



## Briefing

# Environment and Carbon Law

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## Airlines - Are you ready for the EU Emissions Trading Scheme?

As a result of the ongoing legal challenges to the inclusion of airlines in the EU Emissions Trading Scheme (EU ETS) we understand that many airlines are ill prepared for their inclusion in this scheme, as they have (understandably) been hoping the challenges will be successful.

The date for aviation's inclusion in the EU ETS, of 1 January 2012, is only a few days away. Airlines would be well advised to grab this nettle and deal with risk and cost management in the context of the EU ETS, by implementing appropriate emissions trading strategies.

This article explains the basics of the EU ETS, the basis of airlines' inclusion in the scheme and the credits that can be used by aircraft operators and looks at the opportunity to take advantage of carbon trading mechanisms to limit liabilities. It also raises a number of questions we suggest airlines consider as a matter of priority and explains how Burges Salmon could assist in this process.

### EU ETS Basics

The EU ETS is a cornerstone of the European Union's policy to combat climate change and is intended to achieve cost effective reductions of industrial greenhouse gas (GHG) emissions. It is the first and biggest international scheme for the trading of GHG emissions allowances and covers some 11,000 power stations and industrial plants in 30 countries (the 27 EU Member States plus Iceland, Liechtenstein and Norway and, from 1 January 2014, Croatia).

Climate Commissioner Connie Hedegaard (from the European Commission) has stated that the inclusion of aviation in the EU ETS is a matter of common sense as "firm action is needed.....emissions from aviation are growing faster than from any other sector and all forecasts indicate they will continue to do so under business-as-usual conditions."

However, many commentators have claimed that aviation's inclusion in the EU ETS will not change emissions of the sector as carbon prices in the system, which have fallen significantly (to €7.19 for Dec 2011 EUAs at the time of writing), will translate to an insignificant amount in comparison to the cost per litre of kerosene (the fuel used in aircraft).

### Cap and Trade

The EU ETS was launched in 2005 and works on the "cap and trade" principle. This means there is a "cap", or limit, on the total amount of certain GHGs that can be emitted by the factories, power plants and other installations in the system. Within this cap, companies receive emission allowances which they can sell to or buy from one another as needed. The limit on the total number of allowances available is supposed to ensure that they have a value, but progress so far indicates that the limits have not been set tightly enough.

### GHGs covered by the EU ETS

The EU ETS covers carbon dioxide emissions from installations such a power stations, combustion plants, oil refineries and iron and steel works, as well as factories making cement, glass, lime, brick, ceramics, pulp, paper and board. Nitrous oxide emissions from certain processes are also covered. Between them, the installations currently in the scheme account for almost half of the EU's carbon dioxide emissions and 40% of its total GHG emissions.

### Surrender of allowances

At the end of each compliance year each operator in the EU ETS must surrender enough allowances to cover all its emissions, otherwise heavy fines are imposed. If an operator reduces its allowances to cover all its emissions, it can keep surplus allowances to cover its future needs, or else sell them to another company that is short of allowances (or another carbon trader). The flexibility that trading brings is supposed to ensure that emissions are cut where it costs least to do so.

The number of allowances under the EU ETS is reduced over time so that total emissions fall. In 2020, the intention is that emissions will be 21% lower than in 2005.

### Expansion of EU ETS

As well as the inclusion of aviation discussed below, the EU ETS will be further expanded to the petrochemicals, ammonia and aluminium industries and to additional gases in 2013, when the third trading period will start (and run from 2013 – 2020) . At the same time, a series of important changes to the way the EU ETS works will take effect in order to strengthen the system.

## Inclusion of Airlines in the EU ETS

From 1 January 2012 GHG emissions from aircraft are to be included in the EU ETS<sup>1</sup>. Analysts have stated that GHG emissions from aviation have more than doubled since 1990 and are forecast to continue to rise. The EU proposed extending the EU ETS to aviation because of what it saw as a lack of progress on the issue at the UN body.

Airline operators will have to surrender 1 allowance per tonne of carbon dioxide emitted on a flight to and from (and within) the EU. This covers passenger, cargo and non-commercial flights and applies no matter where an operator is based – non-EU carriers will also need to comply with the scheme.

Non-complying operators face a penalty of €100 per missing allowance, on top of the obligation to procure and surrender missing allowances. They may even be banned from operating in the EU.

Carbon dioxide emissions from the aviation industry will be capped at 97% of the average 2004 to 2006 emission levels for 2012, and 95% of the average 2004 to 2006 emission levels from 2013 onwards. Any aviation emissions above these levels will need to be matched by equal reductions in other sectors subject to the EU ETS.

The benchmark for free allowances will use transport data from 2010. As a result, operators need to have had reliable systems to generate this data and had to submit related monitoring plans in 2009. This baseline data will determine the number of free allowances for 9 years (2012/2020), making it worth up to several billion euros for some airlines.

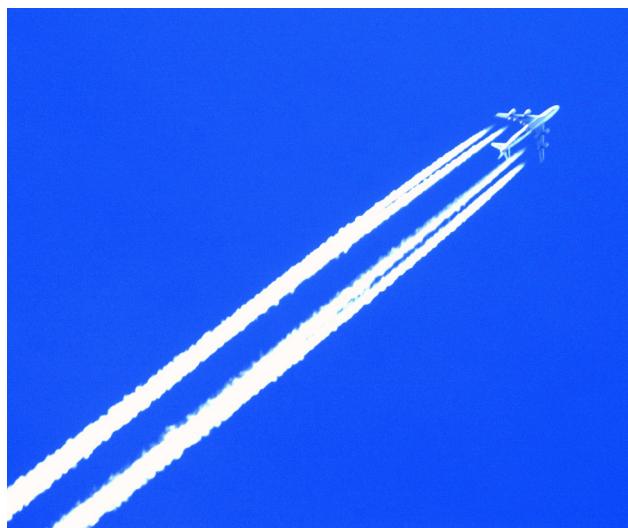
Aircraft operators have needed clarification on many issues. These have included questions on how they should complete Monitoring Plans and how to manage emissions on an ongoing basis.

## Administration of Airlines' Participation in EU ETS

The Aviation Emissions Directive covers both EU and foreign-based aircraft operators. To reduce administrative costs, each aircraft operator will be administered by the Member State in which they run the majority of their EU flights. Member States are also responsible for the aircraft operators to which they issued an operating licence and for the aircraft operators whose GHG emissions in 2006 were mostly attributable to that Member State under rules set out the Aviation Emissions Directive.

Arriving flights from non-EU countries with similar emissions trading systems will be excluded to prevent duplication of regulation.

In order to ensure equal treatment of airlines, the European Commission set a cap on allowances from airline operators for the next 3 trading periods, using a 2006 baseline.



## Challenges to Inclusion in the EU ETS

In December 2009, a number of US aircraft operators brought a judicial review challenge against the Department of Energy and Climate Change (DECC), in respect of their inclusion in the EU ETS. In May 2010, the High Court referred the matter to the Court of Justice of the European Union (ECJ) for a preliminary ruling.

The judicial review challenge was brought by the Air Transport Association of America, American Airlines, Continental Airlines and United Airlines. The basis for their challenge is that the application of the EU ETS to non-EU airlines breaches international law and the principle of the sovereignty of states over their own airspace.

At the time of going to press, the final judgment in the case was still awaited and is expected either at the end of 2011 or early in 2012. However, on 6 October 2011, Advocate General Juliane Kokott of the ECJ delivered her Opinion, which stated that "the inclusion of international aviation in the EU ETS is compatible with the provisions and principles of international law invoked". The Advocate General's Opinion is not binding on the ECJ, but is often followed by the ECJ.

The China Air Transport Association (CATA) has since also made it clear that it intends to bring a challenge against the inclusion of aviation in the EU ETS before the start of 2013. The challenge from CATA is expected to call into question the locality of the application of the EU ETS to the aviation industry in developing nations, bearing in mind European policy on the prevention of climate change, which requires a different level of effort from developing nations.

Despite these challenges, airlines operating flights within, into or out of the EU should now be ready for the changes taking place from 1 January 2012 and preparing for the financial impact these changes will have. The EU has so far appeared unwilling to reverse its decision for aircraft operators, whether based inside or outside the EU, to be included in the scheme.

<sup>1</sup>Under the Aviation Emissions Directive (Directive 2008/101/EC) amending (Directive 2003/87/EC) so as to include aviation activities in the EU ETS.

## Achieving Compliance under the EU ETS

Directive 2008/101/EC, which was adopted in November 2008 and entered into force in February 2009, had the aim of including aviation activities in the EU ETS from 2012 onwards. In order to comply with the Directive, airline operators will have to return allowances equivalent to their certified emissions in the previous calendar year.

The currency to be used in the EU ETS with respect to emissions from aircraft operators are EU Aviation Allowances (EUAAs). One EUAA can be surrendered with respect to 1 metric tonne of carbon dioxide equivalent verified emissions. It should be noted however that it will not be possible to use allocated EUAAs on other emissions trading schemes, as these allowances are not recognised for Kyoto compliance, so other sectors will not be able to use them.

The allowances that airline operators will be able to surrender are:

- "Aviation" allowances, known as EUAAs;
- Joint Implementation (JI) or Clean Development Mechanism (CDM) Credits issued by Kyoto Protocol flexible mechanisms, respectively ERUs and CERs, whose utilisation is limited (to a maximum of 15% of verified emissions in 2012 and with an allowed minimum of 1.5% of the verified emissions for the 2013/20 period); and
- Allowances allocated to other EU ETS sectors, known as EUAs (European Union Allowances).

## Auctioning of EUAAs

The quantity of EUAAs to be auctioned will be much smaller than the number of EUAs to be auctioned under the EU ETS. 85% of the EUAAs will be allocated for free and many commentators anticipate that potential hedging needs (for airlines to purchase the remaining allowances that they will need to surrender) can be satisfied by supply of EUA forwards and futures.

The primary market for trading of EUAAs will be through auctions of EUAAs, although the auctions of EUAAs will be less frequent than the auctions of EUAs due to their restricted use, as they can only be surrendered against emissions from aviation operators only.

## Carbon Price and Opportunities for Trading

The EU ETS has put a price on carbon emissions and emissions from installations in the scheme have been falling as intended - which some commentators claim is more to do with the recession than the operation of the EU ETS. The changes to be introduced in 2013, notably a progressive move towards auctioning of allowances, are intended to further enhance its effectiveness.



However, one of the biggest problems the scheme has had so far is that the limit on carbon allowances has arguably been set far too high and is not a significant enough driver to encourage behavioural change and reduction of emissions.

The carbon price has fallen by more than 40% since June 2011 and commentators have stated that this is partially due to the surplus and growing supply of carbon allowances, the recession and the ongoing eurozone sovereign debt woes and fears for a second, deeper recession. UBS has also said that they expect EUA prices to fall to €5 in 2012/13, with the possibility they may lapse to as low as €3.

By the end of November 2011 benchmark December 2011 futures contracts were trading at €9.05 on ICE Futures Europe. UBS has also pointed to incoming Phase III EUAs via European Investment Bank (EIB) auctions of the so-called New Entrant Reserve (NER) 300 - as the bank has been tasked with selling 300 million EUAs from the pool for new installations joining the EU ETS from 2013 - which will again influence prices.

These factors mean that even aside from the financial stability in the eurozone, there will be a poisonous combination of factors affecting the price of the various carbon credits that can be used by airlines:- including, looming auctions by the EIB, increased supply of CERs from projects, sales of allowances held by governments in Phase II NERs and a flood of ERUs issued by Russia and Ukraine.

In the face of all of these different factors, airlines will need to take cautious steps in developing and documenting their optimal trading strategies for carbon allowances, to make full use of their quota of imported Kyoto offsets, such as CERs and ERUs, as well as EUAs.

## Use of International Credits

As mentioned above, in addition to EUAAs, airlines will be able to use credits issued by the Kyoto Protocol flexible mechanisms (JI and CDM), as well as EUAs, to fulfil their surrender obligations under the EU ETS, subject to certain limits.

Until recently, there has been a real difference between the price of EUAs and CERs that can be used in the same compliance period. This has led organisations participating in the EU ETS to negotiate spot or forward trades of EUAs for CERs, to use surrender of Kyoto project credits to gain a financial advantage.

Airlines will need to ensure that they carefully watch the prices of different carbon credits they can surrender to fulfil their compliance obligations and employ appropriate hedging strategies, in the same way as they do for fuel.

### Restrictions on Use of Carbon credits

Under the EU ETS there are restrictions on the use of specific credits from project types, and the limits are set according to Article 11a (9) of the Directive<sup>2</sup>. From the start of the EU ETS in 2005 full use restrictions have been applied in the EU ETS to CERs from projects at nuclear facilities and from projects in agriculture and forestry (so-called LULUCF).

As of 1 January 2013, CERs (from CDM projects) and ERUs (from JI projects) involving the destruction of trifluoromethane (HFC – 23) and nitrous oxide (N2O) emissions from adipic acid production will be prohibited in the EU ETS. An exception is made until 30 April 2013 for destruction from existing projects that is credited before 1 January 2013.

At the time of going to press, the European Commission was not considering any additional use restrictions.

The use restrictions on CERs and ERUs from projects mean that airlines need to be careful in their trading documentation to only purchase carbon credits that they will be able to use on the EU ETS. This requires specific drafting provisions in the relevant documentation.

There have also been problems with stolen allowances and fraudulent activities under the EU ETS and airlines will need to ensure that suitable protections are inserted into documentation – for example, to cover situations where organisations have purchased allowances that have been previously surrendered under the EU ETS.

### Costs of Joining the EU ETS

According to analysis released by Thomson Reuters Point Carbon and RDC Aviation (the leading independent consultancy in aviation data modelling), the cost for airlines of joining the EU ETS in 2012 could be as high as approximately €1.1 billion using a carbon price of €12 per tonne.

The European Commission is expected to issue 176 million allowances to airlines for free for the year 2012. However, airlines are forecast to need to buy a further 88 million allowances, worth more than €1 billion.

According to analysis by RDC Aviation, all scheduled carriers are to receive 56% of the allowances they need. However, the airlines in this scheme are treated very differently by the process of allocating allowances for free. Scheduled carriers get



between 20 and 100% of the allowances they will need in 2012. Some will have a very small shortfall, while others will have to buy nearly everything they need.

For example, the 27 flag-carriers in the European Economic Area (EEA) will receive, on average, 61% of what they need. However, the larger European flag carriers with substantial long-haul networks fare better: France/KLM, British Airways, Lufthansa and Iberia on average will be allocated 81% of what they need in 2012. This is a smaller relative burden than that faced by their counterparts in the US and China.

Nevertheless, looking at the sums of money involved, even on the much reduced carbon prices discussed above, the cost to the airline industry will be substantial and risk management will need to include hedging and futures contracts for relevant carbon allowances.

### Registry for Trading Carbon Allowances

The registries system composed of the EU ETS registries and the Community Independent Transaction Log (CITL) has been operational since January 2005 and is at the core of the EU ETS. The registries system ensures the accurate accounting of all allowances issued under the EU ETS and keeps track of the ownership of allowances in the same way as a banking system keeps track of the ownership of money.

Allowances are held in accounts in electronic registries administered by the Member States (the EU ETS registries). Each EU Member State plus Norway, Ireland and Liechtenstein has a national ETS registry. The registries are online databases that in summary record: the allowances assigned to each Member States; accounts in which they have been allocated (held by a company or a physical person); transfers of allowances; annual verified carbon dioxide emissions from installations; and annual reconciliation of allowances and verified emissions.

The CITL records and authorises all transactions that take place between accounts in the EU ETS registries. This verification is done automatically and ensures that any transfer of allowances

<sup>2</sup>Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for GHG emissions allowance trading within the community as amended.

from one account to another is consistent with the ETS rules. At present, the national registries are connected to the CITL through a central hub operated by the Secretariat of the United Nations Framework Convention on Climate Change, called the International Transaction Log (ITL).

The revised ETS Directive adopted in 2009 provides for the centralisation of the ETS operations into a single EU registry. This new registry will be operated by the Commission and will replace all EU ETS registries currently hosted in the Member States. All transactions taking place in the registry, which is used by more than 25,000 end-users (e.g. operators, traders) will be subject to the approval of the European Union Transaction Log (EUTL), the successor to the CITL.

## Trading by Airlines on the Registry

Following consultations with Member States, the Commission has decided to activate the single registry in two steps. In a first step and as of 30 January 2012 the single registry will be partially activated in order to allow airlines to open registry accounts and receive free allowances by the end of February 2012. The full activation of the single registry, including the transfer of existing accounts from national registries, will not take place before June 2012.

For airlines, this means that they will have a separate and activated single registry for a number of months before the other operators participating in the EU ETS that are not airlines, join that registry. Consequently, in order to trade EUAs, CERs or ERUs with aircraft operators during the interim period, it will be necessary for those aircraft operators to open separate accounts in one of the National Registries.

It is expected that the allocation of free allowances for 2012 to operators in February 2012 will be followed by the reporting of verified 2011 emissions by operators in March 2012 and the surrender of allowances by operators in April 2012, as well as the final compliance checks in May 2012.

In practical terms, this means that airlines will need to organise themselves to open their registry accounts as quickly as they can, ready to receive their free allowances and commence trading.

## Key Questions for Airlines

Companies looking at their participation in the EU ETS from 1 January 2012 need to consider a range of key questions, such as:

- Whether to participate directly in trading themselves, or via a bank;
- Which platform should they use for trading and what languages and laws are most appropriate for their trading documentation;
- How often they should participate in the auctions for EUAAs;



- How airlines will manage their cash flows for purchase of allowances as against monitoring of emissions, through the course of each compliance year;
- The optimum time for buying EUAAs on the market, as there is obviously a cash benefit to buying later in the year, but potentially more price difficulties as one approaches a surrender date;
- How the airline will manage its allowances purchased against its ongoing emissions;
- How the airlines will book their allowances and where will these costs sit for financial purposes;
- When to sell surplus allowances, or should it bank these over between Phase II and Phase III (from 2012 to 2013);
- Will new credit lines be needed by the bank for trading of carbon allowances;
- When should the banks use international credits such as CERs or ERUs;
- What controls are in place to ensure purchase of eligible CERs or ERUs;
- When would it be sensible to use EUAs as opposed to international project credits or EUAAs – depending on the price fluctuations between the different credits;
- Should the airlines consider investing in emissions reductions projects that generate international project credits;
- How will the airline keep up with regulatory changes affecting the EU ETS;
- What trading documentation does the airline need to have in place for its forward trades and hedging activities; and
- How will the trading documentation be updated to take account of regulatory changes.

## How can Burges Salmon Help?

Burges Salmon works with buyers and sellers of carbon credits in the compulsory and voluntary carbon markets to document their trades, manage risks appropriately and assist with associated activities. We can draw on our considerable experience and track record to help guide airline companies through the complex web of emissions trading regulation, look at implications for each operator of their inclusion in the EU ETS and discuss creative solutions to tackle issues that arise.

Key legal matters we could help airline companies address include:

- Drafting trading documents to put in place optimal trading strategies;
- Including controls in trading documents to ensure protection from purchase of carbon credits that are not eligible for use on the EU ETS;
- Advice on regulatory changes affecting the EU ETS;
- Adaptation of standard trading documentation to reflect the key regulatory changes;
- Assistance with documentation for projects to generate carbon allowances;
- Advice on allocations of carbon allowances under the EU ETS; and
- Advice on eligibility of various carbon credits under the EU ETS.

## Conclusion

The European Commission has decided to include aviation in the EU ETS from 1 January 2012 and the legal challenges brought by various airlines have not yet reached a conclusion by way of a judgment from the ECJ.

In the absence of clarity on next steps in the form of a judgment, airline operators will have to operate on the basis that they will be included in the EU ETS. Operators will have to surrender one allowance per tonne of carbon dioxide emitted on a flight to and from (and within) the EU. This will cover passenger, cargo and non-commercial flights and applies no matter where an operator is based – non-EU carriers will also need to comply with the scheme.

Airlines will be able to use EUAAs, CERs and ERUs, as well as EUAs to achieve compliance, subject to quantitative restrictions.

The European Commission is expected to issue 85% of the necessary EUAs to airlines for free, however they will need to make up the remaining balance through purchase of other carbon allowances – whether more EUAAs, credits from Kyoto Protocol flexible mechanisms (CERs and ERUs), or EUAs.

Analysts such as Thomson Reuters Point Carbon and RDC Aviation speculate that purchase of this remaining balance of carbon credits could cost airlines as much as approximately €1.1 billion using a carbon price of €12 per tonne, or a total of €10.4 billion between now and the end of 2020.

It is expected that long haul carriers will generally face the biggest shortfall in allowances and the highest costs arising from the EU ETS, with freight and fast growing carriers likely to face proportionally larger shortfall. Coupled with the administrative burden of participating in the EU ETS, including installation of data collection and other carbon-related systems, all airlines will face some form of a compliance cost burden.

With this information in mind, it will be essential for airlines to ensure that they have developed optimal trading strategies for carbon allowances and have appropriately drafted legal documentation to achieve the best protections they can as they enter this carbon trading market. Burges Salmon can assist with this process and help airlines to understand the complex regulatory web that governs the EU ETS.

## Further Information

Burges Salmon has a dedicated cross-departmental Carbon Law Team which is familiar with the sector and has practical experience of emissions trading issues. To discuss any of these issues further, please contact:



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