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ARA MARKETS FOCUS ON REGULATION

INSIDE:

Going to market?

Ioannis Generalis of Y. Georgiades & Associates considers the pro and cons of using carbon levies and emissions trading schemes to incentivise decarbonisation

Decarbonising shipping is overwhelmingly seen as the maritime industry's most serious challenge, both at present and for decades to come. The goals set on publication of the IMO's Initial Strategy 2018 of a 40% CO_2 reduction by 2030, and a 50% greenhouse gas (GHG) reduction by 2050 remain the global benchmark, though at times they have been criticised for not pushing the envelope far enough (for example, the UK, the US and Shell have all called for a zero emissions target). However, sure as the destination may be, the route to getting there remains an uncertain, highly debated, and contentious topic.

Few will argue against the value of regulation in achieving decarbonisation. Many consider it as the most important catalyst for change, often citing the recent example of the successful industry-wide implementation of the 0.50% sulphur cap in IMO 2020. However, setting aside the fact IMO 2020 itself took over a decade to materialise, there remains a fundamental difference between the two: the fuel and technologies necessary to abide by IMO 2020 were very much available, whereas those required to comply with the long-term reduction goals for decarbonisation remain to be developed.

Market-based measures (MBMs), specifically in the form of carbon pricing mechanisms, have received renewed attention since 2018, with various industry players calling for their urgent adoption, and regulatory bodies / countries preparing or considering their regional implementation. Following several proposals, MBMs were discussed at IMO's recent 76th Marine Environment Protection Committee in June (MEPC 76). However, no agreement was reached, and discussions were deferred to MEPC 77. Moreover, an event has been organised by the International Chamber of Shipping (ICS) during the upcoming 26th UN Climate Change Conference of the Parties (COP26) in Glasgow this November, which shall be attended by various stakeholders, and the ICS has confirmed MBMs will be on the agenda.

MBMS

MBMs in relation to shipping emissions have featured for decades. In fact, as far back as 2009 in MEPC 59, the overwhelming majority of delegates agreed MBMs were needed as part of wider measures to effectively regulate GHG emissions from international shipping. The IMO stipulates MBMs serve two main functions, namely in-sector and out-of-sector reductions. So, respectively, they should:

- provide an economic incentive to reduce fuel consumption by investing in more fuel-efficient ships and technologies, and to operate ships in a more energy efficient-manner; and
- offset in other sectors of growing ship emissions.

In addition, MBMs fall within a wider set of measures to reduce GHG that should abide by principles set out in MEPC 57. These include cost-effectiveness, practicality and transparency, sustainable environmental development without penalising global trade, equal application to all flag states, minimising competitive distortion, and promoting & facilitating innovation and R&D.

Historically, various MBMs have been proposed by countries and organisations alike. These include a global emissions trading system (ETS) in separate proposals by Norway, the UK and France; a port state levy based on fuel consumed on voyage to a specific port; a leveraged incentive scheme with GHG fund contributions and a refund to 'good performers'; efficiency – credit trading programmes; a penalty on trade and development; and a rebate mechanism to compensate developing countries for the financial impact of MBMs.

At present, three proposals have been submitted to the IMO since it reopened discussions on MBMs. They feature a carbon charge per ton of CO_2 emissions equivalent (Marshall and Solomon Islands, ICS and Intercargo), and a global ETS combined with a GHG intensity limit on fuel (Norway). In fact, these represent the two predominant approaches in carbon pricing MBMs, namely imposing a carbon levy, and introducing an ETS.

CARBON LEVY

A carbon levy essentially works out as a charge per ton of CO_2 equivalent, levied either on bunkers or on emissions. The proposals recently submitted are those of the Solomon and Marshall Islands, which features a $100/ton CO_2 charge, and the ICS and Intercargo, which includes a future determined charge, preferably through an impact study. The two proposals do not only differ on the price figure, since there is a fundamental difference on rev-

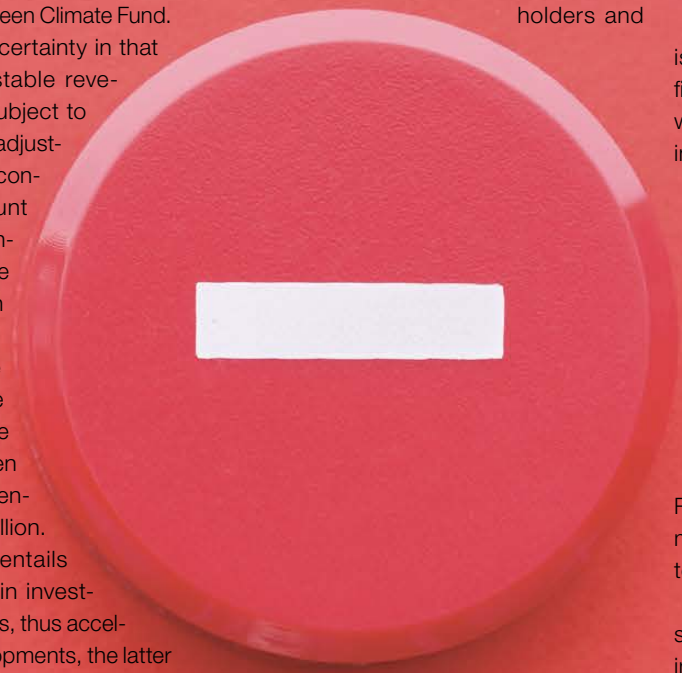
enue distribution. On one hand, the ICS and Intercargo suggest funds should go towards direct decarbonisation actions such as developing bunkering infrastructure and R&D, and should be funnelled through the IMO via a suggested new Maritime and Research Fund, the IMRF. On the other hand, the Marshall and Solomon Islands advocate a 51% revenue distribution towards mitigating the MBM impact on vulnerable nations, with the remaining 33% towards R&D and 16% to port and flag states for transaction costs, and suggest part of the funds could be funnelled through non-IMO entities, such as the UN's Green Climate Fund.

A carbon levy provides certainty in that it forms a fixed yet adjustable revenue stream, not directly subject to market forces. Rather, any adjustment is subject to political consensus, taking into account various factors such as technological developments. The price is still debated, with Trafigura having indicated $250-$300/ton would be most appropriate to achieve the IMO's 2030 goals, while other analysts suggest even a $50/ton would suffice, generating as much as $40 billion. Certainty in expenditure entails much needed conviction in investment for shipping companies, thus accelerating technological developments, the latter also profiting from the steady revenue stream if substantially allocated to R&D. Moreover, from a legal point a carbon levy could be read into contracts if considered a 'tax' as far as allocation of liability is concerned, but a specific 'carbon tax' clause incorporation would remove any doubt. It is however noteworthy that neither owners nor charterers have so far uniformly opposed the introduction of a carbon charge. On the downside, a carbon levy has an indirect correlation to emissions, as it does not set a cap on their allowed maximum level.

ETS

An ETS essentially works on a cap and trade basis, whereby an upper limit on emissions is set, and emissions allowances are traded. A possible ETS introduction for shipping has very much been in the news throughout 2020, via the EU Commission's proposal concerning an expansion into the EU ETS, lately as part of the 'Fit for 55' package. The EU ETS proposal is not unique, for example China started its own ETS last February and is contemplating a similar expansion into maritime. From an IMO perspective, Norway has now revived the concept with its proposal for a global ETS, in conjunction with a GHG fuel intensity standard linked to the 50% GHG reduction by 2050 goal. Both measures would apply to ships over 400 GT, and potentially work in phases. Norway's envisaged solution in case appropriate fuel cannot be sourced would be a compliance fine specified in the regulation.

Given an ETS sets a 'cap', it bears a direct relation to emissions. Moreover, auctioning of allowances can generate funds, which could filter into R&D, but emissions trading itself is between industry stakeholders and would not. Though relatively free from political pressure, an ETS is subject to market forces that can be unpredictable; therefore shipping companies are likely to seek short to medium term solutions rather that invest long-term. Finally, unlike a carbon levy, the EU ETS expansion has met uniform opposition from shipowners fearing a disproportionate bearing of the cost, and evoking the 'polluter pays principle'.



PREDICTIONS

The world of shipping decarbonisation is a complex one, whereby regional clashes with international, and developing countries collide with developed, in the backdrop of opposing stakeholder interests on allocation of liability.

The antithesis between regional and international regulation can be readily seen across the various carbon pricing MBMs, with over 28 ETS schemes and 29 carbon levies under consideration/implementation across the globe. International shipping regulation connotes intergovernmental political consensus through the IMO, which is slow and difficult to achieve. Regional regulation is faster, but it creates an uneven playing field and discourages long-term investment, with shipping companies left contemplating short-term solutions such as rerouting.

> 'Though relatively free from political pressure, an ETS is subject to market forces that can be unpredictable'

The clash between developed and developing nations constitutes a perennial issue on emissions regulation, and the single most important reason why the discussion on MBMs advanced very little between 2009 and 2018. It juxtaposes the 'No More Favourable Treatment' (NMFT) principle, traditionally supported by the IMO and placing every country on an equal footing, and the 'Common But Differentiated Responsibilities' (CBDR) principle, which shifts more liability on developed nations, owing to their historical pre-regulatory polluting.

Bearing in mind all of the above, one has to surmise a carbon levy is far closer to global implementation for various reasons. Firstly, it should generate a greater revenue stream not between stakeholders. Secondly, this greater revenue could be distributed in such a fashion as to correct injustice on disproportionate impact and indirectly incorporate the CBDR principle, while also funding R&D. Thirdly, in a world where industry stakeholders influence governments, political consensus over a carbon charge would be relatively faster to achieve at IMO level, since no single industry group has uniformly opposed a carbon levy. Finally, considering the shipping industry is notoriously cyclical in nature, but IMO's decarbonisation targets are set, one should avoid leaving shipping decarbonisation to the whim of market forces, especially given any uncertainty would discourage much needed long-term investment into novel fuel and emerging technologies.

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