Aviation Group
Carbon Trading Bulletin

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This is the second in our series of bulletins that examine current issues relating to carbon emissions and climate change, and their impact on the Aviation industry. Following the primer on Carbon Trading included in our first bulletin, in this edition we provide information on Carbon Trading and Counterparty Risks.

The road to Copenhagen

Both China and the US now advocate cooperation towards a global agreement on climate change at Copenhagen in December 2009. Translating words into actions is the problem, but trends and consensuses are emerging.

In March 2009 President Obama launched the Major Economies Forum on Energy and Climate (MEF), intended to facilitate negotiations between the 17 largest economies that are responsible for 80% of the World's greenhouse emissions. The MEF meeting on 9 July found common ground on the "pillar" of mitigation, adaptation, finance and technology. A new global partnership was proposed under which different countries will focus on advancing specific types of clean energy technology. In August, the Chinese National People's Congress, its top legislature, approved a resolution supporting international negotiations to contain climate change.

At the UN climate change summit in September, the US pledged a 17% reduction in emissions by 2020 compared with 2005 levels, which is less than the EU's 18-29% or Japan's 30%. China is endeavouring to cut CO_2 emission per unit of GDP by a 'notable' margin but, like Brazil and Mexico, China continues to resist binding targets and limits. More recently, eight South Asian countries including India and Pakistan declared their refusal to be part of any climate change deal that sets legally binding limits on their emissions. In contrast, the US has stated that voluntary targets for fast growing countries such as China and India are not acceptable. While developing countries demand deeper emissions cuts from industrialised countries, developed countries demand firm promises to contain emissions growth from developing countries. Meanwhile, it is thought that if measures are not taken very soon, the Himalayan glaciers, which provide year-round water to over one billion people in China and India, will have gone by 2035; and that the USA's Glacier National Park will have no glaciers left by 2030 unless climate change is slowed.

There is, however, a growing consensus that developed countries will provide financial assistance to developing countries to adapt to climate change. The question is how much. In October, MEF leaders met for talks to discuss funding, and EU finance ministers met to agree an EU aid figure. They concluded that climate change would need €100 billion (£90 billion) funding a year by 2020, and declared that the EU would pay its 'fair share' provided there was reassurance on the money being sensibly spent.

Transport is increasingly under spotlights. The UN Secretary-General Ban Ki-Moon recognises the importance of addressing emissions and it seems clear that both aviation and marine transport sectors will be included. G8 leaders have set a target of 50% reduction of global aviation emissions by 2050, and on 21 October, EU ministers reached agreement on a 10% cut of aviation emissions by 2020 compared with 2005 levels, and shipping emissions by 20%.

ICAO set up the Group on International Aviation and Climate Change (GIACC) to draw up a plan for aviation. GIACC's final report of June 2009 recommends a global aspiration of a 2% annual improvement in fuel efficiency. It proposes that each state should comply with this goal by choosing the portfolio of measures that suits its circumstances. The proposed basket of measures covers aircraft-related technology development; improved air traffic management (ATM) and infrastructure use; more efficient operations; economic/market-based measures; and regulatory measures. The report acknowledges divergent views on substantial issues such as the extent of involvement of developing countries or the need for market-based measures. It recommends that the ICAO Council establishes a process to develop, expeditiously, a framework for market-based measures in international aviation, taking into account the conclusions of ICAO's High-level Meeting and the Copenhagen summit.

Whilst the aviation industry has defended GIACC's approach as being modest and realistic, it has left an intellectual vacuum as regards aviation. If there are special reasons why aviation needs special measures, they need to be spelled out and agreed on quickly if aviation is not to be dealt with along with the body of other carbon emitting activities. IATA is in practice leading the thinking for the aviation industry. We discuss their labours below.

In advance of the Copenhagen summit, first world leaders are seeking to manage the expectations of their counterparts in the developing world. Their message is that only a political consensus is likely to be reached in Copenhagen, with more work needed to turn consensus into a Treaty. In the meantime, the volume of editorial debate is increasing.

Three themes seem to be emerging. It seems widely expected that the endgame will include all forms of carbon emission; there is increasing discussion of the idea of a 'per person' cap on carbon emissions worldwide; and the mechanism used will provide a universal price for carbon use. A global cap-and-trade system, allowing less developed countries with spare 'per person' allowances to sell surplus allowances to those who want them, might be the result, though this approach would need measures to prevent giving incentives for population explosions.

Proposals from the aviation industry

Giovanni Bisignani, IATA's Director General, has recently presented the aviation industry's climate change strategy and targets to ICAO and Ban Ki-Moon. IATA proposes a four-pillar strategy based on technology, operations, infrastructure and economic incentives. They are committed to three targets: improving fuel efficiency by an average of 1.5% annually to 2020; carbon-neutral growth from 2020; and a 50% reduction of carbon emissions by 2050, compared to 2005 levels. IATA sees the use of economic incentives as a 'bridging' step until the full benefits of the other three pillars can be realised.

Not everyone in the industry agrees. The Air Transport Association of America (ATAA) believes that the fuel prices already provide incentives to minimise emissions, a position that seems to ignore the longstanding failure to price future environmental damage into current fuel prices. In contrast, the Association of European Airlines (AEA) advocates market based measures in conjunction with the other three pillars.

IATA predicts a 2% reduction in aviation's carbon footprint this year as a direct result of the four-pillar strategy, though the economic downturn may flatter the figures. Bisignani says that governments must also play their part. He claims that implementing more efficient air traffic management would save about 6.5% of aviation CO_2 emissions annually. Unfortunately, governments currently have little incentive to make ATM more efficient. More controversially, Bisignani claims that fuel from biomass could reduce aviation's carbon footprint by up to 80%.

The industry is, however, united on a global sectoral approach to reduce aviation emissions. This involves three main elements: that aviation's carbon emissions are accounted for at a global level, not by states; that aviation should be fully accountable for its carbon emissions and required to pay only once for these emissions; and that the industry has access to global carbon markets to offset emissions.

A global solution for aviation emissions is likely to have to balance the principle of non-discrimination between operators with a wish to allow differentiated responsibilities between countries at different stages of development.

The AEA proposal tackles this wish. The AEA suggests that countries are grouped into three blocs according to their maturity, each with different targets. Air carriers operating between two different blocs will be subject to the lower target. AEA favours a global, open cap-and-trade system for mature markets (Bloc A) with aviation companies trading allowances with other industry sectors. GIACC is warm to the approach but believes that ICAO lacks authority to implement it.

The Aviation Global Deal (AGD) Group, comprising leading international airlines, aviation sector companies and The Climate Group of general commercial companies, argues that all airlines should participate in an emissions trading scheme which is fully linked to the global carbon market. Individual airlines would be allocated allowances through auctioning and free allocation. Revenue generated from the auctioning of allowances would be distributed through relevant expert international bodies or funds to support climate change initiatives in developing countries.

Implementing the EU Carbon Trading Scheme for airlines

As with all Directives, 2008/101/EC (the "Directive") requires implementation by Member States. They are now putting into place the new laws required to make the EU Emissions Trading Scheme (ETS) apply to aircraft operators. Below we examine their implementation in the United Kingdom, but the same principles apply across the whole EU.

With the assistance of Eurocontrol, all aircraft operators that carry out 'aviation activities', have now been assigned to a Member State, following principles set out by the Commission. This list will be updated periodically.

The first of two tranches of implementation (Regulation No.2301/2009) came into force in the UK on 17 September 2009. This sets out requirements for UK operators to submit Monitoring Plans for CO_2 emissions and tonne-kilometre data for 2010. The regulator for England and Wales is the Environment Agency; for Scotland, the Scottish Environment Protection Agency; and for Northern Ireland, the Northern Ireland Environment Agency.

The second tranche is expected by February 2010, which is the date by which all Member States must have implemented the Directive.

Requirements for aircraft operators

UK operators must have applied to their regulator for an Emissions Plan by 12 November 2009. The plan will outline how the operator will measure its CO_2 emissions and cover many practical issues such as emissions sources, fuel consumption, assessment of uncertainties of measurement and a data flow diagram. Those wishing to apply for free allowances must also apply for a Benchmarking Plan by 31 December 2009 to set baseline emissions data.

Both applications must be accompanied by, amongst other things, a proposed Monitoring Plan and a fee. There is a system of penalties for failure to comply.

Assuming all is in order, the regulator will issue an Emissions Plan. From 1 January 2010, the operator must follow it in monitoring its aviation emissions. The results must be reported in an annual emissions report, which must be verified by an independent verifier by 31 March in the following year. Failure means exposure to more penalties.

There is a similar procedure for Benchmarking Plans. Verified benchmark data is expected to be submitted to the Commission by 30 June 2011, following which the Commission will publish its tonne-kilometre benchmark by 30 September 2011. Allocation of allowances for each operator will then be published by national regulators by 31 December 2011.

These requirements impose a significant burden on airline operators and it is expected that many operators will fail to comply fully with their requirements by the appropriate deadlines. Sources indicate that a substantial number of UK operators have not yet contacted their regulator for information on how to comply. Given that the deadline for applications for Emissions Plans was 12 November 2009, it is likely that many operators will be exposed to fines and failure to submit a compliant application could lead to loss of free allowances.

Although the size of fines may not be a significant deterrent for larger airlines, operators' requirements under the Directive and UK Regulations are ongoing and fines will continue to be imposed. Operators that have not already done so should obtain advice on how to design and put in place systems to satisfy the requirements in the most cost-effective manner.

Chris Walsh and Fred Vroom, with thanks to Rosalinda Tam and Robin Acworth

Carbon Trading and Counterparty Risks

Although the EUA is an intangible – the right to emit one tonne of CO_2 – it is effectively a standardised commodity and has become freely tradable. Since they represent value, parties to an EUA 'trade' are concerned with each other's ability to perform its side of the bargain.

As in any principal-to-principal transaction (known as an 'over-the-counter' (OTC) transaction), the seller takes the risk that the buyer will not pay the price, and the buyer takes the risk that the seller will not deliver the underlying object. Non-, or incomplete, performance may be due to many reasons attributable to either party: some deliberate, some not, some avoidable, some not. These risks are known as 'counterparty risk'. By trading on an exchange, counterparty risks are typically reduced. Exchange transactions can thus provide an attractive alternative to OTC transactions, and all the more so during troubled economic times.

Exchanges typically have three layers: the Exchange itself; its Members; and outsiders who wish to buy or sell the commodity on the exchange.

The rules of exchanges typically require Members to satisfy often stringent financial requirements. These may include balance sheet tests and requirements to put up cash collateral (such as initial deposits and margin calls) to the Exchange in respect of each trade. In addition, each Member typically agrees to make good a pre-agreed percentage of any insolvent Member's unpaid account.

All trade on an exchange is carried only between a Member and the Exchange itself. A typical trade between two Members will thus consist of two complementary contracts in which the two Members each contract with the Exchange. Outsiders (i.e. non-members) must contract with Members, who will in turn enter into a back-to-back trade, as principals, with the Exchange. A trade between two outsiders thus consists of four complementary contracts.

Exchanges and Regulators typically monitor the financial strength of exchange members on a continuing basis, and Regulators typically monitor the exchanges themselves. Through legal mechanisms known as netting and mutuality, and by their ability to match trades, as well as by initial deposits, margin calls, insurance and members' indemnities, exchanges are able to ensure that their solvency is protected in the case of the insolvency of one or more of its members.

For an outsider, counterparty risk is reduced to little more than the risk of the insolvency of the Member with whom they contract. In contrast, an OTC transaction may not be regulated, and the parties to OTC transactions need to consider counterparty risk every time they trade. Whilst this may be more attractive in the case of large, infrequent transactions between very substantial parties, it is usually a less attractive option.

In summary: exchanges have traditionally provided buyers and sellers of commodities, financial derivatives and (more recently) EUAs with a means of reducing the counterparty risk inherent to OTC transactions by limiting that risk to that of insolvency of the exchange member or, where the party is a member of the exchange, to that of the exchange itself.

Buyers and sellers of EUAs and CERs will find that exchanges trading those commodities will not only provide a market-place, but will also – and perhaps more significantly – provide a reduced level of counterparty risk that is easier to monitor.

If you have any questions about these issues, please contact:

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