

SUSTAINABILITY INITIATIVES IN THE AVIATION SECTOR

As the green economy develops, it is inevitable that the spotlight will be directed onto the aviation sector, long held up as a major contributor to global carbon emissions. While the industry is already focused on technological improvements to aviation engines and other operational measures to reduce aircraft emissions, this briefing considers the challenges and opportunities arising out of two significant sustainability-linked initiatives for the sector: the potential application of green or sustainability-linked loans and the impact of the emissions regulatory framework for airlines and other operators which CORSIA has introduced.

GREEN LOANS VS. SUSTAINABILITY-LINKED LOANS WITHIN AVIATION

Loans aiming at sustainable objectives generally include one of two mechanisms. The more traditional approach focusses on "use of proceeds" financings whose sustainable credentials are derived from the application of loan proceeds towards a purpose that is itself beneficial from an environmental sustainability perspective. The Green Loan Principles published by the Loan Market Association (LMA) provide guidance on the use of such "use of proceeds" loans. Under this guidance, lenders looking to put these loans in place must establish (i) requirements as to how the proceeds of such a financing can be used, (ii) criteria for evaluating whether any proposed usage meets such requirements (including, if deemed necessary, external review by an ESG rating agency), (iii) governance mechanics to allow the use of loan proceeds to be tracked so that it can be confirmed how they were allocated, and (iv) reporting procedures for the borrower on how any proceeds have been used.¹

By contrast, sustainability-linked financings typically allow the borrower much greater flexibility as to how it uses the loan proceeds, with limited or no control over how they are applied.² Instead, the credentials of a sustainability-linked loan derive from the inclusion of ESG targets that the borrower is required to

Key issues

Sustainable aircraft financings

- Green (purpose or "use of proceeds") loans vs. sustainability linked loans
- No universally accepted criteria for "green loans" or for "sustainability" of transactions and sector specific challenges

CORSIA

- ICAO decision on eligible emissions units still pending
- National implementation of CORSIA rules may take some time
- Compliance considerations for aircraft lessors and lenders

¹ Green Loan Principles published by the LMA in December 2018.

² See CC publication "[Sustainability Linked Loans – the Star Performer of the Loan Markets?](#)"

comply with in respect of its wider business – the extent to which the borrower does so then determines the loan's pricing³. The nature and content of these ESG targets will vary from borrower to borrower and could be set by reference to a general ESG compliance score issued periodically by an independent third party or could be bespoke to the borrower's business and KPIs, for example the level of carbon dioxide emissions per passenger km. Irrespective of the approach adopted, the underlying expectation is that the targets set under a sustainability-linked loan should encourage above-average improvement by the borrower compared to its peers, not simply maintenance of the status quo.⁴

How are sustainability credentials tested

Currently no universally accepted criteria exist to determine the sustainability credentials of a particular transaction, though there are numerous ongoing efforts to develop more detailed standards to be used for different green financing products.

The European Union has taken steps to develop a uniform taxonomy to describe when an activity that a loan is intended to finance can be classified as *environmentally* sustainable⁵ and various attempts have been made to develop a harmonised green bond standard to allow consistency in the labelling and evaluation of different products.⁶ However, the proposed taxonomy does not yet include any objectives relating to social sustainability.

In any event, until a clear set of criteria has gained market acceptance, there will inevitably be disagreement as to whether many transactions can validly be labelled as "sustainable" and therefore marketed as such. This is particularly relevant for aviation where, in the absence of clear testing criteria, its reputation as a polluting industry will at least create uncertainty over the broader sustainability benefits of many potential transactions.

Green (use of proceeds) loans in the aviation context

We are not aware of any examples of "use of proceeds" loans being used for the financing of aviation assets (i.e. airframes or engines). Indeed, whilst the EU taxonomy report does not address aviation at this stage (though it notes it should be addressed in the future), it does flag the desire for a modal shift from aviation transport to rail and other non-motorised passenger transport. Given this indication, we would expect the criteria that are ultimately produced for "use of proceeds" loans in an aviation context to be set restrictively, requiring a degree of sustainability benefits that goes beyond, for example, simply purchasing new generation aircraft assets that are common within the industry. This would also be consistent with the small number of "use of

³ In theory a failure to meet such targets could instead trigger a default under the loan, though that has not generally been the case. "ESG targets" will usually go beyond simply environmental and climate objectives and also encompass various metrics from social issues to corporate governance and business ethics.

⁴ The LMA has also published the Sustainability Linked Loan Principles in March 2019 to provide guidance on this form of loan.

⁵ Taxonomy Technical Report published by the EU Technical Expert Group on Sustainable Finance in June 2019.

⁶ See, for example, the "Proposal for an EU Green Bond Standard" published by the EU Technical Expert Group on Sustainable Finance in June 2019 and the ASEAN Green Bond Standards published by the ASEAN Capital Markets Forum in 2018.

proceeds" transactions that have been seen within the shipping industry or within the wider aviation industry for airport assets.

In such transactions the financed assets had specific and unusual design features to reduce pollution, but even there the categorisation of such transaction as "green" given their link to a polluting industry such as shipping (and, in certain cases, the oil and gas sector) or aviation has often been controversial.

Given this context and until clearer criteria have been developed to allow parties to determine the credentials of "use of proceeds" loans in an aviation context, the case for using sustainability-linked loans appears much clearer. The inherent requirement under those financings for the borrower to improve its ESG compliance creates a much clearer set of ESG benefits for market participants to evaluate. Sustainability-linked financings may still be subject to accusations of "greenwashing" if market participants feel the ESG targets for the loan are insufficiently stringent or not all-encompassing and it is not unreasonable to assume that such targets will be subject to far greater scrutiny within an industry such as aviation. However, the sharpened focus within the industry on improving environmental performance, together with the increasing regulation of such matters (e.g. pursuant to the CORSIA regime), means that there are likely to be many participants whose business plans and legal obligations already require them to achieve the type of ESG improvements that sustainability loans seek to encourage.

CORSIA: an overview

Aviation is likely to be the largest emitting sector in the UK by 2050, even with strong progress on technology and limiting demand. So says the Committee on Climate Change ("**Committee**") in its letter to the Government advising on how to formally include international aviation and shipping in the Government's legally binding target of net zero emissions by 2050. It is clear from the Committee's letter that achieving net-zero emissions in the aviation sector by 2050 will be challenging and will require a combination of measures, ranging from improved fuel efficiency and sustainable fuels to reducing demand and offsetting any remaining emissions. While the Committee supports the inclusion of emissions from international aviation in the UK's net zero target, it recognised that the primary policy approach for reducing these emissions should be at the international level.

Framework

The primary international mechanism for achieving reductions is the Carbon Offsetting and Reduction Scheme for International Aviation or "CORSIA", developed by the International Civil Aviation Organisation ("**ICAO**").

- Under this "market-based measure", aeroplane operators are required to offset CO₂ emissions on their international flights above 2020 levels (using the average annual emissions between 2019 and 2020 as a baseline) by purchasing eligible units. Domestic flights (between aerodromes in the same state) are not included in CORSIA.
- The scheme is open to voluntary participation by countries from 2021 and is mandatory from 2027 to 2035. Certain developing countries, including landlocked and small island states, will be exempt; and emissions from emergency, police, military, customs and State aircraft and aircraft with a MTOW of or under 5,700 kg or by low-emissions operators will be exempt.

Considerations for Aircraft Owners, Lessors and Lenders

EU ETS provisions

Since the EU ETS was extended to aviation emissions and despite the suspension of certain requirements for "third country emissions" pending adoption of CORSIA (the so-called "Stop the Clock" derogations passed by the EU), it is common for aircraft leases to include provisions addressing EU ETS compliance by the relevant operator (lessee or any sub-lessee), including monitoring, reporting and surrender of allowances, as applicable. Aircraft owners and their financiers also typically require that the airline undertakes to pay any penalties for non-compliance and to notify its regulator that it is the "aircraft operator" for the purposes of the legislation and that the owner and any financiers have an interest in the aircraft, to mitigate against the regulator seeking to enforce against the aircraft or any other party for the airline's non-compliance. For example, under the UK specific legislation, the regulator may detain the aircraft for unpaid charges, where such "aircraft operator" is not identified, and may impose an operational ban for continued breaches.

Parties should continue to document EU ETS specific provisions, particularly in leases and loans to EU airlines or in respect of EU registered aircraft.

Additionally, CORSIA does not apply to helicopters (ICAO uses the distinction between "aeroplane" operator and "aircraft" operator, with only the latter term including helicopters).

- Over 80 countries, representing more than three quarters of international aviation activity, have committed to participating voluntarily in CORSIA. During the voluntary phase, only operators flying between countries that have volunteered to participate will be subject to the regime's offsetting obligation but from 1 January 2019, all operators have been required to monitor, verify and report their international flight emissions.

Compliance cycles will be three years long, starting with a Pilot Phase in 2021-2023. The deadline for surrendering emissions units to meet offset requirements in this phase is 31 January 2025 (or 60 days after the relevant administering authority informs operators of their total final offsetting requirements). The next deadline will be 31 January 2028 and then every three years after that until 2035. The offsetting obligation will initially take a "sectoral approach" (based on total emissions growth in the sector) moving to an individual approach (based on the increase in emissions of each operator), with the weighting between each component changing over time.

In order to offset their emissions, operators will need to purchase and surrender the number of eligible emissions units corresponding to their CO₂ offsetting obligation (calculated based on fuel use). The offsetting obligation can be reduced if an operator has used fuels meeting specified sustainability criteria and certified by an approved sustainability certification scheme. The current criteria require fuel to achieve net greenhouse gas reductions of at least 10% compared to conventional jet fuel on a life-cycle basis, and not to be made from biomass obtained from land with high carbon stock. Other criteria (relating to a range of topics from water and soil to human rights and security) are being developed.

Eligible offsets

Crucially, ICAO has not yet confirmed which units will be eligible under CORSIA but has published Eligibility Criteria. Earlier this year, ICAO invited carbon offset programmes to apply for assessment against the Eligibility Criteria. It received 14 responses, including from the Clean Development Mechanism ("CDM") and REDD.plus programmes, as well as a number of other voluntary carbon offset schemes. The applications are currently being assessed by a Technical Advisory Body that will recommend to the ICAO Council which emissions units to accept under the scheme. A decision is expected sometime in 2020.

Units under the CDM and Paris Agreement are eligible provided they align with decisions by the ICAO Council, including on avoiding double-counting and on eligible vintages and timeframes. These conditions are targeted at addressing widespread concerns about the quality and value of existing CDM units and the risk that they could undermine the effectiveness of CORSIA at achieving substantive emissions reductions, an issue that has plagued the operation of the EU Emissions Trading Scheme ("ETS").

Looking ahead

Overall, the response to CORSIA by airlines has generally been positive, with many welcoming the introduction of an international mechanism which has scope to replace regional schemes, such as the EU ETS. With the carbon offsetting obligation starting to bite in 2021, operators will be looking closely at

CORSIA provisions

In the short to medium-term, the global application of CORSIA will depend on individual states' adoption, including national implementing laws which in most cases have not yet been adopted. Further, given the above uncertainty relating to eligible emissions units, for new leases and loans, the most efficient approach would be to retain and to extend the scope of any EU ETS provisions to cover CORSIA (and equivalent regimes, if there is any national divergence).

- CORSIA identifies the operator responsible for an eligible flight according to a set hierarchy: firstly, by reference to the ICAO designator (as shown on the flight plan). If the aircraft registration mark is included in the flight plan instead, then the operator in whose AOC that aircraft is listed will be the responsible operator. If this is not available, then the operator in whose emissions monitoring plan that aircraft registration mark is included will be the responsible operator. This may lead to issues where aircraft are traded or sub-leased and CORSIA-related information is not updated accordingly.
- Parties should note that if a flight cannot be attributed to an operator according to the above hierarchy, then CORSIA will treat the owner of the aeroplane as responsible for the flight.

how to reduce their emissions over the next few years both by investing in more efficient aircraft engines and by improving operational efficiencies, such as streamlining routes to cut down on flight time and reducing aircraft weight. CORSIA itself is only one measure which ICAO is promoting to achieve its sector objective of "carbon neutral growth". The drive to develop sustainable aviation fuel will also continue apace.

It is possible that national implementing legislation may include enforcement measures which extend liability for CORSIA non-compliance to the owner and/or against the aircraft; lessors and lenders should follow a similar approach to mitigating against the lessee's non-compliance as with the EU-ETS, including information undertakings and event of default triggers.

Finally, from a credit perspective, lessors and lenders should keep in mind that airlines will need to factor the cost of their offsetting obligations under CORSIA into their operating models. IATA has acknowledged that, "as tradeable commodities, the price of emissions units can vary significantly." This volatility risk is not helped by the uncertainty as to what may qualify as an eligible emissions unit.

For further information on topical issues around growing the Green Economy, see our publication "[Growing the Green Economy: Addressing the Sustainability Challenges and Opportunities](#)".

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