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U.S. Could Escalate EU Emissions Standoff

- Congress has until January 3 to finalize legislation to block U.S. airlines from complying with the European Union's Emissions Trading Scheme. The E.T.S. assesses a given flight back to its origin, even in non-EU nations. This has sparked complaints that the EU is infringing on the sovereignty of those nations.
- The U.S. elections on November 6 will influence negotiating posture on both sides, with a Republican win possibly resulting in a more aggressive negotiating posture by the Americans, but action this year more likely under a reelected President Obama.
- However, the eventual solution under any scenario seems likely to be a concession by the EU to tax only miles flown over EU territory and perhaps international waters. An expanded trade war would be a low probability, high impact event.

The EU Plan

The European Union is integrating airline flights into its Emissions Trading Scheme (E.T.S.). Specially, the scheme applies to all airline flights that intersect EU airspace. The controversy has arisen over the scope of the assessments. As an example, a U.S. airliner flying from Los Angeles to Paris is not merely charged for the several hundred miles it travels over EU territory, but for the full 5,600 miles the craft traverses after it leaves LAX.

This has created a firestorm both within the aviation industry and among a large bipartisan majority of Congress, who see the EU scheme as an incursion on U.S. sovereignty and business.

Other nations, including Russia and China, also oppose the EU move.

The U.S. Government Is Unified in Opposition...Sort of

The Obama administration has declared its opposition to the E.T.S. applying to U.S. airlines. Republicans, with virtual unanimity, agree, and most Democrats do as well.

However, the American consensus on this issue is an uneasy one. Republicans are overwhelmingly hostile to the E.T.S. in principle. Three years ago, a Democratic majority in the U.S. House passed similar "cap and trade" legislation only to see it die in the Senate, while Republicans made the potential effect on energy prices a successful wedge issue in the 2010 elections. (Among other things, Republicans labeled the proposal "cap and tax" to highlight the relationship of the concept to an energy tax.) The potential spectacle of the European Union imposing a similar system on U.S. airlines operating in U.S. airspace is almost tailor-made to rile up members of the GOP.

Relevant Stocks

ALK, AMR, DAL, LCC, UAL, ALGT, HA, JBLU, LUV, SAVE, AAWW, FDX, and UPS

Democrats, meanwhile, are supportive of a carbon emissions regime, but cannot tolerate, or be perceived as tolerating, EU imposition of such a scheme on U.S. businesses. In fact, the Obama administration has been up front that they support the goals of the E.T.S., but will resist what they see as overreach.

U.S. Posture After the Elections

Both houses of Congress have now passed legislation that would prohibit U.S. airlines from complying with the EU E.T.S. The versions are different, however, and need to be resolved before they could potentially be sent to President Obama's desk for his signature.

Little work has been done since the Senate cleared their bill in mid-September, as both parties are intensely focused on the November 6 elections that will determine control of the White House and the U.S. Senate. (Control of the House is also at stake, though at this point it is very likely to remain with the Republicans.)

A resolution must be reached before January 3, because all legislation expires and would have to be reintroduced and renegotiated upon the swearing in of the new Congress.

Should President Obama be reelected, we would expect the legislation passed by the Senate to be agreed to quickly. If Mitt Romney is elected, Republicans could block agreement on a bill this year in order to preserve momentum for a harder line in January. However, it's possible they'll push for a bill now, with the option of toughening their position in 2013.

How It Could Be Resolved

The Obama administration has called for ICAO (the International Civil Aviation Organization) to set a global standard for airline emissions - a position supported by other non-EU nations. However, it's unclear if ICAO could impose an effective scheme, and Republicans in the U.S. would also be a stumbling block.

Meanwhile, should the U.S. enact a prohibition on U.S. airlines complying with the EU scheme, the EU could retaliate. Options open to them would include barring E.T.S.-noncompliant airlines from landing on EU soil.

At that point, a trade war would be in effect. However, such an escalation still seems unlikely. More plausibly, over the next year the EU could negotiate a climbdown that would allow it to impose the scheme on non-EU airlines. This could involve limiting the scope of the assessments to miles flown over EU territory, or EU territory plus international waters.

Some Relevant Companies

Affected companies could include passenger airlines (**ALK, AMR, DAL, LCC, UAL, ALGT, HA, JBLU, LUV, and SAVE**) as well as airfreight companies (**AAWW, FDX, and UPS**).

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