



INCLUSION OF DOMESTIC SHIPPING IN THE UK EMISSIONS TRADING SCHEME: WHAT WE KNOW SO FAR

On 25 March 2022, the UK Government's Department of Business, Energy & Industrial Strategy (BEIS) launched a consultation¹ on developing the UK Emissions Trading Scheme, including its expansion to cover the domestic maritime industry. With the consultation due to close at 11:45pm on 17 June 2022, this article discusses what we know so far.

Please see the accompanying factsheet for the proposed application of the UK ETS to the maritime sector on pages 5 and 6

¹ Developing the UK Emissions Trading Scheme (UK ETS) - GOV.UK (www.gov.uk)

“The contribution of domestic UK shipping to the nation’s emissions is not insignificant, accounting for around 5% of all greenhouse gas emissions from UK transport.”

As most readers will be aware, the decarbonisation of the shipping sector is increasingly becoming the subject of both commercial scrutiny and regulatory intervention planned to come into force within this decade. This is occurring at both the international level, via the International Maritime Organisation’s (IMO’s) mandatory short term goal-based technical and operational measures under MARPOL Annex VI, and also at the regional level, via the EU’s ‘Fit for 55’ package of measures. We have previously written extensively on the commercial and legal implications of these measures on the sector.²

Attention on reducing the emissions of the maritime sector is also occurring at the national level too – for example, in the US and China, as we have discussed previously³, but also in the UK, which will be the focus of this briefing.

The contribution of domestic UK shipping to the nation’s emissions is not insignificant, accounting for around 5% of all greenhouse gas emissions from UK transport. This is more than the emissions from the UK rail and bus network combined. Whilst all segments of the sector play their part, the largest contributors are offshore vessels, followed by inland waterways and leisure craft, roll-on/roll-off ferries, the fishing industry, and oil tankers, bulk carriers and passenger-only ferries in equal part.

This has not gone unnoticed by the UK Government. For example, the contribution of shipping to the UK’s total emissions were taken into account for the first time in the UK’s Sixth Carbon Budget, published in December 2020, via which the UK seeks to reduce emissions by 78% by 2035 compared to 1990 levels.⁴ In 2021, the UK Government published the Net Zero Strategy, setting policies and proposals for decarbonising all sectors of the UK economy, including the maritime sector, to meet the UK’s net zero target by 2050.⁵

Against this background, on 25 March 2022 BEIS launched a consultation on developing the UK Emissions Trading Scheme (UK ETS).⁶ This included proposals for widening the scope of the UK ETS (for a summary of the current scope and application of the UK ETS, please refer to the attached factsheet), to include the domestic maritime industry.

The consultation remains at a very early stage, and a lot of detail remains to be decided. We set out below a summary of what we know so far in relation to some of the key issues arising.

When might shipping’s inclusion in the UK ETS come into force?

The consultation does not provide specific dates, but does refer to including UK domestic shipping “by the mid-2020s”.

This would place the inclusion of domestic shipping in the UK ETS on a not too dissimilar implementation trajectory as both the IMO’s Energy Efficiency Existing Ship Index (EEXI) and Carbon Intensity Indicator (CII) regimes under MARPOL, which will enter into force on 1 November 2022 and will apply to relevant vessels on 1 January 2023, and the EU’s Emissions Trading Scheme (EU ETS) which is anticipated to be introduced during 2023 (although no specific implementation date has been formally announced).⁷

Which vessels would be covered?

Under the proposals, only UK **domestic** shipping would be covered by the UK ETS. International shipping would not fall under the scheme, with the consultation stating that the UK Government fully supports the work of the IMO to tackle global shipping emissions. That said, the consultation makes clear that the UK Government is “*monitoring developments of international and regional carbon pricing instruments covering shipping emissions*” (presumably a reference to both the EEXI/CII regimes and the EU’s ‘Fit for 55’ measures) and will consider how these measures might affect domestic policy, including the UK ETS, in future. This would presumably include any amendments to the UK ETS to avoid any ‘double-counting’ of emissions which might subsequently

2 <https://www.hfw.com/Reducing-international-shippings-carbon-intensity-through-the-IMOs-EEXI-and-CII-charterparty-implications-and-challenges>
<https://www.hfw.com/Inclusion-of-shipping-in-the-EU-Emissions-Trading-System-current-landscape-perspective-and-potential-impact>
<https://www.hfw.com/Decarbonisation-in-shipping-Contractual-and-charterparty-issues>

3 <https://www.hfw.com/The-multifaceted-approach-towards-regulating-carbon-emissions-in-international-shipping-June-2021>

4 <https://www.theccc.org.uk/wp-content/uploads/2020/12/The-Sixth-Carbon-Budget-The-UKs-path-to-Net-Zero.pdf>

5 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1033990/net-zero-strategy-beis.pdf

6 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1009448/decarbonising-transport-a-better-greener-britain.pdf

7 There are, of course, other potential measures affecting shipping under the broader ‘Fit for 55’ package, including the expansion of the Energy Taxation Directive representing a tax on bunkers sold in the EEA and shore power electricity for vessels (anticipated to enter into force in 2023), and the FuelEU Maritime initiative (anticipated to enter into force on 1 January 2025).

become covered at a global or EU level.

Certain tonnage thresholds for applicable vessels are suggested in the proposals “to avoid burdening smaller participants”, as discussed further below. Non-commercial UK Government maritime activity (e.g. Royal Navy activity) is also not intended to fall within the scope of any expanded UK ETS, although they are still expected to seek to decarbonise in line with the UK’s net zero commitments.

What emissions will be covered?

The consultation only discussed carbon emissions in the context of shipping. Consequently, it does not seem to be envisaged that other greenhouse gases, such as methane, would fall under the scope of the UK ETS. This contrasts with recent amendments proposed by the European Parliament in relation to the potential inclusion of shipping in the EU ETS where, in light of broader debates over the impact of methane to global warming and the EU’s role in the Global Methane Pledge at COP26, it has been suggested that methane emissions, in addition to carbon emissions, should be covered.

Under the UK Government proposals, emissions would be calculated based on the volume of fuel multiplied by the carbon intensity of the particular fuel being used (i.e. the amount of carbon dioxide equivalent (by weight) which is emitted per unit of the fuel), using the following calculation:

$$\begin{aligned} &\text{AMOUNT OF GREENHOUSE GAS} \\ &\text{EMISSIONS FOR WHICH LIABLE} \\ &= \\ &\text{VOLUME OF FUEL USED ON} \\ &\text{A QUALIFYING JOURNEY} \\ &\times \\ &\text{CARBON INTENSITY} \\ &\text{OF FUEL TYPE} \end{aligned}$$

The greenhouse gas reporting conversion factors used by the UK Government would be used as the basis for assessing the carbon intensity of different fuels, although the consultation acknowledges that these may need to be reviewed in light of new fuel types and blends coming onto the market going forward, including low carbon emission fuels.

Which party will be responsible for compliance, and how will their obligations be fulfilled?

The consultation puts forward three options for how domestic shipping may be included in the UK ETS, with the position regarding responsibility for compliance with the scheme differing under each option.

Lead Option – inclusion of domestic maritime on an ‘activity’ basis

Under this approach, which is modelled on how the UK ETS currently applies to the aviation sector, the UK ETS would apply ‘downstream’ to “ship owners or operators”. This definition could potentially include commercial operators (i.e. charterers) within the scope of responsibility, but this issue does not appear to be developed further within the consultation, which simply treats shipowners and operators as one and the same. It is therefore presently unclear whether shipowners or charterers would be responsible for compliance under this option.

‘Domestic’ voyages only would be covered, defined as “a journey which starts and finishes in a port located in the United Kingdom”. This would include voyages between Great Britain and Northern Island, but not voyages between the UK and Crown Dependencies or Overseas Territories, or international voyages (as discussed above).

The consultation states that the UK Government is minded to apply the UK ETS to vessels of over 5,000 GT, in accordance with the threshold already seen under applicable monitoring, reporting and verification regulations (see below).

In practice, shipowners or operators would be required to determine the volume of fuel used on each qualifying domestic voyage and then multiply this by the UK Government’s greenhouse gas reporting conversion factors to determine emissions, as per the formula set out in the previous section. This would then be reported to the UK ETS regulator annually, with sufficient emissions allowances obtained and surrendered by the responsible party.

The consultation suggests that the monitoring, reporting and verification (MRV) of carbon emissions for this purpose would be carried out

in accordance with the statutory instruments which brought the requirements of the EU’s MRV Regulation (2015/757) into UK law and which were retained post-Brexit, subject to amendments needed to make them operable in a UK-only context. In light of this shared regulatory/legislative approach, there should be some symmetry between the MRV requirements of both the UK ETS and the EU ETS, albeit in respect of different vessels and voyages.

Whilst the UK Government considers that this Lead Option would capture more emissions than any UK ETS that was applied ‘upstream’ (see Alternative Option 1 below), and could also allow flexibility for larger vessel operators in terms of using emissions data “to plan vessel activity and improvements”, there is also a recognition that there could be potential for double charging if the IMO took steps to implement an emissions trading scheme/system at the international level, meaning that the UK Government would have to continue to monitor the situation closely (as discussed above).

Alternative Option 1 – inclusion of domestic maritime on a ‘fuel supplied’ basis

This option would place the obligation to account and pay for emissions on fuel distribution and bunkering firms who supply fuel within the UK, “at the point where fuel becomes liable for excise duty in the UK or, for fuels which may not be subject to excise duty, a similar assessment point”.

In practice, this approach would effectively involve an additional tax payable on bunker suppliers on all conventional bunkers (including alternative fuels) sold within the UK. Bunker suppliers would be required to report the volumes of each kind of marine fuel sold to vessels carrying out domestic voyages (presumably as defined above, but this is not made clear in the consultation) “at the duty point”, and multiplied by the carbon intensity of the relevant fuel using the formula set out above. This obligation would come in addition to the requirements of the Renewable Transport Fuel Obligation (RFTO), which requires companies who supply 450,000 litres or more per year of relevant fuels for use in the

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UK to demonstrate that 5% of the fuel supplied comes from renewable and sustainable sources. The RFTO was extended to maritime fuels at the start of 2022.

The exclusion of marine fuels sold outside of the UK would be achieved under one of two options:

- using HMRC fuel data, which would place a responsibility on bunker suppliers to report and evidence the volumes of fuel they had sold for the purpose of domestic and international voyages respectively; and
- adapting the existing bunker delivery note (BDN) system, leading to a two-tier system where (i) vessels would inform the bunker supplier whether they were purchasing fuel for a domestic or international voyage; and (ii) the bunker supplier would record this information to calculate their own liability at the duty point.

According to the UK Government, the benefits of Alternative Option 1 are that it could reduce the overall administrative burden of the UK ETS, as fewer operators would need to participate actively in the scheme. The effect would essentially be to increase the cost of marine fuel at the point of supply (with more carbon-intensive fuels being subject to a higher premium), with no additional

monitoring or reporting being required. In this way, Alternative Option 1 is less a ‘true’ emissions trading scheme/system, and more of a carbon levy on bunkers sold in the UK for domestic voyages.

The disadvantage of this approach, however, as the UK Government recognises, is that fewer emissions are likely to be captured, due to the fact that some fuel used for domestic voyages is purchased overseas. An additional carbon levy on UK-sold bunkers may only exacerbate this problem, as some vessels may opt to bunker overseas to evade the additional premium.

There may also be practical problems arising when seeking to comply – for example, in some circumstances it may be difficult for bunker suppliers/vessels to state whether they had sold/purchased fuel specifically for domestic voyages, particularly where the relevant vessel is carrying out tramp trades that may be a mixture of UK coastal voyages and voyages between the UK and Ireland/mainland Europe.

Alternative Option 2 – a hybrid approach

This approach combines the previous two approaches, suggesting that they might apply in a mutually exclusive manner to two classes of vessels:

- for “*smaller vessels*”, Alternative Option 1 would apply (the ‘fuel supplied’ basis, i.e. a carbon levy on bunkers sold in the UK for domestic voyages), and applicable vessels would have no further obligations; and
- for “*larger vessels*”, the Lead Option would apply (the ‘activity’ basis, i.e. obtaining and surrendering sufficient emissions allowances to cover emissions from domestic voyages), and applicable vessels would avoid the carbon levy by placing additional reporting requirements on either bunker suppliers or vessel operators.

The consultation does not establish where the divide between “*smaller vessels*” and “*larger vessels*” would lie. However, it is suggested that either a vessel size cut off could be used (for example, ‘under 24m’ or ‘under 400 GT’), or that the divide could be arranged by sector or sub-sector (with, for example, recreational craft being “*smaller vessels*” and cargo ships being “*larger vessels*”). A combination of these approaches is also suggested, without further elaboration.

The consultation considers this option could be the more “*environmentally effective and administratively appropriate way to incorporate domestic maritime*” in the UK ETS. However, it is recognised that there

would be an increased legislative burden in running the UK ETS in this manner. There are also recognised compliance risks in terms of vessels that might sit on the border between “smaller vessels” and “larger vessels”, whichever way that is determined.

How will the purchase and surrendering of any emissions allowances operate in practice?

In light of the discussion above, this question would only have relevance if either the Lead Option or Alternative Option 2 were ultimately adopted by the UK Government.

In any case, this topic is not discussed in the consultation in relation to the domestic maritime industry. Any emissions allowances for the sector would, however, most likely be auctioned and traded on the same exchange as other sectors currently covered by the UK ETS, such as aviation. The relevant platform for this exchange is at present provided by ICE Futures Europe.⁸

Will there be any ‘free allowances’ for domestic maritime under the UK ETS?

Whilst again, this question would only be relevant if either the Lead Option or Alternative Option 2 are ultimately chosen, free allowances specific to domestic maritime are not considered by the consultation.

However, another part of the consultation considers the possible **reduction** or phasing out of free allowances for the aviation sector. Given that the consultation expects that the aviation and maritime sectors will be “the UK’s largest residual emitting sectors by 2050”, it is perhaps unlikely that domestic maritime will benefit from free allowances under the UK ETS, and this would mirror the approach seen under the proposed EU ETS for shipping.

Next steps and considerations

The consultation runs until 17 June 2022, and whilst it will clearly be of

interest to individual companies and representatives of the UK maritime sector, any organisation or individual is able to respond.

It is most certainly early days, and almost all of the details on how the UK ETS will operate, what format it will take, and its scope of application are still to be determined.

Even if interested parties do not intend to become actively engaged with the consultation, it would be prudent to maintain a close watching brief to assess how the measures are shaping up in due course. It is also already possible for parties to assess their potential risk profiles according to the different options put forward in the consultation, so that they can plan ahead in order to mitigate the costs and risks of compliance. This might include considering how both obligations and benefits of the measures might be allocated up and down the contractual chain.

⁸ <https://www.theice.com/futures-europe>

CURRENT SCOPE OF UK ETS

Who does the UK ETS apply to?	
Energy intensive industries	 Regulated activities as listed in Schedule 2 of the Greenhouse Gas Emissions Trading Scheme Order 2020, which result in greenhouse gas emissions, including combustion of fuels on a site where combustion units with a total rated thermal input exceeding 20MW are operated (except in installations for the incineration of hazardous or municipal waste).
The power generation sector	 Regulated activities as listed in Schedule 2 of the Greenhouse Gas Emissions Trading Scheme Order 2020, which result in greenhouse gas emissions, including combustion of fuels on a site where combustion units with a total rated thermal input exceeding 20MW are operated (except in installations for the incineration of hazardous or municipal waste).
Aviation	 Regulated activities as listed in Schedule 1 of the Greenhouse Gas Emissions Trading Scheme Order 2020. These are, broadly, all commercial domestic flights and commercial flights from the UK to the European Economic Area (EEA) and Gibraltar.
Maritime	 The consultation proposes inclusion of the domestic maritime sector by the “mid-2020s”.

Which UK emissions are covered?

Carbon dioxide



Methane/nitrous oxides



Expansion to methane is not discussed in the consultation.

Are there free UK emission allowances for any sectors?

Installation operators



As listed in Schedule 2 (installations) of the Greenhouse Gas Emissions Trading Scheme Order 2020.

Aviation



However, the proposal considers the possible reduction/phasing out of free allowances for aviation.

Maritime



Not considered by the consultation, but seems unlikely given the proposals for phasing out of free allowances for aviation.

How would the UK ETS apply to the maritime sector?

Which vessels would be covered?

A threshold of vessels **over 5,000 GT** is proposed in the consultation. Non-commercial UK Government maritime activity (e.g. Royal Navy activity) is not expected to have to comply.

Which voyages would be covered?

The consultation proposes application of the scheme to **domestic voyages only**.

Who would be responsible for compliance?

Three possible options proposed by the consultation:

Lead Option: activity basis

"Ship owners or operators". As the consultation does not define these parties, it could include commercial operators (which would include charterers).

Alternative Option 1: fuel supplied basis

Bunkering and fuel distribution firms

Alternative Option 2 – a hybrid approach

"Smaller vessels": Alternative Option 1 would apply

"Larger vessels": Lead Option would apply

The consultation does not define the thresholds for "smaller vessels" and "larger vessels".

How are UK emission allowances purchased and surrendered?

ICE Futures Europe currently provides the auctioning platform for allowances. It is anticipated that the same platform would be used for the auctioning of allowances within the maritime sector.

Whilst detail is not provided in the consultation, it is conceivable that maritime participants may need to open an account with the UK Emissions Trading Registry to hold, transfer and surrender allowances.

Allowances must be surrendered by 30 April in the year following the relevant scheme year.

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