UK DEFENCE CLUB

The Impact of the EU Emissions Trading Scheme on Shipping

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Introduction

The Impact of the EU Emissions Trading Scheme on Shipping

The European Union Emissions Trading Scheme ("EU ETS"), launched in 2005, was the first large greenhouse gas emissions trading scheme in the world. It works on a 'cap and trade' principle: caps are set on the amount of greenhouse gases that can be emitted and companies can receive emissions allowances or buy them on the European Energy Exchange as needed. The intention is for the cap to reduce over time, encouraging greener business practices as the price of allowances increases as they become scarcer. In the context of shipping, this may mean increased use of renewable and/or low-carbon fuels, cold ironing (i.e. using shore power and turning off main and auxiliary engines) when ships are in port and, in general, employment of greener ships.

The EU ETS already applied to several sectors (e.g. aviation) and on 16th May, 2023 the European Parliament approved amendments to the EU Emissions Trading Directive (the "Directive"), bringing shipping within the scope of the EU ETS. The expansion of the EU ETS to include the maritime sector forms part of the EU's wider "Fit for 55" package, which aims to reduce greenhouse gas emissions by at least 55% by 2030 and achieve carbon neutrality by 2050. Other proposals in the package which relate to the maritime sector include measures to promote the use of alternative (low carbon and renewable) fuels.

How does it work?

From 1st January, 2024, ships of 5000GT and above which transport cargo or passengers for commercial purposes will be subject to the EU ETS (although the scheme could be extended to ships between 400GT and 5000GT in the future).

It will apply to all emissions produced during voyages between EU ports of call and those produced whilst ships are berthed in EU ports of call, irrespective of the flag of the ship. It will also apply to 50% of emissions produced on voyages which start or end at an EU port of call.

The Directive defines a port of call as the port where a ship stops to load or unload cargo or to embark or disembark passengers, or the port where an offshore ship stops to relieve the crew. The Directive also contains a list of port calls which are excluded from the scheme such as stops for the sole purposes of refuelling, obtaining supplies, relieving the crew (save an offshore ship) or going into dry-dock (please refer to the Directive for a full list of exemptions). Certain other voyages are also exempt, such as those by passenger ships between the mainland and islands of EU member states and voyages between "outermost regions" of a member state and a port of call within the same member state.

Shipping companies (as defined below) will be required to surrender enough allowances to cover 40% of the qualifying emissions they produce in 2024, rising to 70% of emissions produced in 2025 and 100% of emissions produced in 2026. This phased introduction is designed to help the maritime sector adjust to the new obligations.

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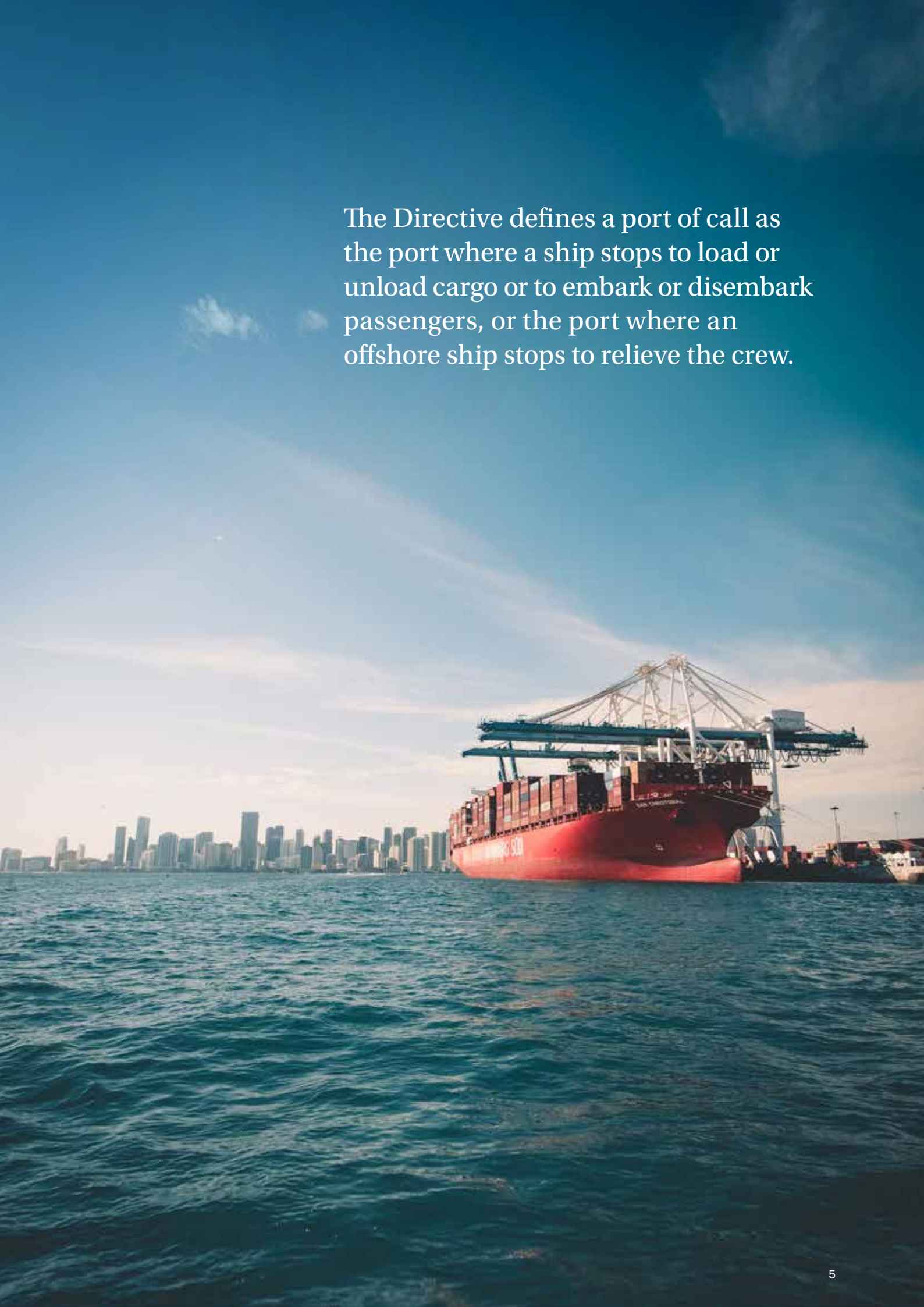


How does it work? (continued)

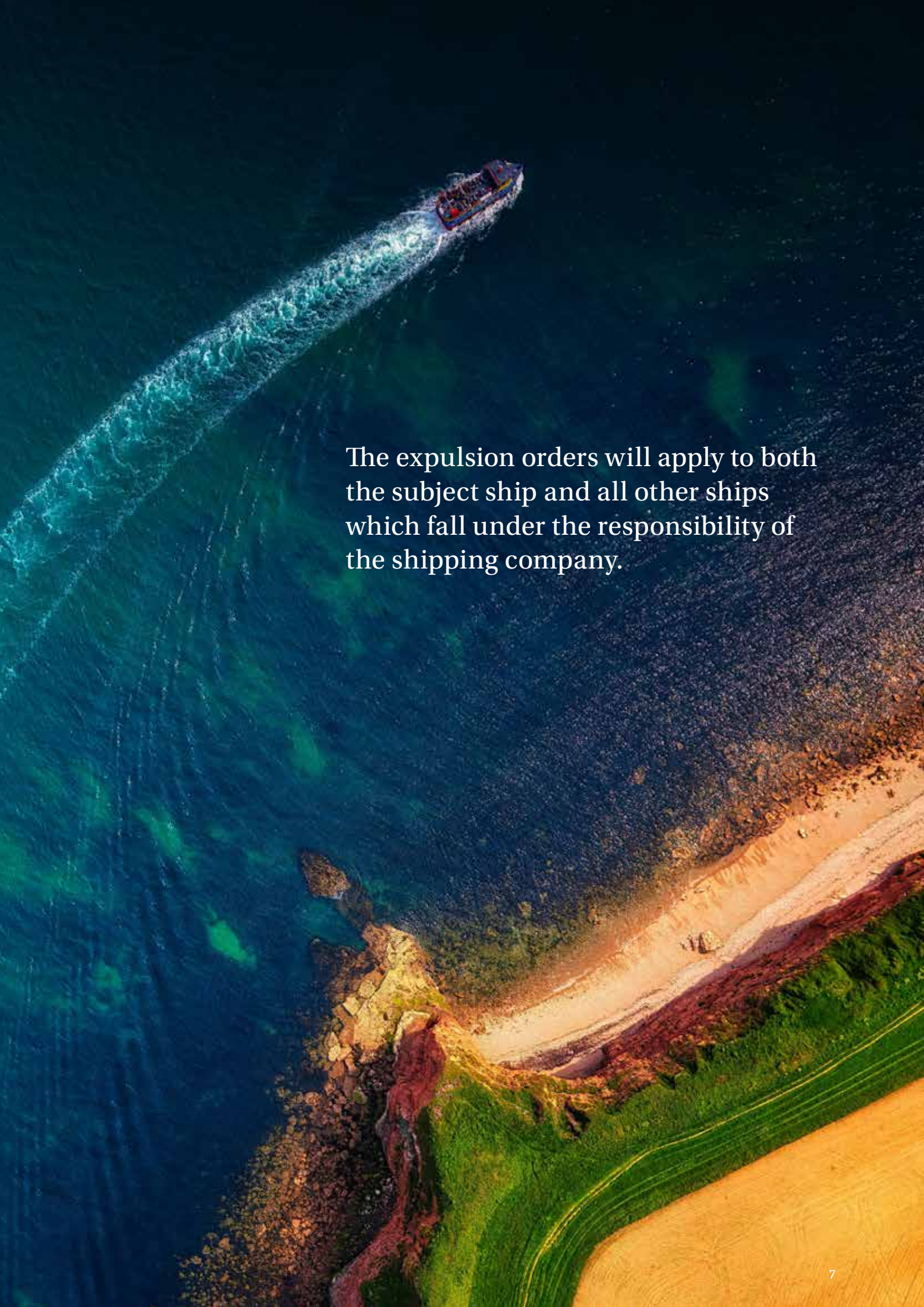
Initially, the scheme will only cover carbon dioxide emissions but will be extended to methane and nitrous oxide emissions from 1st January, 2026.

Each ship which calls at an EU port will have a designated 'shipping company'. The legislation defines 'shipping company' as "the shipowner or any other organisation or person, such as the manager or the bareboat charterer, that has assumed the responsibility for the operation of the ship from the shipowner", including taking responsibility for implementing the ISM code. Therefore the 'shipping company' could be the shipowner, bareboat charterer or technical manager. The precise identity of the 'shipping company' will be determined by the European Commission; however, it will not include time or voyage charterers.

If the shipping company is incorporated in an EU member state then that state will be responsible for administering the scheme for that company. If the shipping company is incorporated elsewhere, then the member state with the highest number of port calls in the last four monitoring years will administer the scheme. If this is not applicable then the member state where the ship first arrived at or started its first voyage will be responsible. The European Commission will keep a list of which member states are responsible for which shipping companies.

If a shipping company has spare emissions allowances, they can be kept for the future or sold to other companies. Whilst the price fluctuates, the cost per tonne of carbon dioxide produced has been above €80/t since 1st February, 2023. Conversely, if shipping companies fail to surrender enough allowances to cover the emissions produced in the preceding calendar year by 30th September the following year, then fines will be imposed based on €100 per tonne of CO2 equivalent emitted that has not been surrendered.

If a shipping company fails to do so for two consecutive calendar years then an expulsion order can be issued, allowing a flag state to detain its ships and other member states to deny the ship entry into their ports. Furthermore, the expulsion orders will apply to both the subject ship and all other ships which fall under the responsibility of the shipping company. This is particularly significant where the shipping company is a technical manager responsible for the compliance of a number of ships under separate ownership – the new rules could see ships being expelled for failures by completely unrelated ships which are managed by the same technical manager.



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Disputes might also arise out of a potential clash between obligations under the scheme and commercial obligations.

Implications for owners and charterers

It is apparent that the implementation of the EU ETS is likely to have a number of implications for both owners and charterers. Most significantly, the Directive applies the "polluter pays" principle i.e. those who produce pollution should bear the costs of managing it to prevent damage to the environment.

The Directive states that each member state will have to take the necessary measures to ensure that when the ultimate responsibility for the purchase of the fuel and/or the operation of the ship is assumed by a different entity to the shipping company pursuant to contractual arrangements, the shipping company is entitled to reimbursement for the costs arising from the surrender of allowances.

The Directive goes on to say that "operation of the ship" means deciding the cargo carried, the route taken and the speed used on a voyage. At this stage, it is not clear how this will work practically given that a significant proportion of charterparties are governed by English law, rather than the law of one of the EU member states.

How this will work in practice will also depend on how the Directive is implemented by the individual member states. Given this uncertainty, we recommend that Members consider incorporating express wording in their charterparties to set out the parties' responsibilities.

The BIMCO ETS clause

In order to assist the shipping industry, BIMCO has published its Emission Trading Scheme Allowances Clause For Time Charter Parties 2022 (the "**Clause**").

The Clause also follows the "polluter pays" principle to ensure that the costs of complying with the EU ETS and other emission trading schemes are passed from the owner to the time charterer by requiring the charterer to provide and pay for the emissions allowances corresponding to the ship's emissions.

The basic structure of the Clause is reasonably clear and in essence envisages that the party which provides and pays for the fuel under the time charterparty will be responsible for providing and paying for the allowances.

Under this arrangement, the owner will have to monitor the ship's emissions and provide to the charterer the relevant emission data and the basis of the calculations. The charterer will then use this data to transfer the required allowances to the owner on a monthly basis.

The BIMCO ETS clause (continued)

There are, however, a number of potential issues, which we consider further below.

i) Application / Definitions: The Clause applies to all emission schemes which regulate the issuance, allocation, trading or surrendering of emission allowances and is drafted in broad enough terms so as to cover methane and nitrous oxide when the EU ETS is expanded in 2026. Therefore, while it will currently apply to the EU ETS, it can also apply to other schemes which are in development, including in the UK and Japan.

ii) Sub-clause (a): The sub-clause requires owners and charterers to "co-operate" and "exchange all relevant data and information in a timely manner". This language does not impose strict deadlines. There is a risk of differing interpretations and the potential for disputes (for example as to whether or not one party or the other has acted in a timely manner).

iii) Sub-clause (b): The sub-clause makes reference to the independent verifier, who is required to assess the reliability, credibility and accuracy of the data and information relating to emissions. Some of the other schemes which are in development do not require data to be checked by an independent verifier.

iv) Sub-clause (c)(iv) and (d): Sub-clause (c)(iv) provides that when a ship is off-hire, the charterer is not liable to provide emission allowances for emissions generated during that period. Sub-clause (d) states that if the charterer fails to transfer any of the emission allowances that it is required to provide, then, subject to five days' notice, the owner has the right to suspend performance of the charterparty. As there is no minimum threshold provision, performance could arguably be suspended in respect of the allowances for a single ton of emissions.

The BIMCO ETS clause (continued)

As there is no minimum threshold provision, performance could arguably be suspended in respect of the allowances for a single ton of emissions.

Further, if there is a dispute regarding whether or not a ship was off-hire during a particular period then the owner could use the notice provision to exert pressure on the charterer.

One possible solution for this problem might be for the parties to agree that the charterer should put the disputed emissions allowance into escrow, pending the outcome of the dispute. The owner should, however, take care when exercising the right to suspend performance of the charterparty as suspension could give rise to other claims (e.g. claims by the receiver for damage or delay to the cargo or by the charterer in circumstances where the suspension of performance is subsequently held not to be lawful).

Finally, it is worth noting that the Clause has been designed for incorporation into a time charter. At present there is not a similar clause for use in a voyage charterparty. Disponent owners are often time charterers themselves and will therefore want to pass on the costs associated with complying with the Clause. They can do so by either incorporating a suitably amended version of the Clause, or possibly increasing freight rates.

Technical Managers

The EU ETS has a number of significant implications for technical managers, who may have to take on additional responsibilities and associated liabilities.

It will be important to review ship management agreements to ensure that cost, risk and responsibility are allocated properly and to minimise the risk of a ship being expelled from EU waters due to failings relating to a ship in different ownership but sharing the same technical manager.

As always, if Members have any questions in relation to the above issues they are invited to contact the Club for further information.

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