



Developing COA Clauses for Emissions Trading Costs

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As 2023 is coming towards a close, carriers and charterers are positioning themselves in anticipation of upcoming costs associated with emissions trading schemes that were developed as a result of new IMO regulations aimed at curbing ship emissions. As of January 1, 2024, vessels trading in the EU will be subject to the EU Emission Trading System (ETS) which has existed since 2005 but only now includes the maritime industry. The EU ETS is essentially a taxation that requires carriers to pay for emission “allowances” based on the amount of carbon produced by each vessel. The system is designed as a “cap and trade” scheme wherein a “cap” on emission allowances is put on the market and can be traded. Each year the cap is reduced with a goal of reaching the EU’s target of curbing shipping emissions by 55% by 2030 and ultimately becoming climate neutral by 2050.

While it is generally agreed that the costs of the ETS will be borne by the Charterer, the methodology of how to pass these costs can become complicated – especially in the realm of Contracts of Affreightment (COAs). Several different versions of clauses are being introduced by owners, charterers and brokers alike. In the parcel tanker trade where COAs dominate the contractual landscape, the goal should be to develop clauses that are as uniform as possible, precise but also scalable.

**The EU’s target
of curbing
shipping
emissions 55%
by 2030**

The Direct Pass Through vs Quarterly Reconciliation

Under the EU ETS, Owners will be responsible to pay for 40% of their emissions allowances in 2024, followed by 70% in 2025 and 100% as of 2026. Although the Owners will be responsible for making the actual payments, Charterers will likely bear the additional costs. Capturing these costs in a transparent and equitable manner is of paramount importance in drafting an applicable COA clause. One such way to encompass these charges under a COA is to draft a clause with a direct pass through of ETS costs upon completion of a voyage. Such clauses will enumerate how the Charterer's pro rata share of ETS costs are calculated and the method of collection. Under this schema, after the voyage is completed, the Owners will present Charterers with an invoice and accounting of their "share" of ETS allowance costs and same will be reconciled similar to a demurrage claim or other additional expenses under the COA.

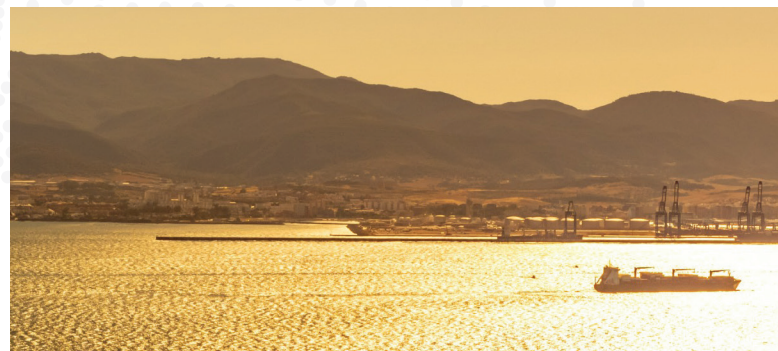
An alternative to the direct pass-through would be a method similar to an outturn freight calculation. Some charterers/owners may elect to have (for example) 90% of the estimated ETS allowances presented as a line item on a freight invoice. After the voyage is completed, the Owner will reconcile the balance of the actual ETS allowances and then "true up" each quarter to settle any further monies owed or credits due to Charterers. The ultimate choice of which method to use will be based on preferences of Owners and Charterers and it's important for all parties to understand the pros and cons of each method to determine which suits the organization best.

The Importance of Scalability and Flexibility

As the push for carbon neutrality grows in application globally, there will likely be other schemas similar to the EU ETS in other regions of the world. For example, there are currently discussions underway to implement an ETS system in the US that would solely apply to imports. With COAs often encompassing a 2-3 year period of duration, there will be a desire to have clauses that can adapt with evolving international regulations. The clauses should be constructed in such a way that COA terms do not need to be "reopened" to adjust to changing global carbon taxes.

Sea Cargo Charter and EU ETS

The Sea Cargo Charter (SCC) was developed to provide "a global framework for aligning chartering activities with responsible environmental behavior to promote international shipping's decarbonization" as indicated on their website. The SCC consists of several "signatories" that include cargo owners and ship owners who have agreed to abide by the principles as set forth in the Charter. Similar to the EU ETS, the SCC involves a method of calculating a ship's carbon emissions which is tracked and reported.



For signatories of the SCC looking to include carbon emissions clauses in their COAs, attention must be paid to how the method of calculating carbon emissions is encapsulated in the clauses. Under the SCC a vessel's carbon emissions output is measured and reported on the basis of actual fuel consumption as reported by the vessel. For shippers operating exclusively within the EU ETS scheme, the calculation is straightforward and represents 100% of the vessel's actual emissions. For vessels trading into and out of the EU ETS scheme, the calculation is based on a point-to-point method basis the voyage from last load port to first subsequent discharge port in Europe. As these methods differ in their effort to capture a vessel's emissions, they could also differ in how the costs for emissions trading schemes are calculated. Therefore, it is important that all parties understand what their obligations are under each method and how the differing calculations could affect the costs of compliance with emissions trading systems.

Approach to Clause Development

While the exact future of carbon emissions costs is unknown, in 2024 alone it is expected that shipping will contribute an additional Euro 4 billion to the already Euro 150 billion carbon market. It is becoming increasingly inevitable that further schemes beyond the EU ETS will emerge presenting new challenges in COA clause development. Clauses should be written with big picture flexibility and a scalability that adapts to the changing landscape of emissions costs. Clauses should be transparent so as to eliminate ambiguity and prevent sticker shock when these costs are presented.

With the proper clause structure, charterers and owners can effectively communicate anticipated costs with a degree of accuracy to all relevant stakeholders. Having a thorough understanding of the implementation and resultant consequences of emission cost clauses is of paramount importance when committing to long-term contractual terms. At Quincannon our experienced team of legal experts are available to provide insight into the development of transparent and equitable clauses designed to meet these rising challenges.



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