

## Turbulence in the EU ETS – a practical overview of the EU ETS for aircraft lessors and lenders

The start of the Year of the Dragon has seen the PRC government formalise its opposition to the imposition of the EU Emissions Trading Scheme ("**EU ETS**") upon foreign airlines flying to and from the EU. On 6 February, under instructions from the State Council, the Civil Aviation Administration of China ("**CAAC**") issued an order to PRC airlines prohibiting them from participating in the EU ETS, without prior governmental approval, and from increasing ticket prices and other charges to cover the cost of the EU ETS.

Further, on 14 February, the US enacted the "FAA Modernization and Reform Act of 2012" (the "**FAA Act**") which includes a clear congressional statement opposing the extra-territorial reach of the EU ETS and advising the government to use "all political, diplomatic and legal tools" at its disposal to ensure the scheme is not applied to US registered aircraft or to the operators of such aircraft.

Against this background, we highlight key considerations for operating lessors and other financiers of aircraft leased to non-EU airlines operating EU routes.

### Aviation EU ETS Framework<sup>1</sup>

As a reminder, this is a "cap and trade" system, under which operators must surrender allowances equal to the tonnes of CO<sub>2</sub> emitted. Allowance caps are set by the EU for specific compliance periods, on a declining basis. For aviation, the caps are a percentage of historical aviation emissions – for example, for the period from 1 January 2012 to 31 December 2012 (the "**2012 Period**"),

the total allowance for aviation is 97% of such emissions. The next allowance period within the overall EU ETS is an 8 year period from 2013 to 2020 (the "**2013-2020 Period**") for which the aviation allowance cap is 95% of historical emissions.

Operators receive a certain number of allowances free each year; and they must obtain additional allowances to cover any shortfall against their actual emissions by purchasing them from government auctions or from other market participants through the trading scheme, or by taking steps to reduce their emission levels (e.g. by replacing older fleet aircraft with newer fuel efficient models) to avoid having a standstill. A percentage of

the total allowances will be reserved for new entrants and for airlines whose activities increase significantly over a certain period.

#### Scope

The EU ETS applies to emissions from flights which depart from or arrive at an EU airport, even if the operator is not EU licensed or the flight is not wholly within the EU, i.e. international flights are caught. There are limited exceptions, including flights by commercial operators that perform worldwide (a) fewer than 243 flights per 4 month period for 3 consecutive periods or (b) flights with annual emissions lower than 10,000 tonnes; and light aircraft, military or emergency flights.

<sup>f1</sup> Our client briefing "[Clearer Skies: Aviation and the EU ETS](#)", September 2008, explains the scheme in detail

## Key requirements and deadlines

### Provision of historical data to qualify for free allowances – 31 March 2011

An operator may apply to the relevant agency in its administering Member State<sup>2</sup> (the "**Administering Agency**") for free allowances. The application requires the airline to submit historical tonne-kilometre data for its aviation activities in respect of a set "monitoring year". This data assists the Member States and the European Commission in setting allowance caps and the amount of allowances to be allocated, auctioned and to be reserved.

Although only aviation emissions from qualifying flights operated since 1 January 2012 (i.e. the start of the 2012 Period) fall within the scheme, the monitoring year for the 2012 Period was 2010 and the application deadline for free allowances was 31 March 2011. For the 2013-2020 Period and for subsequent periods, the monitoring year is the year ending 24 months before the start of the relevant period (i.e. 2010 for the 2013-2020 Period) and the application deadline is 21 months before such date. This means that the application deadline for the 2013-2020 Period was also 31 March 2011.

We assume that any airline with EU operations has already provided this

data for the 2012 Period and for the 2013-2020 Period by last year's deadline, in order to obtain free allowances. The administering Member States have already informed operators of their annual allocations and are required to distribute their free allowances by 28 February of each year.

### Annual reporting requirements – 31 March

Each operator must monitor and report its annual emissions to its Administering Agency according to a prescribed methodology; these requirements have applied to aviation emissions since 1 January 2010. If a report has not been verified as satisfactory by 31 March for emissions in the preceding calendar year, an operator will be prevented from selling allowances until such verification.

### Surrender of annual allowances – 30 April

The first deadline for surrendering allowances against emissions from the 2012 Period is not until 30 April 2013 (and thereafter, the annual deadline will be 30 April for emissions in the preceding compliance/calendar year). Failure to surrender sufficient allowances gives rise to an "excess emissions penalty" of €100<sup>3</sup> per tonne of surplus CO<sub>2</sub> and the shortfall is carried over to the following year.

### Operating Ban

The Administering Agency may ask the Commission to impose an operating ban on an airline for continued non-compliance, where other enforcement measures have been unsuccessful.

### UK Regulations – civil penalties and detention and sale powers for enforcement

Each Member State may impose additional measures at a national level. For example, the UK implementing regulations<sup>4</sup> prescribe civil penalties for non-compliance, in the form of initial fines ranging from £500 to £3750 per breach and daily fines for continued failure, subject to certain maximums. The total cost for a defaulting operator could exceed £150,000.

The UK regulator also has the power to detain an aircraft operated by an airline which has failed to pay a civil penalty for 6 months or which is subject to an operating ban. Subject to certain conditions (including notifying all interested parties), the UK regulator can apply to court to sell the aircraft.

### Lease obligations

Since the extension of the EU ETS to include aviation activities, most aircraft leases will have been drafted to include a specific obligation on the lessee to comply with the requirements of the scheme (an "**EU ETS Compliance Clause**"), particularly where the lessee was an EU registered airline or the leased aircraft was intended to operate on EU routes. Even if the lease involves a non-EU airline and the subject aircraft is not on an EU route, it may be helpful to include a specific lessee obligation to comply with the EU ETS "if applicable", to cover the situation if the airline is flying other aircraft on EU routes.

Otherwise, there should be a general lease provision regarding "compliance

<sup>2</sup> For a non-EU registered airline falling within the EU ETS, its Administering Agency is the relevant authority in the Member State with the highest emissions from that airline's departures from EU and arrivals into EU in 2006 or, for new entrants, in their first year of applicable operation. The list of operators and their administering Member State is set out in EC Regulation 394/2011.

<sup>3</sup> N.B. for airlines where the UK is the administering Member State, the sterling equivalent of €100 according to a set conversion formula

<sup>4</sup> Please refer to our client briefing "[Implementation of EU ETS Aviation Scheme in the UK – a new aircraft lien?](#)", May 2009

with all applicable laws and regulations" (a "**General Compliance Clause**"), although financiers should check whether the General Compliance Clause is limited to the leased aircraft or subject to a "materiality" threshold in terms of the effect of non-compliance on the lessee's obligations.

It is also worth noting that, as the legislation looks to the owner of the aircraft where the operator is not known or not identified by the owner, most aircraft leases since the scheme extension include a specific covenant from the lessee undertaking to identify itself as the operator to its Administering Agency.

While the 30 April 2013 deadline for surrender of allowances for the 2012 Period is clearly a milestone date for compliance with the EU ETS, lessors and lenders should note that the scheme's monitoring and reporting requirements are already "live" (and have been for some time) and already fall within the airline's lease obligations described above.

### PRC Case

The CAAC order now puts those PRC airlines with EU operations in a challenging situation. In following the order, a PRC airline which has entered into a lease of an aircraft which it is operating to and from any EU Member State will be unable to satisfy any EU ETS Compliance Clause in the lease.

The recent meeting in Moscow of 26 non-EU countries opposing the EU ETS highlighted the risks that measures, such as those taken by the PRC, may be replicated in other countries, with Russia taking a significant role to promote further and alternative measures.

If the lease only has a General Compliance Clause, a contradictory

situation may arise as the airline could argue that compliance with the CAAC order actually meets this clause, if the order can be interpreted as an "applicable law or regulation". While the CAAC order is not a "law" or a "regulation", it is an administrative order given by the CAAC (a ministry-level organ of the state) that is binding on all PRC airlines. The conflict between the CAAC order and the EU ETS legislation (which the European Court of Justice has held to be valid under applicable international law<sup>5</sup>) is a complex matter of international law which is unlikely to be addressed by the lease terms.

### US Case

In contrast, the FAA Act does not prohibit US airlines (or operators of US registered aircraft) from complying with the EU ETS, therefore, at present, any such airline should be complying with any applicable EU ETS requirements and thereby satisfying any lease obligations in respect of the scheme.

### Illegality

Aircraft leases and other financing documents will typically provide for termination of the lease (or relevant agreement, as the case may be) where the lessee (or other obligor) is unable to perform its contractual obligations, on the basis that such performance would be unlawful. Such an illegality provision usually requires a change in law to have occurred since execution of the lease and the definition of "Change in Law" will differ across transactions.

### PRC Case

A PRC lessee may seek to claim illegality as a defence to non-performance of any EU ETS Compliance Clause or General Compliance Clause, on the basis that it is bound by the CAAC order.

### Lessor and Financier Considerations

In such circumstances, the lessor and any financiers will need to consider if the illegality provision has been triggered, depending on the specific lease terms, and whether they wish to terminate the lease or if they can allow it to continue while the situation between the PRC (or any other country adopting a similar approach) and the EU develops.

The risk of the operating ban and any other national measures, such as the UK detention power, being imposed should be factored into their risk assessment. In respect of the latter, the UK regulator must release a detained aircraft if the defaulting operator or *any other person claiming an interest in the aircraft* demonstrates to the satisfaction of the regulator that the operator is no longer entitled to possession of the detained aircraft or of any part, including by virtue of *termination of a lease of the aircraft*.

The liability to surrender allowances and to meet the other EU ETS obligations lies with the operator and, therefore, the lessor and any financier should not be held liable for the lessee's non-compliance (provided that the lessee is clearly identified as the operator). Further, EU ETS liability does not attach to the aircraft and should not affect its residual value. Given this insulated position, a lessor or financier might take a pragmatic view of the situation and simply buckle up and wait out the storm.

<sup>5</sup> Please refer to our client briefing "[EU Aviation Emissions – ECJ decision on US airlines' case](#)", December 2011

## Contacts



**Nick Swinburne**  
Partner

E: [nick.swinburne@cliffordchance.com](mailto:nick.swinburne@cliffordchance.com)



**Peter Zaman**  
Partner

E: [peter.zaman@cliffordchance.com](mailto:peter.zaman@cliffordchance.com)



**Paul Greenwell**  
Partner

E: [paul.greenwell@cliffordchance.com](mailto:paul.greenwell@cliffordchance.com)



**Katherine Ke**  
Registered Foreign Lawyer

E: [Katherine.ke@cliffordchance.com](mailto:Katherine.ke@cliffordchance.com)



**Marisa Chan**  
Senior PSL

E: [marisa.chan@cliffordchance.com](mailto:marisa.chan@cliffordchance.com)

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