CORSIA Creates Compliance Complexities for Aviation Financiers

By Jordan Labkon and Barry Moss

The airline industry has generally welcomed the International Civil Aviation Organization’s (ICAO’s) new carbon offsetting scheme, which went into effect on January 1, 2019. However, the scheme’s Standards and Recommended Practices (SARPs) impose an immediate compliance obligation on international airlines and raise a number of potential risks for aircraft financiers and lessors.

In June 2016, the 39th Assembly of ICAO agreed to adopt a global market-based measure to control aviation carbon dioxide (CO2) emissions. This scheme is referred to as the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA). On June 27, 2018, ICAO’s Council adopted the first edition of Annex 16, Volume IV, which details the international SARPs for CORSIA. Ultimately, over 700 aircraft operators worldwide will be required to comply with various aspects of the scheme.

This article first describes the requirements of CORSIA and discusses the process of incorporating those requirements into the national laws of ICAO member states. Next, the article examines risks and challenges for aircraft owners and lessors posed by CORSIA, and particularly the risks associated with individual national government enforcement of CORSIA. The article concludes that while CORSIA commands widespread support, the scheme presents significant risks and uncertainties that have not yet been resolved.

CORSIA’s Requirements
Effective January 1, 2019, all operators not otherwise exempt from CORSIA with annual emissions exceeding 10,000 metric tons of CO2 are required to record and report emissions data for their international flights on a yearly basis. Operators also must submit an emissions monitoring plan by February 28, 2019. Annual emissions reports and emissions monitoring plans must be submitted by an operator to its ICAO contracting state regulator even if the contracting state has opted not to participate in the voluntary phases of CORSIA. The reported data will form the baseline for calculating compliance requirements during the voluntary and compulsory phases of the scheme (see fig. 1).

Under the monitoring, reporting, and verification (MRV) phase (2019–2020), all aircraft operators must submit an emissions monitoring plan no later than February 28, 2019, and report their 2019 and 2020 emissions to their ICAO state regulator by May 31, 2020, and May 31, 2021, respectively.

Incorporation of SARPs into National Law
ICAO expected most of its 192 member states to implement the SARPs into their respective national laws without modification. CORSIA contracting states were given until October 22, 2018, to file disapproval of the SARPs and were also required to file any differences to ICAO in transcribing the SARPs into their national laws by December 1, 2018. On November 21, 2018, the European Union (EU) Council instructed EU member states to file differences to ICAO concerning the lack of time available to transcribe the SARPs into EU law and also advising that certain differences currently exist between EU Directive 2003/87/EC and detailed rules adopted by the EU Commission, on the one hand, and CORSIA, on the other hand, particularly with respect to MRV requirements and offsetting requirements. The EU’s position created widespread concern that the SARPs will not be universally adopted, transcribed, or fully implemented by each contracting state. This could potentially result in a patchwork of different sub-rules,
regulations, and enforcement measures that may apply, and some contracting states may even simply fail to adopt, regulate, and/or enforce CORSIA at all.

Risks for Aircraft Owners and Lessors
CORSIA raises a number of potential and unforeseen credit, political, and reputational risks, not only for operators but also for aircraft owners and lessors. ICAO has yet to determine the types of carbon offset units that will be eligible under the scheme and whether grandfathering of existing offsets will be permissible. Any restriction concerning the type or vintage of eligible offsets may increase the cost of compliance and thus create an economic burden for many operators under CORSIA. The expected bottom-line impact of CORSIA compliance for airlines has attracted the attention of international credit rating agencies such as Moody's, which has stated that “growing carbon offset costs have the potential to become significant relative to operating profit,” estimating that “carbon costs have the potential to lower operating income by between 4% and 15% by 2025, and by between 7% and 35% by 2030, all else being equal.”

CORSIA compliance will present aircraft owners with several commercial and legal risks and challenges. One such challenge is to identify who will be responsible for compliance under the scheme where the operator of a flight has not been identified. The first line of inquiry is the ICAO designator, followed by the aircraft registration mark and holder of an aircraft operator certificate (AOC). If the ICAO designator and AOC holder cannot be readily established, CORSIA compliance will then fall to the aircraft owner identified in the aircraft registration documentation. Should an operator fail to submit an emissions monitoring plan and annual emissions reports, its CORSIA contracting state may not be able to identify the operator of an aircraft’s international flight activity or, consequently, the party responsible for its emissions from such activity. Therefore, in such circumstances, CORSIA compliance obligations would automatically be attributed to the aircraft owner. Any such risk may become compounded for aircraft lessors and investors in asset-backed finance portfolio transactions.

Enforcement of CORSIA
ICAO lacks legal authority to enforce the CORSIA SARPs. This creates a risk that local governments and regulators may hold an aircraft owner responsible for CORSIA noncompliance. Each individual contracting state is responsible for transcribing CORSIA into its domestic law. While it remains unclear how (if at all) and when each contracting state will do so, states could pass laws allowing relevant government entities to impose a lien on, and seize and potentially sell, an aircraft pending cancellation of sufficient emissions offsets for the operator’s entire fleet—notwithstanding the rights of the aircraft owner or mortgagee. Such a law could be similar to the Eurocontrol fleet lien and applicable regulations in certain jurisdictions under the EU Emissions Trading Scheme (EU ETS). In addition, legal and financial consequences may arise should an operator fail to cancel a sufficient quantity of eligible emissions offset units to cover its existing obligations following an insolvency declaration.

Furthermore, current lease and loan documentation practices need to be reconsidered in light of the differences between compliance under the EU ETS and CORSIA. The EU ETS is subject to an annual reporting and emissions allowance surrender cycle. In contrast, while CORSIA will have an annual emissions reporting cycle, cancellation of emissions unit offsets, effective 2020, will be subject to a three-year compliance cycle. This longer cycle is likely to cause aircraft owners to accumulate much greater credit risk exposure. Requiring an operator, as a condition precedent under a lease or loan agreement, to deliver a CORSIA “letter of authority” permitting the relevant regulator to disclose the operator’s emissions obligations as a means for a lessor or mortgagee to monitor this credit exposure will likely have little if any value. It is presently unknown to what extent, if any, contracting state regulators will honor such letters of authority, as CORSIA allows aircraft operators to request regulators to keep commercially sensitive emissions data confidential. Moreover, until the three-year compliance cycle expires, the CORSIA regulator will not be able to confirm the level of an operator’s compliance and financial liability, by which time the damage (and potential exposure for the lessor or mortgagee) may be irreversible. Also, the price of eligible emissions units under CORSIA (measuring the cost of compliance) will not be known until the time of purchase by the operator, unless an operator hedges its CORSIA exposure through a forward contract with a carbon broker.

Should the EU decide to transcribe CORSIA as an annex to the EU ETS, then the existing enforcement measures for noncompliance, which is a statutory penalty of EUR 100 per ton of CO2, plus additional local fees, penalties, and the rights of aircraft seizure, detention, and sale may apply. Meanwhile, the United Kingdom is scheduled to exit the EU ETS in March 2019 and is currently considering its options, including whether to seek to negotiate with the EU to opt back into the EU ETS, or alternatively set up its own ETS or U.K. aviation carbon offset scheme for domestic and intra-European Economic Area (EEA) flights. The United Kingdom remains fully committed to CORSIA for international flights outside the EEA. Meanwhile, the uncertainties surrounding CORSIA could create challenges in disclosing climate change–related risks, trends, or factors in publicly listed leasing and finance company annual financial reports and offering memoranda for securitization transactions that require a credit rating.

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Conclusion
Given the plethora of potential risks and uncertainties under CORSIA, it is important that aircraft owners and financiers understand the basic functions of the scheme, monitor the evolving landscape of requirements and consequences of noncompliance, and consider implementation of risk mitigation measures in lease and loan documentation. While there is considerable momentum for commencing and implementing CORSIA as a global system for reducing aviation emissions, the scheme still presents many uncertainties and risks, but few clear solutions.

Endnotes
3. CORSIA uses the term “aeroplane operator.”
4. Operators subject to CORSIA’s technical exemptions are those (1) with annual emissions of less than 10,000 t/CO2, (2) operating humanitarian medical and firefighting flights, (3) operating military and state flights (presidential, customs, police, etc.), and (4) operating helicopters. Annex 16, Volume IV, supra note 2, at II-1-2.
5. According to the U.K. Department of Transport, 10,000 metric tons of CO2 is approximately equivalent to 4 million liters (1 million gallons) of JET-A aviation fuel.
6. ICAO uses the terms “contracting state” and “member state” interchangeably.
7. An “emissions monitoring plan” is a collaborative tool between the state and the aircraft operator that identifies the most appropriate means and methods for CO2 emissions monitoring on an operator-specific basis, and facilitates the reporting of required information to the state.
8. The first edition of ICAO’s SARPs (Annex 16, Volume IV) was adopted on June 27, 2018. Those parts of the SARPs that were not disapproved by more than half of all contracting states on or before October 22, 2018, became effective on that date and became applicable on January 1, 2019.
10. CORSIA uses the term “aeroplane owner.” The scheme only applies to fixed-wing aircraft and excludes rotor-wing aircraft.
11. For example, it is unclear whether carbon reduction emissions offset units created under the United Nations’ Clean Development Mechanism will be eligible for offset credit under CORSIA.
13. This is a three-letter call sign, but not all operators have such a call sign. See Annex 16, Volume IV, supra note 2, at II-1-2.
14. See id.
15. For example, under the U.K. Greenhouse Gas Emissions Trading Regulations, the U.K. Civil Aviation Authority has the right of seizure, detention, and sale of aircraft in the event of persistent EU ETS aviation noncompliance. However, liens are not applicable where an aircraft is owned by a lessor and liens are not transferable to a new operator of an aircraft that is subject to penalties (i.e., “follow the metal”).
16. The first CORSIA emissions credits are scheduled to be canceled on January 31, 2025.
18. This depends on whether the EU agrees that CORSIA meets the aims and criteria outlined in the declaration made at the European Civil Aviation Conference in Bratislava in September 2016. These include, among other things, that implementation is not delayed and the scheme applies to all states (unless exempted as specifically prescribed under CORSIA), that a review mechanism exists to ensure that environmental ambitions are increased over time and the global objectives of the Paris Agreement are taken into account, that special circumstances and capabilities of individual countries are taken into account, and that all operators on the same route are treated equally to avoid discrimination and market distortion. Declaration of Directors General of Civil Aviation of EU Member States and Other Member States of the European Civil Aviation Conference: Adhering to the Global Market-Based Measure (GMBM) Scheme from the Start (Sept. 3, 2016), https://www.icao.int/environmental-protection/Documents/2016-BRATISLAVA_DECLARATION.pdf.
19. EU Directive 2008/101/EC includes provision of an excess emissions penalty of EUR 100, which applies to each ton of carbon dioxide equivalent emitted for which the aircraft operator has not surrendered allowances. Payment of the excess emissions penalty does not release the operator or aircraft operator from the obligation to surrender an amount of allowances equal to those excess emissions when surrendering allowances in relation to the following calendar year. A similar penalty regime could also apply for CORSIA.
20. The United Kingdom will require aircraft operators reporting to the U.K. regulator to continue to comply with the EU ETS for the 2019 emissions compliance year.
22. Credit risk arising from CORSIA should be a factor in future rating agency modeling.