

## Airlines brace for 'green' costs

**In the aftermath of the recent [Copenhagen](#) conference on climate change, aircraft finance lawyers are uncertain about the regulatory landscape going forward. Barry Parker reports**

The beginning of January marked the beginning of an EU Emissions Trading Scheme (ETS) monitoring and verification period. The year 2010 is serving as a benchmarking year, against which the first set of allowances - applicable to 2012 when the industry officially joins the ETS - would be calculated.

While a cottage industry of online services and computer software, all with a highly scientific patina, has sprung up to assist the industry in the actual monitoring and reporting of emissions, aviation finance experts pointed to considerable uncertainty, with implications for financing facing the industry under the new regime.

Veteran aircraft finance lawyer John Karesh, a shareholder at law firm Vedder Price in [New York](#), told Jane's: "In the early 1990s, as noise abatement regulations were promulgated, the rules were understandable. To meet the regulatory requirements, you could re-engine an aircraft or you could retrofit existing engines. You knew what you were getting into, and workarounds were predictable. That's not the case here."

### Negative effect

Another long-time finance lawyer, Barry Biggar, New York-based partner at King & Spalding, took a dim view of the coming regime, telling Jane's: "The imposition of direct and indirect costs on the industry in the form of taxes based on carbon emissions, or requirements to purchase carbon credits, is an unwelcome development that will negatively affect an already stressed sector."

Besides the financial component, a cloud of legal issues is potentially hanging over the 2012 start date, as far as airlines based outside the EU are concerned.

The Air Transport Association (ATA), which represents major US carriers, wrote to US Senator Barbara Boxer, who chairs a committee dealing with environmental concerns, that "the airline industry urges you and your Senate colleagues to take a broader, more international approach to regulations pertaining to US aviation that places us under a global framework".

Anthony Hobley, London-based partner and head of the global climate change and carbon finance practice at law firm Norton Rose, said: "The market is in a strange place now with policy and regulatory uncertainty. We expect that a number of schemes will emerge regionally."

In a recent post on the National Journal online venue, James May, ATA president and chief executive officer (CEO), expressed his hope for a "global sectoral approach to climate change for aviation developed through the International Civil Aviation Organisation (ICAO)".

Following an ICAO meeting in the third quarter of 2009, Giovanni Bisignani, director general and CEO of the International Air Transport Association (IATA), identified three tenets of the "global sectoral approach".

Bisignani cited: accounting for aviation's emissions globally; keeping aviation accountable for all its emissions - and ensuring that the industry only pays once; and giving aviation access to global carbon markets to offset emissions until technology provides the ultimate solution.

Parts of the "technology" include airlines' hopes to burn alternative fuels, a current area of research that is continuing. Hobley added: "As other schemes emerge, it will soak up offset credits. With greater demand, the prices will likely trend upward. This will impact the airline scheme - anyone can trade the credits."

The instant challenge concerns the legalities of the EU's reach. London-based lawyers Mark Bisset, a partner in the aviation and aerospace group at [Clyde & Co](#), and Georgina Crowhurst, an associate in the firm's environmental practice, after explaining that the EU has produced a list linking individual airlines with EU member states, said, in a memo: "The US Air Transport Association [ATA] and three American carriers, American, Continental and United Airlines, have issued proceedings in the administrative court in [London](#) on 16



December 2009 against the secretary of state for energy and climate change's planned implementation of the EU ETS."

The memo further explained the collective viewpoint of the three carriers: "that a flight from the [UK](#) to the US would occur almost exclusively outside EU airspace" and claims that the UK's implementing regulations - which transpose the

EU directive - represent a breach of both the Kyoto Protocol and the 2007 US-EU bilateral agreement on air transport.

#### **Leadership role**

According to the [Clyde & Co](#) team, the legal action has been started in the [UK](#) because of its leadership role in implementing the early stages of the ETS; they suggest that the [UK](#) court might refer the case to the European Court of Justice for an interpretive ruling.

Additional layers of uncertainty surround the inchoate regulatory scheme in the US, which could happen through the federal government or through Congress.

The very expansive US Environmental Protection Agency (EPA) is a federal agency that has now set its sights on greenhouse gasses, a move announced just prior to the 2009 United Nations Climate Change Conference.

Airline gas emissions are not explicitly on the EPA's radar, but the agency has routinely encroached on transportation operations.

Last year, the EPA began regulating the maritime discharges of more than two dozen substances. A wide swath of business groups, including the ATA, broadly opposes the EPA's efforts to insert itself into greenhouse gas issues.

#### **Additional tax levels**

Airlines also fear US legislative efforts, notably the American Clean Energy and Security Act ([ACES](#)), that was passed by the US House of Representatives in July 2009. The House bill is awaiting a parallel initiative by the US Senate sponsored by Senator Boxer and Senator John Kerry, who was a presidential contender in 2004. The senate bill would create additional levels of taxes on the airlines, because of a mechanism by which the costs of emissions would be borne by fuel producers or traders.

Hobley said: "You can draw a lot from what's happened in other industries - like cement and power. Likely you'll see a lot of activity as bankers are creating caps, floors, collars and similar derivative products, for the airline industry. The smaller airlines may prefer to go through a bank, which has the staff and the understanding of the auctions from their activities in the other industries."

Karesh described the Congressional approach succinctly as "a hybrid between cap-and-trade and a fuel tax".

The ATA's letter to Senator Boxer says: "The fuel producers and importers will simply pass along the cost of allowances to airlines."

The ATA points out that without transparency, "oil companies could extract a premium from our industry for jet fuel".

A representative from the pro-business Heritage Foundation, a Republican-leaning Washington, DC, think-tank, said, just prior to the bill's House passage: "It is clear that cap-and-trade is very expensive and amounts to nothing more than an energy tax in disguise."

Airlines are not explicitly mentioned in the [ACES](#) bill, but the ATA points to language expressing a "sense of the Congress" pointing towards the need for a global solution for aviation.

A Republican policy document quotes an American Petroleum Institute estimate that jet fuel prices could rise by USD0.83 per gallon, if the [ACES](#) bill is to become law.

Despite all the uncertainties on aspects of the new rules, the actual nuts and bolts of aircraft financing and leasing should be little changed as a result of EU ETS.

Karesh said: "Aircraft assets are long-lived; newer assets financed over the past few years, or being financed now, will be around well into the 2030s, and beyond - unless they are effectively rendered prematurely obsolete because they are too expensive to operate due to tightening emissions requirements. The older equipment may not make it to the 2020s if the emissions exceed limits under cap-and-trade, and the fixes are too costly. Bankers have known about the coming of cap-and-trade for quite a while and financing techniques, even on new equipment, have not been affected."

The legal team at [Clyde & Co](#) explained that: "Banks are including a clause in financing agreements that lessees must comply with the ETS. It's pretty clear."

Karesh said: "Wording, about complying with regulations that may be enacted in the future, is standard. The cap-and-trade scheme, however, might not be viewed as a regulation in the sense of preventing operation of certain types of equipment like the noise regulations did, or dictating a cap on total emissions. So it is not a problem of having a non-compliant aircraft that is not financeable; cap-and-trade will just make it more expensive for airlines to operate if the airline's emissions exceed certain limits."

However, Bisset and Crowhurst identified an important difference between ETS and other regulatory schemes, telling Jane's: "Ultimately, if an airline does not comply, by surrendering allowances or paying, enforcement could come down to an action by relevant aviation authorities to detain and sell the asset."

According to a note issued by law firm Allen & Overy's environmental practice, the EU's aviation directive does not itself create a security right or the right to seize an asset, but "member states may incorporate such language into their enabling legislation".

With the new risks and costs, new dimensions will be added to credit appraisals.

The Clyde & Co lawyers said: "A bank or a lessor doing an analysis will look at the creditworthiness of the airline, things like where does it fly and what hubs does it use. But none of this will change the individual financing deals."

Biggar told Jane's: "It's almost a certainty that the cost of carbon reduction will be borne at the corporate level. There may be some impact on individual delivery pricing, but, all in all, the schemes under consideration would impose liability at the operator corporate level."

Allen & Overy identifies a few possible exceptions in which an aircraft lessor may incur liability, including situations in which a lessor is ferrying an aircraft - for example, when repositioning the asset in between two leases, or, more ominously, in a ferry move after repossessing an aircraft.

The Clyde team added: "The airlines' ability to pass on cost increases will depend on the elasticity of demand. There are various reports about elasticity; some suggest that demand is more responsive to changes in fare levels on shorter haul flights where there are easily available alternatives such as rail, but there's a wide range of views."

Karesh asked, rhetorically: "If you are the CEO or CFO [chief financial officer] of an airline, how do you plan?" Biggar was quick to note: "I know several operators are lobbying to have any new taxes imposed as a ticket surcharge, which the operators would then collect on behalf of the taxing authority."

#### **Limit to passing on costs**

He added: "There is, however, a limit to what airlines can charge in the aggregate and still maintain breakeven or profitable load factors."

Stuart Hammer, New York-based member of the corporate department and environmental practice group at law firm Debevoise & Plimpton, told Jane's: "Once airline greenhouse gas emissions are regulated in the United States, lenders will investigate the effect of such initiatives on their borrowers. For example, banks may consider the costs necessary to purchase emission allowances under a cap-and-trade scheme on capital costs necessary to reduce greenhouse gas emissions to comply with any other applicable requirements."

From an organisational standpoint, Hammer offered: "Airlines should be ready to provide this information and should consider who their point person will be on answering climate change-related inquiries from their lenders."



Crowhurst said: "The operator is on the hook under the rules; each flight is allocated to a responsible person. Lessors want to make sure in their documentation that the lessees complete everything correctly."

Yet another aspect that bankers must address is the security aspects of allowances.

#### **Role of carbon credits**

Bisset said that banks are spending a lot of time looking at how to obtain security interests: "Part of the security in other sectors includes the rights to allowances. This is reasonably common in project finance where one source of repayment is the stream of carbon credits."

However, Bisset distinguished the airlines (with mobile assets) from financings of power stations and non-recourse projects, telling Jane's: "The main difficulty is that [carbon] credits won't attach to a particular plane, they attach to the airline as a whole. If you are putting debt into an airline at the corporate level, you might be able to use the credits."

In terms of market prices, one view is that aviation allowances could likely trade at a discount to European Union Emissions Allowances (EUA).

According to the Allen & Overy note: "Aviation allowances will not be as freely tradable as EUAs and so are likely to trade at a discount to EUAs."

Biggar explained: "Financiers will not be keen on financing emission credits unless there are additional tax offsets made available to them. The collateral value of the credits is not equivalent to the collateral value of aircraft and engines."

The Clyde & Co lawyers told Jane's: "A number of airlines are looking at hedging - they are talking to energy market teams at banks about fixing the prices, which would be likely to move around quite a bit."

The lawyers, however, added: "It becomes a bit difficult. The aviation allowances can be bought, banked and sold by everyone, but only an airline can actually use them."

They also pointed out that the credits, with a five-year expiry, have what is effectively a decaying time value: "The time in the cycle is a consideration; if certain entities realise that they don't have to pay, the price of credits in the market could plummet, for example." When probed further about ideas for tax offsets, Biggar referred to a popular device from the early 1980s, and legislated out of existence in 1986, the 168 (f) (8) leases, which he said "allow the transfer of depreciation deductions to anyone who could use them".

He suggested: "A similar scheme would be very desirable for carbon allowances." He said that if such an idea were enacted, "it would lead to a whole new class of parties interested in aircraft leases".

Biggar added: "Theoretically, such a programme should result in lower rental charges for operators" and reduced costs on fleet expansions or upgrades. Besides the considerable study of hedging techniques, evidence of new transaction instruments is anecdotal, at best.

Karesh said: "When fuel is involved, you can pledge the hedge as collateral. On Wall Street, some of

the banks are looking into ways to package carbon certificates into tradable assets."

Biggar mentioned that one of the large Wall Street banks was looking into "carbon bonds", a similar concept. With the new regulations, due diligence takes on a fresh meaning for the banks. Hammer told Jane's: "With respect to airline financings, the scope of environmental due diligence conducted by banks would need to be expanded to account

for risks associated with climate change laws. Currently, banks assess environmental claims associated with contamination and non-compliance issues, as well as issues related to environmental claims."

Like banks, the rating agencies will also be forced to expand the scope of their reviews.

Michael Wilkins, Standard & Poor's (S&P's) global head of carbon markets, said that US legislation (after the Senate passes a bill, which he thinks might happen within 2010 or early 2011) would increase the size of the trading market - currently estimated at around USD200 billion per year - by 10-to-12 times.

He said: "Carbon trading has already had ratings impacts in Europe." Referring to the US, he added: "You are bound to see some rating impacts going forward."

Wilkins said that S&P is looking at a number of key variables for companies in multiple sectors, including aviation. The ability to pass on cap-and-trade costs (alluded to by all the lawyers interviewed for this article) currently remains a subject of uncertainty.

A central theme in any analysis of new rules concerns winners and losers. Karesh was very vocal, telling Janes: "Unlike the noise regulations, these regulations will cost some airlines more than others. This

difference (from the advent of noise rules) is what makes cap-and-trade frightening."

Most analysts have acknowledged that impacts will be most deleterious on what Karesh described as legacy airlines flying older and less-efficient equipment.

The Vedder Price lawyer said: "If the European regime penalises operation of such equipment, there is going to be a period of time when the American carriers will be at a disadvantage."

#### **Advantages of newer aircraft**

He also noted that the revenue tonne kilometre (RTK) methodology is going to favour those airlines flying new and bigger aircraft with higher load factors and a greater proportion of premium fares.

From an asset value perspective, Karesh said that the new scheme "will have a negative impact on the long-term value of existing aircraft. Appraisers have already been thinking about this, but it's hard to quantify the negative impact on asset values".

Karesh explained that these impacts would exacerbate trends rooted in an already tight bank financing market, such as lower advance rates, increased lending spreads, shorter terms and tougher covenants.

He commented: "New equipment always includes operational advances that will reduce operational costs, so it's not fair to say that cap-and-trade is increasing the value of newer equipment. However, the older equipment will become obsolete more rapidly with new aeroplanes coming out, and will get a lower loan-to-value [LTV]."

Biggar told Jane's: "Whether it takes the form of a direct tax, or a requirement to buy credits, it further stretches an operator's cashflow at a time when there is limited liquidity to be had to cover the new cost."

Speaking about airlines with older fleets, Karesh said: "Cap-and-trade is effectively putting an additional tax on the inefficiency of the older equipment. It will be tougher to finance; it will be tougher to find a resale market for it."

The finer points of regulation are also uncertain. Allen & Overy's note suggests: "It is not known whether there will be a separate registry for aviation allowance trading. It seems more likely that a single registry will continue, perhaps using a tagging system to separate aviation and non-aviation allowances."

Under the EU's ETS, each member state has a national registry for tracking trading activity. Under nascent US rules, there are various regulatory outcomes.

A note co-authored by Hammer and colleague Sarah A W Fitts discussing the US House and Senate mentions the US Commodity Futures Trading Commission and the US

Federal Energy Regulatory Commission as possible regulators. The EPA is not mentioned in either bill as a possible regulator.

Politics will play a big role in the future course of markets. Biggar said: "It's fair to say that the political environment is such that some scheme will be imposed on the industry inasmuch as it is an easy target for those pushing a carbon-free agenda."

Bisset and Crowhurst said: "Politics will drive the levels of the caps; aviation rules are tighter than other sectors. We know the glide path of caps out to 2020 - beyond that, politicians will determine the levels."

For free market proponents, uncertainty is amplified by other aspects of governmental intervention. Consider price collars, an unwelcome aspect in the US Senate bill.

A note from Debevoise & Plimpton says: "To help contain costs, emissions allowances will be subject to an annually loosening price collar that will keep allowance prices within a defined range. Initially, emissions allowance prices will be limited to between USD11 and USD28 per tonne."

Worrisome indeed, when some forecasters predict carbon prices derived from free market trading as high as USD40 per tonne several years out. n

### **Springtime for tax leasing**

By now, most airlines have experience hedging jet fuel price volatility, usually accomplished through a customised swap transaction in which the hedge is not already embedded into the price of purchased fuel.

Organisationally, the same staff overseeing risk management of jet fuel purchases will probably be tasked with the trading of carbon allowances.

The swap market is usually conducted "over-the-counter" (OTC) or directly between parties, and credit risk is a constant concern.

The November 2009 Carbon Trading Bulletin issued by law firm Ince & Co reminds airline CFOs - and other interested parties: "By trading on an exchange, counterparty risks are typically reduced. Exchange transactions can, therefore, provide an attractive alternative to OTC transactions, and all the more so during troubled economic times."

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