CLARKSON SECURITIES LIMITED

St. Magnus House 3 Lower Thames Street London EC3R 6HE

Tel: +44 (0) 20 7334 3151
Fax: +44 (0) 20 7283 9412
Email: csl@clarksons.com

www.clarksons.com

Karen V. Gregory,
Federal Maritime Commission,
800 North Capitol Street, N.W. Room 1046,
Washington D.C. 20573-0001

13 July 2012

Dear Ms Gregory,

Re: Docket 12-07, Solicitation of views on requests to develop and release container freight rate indices for U.S. agricultural exports based on a sampling of service contracts filed with the FMC.

Clarkson Securities Limited (CSL) has prepared the following submission in response to the Federal Maritime Commission's Notice of Inquiry into developing an export freight index. CSL is part of Clarkson PLC, the world's leading provider of integrated shipping services and a public company listed in London with over 150 years of history. CSL assisted the Shanghai Shipping Exchange with the development of the SCFI Index and pioneered the use of derivatives in the dry bulk and tanker sectors during the 1990s and continues to offer hedging and risk management advice to a client base of global ship owners and cargo interests. CSL is authorised and regulated by the Financial Services Authority.

In preparing this submission, CSL has endeavoured to answer the questions posed by the Notice of Inquiry. We have also seen, however, a detailed submission from the World Shipping Council which directly attacks the motives of brokers such as CSL and, more worryingly, makes some erroneous statements concerning the need for an index in the US export trades. We have decided to address these comments in an appendix.

1. **Would the shipping public find an export rate benchmark beneficial?**
2. **Should the FMC extract filed rates, or is there a viable alternative?**
3. **What are the pros and cons of added market transparency and indices?**
4. **Should an export index be commodity specific or more general?**

Appendix: Response to World Shipping Council submission

1. Would the shipping public find an export rate benchmark beneficial?

When considering whether the industry would find a rate benchmark beneficial, we should also consider what the purpose of a benchmark is. Indices are not designed to remove, increase or in any way change market conditions, fundamentals or volatility. An index should aim to provide greater price transparency that drives market efficiencies (longer term contracts, fewer resources spent on price negotiations etc) and further provides the potential link to secondary tools such as a hedging market.

Container shipping is well known for its opacity, with freight rates in particular being regarded until recently as a 'known unknown' by many shippers. Most other shipping sectors rely on market pricing, often with independent intermediaries such as Clarkson, to enable price transparency. The container shipping model, however, has evolved with a 'business to consumer' style, direct sales model where shippers procure freight just as individuals might book holidays or airline tickets. Steamship lines themselves have openly prided themselves on the complexity of this sales process that leaves them able to charge wildly differing rates to seemingly similar customers – a practice which is still commonplace today in our experience. In fact, the ability to charge arbitrary premiums to some customers is the main reason that liner executives are resistant to initiatives that promote transparency. For them, commoditization means the end of their ability to sell the same product to certain clients at a vastly inflated price to the mean.

Since the advent of the SCFI in 2009, however (before this index, the only widely available rate benchmark was the quarterly rate average printed in Containerisation International!), this argument has been increasingly neutralised as shippers have become much more aware of rate levels, supply and demand pressures and different pricing strategies. As anecdotal evidence of this trend, Clarkson Research Services Ltd have seen a large increase in demand for their supply and demand analysis in recent years, as shippers become conversant in slow steaming, idle capacity, vessel deliveries and other key drivers of market fundamentals. In short, the wider market has already embraced and seen the benefit of freight indices.

The US export market in particular, has a more commoditized approach, with a more complex structure driving price. Shippers operate on a pure spot basis, removing the complexity of contract rates, but the spot price is driven by a less transparent blend of equipment availability, in land logistics availability and carrier appetite for various cargo types which is itself a function of equipment strategy and the Asian export headhaul freight rate at the time (namely that in times of high headhaul freight rates there is more pressure to export the containers from the US quickly back to origin, which may render some cargo types less attractive). These factors give rise to an environment where there is less pressure on rates not to be transparent, but in fact they remain opaque to shippers without the resources to keep in constant contact with steamship lines.

In the US export market, owing to the backhaul status of the trade, the shipping lines on a commercial level appear to be more supportive of a freight index: a high profile Westbound Trade Vice President commented as much at a recent event we hosted, saying "absolutely the export market is spot, so a rate index would help everyone involved."

2. Should the FMC extract filed rates, or is there a viable alternative?

If we look at other rate benchmarks available in the market, there are two qualities that emerge as essential: neutrality and transparency. Without meeting these two criteria, the usefulness of the benchmark is questionable. The TSA Revenue Index, for example, is transparent (we know who the TSA members are) if not flawed in its handling of BAF and its timeliness, but is definitely not neutral. If we further consider the criteria needed for an index to be used in physical and paper hedging contracts then the bar is raised even further.

Our first contact with the Commission on this topic was prompted by a discussion with several grain exporters (existing clients from the dry bulk market) in which the FMC emerged at the top of a wish list for export index producers. The reasons are very clear: the Commission has unrivalled access to data from the existing process of filing that is an accepted process in the market; the Commission is unquestionably neutral; any FMC product would be robust and the market could reasonably expect it to be around for the long haul; the final benefit would be the FMC's ability to publish historical data which would allow the market to validate and begin to use the index much faster.

In our understanding, there are two main objections to using filed rates as the data source for an export freight index. Firstly that this somehow contravenes the 1998 Shipping Act and by implication, the spirit of the Commission's mandate and secondly that the end product might jeopardise the strictly confidential nature of the originally filed rates. Whilst we aren't conversant enough with the Shipping Act to comment on this point, we do know about confidentiality, foremost through our relationship with The Baltic Exchange where we are both contributors and end users of their indices and through our work with the Shanghai Shipping Exchange developing the SCFI structure.

In simple terms, a benchmark price is one which by its nature is familiar to the wider market: it must be chosen for its broad relevance, which should reduce the sensitivity of it being published. By this thinking, an aggregated price which still is overly representative of one companies rates (and therefore in breach of confidentiality rules) is likely to be unsuitable as the benchmark price (unless, of course that company has a strongly dominant market share in the whole trade). This definition aside, the methodology by which the filed rates are sampled and aggregated should remove all threats to confidentiality. Our experience shows that the contentious part of this process is not the actual aggregation and publication by the independent index provider, but rather the submission of raw data from the market participants. This is something which should not be a concern to the Commission given the established process of rate filing and the difficulty inherent in any participant being able to manipulate or publicise enough filings to cause a problem.

3. What are the pros and cons of added market transparency and indices?

There are many interconnected benefits to greater market transparency through the availability of indices. The greater ease and efficiency of procuring freight drives benefits for both shippers and carriers, but for the purposes of this argument we will highlight the largest advantages, the most prominent of which would be the ability for US exporters to overcome the challenges of freight rate instability and grow their overseas business with far greater confidence.

In today's market, US exporters struggle to sell their products to CIF buyers in Asia. The reason for this is uncertainty of freight cost. A cotton producer is able to hedge their future exposure to the fluctuating price of cotton, but if he sells to a Chinese buyer for delivery in 6 months' time he is exposed to the change in freight cost (which he must bear) as steamship lines cannot give firm, fixed rates for this duration. This same premise goes for all commodities shipped from the US where the seller takes on the freight risk. If the seller tries to pass on freight risk to the buyer, then all too often the price becomes uncompetitive and the transaction falls through. This issue was further explained by several exporters at the AgTC Annual Meeting in June, it has also been publically commented on by Cargill – even the larger players in the export market suffer from the same uncertainty.

Unfortunately, there is no practical method of assisting a shipping line to commit to these forward rates. The volatility in bunkers, headhaul freight rates and the complexity of inland logistics in the US means that committing capacity in this way is too risky. Rather than trying to force the market to comply (as we have seen fail many times over the past 5 years), indexation provides a tool to manage uncertainty and promote growth.

The availability of an index would allow shippers to hedge their future freight exposure and thus be able to commit to forward trades at a stable profit level. Carriers could benefit from stronger, index-linked volume commitments and more accurate forecasting and intermediaries are able to offer fixed rates to shippers unwilling or unable to use the hedging tool themselves.

The real disadvantage of indices is an erosion of the market advantage of those companies that prosper from the opacity of the market. Transparency provides a more level playing field with smaller players being able to access information that might have previously been beyond their resources to access. It must be said, however, that if a larger player sacrifices a knowledge advantage, then he can benefit from an efficiency advantage in the longer run as resources that were dedicated to acquiring the knowledge can be redirected to other tasks. This trade-off is very apparent in the willingness of some of the larger US exporters to support the FMC's initiative despite their current market advantage.

Inevitably there will also be a complaint from steamship lines that freight indices add to the commoditization of their business. Undoubtedly this is true, but the fact remains that an index would not be possible in a market that is not commoditized to a certain degree already! As several shipping lines have already agreed, with the exception of specialized business (e.g. the export of hazardous chemicals), a grain shipper from the US Midwest will have little preference as to who carries his cargo. The fact that prices are always adjusted on a spot basis for the reasons already explained, further reinforces that lowest available price is the driving differentiator in these trades.

Again, it must be repeated that the availability of an index will not bring about a change of market price. Rates on the export trades are low because the steamship line business model views export cargo as a contribution to the cost of repositioning a container, rather than a 'headhaul' cargo which must be served by equipment availability and firmer agreements. Of course, export shippers have been very happy to take advantage of this, but repositioning industries such as the waste paper market could not have developed without the availability of cheap transportation.

4. Should an export index be commodity specific or more general?

Our strong feeling is that a US containerised export index must have a commodity specific format. There is currently a 'Freight All Kinds' benchmark produced by World Container Index from Los Angeles to Shanghai that has not proved to be an accurate benchmark for the export shippers we have contacted.

Inbound freight indices all track freight rates without reference to cargo, as headhaul markets are priced according to one major factor – space on vessels. The US export market, however, rarely prices based on vessel capacity, but rather is moved by equipment availability, inland logistics availability and carrier strategy as explained under point 1. Rates for grain cargo from the Midwest, therefore, can move independently of rates for cotton from Memphis and the levels of fluctuation are well outside the parameters which can turn a trade from profit to loss.

Conclusion

In summary, Clarkson Securities Limited is strongly supportive of the FMC's export index initiative. We have tried to be and will continue to make ourselves of use to help the FMC develop the product further as we have done previously with The Baltic Exchange and The Shanghai Shipping Exchange. We are motivated by our desire to provide access to index-linked hedging tools for our existing client base of US dry bulk exporters and to grow this client base further.

Experience shows us that the resistance from steamship lines is born largely out of an inherently conservative view that is beginning to change as the industry embraces more sophisticated ways of managing price risk. Lines that were initially opposed to the SCFI now regularly use this product for internal benchmarking and are beginning to utilise the more advanced index-linked physical and hedging tools.

Yours faithfully,

Benjamin Gibson
Container Freight Derivatives
Clarkson Securities Limited
St Magnus House
3 Lower Thames Street
London
EC3R 6HE

Appendix: World Shipping Council's Submission to the FMC

Whilst preparing this submission, CSL became aware of the World Shipping Council's (WSC) comments concerning indices, owing to WSC's decision to extensively PR the document to global trade press. We felt that there were some critical comments specifically addressed to derivatives brokers that required a response, but also that WSC had significantly misunderstood some of the aims and purposes of an index – a situation which highlights some of the more backward looking opinions in the container industry which we believe is not representative. Indeed, carriers have embraced indexation to the degree where the TSA now produces a revenue benchmark and we are not aware of any confidentiality issues that have been raised from TSA members.

In fact, CSL believes that the WSC has misread the purpose of the proposed index and completely misunderstood the need for more stable pricing. As we have explained in our submission, indices themselves do not manage or remove volatility, nor are shippers able to obtain fixed rates. The WSC's insistence that the proposed index singles out container shipping unfairly fails to take into account the fact that the outbound rates benchmarked would be inclusive of major export rail moves (therefore taking into account fluctuations in rail costs), that barge costs are pegged to a transparent tariff rate and that, furthermore, there is no need for the Federal Government to provide an index for bulk vessel shipments as these are handled by the existing Baltic indices. In simple terms, the container industry needs greater transparency and the FMC is the best equipped body to provide this in a way that is fair and impartial for all.

If it goes ahead, the FMC export index will provide a useful efficiency tool for shippers and carriers and critically allow those exporters that wish to manage future rate uncertainty. In our experience, US exporters of any size cannot get fixed rates (carriers should learn that fixed does not mean 'fixed, but subject to peak season surcharges' or 'fixed, but subject to bunker adjustment') and so wish to have the tools at their disposal to hedge this exposure. Contrary to what the WSC's submission says, CSL believes that indexation would allow steamship lines to more accurately plan exporters' equipment needs and, if properly serviced, gain more revenue from these customers.

Finally, the existing small group of brokers in the container freight derivatives market have not tried to hide our commercial interest in the FMC's proposal. What the submission fails to point out, however, is that brokers such as CSL are acting on existing, unfulfilled client demand. This is not just about large grain companies, although this group have the experience of hedging bulk freight and so have led the way. They have said loudly that they want to be able to control freight costs, that they cannot do so as part of their existing relationships with carriers and they have asked us to help provide the solution. Attending the recent AgTC Annual Meeting highlighted this need – shippers large and small talked about the difficulty of managing rates, even that offering to pre-pay for forward freight would not persuade a shipping line to guarantee them capacity.