may opt to travel beyond EU borders to avoid some of the policy costs.

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changes⁸ or reshuffling of fleet. These significant competitive distortions as a result of Fit for 55 policies may in turn lead to carbon leakage.

Carbon leakage in air transport

Defined as the potential increase of emissions in a country or region as a result of stringent climate policies in another country or region, carbon leakage reduces the effectiveness of climate policies and hence has a negative impact on the environment⁹. Carbon leakage can also arise in the aviation sector if policies such as carbon pricing, a tax or a SAF mandate are not adopted in a uniform manner. Carbon leakage risks exist both under policies with an intra-EU scope as well as those applying to all departing flights. An increase in the cost of flying introduced by a Member State or a region could result in a diversion of traffic and hence of emissions to other regions. This is why there will be a risk of carbon leakage if other countries do not adopt environmental targets and policies that are as ambitious as those of the European Green Deal.

We expect to see carbon leakage from the Fit for 55 policies impact airline competitiveness in several ways. A passing through of costs will lead to a reduction in market share of EEA-based airlines in many markets as passengers choose flights with non-EEA routes or non-EEA carriers due to fare increases linked to the new regulation. The displacement in demand is driven by firm-level price elasticity that describes a change in demand when one firm increases prices, and other firms in the market do not. Journeys, and therefore CO₂ emissions, leak to non-EEA routes, airlines and countries. The alternative of not passing through costs is that profitability and competitiveness of EEA airlines will be impacted¹⁰. Several studies confirm the sector's exposure to carbon leakage, and place European air transport in the list of sectors with the highest exposure to carbon leakage. A recent analysis on carbon leakage and competitiveness carried by E3-Modelling concluded that the greatest exposure will occur in chemicals (35% of all leakage), metals (33%), cement (14%) and air transport representing 12% of all leakage¹¹.

Carbon leakage and its impact on competitiveness can arise through a number of complex mechanisms linked to the response of both passengers and airlines to the new measures. Different types of carbon leakage can take place depending on the scope of application of the measures. Where the geographic scope of the new policies is intra-EEA, carbon leakage and competitive impacts would arise where passengers switch to alternative non-EEA leisure destinations, and where there is an intra-EEA flight segment as part of a journey from the EEA to a non-EEA location. Where the geographic scope is outside

⁸ Diversion of EU airport traffic to non-EU hubs could result in additional incremental investment outside the EU, increasing network advantages and economies of scale at these non-EU challenger airports.

⁹ The interpretation of carbon leakage described above is in line with the definition used by the Intergovernmental Panel on Climate Change (IPCC), according to which carbon leakage is "the increase in CO₂ emissions outside the countries [11.7.2 Carbon leakage - AR4 WGIII Chapter 11: Mitigation from a cross-sectoral perspective \(ipcc.ch\)](#).

¹⁰ Measures applied in a discriminatory manner to aircraft operators competing on the same market may not lead to a fare increase as carriers affected by the new measure would be reluctant to pass on the additional cost to the consumer for fear of losing market share.

¹¹ Trade & Climate Change Quantitative Assessment of the Best Policy Tools to Achieve Climate Neutrality and Competitiveness, AFEP and E3G, January 2021 (See [here](#)).

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the EEA, carbon leakage and competitive impacts would also arise for journeys between two non-EEA locations that switch from connecting at an EEA airport to a non-EEA airport, for journeys from EEA to non-EEA that switch to alternative routings where policy costs are less, and for leisure trips of non-EEA visitors to European destinations that shift to a non-EEA destination.

In addition, carbon leakage can emerge from the following decisions: (I) fuel tankering for aircraft operator¹²; (II) network reconfiguration resulting from policies of demand changes.

Risk Mitigation

There are limited ways in which the risks of carbon leakage from aviation can be mitigated:

A. Global uniform regulation

A level playing field is indispensable to enable aviation to decarbonise without compromising its ability to continue delivering social and economic benefits globally. The decarbonisation of the sector needs to happen on a global scale. Given the challenges inherent to achieving a greater alignment between the EU's climate goals and those of its global partners, an important pathway to improving cooperation could focus on smaller-scale agreements as confidence building measures towards more ambitious GHG emissions reductions and to diminish competitive distortions over time.

European airlines encourage the wider adoption of global decarbonisation objectives and related actions' contribution to achieving the goals of the Paris Agreement. At the same time, to reach the global climate goals, ICAO needs to step up efforts towards the long-term global aspirational goal for international aviation (LTAG) to be agreed in 2022. Talks with third countries on joint climate action efforts should begin soon. Ambitious and binding environmental clauses should be included in air services agreements with third countries.

More generally, the EU should pursue multiple policies as developed in the Destination 2050 roadmap, in order to maximise potential gains to employment and GDP and to minimise carbon leakage.

B. Carbon Border Adjustment

The proposal for a carbon border adjustment mechanism (CBAM) for selected sectors planned under Fit for 55 is part of a broader EU industrial strategy with a view to reducing the risk of carbon leakage for sectors covered by the EU ETS. However, the design of the CBAM is unlikely to fit well with the specificities of the aviation sector (commodity goods vs services, import duties vs carbon price).

Whilst the application of a border adjustment in the aviation sector should still be explored, other types of mitigation and distortion to the level playing field need to be urgently pursued.

¹² Tankering may be done for direct cost savings due to differences in fuel prices or may be for reasons of scheduling / faster flight turnaround. If the cost of refuelling is higher in Europe, there may be incentives to increase tankering where this is an option. In the case of a kerosene tax or SAF blending mandate, this could also serve as a way to reduce the amount of tax paid or quantity of fuel purchased.

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C. Designated finance mechanism preserving competitiveness neutrality

Existing instruments to protect against carbon leakage, such as the current freely allocated ETS allowances, have to be reassessed in light of the upcoming legislative proposal aiming to decarbonise the sector. Allocated in a targeted way, allowances must take into account international competitiveness and the unprecedented crisis the sector is facing as a result of the COVID-19 pandemic. In the absence of a CBAM, such allowances are a way to account for the risks of carbon leakage¹³.

A provision making the levels of blending obligations revisable in relation to the adoption of mandates in other parts of the world should be included in RefuelEU Aviation.

Conclusion

The elements of the upcoming “Fit for 55” package need to incentivise efficiency, drive decarbonisation through innovation, avoid carbon leakage and thereby ensure a competitive level playing field for European airlines within the EU and globally.

Destination 2050 showed that an alignment of the industry with the EU’s climate targets can be done without further taxation of the sector. Ensuring a level playing field within Europe and vis-à-vis the rest of the world is a prerequisite to achieve the objectives the sector set for itself under the Destination 2050 roadmap.

The EU is poised to lead international efforts to address climate externalities, with continued momentum depending crucially on intra-European cooperation and the ability to convince international partners to align their emissions mitigations or be compelled to do so through innovative policy measures.

¹³ The European Court of Auditors ECA Special Report 18/2020: “The EU’s Emissions Trading System: free allocation of allowances needed better targeting” notably makes recommendations on better targeting as well as better addressing technical challenges when revising the methodology for the free allocation of allowances.

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