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CII – Time for a rethink?

Following low uptake of the BIMCO CII Operations Clause, Ian Short, CJC Director, asks whether it is the time to "think outside the box" and challenge traditional shipping and legal concepts to marry increasing environmental concerns with conventional obligations under charterparties.

When the IMO started to implement its welcome plan to reduce carbon emissions in shipping, the intention was to create measures and frameworks that would ensure individual ships produce lower carbon emissions over time both in terms of their design and build but also in terms of the way in which they are operated.

The goal is clear but the way in which such measures fit within existing charterparty structures and the apportioning of responsibility between owners and charterers for such measures is proving to be complex and is a subject of much current debate.

Whilst the Energy Efficiency Existing Ship Index (EEXI) focusses on the ship itself, the Carbon Intensity Index (CII) relates primarily to the way in which ships are operated and the CO2 output from this operation. The way in which CII works has been helpfully summarised by Neil Jackson and Allen Marks in their recent article. Both indices came into force on 1 January 2023 and both require consideration from owners and charterers alike in terms of apportioning responsibility for the measures in their charterparties. Both are also likely to provide a source of disputes, particularly if not managed now.

BIMCO published the long-awaited CII Operations Clause in November 2022. BIMCO's task was far from an easy one in circumstances where it is the owner's vessel that would obtain the CII Rating A-E after an assessment of each year's carbon emission performance, yet the rating would be determined to a large extent by the way in which a ship had been operated by its charterers. It will also be the case that the rating covering the period of performance for which a charterer may have chartered the ship for will not be known for some time after redelivery.

BIMCO drafted a clause which allows the parties to agree a CII value applicable to the period of the time charterparty as opposed to having to wait for the ship's A-E rating the following year and for the parties to monitor the vessel's attained CII performance during the charterparty to ensure it stays in line with the agreed value. This value is not the A-E rating but an agreed figure reflecting the CII calculation of Annual Fuel Consumption multiplied by the CO2 emissions factor for the fuel type being consumed, divided by the distance travelled multiplied by the deadweight capacity of the ship. With technological advancements and software enabling CII to be monitored on a daily basis, there is a sound basis behind this rationale, and it enables an assessment to be made on a charter-by-charter basis as opposed to awaiting the end of each calendar year.

Feedback on BIMCO clause

The clause has drawn widespread criticism from major operators and charterers with many heavyweight shipping companies signing an open letter to BIMCO in December criticising the BIMCO clause for

putting the CII obligations "disproportionately on the charterers". The soft market will not have helped its uptake.

The writer has given several talks and seminars on CII this year and has sought market feedback on the BIMCO CII Operations Clause. Essentially the clause is not being used. We found one example where it had been, but it was suspected that the charterers had not read through the Riders properly. However, doing nothing is not the answer and could lead to legal disputes in itself as discussed further below.

Whilst there are some inevitable issues with the BIMCO Clause, there is no neat solution and whichever terms are explored are likely to give rise to complications given the nature of CII. Whilst the intention behind CII is undisputed and its implementation is having the effect of getting shipping companies talking about reducing carbon emissions through vessel operation, many of the issues in fitting CII neatly into charterparties start with the CII itself.

The CII has been criticised in some quarters for not taking into account the cargo in fact carried. An individual ship, for example, may be able to achieve a more favourable CII rating by undertaking ballast legs but that does little to reduce carbon emissions from the trade as a whole. A further issue cited is that whilst longer distances improve CII, ships stuck at port for long periods will fare poorly. Even though fuel consumption is lower at port, a ship will still be burning fuel but not traveling any distance. For example, those ships unable to depart Ukraine ports last year staying for many months would have had their CII rating impacted by those stays.

A final criticism levelled at CII is that it does not have visible teeth, in that there are no applicable fines nor financial penalties for adverse ratings. Instead, corrective action will need to be taken for ships with a D rating for three consecutive years and those with an E rating in any one year, via updating a Ship Energy Efficiency Management Plan (SEEMP). A failure to improve the rating thereafter, as matters stand at least, will not see a ship fined or penalised. Until CII has a financial impact on vessel operation, some parties may question why it should affect them.

Whilst the prospect of fines or penalties will be revisited in 2025, it remains to be seen in the meantime if there are to be adverse effects on trading through other means. For example, will port state control have a role to play, perhaps with certain ports only allowing ships to enter with a sufficient CII rating or charging more for low performing ships to enter? Will flag states intervene in respect of poorly rated ships under their flag? Finally, will market forces take hold such that higher rated ships are more attractive on the market, either being more charterable or achieving higher rates while those with low CII rating are adversely impacted? Time will tell but there could well be an indirect financial impact on operating and trading vessels long term as a result of CII even without immediate direct penalties for low ratings.

Legal issues for CII

From a legal and contractual perspective, there are additional issues with CII. Since it is primarily operational, the ship's rating will depend to a large extent on the orders given to the vessel by its charterers. This would be the end time charterer in any contractual chain. That charterer may in turn have voyage chartered the vessel out. Measures to improve a CII rating include slower steaming to improve fuel efficiency, in a similar way in which EEXI compliance with, say, overridable power limiters, causes the ship to proceed more slowly. However, that end time charterer will be under contractual obligations under its voyage charter to proceed with utmost dispatch and all due dispatch and therefore that charterer will not be in a position to order the vessel to slow steam without potentially being in breach of the voyage charter, that is unless it has suitably protected its position under the sub-charter.

Another issue is that the traditional demurrage model does not lend itself to environmental measures such as CII. That charterer providing the orders would prefer a vessel steaming full speed into port, tender its NOR, start the laytime clock ticking under its voyage charter and increasing the demurrage earned, as opposed to slow steaming into port which may improve the vessel's emissions output but will reduce their voyage charterparty earnings.

That time charterer will also want to maximise its income and profits from trading the ship. A slower ship over a period of time could mean fewer voyages and lower freight earnings. There is also little financial incentive to load less cargo and reduce freight earnings that way to improve fuel efficiency.

In other words, there are legal and financial restrictions on a charterer providing a vessel with the orders that it may need to boost its CII rating.

As for the shipowner, absent any provision to the contrary, it is not able to disregard charterers' orders in order to try to bolster the CII rating of its ship without being in breach or the vessel going off-hire. There may be a difference between slow steaming under CII and EEXI as well. A ship that is fitted with a power limiter in order to pass EEXI is restricted in its speed. Notwithstanding any provision or speed and performance warranty in the charter and assuming that the parties did not adopt the BIMCO EEXI Transition Clause, an owner will at least have an argument that an order from a charterer to proceed at full speed in excess of the revised restricted speed is an unlawful or illegitimate order since compliance with such an order would otherwise put the owner in contravention of IMO Conventions, MARPOL, as well as Class requirements. However, an owner that unilaterally decides to slow steam the vessel for CII purposes in contravention of charterers' orders to proceed more swiftly will almost inevitably fall foul of speed and performance warranties and face deductions from hire, as well as potential damages claims for breach in failing to comply with charterers' orders.

It must also be borne in mind that an owner may have due dispatch obligations of its own under bills of lading and, unless a suitable provision is incorporated into the bills of lading, an owner as carrier could face claims under these bills.

The indemnity angle

So, what legal incentive is there for a charterer to co-operate with an owner to improve a ship's CII rating? The one possible angle to this is the implied indemnity. Using a simple example, a charterer charters in the vessel for the 2023 calendar year and redelivers in early 2024. The ship achieves an "E" rating in its survey in early 2024 and the vessel earns less on the market under its subsequent charters in 2024 as a result. Can the shipowner argue that the charterer should indemnify it for its market losses since the low rating was caused by compliance with charterers' orders under the 2023 charter? The argument may not work, not least because there may be causation issues in proving that the orders caused the losses, and it would become even more complex where there are multiple charters in the relevant year, but it is an argument that could, legally at least, persuade charterers to agree to a CII clause.

Given the reported low uptake on the BIMCO CII Operations Clause, the starting point when considering the legal and contractual implications of CII is to consider what the position would be should the parties do nothing and fail to agree any clause dealing with CII in their existing charterparties. This would appear to be the most common situation at the time of writing. That position is set out above, with charterers either unable or incentivised to provide orders that would support a better CII rating and the shipowner unable to do much about it during the period of any charter aside from, possibly, claim under the implied indemnity for losses caused by a low CII rating, a difficult task.

Perhaps the most controversial aspect of the BIMCO CII Clause is the fact that, after warnings to charterers are not heeded, an owner can start to disregard charterers' orders to improve the ship's CII rating, whilst the vessel remains on hire. If the BIMCO CII clause is adopted, this is likely to be a point of conflict, with charterers no doubt putting the vessel off-hire for owners failing to comply with their orders and the owners insisting that they have the right to earn hire whilst disregarding charterers' orders.

Scope of obligations

Another source of possible disputes under the CII Clause is that the owners shall be entitled to claim from the charterers any losses, damages, liabilities, claims, fines, costs, expenses, actions, proceedings, suits or demands suffered by the vessel or the owners which have been caused by any breach by the charterers of their obligations under this clause. This widely worded clause could possibly include losses arising out of poorer market rates achieved due to a low CII rating but questions will remain regarding whether losses were caused by a charterers' non-compliance with the BIMCO CII Clause.

The widely-worded nature of the damages clause does not fit neatly in certain circumstances either. For example, a charterer which trip time charters the vessel in and finds that, through no fault of its own, the vessel remains stuck at the loadport for longer than intended, will already be up against compliance with the agreed charterparty CII value and with no time or ability in the short charter to improve the rating thereafter, will be left exposed to damages claims.

Finally, unless the charterer providing orders protects the position in its voyage charter, it will be unable to provide orders to slow steam without being in breach of its utmost dispatch obligations under the voyage charter.

Given the way in which CII operates, it is not an "easy fit" into existing charterparties. Alternative approaches also have their difficulties. One option adapting the BIMCO CII Clause is for the owner to be permitted upon sufficient notice to take the vessel back off-hire and trade the vessel for its own purpose for a period in order to improve the ship's CII rating. However, in this case, a charterer would have hired in the vessel for a particular purpose and the clause could be exploited depending on market conditions during longer term charters. Another option is for an express indemnity for charterers to compensate owners for a downgraded or low CII rating, or some kind of shared indemnification. However, where this is not calculated contemporaneously and a significant period of time may lapse before a rating is known, issues will arise as to how owners would obtain security for these possible future losses, as well as how any losses are to be calculated.

A further option could be to follow the Emission Trading Scheme approach and its "polluter pays" maxim, with charterers paying a sum of money together with each hire statement which is placed in some kind of escrow or holding account, with the owner retaining the money if a charterer does not meet its agreed emissions figure or charters receiving it back if they do, with possibly a sliding scale depending on emissions performance. Whilst such a scheme would try to provide charterers with financial incentives to improve a ship's CII rating, the parties would have to be careful that it did not incentivise owners to encourage poor CII performance to obtain these funds. Further, practical issues will arise as to where the escrow monies are held and by whom.

An alternative approach

A radical approach challenging traditional shipping models could be to agree different hire rates for different trading activities, such as lower rates for ballast legs and the full rate for port stays and laden passages. Whilst such an approach aims to provide charterers with the necessary financial incentives to consider emissions from the vessel and improve its CII rating, a nagging doubt remains whether, although good for the ship's individual rating, it has only a negligible positive overall effect on carbon emissions – whilst ballast legs may improve a ship's rating, ballast legs are no good for the environment as a ship is polluting whilst not performing its primary purpose of carrying cargo.

Parties will also have to carefully consider their rights and obligations under voyage charterparties and incorporate, as best they can, suitable terms into bills of lading to enable slow steaming orders to be given to the ship without falling foul of pre-exiting conditions in other contracts. The writer has drafted an example clause for this purpose, which is available upon request.

It remains to be seen what impact, if any, a low CII rating will have on a ship, its port dues paid, whether any restrictions develop on trading routes and places and whether the market will recognise the benefit of higher rated vessels or not. Perhaps it will not be until any effects are known when the parties start to agree obligations in respect of CII. Until then, and with a reported low uptake on CII Clauses generally, owners will bear the risk of low ratings whilst to some extent at the mercy of those to whom they charter their ships. If adverse effects of a low rating are felt, inevitably disputes will arise as to who should be responsible for this impact. Such disputes are not likely to be straightforward under unamended charterparties.

Whilst issues have been raised by the CII formula and its overall impact on carbon emissions, we must also recognise that traditional shipping and legal concepts do not fit neatly with environmental measures. Perhaps some of these concepts need to be challenged in order to incentivise parties to put environmental concerns at the forefront of their decision-making.

For further information *on legal issues arising for owners and charterers as a result of the IMO's Carbon Intensity Indicator, please contact Ian Short, Director, CJC.*

Ian Short
Director
Ian@CJCLaw.com

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