GREEN SHOOTS – SUSTAINABILITY DEVELOPMENTS IN THE AVIATION SECTOR

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As a sector, aviation faces obvious sustainability challenges. The physics of flight, safety testing requirements and current technological limitations mean that all-electric, hybrid-electric and sustainable hydrogen-powered commercial airliners are a long way from production. Sustainable aviation fuels (i.e. 'drop-in' replacement hydrocarbon jet aircraft fuels produced from sustainable sources) will present a significant opportunity to reduce aviation greenhouse gas emissions, but they are currently in limited production at this time and require significant commercial development to reach widespread availability. Conventional fossil-based liquid hydrocarbon fuels will therefore continue to play a fundamental role in the aviation sector in the short to medium term.

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After labour, fuel represents the largest cost component in an airline's operations. As a result, the aviation industry has, for economic reasons, trended towards the production of fuel-efficient aircraft. However, an Intergovernmental Panel on Climate Change in 1999 report concluded that aviation accounted for approximately 2% of global greenhouse gas emissions due to human activity, but additionally noted that climate impacts of aviation emissions are especially problematic due to chemical interactions at high altitudes. This, combined with the continued growth in air travel, has focussed regulator, media, climate change activist and public attention on the aviation industry.

The increased spotlight on aviation has resulted in a variety of targets, regulations, laws and practices applicable to the sector that have been received by the international community and market participants with varying degrees of receptivity. While the global aviation sector has not yet developed a clear methodology and pathway, positive strides have been made in this direction.

In 2009, the International Air Transport Association ("IATA") presented an ambitious carbon emissions strategy, with targets and a four-pillar action plan, to the United Nations Framework Convention on Climate Change. The targets were:

a) an average improvement in fuel efficiency of 1.5% per year from 2009 to 2020;

b) a cap on net aviation CO_2 emissions from 2020 (carbon-neutral growth); and

c) a reduction in net aviation CO_2 emissions of 50% by 2050, relative to 2005 levels.

In March 2021, the European Union ("EU") launched their Destination 2050 initiative, which supplements and builds on the IATA carbon emissions strategy. Destination 2050 targets net zero CO_2 emissions by 2050 for all flights within and departing the EU, United Kingdom ("UK") and the European Free Trade Association. The carbon reductions necessary to meet these targets are projected to be achieved through:

a) improving aircraft and engine technologies;

b) using sustainable aviation fuels;

c) improving air traffic management and aircraft operations; and

d) economic measures (i.e. credits and offsetting).

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Regulators engage various methods to promote change, but initiatives are broadly characterised as either reward (i.e. the 'carrot') or penalty (i.e. the 'stick'). In this article, we briefly consider some of the environmental and sustainability initiatives that exist today or are on the horizon.

SUSTAINABLE 'STICK' INITIATIVES

EU ETS

The European Union's Emissions Trading Scheme ("EU ETS") was introduced in 2008 and extended to include aviation in 2012. As a 'cap and trade' mechanism, the legislation imposes the requirements of monitoring, reporting and verifying emissions on airlines and mandates the surrender of tradeable allowances according to these emissions.

The EU ETS scheme was originally intended to apply to all airlines operating to, from or within the European Economic Area ("EEA") whether they are EEA-based airlines or otherwise, but countries including China, India, Russia and the United States reacted adversely. In 2012, the United States enacted the European Union Emissions Trading Scheme Prohibition Act of 2011 which prohibited United States carriers from participating in the EU ETS. Similarly, China threatened to withhold US$60bn in outstanding orders from Airbus, which in turn led to pressure on the European Union in relation to the application of EU ETS. Following such actions, and further by the International Civil Aviation Organisation's ("ICAO") introduction of the implementation of a global carbon offsetting scheme for aviation emissions ("CORSIA"), the EU agreed to limit the EU ETS's application to intra-EEA flights and defer any further application until 2024 pending a review of the operationalisation of CORSIA.

CORSIA

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CORSIA is a product of the IATA carbon emissions strategy, which seeks to establish a system whereby operators will be required to purchase 'emission units' to offset any growth in CO_2 emissions from benchmark performance in 2019 (N.B. this was changed from an average of 2019 and 2020 levels following the impact of the Covid-19 pandemic to air traffic in 2020). States may volunteer for the pilot (2021 to 2023) and the first phase (2024 to 2026), but the second phase (2027 to 2035) will include all ICAO states, subject to certain exemptions. Once the offsetting requirements are set in a given year, the requirements are distributed among aircraft operators participating in the scheme. The distribution of offsetting requirements is intended to be dynamic, evolving from an entirely sectorial approach initially but moving towards a more individualised approach for operators as the regime becomes more established in the years to come.

By providing a single point of accountability and removing the administrative burden of complying with national and regional emissions controls, taxes or offsetting schemes, it is hoped that compliance will become easier for operators. Indeed, a globally coordinated aviation sector-based approach rather than state-based approach is appropriate considering the highly mobile nature of carbon emissions from the aviation sector and to mitigate the risk that the responsibility for these emissions simply moves to other jurisdictions in response to individual states taking unilateral action.

SUSTAINABLE 'CARROT' INITIATIVES

The availability of 'green' finance is the reward for a lessor or airline selecting sustainable aircraft equipment. Green finance appeals to new investor groups, expanding investor appeal and thus reducing financing costs.

The Loan Market Association, the AsiaPac Loan Market Association and the US Loan Syndications and Trading Association published the Green Bond Principles in 2014, the Green Loan Principles in 2016 and the Sustainability-Linked Loan Principles in 2019. The key difference between Sustainability-Linked Loans and Green Bonds/Green Loans is that Sustainability-Linked Loans can be used for general corporate financing but with the interest tied to sustainability key performance indicators, while those from Green Bonds and Green Loans must be focussed on specific 'green projects' (with the rate of interest not contingent on any sustainability metric).

EU Taxonomy

The Sustainable Finance Taxonomy Regulation (the "Taxonomy Regulation") was published in the Official Journal of the European Union on 22 June 2020 and came into force on 12 July 2020. However, it will not apply until 1 January 2022 (at the earliest).

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Green Bond/Loan Principles

The Green Bond Principles are internationally recognised voluntary issuance guidelines that promote transparency, disclosure and reporting in the green bond market. The Green Loan Principles build on and refer to the Green Bond Principles, with a view to promoting consistency across financial markets. The principle aims of both the Green Bond Principles and the Green Loan Principles are the promotion of the development and integrity of the green financing market. However, both products focus on the financing of green projects.

There is no expected margin reduction for a true Green Bond/Loan (although many do have environmentally-linked coupon/margin ratchets) – the 'advantage' for borrowers is the positive publicity and the opportunity of attracting green investors; a Green Bond/Loan carries a badge of credibility which is marketable.

Sustainability-Linked Loan Principles

The Sustainability-Linked Loan Principles deviate from the Green Bond/Loan 'use of proceeds' methodology and do not require proceeds to be used in a specific manner but instead measure the ongoing sustainability profile of a borrower (and therefore an effective use of a coupon/margin ratchet). The borrower's sustainability performance is measured using sustainability performance targets, which include KPIs, external ratings and/or equivalent metrics and which measure improvements in the borrower's sustainability profile.

For Sustainability-Linked Loans, the use of proceeds for a green project is not a determinant in its categorisation and, in most instances, Sustainability-Linked Loans will be used for general corporate purposes. Instead of determining specific uses of proceeds, Sustainability-Linked Loans look to improve the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined sustainability performance targets.

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The Taxonomy Regulation sets out a classification scheme for determining whether an economic activity can be considered as 'environmentally sustainable'. It is intended to provide a common framework to allow investors to make informed decisions as to the environmental sustainability of their investments, and to combat suggestions of 'green washing' (i.e. conveying a false impression that a product is more environmentally sound than it really is) in relation to some financial products marketed as 'green' or environmentally sustainable.

Whilst the Taxonomy Regulation itself is a classification scheme, it underpins other initiatives that will have more direct implications and is a cornerstone of the broader Action Plan on Financing Sustainable Growth (the "Action Plan") that was launched by the European Commission in March 2018. The scope of these initiatives will change over time; however, it will include requirements for (a) any EU or national regulator to apply the taxonomy criteria in respect of financial products marketed as environmentally sustainable (e.g. Green Bonds/Loans and Sustainability-Linked Loans), and (b) financial market participants in the EU (including fund managers, investment firms, and credit institutions) to make statements about alignment with the taxonomy when making available financial products.

Given that the taxonomy is potentially the most comprehensive effort to date of creating a uniform classification of sustainable activities, it is likely that parties may choose to voluntarily align their reporting and/or investment marketing with its criteria, even if not required to do so (e.g. to allow for more accurate benchmarking against their peers or to mitigate accusations of 'greenwashing' as a result of using less strict criteria). It is also possible that other jurisdictions may ultimately use the taxonomy as a basis for similar regulation – for example, the UK has indicated that it will develop its own green taxonomy based on the EU form.

The taxonomy classifications might also be adopted for the purposes of banks' prudential rules (e.g. capital adequacy treatment) as it was referred to in the Action Plan as a key tool in assessing the adequacy of such rules. In this respect, Article 501c of Capital Requirements Regulation 2 gives a mandate to the European Banking Authority to assess the need for a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives.

The initial report by the Technical Expert Group on Sustainable Finance was published in March 2020 and did not include 'technical screening criteria' (i.e. the applicable classification framework) for aviation. It noted however that this should be prioritised as an economic activity, with the European Commission targeting its adoption by end 2021. WFW is currently advising the Aviation Working Group in its discussions with the European Commission in relation to the form of technical screening criteria for aviation.

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CONCLUSION

The aviation sector will continue to be in the spotlight when it comes to sustainability, and particularly in relation to its CO_2 emissions. However, there must be a level of realism as to what is achievable over the short to medium term. It is inevitable that 'stick' initiatives will continue but it's hard to get them right on a global basis, given varying national-level interests. Whereas, 'carrot' initiatives often yield the most effective results in terms of promoting global change.

For there to be a meaningful reduction of CO_2 emissions across the aviation sector, incentive by way of green financing to select a less-carbon intensive option must be available to as many airlines and lessors as possible. Therefore, given the context and influence of the EU taxonomy on green financing, it is imperative that the European Commission take a sensible and pragmatic view in its determination of a technical screening criteria for aviation. The Aviation Working Group recently published an open letter to the European Commission which sets out a principles-based response to how the EU taxonomy might be applied to aviation in the context of aircraft financing and leasing (which can be viewed **here**). It is hoped that the approach adopted by the European Commission helps to encourage the aviation industry, in the context of what is feasible, to a greener future.

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