

# EU Criteria Will Help Aviation Finance Sustainability Push

By **Richard Williams** (October 25, 2022)

The aviation industry is taking seriously its responsibility to achieve net-zero through self-led strategies.

Historically, carbon reduction has been driven by new airframe and engine technology developed to reduce fuel burn — though with the intent of reducing operating cost as well as carbon. The industry otherwise has tended to defer to governments and supranational organizations for big-picture macro strategies to manage aviation's impact on climate change.

But this approach — involving policies such as carbon trading — has had limited success, due to the requirement for widespread international cooperation, which has not been forthcoming.

With other efforts to be more green — for example, carbon offset options for passengers when purchasing a ticket, a scheme introduced by some airlines — having equally limited success, it became clear over time that the industry had to more, and had to do better.

Fast-forward to the present. Now all industry participants — from manufacturers to leasing companies, from energy producers to maintenance, repair and overhaul providers — are mining new technologies and processes to produce radical plans to reach net-zero.

These new strategies range from electric engines to feedstock fuel and beyond — all while continuing to push the envelope on developing more efficient airframe and engine technologies.

The global finance industry also recognized it could, and needed to, play a significant role in reaching net-zero. It has typically pursued this goal through financing green assets and projects — for example, funds established to exclusively invest in renewable technologies.

However, the development of sustainability-linked finance has begun to bridge the gap between green industries and traditional industries, to assist the latter in achieving environmental, social and governance targets. This has given aviation financiers a new tool with which to play their part in the wider aviation industry drive to reach net-zero.

Sustainability-linked finance works because it rewards borrowers through pricing for achieving defined ESG targets. This approach closely follows the guidance issued by various industry bodies around the world, including the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association.

In aviation, this may involve rewarding participating airlines with rent rebates and reductions in margins on their financing, if said airlines achieve periodic key performance indicators, or KPIs, which will assist in reducing their carbon output.

For example, an airline and financier may agree that the airline will benefit from a reduced margin on its financing if the airline year-over-year increases its use of sustainable feedstock aviation fuel as a proportion of its annual aggregate fuel use. Or an airline and a lessor may agree that if the airline increases the proportion of more efficient new technology aircraft in its entire fleet, then it will receive a rent rebate.



Richard Williams

Conceptually, sustainability-linked financing seems straightforward. But calibrating KPIs can be complex. If they are too easy to achieve, the borrower and the financier may be accused of greenwashing. If they are too difficult to achieve, the borrower may abandon them.

Also, care should be taken not to cause a margin call effect on the borrower. If a KPI cannot be achieved because unforeseen circumstances have stalled a borrower's planned investment — such as an airline's plan to move to a more efficient fleet — the increase in pricing as a consequence of failing to achieve the related KPI would make it even more difficult, and therefore more unlikely, for the borrower to ever be able to make the required investment, and thus achieve the KPI.

One method of addressing these issues has been to increase the applicable target periodically, so that the borrower enjoys cheaper pricing from the beginning of the transaction, and can be rewarded for continuous investment and achieving year-over-year improvements.

Finally, KPIs must be capable of accurate measurement. Calibrating them by reference to inputs rather than outputs can address this requirement.

For example, measuring new technology aircraft as a proportion of a fleet is easier than measuring how many tons of carbon are emitted by an airline over a period of time. Precise measurement also increases transparency for the public.

Sustainability-linked finance is therefore an effective strategy for incentivizing carbon reduction in the industry — not only by assisting financiers in achieving their own ESG obligations, but also by providing a double benefit for airlines. An airline already enjoys a benefit by adopting the technology which forms the basis of a KPI, even before it enjoys the reduction in its financing cost by achieving the KPI.

Micro strategies, such as sustainability-linked finance, do need to be widespread in order to have a significant impact, but sustainability linked finance is simple enough to be easily implemented — which is likely to guarantee its place in the aviation industry's tool kit to reach net-zero.

Currently, sustainability-linked finance is limited to lender/airline finance, and has been deployed in various financing structures, including Japanese operating lease with call option. In principle, there is no reason why it cannot be extended to financing provided to lessors, and to rentals paid for operating leasing.

Such extensions would require some thought around the applicable KPIs. But otherwise, the existing framework, with regard to, for example, reporting, should suffice.

Lessors and financiers might even consider whether there is any reason why existing transactions could not be amended to introduce sustainability KPIs — thus substantially increasing their usefulness and impact toward reaching net-zero.

Benchmarking the deployment of new technology aircraft and the use of sustainable aviation fuels will also be significant factors in determining whether an economic activity in aviation — such as a finance or leasing transaction — can be considered sustainable for the purposes of the European Union's Taxonomy Regulations. These regulations are key to the EU's drive to achieve net-zero by 2050 by incentivizing private capital to invest in sustainable industries.

The regulations established six objectives to assess whether an economic activity is sustainable or not, including whether the activity mitigates climate change, which is the most relevant for the aviation industry.

This is intended to provide a uniform and standard benchmark, allowing investors and other industry participants to evaluate whether the economic activity in which they are participating is sustainable — of particular importance to many financial institutions in the EU, as they have an obligation to report on matters related to sustainability in their annual financial statements.

Assessing whether an economic activity in a particular industry is sustainable can be achieved by means of the technical screening criteria developed for that industry by experts and relevant stakeholders. But in the case of aviation, such technical screening criteria remain in development and have not been finalized.

Agreeing on technical screening criteria for aviation has been challenging, because aviation cannot currently be classified as a low carbon industry — leading some critics to argue whether it should be considered sustainable at all.

Notwithstanding the critics, pursuant to the draft technical screening criteria, an economic activity in aviation can be classified as sustainable under the EU's Taxonomy Regulations if it satisfies the criteria for transition activities.

If, for example, the applicable economic activity is one of the best performers in the industry in terms of carbon emissions, then it will be determined to be making a substantial contribution to climate change mitigation — one of the objectives of the regulations — and to the transition to a low carbon economy.

Next generation aircraft, at the cutting edge of carbon emissions, should fulfill these criteria; thus, they are included as a KPI in sustainability linked loans. The requirement to use sustainable aviation fuel will also likely be included in the technical screening criteria on a similar basis.

The technical screening criteria for aviation are expected to be finalized by the end of this year. However, further consultation could cause a delay.

---

*Richard Williams is counsel at Watson Farley & Williams LLP.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*