Baltic Exchange

THE BALTIC EXCHANGE
Index Linked Agreements

January 2022

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- The Baltic Exchange is the world's leading source of independent freight market data. Our information is used by shipbrokers, owners & operators, traders, financiers and charterers as a reliable and independent view of the dry bulk, tanker, gas, container and air freight markets.

- “Our Word Our Bond” is at the heart of what the Baltic Exchange and its global membership stands for. This ethos is embedded in the Baltic Code.

BALTIC EXCHANGE

GLOBAL PRESENCE

278
years as a business

4,600+
members, across

60
countries

37
years
publishing indices

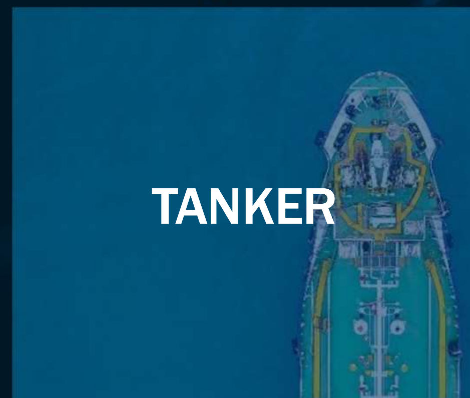
FREIGHT

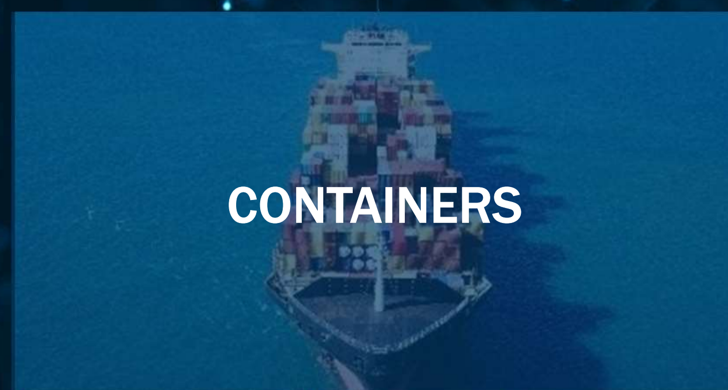
5
market sectors

82
global panelist companies

200
indices

1200+
Daily data points





Freight Contract Negotiations

- **The Issue:**

- Lengthy and complex price negotiations to the detriment of conversations to improve and cement the relationship
- Contracts fall apart as the spot prices diverge from the fixed contract rate
- Contracts are unenforceable and can be cancelled with insufficient notice

- **The Objective:**

- To provide long-term contract security
- To mitigate the negative effects of volatility
- To concentrate on improving service by maintaining and developing relationships

What is wrong with annual fixed price negotiations?

In theory fixing a price once a year is a simple way of hedging your exposure to a spot market. However, the annual freight rate negotiations may exclude key monthly fluctuating cost components, such as fuel and currency.

There is nothing wrong with this approach if all parties honour their contracts in the face of spot rate volatility. The annual round of negotiations between buyers and airlines relies on both parties committing to minimum cargo volumes and service levels in return for a fixed rate. FBX can be used as a price discovery starting point for negotiations: it is a fair and transparent assessment of the market. Typically, the Freight Forwarder or Shippers will aim to negotiate a rate below the spot market and can use the index as a reference point.

The reality, however, is that these types of contracts, which can extend for a full year, are rarely enforced and there are no legal penalties for non-performance. They are little more than a show of goodwill. A Shipper, for example, faced with a lower spot market can walk away and ship with an alternative provider. A Carrier might also give their space away to higher paying customers or require premiums to be paid in a higher spot market scenario. It cannot be an efficient use of time or human resources to enter into lengthy, opaque, costly, and relationship-straining negotiations only for one party to walk away from the agreement a few months later as economic conditions change.

What is wrong with annual fixed price negotiations?

The time spent on negotiations can be substantial and rates can be renegotiated several times over the course of the year. Procurement teams expend significant resources, relationships can be strained, and it can be in no-one's long-term interest to be almost constantly battling price in a volatile market. The end-result is a market where both sides are mutually dependent on the other, but constantly frustrated at the negative impact of the other's behaviour. The extreme COVID-19 induced volatility is just one recent example placing further stress on this way of conducting business.

Index-linked floating contracts offer stability and an alternative cost-effective solution to current industry practices. Rather than rely on an annual rate review, an index-linked contract allows companies to sign contracts which provide an adjustment mechanism as the cost of ocean transportation rises or falls. It is not possible therefore for the contract price and the market price to deviate and enables both parties to feel that they are paying or receiving a fair rate.

Floating long-term contracts could be a game changer for the industry.

There are several methods that can be employed when creating your index-linked contract, some of which are discussed next

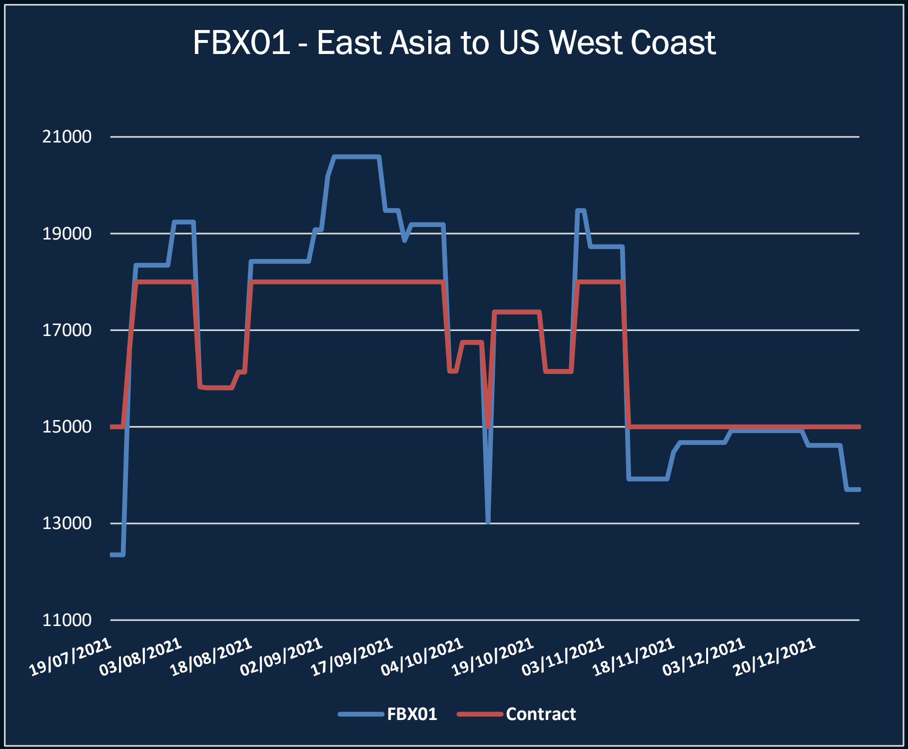
Floors and Ceilings

Index-linked contracts enable more stable, multi-year contract terms and reduce the threat that either party will walk away from the contract when market conditions change. Traditional fixed-rate annual contracts run the risk of locking Shippers into high relative freight costs when the market falls and potential capacity shortfalls when market rates rise.

Where a contract is linked to a spot index both parties will be satisfied with the increase in contract security, but the index could drop to levels the seller may not accept (needing to cover operating costs for example), and likewise increase to numbers the buyer cannot afford. In this case, both parties can consider implementing a contract floor and ceiling to mitigate extreme volatility but still allowing a single wide band of floating pricing. Both parties will agree to a minimum and maximum freight rate. This protects both the Shipper and Carrier from extreme rises and falls, while still allowing for some benefits of price differentials to accrue.

It is perfectly possible to have a contract without ceilings and floors, or even with a floor and no ceiling and vice versa. The contract will reflect what both counterparties are comfortable with going forward and no external party should influence the terms of this private contract.

Floors and Ceilings Example



In this simple floor and ceiling exercise, both sides take equal risk. The Seller agrees a ceiling of USD 18,000 per FEU whilst the Buyer agrees a floor of USD 15,000 per FEU.

In this form, the Seller, takes all the benefits when prices fall below the floor: e.g. at USD 14,000 they benefit by USD 1,000 per FEU, but they also bear all the risk when it rises above the celling: e.g. at USD 19,000 they lose USD 1,000 per FEU.

However, it remains index linked between USD 15,000 and USD 18,000, allowing for a degree of risk pooling and certainty, while still allowing for some benefits of price differentials to accrue.

Price Bands

Price Bands are pre-agreed fixed prices, that are triggered by the index reaching certain levels for an agreed period of time. A floating rate might calculate the average of the index over the last 7 or 14 days and use that price. Price bands are a set price while the index operates within a band. This is normally used to help with the accounting, as no average or access to historical data is required by back office.

They reference the price on the day of the shipment and use the agreed set price associated to the level of the index.

Contract Considerations

- Scope of tariff to be index-linked
- Contract period
- Choice of index
- Starting rate
- Contract rate adjustment mechanism
- Carrier service commitment
- Shipper volume commitments

Why use FBX?

Bookable • Audited • Transparent • Current • Independent

- FBX also has the advantage for users of being a macro index. It focuses on region to region rather than specific origin or destination ports within that same region. What this means is a huge increase in the number of available counterparties in the market. Restricting the scope to one origin and one destination port can drastically reduce the number of companies able and willing to enter into a contract.

- The FBX is a daily index, published at 14:00 London.

Price Mechanism

It is usual to follow the index with a percentage premium or discount. If a fixed price differential is taken, the effect of the dollar amount is either unduly influential when the index is low or has little bearing when the index level is high. A percentage difference is therefore a fairer tracker of the index in a contract.

Frequency of settlement

The frequency of shipment should be the determining factor on when settlement should occur.

The settlement period should allow enough time for averaging to occur but not be too long a period so that there is a significant gap between invoices.

We would suggest the following as a guide:

Frequency of Shipment	Settlement
Weekly	Every 2 weeks
Monthly	Every 6-8 weeks
Quarterly	Every 16 weeks

Frequency of renegotiation

The index-linked contract evolved to counter the need for frequent renegotiation. They are designed to increase efficiency of contracting and procurement teams so that their time can be better spent on improving the service relationship between parties.

Any clauses included in an index-linked contract that provide the ability to adjust the mechanism, are more there for comfort; to reassure both parties to the contract. It would be sensible to check how the contract is running every six months or so (depending on the agreed contract length, if any) and if all is acceptable, let it continue to run.

It would be unusual to include a break clause if there is an ability to adjust the mechanism within the contract and both sides are committed to the fulfilment of the contract.

Deadfreight

If the contract price is resolved by the use of an index-linked contract, then volume commitment can become the pain point instead.

A solution is of course to include a deadfreight clause in the contract, but these have also been traditionally hard to enforce in fixed rate contracts.

Here, the deadfreight can also be index-linked at a percentage level agreeable to both parties. The notice period is still a point to be agreed by the seller and buyer – this issue cannot be fixed with an index-linked contract. However, the goodwill that is usually created by eliminating the need for frequent renegotiations of a fixed rate contract, should free up more time to concentrate on service commitments on both sides.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