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PREVENTION OF AIR POLLUTION FROM SHIPS

Further elements for the development of an Emissions Trading System for International Shipping

Submitted by France

SUMMARY	
Executive summary:	In the context of the work plan for further consideration of market-based instruments adopted at MEPC 59, this proposal builds on the documents submitted previously by France on the creation of an Emissions Trading System for international shipping, and provides further details, in particular on the auctioning procedures which could be implemented to sell shipping allowances
Strategic direction:	7.3
High-level action:	7.3.1
Planned output:	7.3.1.1
Action to be taken:	Paragraph 18
Related documents:	GHG-WG 1/5/6; MEPC 59/4/5, MEPC 59/4/25 and MEPC 59/4/26

Introduction

1 The purpose of this document is to provide further input for continuation of discussions on the development of market-based measures to address greenhouse gas (GHG) emissions from international shipping. France has submitted and co-sponsored documents to the fifty-ninth session of the Committee and to the intersessional meeting held in Oslo, Norway in June 2008, which outlined the main elements of a Maritime Emissions Trading System (METS). This submission aims to build on these previous submissions to provide further detail on certain technical aspects of the proposed scheme.

2 As stated in document MEPC 59/4/25, an ETS for international shipping should be implemented, its scope should be global, so as to prevent risks of carbon leakage, and achieve effective reductions in maritime emissions.

Responsible entity

3 The participants in the scheme will be ships above 400 GT, regardless of their flags, but identified by their IMO number. The legally responsible entity for compliance with the METS obligations should be the company as per SOLAS regulation IX/I and the ISM Code (identified by its company IMO number): "*Company* means the owner of the ship or any other organization or person such as the manager, or the bareboat charterer, who has assumed the responsibility for operation of the ship from the owner of the ship and who on assuming such responsibility has agreed to take over all the duties and responsibilities imposed by the International Safety Management Code".

Monitoring and reporting obligations

4 Ship operators will be required to monitor their emissions (based on quantities of bunkered fuel) and surrender allowances for each unit of emissions to the METS administrator (responsibility for the governance of the METS will have to be assigned, with the IMO playing an important role), or risk paying a penalty. There are two main approaches to compliance and monitoring:

.1 the first one is based on what exists currently for emissions trading schemes: it consists in periodical (usually annual) reporting by companies of their emissions, and surrendering of an equivalent quantity of allowances within a given deadline following the end of the compliance period. Should a ship be sold during a compliance period, it would be the responsibility of the buyer to factor in any emissions liabilities and demand either allowances or cash to acquire allowances to cover emissions during the first part of the year; and

.2 an alternative option would consist in an "ongoing" process: to be considered compliant, a ship operator would have to regularly surrender allowances corresponding to the quantity of fuel bunkered for each ship, which is shown on the Bunker Delivery Notes held on board. The compliance delay following each bunkering would be [one] month. Information on the quantity of allowances held by each ship in its registry account and its compliance status will be available in real time in the registry held by the METS administrator. Note that in order to impose such obligations, the auctioning frequency will have to be high enough: for instance, if the compliance delay is one month, auctions should be held on a weekly basis. This approach entails a slightly heavier administrative burden for ship operators, but may facilitate accounting for the CO_2 costs in existing contracts between shipowners and charterers (the entity responsible for the purchase of allowances will have to be clearly designated in charter contracts), as well as during ship sales, and may ensure a more efficient control by the Port State Authority.

5 The GHG emissions of ships will not be directly monitored but calculated using the quantity of bunkered fuel and international standardized emission factors corresponding to the type of fuel shown on the Bunker Delivery Note. As part of flag State control, reported emissions will be regularly verified by an independent third party, who will in particular check consistency with the Bunker Delivery Notes. Port State control will also have an important role to play: it will have access to real-time information from the METS administrator about a ship's compliance status and will be able to enforce sanctions as necessary. A system of gradual sanctions could be envisaged, ranging from a set fine to detention of the ship.

Allowance allocation: auctioning

6 As mentioned in previous submissions, auctioning should be the preferred method for allocating allowances, as it is simpler, would improve the efficiency of the scheme, avoid risks of competitive distortion and alleviate administrative burden associated with free allocations. Auctioning is increasingly used to allocate allowances in emissions trading systems worldwide: it is used in the first regional emissions trading system in the United States (the Regional Greenhouse Gas Initiative), as well as by certain European Union countries in the EU Emissions Trading System (EU ETS), and will become the rule for allocating allowances in the EU ETS as of 2013. The knowledge gained from these experiences and the in-depth reflection carried out during the drafting of the EU ETS auctioning regulation, offer insight for the organization of auctions for the shipping sector. The METS could also build upon existing allowance auctioning infrastructure to ensure a cost-efficient implementation of auctions. However, auctioning procedures will need to be adapted to the specificities of the global shipping sector.

7 There are various ways to auction allowances. The guiding principles of any auction procedure should be to ensure an efficient allocation of allowances, minimize cost and administration burden for participants, and prevent market manipulations. Auctions should also be designed in such a way that they are easily accessible to all ship operators.

8 These objectives would be best achieved by setting up a single auctioning platform, administered on behalf of the Parties by the body in charge of administering the METS. This would maximize auctioning efficiency, ensure a uniform price signal, minimize operational risks and costs for all participants, and guarantee access to all ship operators to the auctioned allowances. On the contrary, the coexistence of several auctioning platforms managed by different Parties would lead to a duplication of fixed costs and administrative burdens, and could entail risks of discrimination against ship operators based on their flag.

9 It is crucial to ensure that shipping companies of different size and complexity can easily participate in auctions. If necessary, a simpler parallel system of access to the auctions could be implemented to cater for the specific needs of some of them, through the organization of non-competitive auction windows. These specific windows would be endowed ex-ante with a certain volume of allowances. Participants in non-competitive auctions can only acquire a small pre-determined number of allowances, sold in small lots (for instance, one tonne). The price paid corresponds to the equilibrium price observed during the most recent competitive auction. Participants in non-competitive auctions only bid on a quantity and not a price, therefore there is no need to guess the price level in order to bid.

10 It is also essential to ensure that auctions are appropriately shielded from the risk of manipulation: one example of such manipulation consists in one auction participant attempting to acquire a significant proportion of all allowances auctioned in order to be able to manipulate the price. One measure to prevent this type of “cornering strategy” could consist in imposing a maximum bid-size allowed from a single entity to deter one or more bidders from using auctions to manipulate the market individually or collectively to acquire a dominant position.

11 Auctioning frequency is another important aspect of auction design. Operating auctions frequently reduces the potential risk for buyers as they can return to buy more allowances at later auctions or spread their bids across auctions: the money involved in any individual auction is relatively small. A high auctioning frequency allows emitters to buy allowances at times that match their requirements rather than being determined by an exogenous schedule, avoiding cash-flow constraints. As a result, the frequency of auction should be fairly high.

Access to the market to non-compliance actors and market regulation and oversight

12 An important aspect of the design of a METS is whether to restrict the right to hold "shipping allowances" to ship operators covered by the scheme (on the basis that allowances must be reserved to those actors who legally need them in order to comply with their obligations under the scheme), or to allow other entities (e.g., financial intermediaries, fuel suppliers, P&I Clubs, professional organizations) to acquire and trade shipping allowances as well. While restricting access to the METS to compliance players only may sound like a good idea to protect the market against speculative behaviour, it is important to note that such a distinction between ship operators and other entities is not always easy, as banks and fuel suppliers may also be involved in shipping activities. Furthermore, experience in the EU ETS suggests that non-compliance players played a useful role in increasing the liquidity of the carbon markets. This increased liquidity guarantees a certain form of price stability and brings certainty to compliance operators as to their capacity to find a counterparty for a purchase or a sale of allowances in all circumstances. Finally, allowing non-compliance players to trade shipping allowances may enable small operators to request a third party (for instance a bank or a P&I Club) to buy and submit the required allowances to their registry account on their behalf.

13 A prerequisite for allowing non-compliance actors to acquire and trade shipping allowances is to ensure that the market (both auctions and secondary markets) is strictly regulated and monitored in order to protect its integrity and efficiency and hence its legitimacy as an efficient tool against climate change. The regulation and oversight framework should aim at appropriately preventing market abuse (including conflict of interest), fraud and excessive risk taking, improving market transparency and ensuring appropriate market oversight.

14 An additional challenge for the regulation and oversight of a METS, compared to a national or regional ETS, lies in its international nature: it is likely that the METS administrator will not have inquiry and injunction powers over participants in the scheme – it will have to rely to a large extent on national authorities. For ship operators, it can rely on flag State and port State controls. However, for non-compliance participants in the market, the METS administrator will have to rely on other national authorities, such as financial markets authorities, to enforce rules for participation in the market. This calls for a strict screening of players authorized to hold shipping allowances in the first place, to check their integrity and ensure they are clearly identified.

15 The overall objective should of course be to design a regulatory and oversight framework commensurate with the level of risk, not to create an excessive regulation that will generate unjustified burden on market participants, putting the well-functioning and the economic efficiency of carbon market at risk.

Linking to other schemes

16 As mentioned in document MEPC 59/4/26, an open trading system has the advantage of allowing trade with entities in other sectors that may face a lower marginal abatement cost than the shipping sector. Therefore trade should be permitted with other "compatible" cap-and-trade systems, and in addition the shipping industry should be able to use credits generated by the Clean Development Mechanism (CDM) projects under the Kyoto Protocol or any equivalent type of mechanisms recognized by a future international agreement.

Auctioning revenues utilization

17 Depending on the cap set on GHG emissions from the shipping sector, and the price reached by "shipping allowances", auctioning could raise revenues in the order of $20bn annually by 2020. The determination of how to utilize these revenues could follow the principles laid out in the Danish proposal (MEPC 59/4/5), with the final allocation of the revenues to be decided by the Parties taking into account the principle of common but differentiated responsibilities and respective capabilities. Auctioning revenues could in particular be used to:

.1 cover expenses for the central administration of the scheme;

.2 finance mitigation and adaptation efforts in developing countries, in particular the most vulnerable developing countries, such as the least developed countries, small island developing States and Africa, for instance through the Copenhagen Green Climate Fund; and

.3 finance R&D and technology transfer in the maritime sector and technical cooperation to assist developing country operators.

Action requested of the Committee

18 The Committee is invited to consider the aspects brought forward in this document during its discussions on market-based instruments and to take action as appropriate.