Counting the Cost of Piracy

Rear Admiral Chris Parry CBE, the Chair of the UK's Marine Management Organisation had the following to say in a recent newsletter, "[P]iracy in the modern world – especially that in the Horn of Africa - has become big business, characterised and facilitated by an irregular version of venture capitalism and illicit methods of international exchange."

Piracy has become an ever increasing threat on the high seas, not only to the safety of seamen passing through the 'hotspot' areas, but also to the stability of trade routes and the global economy. Every week we learn of new and increasingly brazen attacks, and the problem is spreading progressively to locations previously regarded as 'pirate free'.

The overall cost of piracy is extremely difficult to calculate, because there is a lack of consensus on how to quantify the financial implications. This problem is exacerbated by a shortage of data and the use of averages and estimates to fill the gaps. Also, to avoid lengthy investigations and bad publicity, many ship owners do not report pirate attacks. As a result we are left with a broad estimate of a cost of between 7 and 12 billion US Dollars a year – a figure calculated by "Oceans Beyond Piracy", a privately funded project established to help promote a long-term solution to the problem.

Although this menace manifests itself far from our shores, the financial implications of piracy have a ripple effect through the global economy and are ultimately felt by the consumer. It would therefore be short-sighted to dismiss piracy as a distant scourge.

The obvious upfront costs – such as those relating to paying ransoms, re-routing of vessels and purchasing deterrent security equipment – are carried by the ship owner. But is it clear that owners look to pass on this additional expenditure to other parties by factoring the costs into the freight rate charged to carry the cargo or to charter the ship.

One area which has shown a measurable cost increase in response to the threat of piracy is the price of insurance. Increased premiums have had a direct cost on the shipping and transport industry, hitting the pockets of ship owners, charterers and merchants alike. According to a recent report in Risk Management Magazine, insurance premiums for ships sailing through the Gulf of Aden have risen in 2011 between 0.05% and 0.175% of the value of the cargo insured. This is an increase of 350% since 2008. Moreover, premiums on kidnap and ransom insurance policies have risen in excess of 1000% during the same period.

As of 8 January 2011 the North of England P&I Association, one of the world's largest protection and indemnity insurers, levied an additional war risk premium due to an expanding exclusion zone for war risk cover.

As marine insurers extend the piracy risk zone, cautious ship operators who sought to circumvent additional insurance premiums by avoiding these areas are now burdened with substantial costs. They are either forced to sail additional days to avoid this now expanded zone or they must shoulder additional insurance premiums. To illustrate the effects, Fairmont Shipping (Canada) Ltd reports incurring $100 000 to $120 000 in additional insurance premiums for each trip due to this increased area of high-risk. This effectively doubles their insurance cost for every trip.

Apart from the increased cost of traditional marine insurance cover, some ship owners and cargo interests are now opting to take out new forms of cover which are available in the market, such as "kidnap and ransom" insurance and cover for loss of earnings while a ship is under siege by pirates. These additional costs are inevitably passed on to consumers too, which is reflected in the cost of commodities and manufactured goods.

From a legal perspective, the English case of *Masefield AG v Amlin Corporate Member Ltd* provides a useful illustration of the insurance issues which can arise in modern day piracy.

In this case, the *Bunga Melati Dua*, a biodiesel-carrying vessel, was captured by Somali pirates in the Gulf of Aden on a voyage between Malaysia and Rotterdam. The vessel was released some six weeks after her capture upon payment of a $2 million ransom. This delay prevented the vessel from discharging the cargo during the seasonal biofuel market, and the product was ultimately sold for less than its insured value.

Masefield claimed the loss from its underwriter Amlin under the terms of its cargo policy. It argued that the piracy event created an immediate actual total loss (ATL) of the cargo, irrespective of the possibility of the ship being returned to the owner. In defence of the claim, Amlin relied on the English statutory requirement that the insured must be "irretrievably deprived" of its property – that is to say, there must be a physical or legal impossibility of recovery – before the insured is entitled to an indemnity for an ATL. Amlin argued that because the cargo had been recovered, there was no physical loss and therefore no claim under the policy.

The court determined, in the first place, the legality of ransom payments, holding that no such prohibition appeared to exist under international law. This, in itself, is a significant finding, as there had been considerable legal debate surrounding this issue prior to the judgment.

As regards the merits of a claim for an ATL, the court found in favour of Amlin, holding that paying a ransom prevented the insured from claiming an ATL. This decision means that the mere capture of a ship does not automatically trigger an ATL. Instead, such a claim will only succeed where there is no possibility of ever recovering possession of the vessel.

The effect of a case such as *Masefield* is that it clarifies the boundaries of what is covered under a policy of marine insurance in the event of a piracy incident. Where traditional marine insurance does not cover certain elements of the risk, cargo owners will be obliged to mitigate their exposure in other ways, which may be at the expense of the end consumer of the product.

As long as piracy continues in its current state, or indeed escalates, the costs are unlikely to abate. Current anti-piracy measures are defensive in nature and do not appear to address the heart of the problem. Onboard deterrents, such as high-pitch loudspeakers, deck hoses and deck patrols are little more than a quick fix, while the deployment of naval forces to the Gulf of Aden to deter pirate attacks have had mixed success.

It is undeniable that the only permanent solution to the piracy problem off the coast of East Africa is the formation of a stable Somali state. These pirates are no longer a band of unsophisticated and opportunistic individuals. They are now a well-organised network involving numerous support structures. The burden rests on the international community to adopt a multi-faceted approach aimed primarily at severing the links between the pirates and the individuals or institutions which empower piracy through corrupt practices and money laundering.

The world must take heed of the piracy infestation in East Africa and deal with it swiftly. This isolated problem has global ramifications, which, if not quarantined, will continue to thrive wherever international and state structures are vulnerable.