Contribution by the Government of Iceland

EU ETS for maritime, aviation and stationary installations, and of the Market Stability Reserve – review (Ares(2025)3030455).

Reykjavík, Iceland
8 July 2025

8 July 2025

In a nutshell:

- Iceland remains fully committed to climate action and supports an equitable and effective carbon pricing in aviation.
- The ETS system must reflect geographic and market differences to ensure that ambition does not come at the cost of cohesion, fairness, and connectivity.
- The EU Emission Trading System (ETS) today has a negative impact on the competitiveness of EEA aviation operators and EEA hubs serving destinations outside the EEA.
- It is essential that the functioning of the system and measures taken are proportional to current realities and the aims it is meant to achieve.
- The application of the ETS system should not result in unlevel terms of competition for hub and spoke airports and operations across the EEA which favours airports and operation outside the EEA area.
- The current ETS system can have a negative impact on social economic conditions, in particular on low-income families in rural regional areas served by small regional airports.
- While addressing several aspects, the key aim of the following contribution is to outline the justifications and provide complementary data and information regarding ETS aviation in order to have the current system modified in a sufficient and just manner.

Introduction

The aim of this response to the call for evidence *EU emissions trading system for maritime, aviation and stationary installations, and market stability reserve – review* is to explain and highlight the possible impact the EU Emission Trading System (ETS) can have on outliers within the EEA, such as islands and remote areas, as opposed to median or average impact on the EU or EEA EFTA States. The ETS system can also negatively affect competitiveness of hub and spoke aviation operations within the EEA, both between airports within the EEA but vis-à-vis such operations outside the EEA. The same applies in many aspects to shipping. Furthermore, the contribution aims to explain why such effect needs to be mitigated within the system itself - address the situation for the outliers. Otherwise, there is considerable risk that the cost of the measures for islands and remote areas in situations like Iceland become severely disproportionate compared to the goals the rules are supposed to achieve, or even contrary to the aims, causing negative climate effect and harm to those areas and the industries in question. Iceland fully supports climate action and carbon pricing in aviation, but the system must account for geographic and market realities to safeguard fairness, cohesion, and connectivity.

To support the Commission’s work, this submission is accompanied by an annex with complementary data and information related to Iceland and ETS aviation. Iceland stands ready to provide further input or assistance as needed to help ensure that the revision of the ETS results in a fair, effective, and well-functioning system.

1 Iceland's general position on the ETS and aviation

The EU ETS-system continues to be recognised as the most economically effective way to provide incentives for industry to cut emissions. The participation of Iceland in the ETS system through the EEA Agreement continues to be one of the key pillars of Iceland's climate action. Iceland continues to share ambition with the EU in the fight against climate change.

At the same time, the functioning of the system and measures taken must be proportional to the aims they are meant to achieve. This holds particularly true as regards aviation and remote areas, or remote island states, where there are no other realistic modes of transport than travel by air to and from those areas or islands. It can be derived from the preparatory documents and the relevant legislation[1] that the changes made by the Fit-For-55 legislative package were intended to capture short-haul flights (of less than 1 000 km) to promote a modal shift towards alternative, more sustainable modes of transport. This modal shift is a realistic and valid policy objective on continental Europe, particularly for shorter distances, but not to and from remote islands, such as Iceland. Moreover, it can significantly affect the competitiveness of Iceland's air services sector, lead to a loss in connectivity and impose disproportionate costs on the population. The system must strike a fair balance between environmental ambition and the need to maintain essential connectivity while providing effective incentives to reduce emissions.

The application of the ETS system should also not result in unlevel terms of competition for 'hub and spoke' airports and operations across the EEA and towards such airports and operations in third countries. The latter has the potential to cause carbon leakage, where companies move operations or their base to airports where the regulatory cost is lower, running counter to the aims of the system of reducing emissions. Key contributing factors are a) that cost of emissions are in correlation to the length of the flight, and b) the stop-the-clock provision.

It is the position of Iceland that such a situation which was clearly not intended to be covered by the aim of the legislation itself, should be addressed therein with the appropriate mitigating factors. Such a situation should not require individual EEA States to address their concerns with less effective measures, including State aid. This holds particularly true in the case of Iceland where the international aviation sector operates in competitive environment, free of state intervention and state aid and constitutes a vital interest for Iceland.

When making changes to how the ETS-system applies to aviation it is important to provide stakeholders with predictable conditions for the short and medium term. In this respect, 1 January 2027 is less than 18 months away, which is very close in time in aviation planning. The situation post 2026 is already creating uncertainty. It is important that the sector has a clear and timely outlook.

2 Iceland's geographical position, societal factors and the ETS

Iceland´s geographical position is unique within the internal market, an island in the Northwest Atlantic at the periphery of the internal market, with long distances to the nearest EEA State in Europe over high seas. The closest EEA capital is Dublin approx.1 500 km away and approx. 2 000

[1] See e.g. Directive (EU) 2023/958, 35th recital.

km to the nearest capitals on continental Europe. For illustration that is equivalent to the distance from Madrid to Copenhagen.

This physical distance to the rest of Europe has made the modern society of around 400 000 inhabitants in Iceland particularly reliant on aviation for transport from the island. Strategically located between Europe and North America, Iceland quickly became a hub for flights between the two continents. Since then, the international airport at Keflavík and the aviation sector in Iceland have developed an efficient hub and spoke system which provides around 100 destinations to and from the country. The location in the North allows for use of smaller aircrafts for connecting the two continents with positive environmental and climate consequences as compared to larger long-haul aircrafts. This has been pivotal for the connectivity of Iceland and bridges the physical distance with mental proximity. Over the past decade, the hub has also contributed to the fast-growing tourist industry, which is now a key pillar of the economy, providing about 33% of Iceland's export revenue.

The contribution of aviation and tourism to the GDP of Iceland was estimated at its highest 19% in 2017 according to Statistics Iceland. In 2023 it was 14%, one percentage lower than 2019. At that time, approximately 10 million passengers passed through Keflavík airport, with 40% of them being transfer passengers.

While committed to reducing emissions in aviation, increasing regulatory costs can have grave consequences for the connectivity and thus the economy of Iceland, especially if they place airlines based in Iceland and the international airport in Keflavík at a substantial competitive disadvantage. Such change can be sudden and nonlinear. As the ETS cost for aviation increases in proportion to the length of a flight, the system has direct implication for Iceland. Much longer part of a connecting flight to North America takes place within the EEA on a route via Iceland. With the phaseout of free allowance in aviation and given the "stop the clock" provision, the ETS would have had direct impact on competition on the transatlantic route and had the potential to cause severe impact to Iceland's connectivity in a short span of time. In recognition of these concerns, Iceland and the EU agreed on a specific and time limited derogation during the incorporation of the acts in question into the EEA Agreement[2]. This adaptation aims to partially offset the unlevel terms of competition, while the future of the "stop the clock" provision post 2026 would be determined.

3 Matters of concern for Iceland

a. Distortion in Level Playing Field

To understand the impact on term of competition it is important to compare the cost of ETS allowances against the price of a relevant airfare. Low-income families and/or persons are most likely to shop around for low airfares and purchase tickets in the economy class. These groups have the highest price elasticity.

Taking the example of a flight from Berlin to Seattle (via Frankfurt, New York or Iceland). The prices of the airfare, economy + one checked bag, are very similar, ranging from 620 Euros to 650 Euros

[2] EEA Joint Committee Decision No. 334/2023 of 8 December 2023.

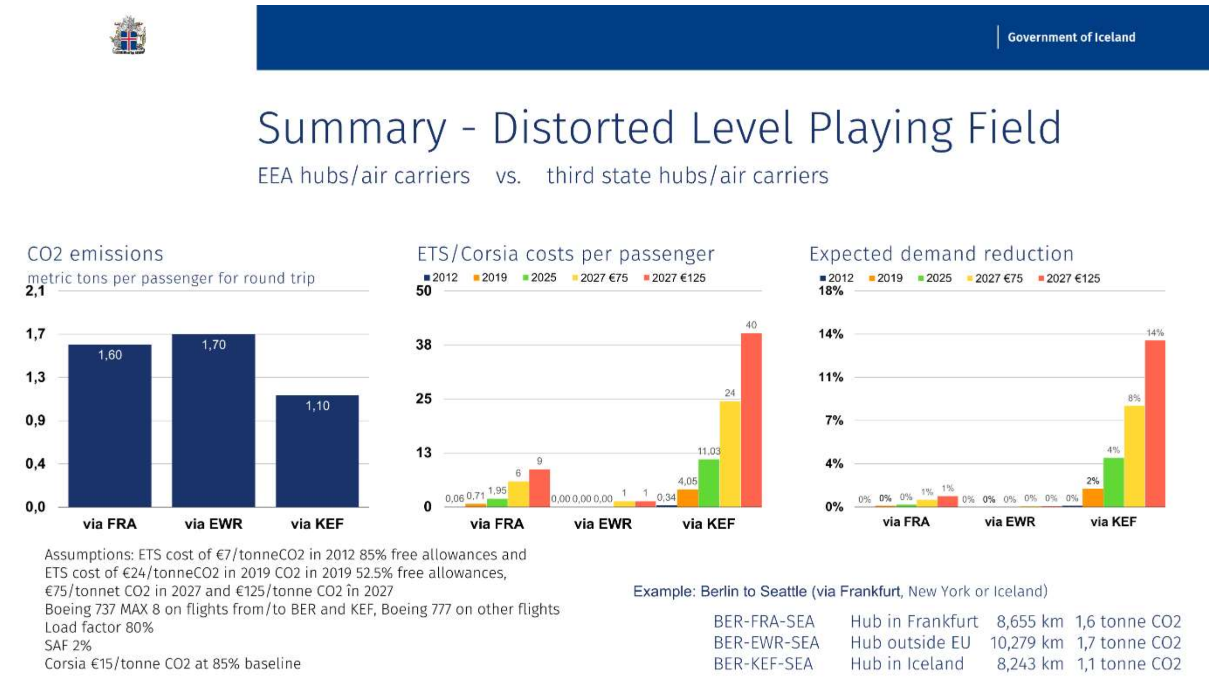
and indicate general market prices for an airfare on this route. The price via the Keflavík hub is the lowest indicating the lowest market power and the least competitive position of the three airlines.

The graph below demonstrates the high divergence of the ETS system and the CORSIA system or the lack of it. The graph shows the cost per passenger from 2012 when the ETS came into effect for aviation, 2019 the last full pre pandemic year, and expected cost per passenger in 2027 assuming that the stop the clock stipulation or equivalent continues. The graph shows a rapidly rising cost per passenger since 2012. More details are presented in the supplementary document.

The magnitude of the distortion is related to the price of ETS allowances and distance flown within the EEA to the transfer hub for the passenger continuing the journey to a third state airport. The average distance from EEA airports serviced from Keflavík airport is 2 200 km while the average flight distance within the EEA is 1 000 km. Thus, it is safe to say that the distortion effect is more than twice the average of other transfer hubs within EEA.

The cost difference behind sold tickets introduces competitive distortion between the airlines, putting the low emitter at a disadvantage.

Summary chart: Unlevel terms of competition – EEA hubs/airs carrier vs. third state hubs/air carriers - Example: Berlin to Seattle (via Frankfurt, New York or Iceland)



The numbers, shown below without brackets, calculated for 2025 assume 50% free allowances and represent the cost in the current year (see graph and info in the accompanying document). The examples are based on current ETS prices of 70-75 Euros per tonne. The Corsia is in its voluntary phase until 2027 and then calculations are based on the price of 15 Euros for tonne of Corsia carbon credits.

The numbers in brackets assume no free allowances are granted and represent the year 2027 with continuing “stop the clock” stipulation. The numbers in the second bracket represent the cost per airfare in 2027 and no “stop the clock” stipulation in the ETS directive, all outgoing flights need ETS allowances.

The cost of ETS allowances pr ticket is 1,95 (6) (58,99) Euros when choosing a flight with a transfer in Frankfurt. The emission is 1.6 tonne co2 pr. ticket. The price of a ticket with a checked baggage is 626 Euros in October 2025.

The cost of allowances pr ticket is 0 (1) (42,71) Euros when choosing a flight with a transfer in New Jersey. The emission is 1.7 tonne pr ticket. The price of a ticket is 650 Euros pr person with a checked baggage.

The cost of ETS allowances are 11 (24) (53) Euros when choosing a flight with a transfer in Keflavík, Iceland. The emission is 1.1 ton pr ticket. The price of a return ticket is 620 Euros when choosing a flight with a transfer in Keflavík.

The graph above shows an estimated 8% reduction in the demand for air ticket via the Keflavík hub in 2027 at current ETS regime and prices. At the ETS prices of 125 the reduction of demand for air tickets via the Keflavík hub would be 14%.

The ETS prices are predicted to rise after 2030 and the effects of 125 Euro per ton is shown in the graph. The prices without “stop the clock” stipulation shown in the graph of the supplementary document are about 97, 70, and 87 Euros for Frankfurt, New Jersey and Keflavík respectively.

Another factor of vulnerability is the ratio of passengers travelling intra EEA to passengers travelling via an EEA hub to extra-EEA destinations. The ratio of customers of airlines competing on the transatlantic market using Keflavík as a hub can be up to 50% introducing added vulnerability.

For most hubs, distortions may not lead immediately to major changes in the demand for air travel to a given destination via disadvantaged hubs. The most fragile airlines and destinations would be the first to be the subject of service termination.

Istanbul is often mentioned as a potential beneficiary from being exempted from the EU climate policy cost. In June 2025 ACI –Europe (Airport Council International) published a connectivity report. The global connectivity of Istanbul airport has increased by 59% from the pre-COVID19 year of 2019. It has replaced Frankfurt airport as the globally most connected airport of which the global connectivity has declined by 21% since 2019. The causes of these dramatic changes should be investigated further. Extending the ETS regime to all outgoing flights would improve the competitiveness of Istanbul airport very much more given that carrying transfer passengers from the EEA to further destinations would not need ETS allowances and only allowances for the flight from the EEA. Flights from EEA airports to those destinations would need allowances for the whole journey.

Should the price of ETS allowances go to and beyond 125 Euros the distorting effect would increase accordingly as the summary graph shows. In this case the ETS cost pr ticket would grow multiple and would negatively impact demand for air travel on this route.

b. Carbon Leakage

There is a considerable risk of carbon leakage in the ETS in aviation system. The example above in the paragraph on "Distortion in Level Playing Field" shows the cost difference of ETS allowances pr airfare on the round-trip Berlin-Seattle via three different hubs. The route via Keflavík hub has the highest cost when the "stop the clock" is in force, while having the lowest emission, which clearly runs counter to the aim of the ETS. The emissions are about 50% higher per passenger, or 1,7 tonne vs 1,1 tonne, when opting for a transfer in Frankfurt or New Jersey. As can be seen in our example in the paragraph above, the case of requiring ETS allowances for all outgoing flights would relatively even out the level playing field at conditions of the example. The airlines operating at North American hubs would still maintain certain competitive advantage. Still the cost of allowances is far from being proportional to the emissions as it should be 50% higher for passengers via Frankfurt and New Jersey if it were to be proportional with the emissions per passenger.

In June 2025, Fly Play, an airline serviced by the Iceland hub, announced that the company will cease transatlantic service via Keflavík hub altogether in autumn 2025. It decided to reduce the number of aircrafts in its operations from 10 to 4 and focus on point-to-point services. In response to a question of what factors led to the decision, the airline gave the following answer: "The increased cost of the ETS allowances and changes in the system that decrease the competitiveness of Keflavík airport is certainly one of the reasons why Fly Play decided to abandon the hub and spoke operation."

The carbon leakage would first occur in fragile destinations that would not sustain the extra allowance cost. One airline, Fly Play, has abandoned the transatlantic service as of autumn 2025. The company has employed narrow body A320/A321 to provide transatlantic service. Very likely many of its customers will revert to wide-body more emitting alternatives a clear example of carbon leakage.

c. Connectivity of Iceland

Through the years the hub transfer service of Keflavík airport has been the cornerstone of the connectivity of Iceland, connecting destinations in N-America and Europe. Since 2011 the tourism industry has grown from 0,5 million visitors in 2011 up to over 2 million in 2024, reaching a peak in 2017 and 2018. The synergies of strong tourism and the hub services of Keflavík airport has been the backbone of the increase in connectivity of Iceland.

Graphs in the appendix show that connectivity rose to its highest level in 2017 and 2018 both in terms of daily departures and destinations served. The connectivity has not reached the 2018 numbers yet. The discontinuation of Fly Play of hub-and-spoke operations takes effect in autumn 2025 and will cause a setback for connectivity. This decision also demonstrates the importance and the vulnerability of the Iceland hub linking transatlantic markets.

Iceland notes that Directive (EU) 2023/958 mandates a report in 2026 on the effect of the ETS system on the connectivity of islands and remote areas. Under the adaptation for the act upon the incorporation of the act into the EEA Agreement (EEA Joint Committee Decisions no. 334/2024) there should be a report evaluating the air connectivity of Iceland, including consideration of competitiveness and carbon leakage, as well as environmental and climate impacts, and of the adaptations set out in the decision.

d. Cost of travel for inhabitants of Iceland to other countries

The cost of international air travel in Iceland is measured monthly for composition of the Icelandic consumer price index. The prices fluctuate by season, lower prices during the winter months and higher in the summer. The price level of air travel between June 2024 and June 2025 rose by about 2% and by about 12% between June 2019 and June 2025.

e. Mechanisms to deal with outlier situation

Airlines operating on the transatlantic route are by and large operating a modern fleet of aircrafts and have already optimized flight routes for fuel efficacy. Each new generation of aircrafts provides about 10% fuel efficiency and alternative technologies to engines run on kerosine/jetfuel for longer flights are at least 10 years off or even further way. The only realistic option for operators to cut emissions is the use of sustainable aviation fuels (SAF). While SAF is not available in sufficient quantities and prices of ETS allowances are high compared to Corsia, the effects on outliers are hard to address. Under these conditions, unlike ETS in stationary installations, the cost increases relative to the distance traveled.

As the cost rises in absolute terms, it affects fragile air service to small regional airports serving distant regions and islands. In the connectivity report of ACI, the connectivity of small regional airports is still 35,1% under the pre-COVID19 levels of 2019.

The competitiveness of EEA airlines also declines in proportion to the distance of the EEA leg of an outbound passenger. One way to address this problem is to put a limit on the distance the ETS is applied to in these cases, see part 5 below.

f. The perspective for the “Stop the clock”-provision

The effect of the “stop the clock”-provision and what will replace it post 2026 has to be considered carefully with respect to the effect on competitiveness of EEA airlines and hubs, as well as effect on the outlier situation within the EEA. The cost of ETS-allowances has increased in recent years and is projected to increase further. By 2026 free allowances for aviation operators will in principle have been phased out. The cost of emissions within the EEA will be much higher than outside the EEA. It is important that this situation is addressed to maintain competitiveness for EEA hub and airlines, while providing clear incentives to reduce emissions and while keeping regulatory costs reasonable.

g. Other matters to address

i. Availability of SAF and refund mechanism for price difference of SAF and kerosine

Today and in the foreseeable future there is no clean alternative to aviation fuel use than SAF. SAF is currently not available in meaningful quantities nor at competitive prices, which is a fundamental prerequisite for reducing CO2 emissions. The EU should continue to encourage investment in SAF production with the available means to secure the required level of 6% in 2030. It has to be borne in mind that the aviation sector is competing with other sectors for sustainable fuels. Without sufficient SAF production and uptake the ETS system risks being ineffective for pushing airlines towards lower emissions. The cost of aviation fuel is currently about 30% of the cost of operations and provides high incentives to rationalize and reduce fuel use. ETS provides added incentives to this effect. Without access to sufficient SAF the ETS costs will only increase prices of air fares while not contributing meaningfully to reduced emissions.

While it is premature to evaluate the success of the mechanism to fund the price difference of SAF, the mechanism needs to be continued and ramped up to increase uptake of SAF beyond the required levels. It should aim to refund as far as possible the actual price difference of fuels and should not be burdensome to use by airlines. The higher 100% refund level for islands should be maintained.

The flexibility mechanism under the RefuelEU Aviation Regulation is important while SAF production and distribution is more limited and costly. However, it also provides incentives to limit availability of SAF at outlier airports, thus barring higher uptake of SAF.

ii. Price of ETS allowances and the Market Stability Reserve

Since its extension to aviation in 2012, ETS allowance prices have risen significantly—from around €7 to peaks over €100 per tonne—before stabilising in the €75–80 range, in part due to the Market Stability Reserve (MSR). The currentprovideevel of ETS allowances coupled with the phasing out of free allowances provides ample incentive to reduce emissions where it is possible. It is important for business and governments that the price of ETS allowances is stable and predictable. Therefore, Iceland supports the continued operation of the Market Stability Reserve.

iii. Non-CO_2 emissions

Achieving the long-term temperature goal of 1.5°C requires reducing all greenhouse gases covered by the Paris Agreement—not only carbon dioxide. According to Directive (EU) 2023/958, the Commission shall submit by 31 December 2027 a report on monitoring of non-CO_2 emissions, and, where appropriate and after having first carried out an impact assessment, a legislative proposal to mitigate non-CO_2 aviation effects by expanding the scope of the EU ETS to include non-CO_2 aviation effects.

Iceland would like to highlight the importance of giving particular consideration, in the forthcoming report, to the effects on remote areas and islands such as Iceland. It is in our view especially relevant to account for regional and altitude-specific variations in non-CO2 emissions, including those resulting from aviation activities in the High North and polar regions.

Before any decisions are made to include non-CO2 emissions in the ETS system, the impact should be carefully assessed and allowing for sufficient time for transition for operators.

4 Evaluation and impact assessment in Iceland

The Ministry of the Environment, Energy and Climate has commissioned a consultancy firm to carry out a socio-economic analysis of the impact of the ETS on Iceland. The Minister of Environment, Energy and Climate will present this analysis to the Icelandic Parliament in accordance with interim provision VII of Act 96/2023 on the EU Emissions Trading Scheme in November this year to ensure that members of Parliament are informed of the cost and benefits of the system. In addition, the results of the analysis will help the Ministry in assessing the impact of the ETS on public and private sectors in Iceland.

The analysis will examine the following aspects:

- The socio-economic impact of the ETS system on the economy, i.e. the operators covered by the system such as the local industry, aviation and shipping.
- The socio-economic impact on the general public in Icelandic society in terms of consumption and travel.
- The environmental impact of the ETS system comparing emissions with and without the ETS and the socio-economic cost (or benefits) of not mitigating climate change in terms of urban and rural societies, infrastructure, tourism, and energy generation.

Iceland stands ready to share the outcome of the analysis with the European Commission, once available.

5 ETS and maritime transport to and from Iceland

The inclusion of maritime transport in the ETS system was a timely decision to provide incentives for the shipping industry to cut emissions, where limited incentives existed before, regardless of where ships are registered. At the same time the sector is subjected to new requirements as regards fuel use under the FuelEU Maritime regulation.

Due to Iceland's geographical position, the country is particularly reliant on maritime transport for timely freight to and from the country. The shipping routes to and from Iceland are perhaps comparable to longer shipping distances on mainland Europe. However, Iceland has no land border with other countries or relatively close island neighbours, except the Faroes and Greenland. Iceland can therefore not rely on or use road, ferry or train transport as alternates for access for exports to main markets or for supply for the domestic market.

The Northwest region is mutually supportive in terms of freight transport by sea and due to small populations and volumes, trade routes are vulnerable to increases in regulatory costs. The effect of the ETS-system for connectivity in the region can be considerable.

Iceland would favour delaying any decision on including ships smaller than 5 000 gross tonnages in the ETS-system, until sufficient experience has been gained on including larger vessels.

As in aviation and for the time being, the shipping sector will be very reliant on alternative fuels for combustion engines. The sector will be competing with other transport sectors for such sustainable fuels. Investments in the shipping sectors are long term and while alternative engines and fuels are being explored, such technology will at least not be sufficiently developed and commonly available in the next 10 years. Without access to alternative fuels at competitive prices, the cost of emissions risks being rolled on to consumers and industries, while not contributing to lowering emissions.

Currently a system of emission monitoring and reporting is being implemented and a possible system comparable to CORSIA in aviation is being discussed at the International Maritime Organization, with possible decisions to be taken in October 2025. While Iceland would prefer an international solution, it is important that these different systems do not accumulate with significant extra administrative and regulatory burden for shipping companies. Due regard should be given to international developments when the ETS-rules on shipping will be reviewed. The aim should be that shipping companies only need to abide by one system, for intra EEA-shipping or extra-EEA shipping respectively.

6 Proposed solutions

The link between the cost of ETS allowances and the distance travelled presents challenges in the coexistence of two very different systems, ETS and Corsia. The best solution is to only have one global system to encourage lower emissions in international aviation.

The high divergence between cost of allowances in the two systems produces a serious problem when the two systems interact as is in the case of Iceland. The problem grows in relation to distance travelled within the ETS system carrying a passenger to outbound destinations. One possible way is to break the link between cost and distance travelled for longer flights or on the way to external destinations.

These solutions can reduce the impact of the problem. One solution for aviation was informally introduced by Iceland during the Fit-for-55 legislative process and is the following:

- The ETS system could apply only to the first 800-1000 km of flight or the average distance of EU flight legs and apply Corsia for the remainder of flights. The risk of carbon leakage would be limited but not eliminated, while producing sufficient incentives to continue to reduce emissions. This would reduce the competitive advantage of airports close to the EEA in the regime of ETS for all outgoing flights and also if it were applied to all incoming flights. This would also limit the cost the aviation operators would have to pass on to customers when they cannot realistically reduce emissions.

- The 800 km exemption may be further designed to exempt communities that only have one or two transport modes for travel over 800 km which is near the cutoff point for train services. This would benefit more distant communities.
- Allowances for 50% of departing and arriving flights. This would also limit the risk of carbon leakage but not eliminate it. Compared to the 1000 km solution, this approach would add cost to travellers and air services to more distant destinations.

For Maritime, Iceland proposes the following solution:

- Consideration should be given to allow for reduced ETS-rates or other mitigating factors for direct shipping along an established principal shipping route from a key harbour in another EEA State to a key harbour on a remote EEA island state. In the case of Iceland this would be the Reykjavik-Rotterdam route.

Annex

Contribution by the Government of Iceland

EU ETS for maritime, aviation and stationary installations, and of the Market Stability Reserve – review (Ares(2025)3030455).

Reykjavík, Iceland
8 July 2025

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Summary

This annex supports Iceland's response to the European Commission's Call for Evidence (14 April – 8 July 2025) on the EU Emissions Trading System (EU ETS) for maritime, aviation, and stationary installations, and on the Market Stability Reserve (Ares(2025)3030455). This annex focuses specifically on aviation and the EU ETS. As a remote island state within the EEA, Iceland depends almost entirely on aviation for international connectivity. The purpose of this submission is to highlight how the EU ETS framework - while effective in general - can produce disproportionate impacts on geographic and operational outliers like Iceland.

The annex examines the systemic challenges posed by Iceland's structural characteristics, such as its long average flight distances, lack of viable transport alternatives, and reliance on hub-and-spoke models centred around Keflavík Airport. These factors interact with the EU ETS in ways that threaten connectivity, competitiveness, and climate coherence. The submission stresses the risk of 'hub carbon leakage' and structural cost distortion when ETS-based compliance costs are unevenly distributed among air carriers and transfer hubs, particularly when compared with non-EEA counterparts or direct long-haul competitors.

While firmly supporting the EU's climate objectives, Iceland argues that a one-size-fits-all approach risks undermining the very goals it seeks to achieve in remote and island contexts. The document calls for targeted mitigation within the EU ETS framework to safeguard regional air connectivity and economic sustainability. It provides evidence-based policy options, drawing from traffic and economic modelling, to ensure that the EU ETS operates equitably and effectively as it moves toward the 2026 review.

Importantly, the revision of the ETS Directive shall be based on a report that the Commission shall submit to the European Parliament and the Council by July 2026, specifically evaluating the system's impact on air connectivity, carbon leakage, and competitiveness - including with regard to Iceland. This annex supports that work by providing complementary data and context on Iceland's aviation sector under the ETS. Iceland stands ready to provide further input or assistance to help ensure that the revision leads to a fair, effective, and well-functioning system.

This contribution focuses solely on aviation in the Icelandic context and does not, at this stage, address the EU ETS as it applies to maritime transport or stationary installations. Iceland's key positions regarding development of the ETS for shipping are contained in the main contribution.

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7 Introduction and Background

This contribution to the public consultation on the EU Emissions Trading System (EU ETS) is submitted by Iceland to ensure that all relevant information concerning the application and effects of the ETS on aviation in Iceland is fully considered in the upcoming 2026 review. As a country participating in the ETS since 2008[3]—and in its aviation component since 2012[4] - Iceland has direct experience with the system's implementation and evolving impact.

The 2023 revision of the ETS Directive under the Fit for 55 package introduced significant changes to the aviation sector, including the phase-out of free allocation and a greater emphasis on aligning aviation with the EU's 2030 climate targets[5]. It also introduced specific obligations for the Commission to evaluate the effects of the EU ETS on air connectivity, competitiveness, and carbon leakage - explicitly including Iceland—by July 2026[6].

Aviation plays a unique and critical role for Iceland. As a remote island state with no alternative forms of international public transport, air travel is essential for economic activity, tourism, social inclusion, and regional cohesion. The Icelandic transatlantic hub at Keflavík Airport facilitates vital connectivity between Europe and North America, supporting both passenger flows and economic development.

This submission provides:

- An overview of Iceland's participation in the ETS and its aviation sector structure;
- Context on the geographic and market characteristics that shape Iceland's air connectivity;
- Modelling and analysis of the expected impacts of the EU ETS and the ReFuelEU Aviation Regulation on airfares, hub competitiveness, and socioeconomic conditions in Iceland;
- Recommendations for how these factors should be taken into account in the Commission's 2026 Carbon Market Report.

The focus of this contribution is on aviation. ETS impacts on maritime transport and stationary installations are not addressed in this submission. The analysis aligns with

[3] EEA J Joint Committee Decision No. 146/2007 of 26 October 2007, incorporating Directive 2003/87/EC into the EEA Agreement.
[4] EEA Joint Committee Decision No. 6/2011 of 1 April 2011, incorporating Directive 2008/101/EC extending the ETS to aviation.
[5] Directive (EU) 2023/958 of 10 May 2023, amending Directive 2003/87/EC as regards aviation's contribution to the Union's emission reduction target.
[6] EEA Joint Committee Decision No. 334/2023 of 8 December 2023, including specific evaluation requirements for Iceland under Article 30(8) of Directive 2003/87/EC.

the objectives set out in the European Commission's call for tenders[7], including evaluation of air connectivity for island and remote regions, social impacts, and the implementation of CORSIA.

Iceland remains committed to cooperate with the EU and its Member States to combat climate change with effective carbon pricing and recognise the need for aviation to contribute to emission reductions. However, it is crucial that these efforts take into account the limited availability of technological alternatives, the disproportionate exposure of island and peripheral regions, and the already declining trend in emissions per passenger-kilometre. Well-designed policies should maximise climate impact while preserving vital connectivity and avoiding carbon leakage through displacement of hub operations or air traffic to jurisdictions outside the ETS. The structure of the ETS must reflect real differences in geography and market exposure and ensure that environmental ambition does not come at the expense of economic fairness and essential connectivity.

8 Aviation in the Icelandic Context

The geographic location of Iceland in the middle of the North Atlantic left the island isolated for centuries, only having ships bringing supplies in the summer months. This changed with advances in ship technology but scheduled air service to the external world was a revolution in transport for Icelanders. Similarly, aviation has played an important role for many islands and communities and opened stronger communication between continents.

The aviation service operated in Iceland has always been provided by private companies founded by pioneers in the field. They managed to build scheduled air service in part built on the location of Iceland in the middle of the Atlantic Ocean and developing Iceland as a hub. In the last decade the tourism industry grew rapidly and air connectivity of Iceland as well.

This section provides information on the aviation operations and importance of aviation to Iceland. Information on recent development of aviation in Iceland and some relevant development in European aviation.

[7] European Commission Call for enders: EC-CLIMA/2024/OP/0006 – *Support for the review by the Commission concerning the implementation of ICAO's CORSIA, and for Commission reports on certain types of flights, social impacts, and air connectivity of islands, remote territories and Iceland*.

8.1 The importance of Aviation for Iceland

Aviation is indispensable for Iceland. As an island located in the North Atlantic with no alternative modes of international passenger transport, air travel is the only viable means of connecting Iceland with Europe and North America. It is also a major contributor to Iceland's economy: aviation and tourism jointly accounted for 14% of Iceland's GDP in 2023, and as high as 19% in 2017 at the peak of trans-Atlantic hub activity.

The Keflavík hub model supports both transatlantic transfer passengers and tourism to Iceland, but its viability depends heavily on maintaining cost-competitive operations. The ETS, as currently structured, creates a structural disadvantage for Iceland-based operations due to:

- The greater distance between Iceland and the European mainland (average 2,200 km, compared to the intra-EU average of 1,000 km);
- The distance-based nature of ETS obligations in aviation;
- The regional scope of ETS obligations that does not extend to comparable journeys operated via North American hubs.

8.2 Air Connectivity of Islands and Remote Territories- including Iceland

The aim of the Fit for 55 is to reduce climate emissions by incentivising modes of travel that emit less CO_2 per travelled kilometre than aviation. This does not apply to Iceland nor many other islands and remote territories, as there are no viable alternatives to air travel.

At a conference with the topic of regional airports in Turkey this year in April a structural shift in aviation was detected. The statistics of smaller regional airports, under 1 million passengers, showed 35% less volume from before 2019. The volume of larger regional airports over 1 million passengers were up 11.7%. The seats offered by ultra low-cost airlines were 27% fewer for smaller regional airports but increased by 29% for larger ones.

The following explanation was offered by Oliver Jankovic DG of ACI Europe:

> "*Looking ahead, these financial challenges are only set to worsen, given the expected impact of EU and UK climate regulations on air fares and demand. Independent studies have shown that smaller regional airports relying on LCCs will be the most affected, with their passenger traffic decreasing by up to -20% by 2050. This will result in much degraded connectivity for our regional communities, directly harming cohesion and territorial equality — and, beyond that,*

> *undermining Europe's competitiveness, as regional airports currently account for 35% of Europe's air connectivity."*

As pointed out here above, the most fragile services will be first to be axed in case of difficulties. Scheduled air services to many smaller regional airports are an example of fragile services. The increased cost of air tickets, including the cost of ETS allowances, cannot easily be absorbed with efficiency gains, will lead to higher prices and add to the problems of the most fragile air service links. Small regional airports often serve communities that have few transportation alternatives.

8.2.1 Air Connectivity of Iceland

From 2006-2011 only 3-4 airlines serviced Iceland during the winter and up to 12 airlines provided services in the summertime. Only airlines from Europe provided services to Iceland, none from the North America. Airlines from North America started to service Iceland in 2011. Before that time, only Icelandair and Iceland Express provided air service between Iceland and North America.

The growth in number of airlines flying to Iceland has first and foremost been driven by an increased tourism both from Europe and North America.

The **Error! Reference source not found.** shows the number of airlines flying to Iceland every year since 2011 in total. The graph also shows the number of airlines servicing Iceland the whole year, during the summer months and during the winter months. Here is a link to a list of the airlines flying to Keflavik airport.

In 2025, 16 airlines are expected to provide a whole year service. There were 26 airlines providing scheduled services to Iceland during the summertime and 21 are expected to provide service during the winter months.

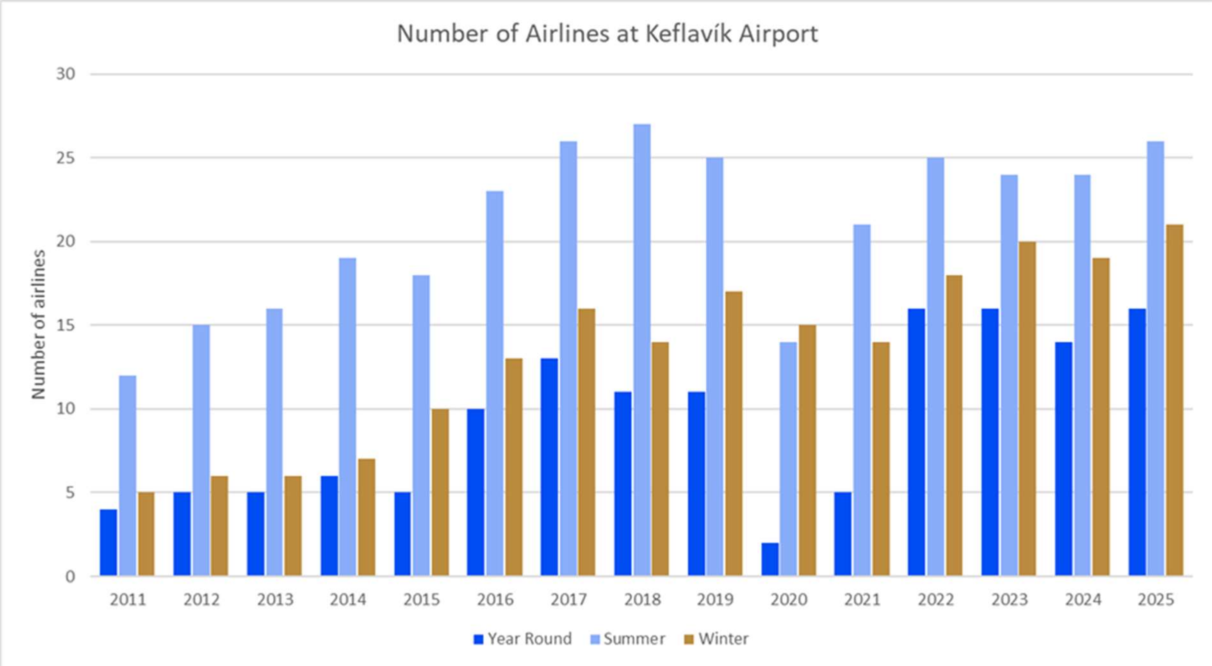

Figure 1 Number of Airlines at Keflavík Airport 2011-2025.

Many airlines flying to Iceland are low-cost airlines based in Europe flying point to point and not using hub services. They include for example Easy Jet, Norwegian, Wizz Air, Transavia and Vueling.

A few carriers from North America service Iceland but only during the summertime. They are full-service air carriers with link to Iceland providing hub services from airports in North America to destinations in North America, South America and many other areas. They include United Airlines, Delta and Air Canada.

Finally, a few full-service European carriers service Iceland from European airport hubs. Those airlines provide hub services to various destinations in Europe, Asia, America, and other areas. They include for example SAS, LOT, Lufthansa, Finnair and British Airways.

In 2025 only two airlines offered transatlantic flight service via Iceland as hub: Icelandair and Fly Play. Icelandair offers flights to and from Iceland as well as transatlantic services using Keflavík airport as a hub. Still, according to quarterly reports, the airline has consistently shown a loss from operations during winter months up to this day and minimum profit during the summer months. The aviation business in Iceland is challenging due to higher labour costs and standards compared to many other operating locations.

The other Icelandic airline, Fly Play, also offers transatlantic services with Keflavík as a hub. The airline has had financial difficulties, especially during winter months, and are rationalizing and reorganizing their operations. Fly Play has concluded that transatlantic services is not profitable and are winding down this operation. They have cut down on aircraft in operation by ceasing transatlantic flights from October 2025 and increasingly averted to point-to-point services to and from Iceland. They will operate four aircraft this upcoming winter at Keflavik Airport reducing the number from 10 aircraft a year ago.

The transatlantic Icelandic hub is unique in terms of hub activities in island states of EEA. Malta and Cyprus do not enjoy the added connectivity of an international hub services. Therefore, the hub is essential in maintaining the connectivity of Iceland.

Airports in Malta, handling almost 9 million passengers in 2024, route some transfer passengers, they are however negligible and sometimes none.

Cyprus airports, handling over 12 million passengers in 2024, do not keep records of transfer passengers, which remain few.

Similarly, airports in Canary islands, handling over 52.8 million passengers in 2024, do not keep records of transfer passengers.

The graph on daily departures from Iceland shows that connectivity has not reached the 2017 and 2018 levels but has surpassed the 2019 levels. It remains to be seen what the effect of Fly Play discontinuing the hub-and-spoke system will be on the connectivity of Iceland.

The adaptation Iceland negotiated for flights to Iceland allows for free allowances until 30 December 2026. Without the adaptation, or adjustment in the system post 2026, the full effect of the cost of ETS will hit the hub and spoke operation via Iceland, with the associated impact on connectivity and social economic conditions.

8.2.2 Number of Destinations Served from Iceland

Figure 2 shows the total number of destinations serviced from Iceland since 2010. The number of destinations serviced by Keflavík airport has grown substantially in line with the increase in tourism. In 2010 there were flights to total 52 destinations and in 2025 the total destinations served were 97 almost the same number as in 2018 at the peak of number of destinations.

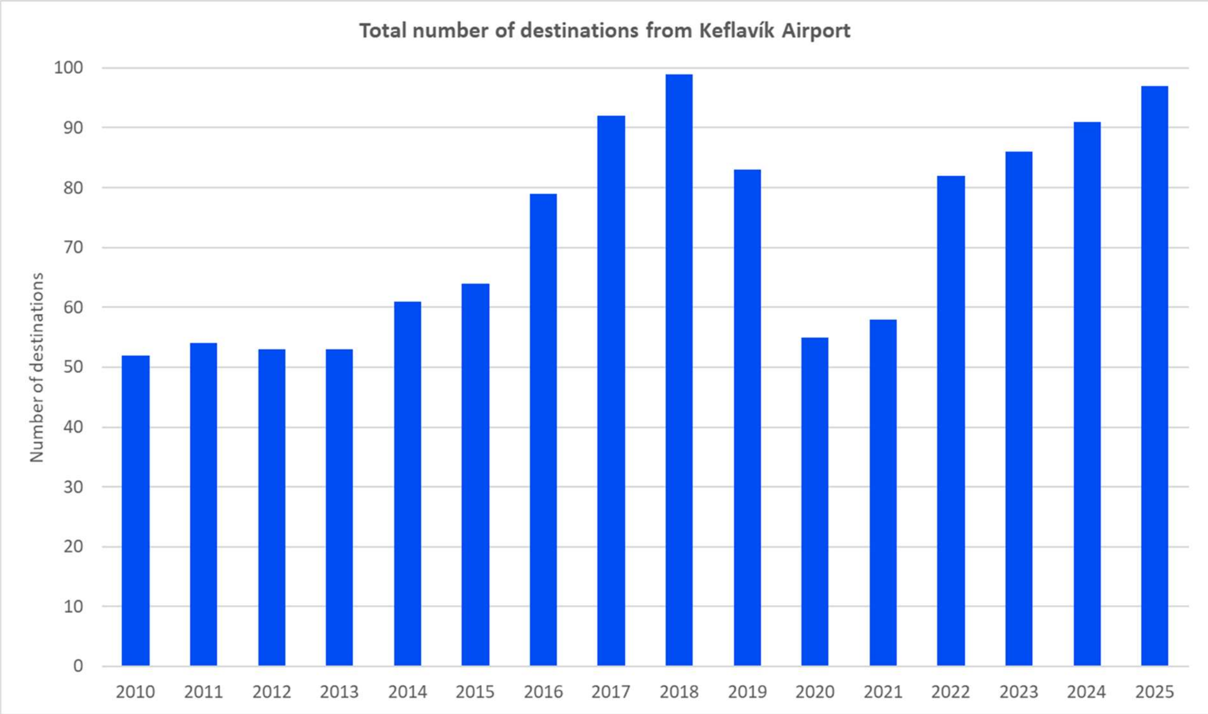

Figure 2 Number of destinations serviced from the Keflavik Airport by year.

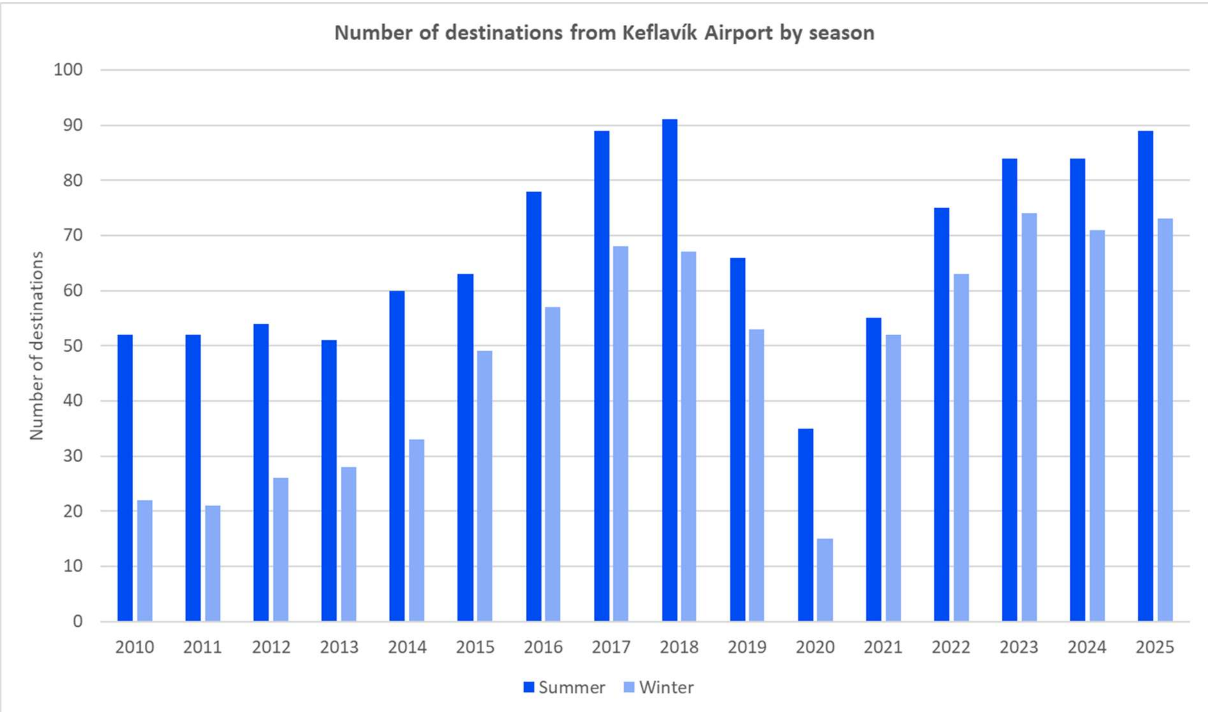

Figure 3 Number of destinations from Keflavik Airport by season.

Figure 3 shows the number of destinations in the wintertime on one hand and in the summertime on the other.

In 2010 a total of 460 thousand tourists visited Iceland. Only three airlines were providing service to Iceland during the winter months to 22 destinations and nine airlines to 52 destinations during the summer months.

In 2024 over two million tourists visited Iceland. There were 19 airlines providing connections to 71 destinations during the winter months and 24 airlines providing connections to 89 destinations in the summer months.

Icelandair has the highest market share and the highest number of destinations. The number of destinations of Icelandair is very much the product of synergies between trans-Atlantic services and flying tourists to Iceland as well as opening up travel opportunities for the Icelandic population and facilitating business and trade.

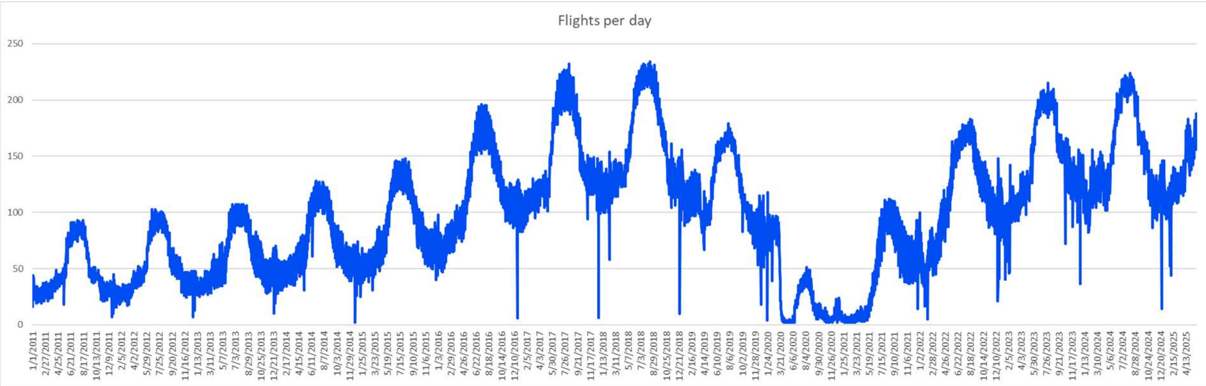

Figure 4 Flights per day through Keflavík Airport 2011-2025.

Flights per day is a good indicator of connectivity for Iceland. The picture shows the flights per day since 2011. It shows that the number of departures was at its highest level in 2018 and has not reached that level since. Still the number of departures is growing and in 2024 they were close to 2017 levels. The effect of Play air to abandon the hub-and-spoke system and reducing the number of aircraft in its fleet will not come fully into effect and be visible until in the autumn 2025.

8.3 Hub Airports Serving Transfer Traffic to External EEA Destinations

There are number of global aviation hubs in Europe that connect to external destinations. To name a few, Brussels airport, Frankfurt, Copenhagen, Amsterdam, Madrid, Lisbon, Paris CDG, and Rome.

All hubs within Europe are subject to cost of ETS allowances for passengers flying from an EEA state to EEA hub bound for external destination. The cost is varying in relation to the length of the EEA leg, but the average leg in Europe is about 1000 km.

The EEA leg leads to extra distance based regulatory cost on the intra-EEA leg before flying to extra EEA destination. In comparison airfares for direct flight out of EEA between the same destinations do not carry such cost nor the transfer in extra-EEA airports. Examples of extra EEA transfers hubs is Istanbul on the way to Africa, Middle East and Asia. Others are in Dubai, in the North America and potentially London.

The Iceland hub is competing with well-connected hubs in North America in cities that connect to multiple destinations in N-America as well as other continents. Examples are New York, New Jersey, Baltimore, Dallas, Chicago, Atlanta, Seattle and Toronto.

8.4 Growth Trends of Transfer Passengers in EEA+ Hubs

The volume of passengers in EEA +UK achieved full recovery in 2024 from pre pandemic (2019) years and continues to grow in 2025. However, the 2025 ACI connectivity report reveals that despite connectivity (direct and indirect) increasing by +7% in 2025 over the preceding year, air connectivity (direct + indirect air connectivity) in EEA + UK still remains -8% below pre pandemic (2019) levels.

Istanbul airport is often cited by airlines as a competing airport near EEA for global connections to the Middle East, Asia and Africa. The claim is that it would have competitive advantage for global connectivity as flights from Istanbul to destinations outside Europe do not have regulatory burdens of climate regulations. According to the statistics of ACI, Istanbul has grown its global connectivity by 59% since 2019. It surpassed Frankfurt airport that enjoyed the highest global connectivity in 2019, global connectivity declined 21% since 2019.

Another airport Albania just outside the EEA shows very high growth in connectivity (direct and indirect), that is 56% from the 2019 numbers. Neighbouring airports just outside EEA also showed growth, Kosova 1%, Serbia 8% and North Macedonia 17% while the European average shows a decline of 9%

8.5 Growth Trends of Transfer Passengers in the Icelandic Hub

The increase in tourism to Iceland and accompanying increase in foreign participation in the labour market has driven the growth in traffic in the aviation hub in Iceland, Keflavik airport. The increase since 2010 is from about 400 thousand to over 2 million tourists in 2024. This increase in tourism is in part contributed to various factor one being the attention Iceland attracted during the eruption of Eyjafjallajökull and Grimsvötn í Vatnajökull.

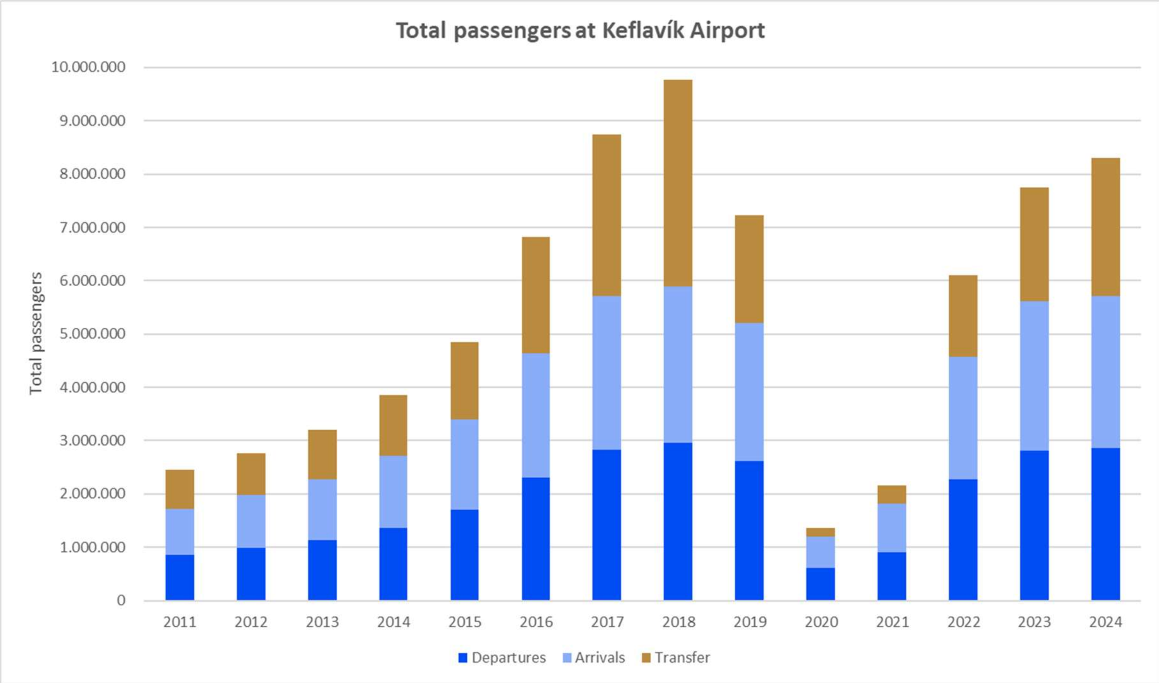

Figure 5 Total passengers at Keflavík Airport 2011-2024.

Figure 5 shows the total number of passengers visiting Keflavik airport. It should be noted that every passenger, including the transfer passengers, is counted twice, that is when inbound and outbound from the airport.

The total number of passengers is 8,7 million in 2017, 9,8 million in 2018, 7,3 million in 2019, 7,7 million in 2023 and 8,3 million in 2024. It is estimated that the number of passengers will be at the same level in 2025 as it was in 2024.

The graph shows that the number of passengers in 2024 are still well below the peak of 2018 and the number is also lower than the total number of passengers in 2017.

The number of transfer passengers was 3 million in 2017, 3.9 million in 2018, 2 million in 2019, 2.1 million in 2023 and 2.6 million in 2024.

The share of transfer passengers reaches its peak in 2018 of 40% but is 27% in 2023 and 31% in 2024. The number of transfer passengers is projected to decrease following the abandonment of Fly Play of the hub and spoke system.

As shown in the graph the share of transfer passengers fluctuates between years, in relation to competitive conditions on the market. The demand for tourism visiting Iceland is therefore an important factor in growth of transfer passengers.

The share of transfer passengers in Keflavik airport has been around 30%, some years higher and some years lower. This indicates that the price of airfare is a variable in adjusting supply and demand of trans-Atlantic services to the very much lower demand during the winter months. Another variable is the offered seat capacity. As a result, the airlines providing trans-Atlantic service via Keflavík airport are not profitable during the winter months.

As mentioned before, Fly Play, reduced its trans-Atlantic service in the second half of 2024 and now announced that the airline will cease it all together in the autumn of 2025. In the year the airline carried 1.6 m passengers of which 39% were transfer passengers or 625 thousand. The abandonment of the trans-Atlantic service will have effect in reducing the number of trans-Atlantic passengers going via Keflavik airport.

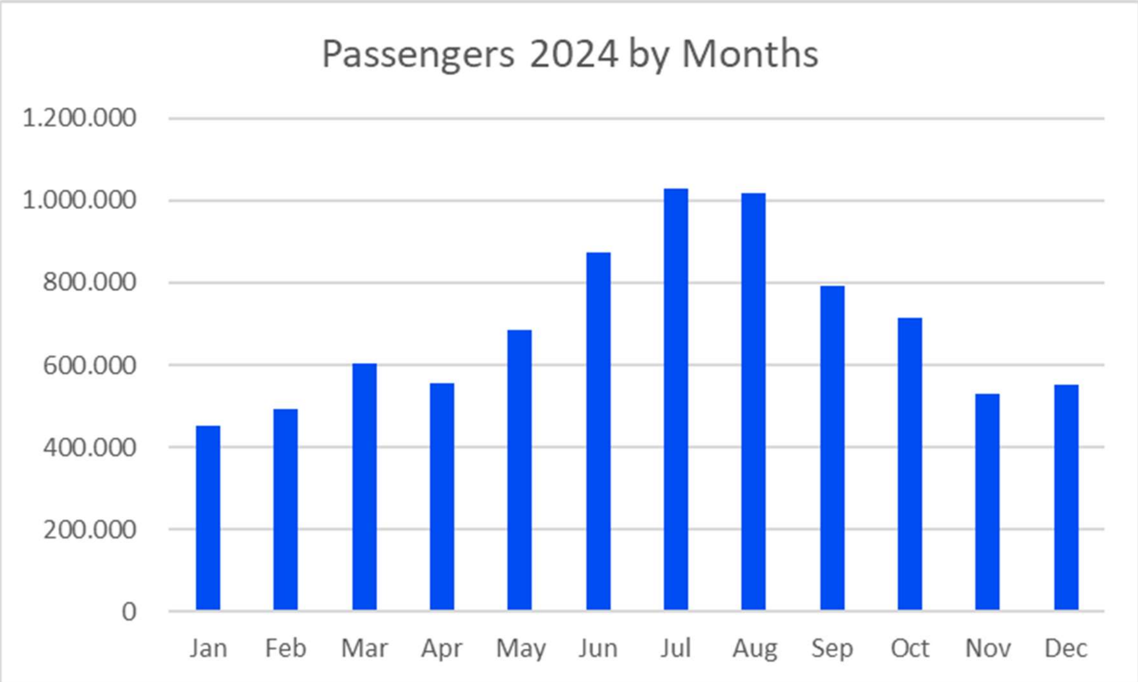

Figure 6 Share of transfer passengers pr month of the year 2024.

Figure 6 shows a weak demand of Iceland international airport during the winter months, especially in January and February. This is exacerbated by heavy loss of the Icelandic carriers for the winter quarters despite cost cutting efforts and at the same time putting efforts into maintain and protect their investment in their destinations.

8.6 Vulnerability of the Icelandic International Hub

The aviation business operates in a quite fluid and volatile environment, changes in different markets can almost instantly affect other markets apart from the general constant growth in aviation. Many examples of this are in the past s.a. closure of the Russian airspace which let airlines shift their capacity to the trans-Atlantic market. Another example was the price war when the Norwegian entered the trans-Atlantic market. Further back in time during the Asian economic crisis when airlines shifted resources to the trans-Atlantic market. On top of this are risks associated with systematic problems with aircraft s.a. the suspension of Boing 737 MAX aircraft.

These crises induce vulnerability to airlines which frequently lead to difficult decisions such as cutting operations and destinations. Increased regulatory burden compared to competitors outside the regulatory regime makes airlines more vulnerable to adverse market conditions.

The graphs for Keflavik Airport above show weak demand in the winter months. This is reflected in the graphs the monthly number of passengers using the airport, number of airlines serving the airport, and number of destinations served by the airport. This is further demonstrated in the graph showing the daily number of departures.

The strongest indicator is the graph of daily departures that shows that the number of daily departures has not reached the pre-covid level. The graph does not show the effect of Fly Play reduced operations and abandonment of transatlantic flights. This points to reduced connectivity.

Another factor of vulnerability is the ratio of passengers travelling intra EEA to passengers travelling via an EEA hub to extra-EEA destinations. The ratio of customers of airlines competing on the transatlantic market using Keflavik as a hub can be up to 50%. This high dependability on the hub-and-spoke system connecting the transatlantic market increases the risk stemming from the ETS system and vulnerability of the hub and the airlines using its services.

The quarterly reports of Icelandair and Fly Play, the two airlines offering transatlantic services via Keflavik hub, have shown a high loss from operations during the winter months. The airlines try to address this vulnerability by reducing overall operations to cut losses as much as possible. This includes lowering frequency, cutting destinations, laying off employees, and various other cost-cutting measures.

It is difficult to isolate the effects of the cost of ETS allowances on connectivity. The obligation to acquire ETS allowances for all emissions has not come into full effect so all the cost has not materialized yet. Only then the full impact will come into light but there are already indications of shift in hub activities and signs of less connectivity at the most fragile routes.

In the following text is cost estimation and analysis of the impact of ETS system on the competitiveness of the Icelandic international hub and the connectivity of Iceland.

9 ETS Aviation and Iceland

As a party to the EEA Agreement, Iceland participates in the European Emissions Trading System (EU ETS), which regulates greenhouse gas emissions from stationary installations, aviation, and maritime transport. While the EU ETS is a central pillar of the EU's climate strategy, its application to aviation - particularly geographically remote regions - can impose disproportionate costs that raise competitiveness, equity, and operational concerns.

For Iceland, a country entirely dependent on air transport for international connectivity, the structure of the EU ETS poses challenges. This is especially true post-2026, when the phase-out of free allowances will significantly increase compliance costs for aircraft operators.

The most pressing concern is the impact of the ETS on the competitiveness of the Icelandic transatlantic hub, centered at Keflavík Airport. This hub is essential to Iceland's economic and social resilience. Aviation and tourism jointly contributed 14% to Iceland's GDP in 2023, and up to 19% in 2017 at the peak of hub activity. According to analysis of IATA, the aviation sector supported as much as 25.1% of Iceland's GDP in 2023.

Since aviation was first included in the ETS, the cost of compliance has risen sharply. The price of allowances has increased several-fold, while the volume of free allocation has declined—and will be eliminated by 2027. ETS costs now represent a substantial share of total operating costs, which is particularly burdensome in a sector where the overall long-term net profit margins average ranges from 2-5%, was 2.7% in 2024 and is often only 1–3% for full-service carriers.

Importantly, aviation differs structurally from stationary installations. In the case of industrial emitters, emissions are tied to fixed production processes that can be mitigated through changes in fuel input, efficiency upgrades, or production volumes. By contrast, aviation emissions are directly linked to distance travelled - movement itself is the emitting activity. ETS obligations for aviation therefore increase proportionally with distance flown, which introduces a systemic disadvantage for geographically peripheral countries like Iceland. It is furthermore contrary to many other policies such as cohesion policies and the integration of the single market.

- The average intra-European flight is approximately 1,000 km.
- The average distance from European airports to Iceland is around 2,200 km.
- Flights to and from Iceland thus require more than twice the number of emission allowances, significantly inflating the cost per passenger.

Moreover, under the current "Stop the Clock" provision, passengers flying from Europe to Iceland are fully covered by the ETS for the full distance (approx. 2,200 km) before transferring onward to North America. In contrast, passengers flying via hubs outside the EEA - such as New York or Toronto—incur no ETS costs on the intra-North American segment. This results in a substantial competitive advantage for non-EEA carriers and hubs, despite comparable emissions, and creates distortions in the level playing field that disproportionately affect Iceland.

This section looks at factors of ETS in relation to aviation in Iceland.

9.1 ETS Aircraft operators in Iceland

Under the ETS, Iceland is responsible for administering compliance for aircraft operators with an Air Operator Certificate (AOC) issued by Iceland, as well as certain non-European carriers whose emissions fall under Iceland's jurisdiction based on historical activity and routing patterns. The Environment Agency of Iceland is the competent authority and manages s this role by approving emissions monitoring plans, receiving annual verified emissions reports, and ensuring that operators surrender allowances corresponding to their emissions.

Each year, the European Commission, using data from Eurocontrol, updates the list of aircraft operators subject to the ETS. Only those exceeding 10 000 tonnes of CO_2 emissions (for commercial operations) or 1 000 tons (for non-commercial) are subject to full compliance obligations. While Iceland is listed as the administering state for a large number of aircraft operators, only four aircraft operators exceed these thresholds and are required to report and surrender allowances.

In 2024, verified aviation emissions under Iceland's jurisdiction amounted to 0.64 million tonnes of CO_2-equivalent 1 % of the emissions withing the ETS.

Because aviation emissions are directly proportional to distance travelled under the ETS, operators based in geographically remote locations like Iceland face a structurally higher ETS burden. This creates cost pressures not experienced by airlines operating primarily on shorter intra-European routes, raising concerns around competitiveness, connectivity, and the economic sustainability of essential air services.

9.2 ETS Aviation revision in 2026 in relation to Iceland

The ETS Directive, adopted in 2008, was designed to apply to emissions from flights from, to and within the European Economic Area (EEA) – the EU Member States, plus Iceland, Liechtenstein and Norway. The EU, however, decided to temporarily limit the scope of the EU ETS to flights within the EEA, to support the development of a global measure at ICAO, in light of the launch of CORSIA, this limitation has been extended several times. During the latest revision of the ETS Directive, it was extended for what is to be the last time, until the start of 2027.

By July 2026, the Commission will carry out an assessment of whether more action is required for flights to and from Europe, in line with criteria set in the EU ETS Directive.

Subject to the outcome of this assessment, the Commission will make a legislative proposal that could extend the scope of EU emissions trading to departing flights and exempt incoming flights. Alternatively, the proposal could be to maintain the intra-European scope if CORSIA is strengthened and has a high level of global participation and implementation.

9.3 ETS Allowance Prices

In 2012 when the ETS was extended to aviation the average price of allowances were around 7 Euros.

The price of ETS allowances has increased substantially since 2012 as shown in the graph from website of TradingEconomics above the price of ETS allowances in 2023 reached momentarily over 100 euros pr ton but lowered in 2025 to typically 75-80 euros per ton.

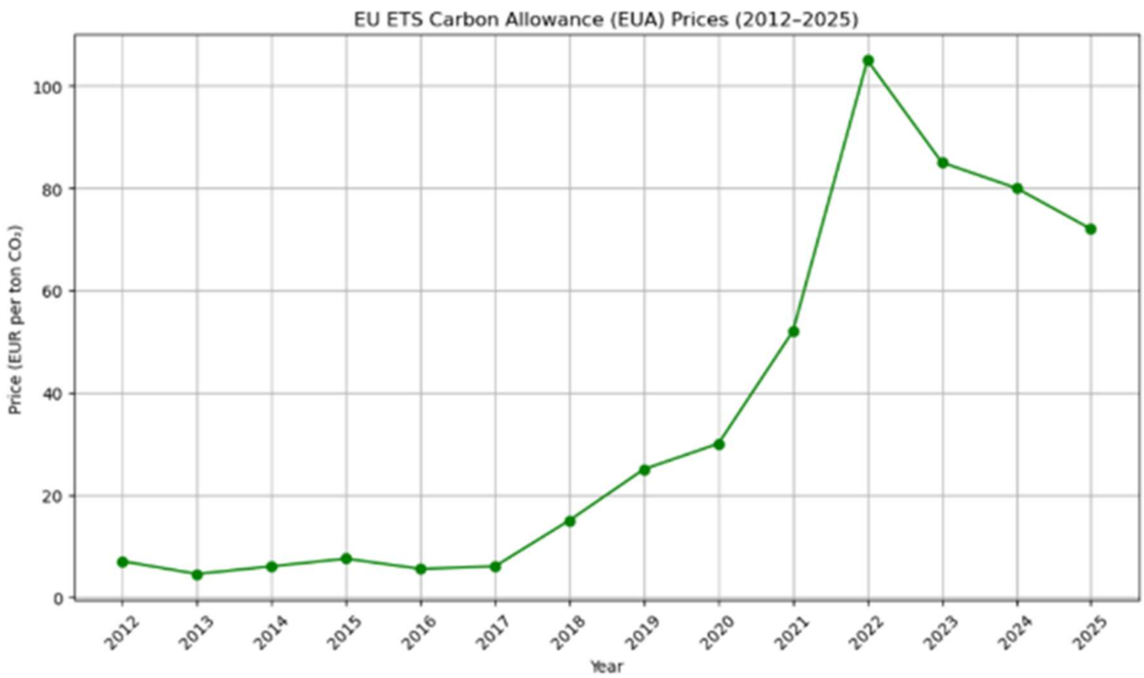

Figure 7 Price of ETS allowances euros/tonne.

The price of allowances is predicted by Enerdata to remain near range the range of 70-75 Euros pr tonnes until 2030 but predicted to rise significantly after 2030.

The CORSIA system is a global system and due to be obligatory in 2027. It is not as rigorous as the ETS system, emissions are to be kept within 85% of the emissions of the baseline year 2019. Airlines would need to buy carbon credits when unable to accommodate the increased emissions with other means within the Corsia regime.

The prices of tonne of Corsia carbon credit are projected to increase considerably in 2027 when the Corsia system is to come into effect and reach 14-16 USD pr tonne. It is expected to rise in subsequent years, and some predictions indicate prices as high as 90 USD pr tonne by 2035.

The demand and prices of carbon credits face high level of uncertainty, especially in relation to the current US climate policies. In the analysis of this text the cost of complying with Corsia is on average estimated at 15 Euros per emitted tonne.

9.4 The Role of SAF reducing ETS Emissions

Aviation is widely recognized as a hard-to-abate sector, as highlighted in the 2024 *Draghi Report on the Future of European Competitiveness*[8]. There are currently no short-term solutions for full decarbonization of air transport, particularly for medium- and long-distance flights, which make up near all of Iceland's international air services (1500 km minimum from Keflavik). While fuel efficiency improvements continue, the only near-to-medium-term option for substantial emissions reduction is through the deployment of Sustainable Aviation Fuels (SAF).

SAF is a cornerstone of the EU's aviation decarbonisation strategy, with binding mandates set under the ReFuelEU Aviation Regulation[9]. These mandates start at 2% in 2025 and increase to 6% in 2030, with longer-term targets rising to 70% by 2050. However, global SAF production remains critically low. While output is expected to double to 2 million tonnes by 2025, this will still represent only 0.7% of global aviation fuel demand, according to IATA estimates[10]—well short of the 65% contribution SAF is expected to make in aviation's net-zero pathway[11].

In addition to limited availability, SAF is significantly more expensive than conventional jet fuel, typically costing 2 to 6 times more[12]. For island nations like Iceland, which lack domestic biofuel production capacity and must rely entirely on imports, this presents

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[8] *Report of the High-Level Group on the Future of EU Competitiveness* (Draghi Report), European Commission, 2024.
[9] Regulation (EU) 2023/2405 of the European Parliament and of the Council of 18 October 2023 (ReFuelEU Aviation Regulation).
[10] IATA, Net Zero by 2050: *Flightpath to Aviation Sustainability*, 2023 update.
[11] European Commission, *Staff Working Document: ReFuelEU Impact Assessment,* SWD(2021) 634 final.
[12] Clean Skies for Tomorrow Coalition, World Economic Forum, *SAF Market Outlook* 2023.

both cost and access barriers. Moreover, SAF-ready infrastructure—such as blending facilities and storage at airports - is not yet available in Iceland.

Although modern aircraft can operate with SAF blends of up to 50%, full SAF compatibility (i.e. 100% SAF use without blending) is still in development and not expected to be widely available until 2030 or later[13]. Iceland strongly supports EU climate goals, but emphasises that SAF implementation must reflect regional constraints, technological readiness, and infrastructure gaps.

For the time being, SAF is not a viable emissions reduction solution for Icelandic airlines, and ETS compliance costs remain the primary financial burden under the Fit for 55 package. With fuel accounting for approximately 30% of airline operating costs, the higher price of SAF combined with rising ETS allowance costs creates a compounding effect. Profit margins in the airline industry remain narrow - 2–5% on average, with full-service carriers often operating at 1–3%[14].

While technological advances have made modern aircraft up to 80% more fuel-efficient than those flying 60 years ago, further gains are increasingly difficult to achieve. The efficiency of flight has improved dramatically, but the basic physics remains unchanged - moving 100 to 400 passengers at high speed over long distances will always require a significant amount of energy[15].

There are limited alternatives available. Efficiency improvements in aircraft design and operations can help reduce emissions, but these gains are incremental. Broader improvements—such as airspace modernisation through the Single European Sky initiative—remain unrealised due to political and administrative deadlock[16].

Given these challenges, Iceland emphasises that the ETS for aviation must remain proportional to technological and market realities, especially in the short to medium term. Scaling up SAF supply will require massive investment and sustained policy support. In the meantime, SAF policies and ETS obligations must be:

- Technologically and economically feasible;
- Supported by infrastructure and supply availability; and
- Calibrated to reflect regional circumstances and operational realities.

Without such an approach, there is a risk that well-intended policies could undermine the competitiveness of European aviation, weaken air connectivity for peripheral regions, and increase socioeconomic disparities across the EEA.

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[13] ICAO, *SAF Readiness Level Guidance*, 2023.
[14] IATA Economics, World Air Transport Statistics, 2023.
[15] IATA Fact sheet 7: Liquid hydrogen as a potential low carbon fuel for aviation. [IATA Fact Sheet]
[16] European Court of Auditors, *Special Report: Single European Sky – a dream deflected*, 2023

Unfortunately, conditions for airlines to revert to SAF to reduce emissions are not at hand nor will be for a very long time. Therefore, the ETS system for aviation needs be proportional to current and projected realities.

9.4.1 ETS financed SAF support

The revised EU ETS Directive introduces a dedicated support mechanism to bridge the cost gap between Sustainable Aviation Fuels (SAF) and conventional fossil-based kerosene. This mechanism aims to accelerate the deployment of SAF by covering part - or in certain cases, the full price difference - between SAF and fossil jet fuel.

Aircraft operators operating from certain island regions, including Iceland, are eligible to apply for support covering up to 100% of this cost difference[17]. Iceland welcomes this recognition of the structural challenges faced by geographically isolated regions with limited access to alternative transport modes and fuel supply chains. The inclusion of such targeted support represents a vital step toward levelling the playing field and enabling aviation decarbonisation in remote regions.

The price difference for using SAF is compensated fully or partly within the ETS, but not within the SAF mandate regime. As the current compensation can only be provided within the ETS scope, it is necessary to review and ensure the alignment of the SAF cost compensation mechanism with the ongoing revision of the ETS and any changes to its geographical or sectoral coverage. For flights not covered by the ETS, alternative policy tools or financial mechanisms should be considered to reduce the cost gap and support the uptake of SAF across the broader aviation sector.

Iceland supports this mechanism as an important tool for reducing aviation emissions and acknowledges its potential to incentivise early SAF adoption. However, Iceland also wishes to underscore a critical limitation: the mechanism cannot deliver its intended impact if SAF is not physically available. At present, SAF is not commercially available in Iceland, and there are no domestic production facilities or established import logistics. This lack of access severely limits the ability of Icelandic operators to benefit from the mechanism - even when 100% cost coverage is permitted.

Importantly, the ETS Directive introduces a flexible approach to fuel attribution. Where SAF cannot be physically linked to a specific flight, the Directive allows support to be granted on a proportional basis. That is, allowances may be made available for SAF uplifted at an airport in proportion to the emissions from flights operated from that airport for which allowances must be surrendered. Iceland supports this practical and

[17] DECISION OF THE EEA JOINT COMMITTEE No 334/2023 of 8 December 2023 amending Annex XX (Environment) to the EEA Agreement [2024/1419]

necessary flexibility, particularly at airports where SAF supply chains or fuel infrastructure may limit precise traceability.

However, this flexibility only has practical value where SAF is actually available for uplift. In Iceland's case, the primary barrier remains not only cost attribution but physical access and supply. The lack of SAF on the Icelandic market makes it impossible for operators to benefit from the mechanism as intended, regardless of the level of support.

To make this mechanism effective for remote regions, Iceland urges the EU to:

- Consider transitional flexibilities or equivalent compliance pathways for regions where SAF cannot yet be sourced in practice.
- Support investment in SAF logistics and infrastructure in outermost and island regions.
- Ensure timely coordination between the SAF support mechanism and ReFuelEU Aviation blending mandates, so that operators are not penalised for the absence of available fuel;

While Iceland appreciates the inclusion of higher support levels and supports the proportional allocation method it introduces, the mechanism must be accompanied by measures to ensure actual SAF availability in remote and island areas. Without such support, the mechanism risks failing to deliver the climate benefits it is designed to achieve, particularly in geographies where the need for transitional assistance is greatest.

9.5 Socio-economic Impacts of the ETS in Iceland

As previously outlined, aviation is not optional for Iceland—it is essential. With no land borders or access to rail networks, air transport is the only mode of international connectivity for Icelanders. Aviation creates a wide range of social and economic benefits, enabling access to education, connecting friends and families, supporting cultural exchange, and facilitating trade and tourism. Together, these functions contribute directly to long-term growth, social cohesion, and improved living standards.

The aviation sector is also a cornerstone of Iceland's economy. In 2023, it directly employed 17,100 people, contributing USD 1.9 billion, or 6.3% of Iceland's GDP. When accounting for the wider supply chain, employee spending, and tourism, aviation supported an estimated 55, 400 jobs and USD 7.8 billion in GDP, representing 25.1% of total national output[18]. These figures highlight how deeply integrated air transport is into Iceland's economic structure—not only through tourism, but also via export-driven sectors such as fisheries, tech, and professional services. Air transport enables the

[18] IATA (2024). *The Importance of Air Transport to Iceland.*

delivery of time-sensitive goods, such as fresh seafood, that rely on frequent and reliable passenger aircraft departures.

Socially, aviation is a key enabler of mobility and opportunity. It supports the movement of students, health professionals, skilled workers, and families, and offers essential access to services and international networks. Around 2 million travellers arrive in Iceland annually, though national statistics do not fully distinguish between tourists and temporary labour migrants. Similarly, the number of business travellers and Icelanders flying abroad for education or family reasons is difficult to isolate, but clearly significant.

The cost of air travel is critical to the accessibility of these social and economic benefits. Rising operational costs due to the ETS - particularly with the phase-out of free allowances and the introduction of SAF blending mandates—may lead to higher airfares, disproportionately affecting lower-income households, students, pensioners, and persons with disabilities.

In addition, Iceland's aviation system is based on facilitating a hub-and-spoke model of airlines, centred at Keflavík International Airport. It serves both origin-destination passengers and those transferring between Europe and North America. The competitiveness of this hub is vital not only for Iceland’s tourism economy, but also for its broader international connectivity. A decline in hub competitiveness -resulting from uneven ETS cost burdens - would risk reducing connectivity, further isolating the country, and limiting access to global markets, education, and services.

Research by ACI-Europe shows that a 10% increase in air connectivity can lead to a 0.5% increase in GDP[19]. Since 2012, Iceland has experienced significant growth in both connectivity and GDP, with aviation and tourism accounting for 14% of GDP in 2023[20], and as much as 19% in 2017. Earlier studies, such as the one by Ásgeir Jónsson (now Governor of the Central Bank of Iceland) and Þórunn Helgadóttir, found that aviation alone contributed over 12% of GDP in 2017[21].

[19] ACI Europe (2022). The Economic Impact of Air Connectivity.
[20] Statistics Iceland (2024). *Tourism Satellite Accounts – Contribution of tourism to GDP*.
[21] Jónsson, Á. & Helgadóttir, Þ. (2017). *Hagfræðileg áhrif íslensks flugrekstrar*. University of Iceland, Department of Economics.

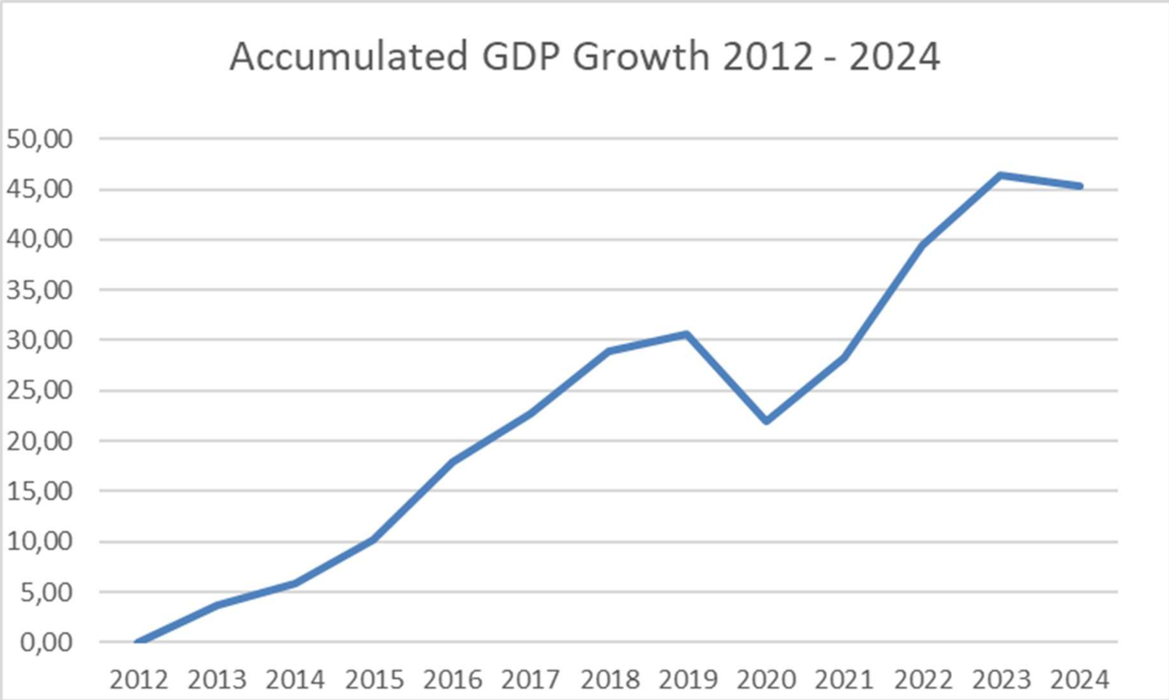


Figure 8 Iceland's GDP 2012-2024 (Source Statistics Iceland)

At the same time, Iceland fully recognises the climate and environmental impacts of aviation and supports the long-term decarbonisation of the sector. The cost of climate inaction - including extreme weather events, environmental degradation, and economic disruption - is substantial and rising. It is therefore crucial to design effective and fair policies that enable emissions reduction while safeguarding essential connectivity, especially for remote and island regions. Mechanisms such as the ETS must drive genuine environmental progress without undermining social equity or economic resilience.

The continued success and inclusivity of Iceland's economy depend on affordable, reliable, and frequent air transport, which in turn depends on fair and proportionate climate policy. If rising ETS costs are not balanced by effective implementation strategies—especially in regions with no modal alternatives—they may lead to reduced route viability, diminished access, and broader socio-economic harm.

In light of these challenges and obligations, Iceland calls for a careful and transparent assessment of the socio-economic impacts of the EU ETS on aviation, particularly in geographically isolated EEA regions, as part of the upcoming 2026 Carbon Market Report. Climate action is urgent—but it must be carried out in a way that is regionally sensitive, economically sound, and socially just.

9.5.1 Further Evaluation and Impact Assessment in Iceland

The Ministry of the Environment, Energy and Climate has commissioned a consultancy firm to carry out a socio-economic analysis of the impact of the ETS on Iceland. The Minister of Environment, Energy and Climate will present this analysis to the Icelandic

Parliament in accordance with interim provision VII of Act 96/2023 on the EU Emissions Trading Scheme in November this year to ensure that members of Parliament are informed of the cost and benefits of the system. In addition, the results of the analysis will help the Ministry in assessing the impact of the ETS on public and private sectors in Iceland.

The analysis will examine the following aspects:

- The socio-economic impact of the ETS system on the economy, i.e. the operators covered by the system such as the local industry, aviation and shipping.
- The socio-economic impact on the general public in Icelandic society in terms of consumption and travel.
- The environmental impact of the ETS system comparing emissions with and without the ETS and the socio-economic cost (or benefits) of not mitigating climate change in terms of urban and rural societies, infrastructure, tourism, and energy generation.

Iceland's stands ready to share the outcome of the analysis with the European Commission, once available.

10 Market Distortions and Competitiveness Issues, and the risk of 'hub carbon leakage'

The distortive effects of the ETS system arise from its interaction with a global regulatory regime, especially when a passenger travels within the ETS system to an EEA transfer hub for continuing travel to an external destination. The greater the price difference of allowances between the global system (Corsia) and the regional system (ETS) and the longer the flight leg within the regional system the greater is the competitive distortion. This section provides information and examples of the competitive distortion between airlines using intra EEA hub and the ones using extra EEA hub.

10.1 Level Playing Field Challenges for Iceland as a Hub

The Iceland hub is competing with well-connected hubs in N-America in cities that connect to multiple destinations in N-America as well as other continents. Examples are New York, New Jersey, Baltimore, Dallas, Chicago, Atlanta, Seattle and Toronto. These airport hubs are in direct competition with Keflavik Airport hub. N-American based airlines typically offer air fares from destinations within EEA s.a. Brussels to various destinations within USA via an N-American hub, currently without having any obligation to purchase ETS allowances. They would need to comply with Corsia obligations that are considerably less costly as demonstrated in this section.

The average distance from EEA airports serviced from Keflavík airport is 2 200 km and in comparison, the average flight distance within EEA is 1 000 km. Thus, the distortion effect is more than twice the average of other transfer hubs within EEA.

For most hubs, distortions may not lead immediately to major changes in the demand for air travel to a given destination via disadvantaged hubs. The most fragile airlines and destinations would be the first to be the subject of service termination. This is addressed in the text of the paragraph on “Vulnerability of the Icelandic international hub”.

In June 2025, Fly Play announced that the company will cease trans-Atlantic service via Keflavik hub altogether in the autumn 2025. In a response to a question of what factors led to the decision, the airline gave the following answer:

> “The increased cost of the ETS system and changes in the system that decrease the competitiveness of Keflavik airport is certainly one of the reasons that Fly Play decided to abandon our hub and spoke system.”

10.1.1 Misalignment Between ETS Costs and Climate Impact

The EU ETS was extended to aviation on 1 January 2012, with approximately 82% of allowances allocated free of charge and the average carbon price around €7 per tonne. By 2018, the price had increased to €20, and free allocation had declined to 52.5%. From 2026, aircraft operators will receive no free allowances and must purchase ETS allowances for 100% of emissions within the scope of the system. In recent years, allowance prices have approached or exceeded €70 per tonne, substantially increasing the cost of compliance for airlines operating within the EEA.

However, the price of a flight ticket does not necessarily reflect the environmental or climate impact of that flight. The ETS only applies to intra-EEA flights and excludes emissions from flights departing to or arriving from third countries. As a result, two passengers flying to the same long-haul destination—such as Seattle—may face significantly different ETS-related costs depending on whether they connect via Keflavík Airport (inside the EEA and fully covered under ETS) or via a non-EEA hub, such as Toronto or New York, where the connecting leg is outside the scope of the ETS. In addition, the emissions may be much lower for the high ETS cost per passenger. This creates a competitive distortion in the market and undermines the polluter-pays principle.

For Iceland, this situation is particularly problematic. The aim of the Fit for 55 scheme is to reduce climate emissions by incentivising modes of travel that emit less CO_2 per travelled kilometre than aviation. For Iceland there are no viable alternatives to air travel. The country’s geographic location means that all international flights are long-distance, and all emissions on those flights fall within ETS scope under the current "stop-the-clock" configuration. Icelandic carriers thus bear a disproportionate cost burden, especially when compared to carriers using non-EEA hubs for trans-Atlantic connections, which face lower or no ETS-related costs for equivalent emissions. At the same time, the carbon price - while rising - does not account for non-CO_2 effects or the altitude and location-specific climate impact of emissions, further weakening the environmental precision of the system.

10.2 Scenarios of Level Playing Field Impacts

For analysis of distorted level playing field due to the ETS, the example of passenger travelling round trip between Seattle-Berlin was used.

The example used is the of three different passengers that purchase air ticket for round-trip Berlin-Seattle. One purchases return air ticket with a stopover at Keflavik. The second one purchases return ticket with a stopover in Frankfurt and the third passenger purchases return ticket with a stopover in New York (EWR). At the time of the calculations no direct flights were offered on this route.

Below are presented the result of analysis of the three different scenarios. The Main assumptions are listed for each scenario. In all three scenarios:

- Only cost of ETS is included and not the cost of the 2% SAF blending mandate. These examples are meant to highlight the cost effect of the ETS system. The cost of SAF is calculated to be 5,4 Euros per passenger on the route Berlin -NJ, 6,95 Euros Frankfurt-Seattle and 3,3 Euros Keflavik – Seattle.
- Due to the 2% SAF mandate the cost of 98% of allowances needed are included in the calculations.
- The cost of Corsia is excluded from the cost in the ETS regime but accounted for in the extra - EES regime.
- The prices of the return tickets, with one checked bag, are very similar for the Berlin – Seattle example, reflecting the high competition. They are 626 Euros via Frankfurt, 650 via New York (EWR) and 620 Euros via Iceland.
- See further preconditions for the examples in Annex I.

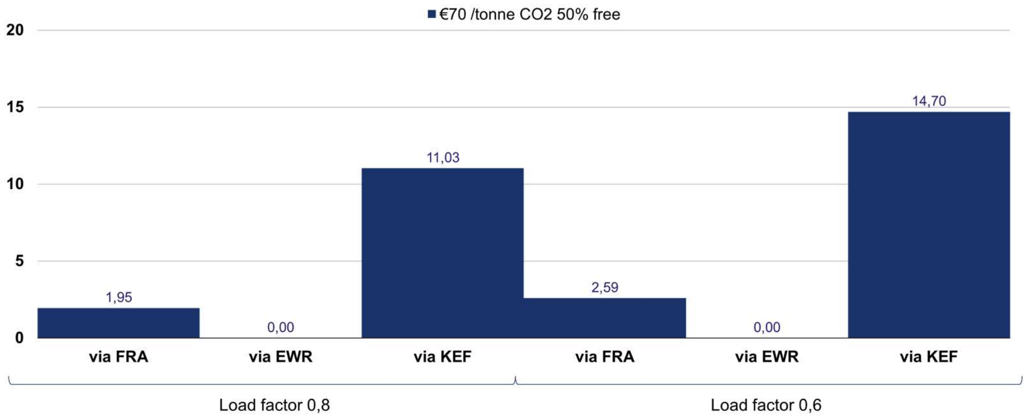
Figure 9 Flight routes that the scenarios are based on.

10.2.1 Scenario 1: Distorted Level Playing Field 2025

The first scenario shows the ETS cost of the ticket in accordance with the “Stop the clock” stipulation which is to expire after 2026. This means that all flights from EEA airports to destinations outside EEA continue to be under the Corsia system as it is today. The cost of ETS allowances is exclusively used to calculate the cost of the ETS regime.

The scenario shows the estimated ETS cost per purchased round trip airfare under the regulatory conditions in 2025. It compares EEA hubs/air carriers vs. third state hubs/air carriers.

2025 – Stop-the clock - ETS cost per passenger for round trip



Example: Berlin to Seattle (via Frankfurt, New York or Iceland)

Route	Hub	Distance (km)	Emissions (t CO2-e.)	ETS Cost (€)
BER-FRA-SEA	Germany	8.655	1,6	1,95 – 2,59
BER-EWR-SEA	New York	10.279	1,7	0
BER-KEF-SEA	Iceland	8.243	1,1	11,03 – 14,70

Assumptions:

- ETS cost of €70/tonne CO2 50% free allowance
- Boeing 737 MAX 8 on flights from/to BER and KEF, Boeing 777 on other flights
- Load factor 80% and 60%
- SAF 2%
- No CORSIA
- No Taxes

Figure 10 Scenario 1: Distorted Level Playing Field. ETS cost per passenger for round trip during "Stop the clock"

Free allocation in 2025 is assumed to be 50% for reference purposes. The actual number varies and is different. Free allocation could be 8-10% higher in the case of flights to Iceland because of adaptations of Iceland to the ETS directive in force until end 2026.

The ETS cost per ticket, 11,03 Euros, is about 5,7 times higher for flights via Keflavik hub compared to 1,95 Euros for flights via Frankfurt hub. The flight via New York (EWR) carries no emissions cost as the Corsia system is in a voluntary phase until 2027 and so is the carbon credit market. Still, the emissions per passenger on the route via Frankfurt and via New York is about and over 50% higher than Keflavik hub.

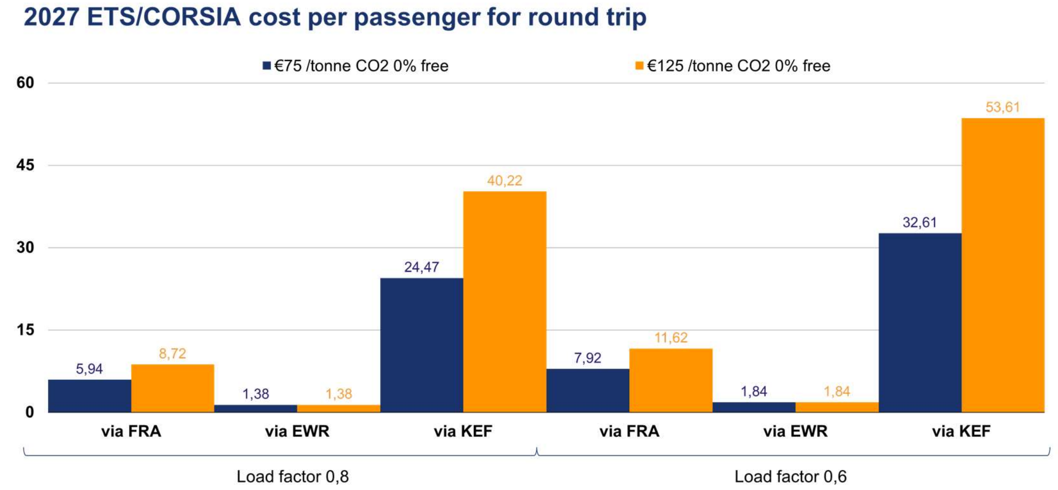
The cost difference behind each ticket is due to the fact that transfer passengers are flying 2.400 km that falls within the ETS on their way to Keflavik hub and the aircraft used. In contrast the passenger is flying about 450 km in the ETS regime from Berlin to the Frankfurt hub and the passenger flying to the New York (EWR) hub is flying in the Corsia regime all the way.

The competitive distortion, represented by the cost difference between passengers according to which hub the transfer takes place, is obviously the highest in Iceland, compared with Frankfurt and New York hubs.

10.2.2 Scenario 2: Distorted Level Playing Field - 2027 ETS and CORSIA

The second scenario shows the ETS cost of the ticket if the “Stop the clock” stipulation of the directive continues after 1. January 2027. This again means that all flights from EEA airports to destinations outside the EEA continue to be under the CORSIA system as it is today.

The adaptation of Iceland for the ETS directive extends until 1. January 2027 and the calculation of the cost does not include any modifications for Iceland as regards the ETS for aviation.



Example: Berlin to Seattle (via Frankfurt, New York or Iceland)

Route	Hub	Distance (km)	Emissions (t CO2-e.)	ETS Cost (€75)	ETS Cost (€125)
BER-FRA-SEA	Germany	8.655	1,6	5,94 – 7,92	8,72 – 11,62
BER-EWR-SEA	New York	10.279	1,7	1,38-7,92	1,38 - 11,62
BER-KEF-SEA	Iceland	8.243	1,1	24,47- 32,61	40,22 - 53,61

Assumptions:

- ETS cost of €75/tonne CO2 or €125/tonne CO2, 0% free allowance
- Boeing 737 MAX 8 on flights from/to BER and KEF, Boeing 777 on other flights
- Load factor 80% and 60%
- SAF 2%
- CORSIA €15/tonne CO2 at 85% baseline
- No Taxes

Figure 11 Scenario 2: 2027 – ETS and CORSIA cost per passenger for round trip - Distorted Level Playing Field.

In scenario 2, no free allowances are provided.

As expected, the distortion of level playing field is high and much greater than in Scenario 1: 2025.

The ETS cost at current ETS prices of 75 Euros for journeys via the Iceland hub is 24,47 Euros. It represents 4% of the ticket prices and increases to 40,22 Euros or 6,5% at ETS prices of 125 Euros.

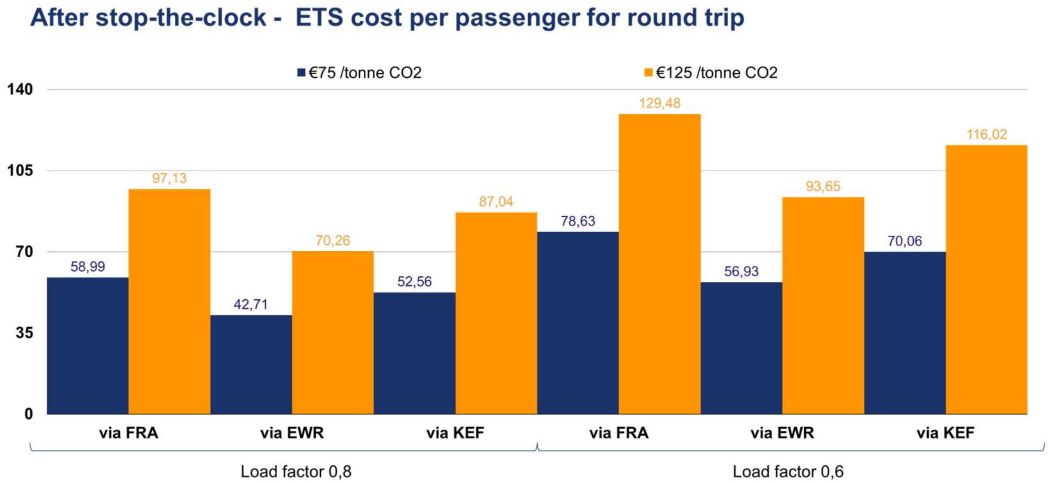
The ETS cost of 5,94 Euros is less than 1% of the ticket prices for journeys via Frankfurt hub and goes up to 8,72 Euros or to 1,5% at ETS prices at 125 Euros.

The emissions cost is negligible for the New York (EWR) hub which is the cost of CORSIA carbon credits only.

As before, the emissions per passenger are 50% higher for journeys via Frankfurt and New York (EWR) than for journeys via Keflavik Airport. On the other hand, the emissions cost of journeys via Keflavik Airport is 4.1 times the cost for passenger going via Frankfurt and 17,7 times the cost of journeys via New York (EWR).

10.2.3 Scenario 3: Distorted Level Playing Field – After “stop-the-clock”

The third scenario shows the cost of the airfare if the ETS system is extended to all outgoing flights from EEA to third states.



Example: Berlin to Seattle (via Frankfurt, New York or Iceland)

Route	Hub	Distance (km)	Emissions (t CO2-e.)	ETS Cost (€75)	ETS Cost (€125)
BER-FRA-SEA	Germany	8.655	1,6	58,99 – 78,63	97,13 -129,48
BER-EWR-SEA	New York	10.279	1,7	42,71 – 56,93	70,26 – 93,65
BER-KEF-SEA	Iceland	8.243	1,1	52,56 – 70,06	87,04 – 116,02

Assumptions:

- ETS cost of €75/tonneCO2 or $125/tonne CO2, also applied on departing EU flights
- Boeing 737 MAX 8 on flights from/to BER and KEF, Boeing 777 on other flights
- Load factor 80% and 60%
- SAF 2%
- Corsia €15/tonne CO2 at 85% baseline
- No Taxes

Figure 12 Scenario 3: After stop the clock: Distorted Level Playing Field.

In scenario 3, the level playing field is less distorted. Still, the airline using the N-America hub enjoys some competitive advantages. On the other hand, the cost per ticket goes up by multiple and is certain to raise prices.

The cost of ETS is calculated to be 52,56 Euros or 8,5% of the airfare (620 Euros) at current ETS allowance prices via Keflavik, and 87,04 Euros or 14% of the airfare at ETS allowance prices of 125 Euros.

The cost of ETS is 58,99 Euros or 9,4% of air fare (626 Euros) via Frankfurt and 97,13 Euros or 15,5% of the airfare at ETS allowance prices of 125 Euros.

The cost of ETS is 42,71 Euros or 6,6% of ticket prices (650 Euros) via New York (EWR) and about 70,26 Euros or 10,8% at ETS allowance prices of 125 Euros.

The ETS cost per ticket is not relative to emissions in this case either taking into account that the emissions are 1,6 and 1,7 tonne per passenger when flying via Frankfurt and New York (EWR) compared to 1,1 tonne when flying via Iceland. This is about 50% difference in emissions per passenger.

The emissions cost per passenger flying via New York (EWR) hub is 23% lower than for the passenger flying via Iceland hub but the emissions are 50% higher. To send out right signals to the consumer in accordance with the polluter pays principle, the cost per passenger should be relative to the emissions per passenger.

The high ETS cost is certain to reduce the demand for air travel on this route, which will lead to lower emissions. On the other hand, the lower demand due to higher prices is likely to primarily affect connectivity and low-income passenger groups.

10.2.4 Distortions of level of playing field - Comparison of scenarios

Our calculations show that, notwithstanding the preceding arguments, Iceland would be disproportionately affected solely on the basis of having much longer average flight routes with in the ETS regime than other countries affected by the scheme.

The summary graph shows the steep increase in ETS cost per passenger since the inclusion of aviation into the ETS system in 2012.

This summary graph also shows the cost difference of scenarios 1 and 2 between the choice of the passenger transferring in Iceland, Frankfurt and New York (EWR) on his journey. This graph assumes that the stipulation in the directive of “Stop the Clock” continues into 2027.

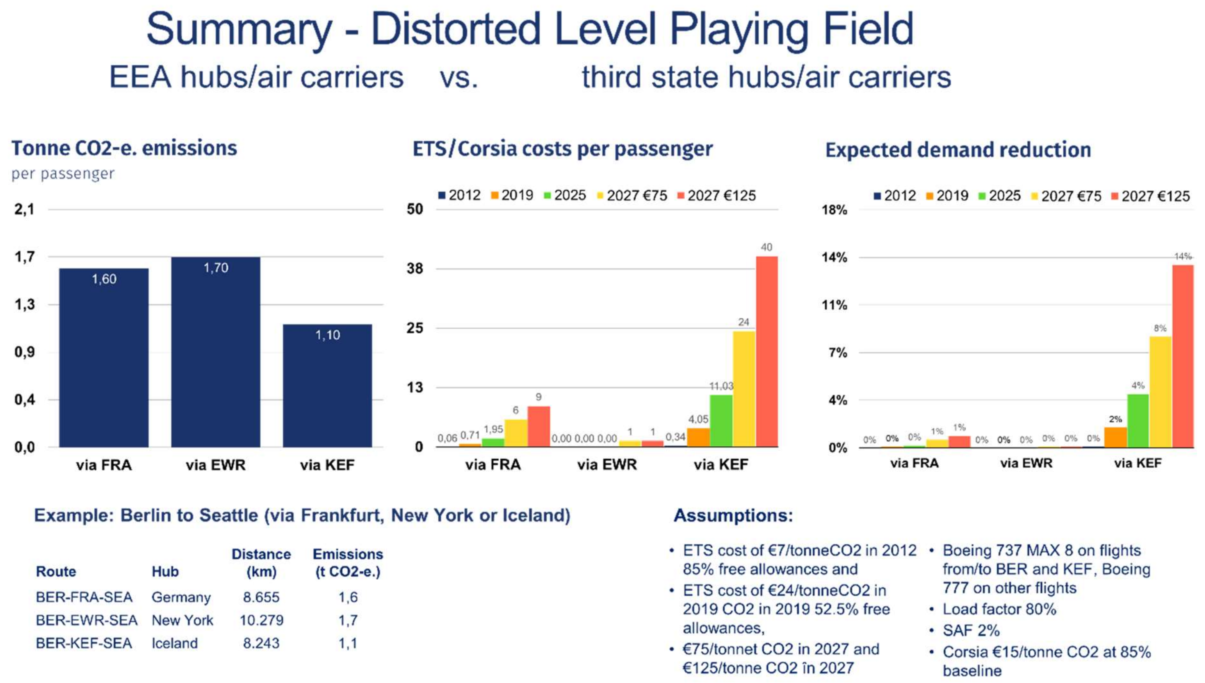


Figure 13 Comparison of cost for each flight ticket in each scenario.

As demonstrated in the graph he initial ETS cost in 2012 pr ticket for the Berlin-Seattle air ticket ranges from 0 Euro (New York (EWR), 0.06 Euros (Frankfurt) to 0.34 Euros (Keflavik). The cost per passenger was insignificant in the year 2012 due to low prices of allowances and a high percentage of free allowances.

The ETS allowance price is 24 Euros in 2019 and cost per passenger is still low for journeys via the Frankfurt and New York (EWR) hubs or 0,71 Euros and 0 Euros respectively. But the cost per passenger travelling via the Keflavik hub is 4,05 Euros and is starting to be significant.

The allowance cost in 2025 ranges from 70-75 Euros and cost per passenger is 1,95 Euros travelling via Frankfurt but none for passenger via New York (EWR). The cost this year for passenger travelling via Iceland is increasing, 11,03 Euros which leads to 4% reduction in demand compared to 1% reduction for Frankfurt hub and no effect for the flight via the New York (EWR) hub.

In 2027 the cost per passenger is projected to be 24,47 Euros, for flights via Keflavik at current ETS allowance prices or 75 Euros, compared to a cost pr passenger of 5,94 Euros and 1,38 Euros for passenger travelling via Frankfurt hub and New York (EWR) hub respectively. This puts the Keflavik hub at a clear competitive disadvantage compared to the other two hubs. At current ETS allowances price, the model predicts an 8% decline in demand for journeys via Keflavik hub compared with 1% reduction in demand for Frankfurt and no reduction for New York (EWR) hub.

In the future, ETS prices are predicted to rise significantly. At the high ETS allowance price of 125 Euros the cost per passenger rises to 40 Euros, 9 Euros and 1 Euro via Keflavik, Frankfurt and New York (EWR) respectively. The disadvantage of the Keflavik hub is therefore much higher as the model predicts a 14% decline in demand for the Keflavik hub.

Scenario 3 assumes that “Stop the Clock” stipulation will expire and that there will be an obligation in place for all outgoing flights to have ETS allowances for emissions. The reduced demand for air travel and hub services in this case seriously risks that air connectivity of Iceland will suffer and result in loss of the weakest destinations from Keflavík Airport. This would lead to passengers mostly or only having more emitting options for trans-Atlantic journeys leading to carbon leakage.

In our Berlin – Seattle example the cost difference due to ETS allowances pr air ticket strongly favour the transfer hubs in Frankfurt and New York (EWR). The emissions per air tickets are 1,6 and 1,7 tonnes for those choosing those routes, comparing to 1.1 tonne when choosing journeys via Iceland. The allowance cost per passenger favours the high emitters compared to the low emitter constituting an obvious risk of carbon leakage.

When the ration of the cost to ticket prices is put in context to 3-5% net profit margin of airlines it conveys serious distortion of the level playing field.

There were also deliberations on extending the obligation to all outgoing and incoming flights. This would of course add increased cost to the price of the air tickets and have further implications for air service in terms of demand reduction. This is an unlikely scenario and is omitted from analysis of this document.

10.3 Hub Carbon Leakage

Keflavík Airport is at significant risk of hub carbon leakage. It functions as Iceland’s main international hub, connecting Europe and North America in a single stop. In 2023, approximately 31% of passengers (2.58 million) used Keflavík as a transfer point, and the airport handles 98% of Iceland’s international traffic.

Under the current EU ETS structure, flights connecting via Keflavík incur full ETS obligations on the European leg of the journey (on average 2,200 km). By contrast, flights through non-EEA hubs such as New York, Toronto or Boston avoid these costs entirely, even with higher total emissions. This creates a competitive distortion, incentivizing airlines and passengers to shift traffic to non-EEA hubs. As a result, Iceland risks losing its strategic role as a transatlantic hub. Less connectivity via Iceland hub would leave passengers with mostly or sole options of journeys with more emitting carriers and the ETS’s environmental efficacy is undermined.

The recent decision of Play Air to abandon its hub-and-spoke system as of October 2025 provides an example of possible carbon leakage, as the increased ETS costs contributed to the decision of the operator. As of today, the airline operates efficient narrow body A320/A321 aircrafts for trans-Atlantic service with a stopover in Iceland. This recent development is likely to result in fewer options for passengers traveling across the Atlantic, and potentially increasing reliance on alternative direct routes that are less climate friendly, as illustrated by the Berlin-Seattle example above.

10.3.1 Carbon Leakage Risk for Point-to-Point Services

It is unlikely that the cost of ETS allowances would distort the level playing field in relation to point-to-point services within EEA. The emissions generated from such operations, and the corresponding requirement to surrender ETS allowances, are inherent to the business decisions made by airlines.

Where ETS costs for flying to destinations within the EEA are significantly higher than for flights to destinations outside the EEA, there exists a risk of carbon leakage or at least a risk of a shift in travel choices.

For example, a low-income family is likely to consider a holiday in N-Africa instead of S-Spain, due to lower air ticket prices. This could lead to reduced economic activity within the EEA. Furthermore, it could incentivise airlines to use their less efficient, and potentially older, aircraft on such routes and thereby increasing the risk of carbon leakage.

10.3.2 Options to Minimise the Risk of Hub Carbon Leakage

The principal problem of hub carbon leakage is that the relationship between the price of air tickets and the carbon emitted is not relative to one another. This is visibly demonstrated in the Berlin-Seattle example above, where the ETS cost of the highest emitter pr seat is the lowest. It is Iceland's belief that the apparent way to establish the link between cost and the volume of carbon emissions is to adopt a global ETS system.

There are no sensible solutions that can address the problem of carbon leakage flawlessly within the ETS system. However, there are solutions that can reduce the impact of the problem. Iceland informally introduced possible solutions in 2023, and they were the following:

- The ETS system would only apply to the first 800 -1000 km of flight or the average distance of EU flight legs and consequently apply CORSIA for the remainder of flights. This would result in limiting the risk of carbon leakage but not eliminating it. Moreover, this would reduce the competitive advantage of airports close to the

EEA in the regime of ETS for all outgoing flights and also if it were applied to all incoming flights.

- The 800 km exemption may be further designed to exempt communities that only have one or two transport modes for travel over 800 km, which is near the cut-off point for train services. This solution would benefit more distant communities.
- By comparison, under an alternative model, aircraft operators would be required to surrender allowances for 50% of emissions from departing and arriving flights. This would also limit the risk of carbon leakage but not eliminate it. Compared to the 1000 km solution, this measure may disproportionately affect travellers and air services to more distant destinations.

11 Additional aspects for revision of ETS Aviation

According to the revised EU ETS Directive, the European Commission is required to evaluate several additional aspects in preparation for the upcoming revision of the Directive by July 2026. These evaluations are part of the review obligations introduced under the Fit for 55 package. Among the areas to be assessed are the environmental and climate impacts of short-haul flights under 1,000 km, as well as the implications of current exemptions granted to certain flights based on aircraft weight or total annual emissions. The purpose of these reviews is to determine whether these exemptions remain justified in light of climate objectives, and to ensure that the overall functioning of the EU ETS remains effective, fair, and environmentally robust.

This section looks at additional aspects that are important for the upcoming revision of the ETS Directive in relation to aviation.

11.1 Environmental and Climate Impacts of Flights Under 1,000 km

There are no international flights to or from Iceland under 1,000 km that fall within the scope of the ETS. In fact, is the shortest international flight distance under the ETS to or from Iceland is near 1500 km.

However, domestic flights within Iceland—such as those between Reykjavík and Akureyri, Egilsstaðir, Ísafjörður, and other regional airports—are under the scope of the EU ETS, following the incorporation of relevant provisions through the EEA Agreement.

Emissions from Iceland’s domestic flights have declined significantly, from 33.6 kilotonnes CO_2-equivalent in 1990 to 22.5 kt in 2023, a 33% reduction. These flights represent a very small share of Iceland's total national emissions, and this downward trend reflects increased fuel efficiency and operational optimisation.

While short-haul flights generally have higher per passenger-kilometre emissions, their overall contribution to emissions is modest in Iceland's case. Moreover, due to the country's geography and lack of alternative transport infrastructure, aviation is an important means of domestic connectivity, especially to remote and rural communities.

As the Commission prepares to evaluate the environmental and climate impacts of flights under 1,000 km for the 2026 Carbon Market Report, Iceland emphasises that including such flights more stringently in the ETS—beyond current obligations—would offer limited additional climate benefit. At the same time, it could introduce a disproportionate burden on essential regional air services, which are already operating with narrow margins and serve communities without viable surface alternatives.

11.2 Environmental and climate impacts of exempted flights

Pursuant to the EU ETS Directive, certain flights are exempt from emissions trading obligations to ensure proportionality and administrative efficiency. In particular, the Directive provides exemptions for:

- (h) flights performed by aircraft with a certified maximum take-off mass of less than 5,700 kg, and
- (k) flights performed by non-commercial aircraft operators with total annual emissions lower than 1,000 tonnes of CO_2

These exemptions are intended to avoid imposing a disproportionate administrative burden on small aircraft operators and low-emitting activities, where the cost of compliance could outweigh the environmental benefit.

Iceland emphasises the importance of carefully evaluating the environmental and climate impact of these exempted flights before considering any expansion of the ETS scope or revisions to the exemption thresholds. Any such changes must be supported by robust evidence and consider the practical implications for operators and competent authorities.

A change in scope could result in a substantial increase in the number of operators subject to compliance, while producing only marginal gains in emissions reduction. This would risk increasing complexity and costs for both operators and administrators, particularly in smaller EEA states with limited resources.

Therefore, Iceland recommends that any review or revision of these exemptions be aligned with the broader post-2026 ETS Directive revision and be guided by principles of environmental effectiveness, proportionality, and administrative feasibility.

11.3 Non-CO_2 Emissions and Impacts in Arctic and Northern Regions

While scientific understanding of non-CO_2 effects from aviation continues to evolve, there is broad consensus that these emissions contribute significantly to global warming. Despite remaining uncertainties, it is essential to identify and implement cost-effective and technologically feasible mitigation measures that address the full climate impact of aviation, including both CO_2 and non-CO_2 emissions.

When developing such measures, it is critical to account for the complex interactions between various non-CO_2 climate forcers—such as nitrogen oxides (NO_x), water vapor, and soot - as well as the specific atmospheric conditions in which they are emitted. The climate impact of non-CO_2 emissions depends strongly on both emission altitude and geographic location. Emissions at cruise altitude in colder regions, such as the upper troposphere over polar and subpolar areas, are associated with heightened warming effects, particularly through contrail formation and persistent cirrus clouds.

Iceland wishes to underline the importance of ensuring that these factors are fully recognised in the development of future aviation climate policies. Due to its northern geographic location and reliance on long-haul, high-altitude routes, Iceland is especially exposed to the amplified impacts of non-CO_2 emissions.

Effective policy responses must be grounded in robust, location-sensitive scientific evidence and must ensure that any proposed measures are technologically and operationally feasible. Without this balance, there is a real risk that regulatory actions could undermine the competitiveness of EEA-based aviation operators without delivering meaningful climate benefits -particularly if emissions are simply shifted to jurisdictions outside the EU ETS.

12Conclusion and Key Message

This document is an annex presents Iceland's analysis of the effects of the EU Emissions Trading System (EU ETS) on the aviation sector in the context of the 2026 Carbon Market Report and upcoming revisions of the ETS Directive. The findings and recommendations provided here are specific to aviation, as this is the current focus of the consultation and Iceland's submission. However, many of the structural challenges and arguments identified - particularly those relating to geographic isolation, connectivity, and proportionality - are also relevant to the maritime sector and should be considered in parallel assessments.

The ETS plays an important role in supporting the EU's climate objectives, and Iceland is committed to participating constructively in its implementation. Nonetheless, the analysis shows that without tailored policy solutions, the current structure of the ETS results in disproportionate burdens for island states like Iceland, while at the same time failing to reflect the true climate impact of different types of air travel. As the ETS evolves, it is essential that equity, environmental effectiveness, and economic viability are all taken into account.

12.1 Key message

- Iceland's aviation sector faces elevated ETS costs due to its geographic location, with longer-than-average flight distances and full inclusion under intra-EEA ETS obligations.
- The phase-out of free allowances by 2026, combined with high carbon prices and emerging SAF mandates, will further increase compliance costs.
- Iceland's transatlantic hub at Keflavík Airport is at risk of hub carbon leakage, as connecting traffic shifts to non-EEA hubs where ETS costs do not apply.
- Although Iceland is eligible for 100% SAF price bridging support under Article 3c(6), SAF is not available in the country, rendering the support mechanism ineffective in practice.
- SAF price bridging support must be extended to include all flights under the SAF mandate.
- The ETS does not account for non-CO_2 effects or the actual environmental differences between flight routes and altitudes.
- The current structure creates pricing inconsistencies, where ticket prices may not reflect environmental impact, but rather regulatory coverage.
- The socio-economic impact of increased costs and reduced connectivity would be substantial in Iceland, where aviation supports up to 25% of GDP and has no viable alternative.

12.2 Recommendations

- Adapt ETS design to geographic realities. Recognise that island states like Iceland cannot reduce exposure to ETS costs through modal shifts or shorter routes.
- Ensure SAF availability for remote regions. Support mechanisms must be backed by infrastructure and supply-side measures to enable actual access to SAF.

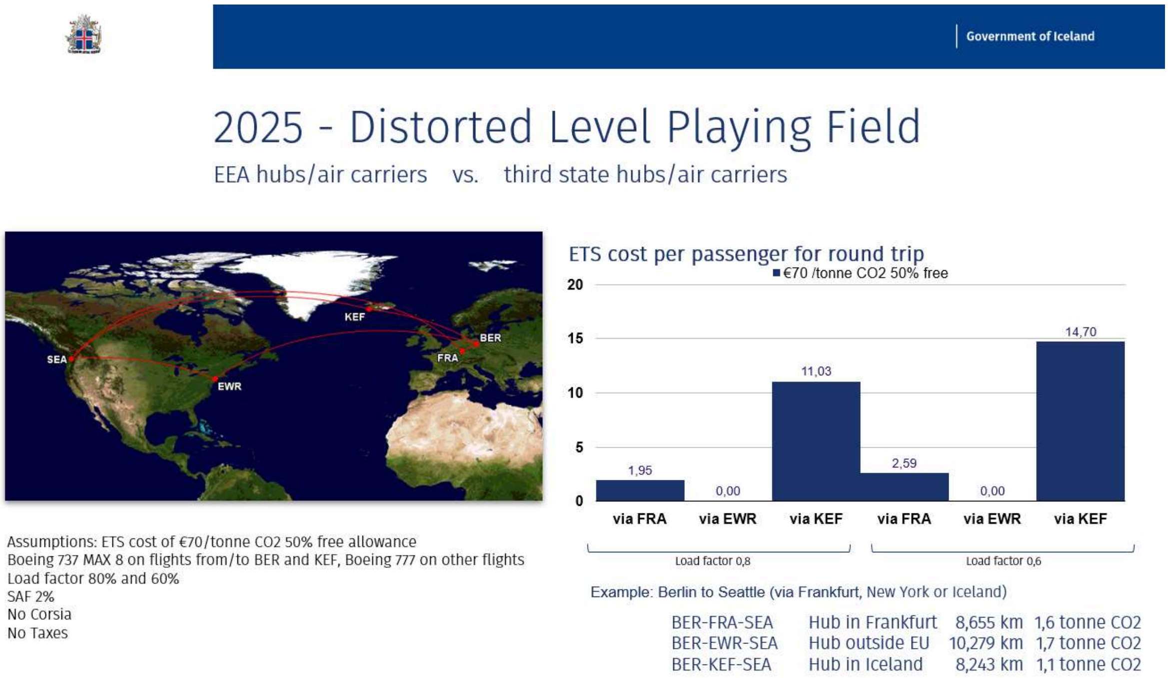
- Preserve hub competitiveness. Consider adjustments such as distance weighting, partial exemptions, or alternative compliance pathways to avoid hub carbon leakage.
- Protect operational viability and equity. Regulation must reflect the limited flexibility of small aviation markets and ensure fair treatment across regions.
- Review scope exemptions carefully. Changes to exemptions for low-emission or small aircraft operators should be based on detailed analysis of administrative burden and climate benefit.
- Account for non-CO_2 emissions and emission location. Future reforms should reflect scientific findings on altitude and regional climate impact.
- Ensure predictability and proportionality. Provide adequate lead time for compliance, especially for infrastructure-limited regions.
- Include Iceland-specific analysis in the 2026 Carbon Market Report. Assessments should capture national circumstances to inform fair and effective policy design.

Annex I Preconditions for analysis of scenarios

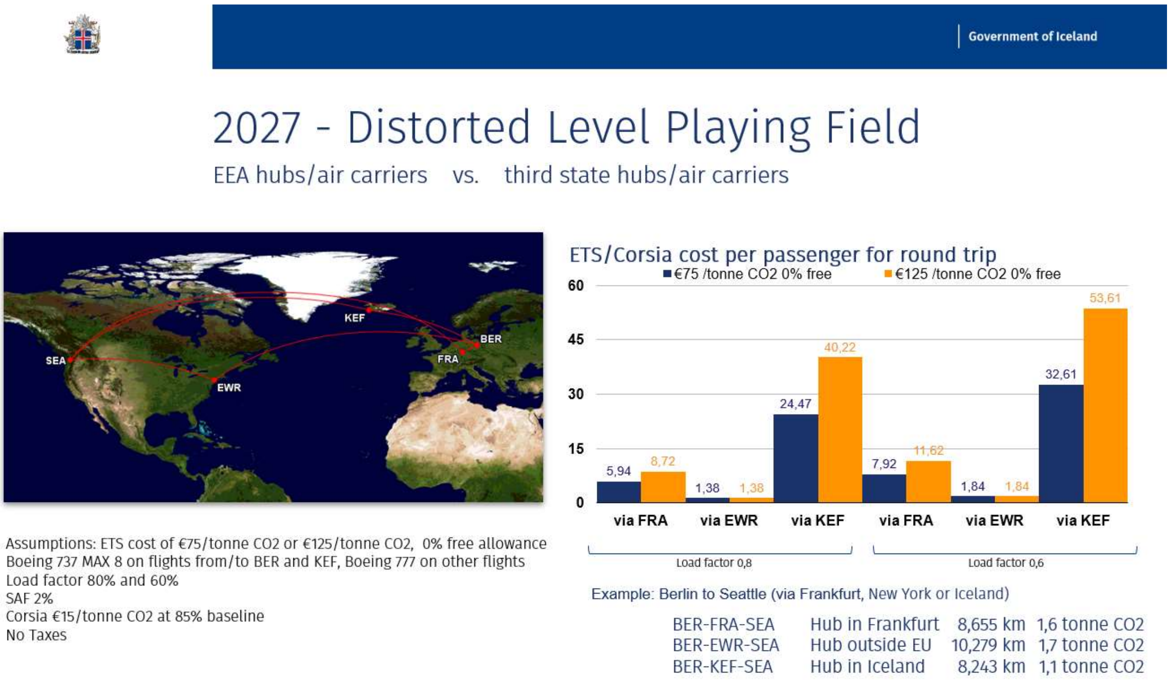
- The example is chosen to demonstrate the distortion caused by the ETS system in face of carrying a passenger via Iceland compared to other transfer hubs within EEA and outside EEA.
- The example Berlin-Seattle is chosen due of frequent service of the airlines concerned. The flight distance from Berlin is about 2.400 km compared to the 2.200 average distance from EEA airports to Iceland.
- ETS cost pr. sold ticket of carrying a passenger from Berlin-Seattle and back via three different hubs, that is Frankfurt, New York (EWR) and Keflavik. At the time of calculations there were no direct flights between those destinations.
- Aircraft used in this example were the actual aircraft servicing the route at the time of calculations.
- The ETS cost is linked to the price of a ticket by dividing the total ETS cost of the flight between tickets sold by carrying the passenger from his point of departure to destination and back.
- The analysis includes examples of cost pr ticket calculated for two different load factors, 0,8 and 0,6. This means that on average 80% of seats available in an aircraft are sold. The annual report of Icelandair 2024 shows an average yearly load factor of 82.6 across all of its destinations, up from 81,5.
- The load factor of 0,6 is also shown as an assumption for the minimum load factor for a scheduled service to be sustainable. In normal circumstances airlines would not service a route via transfer hub if the load factor would be near 0.6 given all other factors equal within the airline company. The ETS cost pr ticket goes substantially up with lower load factor. It will lead to abandonment of scheduled service earlier than without the ETS cost. This can lead to reduced connectivity to distant communities served by small regional airport and a fragile air service. The rationale for linking the ETS cost to the price of airfare is to link the purchasing decisions of the passenger directly to the cost of emissions. The problem is that the emission cost pr ticket is very much unrelated to the actual emissions pr ticket.
- Regulatory costs of managing the ETS system is not counted for in the example neither for the regulatory bodies nor the airlines.
- Price elasticity of airfare. (Description on the price elasticity for different travellers. Effect on purchase decisions of airfare). In a report from IATA, price elasticity is estimated for different scenarios. In our scenarios the elasticity factor estimated to be 2.
- The market forces will dictate the possible price hike of airfares.

Annex II- Scenarios – based on Berlin – Seatle

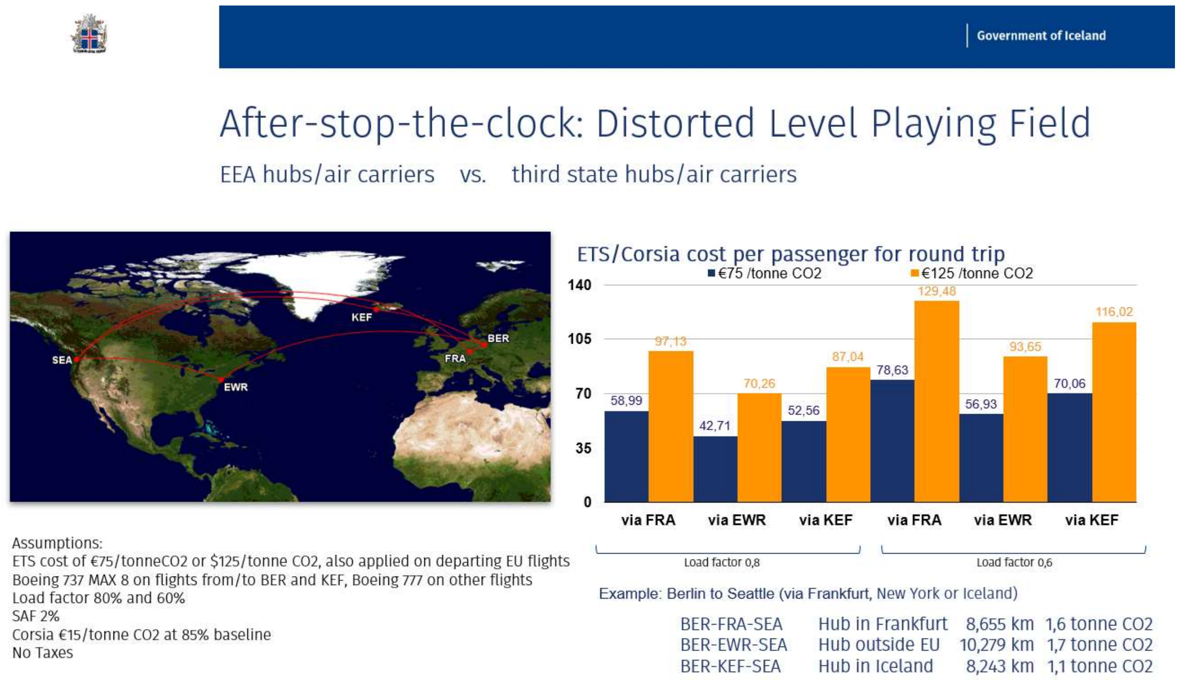
Scenario I - Distorted Level Playing Field 2025



Scenario II - Distorted Level Playing Field 2027



Scenario III - Distorted Level Playing After stop the clock



Scenario IV – Summary - Distorted Level Playing Field 2027