Shipping ETS: Policy Briefing

November 2021

Summary

The EU Commission's proposal to include shipping in the Emissions Trading System (ETS) represents a positive step towards decarbonising the sector. That said, some issues remain to be ironed out if the ETS is to contribute to the ultimate objective of decarbonising shipping. These include:

- An additional mechanism in the ETS to bridge the fuel price gap for shipping
- Shipping Carbon Contracts for Difference (CCfDs) through a dedicated Ocean Fund to de-risk the operational costs of the first-moving companies.
- Getting rid of the phase-in period
- Reducing the threshold from 5,000GT to 400GT
- Fleshing out mechanisms to address carbon leakage in peripheral transhipment ports

This is all contingent upon retaining and strengthening the scope of the legislation, without which, the European Union will delay shipping decarbonisation for years and ultimately endanger both its climate objectives and the wider Paris Agreement. This briefing will detail how the shipping ETS proposal should be amended to achieve its ultimate goal.

1. Geographic Scope

The most important part of the Commission's proposal is the scope, which must be maintained as a bare minimum. As a reminder, the ETS will apply to all voyages between European ports, as well as 50% of voyages arriving or leaving at a European port (so called, 50:50 approach), as well as all emissions at berth.

The environmental case for this scope is clear: a limited scope would exempt over 60% of European shipping emissions. It would also place the burden of decarbonisation on short sea shipping, while exempting intercontinental shipping from carbon pricing in spite of this segment having the most technical and operational capacity to reduce emissions and the financial ability to deploy innovative technologies and new fuels.

The geographical scope of the proposed ETS also provides an innovative response to UNFCCC's Common but differentiated responsibilities and respective capacity (CBDR-RC) principles (recital 17). It ensures that the measure facilitates an ambitious but also a fair and equitable transition by

allowing developing countries to lead, while also leaving space for others to follow suit in the near future. The current choice of scope therefore sets a precedent for future climate policy on shipping emissions and can be integrated into UNFCCC guidelines for emissions inventories to establish a standard global framework. Already with China and the UK having adopted a route-based shipping emission allocation system similar to the EU's MRV (and a US proposal in the pipeline), the path towards a strong regulatory framework for shipping emissions is clear. The Commission has tacitly recognised their responsibility under the Paris Agreement to regulate shipping and has ended the fallacy that international shipping emissions are ungovernable.

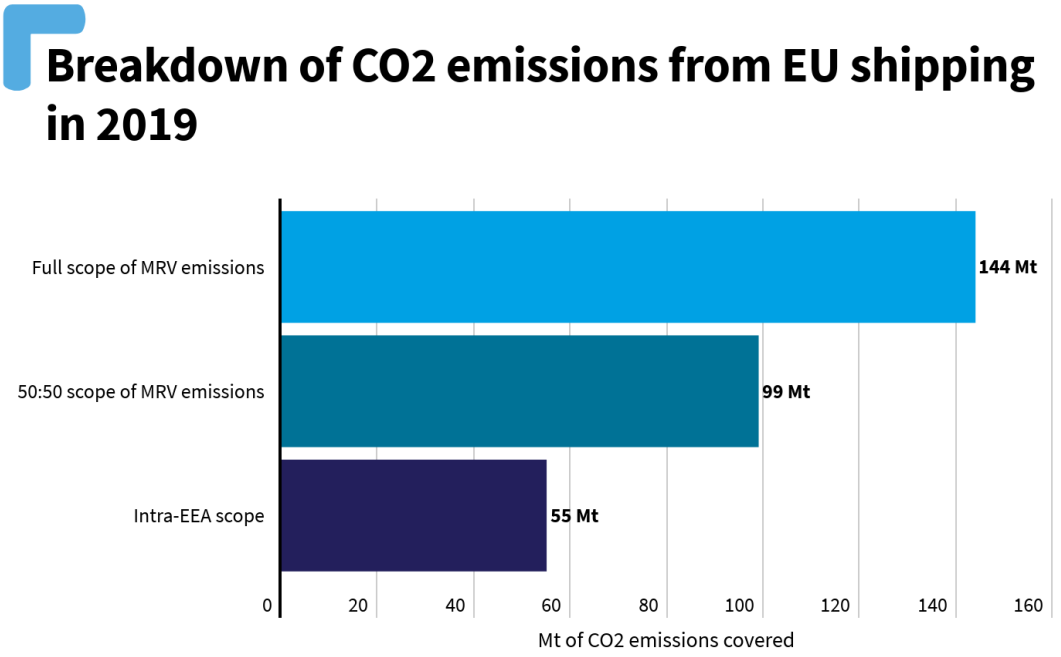


Figure 1: Breakdown of EU shipping's CO2 emissions

Using the ETS to Decarbonise Shipping

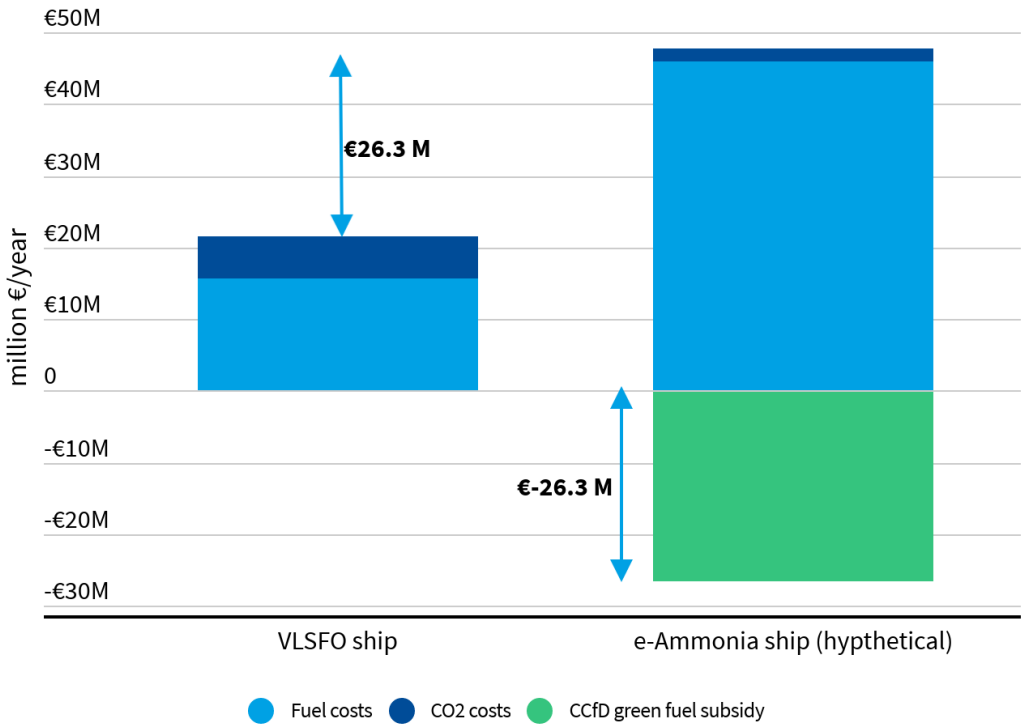
Moving forward, the ETS proposal must be improved with the final objective in mind: shipping decarbonisation.

Firstly, expected ETS carbon prices alone are unlikely to render sustainable marine fuels/technologies cost-competitive.[1] The EU should implement an additional mechanism, such as a **carbon price floor** to ensure emissions abatement and bridge the price gap between fossil and

[1] See, for instance, the Commission Impact Assessment, page 146

sustainable marine fuels. Such a mechanism would also address business concerns related to fluctuations in the carbon price, which will lead to problems when the shipowner is not the operator of the ship. In cases when the latter is based in third countries, the shipowner has limited recourse to ensure the ship operator pays the exact carbon price. ECSA, the shipowners lobby group, has recently called for a mechanism similar to a carbon price floor and national shipping associations in Greece and elsewhere have previously called for a price-stabilisation mechanism. The final ETS proposal should therefore include such a mechanism to assuage business concerns and provide additional environmental benefits.

Secondly, revenues must be channeled back into the sector with the explicit aim of decarbonisation. **Carbon Contracts for Difference (CCfDs)** are a very effective operational subsidy scheme to push the ramp-up of new technologies. Its job is to immediately bridge the price gap between green and fossil fuels in operation and de-risk financial risks for the first moving companies. CCfDs worked with huge success in the UK renewable energy sector by giving security to private finance to invest in these new technologies - something financiers will not do in shipping now whilst fossil fuel subsidies mean there is no business case for clean technologies.



Note: T&E calculations using fuel consumption data from the EU MRV v.67 using COSCO SHIPPING TAURUS containership as an example. The following assumptions have been used: VLSFO price - 510€/tonne, NH3 price - 876€/tonne, carbon price - 60€/tonne CO2, energy content - 41 MJ/kg (VLSFO) and 18.6 MJ/kg (ammonia), C-factor for VLSFO - 3.206 (gCO2/gFuel), NH3-VLSFO co-combustion ratio - 70%-30%.

Figure 2: CCfDs will ensure ramp-up in production and deployment of clean fuels

CCfDs should be channeled through a dedicated **Ocean Fund**, as called for by the European Parliament and industry groups. Given that the ETS distribution key will remain unchanged, the Ocean Fund is an equitable way to channel funds back to innovative projects related to the shipping sector, where port infrastructure and supply chains are concentrated in shipping nations. This Fund can be set up in the same way as the Innovation Fund, with 20 million allowances per year dedicated to an Ocean Fund with the express objective of shipping decarbonisation.

Thirdly, for it to be successful, the ETS must fully implement the polluter pays principle. This means **getting rid of the phase-in period** from 2023 to 2026. The Commission Impact Assessment indicates no justification for such a phase-in. Furthermore, industry has known since 2017 that it would be regulated as from 2023, and as long as the proposal is designed well, shipping companies will be able to absorb the costs, meaning there is no economic sense for such a phase-in. The phase-in will also forego revenues needed to decarbonise shipping and delay the hugely necessary price signals needed to get shipping companies to invest in and operate emissions reduction technologies.

Polluter-pays principle also means reducing the **threshold** of shipping legislation from 5,000GT to 400GT. This is to ensure price signals for the smallest vessels, which will be easier to decarbonise, as well as to capture emissions estimated around 10-15% of total shipping emissions (somewhere around 15-20Mt/year, equivalent to a medium-size Member State like Croatia). There is also clear business sense to changing the threshold. Ships of 5,000GT are large ships, up to 120 metres long, with strong competition with vessels just under the threshold.

Implementation of the polluter pays principle also means making sure the **entity ultimately responsible for the ETS costs** is also the entity responsible for making operational decisions to reduce emissions. That entity is usually responsible for fuel costs, cargo or passenger load, speed and itinerary of the voyage: i.e. the commercial operator of the vessel. Transposing recital 20, which recognises the role for commercial operators, to an operative text in the ETS directive is an appropriate way to ensure ultimate costs are obligated in contractual arrangements between the commercial charterers and the vessel owners.

Finally, although the Commission and other reports have concluded that the risk of **carbon leakage** is limited to one or two peripheral transhipment ports, additional mechanisms to provide a peace of mind to European ports can be helpful. These mechanisms could include penalties for ships or businesses engaging in carbon leakage. The MRV can be used to detect ships engaged in carbon leakage (this is easily done: carbon leakage will be shown by a reduction in long-haul traffic to a port and the increase in short-haul traffic from a non-European port). Ships identified to be engaged in carbon leakage will therefore be subject to the measure announced by the Commission to deter carbon leakage. Alternatively, a similar mechanism under the Carbon Border Adjustment Mechanism could be considered.

Further information

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