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# COP26 and Aviation

## Turbulence ahead

With mounting pressure to slash emissions and limited options for ESG-friendly financing, an embattled industry must quickly win over regulators and stakeholders

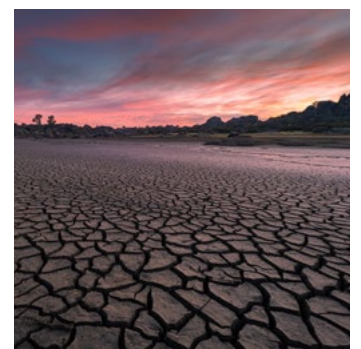
The aviation industry's role in climate change is well documented, resulting mainly from aircraft greenhouse gas (GHG) emissions. The industry body Air Transport Action Group reports that in 2019 flights worldwide produced 915 million tonnes of CO<sub>2</sub>, roughly 2% of human-induced CO<sub>2</sub> emissions that year. Against that backdrop, many countries are implementing ambitious targets for sustainable aviation, such as UK commitments to achieve net-zero aviation by 2050. In parallel, industry participants are beginning to adapt to the significant impacts climate change will have on their operational performance and infrastructure.

This article considers some of the main carbon reduction measures being taken or planned by governments and international organisations. It begins by examining emissions trading

schemes, explores the growing focus on sustainable aviation fuels and finally considers how these efforts are supported by financing.

### Emissions trading schemes in the UK and EU

There are currently several emissions trading schemes (ETS) impacting aviation around the world. The International Civil Aviation Organisation (ICAO) has developed a Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). This operates as an offsetting regime where industry emissions may increase only if compensated by offsets. However, CORSIA only applies to international flights, while participation will be initially voluntary, becoming mandatory from 2027.



Aviation emissions are also regulated through cap-and-trade schemes which set upper limits on total emissions that decrease over time. In the European Union, the Emissions Trading System (EU ETS) was established in 2005, with aviation activities added in 2008. Following the Brexit transition period, a new scheme for the UK (UK ETS) came into force on 1 January 2021. Although the UK and EU are committed to give “serious consideration” to linking their respective schemes under the EU-UK Trade and Co-operation Agreement, the two regimes remain distinct and operate in parallel.

The absence of harmonising legislation gives rise to the potential for overlap between the three schemes given that CORSIA, like the other two equivalents, covers international flights within the European Economic Area (EEA) and flights between the UK and the EEA.

The requirement to comply with various ETS regimes continues to put pressure on aircraft operators, both in meeting the requirements and satisfying counterparties and financiers. Aircraft operators must meet requirements of the relevant ETS and make necessary payments to avoid sanctions, including fines; and ensure they can meet their obligations and avoid events of default arising from non-compliance.

### Sustainable aviation fuels – The big hope

There is increasing focus on sustainable aviation fuel (SAF) as an important part of industry carbon reduction. SAF is an alternative to fossil-derived fuel with substantially lower GHG emissions. Rather than relying on kerosene, SAF is produced from sustainable feedstock such as biomass. It can also easily be combined with conventional aviation fuels without significant changes to existing aircraft or engine technologies.

But substantial operational and technological barriers need to be overcome before SAF can be meaningfully commercialised. According to the UK government’s recent consultation on introducing a SAF mandate, production costs associated with SAF mean it is up to eight times the price of kerosene.

Various governments and international bodies across North America, South America, Europe and Asia have adopted, or are developing, policies to support scaling up SAF production and use. According to the ICAO, there are currently 18 such policies globally. These mainly take the form of mandates requiring minimum levels of SAF blending in jet fuels or specified reductions in the carbon footprint of aviation fuels. Economic incentives have also been introduced, such as recent US government proposals to introduce tax credits to back SAF use.

Mandates, under which fuel suppliers are often the obligated parties, are an effective way to promote SAF production and largescale commercial delivery. Making SAF use mandatory to reduce the carbon footprint of aviation fuels would generate demand and trigger investment in the technology, driving down associated costs and risks. At this stage, 11 of the 18 SAF policies are mandates. Of these, nine remain in development, with Norway and Indonesia the only countries to have adopted mandates. These mandates have varied models, with some structured as GHG emissions schemes and others based on fuel volume.

As most of the proposed mandates remain under development, detail around how they might operate are still uncertain. This is unsurprising given the novelty of SAF use, its limited production and the fact that eight of the 11 mandates were only proposed in the last two years. However, given pressure on states to hit climate targets, development will likely move quickly and enforcement generally include substantial financial penalties for non-compliance. The EU, for example, announced plans for a SAF mandate in 2020 as part of its [ReFuelEU Aviation](#) initiative and published draft regulations in July 2021, which include provisions for substantial fines on non-complying fuel suppliers.

It is already clear the SAF policies being pursued will lead to important shifts in industry dynamics. The legal landscape surrounding the policies is likely to develop at pace and not uniformly. Aviation players will therefore need to grasp the nuances between the applicable regimes to take advantage of incentives and abide by emerging obligations.

### ESG in aviation finance – Finally taking off

The aviation sector will also be impacted by the rising importance of climate change and other ESG factors in investment decisions, including financing. These factors are criteria which corporates, their creditors and other stakeholders are increasingly considering in investment. They cover not only climate change but issues such as raw material use and pollution, social issues such as human rights, employment rights and equality, and governance factors such as transparency and executive pay.

There are two main types of ESG financing, the first requiring proceeds of lending to be used for a specific sustainable purpose (these are often referred to as “green” products). The second option requires the borrower to achieve certain ESG targets within its wider business in exchange for pricing benefits (often referred to as “sustainability-linked” products).

Until recently, there has been a perception that no investment in aviation could be ESG-compliant thanks to the industry’s carbon footprint. There is particular risk that ESG financing in the sector will attract allegations of greenwashing, where products, services or behaviours have overstated or untrue environmental claims. For instance, in 2020 the UK’s advertising regulator banned a campaign including claims that Ryanair was Europe’s “lowest emissions airline” as misleading. However, there have recently been a spate of green or sustainability-linked financings involving aircraft operators, lessors and airports.

From an EU perspective, the [EU Taxonomy Regulation](#), (the Taxonomy) which came into force on 12 July 2020, introduced a harmonised set of criteria to determine which products can be marketed to investors as sustainable. Sector-specific requirements of the Taxonomy will be implemented through “technical screening criteria” under delegated legislation.

On 3 August 2021, an EU-backed advisory group published preliminary recommendations for technical screening criteria for the Taxonomy. The key focus of this draft report focused on a set of priority economic activities. A number of these are relevant to the aviation sector, including the “manufacture of other transport equipment”, “manufacturing of aircraft”, “passenger air transport” and “air transportation ground handling operations”. Importantly, the annex to the draft report says screening criteria for aviation will require:

- promotion of the replacement of old aircraft for new, more efficient models, without increasing the fleet size;
- acceleration of development and introduction of more efficient aircraft, without compromising development of zero-exhaust carbon dioxide emission technologies; and
- the introduction of SAF, including ensuring that aircraft operators are ready to operate with high amounts of SAF mixed with conventional fuels.

The growth of ESG financing within the aviation sector will not be without challenges but regulators moving towards harmonisation of ESG criteria should at least provide more certainty to the industry, enabling the risk of greenwashing claims to be managed.

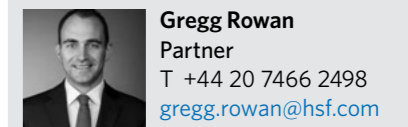
The role of state finance to aircraft operators, including support during the Covid-19 crisis, will be interesting in respect of green financing options. Some of this aid has been made conditional on meeting sustainability targets. The implementation of state aid has already been subject to various challenges by non-governmental organisations (including, for example, the Dutch government’s aid package to KLM in 2020) alleging that the sustainability targets do not go far enough in ensuring compliance with climate obligations. These state interventions are likely to accelerate development of further ESG financing initiatives and put a greater onus on aircraft operators to improve their climate credentials.

### Conclusion

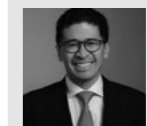
As climate change and sustainability issues remain at the forefront of government agendas, the development of ESG initiatives in aviation will likely be driven by increased regulation through emissions trading schemes and moves to bolster SAF use. In addition, it appears likely that future state aid to the sector will be made conditional on compliance with sustainability conditions.

From a practical perspective, aircraft operators and other industry participants will clearly face mounting pressure from investors and stakeholders to build credible ESG strategies. Increasing focus on sustainability will also likely further stoke activist campaigns and litigation against the industry to enforce that change. The emergence of ESG financing options may be increasingly necessary but such tools will have to evolve considerably to overcome tougher scrutiny and entrenched perceptions of aviation as a high-carbon industry.

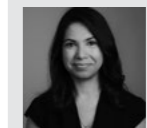
#### Key contacts



**Gregg Rowan**  
Partner  
T +44 20 7466 2498  
[gregg.rowan@hsf.com](mailto:gregg.rowan@hsf.com)



**Rex Rosales**  
Partner  
T +44 20 7466 2586  
[rex.rosales@hsf.com](mailto:rex.rosales@hsf.com)



**Jahnvi Ramachandran**  
Partner  
T +44 20 7466 2408  
[jahnvi.ramachandran@hsf.com](mailto:jahnvi.ramachandran@hsf.com)



**Olivia Walton**  
Senior Associate  
T +44 20 7466 2787  
[olivia.walton@hsf.com](mailto:olivia.walton@hsf.com)

