

IMO 2020 SULPHUR REQUIREMENTS: KEY CONTRACT ISSUES FOR SHIPOWNERS TO CONSIDER

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Key issues for shipowners in contracts for the acquisition, transport, installation and commissioning of scrubbers to meet IMO 2020 sulphur requirements.

In our briefing of October 2018, we discussed the background to MARPOL Annex VI and some related financing issues. As the countdown begins to the implementation of MARPOL Annex VI regulation 14.1.3 on 1 January 2020, the debate grows concerning the responsibility of bunker suppliers to produce a greater quantity of very low sulphur fuel oils (“VLSFO”). The market has seen an increasing uptake by shipowners of the acquisition and installation of both open and closed loop scrubber systems on vessels.

Watson Farley & Williams (“WFW”) has advised on a broad range of scrubber acquisition and financing contracts and as such, have unrivalled knowledge of the developing contractual and commercial market standard forming amongst shipowners, scrubber manufacturers, financiers and shipyards in relation to such projects.

Shipowners that have made the decision to acquire and install scrubbers cannot afford to have contractual disputes delay or derail their installation projects. Such issues could result in installation failing to be completed in time to meet the regulatory deadline which, in turn, would result in a delay in the shipowner being able to reap the upside of burning high sulphur fuel but charging a charter rate commensurate with compliance with the IMO 2020 sulphur regulations – a benefit that may have a limited shelf life as VLSFO becomes more readily available and new ships are launched with scrubber technology installed upon delivery.

This briefing sets out a few of the key issues to be considered by shipowners when negotiating their scrubber acquisition contracts. It should be noted that many of these issues also apply when acquiring a broad range of other equipment for installation on vessels, such as ballast water treatment systems (“BWTS”).

TURNKEY VS SELF-MANAGED

An acquirer of scrubbers should investigate the pros and cons of entering into a turnkey arrangement (where one provider is fully responsible for acquisition, transport, installation and commissioning of the scrubbers), versus directly engaging separate providers for each of the elements.

Turnkey arrangements are often more expensive but can reduce the risk of disconnect between the relevant parts of the process. They can, if documented correctly, be much easier to manage, particularly if a shipowner does not have the breadth of contacts to obtain a commercially beneficial and contractually sound deal from the various stakeholders involved (including the manufacturer, supplier and installation yard).

A self-managed process may appear cost-effective, but greater care needs to be taken with the respective providers' contracts; they need be harmonized in such a way to ensure there are no gaps such that liability or risk inadvertently ends up with the shipowner, and no inconsistencies that may cause delays in the overall timeline.

PAYMENT PROFILE

Determining the trigger milestones and percentage instalments for payment of the purchase price is a key part of the negotiations. Scrubber manufacturers will often want a large up-front amount, but this should not result in a payment profile that is disproportionately weighted against the interests of shipowners. This is especially so where the provider is offering a turnkey solution and thus should be properly incentivised to perform right up until commissioning. In some cases, WFW negotiated successfully to delay the final instalment of the purchase price payable until a certain period after commissioning so as to mitigate (through rights of set off or retention) against the risk of any installed and commissioned scrubbers not performing in accordance with their specifications or the applicable regulations.

TITLE TO GOODS

Often acquisition and installation contracts are converted from old shipbuilding or ship repair contracts. Such contracts may not have adequate provisions regarding when title to the scrubber itself passes to the shipowner. This is especially important when instalments are payable after the equipment is installed on the ship. Although the contract has not been completed, nor the purchase price fully paid, the shipowner must ensure it has unencumbered title to the scrubber so that any termination or default after installation does not result in the provider seeking to repossess the scrubber or even arrest the vessel in order to do so.

COUNTER-PARTY RISK

As mentioned, manufacturers and turnkey providers will often want a large first installment of the purchase price paid upon signing. This can lead to substantial counterparty performance risk, especially if the provider is not well known to the shipowner. We have occasionally seen corporate or refund guarantees granted to secure refund of the advance installments, but scrubber manufacturers and turnkey providers are not always willing to provide these.

There are other ways to reduce counterparty risk which we have successfully employed in scrubber contracts, such as structuring each scrubber acquisition as an option rather than a firm obligation, allowing the shipowners to back out of future orders if the initial orders are not satisfactory.

FINANCING

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There are a number of considerations regarding the financing of scrubbers or BWTS which we flagged in our October 2018 briefing. Providing security over the equipment itself may not be a viable option as the equipment is not easily extracted from the vessel once installed due to the fact that, post-installation, it forms part of the vessel. Despite this, we have worked with a number of banks and shipowners to find alternatives; for instance, an upsize in an existing facility over the vessel or obtaining security over alternative collateral.

LITIGATION

As we get closer to the IMO 2020 deadline, litigation issues will arise in relation to scrubber contracts, especially regarding delay and performance issues. A problem with the scrubber contract itself could evolve into a risk of regulatory non-compliance by a shipowner and leave the shipowner facing the double cost of obtaining scrubbers but also having to purchase low-sulphur fuel whilst disputes are resolved. Our dispute resolution department is aware of the issues surrounding these contracts and knows that a commercially-minded solution will be needed.

CONCLUSION

We are seeing an increasing number of scrubber and BWTS contracts and have the necessary in-depth expertise to advise on contract negotiation with a view to avoiding disputes or litigation – and on any disputes or litigation which may arise.

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