



HEDGING ON RATE FUTURES



AN EFFORT TO BUILD
A MARKET FOR FREIGHT
PRICE FUTURES MARKS
A NEW ATTEMPT
TO TAME SHIPPING'S
WILD RATE SWINGS

BULK SHIPPERS AND CARRIERS

By Peter T. Leach

routinely buy and sell futures contracts called freight forward agreements based on the Baltic Dry Index of bulk rates, to hedge against the risk that a rise or fall in the spot rate might cut into the profit they expect from the voyage. But ocean container shippers and carriers have had no such hedging options.

With container freight rates in the midst of seemingly unprecedented volatility, one London brokerage firm is betting it can develop a market where container carriers and shippers would buy and sell futures contracts based on container freight rates.

Clarkson Securities, the derivatives brokerage arm of London ship broker Clarksons, launched the first trade last month of what it calls the Container Freight Swap Agreement between Morgan Stanley and Delphis, a container ship operator that owns a European feeder line. The swap agreement will be settled against the new Shanghai Containerized Freight Index of average weekly spot rates, launched by the Shanghai Shipping Exchange last October.

The swap agreements are being traded against the indexes for rates on four major east-west trade lanes, from Shanghai to northern Europe, the Mediterranean, and the U.S. East and West coasts.

Clarkson is launching the plan after trying for about a decade to figure out how to set up such a futures market. But the timing for much of the freight shipping world couldn't be more turbulent for rate shopping. Trucking, rail and air cargo rates have swung sharply over the last two years, although they've been heading mostly on a downward track in domestic shipping markets.

In international markets, however, pricing has moved up and down with what appears to be unprecedented force, with container shipping rates taking the most dramatic swings. Spot prices in some markets have more than doubled in the last year after dropping by three quarters in the year before that, according to the Container Rate

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Benchmark issued by Drewry Shipping Consultants of London.

That’s brought more voices from the shipper and carrier ranks calling for mechanisms that would bring greater stability to the market.

Bjorn Vang Jensen, vice president of global freight and logistics services at Electrolux, last year said he favored contracts built on automatic rate adjustments based on certain market criteria — an instrument that would operate like an index-based fuel surcharge.

Many carriers hedge against fuel prices, of course, and the Clarkson Container Freight Swap Agreement may give carriers and shippers the ability to hedge on freight rates themselves.

The agreement is in its infancy and may take a few months to develop as a full-fledged market where buyers and sellers can conduct routine trades. Carriers appear likely to use it, and banks and securities firms may find it attractive as a vehicle for speculating on the spread between the spot rate one month and several months later.

But shippers and non-vessel-operating common carriers appear skeptical that there is a need for it.

There has been only one action so far — the Jan. 15 trade between Morgan Stanley and Delphis. It involved a small number of 20-foot containers and was conducted as much to demonstrate that such a trade was feasible as to hedge against price fluctuations. The trade, which has yet to be settled against the monthly average of rates compiled by the Shanghai Freight Exchange, was conducted as an over-the-counter trade among the parties outside of any established market or clearinghouse.

“We are working on bringing new counterparties into the market,” said Benjamin Gibson, the freight rate derivatives broker at Clarkson Securities in charge of developing the new container freight rate trading instrument.

“We have a number of banks that are interested in the product and can quite easily trade over the counter between each other, but bringing a shipping company with little derivative experience to a position where

it can trade takes a little longer. Obviously, however, it is important to try to bring in some actual players from the container industry,” he said.

Clarkson wants to convert what will start as over-the-counter trades into a cleared market, where many more counterparties will be able to access the market. “We’re in this OTC period of the market, and our goal is to bring in a clearinghouse in the second quarter,” Gibson said. “In the current dry bulk FFA market, almost 100 percent of the trades are now done through a clearinghouse, which greatly reduces any counterparty credit risk.”

Three clearinghouses are involved in the freight forward agreement market — the London Clearing House, NOS in Oslo and SGX in Singapore.

Container shipping lines have expressed strong interest in the new instrument for trading spot rates, said Brian Nixon, executive director of commodities at Morgan Stanley in London. He thinks the index will become increasingly important because the freight rates on routes where the instruments will be traded are being increasingly driven by spot prices, especially on trade lanes from Asia to Europe and Asia to the Mediterranean.

Nixon said the indexed futures could help bridge the gap in trust between shipping lines and non-vessel-operating common carriers, a gap that has grown amid the recent price volatility.

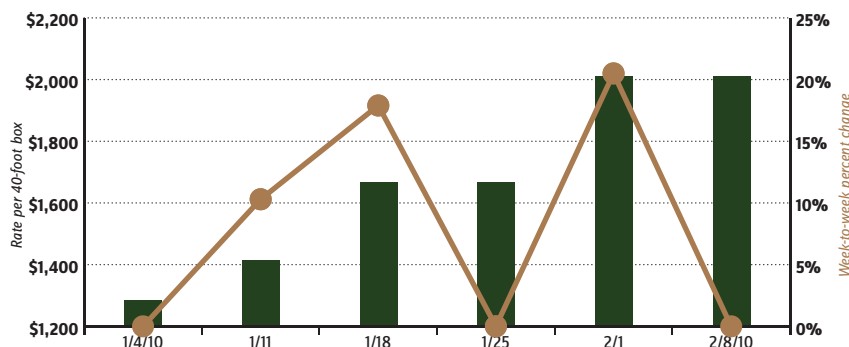
“Contracts were ripped up by the NVOs, and the lines had to accept lower rates because the spot market was lower,” he said. “Having a definitive spot market actually improves price transparency for all. If you had a derivative hedge against some of the spot risk, this would at least mitigate some of that price risk.”

Carriers are still evaluating the viability of the trading instrument. “Clearly, this could be a means for balancing freight rates,” said Kasper Andreasen, director of financial planning and analysis at Maersk Line. “But

CONTAINER RATE BENCHMARK

■ The rate benchmark is based on Drewry Shipping Consultants’ research and derived from NVOCCs shipping Hong Kong to Los Angeles. The rate is in dollars and based on a full 40-foot containerload, excluding terminal-handling charges in Hong Kong.

Rates in the Drewry Container Rate Benchmark have grown 56.8 percent so far this year and were up last week 41 percent over last year.



Source: Drewry Shipping Consultants London, www.drewry.co.uk, +44 20 7538 0191



it's clearly dependent on getting liquidity. We are so far seeing only very small 'test' trades being done, and we would, of course, need a deep market to be able to even just fine-tune our exposure."

Maersk Line parent A.P. Moller-Maersk now hedges on fluctuations in interest rates and in foreign exchange. As both an oil producer and consumer, it seeks to hedge only the net position, and in order to limit the negative effect of changes in oil prices enters into hedge contracts, primarily options, Andreassen said.

But for the carrier to decide to use the new index futures as a hedge, he said, Maersk Line needs to be fully confident the Shanghai index is fair and can't be manipulated. "If you base any sort of hedging on an index, then you better make sure that index is genuine, so that we don't have one party to the trade affect the outcome. That's all part of what we are looking at now, at how fragile the index is. That's critical," he said.

To help create a neutral index, Clarkson, which originally set up the freight forward agreement traded on the Baltic Dry Index, suggested to the Shanghai Shipping Exchange that it average freight rates supplied by both carriers and by NVOs.

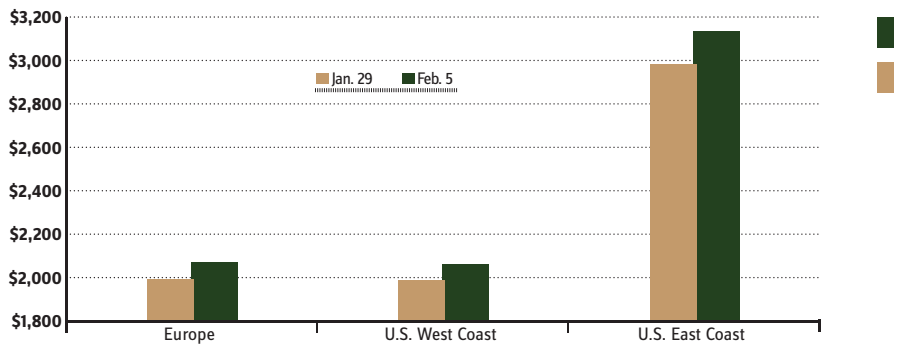
"An index needs to be impartial, come rain or shine," said Alex Gray, CEO of Clarkson Securities.

To ensure neutrality, the SSE established a panel of 15 carriers, including Maersk Line, Hapag-Lloyd, OOCL, Cosco and China Shipping, and 15 Chinese NVOs and logistics companies, including OOIL Logistics, Cosco Logistics and Sinotrans. "This way, we can see what vessel-owning companies

SHANGHAI FREIGHT INDEX

■ The weekly New Shanghai Containerized Freight Index on container shipments out of Shanghai to Europe and the U.S. West Coast

The overall rate index grew 3.2 percent the week of Feb. 5 from the week before and the rates out of Asia have grown more than 25 percent since October.



Source: China Shipping, en.chinashipping.com.cn

are charging and what NVOs are being charged to give it some balance and make it more even," Gray said.

Morgan Stanley, which will sell the new instrument to buyers and sellers on each side of the agreement, is preparing to market the futures agreement to large shippers and freight forwarders. It is already apparent that this could take time, but the model of the dry and wet freight, as well as most commodity futures markets, should speed up that process.

"From the standpoint of a shipper that dealt directly with ocean carriers and used NVOs only occasionally, I don't know where it would fit," said John Isbell, vice president of the Starboard Alliance and former director of corporate logistics at Nike. "Maybe it would be used by an NVO or a shipper who is looking for spot rates for cargo he's got to get moving. It would only be useful to a plain vanilla shipper from port to port."

He said most large shippers want terms and conditions in their contracts that could not be part of a swap agreement.

Philip Damas, division director of Drewry Shipping Consultants, said the Baltic Exchange in London tried to set up a trading instrument based on charter rates a few years ago, but it failed "because there was no demand from the charterers or the shippers."

Although he called the new instrument an "excellent idea" that has worked in bulk shipping with the freight forward agreement market, he was dubious about its prospects among container shippers because the cost of container freight as a percentage of the landed value of the product is very low, so the shipper can absorb the risk.

"If you are in bulk shipping and your freight contract is 30 percent of the landed value of the coal and other bulk cargoes, the risk to the impact on your profitability is enormous," he said. "That's not the case in container shipping for most shippers."

Shippers also are not used to using such instruments in their business, relying instead on annual or semi-annual contracts.

Damas said Drewry recommends multiyear container freight contracts as an alternative to financial derivatives. "Shippers can negotiate a multiyear contract with a carrier where it specifies that the rate for the second year or the third year will be indexed on a third-party price of freight rates," he said.

Multiyear contracts of this type are being used by relatively few shippers, mostly on Asia-to-Europe lanes. "It's possibly an easier way to guarantee to both sides that they will maintain the relationship," Damas said. **joc**

Contact Peter T. Leach at pleach@joc.com.

