EU - EMISSIONS TRADING SCHEME FOR THE AVIATION INDUSTRY

European Union Emissions Trading System ("EU ETS")

BACKGROUND

The EU ETS (implemented by way of Directive 2003/87/EC) was introduced to reduce greenhouse gas emissions by 8% below 1990 levels under the Kyoto Protocol. This ‘cap and trade’ scheme sets an overall limit on the total greenhouse gas emissions (calculated on carbon dioxide tonnage) allowed from all ‘installations’ (e.g. power stations, factories etc). The European Commission included aviation within the scheme by way of Directive 2008/101/EC (Directive 2003/87/EC as amended by Directive 2008/101/EC, the “Directive”). The UK implemented the Directive with The Aviation Greenhouse Gas Emissions Trading Scheme Regulations 2009 and 2010 (the “UK Regulations”).

Allowances for airlines will be calculated on the basis of a percentage per 1,000 tonne-kilometres and airlines are required to surrender those allowances to account for actual greenhouse gas emissions in a given period. If an airline reduces its emissions, it can carry over its unused allowances or trade them with other companies which don’t have enough to cover actual emissions. Limiting the allowances available ensures such allowances have a value and are subsequently tradable.

The allowances allocated to the aviation sector in 2012 is equal to 97% of the EEA-wide historical aviation emissions. In 2013 this will be reduced to 95% and allowances will be reduced each year so that over time emissions fall.

WHO IS COVERED?

All aircraft operators (who can be natural or legal persons under the legislation) performing flights arriving at or departing from any airport situated in the territory of the EU or an EEA/EFTA state (Iceland, Liechtenstein, Norway) will be included. It will be extended to Croatia on 1 January 2014.

There is no regard to flight time or actual time spent in EU airspace. Passenger, cargo and non-commercial flights are included.

Exemptions are limited and include light aircraft, military/government or emergency aircraft and commercial operators of less than 243 flights for 3 consecutive 4 month periods or reporting less than 10,000 tonnes of emissions per annum.

WHO WILL MONITOR THE EMISSIONS?

Each aircraft operator will be allocated an administering state in the EU which will be responsible for monitoring compliance and enforcement.

When an aircraft operator is based in the EU or an EEA/EFTA country and has a valid operating licence
issued by such country, that country will administer the aircraft operator. For example, British Airways is based in the UK and will be monitored by the UK, similarly, Air France will be monitored by France.

For other aircraft operators, it will be the state with the greatest attributed aviation emissions performed by that aircraft operator in each relevant year. For example, it has been determined that Qantas, although based in Australia, will be monitored by the UK on the basis that the majority of its aviation emissions within the EU occur in the UK. A link to the current list of operators and monitoring states adopted in February 2012 is available at the end of this note.

HOW WILL ALLOWANCES BE DISTRIBUTED?

Following the 2012 benchmarking process, 82% of allowances have been given away free to aircraft operators.

Allowances of 3% are allocated to a special reserve for new entrants to the market (i.e. those who being activity during a monitoring year) and high growth aircraft operators (i.e. those whose tonne-kilometre data increases by an average of 18% in a monitoring year and the second calendar year in that period). This special reserve will become available in the period beginning in 2013 and is therefore yet to be demonstrated in practice.

A further 15% is allocated by auctioning. Any further shortfalls in allowances up to a total of 15% will need to be covered by trading on the secondary market. The first trading period will begin in 2013 based on allowances allocated in 2012. As such, it is unclear how active this secondary market will be, particularly amongst airline operators.

HOW IS AN AIRCRAFT OPERATOR IDENTIFIED IN THE UK?

If an aircraft operator cannot be identified, the UK Environment Agency (the “Regulator”) may require the owner to identify the operator. Provided the owner can identify the relevant aircraft operator, for example by evidencing a current operating lease, then the liabilities to comply with the UK Regulations will remain with the aircraft operator. Neither the Directive nor the UK Regulations suggest that the owner will be held liable for an operator’s non-compliance unless the operator cannot be identified or the owner cannot prove the operator at the relevant time.

WHAT ARE THE OBLIGATIONS OF AIRCRAFT OPERATORS?

Under the UK Regulations, aircraft operators are required to produce monitoring and reporting plans relating to annual emissions. Any substantive changes to these plans need to be approved by the Regulator. Further, aircraft operators are also obliged to monitor and submit annual reports (which must then be independently verified by 31 March each year) to the Regulator.

Following submission of these plans and reports, aircraft operators must surrender allowances each year equal to the total emissions in the preceding year. Allowances for 2012 emissions must be surrendered by 30 April 2013.

Lessors and financiers will want to ensure that aircraft operators comply with the obligations placed upon pursuant to the UK Regulations by drafting compliance undertakings into transaction documents, including an obligation for the lessee to identify itself as operator to the Regulator. Lessors and financiers may also consider undertakings for aircraft operators to promptly discharge any penalties incurred for non-compliance and remedy failures to comply within set time periods taking all steps necessary to avoid detention of the aircraft by the Regulator. Further protection can be obtained by requiring a letter of authorisation (similar to the Eurocontrol letters typically obtained in leasing or financing transactions) as a condition to delivery and/or funding allowing lessors/financiers to contact the Regulator for details of an aircraft operator’s compliance.

Wet leases could become problematic if there is any disagreement over who is the aircraft operator for the purposes of the UK Regulations. ICAO’s view is that the wet lessee should be responsible for compliance. In this case, the wet lease agreement should include an obligation for the wet lessor to provide the necessary information to allow the wet lessee to comply with the UK Regulations. The wet lessor may also want corresponding obligations from the wet lessee that the UK Regulations have been complied with and any penalties discharged.

WHAT ARE THE PENALTIES?

The UK Regulations provide for a fine of €100 per tonne of CO2 for which allowances are not surrendered. Any shortfall in allowances will also be added to the overall total emissions for the aircraft operator for the following year. The UK Regulations also include fines starting from £500 for failure to comply with monitoring and reporting obligations or the emissions plans. Additional daily rates for each day of non-compliance may also apply up to a maximum daily rate of £33,750 in some cases depending on the breach in question.
The Regulator is also able to impose an operating ban on persistent offenders. However, the test for identifying a ‘persistent offender’ is not clear.

If fines are not paid for 6 months, or an operating ban is in place then the Regulator can detain any aircraft operated by the offending aircraft operator. Any such detention also extends to records and equipment. If such detention is for a period of more than 56 days the Regulator can apply to the court for leave to sell the aircraft. It is important to stress here that this analysis only covers the detention rights with respect to the UK Regulations and as yet remains untested. Furthermore, the position in other EU countries may be different and as such, local advice should be sought in the relevant jurisdiction where necessary.

The Regulator will not be entitled to detain, continue to detain nor sell the aircraft if (i) there is an appeal by the aircraft operator accompanied by provision of sufficient security to cover any outstanding penalties or (ii) another party claiming interest in the aircraft demonstrates that the aircraft operator is no longer lessee of the aircraft or any part of it.

Before the Regulator may apply to the court for leave to sell the aircraft, it must take steps to notify any other person with an interest in such aircraft. A court will only grant leave to sell the aircraft where it is satisfied that (i) a penalty is due to the Regulator, (ii) the penalty has not been paid and (iii) the Regulator is entitled to sell an aircraft. If leave is granted then the Regulator must sell the aircraft at the best price. The UK Regulations then detail the order of priority for the proceeds of sale. Only after any sales expenses, Regulator expenses, the penalties due and any airport charges have been settled will the remaining proceeds be distributed to any other party with an interest in the aircraft such as the owner or a financier. It will be useful to detail this order of priority in any relevant financing documents, particularly to the exclusion of the aircraft operator.

Any aircraft in the operator’s fleet can be detained or sold regardless of how penalties have been incurred. This represents a significant risk to owners and financiers. The Regulator must notify the following persons of its intention to sell an aircraft detained under the UK Regulations:

- the person in whose name the aircraft is registered;
- the person who appears to the Regulator to be the owner of the aircraft;
- any person who is registered as a mortgagee of the aircraft; and
- any other person who appears to have a proprietary interest in the aircraft.

Provided that the relevant interests are properly recorded with the aircraft registration then the relevant parties will be notified. However, in order to halt proceedings, the UK Regulations state that the owner or financier is required to demonstrate that the aircraft operator is no longer operator of the aircraft. For example, a lease termination notice may be sufficient to show that the aircraft is no longer operated by the airline in question and if registered with the UK CAA, an endorsed certificate of registration showing cancellation of the registration may also be useful, however, this process is yet to be tested in practice. It is important to take specific advice in this regard as initiating deregistration may not be appropriate in all circumstances.

Any action or detention by the Regulator in respect of the aircraft will need to be considered as a termination event in the relevant transaction documents. However, this could lead to wider problems, for example, if there are cross default provisions with other aircraft in the aircraft operator’s fleet which are on lease from the same owner or lessor. In light of the opposition to the scheme (see further below), a situation could arise where a lessor has a number of aircraft on lease to an operator and the leases are performing well though the operator refuses to comply with the UK Regulations. Terminating the lease may not be an attractive option for the lessor but the UK Regulations will force their hand in order to prevent the aircraft from being sold.

**HAS THERE BEEN ANY OPPOSITION TO THE SCHEME?**

On 21 December 2011, the European Court of Justice ("ECJ") delivered its judgment in a legal case brought by a group of US airlines and the US Air Transport Association against the inclusion of aviation in the EU ETS. The ECJ upheld the legislation, stating that the extension of the EU ETS to aviation infringes neither the principle of territoriality, nor the sovereignty of third countries.

Representatives of 23 governments also prepared a joint declaration in February 2012 indicating that opponents may file a legal challenge under the Chicago Convention (which provides, inter alios, that each nation has sovereignty over its airspace and aviation fuel is exempt from taxation). The ECJ found that the Chicago Convention does not fully apply to the EU and therefore didn’t rule on it in its December 2011 judgment.
There have been strong reactions around the globe to the EU-ETS:

- **February 2012** - China bans its airlines from getting involved in the scheme and prevented any ticket price increases. The US enacts the FAA Act 2012 which includes a statement opposing the extra-territorial effect of the scheme. It is reported that Russia is considering a similar approach;

- **March 2012** - a group led by Airbus writes to EU politicians urging them to put the scheme on hold until a global action plan for emissions is agreed;

- **May 2012** - India threatens to ban the EU-ETS scheme and retaliatory sanctions for EU based airlines;

- **June 2012** – the International Civil Aviation Organisation (ICAO) confirms its aim to have a draft proposal tackling aviation emissions by March 2013 as an alternative to EU-ETS.

The controversy surrounding the apparent extra-territorial effect of the Directive has led to speculation that it could lead to a ‘trade war’ - despite the fact that the measure only concerns small sums of approximately $2-3 per transatlantic flight.

**WHAT IS THE WIDER IMPACT ON THE INDUSTRY?**

It has already been reported in the press that some airlines have taken the decision to pass on EU-ETS costs to its customers through ticket prices. It is likely that others will do the same. Though it is alleged that these costs will be low, taken together with increasing fuel prices and other financial pressures in the global financial market, further ticket price increases may become necessary.

Air traffic may also change with patterns shifting towards increased demand in Switzerland, Russia, former Yugoslav republics and reducing traffic through EU hubs putting the EU at a competitive disadvantage.

**WHAT NEXT?**


In the meantime, while 2011 verified emissions reports have been received accounting for 99 per cent of emissions expected to be reported, the Regulator is still considering what action to take with respect to those operators who failed to submit reports on time.

**USEFUL SOURCES**

**Directive 2003/87/EC**


**Directive 2008/101/EC**


**The Aviation Greenhouse Gas Emissions Trading Scheme Regulations 2009 and 2010**


**ECJ 21 December 2011 judgment**


**European Commission FAQs**

http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm
http://ec.europa.eu/clima/policies/transport/aviation/faq_en.htm

**Environment Agency**


**Department of Energy and Climate Change**

http://www.decc.gov.uk/en/content/cms/emissions/eu_ets/eu_ets.aspx

**Aircraft Operators and Monitoring States (effective 3 February 2012)**

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