

## **Using FFAs to hedge physical exposure:**

*1. A shipowner is a natural seller of FFAs, using them to protect themselves against falling freight rates in the future.*

*Shipowner "A" owns a panamax vessel which they normally charter out on period to an operator at a fixed daily hire rate. By doing so, the shipowner effectively gives the operator the opportunity to make money if the freight market improves. 'A' wishes to play the spot market themselves and keep control of the ship. By selling an FFA instead of chartering out the vessel, they will still be covered if the market falls below the agreed level and retain the trading options on the vessel.*

*Therefore 'A' keeps the vessel under his control and **sells** a full calendar FFA contract as follows:*

*2011 - 12 months - \$18,500 per day – 30 days per month – panamax 4 timecharter average.*

*The FFA contract settles monthly – the first settlement date being 31 January 2010.*

*If any of the monthly settlements are below the agreed price – 'A' will be paid the difference multiplied by the contract size.*

*Example: If the average of January is \$15,000 – 'A' is due  $\$18,500 - \$15,000 = \$3,500 \times 30\text{days} = \$105,000$ . And so on throughout the rest of the calendar contract.*

*These costs and incomes are balanced by the vessel's earnings on the spot market. The owners retains the option to buy back the FFA contract and/or charter out the vessel which provides far more flexibility than simply fixing the vessel for period charter.*

*2. A charterer is a natural buyer of FFAs, using them to protect themselves against rising future freight rates*

*Charterer 'B' has a Contract of Affreightment (COA) with shipments during the third and fourth quarters of 2010. They would like to play the spot market rather than fixing all the cargoes en bloc to an operator at a fixed freight rate.*

*Thus 'B' keeps all the cargoes under their control and **buys** a Q3+4 FFA contract as follows:*

*2010 – Q3+4 – 6 months - \$19,000 per day – 30 days per month – panamax 4 timecharter average.*

*The FFA contract settles monthly – the first settlement being 31 July 2010.*

*If any of the months settle above the agreed price – 'B' will be paid the difference multiplied by the contract size.*

*Example: If the average of July is \$22,000 – 'B' is due  $\$22,000 - \$19,000 = \$3,000 \times 30\text{days} = \$90,000$ . And so on for the duration of the FFA contract.*

*These funds can then be put towards the cost of spot chartering.*

*On the other hand, if the freight market falls and any of the six months settle below the agreed level – 'B' will have to pay the difference. However, at the same time they will be able to take advantage of a lower freight rates when fixing the cargoes on the spot physical market. Again, the charterer has retained day-to-day flexibility whilst still fixing their freight costs.*