

Setting reserves at the right level

Sasha Dobra, of Kalimbassieris, looks at the costs of ship repair and the need to reserve properly

The ability to reserve correctly for claims is always important to insurers, but especially so when economic times are tough. After the financial crisis hit in 2008 there was some concern amongst insurers that, with vessel prices falling, there would be pressure to reduce premium levels.

However, with the frequency of claims constant and repair bills remaining high, insurers wanted to ensure that they were reserving prudently. It was against this background that a number of clients asked us for guidance about what correlations they could use to assess their exposures more accurately.

Inevitably this is a complex and difficult area and there are no absolute tools for predicting how repair costs might move. There are, however, a number of indicators that, taken together, can help give an overview of trends.

At the risk

of stating the obvious, every case is unique and the costs of repairs will be affected by a number of factors peculiar to it. The type and extent of the damage is a key factor: is it grounding damage requiring steel renewal; does it involve machinery damage?

The type and size of the vessel will also have an impact on costs: for example, LPG carriers are likely to be more expensive to repair, larger vessels are subject to higher dry-docking dues and the size may limit the choice of where the vessel can be accommodated.

As well as these specifics, ship repairs – like any other industry – are affected by the macro trends of demand and supply of repair facilities, as well as cost and availability of raw materials and labour, all of which have an impact on repair prices.

Demand

The state of the shipping market is a



Sasha Dobra is in charge of legal issues for Kalimbassieris

major factor when talking about demand for repairs and therefore the impact on costs. When shipping rates are very high, vessels are in continuous use – creating more ‘wear and tear’ and accidents.

However, in order to keep the vessels in operation owners will often opt to defer repairs and/or maintenance, or are more concerned with reducing the off hire period than securing the lowest possible repair prices.

In this climate, yards are under less pressure to keep prices down. Conversely, when rates slump, the scales tip and costs are more important than timing and there will be greater scrutiny and pressure on yards to offer the lowest possible prices.

Equally, the size and age of the world fleet will affect demand. Newer ships will generally require less maintenance and fewer



repairs, apart from an initial period as crew become familiar with new technology and design flaws are being ironed out.

An older fleet will have higher needs, with the caveat that maintenance and repair work generally decrease toward the end of a vessel's life. Some of the indicators which are worth looking at include the world fleet profile, lay-up statistics and the demolition rates.

Supply

On the other side of the scale, the supply of yard space has grown rapidly in recent years and facilities have also improved. Built in response to the surge in newbuildings, many now have surplus capacity as order books have dried up and are re-focussing on repairs. The result is a competitive market that is driving down repair prices.

The availability and price of labour and materials will also be key contributors to repair costs. As a general rule manpower will be the major component, although its share will vary according to the kind of work and also the repair yard/region.

This is, for example, the major reason why yards in certain countries, such as China or Turkey, have a competitive advantage on prices. The cost of steel is also significant and can vary from one region to the next, with Asian prices being significantly lower than those in the European Union.

Looking at a comparison between the prices of steel and repairs shows that there is a correlation between the two, but there is a time lag of several months between the movements in steel prices and repairs.

This could be attributed to the fact that yards generally stockpile their steel; price rises will be

passed on immediately while reductions may only come into effect once the stockpile has been exhausted and new steel is purchased.

Currency fluctuations also play their part, particularly in areas where the yard is charging for repairs in one currency but paying for steel and workers in another. The availability and cost of finance will also have an effect with yards relying on banks for revolving credit lines to finance working capital.

For example, in Turkey finance is still being provided by local banks albeit that rates have increased three- or fourfold since the financial crisis.

Understanding the model

The price that a particular yard will charge for repairs is driven, in many instances, by their own business model and circumstances. All yards have two primary assets: their dry dock(s) and workforce. They want to optimise the use of both.

As a general rule, the ideal work for the yards is planned repair or maintenance for short periods in dry-dock, involving a wide variety of work – enabling forward planning.

Shorter periods in dry-dock also means that the yard's income from docking and undocking manoeuvres is higher and also that it maximises the number of clients it can service, an advantage in terms of marketing.

Repairs or maintenance which involve a wide variety of work, for example, steel work, surface preparation and painting, machinery work/overhaul, piping, electrical, measuring rudder clearances, etc, is attractive for the yard because it makes the most of the yard's workforce.

Conversely, the least attractive projects for

the yard are generally damage repairs requiring a long period in dry-dock and with minimal use of the yard's workforce. Large damage repairs requiring urgent dry-docking can create planning issues for the yard and can also tie up the dock, perhaps meaning that the yard will be forced to turn away other more attractive work in the meantime.

Each region will have its own seasonal issues to consider. At certain times of the year the cycle of the local shipping industry will mean higher demand for maintenance during the off period, plus higher rate of casualties during the busy period.

Weather patterns may also result in a higher rate of incidents during a particular season, plus practical problems for repair/maintenance where welding or painting is interrupted or delayed due to bad weather conditions.

Understanding the process

Other than hard factors such as the price of raw materials or labour, less tangible process management steps can significantly affect the cost of a claim. For example, establishing the extent of the damage through underwater and internal inspections, as soon as possible after the incident, will help determine how to manage the case and control costs.

It is often difficult at this stage to establish the full extent of damage but every effort should be made to do so.

Managing the tendering process correctly can also yield tangible benefits. The specification should be sent simultaneously to all competent yards in the region in open copy and, where possible, all yards should be invited on board to inspect the damage at the same time.

Both of these will increase the element of competition and have a beneficial knock-on effect on prices.

Managing the tender so that as far as possible all yards quote on the same basis is also very important. This will allow a proper evaluation of which yards are most competitive and also on which key items it might be possible to negotiate further.

The bottom line

For the insurance company in search of the Holy Grail of predicting repair costs, the sad truth is that it is simply not possible with any degree of accuracy. Despite the fact that there appears to be a broad correlation with steel prices, insurers should not pin their hopes on it.

The reality is that there are a diverse range of factors at play which, combined with the complexity and colour of each individual case, means that such predictions will be an inexact science. ■