

East Asian shipyards in push for escalation clauses

Owners will have to pay extra cash for contracts, writes Sam Chambers in Beijing
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THE clamour for escalation clauses in all shipbuilding contracts is growing across east Asia, with certain Chinese yards already instituting currency fluctuation agreements.

The message is clear: if owners want ships from now on, they must be prepared to pay additional payments during the construction of their vessels.

This is because yards, with an eye on the lines' record earnings, are reeling from high raw material costs and the effects of a weak dollar.

The yards claim they are trying to get on a level playing field in negotiating with their customers.

Renegotiations are going on in many contracts at the moment — even one the week before last between a European owner and a Chinese yard which demanded more money just as the ship had completed sea trials.

“The Chinese are doing the rounds at the moment, saying they cannot get back their refund guarantee unless owners stump up extra cash,” said one shipbroker in Hong Kong.

The broker added that of all the yards he was speaking to in the region, not one was willing to commit to contracts without some form of an escalation clause inserted.

An executive from shipowning group IMC has defined such rises as “holding the shipowner to ransom”, adding that such increases should be factored in to the price.

With backlogs up to four years, there have been reports of yards simply refusing to carry out cheaper orders contracted earlier.

They pay a maximum penalty cap of around \$2m — a loss which is easily absorbed by a new, far higher priced contract in this tight market.

“Non-performance sometimes pays,” commented one shipbuilding consultant wryly.

“If you are realistic in getting your ship delivered on time, then you have to renegotiate and put your hand in your wallet,” Peter Murray, a Shanghai based partner at law firm Ince and Co told delegates attending Asia Shipbuilding 2005.

An adjustment mechanism was needed, he said, rather than a straight escalation clause. An independent third-party body was needed to monitor price indexes for essential shipbuilding materials such as steel plate.

Jeremy Gibb, a Hong Kong-based partner at law firm Norton Rose, observed: “For companies in the construction and aviation industries, such as Boeing, there have been escalation clauses for years in their case linked to [the consumer price index].”

Likewise, in eastern Europe, many yards have escalation clauses to guard against currency moves.

The Japanese used to have such additions to their shipbuilding contracts a number of years ago and are very keen to bring them back.

The chairman of the Shipbuilders' Association of Japan, Mototsugu Ito, said in February that shipbuilding, like plant construction, another high-capital, long-term project industry, should have escalation clauses.

Meanwhile, across the Sea of Japan, a senior Korean shipbuilding executive told Lloyd's List the yards there were trying to instigate the clauses too.

"We prefer to have it but I don't know whether the market will accept it," the source said. "There is general consensus for it, though we have but no joint national effort yet." Korean yards already impose escalation clauses on offshore contracts.

Meanwhile, Chinese shipbuilders, rightly paranoid about a possible revaluation of the national currency, the yuan, have stolen a march on their east Asian rivals with a few exchange rate fluctuation agreements inserted into shipbuilding contracts in the last month.

So if the yuan goes outside a narrow margin during the first couple of phases of payment, the buyer assumes the risk, and if during the latter phases of payment, then the risk is split 50:50 with the yard.

China's top 50 yards made a paltry Yuan1.9bn (\$230m) combined profit last year. A 3% swing in the currency against the US dollar would wipe out that profit, and a 6% swing, which some analysts have predicted, would cause "catastrophic strife" among the yards as one shipbuilding expert described.

A 4% revaluation of the currency is deemed the most likely by China economy analysts polled by Lloyd's List.