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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**on the feasibility of a financial instrument that would facilitate safe and sound ship
recycling**

I. INTRODUCTION

Each year, hundreds of large ships are sold for dismantling on the tidal beaches of South Asia¹. The negative impacts of this practice on the environment and human health have been extensively documented². Difficulties in enforcing the Basel Convention³ with regards to ships, as well as the European ban on exports of hazardous waste outside the OECD⁴, led to the adoption of the Hong Kong Convention in 2009⁵ and the European Ship Recycling Regulation in 2013⁶ respectively. Using the possibility offered by Article 1(2) of the Hong Kong Convention, the Ship Recycling Regulation sets more stringent requirements than the Convention, notably with regards to health, safety and the environment.

Article 29 ('Financial incentive') of Regulation (EU) No 1257/2013 on ship recycling⁷ calls on the Commission to report on "the feasibility of a financial instrument that would facilitate safe and sound ship recycling and, if appropriate, accompany the report by a legislative proposal". This report is submitted to comply with that reporting obligation. It first summarises the current regulatory approach to the issues stemming from ship recycling (I). It then presents the state of play of research on the feasibility of a financial incentive for safe and sound ship recycling (II), introducing a new concept, the *Ship Recycling Licence* (III). The report also contains a summary of stakeholders' feedback (IV) and ends with a conclusion (V).

The Ship Recycling Regulation introduces a clear sequence of instruments. The primary instrument, with a timeline for establishment and a set of related obligations explicitly set in the text of the Regulation, is the *European List of ship recycling facilities*. From a date to fall at the latest on 31 December 2018, EU-flagged ships may only be recycled in listed facilities. A first list of 18 compliant facilities located in the EU was published in December 2016⁸. Additional facilities located outside the EU might be added to the List from 2017⁹. Because it

¹ NGO Shipbreaking Platform, List of all ships scrapped worldwide in 2016,

http://www.shipbreakingplatform.org/shipbrea_wp2011/wp-content/uploads/2017/02/Stats-Graphs_2016-List_FINAL1.pdf

² See notably Science for Environment Policy, Issue 55, June 2016,

http://ec.europa.eu/environment/integration/research/newsalert/pdf/ship_recycling_reducing_human_and_environmental_impacts_55si_en.pdf

³ Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal was adopted on 22 March 1989; <http://www.basel.int/theconvention/overview/tabid/1271/default.aspx>

⁴ Regulation (EC) No 1013/2006 of the European Parliament and of the Council of 14 June 2006 on shipments of waste, <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1454069470717&uri=CELEX:02006R1013-20160101>

⁵ Hong Kong International Convention for the Safe and Environmentally Sound Recycling of Ships. To enter into force, the HKC requires ratification by 15 States representing no less than 40% of the world fleet's tonnage and a combined maximum annual ship recycling volume of not less than 3% of the tonnage of the fleet of the ratifying states. As of February 2017, the HKC was yet to enter into force, having been ratified by five countries, including EU Member States France and Belgium and no major ship recycling state

<http://www.imo.org/en/About/conventions/listofconventions/pages/the-hong-kong-international-convention-for-the-safe-and-environmentally-sound-recycling-of-ships.aspx>

⁶ The Regulation has a specific focus on all ships trading in EU waters and ships sailing under the flags of Member States of the Union. The Regulation not only mirrors the requirements of the HKC, it also adds stricter environmental and safety requirements, as authorised by Article 1(2) HKC.

⁷ 'The Ship Recycling Regulation' - Regulation (EU) No 1257/2013 of the European Parliament and of the Council of 20 November 2013 on ship recycling; <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013R1257>

⁸ http://ec.europa.eu/environment/waste/ships/pdf/list_ship_recycling_facilities.pdf

⁹ The Commission is currently reviewing 22 applications for inclusion on the List received from ship recycling facilities located in China, India, Turkey and the USA.

is underpinned by assessments and site inspections independent from business interests, the European List creates unique reputational added-value to the sector. Ship recyclers may gain exclusive access to the recycling of EU-flagged ships in return for reaching high performance standards. Similarly, ship owners may reinforce their corporate social responsibility credentials and limit their liability related to substandard recycling by having their ships dismantled in facilities on the List. Furthermore, the European List being the only instrument of its kind, it could provide incentive for improvement beyond EU-flagged ships, which could contribute to levelling up the international playing field.

In its Article 29 and Recital 19, the Ship Recycling Regulation alludes to a potential second instrument of a financial nature as a contingency measure against possible risks of circumvention of the European List¹⁰. Circumvention would consist in ships changing flag to non-EU flags to facilitate dismantling in a yard not included on the European List. Central to this risk is profit maximisation: the market for ship recycling has mostly been captured by sub-standard yards able to offer better prices for end-of-life vessels as a result of low labour costs, high health, safety and environmental externalities, inadequate investment in machinery and little to no hazardous waste management capacity. The result, it has been observed, is that *"the polluter pays principle is usually not applied"* in ship recycling¹¹. A financial incentive would aim to cancel out the profit gap between dismantling in substandard yards and dismantling in yards listed on the European List.

The 2008 Communication proposing an EU strategy on ship dismantling¹² and the 2012 Impact Assessment¹³ had both anticipated the staged approach reflected in the Regulation.

II. STATE OF PLAY OF RESEARCH ON A POTENTIAL FINANCIAL INSTRUMENT

A financial instrument was already considered in the lead up to the adoption of the Hong Kong Convention. A 2005 study¹⁴ called for a *"Ship Recycling Fund"* tasked with collecting fees and disbursing funds for environmentally sound scrapping. It also considered the establishment of an *"obligatory life insurance"* to cover the costs of clean recycling. Taking a different approach, the Hong Kong Convention contains a "funding" clause in its article on technical cooperation, on the basis of voluntary contributions. The clause does not refer to the

¹⁰ Article 29 contains the reporting obligation; Recital 19 goes in greater details, underlining the flag-neutral, shipowner-focused approach of the potential incentive.

¹¹ See also Milieu&COWI, Study in relation to options for new initiatives regarding dismantling of ships – Note on the ship dismantling fund, Pros and cons of the three options, p. 17, August 2009 http://ec.europa.eu/environment/waste/ships/pdf/fund_note.pdf

¹² Communication COM (2008) 767 final of 19 November 2008 presenting an "EU strategy for better ship dismantling", and its impact assessment in Commission Staff Working Document SEC(2008) 2846: *"if it turns out that the [...] reactions by market participants do not deliver the desired result, the option of a funding system implementing the 'polluter pays' principle should be reconsidered"*

¹³ Impact Assessment accompanying the proposal for a Regulation on ship recycling (SWD(2012) 47 final), <http://ec.europa.eu/environment/waste/ships/pdf/Impact%20Assessment.pdf> *"Should compliance problems continue, further actions could be undertaken at EU level like the setting up of an EU ship dismantling fund."*

¹⁴ The Ship Recycling Fund – Financing environmentally sound scrapping and recycling of sea-going ships, Ecorys (2005) http://www.shipbreakingplatform.org/shipbrea_wp2011/wp-content/uploads/2011/11/ECORYS-survey-on-a-ship-recycling-fund.pdf

"polluter-pays" principle. Outside the EU, China introduced a combined financial scheme for the building and recycling of Chinese-flagged ships in 2013; the scheme was renewed in 2016.

In December 2014, the Commission ordered a study to inform the present report. The study was to build on earlier studies¹⁵ and address research gaps, including on the financial means to be generated and disbursed, effects on competition, administrative burden and legal implications with regards to e.g. World Trade Organisation and EU rules. The study also aimed to inform the design of an operational instrument to facilitate safe and environmentally sound ship recycling.

The study was published in June 2016¹⁶. It discarded several options investigated in past studies on the following grounds:

Category of option	Option	Main shortcoming
(Non-financial instruments)	(Non-financial measures, e.g. penalties on penultimate owner)	(Easy to circumvent or stimulating additional circumvention behaviour, and/or lack of suitable enforcement mechanism.)
Instruments obliging shipowners to collect the required capital through a privately managed mechanism that is attached to a unique ship	Ship Recycling Guarantee	Difficult to transfer in case of change of ownership; disproportionate to ships with low frequency of calls at EU ports.
	Ship Recycling Account	Difficult to transfer in case of change of ownership; disproportionate to ships with low frequency of calls at EU ports.
	Ship Recycling Insurance	Lack of “insured object” due to lack of unforeseen event, other than loss of the vessel due to an accident. Not feasible as separate instrument.
Instruments obliging shipowners to contribute to a public regime (a fund) based on payments to be made when accessing EU ports.	Port levy	High administrative burden for ports; potentially not WTO compliant; possibly considered as tax outside the competence of the EU.

III. THE SHIP RECYCLING LICENCE

The 2016 study identifies a new option – the *Ship Recycling Licence*. The Licence is an attempt at combining the strengths of the discarded options while overcoming their drawbacks. Its key principles are the following:

¹⁵ See notably Ecorys 2005 for Greenpeace, COWI/Milieu 2009 for the Commission's Impact Assessment, Profundo 2013 *Financial mechanisms to ensure responsible ship recycling*, Milieu 2013 for the European Parliament. It should be noted that existing studies– except for the 2016 study carried out to inform the present report – all pre-date the adoption of the Ship Recycling Regulation in its final form.

¹⁶ Ecorys, DNV-GL, Erasmus School of Law, *Financial instrument to facilitate safe and sound ship recycling*, June 2016. http://ec.europa.eu/environment/waste/ships/pdf/financial_instrument_ship_recycling.pdf

1. Ships calling at EU ports would obtain a prior licence from a centralised agency (e.g. an existing European agency). The licence would be an instrument of a public, administrative law nature;
2. When applying for the Licence, ship owners would be charged a contribution. The contribution would cover a small administrative retribution (0.8%) and a premium earmarked to the individual ship (99.2%);
3. The premium levied would depend on the capital amount that needs to be accumulated to bridge the financial gap between dismantling in a substandard yard and dismantling in a yard included on the European List at the end of the ship's lifetime. The premium would also depend on the timeframe within which to accumulate the capital;
4. The full capital amount would be paid to the ultimate owner of the ship on a condition that the ship was sent to a ship recycling facility on the European List;
5. The penalty for not opting for recycling in a facility included in the European List would be a forfeiture of the accrued rights;
6. To avoid a system working disproportionately against ships with either very high or very low port call frequency, the Licence validity would be time-based rather than based on the number of calls (i.e. a one-month licence would be cheaper than an annual licence, but provide for a lesser right to payment at end-of-life). Refined criteria could be envisaged, e.g. to benefit ships designed for easier recycling.

The study identifies some of the potential impacts¹⁷ of establishing a Ship Recycling Licence and outlines considerations for implementation¹⁸ including the role of a European Agency (new or existing), the use of forfeited funds and a simple scheme for third-country flagged ships.

IV. STAKEHOLDER FEEDBACK

The European Economic and Social Committee (EESC) and a variety of stakeholder associations have expressed a position on the Ship Recycling Licence.

The EESC adopted an opinion on the matter on 19 October 2016¹⁹. The opinion labels the Ship Recycling Licence "*a progressive, enforceable financial mechanism*" and calls on the European Commission to establish it. The NGO Shipbreaking Platform – an umbrella organisation for various NGOs involved in ship recycling –, trade union confederation IndustriAll and SEA EUROPE (the Shipyards and Maritime Equipment Association), issued a joint statement supporting the conclusions of the EESC opinion on 20 October 2016.

¹⁷ See section 4 of Ecorys, DNV-GL, Erasmus School of Law June 2016 (a matrix of impacts depending on the cost of the Licence can be found page 83).

¹⁸ See section 5.2 of Ecorys, DNV-GL, Erasmus School of Law June 2016.

¹⁹ EESC opinion: Shipbreaking and the recycling society, EESC-2016-00456. Adoption: 202 for, 2 against, 3 abstentions. <http://www.eesc.europa.eu/?i=portal.en.ccmi-opinions.38327>

ESPO, the association of European ports, withdrew its opposition to the financial incentive in 2015, considering that the Licence avoids the main drawback of an earlier concept whereby ports would collect the contributions.

Shipowner organisations ECSA (European Community of Shipowners Associations), ASA (Asian Shipowners Association) and ICS (International Chamber of Shipping) reacted to the publication of the study in July 2016. Their position is that the Ship Recycling Licence would disrupt efforts to ratify the Hong Kong Convention. A legal opinion commissioned by the shipowner organisations further describes the Ship Recycling Licence as a "*primary fiscal measure*", suggests that the EU would have no competence to administer an EU ship recycling scheme and infers an incompatibility with the UN Law of the Sea Convention (UNCLOS), with World Trade Organisation rules and the Principle of Common but Differentiated Responsibilities. It should be noted that several of these points are addressed in the 2016 study ordered by the Commission²⁰.

In contrast, the NGO Shipbreaking Platform published a position paper in October 2016²¹ supporting the legal arguments of the 2016 study. The analysis stresses that the Ship Recycling Licence would not cause the "hindrance to trade" feared by the shipowner organisations as the key argument for incompatibility with World Trade Organisation rules, be it trade in goods, trade in vessels or trade in steel at end of life. The analysis also notes that the Ship Recycling Regulation constitutes a complement of action to the Hong Kong Convention, as authorised in the HKC itself and as generally encouraged under the UN Convention on the Law of the Sea (UNCLOS), where the shipowners' organisations tend to see a conflict of legal regimes.

V. CONCLUSION

The Commission acknowledges the merits of a potential Ship Recycling Licence, which represents the most promising option investigated thus far. Nevertheless, the Commission is aware that a number of issues deserve further analysis, including with regard to the compatibility of such a potential financial instrument with EU and international law.

In line with the gradual approach first described in the 2008 Commission Communication and 2012 Impact Assessment and reflected in the final text of the Ship Recycling Regulation, the need for additional measures on financial incentives will be reassessed at a later stage, based on an analysis of the use and effects of the European List of ship recycling facilities.

²⁰ Annexes B ("WTO compliance") and C ("Extraterritoriality and the SRL") of the 2016 study underline that (a) there is a clear legal case not to identify the SRL with a "fiscal measure", (b) the EU would be acting within the remit of its competence, (c) the SRL precisely avoids discriminating against ships flying under the flag of third countries and (d) case law points to the strong likelihood of compatibility with WTO rules.

²¹ NGO Shipbreaking Platform, *Make the Polluter pay! Why we need the EU Ship Recycling Licence*, http://www.shipbreakingplatform.org/shipbrea_wp2011/wp-content/uploads/2016/10/Position-Paper-FINANCIAL-INCENTIVE-Final-Version.pdf