

PRIVATE VS. ZONE MAINTENANCE AGREEMENTS

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Abstract: During the next 2-3 years many of the world's cable maintenance agreements have to be renewed. Considering that these will be effective for the following 3-5 years or more and the fact that the world's cable ship fleet is steadily growing older, the industry is facing some structural challenges.

Will there be sufficient and adequate resources to renew the agreements, will there be any shortfalls, and what will be the best way to approach these challenges?

This paper will try to address these questions and present possible ways forward.

1 THE PROBLEM

Since the burst of the "dot-com" bubble left the cable ship industry in a very poor state with a huge oversupply of cable ships, no one has been seriously considering building a new build cable ship since the business case simply does not justify it. The last new build cable ship was delivered from a shipyard in early 2003. However, the order for this was most likely placed in late 1999 or early 2000. Since that time the industry has not taken any initiative to replace older ships so the age of the cable ship fleet has steadily increased, while capabilities have stagnated or even decreased..

Till 2003, new cable ships had been built every year since 1970, with the maximum period without a new build being delivered being 2 years. It has now been 7 years since the last new build was delivered. This period will be extended to at least 9 years since it would take 2 years to build a new cable ship if it was ordered today.

The result is that the average age of the cable ship fleet in operation today has increased to 16.1 years and there are no signs of this improving in the foreseeable future. [1]

Although cable ships are generally well maintained and are in a better condition than ships in general, older ships may not perform 100% to their original specifications and may not be as reliable as younger ships.

Therefore, there is a real risk that operations will become more unreliable as the age of the cable ship fleet increases. In addition to the average age increasing, a structural difference between the installation and maintenance cable ships is also taking place with the maintenance segment having a higher average age and a large number of relatively old ships, as shown in Figure 1 and Figure 2 below. [1]

The maintenance segment will be the first to suffer the consequences of ageing ships unless the industry finds new ways of attracting new/newer tonnage to this segment.

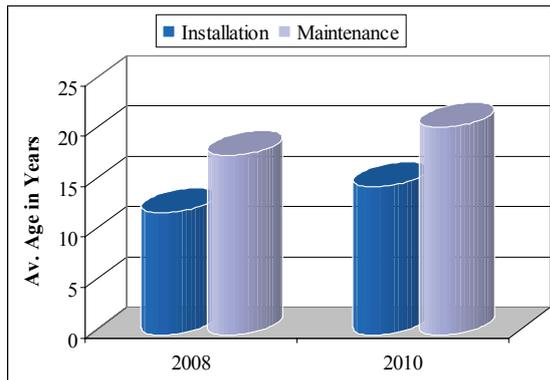


Figure 1 : Evolution of Average Age for Active Cable Ships

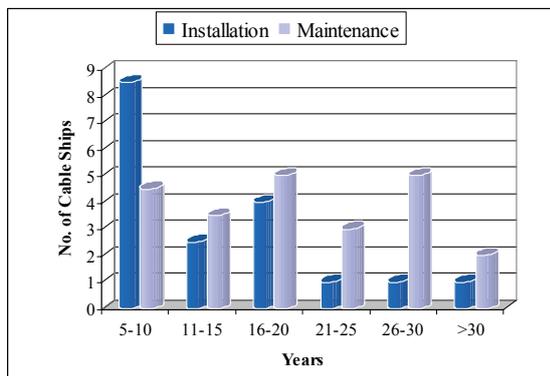


Figure 2 : Age Distribution of Cable Installation and Maintenance Ships

The main cause of this problem is insufficient revenues to justify any real investments in new ships, in particular for the maintenance segment. Low revenues resulted initially from the massive oversupply situation following the market collapse early this decade, and have subsisted up till now.

To illustrate the unattractiveness of investing in new cable shops, a simple exercise can be done using relevant price indices over the period 2001-2010. Firstly let's take a price index for consumer prices and for shipbuilding prices over the period of 2001-2010. Using an index of 100 for 2001, the consumer price index has increased to approximately 125 (depending on country) in 2010, while the shipbuilding price index has increased to approximately 200 in the same period. (This is an average figure as shipbuilding prices fluctuate according to steel prices, yard capacity and vessel type.)

In the same period, the index for the average price of a maintenance vessel operating in the Atlantic in the same period remains at 100 or slightly below, having reached a bottom level of approximately 80 during this period. Let's also assume that the market rate for such a maintenance vessel operating in 2001, corresponding to a price index of 100, was sufficient to justify investments in cable ships at that time.

By using a rough split of the cost of operating a cable ship as 50% capital cost and 50% Opex (salaries, ships stores, spare parts etc.), the index applicable to the cost of building and operating a new cable ship in year 2010 should be approximately $0.5 \cdot 200 + 0.5 \cdot 125 = 162.5$. From this simple exercise, it can be seen that the costs to be borne by owners/operators of maintenance vessels have risen far more than market prices for maintenance services over the last 10 years.

The economics of this is a key element in the disproportionate ageing of the maintenance fleet, i.e. it promotes the increased use of cheaper maintenance ships.

This leads to two significant questions:

- How can the maintenance segment deal with this issue and attract the new/newer tonnage that will be necessary in the future?
- Will the type of maintenance agreement (private vs. club agreement) make any difference to how this is solved?

2 THE ZONE AGREEMENT

The term "zone agreement" may not have the same meaning all over the world these days. Historically the zone agreement was typically set up by a group of stakeholders in a set of cable systems to organize the means for repairing the cables covered by the agreement. Typically some of these stakeholders or their subsidiaries also owned cable ships and some were provided

as part of the means attached to the zone agreement. Therefore the commercial conditions for the ship owners were generally reasonable (in many cases cost plus) and the agreements were normally for a long term, thereby securing a safe and reliable return for the ship owners on their cable ship investments.

In the last decade carriers with cable ships started to outsource their marine activities. Coupled with the downturn in the installation market in the early part of this decade, this led to an oversupply situation in the maintenance market. Consequently, some of the groups in “zone agreements” were able to benefit from these market conditions and gradually evolved into something resembling a consumers’ association, where a group of customers combine their buying power to obtain a good deal from competing suppliers.

In general, membership of a consumers’ association can be very beneficial, and for some system owners this has led to agreements with absolute minimum prices for maintenance of their systems, due to the over-supply situation in the market. In order for this to work in the long term however, the market needs to be relatively “free” and “mature”, characterised by a) several suppliers offering the same product/service in free competition, b) several customers that eventually buy from different suppliers, and c) sufficient customers that have the same requirements.

So, does it work in real life? Yes, but only as long as there is a sufficient oversupply of suitable ships.

When the extreme age of a cable ship necessitates retirement and renewal is not attractive, the number of potential suppliers will gradually decrease resulting in less competition. Furthermore, the maintenance market can’t really be considered as a free market because permitting, immigration rules and other regional issues tend to restrict free market forces.

The fact that some zone agreements have resorted to “consumers’ association” behaviour often scares off potential contractors since the business is usually attributed on an all or nothing basis with onerous conditions. In the end that will discourage contractors from making any investment aimed at the maintenance market since they will naturally focus on areas where reasonable and predictable revenue can be expected.

In short, playing the market will only work while there is a market to play in.

Another characteristic of “zone agreements” is that a number of customers have to agree on a) the scope of the service, b) the commercial conditions and c) rules to ensure that everybody is treated equally. This tends to result in agreement on the lowest common denominator for the service, and consequently, each customer may end up with a service that is not 100% in line with actual requirements for his system and a price that is not necessarily the optimal for his system.

In addition, the contracting process leaves very little operational flexibility as this has to be achieved in consensus with a large group of customers rather than with individuals - almost like getting agreement on a UN resolution. This often results in the contractor having little or no motivation to optimise the utilisation of the resources.

Even in zones with multiple ships, the ships are mainly treated as individual ships on charter (standby duties) rather than as a pool of resources that can be put to positive use.

3 THE PRIVATE AGREEMENT

The private model is like any business deal where two individual parties bilaterally agree on a product/service and the conditions under which it will be supplied. It will only work well if it satisfies the needs of both sides. Under this model, the customers aim to get a service tailored more towards their specific requirements

for the individual systems while the contractor will typically aim to get more flexibility concerning use of his resources. This flexibility is often traded against a reduced standby fee compared to a zone agreement. A reduced standby fee coupled with more flexibility in the use of resources gives the contractor both the motivation and the scope to optimise the utilisation of his resources (and thereby his income).

Such an arrangement is equally of interest to the customer as well. The result can be a “better” service or perhaps the “correct” service for the system, and potentially at a better price. With a private agreement, the customer shouldn’t be paying for services he doesn’t want, and he should not have to buy supplementary services outside the agreement as he can depend on a number of system specific factors. In addition, the overall price may be better than sticking with a group – as in any other business.

The Private Agreement therefore provides greater flexibility for both the provider and the customer. This flexibility comes in many different ways. As already highlighted the Private Agreement can be tailored towards the customer needs and provide a price which is typically less than the Zone Agreement. The reason for this is the flexibility that Private Agreements give to the provider for the utilisation of the vessel(s). The provider typically prefers to utilise the maintenance vessels as part of a managed pool of resources, since it leads to better productivity of the vessels, e.g. by using local resources to avoid long transits around the world. The real key is the flexibility to use cable ships from the provider’s own fleet or from an external source when maintenance demands require. In the past few years the benefits of such flexibility have been clearly demonstrated during the earthquake disasters of 2006 and 2008 off Taiwan.

Nevertheless, a level of detailed management is required to ensure the service is always maintained, by taking

care to program vessel movements and to ensure access to spare cable/plant at all times. This is typically performed by ensuring that the maintenance vessels carry a set of “Strategic Spares” to allow the vessels to respond more quickly to a mobilisation request and to move from one repair to another without having to return to the depot to load spare cable. In addition, the flexibility for additional vessels to load spare cable directly from a depot if the need arises must also be maintained.

It should be noted however that the maintenance market is a relatively small market and very few locations in the world have the density of cables and cable faults to support numerous competitors within a specific regional area.

4 EVOLUTION OF THE MODELS

Can the zone model become more like the private model or can the private model become more like the zone model? Can a hybrid model emerge, combining the best features of both?

In our view, we believe that this is possible.

The main challenge here is how to generate an environment where the contractors can justify investment in maintenance resources based on a relatively predictable and reasonable return on their investment.

One way would be to have a more flexible approach to the utilisation of the cable ships allowing vessels to be used partly for maintenance work and partly for installation work. This flexibility would open the way to two alternative sources of income for contractors, and most likely a higher utilisation of vessels.

Another way could be for the industry to move away from the smaller zone agreements and move towards larger “ocean wide” or “global” agreements to avoid the all or nothing gamble for the suppliers in the tendering process for the zone agreements. This should also generate

the potential for more flexible utilisation of the cable ships.

The key questions are:

- Who should be in control of the vessels?
- In particular who should be in control of the flexibility?

So far, the customers involved in zone agreements have shown little inclination to loosen control of the designated maintenance vessels. In reality most “zone agreements” today are actually charter agreements even though attempts have been made to mask these as service agreements, with all the control given to the customer(s). However, in order to reach a better vessel utilisation and improved responsiveness to market needs, the contractor’s ultimate goal is to have control of the vessels allowing him to manage very tight time scales.

A possible hybrid model may be based on a co-ordinated group of maintenance contractors working together to serve a particular ocean/area, with control of resources being carried out within this group. This should alleviate the customer’s fear (or his perception) of being over-charged or cornered by a contractor and would also give the individual contractors better conditions as they would then be working with equals, working to the same type of timescales and having similar operational issues etc.

5 CONCLUSION

Unless some ways are found under the zone agreement model to give the potential contractors a) a reasonable revenue and b) reliable income, or a hybrid model emerges, contractors may very well find it hard to justify future investments directly aimed at the maintenance segment. The private model often has more flexibility for the contractor to obtain additional revenues and thereby create a better business case for new investments. From the contractors point of view this model is preferable and

maybe the only one that can eventually secure the required investments for renewal of the ships used for cable maintenance.

Change is required to secure investment in new vessels to replace some of the very old cable ships in the ageing cable ship fleet. In the transition period until new cable ships can be introduced, a more flexible utilisation of both installation and maintenance vessels in the maintenance market would reduce the average age of vessels being used for maintenance and would reduce the risk of a shortfall of vessels to meet needs of the maintenance segment.

6 REFERENCES

[1] O. Smidt, “The World’s Aging Cable Fleet”, SubOptic 2010, Yokohama, Japan

Disclaimer:

All calculations have been made based on the ASN internal database of the world fleet of cable ships. It only contains the ships relevant for ASN to track and therefore may not be 100% complete.