



## **“EMISSIONS REGULATIONS IN SHIPPING – WILL THE POLLUTER PAY?”**

**The global freight industry is facing both downwards (regulatory) and upwards (consumer) pressure to reduce its carbon emissions. We take a look at some of these pressures in this briefing and consider what their impact may be.**

### **Downwards pressure:**

Two IMO regimes, the Energy Efficiency Existing Ship Index (**EEXI**) and Carbon Intensity Indicator (CII), have just come into force (on 1 November 2022) via amendments to MARPOL Annex VI, and will have to be complied with by applicable ships from 1 January 2023.

The EEXI regime relates to the technical design of ships and aims to improve the energy efficiency of the global fleet. It is comparable to the Energy Efficiency Design Index (EEDI) which has been in force since 2013, though

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EEDI applies only to newbuild ships, whereas EEXI applies to existing ships. It will apply to any ship above 400 GT subject to certain exempt categories<sup>1</sup>. The EEXI regime works by comparing a ship's so called “Attained EEXI” with its “Required EEXI”. The Required EEXI is a benchmark measure of energy efficiency which is determined by each ship's type, capacity and means of propulsion; the Attained EEXI is the estimated energy efficiency of the relevant individual ship calculated by reference to technical guidelines.

Where a relevant ship's Attained EEXI is shown to be less energy efficient than the Required EEXI, the ship will be required to take steps to meet the Required EEXI. This will entail technical modifications to the ship's design, such as engine/shaft power limitation, bow or propeller improvements, or use of alternative more energy efficient fuels, although the regulations do not prescribe what modification is to be deployed in each individual case – it simply sets the energy efficiency benchmark which is to be met. Compliance with the regime will be reflected in the ship's International Energy Efficiency Certificate (IEEC).

Whilst the EEXI regime is a *technical* measure, the CII regime relates to the *operational* energy efficiency of ships over 5,000 GT. Under an enhanced Ship Energy Efficiency Management Plan (**SEEMP**), shipowners will need to monitor the amount of

carbon dioxide emitted by each ship compared to the operating mileage it undertakes each year. Depending on the efficiency of its operations as calculated under the regulations, the ship will be awarded a CII rating on a scale from A (major superior) through to E (inferior). The middle point of a CII rating of C (moderate) is the minimum required grade or “Required CII”, and those ships which attain a CII rating of D (minor inferior) for three consecutive years, or a CII rating of E (inferior) for any one year will be required to devise a plan of corrective action to improve performance under the CII regime, to be set out in the SEEMP. Beyond this corrective plan, it remains unclear at present how the regime will be enforced in practice, as this will ultimately be decided by each of the signatory states to MARPOL, via Flag State administration and/or Port State Control and/or subject to further directions from IMO.

A ship's ability to reduce its carbon intensity under the CII regime can be achieved by various operational and technical measures, including optimising the speed and routing of the ship or even limiting in what weather conditions the ship transports goods. These measures in particular might be challenging for ships operating on short sea routes covering limited distances and spending a relatively high proportion of their time in port. Compliance with the CII regime may also cause

significant issues under traditional shipping contracts, as we have discussed elsewhere.<sup>2</sup>

International shipping also seems likely to be brought under the aegis of the EU's Emissions Trading System (ETS), as part of its “FIT for 55” package<sup>3</sup>, although the legislative text is still being debated and several areas of uncertainty remain.<sup>4</sup> The general idea of the EU ETS is that the emissions of all participants in the system are capped, with a finite number of “allowances” (rights to emit a specific quantity of emissions) available to purchase and trade in an open market. Once shipping is included in the EU ETS, allowances sufficient to cover the monitored, reported and verified emissions of each applicable ship will need to be purchased on the market and surrendered to the relevant authorities, failing which the ship may be subject to penalties and even potential refusal of entry into the ports of Member States.<sup>5</sup> Ultimately, the EU ETS aims to incentivise participants to invest in reducing their carbon output, both to avoid penalties and with the aim of having excess allowances to trade in the market.

## Upwards pressure:

Much of the pressure to reduce carbon emissions is not necessarily driven by regulations but by consumers. To this end, it is not uncommon to see shippers and

<sup>1</sup> Such as ships not propelled by mechanical means, platforms and drilling rigs, category A ships as defined in the IMO's International Code for Ships Operating in Polar Waters and ships which have non-conventional propulsion such as diesel electric, turbine or hybrid propulsion systems (except LNG carrier and cruise passenger ships).

<sup>2</sup> <https://www.hfw.com/Decarbonisation-in-shipping-Contractual-and-charterparty-issues>

<sup>3</sup> [Fit for 55 - The EU's plan for a green transition - Consilium \(europa.eu\)](https://www.consilium.europa.eu/en/policies/fit-for-55/).

<sup>4</sup> For further details, see: <https://www.hfw.com/EU-Emissions-Trading-System-Current-status-and-key-issues-July-2022>

<sup>5</sup> For further details, see: <https://www.hfw.com/Decarbonisation-in-shipping-Contractual-and-charterparty-issues>

carriers establish their own goals which often exceed the regulatory targets.

Cargo Owners for Zero Emission Vessels (**coZEV**), a collective of (at present) 19 global brands including Unilever, Amazon and IKEA has pledged in respect of its maritime freight carbon footprint to reach net-zero by 2040. In response to this one leading container line has set the same target for its entire group – to attain carbon neutrality by 2040 relying principally on shifting to the use of green fuels to power its fleet. This goal exceeds the IMO's own goal of cutting carbon emissions in international shipping by at least 50% by 2050 compared to 2008.

As far back as 2003 we have also seen collaborations between container carriers, freight forwarders and shippers in for example the Clean Cargo Working Group, a membership space dedicated to accurately measuring carbon emissions with the container shipping industry, allowing its members to accurately track their emissions and so enabling them to plot their paths to net zero.

It must also be said that consumers (and investors) hold companies to account if they do not follow their own environmental, social and governance (ESG) commitments or engage in so called “greenwashing”. There have been several recent cases of this. Looking at an example in the broader logistics market, in 2020, the UK's Advertising Standards Authority (**ASA**) received a complaint about a marketing campaign issued by Ryanair which featured text which stated, “*Europe's Lowest Fares, Lowest Emissions Airline*” and indicated that it had “*low CO<sub>2</sub> emissions*”. ASA concluded that the

claims in the advertising campaign were misleading and breached a number of CAP Code and BCAP Code rules (UK Advertising Codes which set rules for advertisers, agencies and media owners). The ASA subsequently banned the advertisements on the basis that the airline had failed to substantiate its environmental claims.

#### **Market response:**

Complying with self-set goals or regulations will ultimately impact freight costs throughout the supply chain, from ship owners down to shippers and ultimately end consumers.

Various container lines have stated that a consequence of complying with CII will be the slowing down of container lines (as slower moving ships are more energy efficient). This will translate into carriers employing more container ships on services in order to meet the same global freight demands – anywhere between 5% and 18% more capacity will be required depending on who you ask. Carriers are prepared for this. Some of the major container lines' orderbook stands at between 14-43% of their respective current fleet sizes. One wonders if an increase in fleet sizes is the outcome the IMO was looking for when it first conceived CII (though arguably fleet sizes would have increased irrespective of the CII regime as carriers sought to make the most of the high freight rates the shipping industry had enjoyed in recent years).

In the short term the cost impact of increasing the fleet size may be offset by countervailing market conditions (that of falling freight rates in line with falling consumer

demand). Unless carriers are able to convince shippers of any genuine increase in costs to serve existing freight volumes, there may be no appreciable increase in freight rates as a consequence of the forthcoming changes. In a challenging market for carriers, it will be interesting to see where negotiations settle to ensure regulatory compliance in order to achieve sizeable reductions in carbon emissions.

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