ASSOCIATION OF AVERAGE ADJUSTERS SEMINAR

12th December 2007

"SALVAGE AND THE SUPER SHIPS"

(Presented by Richard Cornah,
Chairman of the Association of Average Adjusters.)

Growth Statistics

The growth of containerisation in recent years is a familiar story, but the figures are remarkable and are worth reviewing.

- By the end of June 2007 there were 1,259 container vessels on order representing 51% of the TEU capacity already in operation

- By mid 2007 the fully cellular fleet reached 4,098 ships with a capacity of 10.8m TEU

- 98 ships on order with capacity in excess of 12,000 TEU.

(Alphaliner, Marinelink.com)

Super-size Ships

Much of this capacity increase is in a new generation of 8,000 plus TEU ships, with a significant number of these breaking the 10,000 TEU barrier. These new vessels provide a number of practical and financial challenges for the salvage community.

The Salvage Community

The problems that may or will arise with such vessels do not just impinge on one sector of the shipping, salvage or insurance industries – they need to be addressed by the salvage community as a whole. By the salvage community, I mean property owners, property and liability insurers, and the salvors themselves. To the neutral observer, issues relating to salvage often seem to be debated on the basis of safeguarding a particular interest, sometimes leading to an uncomfortable stalemate. The rationale for the law relating to salvage was founded on considerations of public policy and was summarised in 1898 in the "Glengyle" as follows:

> *"The maintenance of salvage steamers ….. is for the benefit of owners and underwriters and others interested in seagoing vessels and their cargoes and the crews and passengers of those vessels and ….. the Admiralty Court will be liberal in its awards in respect of services rendered by salvage steamers even though the awards may fall somewhat heavily on individual owners. The owners of salvage steamers invest a large amount of capital in them and*

> *maintain them and their crews divers and appliances and have no remuneration to look forward to except that which may be earned by occasional salvage services."*

The last phrase is no longer entirely true. There are hardly any professional salvors who maintain tugs on station which do not also engage in non-salvage work such as contract towage. But the principle that salvors should be encouraged by generous awards as a matter of public policy still applies. Very large container vessels require large and powerful tugs to carry out firefighting and towing, and they also present considerable challenges to equipment required for lightening operations.

Concerns

The concerns that have been discussed in the context of these super-size ships are many and varied but the following gives a flavour.

> **Property owners** – one thing that characterises any container ship cargo manifest is the variety of goods, shippers and receivers that can be found, but a consistent theme for almost all is speed of delivery. Just In Time delivery systems (or Just Too Late as harassed logistics people call them) mean that companies keep minimum inventories, and container vessels are used as a mobile ware-housing system. This is a testament to the extra-ordinary levels of reliability that have been achieved, but it means that companies are very exposed to any delay in delivery. Receiving cargo with the minimum delay is the number one priority for the receiver.

> **Property insurers** – compared with the days of tween-deckers, container shipping has improved the loss record for cargo insurance to a considerable degree. The expansion in capacity will continue the trend for more types of cargo to be carried on a containerised basis. However, cargo insurers are understandably concerned about the aggregation of risk in one hull – our figures suggest that there are probably already US$1 billion cargos on the high seas. The size of the vessels may increase the difficulty and hence cost of salvage operations, and the ensuing processes of security collection and arbitration may also increase in cost.

> **Salvors** – the practical challenges presented by the super-size vessels are evident, but Salvors will also be concerned that the number of containers involved in super-size ships will bring the processes of collecting security and holding the Arbitration to a grinding halt.

Whatever their individual concerns, all parties must surely want to see a system that is rational, equitable and commercial.

The Present System

Many of the problems that I am going to discuss arise from the fact that most major containership casualties involve a salvage contract (typically Lloyd's Open Form or LOF) under which payment is obtained from all the individual parties who benefit from the services. The present system is therefore:

- "pay as you go" – you only pay when you receive the services.
- based on "passing the hat round" – payment is made by seeking a contribution from all concerned.

Adjusters are often requested by salvors to co-ordinate the collection of salvage security, in tandem with their General Average activities, and my comments are therefore made from the Adjuster's point of view.

Alternatives

If the size of containerships creates a danger of making the present system unwieldy, uneconomic or commercially unacceptable, the first step must therefore be to consider the alternatives.

It must surely be common ground that the continuing existence of salvage equipment and expertise is essential to maritime commerce. Container shipping has brought about a very significant improvement in the safety of the transportation of cargo, but some losses will still occur. Given that the need for a salvage industry is accepted, it might be suggested that either the insurance or shipping industry (or perhaps a combination of both) should finance that industry annually on a fixed cost basis – something that car drivers do with motoring organisations all the time.

That this has not yet happened, and most here would think it unlikely ever to happen, is due to a number of significant barriers to such a solution:

- quantum: how do you establish what is necessary to fund the salvage industry?
- collection/distribution: even if you can reach agreement on a suitable figure, you then have to decide how much individual companies pay or receive.

Assuming both these problems could be overcome, you would need to create and finance an administrative body to carry the process out.

All these factors make it likely that a "pay as you go" and "pass the hat around" salvage system will continue for the foreseeable future.

Governmental and Insurance Solutions

It is worth mentioning two current exceptions to that status quo.

One element of the salvage function – namely the provision of powerful salvage vessels on standby in key locations – is presently funded by the tax-payers in certain countries, notably the United Kingdom and France. However, it is generally only the standby function that is so financed and such vessels will often seek salvage payments for services actually rendered.

The other exception does not relate to the "pay as you go" aspect but does intervene to prevent the necessity for passing the hat round. For many years now Hull and Machinery Policies have included "Absorption" Clauses whereby Hull insurers pay 100% of General Average and Salvage rather than paying only ship's proportion. Such clauses are now commonplace with all types of vessel (a straw poll amongst colleagues suggests in at least 80% of all blue water policies) and are invariably found with container ship covers. Such clauses have played a valuable role in reducing the number of uneconomic General Average cases, leading to a reduction of such cases involving cargo by at least 50% in the last decade.

However, the limit of the Absorption Clause is a matter for negotiation with the Hull insurer, who may find his Assured unwilling to pay any additional premium for such a facility. With the exception of major owners such clauses may therefore often be limited to the US$250,000/500,000 range, which in itself is inadequate for anything but the smaller container vessels. Some owners therefore arrange a separate insurance to "top up" this cover to a more realistic level so that they do not need to look to cargo for any General Average or Salvage contributions except in the more serious cases. Additionally, similar special covers may be taken out by Charterers and/or Slot-charterers to ensure that their valued customers are not troubled by General Average or Salvage security formalities and delays, except in the most serious cases.

The insurance solution to the need to "pass the hat round" is becoming more commonplace and I expect this process to continue as more insurers consider offering such facilities. However, given the practical difficulties of providing salvage services to large container vessels and the very large salved funds involved, exposure to salvage awards in excess of US$10 million will not be exceptional and this is a risk that many operators may not wish to pay an economic premium for. Ironically, it is the very good safety record of such vessels that makes such risks difficult for insurers to rate satisfactorily.

The status quo – is that it?

Highlighting concerns should not eclipse the positive features of the present system. The LOF approach has proved to be commercially useful and able to adapt to changing circumstances. Even if many cases do not go to Arbitration, this should be seen as a sign of the usefulness of the framework that a well understood contract provides.

However, I am not aware of a LOF case involving anything larger that a 6,000 TEU, vessel and the new generation of vessels will need security collection methods to be reviewed by all members of the salvage community.

In the balance of this paper, I have attempted to identify areas that would benefit from consideration. No doubt there are flaws in many of the ideas and practical difficulties, but I hope they can all be viewed with the big picture (achieving a rational and commercial process) in mind.

Discarding Low Values

Starting from an adjuster's viewpoint, it is a common practice in dealing with General Average adjustments to consider excluding low value interests from a security collection, or even at the settlement stage, on grounds of economy. Clearly, there is little point in spending US$200 in fees to collect a contribution of US$190.

A recent container vessel general average illustrates the point. The total cargo value was an unusually high one of US$437 million, made up of 3,084 separate interests. (The number of interests is different from the number of containers or TEU on board. It refers to the number of separately owned items of cargo). If values of less than US$10,000 are omitted the total value drops marginally to US$435 million, but 484 interests are taken out of consideration. On a 2% general average their contribution would have been only US$40,000, so the potential savings are clear.

A more radical approach of excluding values below US$30,000 cuts out no less than 1,100 interests, while reducing the total values by only US$16,000,000, or 3.6%.

An example with more modest values involved a General Average and Salvage case on an East/West mainline vessel that suffered a fire. The total cargo value is around US$180 million, made up of 3,898 interests. Omitting values of less than US$10,000 removes 880 interests but the fund drops by only US$4 million. The contribution of those 880 interests to a 10% salvage would be around US$400,000. If they were taken out of consideration, other interests would in theory be paying US$132 extra each, but if those interests had been excluded from the start considerable savings would have resulted in adjusters/Solicitors/Lloyd's costs in:

- collecting security
- obtaining information regarding damage/claims etc.
- calculating salved values
- ascertaining representation
- notices regarding arbitration and awards
- collecting settlements

Our experience shows (and I am certain Lloyd's and Solicitors personnel would agree) that lower value cargoes absorb a disproportionate amount of time that also extends the Arbitration process. They are more likely to be uninsured or part of a consolidated box or are simply unfamiliar with the commercial procedures. In cases where their presence has a minimal effect on the salved fund and the eventual award, is it necessary or sensible to insist that they are brought in, only to gum up the works and increase costs?

The problem of low value cargo in 4,000 TEU vessels may be an irritant that is bearable, but our topic is vessels of twice or three times that size. Even the best systems for handling security would expect to see situations in which the release of higher value cargo will be delayed by the sheer volume of low value cargo competing for attention.

LOF already excludes from consideration personal effects (box 2) and extends this to accompanied motor cars (LSSAC 3.2), for obvious practical reasons. However, if a salvor were to exclude other low value cargo in a container vessel case on the basis that it made practical sense to do so, his decision would be open to attack by other interests at the Arbitration. The Arbitrator would be obliged to consider his award on the basis of all the cargo, high and low value, on board the vessel and the salvor would be left with a shortfall. If it is accepted that excluding low value cargo is the right way to proceed when dealing with super-size vessels, it seems inequitable that the salvor should be penalised for an approach that is beneficial to all interests.

If the contractual freedom offered by LOF can be used to exclude personal effects and accompanied motor cars (the York-Antwerp Rules 1994 and 2004 do likewise, but there is no equivalent provision that I can find in the Salvage Convention), then consideration should surely be given to create an option to exclude cargo below a specified value, in appropriate cases.

Having an agreed sliding scale based on size of vessel would be simple if inflexible, and an alternative would be a box to fill in when the LOF is signed by the parties. Entitlement to fall within the exclusion and to be released

without security would be demonstrated by producing the CIF invoice for the goods, which is frequently a customs requirement in any event.

The Values Problem

Salvors face some difficult dilemmas when it comes to deciding on the amount of security to demand, and the extent to which they use the powers given them by LOF, the Salvage Convention and many jurisdictions. Sometimes one encounters a "belt and braces" approach that may be appropriate with a single interest bulk carrier, but does not recognise the difference in exposure when dealing with one interest amongst thousands.

Nonetheless the problems are very real. Too little security demanded or an overly relaxed attitude towards arrest may leave the Salvors exposed. Too high a demand will raise the temperature in dealing with salved interests and prompt abandonment of cargo. Much of this difficulty is to do with values.

If we examine the container vessel cases that we have on record covering the past 21 years the average value per container comes to around US$26,000 per TEU. This average figure has been given wide circulation and often appears in the press, but it needs to be viewed with caution.

Of particular interest is the fact that the average value has changed little during that period, whereas the effects of inflation should have pushed it well over the US$50,000 mark. The explanation lies in the significant reductions in unit freight costs during that period due to the efficiency of the modern shipping and logistics industries, without which the process of globalisation of trade would never have got off the ground. In the early days it was only viable to ship relatively high value goods around the world – for example electronic goods from Japan – but now everything from cane furniture to T-shirts can be sent at a profit. The relative uniformity of values from one ship or trade to another has therefore gone and we are faced with radical variations. The highest value we have seen for one container is in excess of US$20 million (encryption software) and containers of US$1 million values (e.g. pharmaceuticals, blood plasma) are not uncommon. At the other end of the scale, items are sent that have minimal value other than the cost of the pre-paid freight.

Looking at values on a per vessel basis we have seen average values of US$75,000 per TEU at the higher end of the scale and US$11,000 per TEU at the lower. It is therefore important to understand the particular trade in question.

Salvage Security

I have made very few references to General Average for the practical reason that the involvement of cargo interests in these large cases is generally driven by an LOF salvage. The Absorption clauses commonly in use will mop up any straightforward "port of refuge" general averages and it is the additional exposure to an LOF award that triggers the need for security. The only exception to this would be cases involving significant general average sacrifice of cargo, but I have only come across one case where this was not accompanied by an LOF salvage service.

However, one feature of General Average is worthy of remark in this context; when insurers provide a G.A. guarantee this is almost invariably given without limitation to amount – the only ceiling being the Contributory Value of the cargo in question. This provides considerable flexibility. The insurer will expect the adjuster to give an indication of the likely G.A. percentage, but accepts that he may be liable if, for example, some unexpected G.A. sacrifice damage materialises.

The salvage system works to fixed guarantee limits and the salvor only has one bite at the cherry, resulting in conservative (i.e. high) security demands. This is particularly the case in container ship cases in which salvors will be under pressure to name their security figure promptly to enable cargo to be delivered or transhipped. This is often at a stage where the extent of damage to ship and/or cargo is unclear and before an initial picture of overall cargo values can be obtained.

Excessive or unreasonable security demands can be raised at Arbitration and penalised accordingly but I am thinking here of demands that are not unreasonable but are simply higher than was actually necessary given the benefit of hindsight. Even if one is only looking at an extra margin of 5%, this is a great deal of unnecessary over-reserving by the insurers concerned in a 8000 TEU vessel.

This is a difficult and understandably sensitive area, but one solution might lie with security given under ISU 1 (a form of security that is given direct by insurers to salvors) being on a provisional basis. Some degree of finality would obviously be required so that the entitlement to an uplift could be limited to a maximum percentage of the original demand, to be exercised within a specified period – say 25% within 60 days.

Cargo Insurers

Given the relatively low cost of cargo insurance (0.2% of CIF value for door to door cover on "All Risks" terms is a commonly quoted indication) it is surprising how much cargo is found to be uninsured. On a recent fire case involving an East/West mainline service there were over 750 uninsured cargo interests on board, roughly 18.75% of the total. We thought this was

high, but looking back at six previous cases we found that the average is just over 12%.

If cargo is uninsured it is necessary to obtain a cash deposit, which invariably comes as an unpleasant surprise to the receiver. If the security demand is a high one, their reaction may often be to consider abandoning their cargo; if a cash deposit is forthcoming the costs of the administrative process are often out of proportion to the values involved. During the lengthy and sometimes acrimonious telephone conversations that ensue, it often emerges that receivers have little idea of the modest cost of cargo insurance, perhaps basing their expectations on their latest motor insurance renewal. If the figures regarding annual container movements are correct, 12% of that total surely presents a tempting marketing target for cargo insurers. Although the majority of uninsured cargo is usually of low value, this is not always the case, and we have seen shipments valued in the millions. Reducing the amount of uninsured cargo would greatly speed up the security collection process.

Container Operators

Many Consortium Agreements and Slot Charterers show little attention to possible issues that may arise in the event of a casualty. Whilst this is understandable in the context of container vessels suffering serious casualties only infrequently, it is something that could be looked at by the industry bodies with a view to producing recognised procedures and protocols. Typical areas in which one often seems to be re-inventing the wheel each time a casualty occurs include:

- responsibility for holding cargo in relation to a general average lien by the shipowner or a salvor's lien.

- responsibility for port of refuge expenses, such as handling, storing or forwarding cargo.

- agreement to provide an ISU 2 undertaking to salvors.

Consortium operation often leads to a clash of interests once a casualty has occurred, as consortium members seek to prove that one of their number brought (for example) the spontaneously combusting container on board. Separate legal representation then follows and the developing disputes can slow down the effective management of the casualty and its aftermath.

Although not exactly comparable, the oil industry has developed offshore fields on a consortium basis for many years. Liabilities are effectively pooled by extensive "hold harmless" clauses which often embrace the main Contractors. Should a similar regime be appropriate for the modern container operation, so that the focus remains on client service rather than attributing liabilities?

Consolidators

Not all shippers wish to send a complete container load and a separate branch of the industry has grown up to serve their needs. Variously referred to as freight forwarders, Non Vessel Owning Common Carriers and consolidators, specialist companies ship their containers under an ocean bill of lading, and then issue their own documents to the owners of goods they consolidate into that container.

At present the responsibility to provide salvage security rests with the individual owners of the goods rather than the consolidators. This creates a number of significant practical problems:

- the owner of the goods is one step further removed in the communication link following the casualty.

- a container cannot be released until all cargo in it has been secured, so that interests that provide security promptly will be held up by those that do not.

- those shipping goods in consolidated containers often fall within the lower bands of values referred to above.

I am sure that Lloyd's Salvage and Arbitration branch and all solicitors regularly involved in such matters would confirm adjusters' experience that consolidated cargoes involve time and trouble that is wholly disproportionate to their contribution to the salved fund and ultimate award. Figures from six recent cases showed that on average only some 5% of boxes were consolidated, but consolidated cargo interests (i.e. separate receiving parties) formed 30% of the total number on board, which gives a clear indication of the imbalance between the costs of collecting security and eventual contributions.

At present, we seek a partial solution by obtaining special undertakings on a case by case basis. These allow the consolidator to take delivery of the containers without security being provided; the consolidator can then unstuff the container in his premises and release parcels of cargo as and when these are secured. If any cargo is released without security the consolidator becomes liable for the relevant salvage payment. This is at best a partial solution – the terms of the agreement have to be agreed by salvors and if, as often happens, an ISU 2 form has been signed, by the issuer of the ocean bill of lading. The situation would be improved if such undertakings were built into the contract between the consolidator and the carrying line, but the cleanest solution would undoubtedly be for consolidators to assume, and insure, the liability of "their" cargo for general average and salvage.

Summary

The current system has the potential flexibility to adapt to the demands of the super-size vessels. However, steps need to be taken to explore and utilise the insurance options that are available, at the same time recognising that collection of security in order to "pass around the hat" will still be necessary in some cases, and that the systems for doing this need to be reviewed. Such a review should be a matter for all parts of the salvage community to be involved in, to ensure that a rational and commercial system is maintained.

R. R. Cornah
12 December 2007