UK DEFENCE CLUB

Soundings

Sulphur emissions - avoiding and minimising charterparty disputes

The forthcoming changes to the rules governing sulphur emissions contained in MARPOL Annex VI present technical, commercial and contractual challenges to shipowners.

- **Which party is responsible for additional costs?**
- **What amendments will need to be made to charterparty terms currently in use?**
- **How can shipowners deal with existing or future charterparties providing for redelivery after the rule changes?**

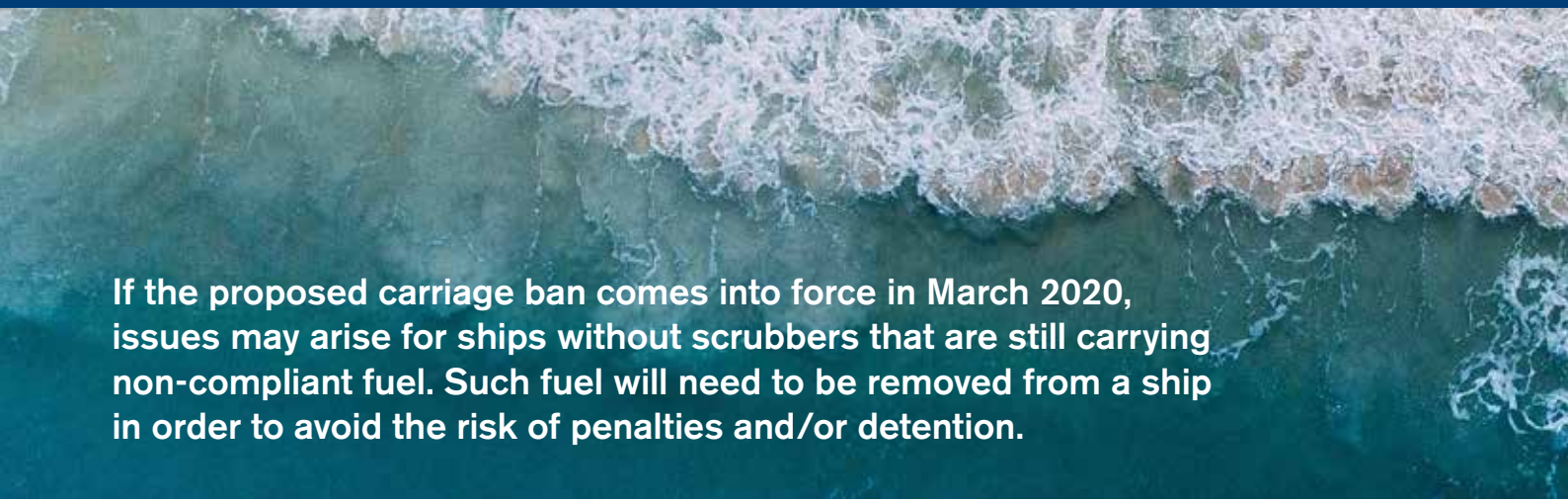
Timeline

Annex VI of MARPOL, which first came into force in May 2005, contains rules governing air pollution from ships. To that end, it regulates emissions contained in ships' exhaust gas, including sulphur oxides. A revised version of Annex VI came into force in July 2010, and in January 2015, the scheme was amended further to introduce Emission Control Areas ("ECAs") in which the sulphur emissions ceiling was reduced still further.

The current global limit for sulphur content of fuel oil is 3.5% m/m (mass for mass). The limit within ECAs is 0.1% m/m. From 1st January 2020, the global limit will be reduced significantly to 0.5% m/m and the ECA limit will remain in place. It is also possible (though not yet certain) that from March 2020, a ban on the carriage of fuel oil over 0.5% m/m will also come into force.

The proposed carriage ban is seen as an important means of enforcing the new sulphur limits. The new rules will be enforced by flag and port states: ships must be issued with an International Air Pollution Prevention (IAPP) certificate. Bunker delivery notes will also be required to evidence the sulphur content of delivered bunkers.

continued overleaf



If the proposed carriage ban comes into force in March 2020, issues may arise for ships without scrubbers that are still carrying non-compliant fuel. Such fuel will need to be removed from a ship in order to avoid the risk of penalties and/or detention.

Possible responses to the new rules

The new rules pose some tricky questions for shipowners. Traditionally, compliance with environmental regulations has been a matter for owners. However, responsibility for bunkers and their quality generally falls within charterers' remit. The new rules therefore operate in the border between owners' and charterers' traditional spheres of responsibility, and are likely to give rise to issues which are not expressly addressed by standard charter terms currently in use.

The first question facing owners is whether any modification or retro-fitting of ships will be necessary in order for ships to be able to operate in compliance with the new rules. The appropriate course will depend on a close analysis of many factors, including a particular ship's technical specifications, likely trading patterns and remaining working life. Broadly, though, the possible responses fall into three main categories:

- Require charterers to use compliant low-sulphur fuel. It is not yet clear, however, whether sufficient low sulphur fuel will be available on the market at commercially viable cost. Further, although this option involves no initial outlay, increased fuel costs may affect the ships commercial competitiveness and/or earning capacity.

- Switch to emerging or alternative fuels such as distillates, gas or LNG. This may require ships to be converted or retrofitted for use, and may also involve extra cleaning or other costs. The cost and availability of such alternative fuels is also an unpredictable element.

- Retrofit ships with exhaust gas cleaning systems ("scrubbers"). Such apparatus is recognised under MARPOL as a possible method of compliance. Cost and downtime are the obvious disadvantages, but there may also be contractual issues relating to, for example, responsibility for the cost or time of effluent waste removal and/or maintenance costs and downtime.

Seaworthiness

In some cases, failure to take steps to convert or retrofit a ship as necessary for compliance with the new rules could result in a ship being considered as unseaworthy or unfit for the chartered service. Where a charterparty was entered into before the new rules come into force, this may place an owner in breach of contractual obligations to maintain the condition of the ship: compare, for example, The Elli & The Frixos (2008 Lloyds Law Rep) in which a failure to comply with MARPOL rules governing the carriage of fuel oil, which came into force during the course of the chartered service, was held to amount to a breach of contract.

However, it is important to note that the issues presented by the new sulphur emissions rules are potentially more complex than those considered by the court in The Elli & The Frixos. In that case, the relevant MARPOL rules prohibited the carriage of fuel oil in non double-sided vessels. The ship was not double sided. It followed that she was not fit for the chartered service, namely the carriage of fuel oil, and could not be unless and until the ship was modified. Any performance of the contract would have involved a breach of the law. By contrast, there may be ships that are able to continue performing by simply switching to low sulphur fuel. The difficulty in such cases is not that performance is necessarily unlawful, but that performance has become more expensive (by virtue of fuel prices and possibly the need to re-fuel more frequently).

Insufficient availability of low sulphur fuel

Another situation in which a compromise might be the best outcome would arise where, although the ship is able to operate without conversion, there is insufficient low sulphur fuel available. In that case, the charterer (who is responsible for bunkering the ship) would bear the immediate risk of being unable to employ her: it would be difficult to argue that a lack of available fuel affected the ship's seaworthiness or fitness to perform, or meant that the ship was not at the charterer's disposal. However, there might also be an incentive in such a situation for an owner to seek to modify the ship so as to secure her longer term ability to trade. In such a case, the parties might well agree to share the costs of conversion.

Engine damage

The question of responsibility for engine damage resulting from the use of low sulphur (or possibly new or hybrid fuels) is not straightforward. Although it might naturally be assumed that a charterer must be responsible for such damage, which arose as a natural consequence of the bunkers it supplied, it might be argued in response that the ship is unseaworthy or not fit for service because she is unable to perform the chartered service, as contemplated

by the charterparty, without sustaining damage. The best course, therefore, would be to seek to address liability for costs and downtime associated with such engine damage in the charterparty terms.

If the proposed carriage ban comes into force in March 2020, issues may arise for ships without scrubbers that are still carrying non-compliant fuel. Such fuel will need to be removed from a ship in order to avoid the risk of penalties and/or detention. Again, it may not be entirely clear which party must bear the cost of removal and/or ultimate liability for any penalty: it will in most cases be arguable that this must fall for the charterer's account on the basis of express or implied rights of indemnity, but it will be preferable to put the matter beyond doubt by means of an express provision where possible.

Existing charterparties – what happens on 1st January 2020?

The distinction between "unlawful performance" on the one hand and "more expensive performance" on the other provides a helpful basic touchstone for assessing the parties' respective responsibility for compliance with the rules.

Ships not requiring modification

If it is possible to continue to operate a ship without modifying her, for example by switching to low sulphur fuel, then unless the charterparty expressly stipulates the %m/m or includes any other inconsistent term, there will be a strong argument that the charterer is obliged to absorb the extra costs of compliance with the rules by purchasing compliant fuel (and, if necessary, removing non-compliant fuel from the ship). This construction of a charterparty would be particularly compelling if the charterparty had been concluded in the knowledge (or deemed knowledge) that the rules governing sulphur emissions were likely to change. On that basis, it would be argued that the charterer must have contemplated that the cost of providing compliant fuels would increase over the term of the charterparty. Furthermore, it would be arguable, on the same basis, that the owner would become entitled to an indemnity in respect of any fine or penalty incurred as a result of the charterer's stemming of non-compliant fuels.

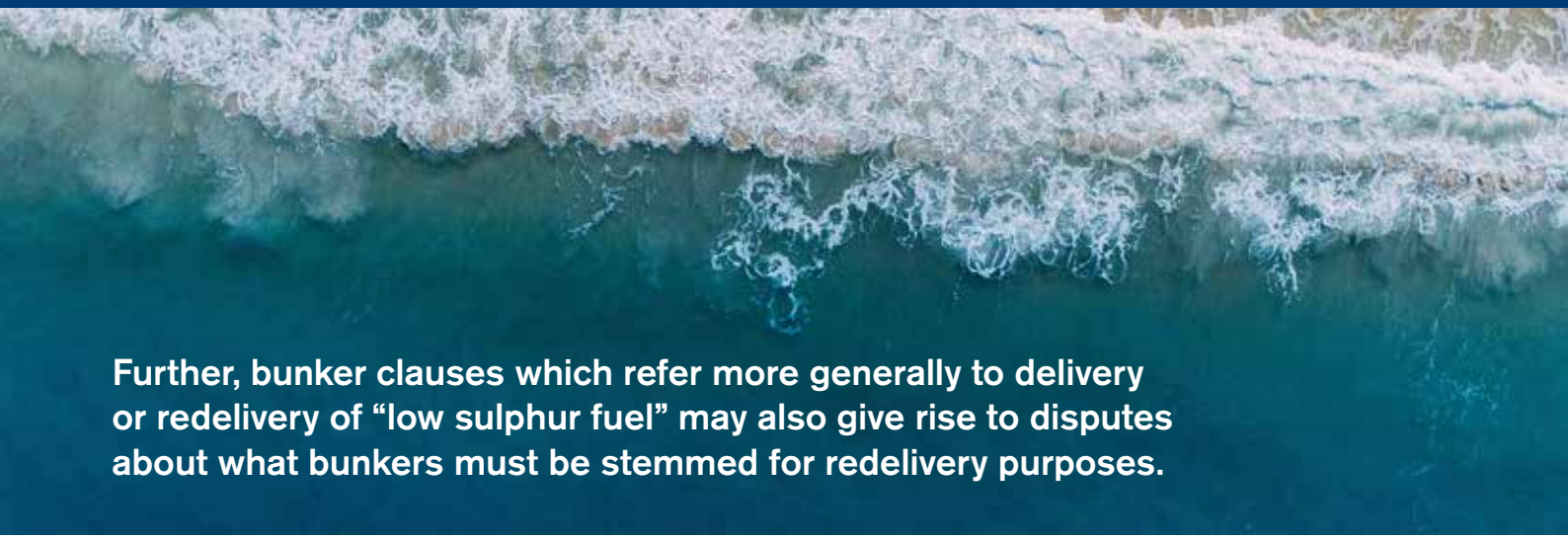
It would, of course, be necessary to check all the provisions of the charterparty to ensure that this conclusion reflected the intended overall allocation of risks/costs. For example, if the charterparty expressly stipulates the sulphur content of permissible fuels, or if the performance warranties are predicated upon the use of particular fuels, or if there is any other inconsistent provision, then the argument that the charterer is obliged to bear the cost of switching to the more expensive, compliant fuel may become more problematic.

Assuming, though, that the argument holds and that the ship can be operated successfully (albeit more expensively) by using compliant fuel, then the charterer would not be able to insist on the carrying out of modifications (for example, the installation of scrubbers) at the owner's expense. That would be the case even if the cost of such modifications was less than the aggregate costs of supplying compliant fuel. However, in such a case the owner might be in a good commercial position to reach an arrangement with the charterer whereby the cost of such modification (and of maintenance/operation adjustment to the hire rate). It would be important to ensure, in such a case, that the consequential costs (eg maintenance and cleaning of any new equipment, and/or associated loss of time) were also addressed in any addendum or amendment.

Ships requiring modification

If, by contrast, the ship is unable to operate without conversion, then the more likely conclusion is that the owner is in breach of the charterparty maintenance clause (as in The Elli & The Frixos). In such a case, the owner would be obliged to carry out modifications to restore the ship to the contracted-for condition, and to allow the chartered service to continue. In practice, this might involve, for example, the fitting of scrubbers. Again, and by parity of reasoning: the fact that this involves greater expense than was anticipated at the time of contracting is unlikely to matter in law. The owner has assumed the obligation of maintaining the ship's condition: if this requires remedial or conversion works, then that is what the owner must do, even if this involves financial outlay and loss of time.

However, the owner's' obligation would be limited to doing the bare minimum required to bring the ship back to the contracted-for condition: therefore, the charterer could not insist on any particular modification. Again, though, if the parties contemplate a long-term relationship, there may be scope commercially for some arrangement whereby



Further, bunker clauses which refer more generally to delivery or redelivery of "low sulphur fuel" may also give rise to disputes about what bunkers must be stemmed for redelivery purposes.

the charterer contributes to the cost of modifications – particularly if the effect of such will be to reduce its own expenditure on bunkers over a period of time.

Bunker clauses

Bunker clauses present some particular issues due to the differential in price between high and low sulphur fuels, and lack of accuracy in definition. Where the charter period straddles the pre- and post- change date, the cost of redelivering with compliant fuel on board may significantly exceed the cost of the (wholly or partly non-compliant) bunkers on board at delivery.

However, consistent with the principles discussed above, increased cost of performance does not usually excuse a party from performing the contract, and these extra costs should be absorbed by the paying party. Further, bunker clauses which refer more generally to delivery or redelivery of "low sulphur fuel" may also give rise to disputes about what bunkers must be stemmed for redelivery purposes. It is strongly arguable that such provisions must be interpreted consistently with the MARPOL regime in force at the date of redelivery, but such arguments are not failsafe and where, for example, stemming compliant bunkers may involve extra costs over and above the price differential between low and high sulphur fuel, an owner may need to contribute.

More detailed provisions may also be problematic: for example, where the bunker clause imposes detailed requirements relating to the specifications of bunkers rob on redelivery which fail to reflect the updated MARPOL requirements. What if the express terms of the charterparty require or allow the ship to be redelivered with non-compliant bunkers on board? In the case of ships without scrubbers, this might amount to a breach of the new carriage regulations potentially to be brought into force in March 2020. In such a case, the analogy of authorities on carriage of illegal cargoes suggests that the contract may become frustrated/impossible to perform, and both parties excused from further performance.

However, both the law on illegality and the remedies for frustration are notoriously complex and the outcome of any dispute would be difficult to predict.

The best response to all such situations may well be to agree an amendment to charterparty provisions to allow the speediest and most efficient redelivery. This will be particularly important where there is a risk of the ship being redelivered with insufficient compliant bunkers to reach a bunkering port.

Future charterparties

Owners will wish to ensure that as much of the costs of compliance as possible are placed on charterers. They may wish to consider:

- Specifying that charterers are responsible for compliance with the MARPOL rules, requiring the provision of compliant fuels, or stipulating detailed fuel specifications;
- Providing expressly for an indemnity in respect of costs/penalties/loss of time arising from breach of the rules;
- Ensuring that off hire clauses do not entitle charterers to claim off hire in respect of delays caused by the supply of non-compliant fuel and/or time spent operating, maintaining or using scrubbers, cleaning tanks, removing or segregating fuel;
- Amending any performance warranties if necessary, to reflect the use of compliant fuel; and
- Amending redelivery clauses to ensure redelivery with compliant fuels on board and/or sufficient compliant fuel to exit any ECA/ reach a bunkering port.

The Managers are in the process of drafting model charterparty clauses which can be made available to Members on request. If Members have questions or require any further assistance they should contact the Managers.

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