The Dynamic Duo: Container Swaps & Carrier Contracts

Objections to container swaps have centred on a perceived threat to long-term carrier contracts. But a liquid container swaps market would increase carrier contract participation, encourage the formation of long-term relationships and simultaneously reduce the risk of default, writes Arthur Worsley

Carrier contracts are a good thing. By allowing both carriers and shippers to negotiate fixed rates and services they facilitate efficient trading, promote operational and financial stability and eliminate pricing volatility.

Contract inefficiency is, however, a bad thing. At best counterparties make a net loss on unrealised revenues/costs. At worst, a contract default scenario occurs where one, or both counterparties are no longer able to fulfil the financial obligations of a carrier-contract. This is the worst possible result for both counterparties.

A poorly managed contract can quickly jeopardise even the longest of carrier-shipper relationships. At risk are the cost, time and effort placed in developing the client-supplier relationship and mounting tensions between carrier and shipper. In a worst-case scenario, the carrier may lose a good customer as well as guaranteed volume and revenue. The customer may find themselves in the daunting position of searching for a new carrier, losing relationship-specific service benefits and reduced costs that may have been earned or negotiated over several years.

In the post-conference era, contract inefficiency occurs for one simple reason: the spot market is highly volatile and significantly dislocates itself from the fixed rates agreed at the start of a long-term contract. Should costs (bunker fuel, port charges, insurance, demand premiums etc) increase, a fixed, inflexible, long-term box-rate agreed in a contract may become an unprofitable, financial burden to a carrier.

Similarly, in a market where freight rates are falling, a shipper may find the box-rate agreed last month becomes a cost burden when trying to contend with competitors enjoying the benefits of spot market trading. So how can the industry solve this problem? Both carrier and shipper may choose to re-negotiate the contract but this approach entirely defeats the point of the agreement.

For a carrier in a falling spot market, this can be a frustrating exercise with counterparty default used as a bargaining chip by shippers who hold significant volumes of freight to ransom in exchange for better rates. Similarly, shippers are frequently saddled with unexpected surcharges to their supposedly fixed tariffs in a rising or peak season market.

Both carriers and shippers experience these scenarios on a daily basis as a result of the endemic volatility in spot market pricing.

It is this concern that has acted as the single most limiting factor in the expansion of the carrier-contracted market and the single greatest risk to both carriers and lines for the stability of such contracts where they exist.

One use of container swaps – among many others – is to solve this age-old problem. By permitting players to trade paper positions with counterparties that are independent of their carrier-contract partners, a container swap/carrier-contract risk management strategy presents itself.

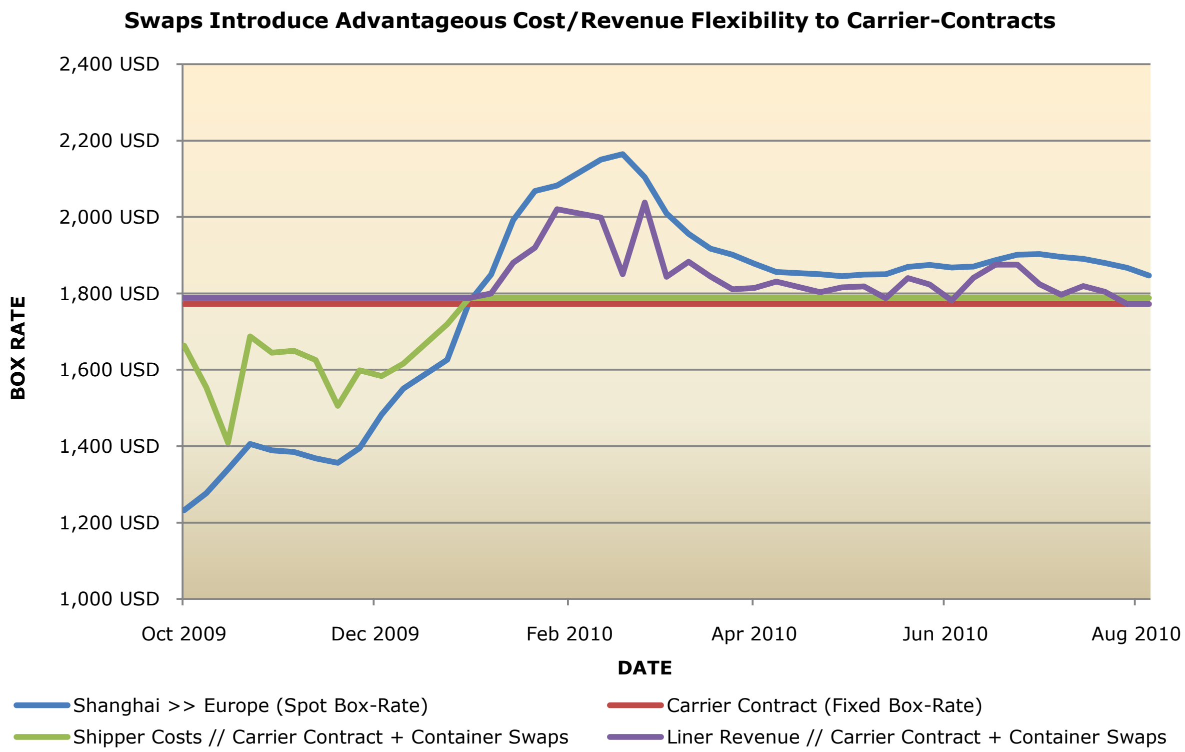

Figure 1: This graph illustrates the benefits to both lines and shippers of using container swaps as a complimentary addition to carrier-contract risk management strategies.

The graph illustrates how this strategy allows both carriers and shippers to explore cost/revenue flexibility during favourable spot market conditions that they would otherwise be unable to take advantage of.

The pricing stress incurred when spot market and contract agreed box rates diverge is alleviated significantly, reducing contract inefficiency and the risk of default as well as eliminating a key prohibitive factor in the decisions of many shippers to remain on the sidelines of the spot market. This result can be achieved without a need to re-negotiate (and thus potentially jeopardise) physical contract terms.

Below is an example of a carrier contract between Carrier A and Shipper B in a rising spot market. It is worth noting that the positions in this example can be reversed quite easily to explore the possible scenarios for a shipper.

For simplicity, we have not included the concept of 'basis' (which allows carriers and shippers to trade against the Shanghai Containerized Freight Index (SCFI) regardless of a difference between the former's physical box-rates and the latter's USD indication of spot box-rates).

In March, 2011, Carrier A ties itself in to a long term agreement with Shipper B to ship 2,000 containers a month from Shanghai to Hamburg at an all inclusive cost of $1500 per box.

Having signed the agreement, Carrier A realises that during June, bunker prices are likely to increase significantly resulting in a need to adjust its spot-market box-rates correspondingly. The low profit-margin of the contract, coupled with this increased cost will mean that Carrier A will actually begin to lose money on its contract with Shipper B.

The carrier has four choices:

1. Default on the contract with Shipper B and risk losing the customer to another line.

2. Approach Shipper B immediately to renegotiate the annual rate and risk losing the customer to another line.

3. Introduce a fuel surcharge on the contract during June. This risks upsetting Shipper B, straining the relationship and may also cause them to default on the contract.

4. Honour the contract with Shipper B and buy 2,000 container swaps contracts for June in order to hedge against the risk of increase in spot market box-rates.

It is January and rather than risk losing Shipper B's custom, Carrier A opts for option 4. Carrier A negotiates a purchase of 2,000 LCH-cleared container swap contracts for June against the Shanghai to Europe SCFI index at $1,600/box.

As suspected, firming bunker costs cause a significant increase in spot box-rates during June and the June monthly spot-market average for the index (against which the container swaps are settled) closes at $1,800/box.

So, during June, whilst Carrier A still receives only $1,500 x 2,000 boxes = $3,000,000 from its contractual agreement with Shipper B it also receives an additional ($1,800-$1,600) x 2,000 contracts = $400,000 from its swap position.

The carrier has successfully hedged against an unfavourable movement of the spot market and increased its net June revenues on the contract by 13%. Further, unlike its competitors, it has achieved this gain without needing to renegotiate rates on its existing contract.

Shipper B is delighted at the high level of service and pricing fidelity exhibited by Carrier A and is happy to continue with its services the following March, when the contract is renegotiated.

Container swaps present an exciting, complimentary addition to the excellent, tried-and-tested risk-management approaches that have served the container industry well for the past several decades.

Their ability to solve one of the key problems for carrier-contracts barely scrapes the surface of their potential benefits and a developed and liquid container swaps market would add significant value to the daily operations of carriers and shippers alike.

As the container swaps market has matured and understanding increased, we have been delighted to see an increasing body of market participants (carriers, NVOCCs, freight forwarders and shippers alike) begin to accept container swaps as an important, progressive, evolution of the status quo rather than an aggressive, external usurper.

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About FIS

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