

THE EU DIRECTIVE ON LOW SULPHUR FUEL (2005/33/EC): A LEGAL AND INSURANCE INDUSTRY PERSPECTIVE

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The new EU low-sulphur Directive (Directive 1999/32/EC as amended by Directive 2005/33/EC) has now come into force and is aimed at controlling marine fuel emissions from vessels within EU ports.

EU Directive 2005/33/EC

Article 4b of EU Directive 2005/33/EC requires that, with effect from 1 January 2010, Member States must take all necessary steps to ensure that ships berthed or anchored in European Community ports are not permitted to consume marine fuels with a sulphur content exceeding 0.1% by mass. This regulation applies to all vessels irrespective of flag, ship type, age or tonnage¹.

In practice this means that it will be necessary for many ships to switch from residual fuel oil (heavy fuel oil) to distillate fuel, such as marine gas oil, when in port. The Directive requires that this fuel change-over operation should be carried out as soon as possible after arrival and as late as possible prior to sailing.

There are serious concerns that switching from HFO to low sulphur MGO in existing boilers, which are constructed for HFO use, could lead to operational problems and potential safety risks, including flame failure and, in extreme cases, an increased risk of explosion. In California, where similar fuel switching regulations have been in force since 1 July 2009, there were 15 reported casualty investigations attributed to fuel switching in the three months following implementation. The San Francisco Bar Pilots now say they have seen an incident every 1 – 3 days, involving engine failures, start failure whilst at berth and/or changes in speed which effect manoeuvrability. Consequently, it is clear that many vessels trading to/from EU ports will need to conduct modifications extending to boilers, engines, and associated fuel storage, supply and control systems, in order to ensure safe compliance with the Directive.

Initially, many shipowners assumed (wrongly) that the EU would take into account the growing safety concerns and postpone implementation of the Directive so as to be brought into line with the IMO sulphur limits prescribed in MARPOL Annex VI. For this, and other, reasons, the modification process only started in earnest during 2008, and this has placed an enormous burden on the shipping industry. As the 1 January 2010 deadline approached, it became apparent that a large number of vessels had not undertaken, or could not undertake in time, the necessary modifications and verifications required. Given this widespread non-compliance and the safety concerns highlighted by the industry, there were practical arguments for the EU postponing implementation or introducing a phase-in period for the Directive. Consequently, there has been considerable uncertainty (arguably with justification) as to how, and to what extent, the Directive would be enforced after the 1 January deadline.

¹ The Directive has very few exceptions, but does not apply to vessels which are at berth for less than two hours as part of a published time table (for instance ferries on scheduled services).

European Commission Recommendation: 21 December 2009

On 21 December 2009, the EU moved to dispel the confusion surrounding the implementation of the Directive by publishing a Recommendation designed to provide guidance and clarification to Member States as to the enforcement of the Directive. The Recommendation directs Member States to enforce the Directive fully and completely as from 1 January 2010. However, the Recommendation also indicates that, in assessing the appropriate penalty to be applied to non-complying vessels, the Member States should take into account the concrete steps undertaken by the shipowner to achieve compliance. These steps should necessarily include disclosure of a contract with the manufacturer and a Class approved retrofit plan clearly providing a date of completion of the adaptation within 8 months after the enforcement date.

This 8 month period seems to be being treated as a phase-in period. However, it is not, as has been widely reported, an official EU transitional period. Shipowners should be left in no doubt that EU Directive 2005/33/EC is fully in force. Implementation has not been suspended and there are no effective exemptions even when modifications have been arranged but not yet carried out. EU Members have been directed, and are obliged to enforce the Directive fully, although with some flexibility as to the appropriate enforcement action. Any non-compliant vessel will be in breach of the Directive, and therefore at risk.

The Current Position on Enforcement (as of April 2010).

As stated, the Directive gives a great deal of latitude to Member States in determining the appropriate penalty for non-compliance, and on whom liability falls. The only constraint is that the penalties for breach must be effective, proportionate and persuasive. Therefore, at this early stage (and at least until widespread enactment²) it is difficult to assess to what extent the Directive is being enforced and what the appropriate penalties are deemed to be for non-compliance.

Prompted by an awareness that many ships calling at European ports are not in compliance with the Directive, many Member States are not, at present, widely enforcing the Directive. However, this will change. The position beginning to emerge is that Member States are beginning to enforce the Directive, in some cases reluctantly, but in some cases with gusto.

In Italy, for example, the Authorities have directed that until August 2010, vessels can apply to the Harbour Master for authorisation to burn fuels exceeding the 0.1% limit. However, the application must be made one day prior to the vessel's arrival and must include a statement from the vessel's Registry confirming full details of the approved retrofit plan. Notwithstanding this, some Italian ports have taken a harder line and Trieste, for example, will issue non-complaint vessels burning higher sulphur fuels with fines of between €15,000 and €150,000, and will subject vessels burning low sulphur fuels without approved modifications to Port State Control inspection due to unsafe practice.

The writer has been anecdotally informed of at least two cases where vessels have been refused entry to Italian ports on the basis of non-compliance with the Directive.

In early April 2010, the United Kingdom announced that it would be fully enforcing the Directive from 20 April 2010. From this date, ships at berth in U.K. ports are not permitted to use bunker fuel exceeding the 0.1% limit. The U.K. Maritime and Coastguard Agency (MCA) has issued a Marine Information Note, MIN 376, providing the U.K. Ports with guidance and interpretation of different provisions of the EU Directive. These guidelines recommend that one hour is considered sufficient time to complete fuel changeover operations. This does not include time to procure and have delivered to the ship marine fuel with a sulphur content not exceeding 0.1%. A ship is expected to have compliant fuel onboard on arrival at berth.

² It is important to remember that each Member State must implement the EU directive through national legislation to make them law in their own states.

The MCA makes reference to the EU Recommendation but leaves it to the ports discretion as to how, if at all, the Recommendation is applied.

In contrast, authorities in France and Germany have confirmed that they will be applying the Directive, but do not appear to have offered a clear response or guidelines (at the time of writing) as to the enforcement measures or penalties to be applied.

There are also fears that, in some jurisdictions, the crew may bear the brunt of additional inspections and penalties, with some Member States levying penalties against the Master and/or Chief Engineer, rather than the shipowner.

Given the differences in enforcement, even within Members States, shipowners should be prepared. For the time being, any shipowner with a vessel unable to safely comply with the Directive should check the relevant control measures being taken by individual states when fixing charters and prior to entering the designated EU port.

Availability of Low Sulphur Fuels in EU Ports

More generally, there has been concern expressed regarding the future availability of low sulphur fuel oils at EU Ports.

As demand for lower sulphur fuels increases, the oil industry has little choice but to turn to crude oils with higher sulphur content to produce the low sulphur fuels. In order to ensure that the refined products meet EU requirements, cutter stock (or other additives) may need to be added in order to reduce the average sulphur content in the fuel. However, these additives carry an increased risk of particular contamination. Contaminants such as these are a costly problem for shipowners, as particles can enter and damage an engine relatively rapidly. A ship which has taken on a contaminated supply can be immobilised within days.

The EU has stated that it predicts that measures to ensure supply of safe low sulphur fuels to the marine industry will add a premium of US\$65 per mt for 0.1% sulphur bunker fuel, and a US\$130 premium on 0.1% sulphur MGO. These increases, if correct, would equate to overall increased fuel costs of US\$1.3 billion per annum for shipowners.

As importantly, the Directive provides no guidance, nor does it offer any concessions, in circumstances where ships attempt but are unable to obtain the required low sulphur fuels prior to calling at an EU port. Intertanko has made a recommendation to the EU Commission requesting that it advise Members States when assessing penalties to take into consideration, and have due regard for, a shipowner who is able to demonstrate that it tried but could not source a suitable supply of low sulphur fuel. However, this recommendation has been rejected by the EU Commission on the basis that this would involve a lengthy process amending the Directive and that any concession may result in shipowners seeking to avoid their obligation to source supplies of low sulphur fuel prior to entering the EU.

The Directive also presumes that ships not able to source low-sulphur fuels before arrival at EU ports, will be promptly supplied when arriving at an EU Port. This assumes that such supplies will always be available. However, this would require a fuel supply system that differs widely from the one currently in place within the EU.

Legal and Insurance Considerations

With respect to non-compliant vessels, the implementation of the Directive may have significant legal and insurance related implications on the operation and trading of the vessel. Whilst an exhaustive list of these implications is not possible, these may include the following:

- Fines: Any fines imposed for non-compliance with the Directive will not generally be covered items under a ship-owners' P&I insurance. Such fines are unlikely to fall within the categories of covered fines as set out in the P&I Clubs' Rules, and in addition they are unlikely to be covered under any discretionary cover which is usually provided only in exceptional circumstances.
- Insurance Considerations: The insurance industry has yet to grapple with the strict insurance implications of vessels' non-compliance with the EU Directive. However, a shipowner should be aware that insurance companies may have, as an express condition to cover, the requirement that a ship fully complies with all rules, regulations, recommendations and requirements of applicable public authorities.

Additionally, if the shipowner attempts to burn low sulphur fuel in a vessel without approved modifications, then the EU may consider this to be unsafe practice. Insurance companies often have a provision potentially excluding cover in circumstances of intentional acts or deliberate omissions, with knowledge that this act or omission will result in injury, loss or damage to the vessel. It is unclear, but certainly arguable, that this provision could apply in such circumstances.

- Charterparty Considerations: If a vessel is non-compliant there may be issues relating to the shipowners' trading limit warranties. In a charterparty, a shipowner will usually warrant that the vessel can trade within certain areas or limits (eg NYPE 93 Clause 5). It is conceivable that at some point non-compliant vessels will be prohibited from continuing trading to EU ports, which may mean that the shipowner will be in breach of this charterparty warranty and entitling the charterer to claim damages and, if the breach is held to be sufficiently serious as to be repudiatory, it will entitle the charterer to terminate the contract.
- Many charterparties also contain a warranty that the vessel fully complies with applicable conventions, laws, regulations and ordinances of any international, national, state or local government authority. The risk of such legislation being implemented during a long term time charter rests with the shipowner.
- Owners have an obligation to ensure that the vessel is "legally fit" for the service required. If a vessel is not able to burn low sulphur fuel in compliance with the Directive, the vessel is unlikely to be considered to be "*in every way fitted for the [charterers] service*". (see eg. NYPE 46 Line 22, Baltim 2001). In this context "*fitted for*" means "*fit for*" or "*suitable for*". This would probably include compliance with regulatory requirements (see *the Elli and the Frixos* [2008] 2 Lloyd's Rep 119).

If the charterparty incorporates the BIMCO Fuel Sulphur Content Clause then shipowners will be held to have expressly warranted that the vessel "*shall be able to consume fuels of the required sulphur content when ordered by the charterers to trade within any such zone*".

- Non-compliant vessels may also fall foul of vetting clauses and/or other necessary trading approvals. Tanker charters often contain a provision that the vessel must be maintained to a technical standard to be acceptable to major oil companies under, for example, the OCIMF SIRE Inspection programme. It is almost certain that oil majors will be reluctant or unwilling to fix non-compliant ships for business to or from the EU. Therefore, compliance will have a material impact on the ability to trade and/or sub-charter the vessel.

Legal and insurance implications are not confined to non-compliant vessels. In seeking to comply with the Directive additional considerations arise including the following:

- Modifications: All vessel modifications must be made in accordance with manufacturers' recommendations and approved by Class. Boilers that do not require modification should be inspected and similarly approved. Failure to obtain Class approval may prejudice insurance cover and may jeopardise existing charter contracts. Faulty modifications may also give rise to contractual claims associated with vessel breakdown including claims for unseaworthiness and/or loss of use of the vessel.
- Charterparty Considerations: Shipowners and charterers will need to reallocate the cost and risk under the charterparty of changes brought about by compliance with the Directive.
- Modifications may have an impact on the vessel's description warranties contained in the charterparty including *inter alia* lifting capacity, stability, trim, and vessel's performance. For example, a ship may need to have a set of segregated storage tanks specifically designated as low sulphur tanks, and possibly dual pumping systems. This may be at the expense of tanks previously used to carry fuel of other grades. This modification may have an impact on the vessel's stability and/or reduce the vessel's ability to lift a charterers' cargo, both of which will potentially give rise to claims for damages under the charter.
- Time charterparties often include a clause stipulating the grade of fuel to be supplied by the charterer, and if the charterer is only contractually obligated to provide high sulphur bunkers, he may refuse or fail to supply fuel appropriate to comply with the EU Directive (which will almost certainly be more expensive). This may result in damages and off-hire claims, particularly where a Master feels unable or unwilling to proceed to an EU port as a result.
- Shipbuilding contracts: Questions have arisen regarding on whom the additional costs of modifications should rest under purchase or shipbuilding contracts, and whether a Yard will be in breach of ship building contract by refusing to make adaptations and thereafter delivering a vessel in compliance with the original specifications but unable to carry out its intended trading operations.
- Bunker supplier contracts: There will be a burden on bunker suppliers to supply fuel in conformity with the low sulphur regulations. However, the burden of demonstrating compliance will be on the shipowners. The requirements will include retaining Bunker Delivery Receipts, which must show the sulphur content of all fuels received.

Note. There are also numerous additional, and often unforeseen, technical and operational issues which have arisen. For example, technical experts have identified that sulphur acts as a lubricant and that burning low sulphur fuel may have an impact on cylinder lubrication. Cylinder failure, engine breakdown and resulting marine incidents may have an adverse environmental impact which may more than counteract the positive environmental consequences the regulations were seeking to promote. There are certainly unexpected consequences arising that need to be evaluated and addressed.

Lessons to be learned and conclusions

Environmental legislation is, or should be, welcomed by all. We all have a vested interest in a cleaner, more environmentally friendly, marine industry. The vast majority of those involved in the shipping industry, including ship owners and operators, recognise and agree with this. Indeed, there have been quantum leaps forward in introducing environmental improvements to ships in recent years.

However, such regulation must be straightforward and clear in its scope and application, in order to avoid confusion and ensure certainty and efficient implementation. It is equally important that the effects of the regulations are properly and fully thought through, in order to minimise unexpected and

unintended consequences and/or which place an excessive burden on shipowners, charterers and the industry as a whole.

It should be strongly recommended that members of the shipping industry including organisations such as Intertanko, shipowners and technical marine experts be fully consulted in the planning and assessment of environmental measures. There is also a strong feeling from within the industry that regulation is more appropriately (and efficiently) dealt with on a global basis through the IMO rather than at a local and/or regional level. Certainly, consideration for straightforward and uniform regulation is paramount. This can only assist in the clear and efficient implementation of environmental regulations which will serve all interests.

In conclusion, the enforcement and legal impact of the EU low-sulphur Directive is still far from clear. The burden and risk of modifying ships to comply with these EU standards rests squarely with shipowners. It remains to be seen how the Member States will enforce the Directive, but it is clear that significant operational and legal challenges remain for the shipping industry in complying with regulations imposed by the Directive.

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