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Morgan Stanley

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

Re: DOCKET No. 12-07, NOTICE OF INQUIRY

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

Dear Ms. Gregory,

Morgan Stanley's EMEA Commodities Division ("Morgan Stanley") hereby encloses support for the FMC's Notice of Inquiry concerning the development of container freight rate indices for U.S. agricultural exports.

Morgan Stanley is a major player in the physical commodities market, being an active physical trader across the commodity spectrum, including a substantial tanker and dry freight charter business. Expertise is focused on managing commodity risk on behalf of clients, for example, container shipping lines hedging their fuel oil exposure. We are increasingly using this expertise to work with a broad range of container industry participants, from shipping lines, freight forwarders and beneficial cargo owners, to industry investors and ship owners to initiate risk management programmes and index-linked contract methodologies. Further, we are already seeing considerable interest from U.S. export clients to hedge their container freight risk, when a suitable index becomes available.

The last four years have subjected the container shipping industry to its most violent and sustained period of volatility in history. The development of a number of global container freight indices is a direct function of this uncertain and unpredictable environment, and has presented the opportunity for industry players, small and large, to innovate and drive the industry of tomorrow, within a wider framework of increased contract accountability and management of risk.

The launch of the SCFI index in March 2009 set the sails for the wave of growth that was to follow. Initial meetings between Morgan Stanley and a number of our clients exposed considerable scepticism as to the usefulness of such indices in the physical market. This was paired with a general lack of trust in available indices. Just three years on, the use and support for indices has matured and developed in a way that has far exceeded initial expectations; carriers and forwarders, once concerned about the heightened level of transparency indices would bring to the market, are actively embracing index-linked contract methodologies and hedging programmes.

The FMC's rule to allow service contracts to reference freight indices is a huge step forward for the market, and we hope that this progress can be replicated on the US export trades, which remain without suitable commodity-specific export indices to provide the foundation for new contracting methodologies and hedging instruments. We outline below, how, in our opinion the development of FMC indices would support the stated purpose of the Shipping Act to "promote the growth and development of United States exports through competitive and efficient ocean transportation and by placing a greater reliance on the marketplace"

The notice of inquiry specifically highlighted key questions to address. Please find below responses to these questions.

(1) Whether and to what extent the shipping public would find targeted U.S. export rate indices beneficial AND The positive and negative influences on the export commodities and ocean transportation marketplaces of the greater transparency such indices might provide

The benefits of indices are threefold.

(i) greater transparency and accountability:

The development of indices is a natural product of a volatile market. Aggressive swings in freight rates pose major price risk to industry participants. For shippers, the magnitude of recent rate swings can all but wipe out and reverse positive margins. For carriers, a fall in rates, against significant operating and capital costs can place severe pressure on cash flow, as has been seen on a number of occasions in recent years. The feast to famine nature of the container shipping industry has resulted in significant increases in not only price risk, but also service risk. In an existing "fixed" contract mechanism, there is a risk of a shipper's cargo not being loaded onto the vessel if the pre-agreed rate is lower than the prevailing spot market price. The absence of legally-enforced service contract performance results in drastic swings in contract rates that are supposed to be fixed. Index-linked contracts, which track spot rates provide a price reference, which places both counterparties on a level playing field at the point of agreement. Either counterparty is then able to independently hedge their risk to fluctuating rates, or rather choose to pay/receive the market rate for the contracted cargo. The act of constraining service terms within the physical contract, and managing price risk externally through hedging instruments is a proven mechanism that is actively practiced across global commodities markets to good effect, including shipping lines in their hedging of fuel oil risk.

(ii) provide a basis for risk management

In order risk management to be made available to the market, reliable and transparent indices are required to reliably and accurately track the physical market. The SCFI index has led to increasing hedging activity on behalf of carriers, freight forwarders and beneficial cargo owners on the Asia to Europe, Mediterranean, and transpacific trades. A number of carriers and freight forwarders are becoming increasingly vocal regarding their support for index-linked contracts on these inbound trade lanes. The U.S. export market, it could be argued, is in more drastic need of hedging mechanisms than these already index-active tradelanes as a result of tighter trading margins on physical commodities. Shipping lines and existing contract methodologies have severely failed to provide a trustworthy and predictable forward environment for commodity shippers to conduct ocean borne trade. The inability of shipping lines to provide truly fixed forward rates to shippers more than 30-60 days out at best, dramatically impacts the competitiveness of U.S. exporters delivering to distant locations where freight costs are a significant proportion of delivered commodity prices. A liquidly traded forward market for U.S. container freight exports would bring certainty in costs a minimum of 12 months forward, allowing for the sale of delivered commodity to take place further into the future, whilst locking in economic margins that are not subject to arbitrary carrier rate increases or surcharges.

(iii) foundation for more effective and efficient market pricing

The use of index-linked contract methodologies will shift the contract focus away from price, in favour of quality of service and product offering. In the existing market, regardless of carrier quality, herd mentality drives rates up and down, meaning that high quality carriers potentially cannot attract the deserved rate premiums, and lower quality carriers are artificially subsidised. A move towards indexation and away from arbitrary contract pricing will provide the platform for carriers to not only offer differentiated services, but to be compensated to the extent that the market places monetary value on the higher quality service. In the long-term, lower quality carriers will be forced off trade lanes when they can no longer fill slots at heavily discounted rates to index in the face of shippers willing to pay a premium for certainty and reliability. With index-linked rates in place, carriers can centralise pricing, reduce the administrative burden of having to re-file contracts when rates change, and shippers and carriers will spend significantly less time arguing over price. All of these efficiency gains will filter into reduced transport costs in the long term, serving to support U.S. exporters' competitiveness against international competition where freight costs are a lesser proportion of delivered commodity prices.

Whilst the development of U.S. export indices is a major step forward, it is worth highlighting the challenges of a move towards indexation and hedging exposes. Indexation and hedging are new concepts for the container freight market, and the step from understanding to fully utilising the benefits is significant. The scepticism and negativity that is displayed from a number of shipping lines should be expected, and largely mirrors the reception received in other major commodities markets that subsequently embraced the shift from an annual contract to spot market pricing mechanism. In the medium term, fully utilising index-linked contracts and risk management methodologies to provide customers with fixed, forward prices, will require considerable education of sales teams and major pricing strategy changes. It is therefore not unjustified for some carriers to remain defensive against change, but we urge that this scepticism and inertia does not sit in the way of the major progress that is already taking place, and will accelerate through the development of FMC led U.S. export indices.

(2) Whether the Commission should extract rate information from service contracts or whether suitable alternatives exist

The rate filing process that is already well-established between the industry and the FMC provide the ideal framework for the creation of an index. The success of an index, whether to provide a benchmark rate for a particular trade route, or to provide the basis for hedging to take place, is founded on the extent to which the index reflects the physical market environment. The method of the FMC using service contract rates to compile suitable indices should provide a robust calculation methodology that is trusted by the market and is a fair representation of the physical environment.

Of course, there is a vast range of index methodologies in practice across global markets, so suitable alternatives to the FMC's creation of indices can, and will always exist. The alternatives however do not have ready access to the depth of service contracts that the FMC already see, which would place alternative solutions many months behind the FMC in potential time to market. Due to the lengthy process of physical participants understanding and utilising index-linked methodologies, in our view, a solution that is more readily available should be favoured over theoretical alternatives.

The SCFI index is compiled by the Shanghai Shipping Exchange (SSE), which was jointly founded by the China Ministry of Transport and Shanghai Municipal People's Government. In the early days of launch, considerable pushback occurred from the industry on whether the SSE was the right entity to publish such an index, and questions were asked as to the trustworthiness of the index. This index is now widely quoted in official carrier statements, presentations and annual reports, and is increasingly the basis of index-linked contracts and hedging programmes. This progress is entirely the result of the index's effectiveness in reflecting the physical spot market.

Finally, the FMC index should be a reflection of spot market rates, characterised by a pre-determined physical rate validity period, should be compiled using a broad number of underlying rates and the publication should be timely with minimal delay. In our opinion, the index should be published as frequently as possible, incorporating all ocean borne surcharges and should ensure that the output is the aggregated result of the underlying data, to ensure that component rates remain anonymous.

(3) Whether, these indices, if developed, should be commodity specific for different prescribed routes or whether more broadly based indices would meet U.S. exporters' needs

The index needs to offer a true reflection of the physical market in order to be an effective basis for index-linked contracts and risk management mechanisms. The U.S. containerised export trade remains less commoditised than the inbound Asia-US and Asia-Europe trades that lend themselves well to broadly-based $/box rates, irrelevant of the contained cargo. The U.S. containerised export trade is sensitive to the underlying cargo being shipped, and each commodity, whether hay, cotton, grain, frozen meat or other, has its own demand and supply fundamentals and location constraints. For this reason, a general $/box US-Asia rate would not

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provide a sufficiently granular benchmark for the purpose of contracting specific and varied commodities in the physical container market.

The question of whether parties to a service contract should have the option of not having their contract rates incorporated into an index is an interesting one. One could argue that the container shipping industry is in drastic need of change in contract and pricing methodologies and indices now provide this solution. For this reason, it could be argued that mandatory contribution is necessary to drive the industry forward. On the other hand, giving parties the option to not participate could make relatively little difference to the success of the index. The choice to not contribute however should be questioned. As the market moves increasingly towards an index-linked basis, it is arguably in every parties needs to have their rates reflected in the index that will to some extend determine the costs or revenues in their business.

To summarise, the development of new container freight indices remains an exciting and progressive development for the container shipping industry. We have aimed to outline our views on the impact that the FMC index could have on the physical market between cargo owners and providers of freight services. The benefits of a market shift towards indexation and risk management far outreach the discussion here. With a liquidly tradeable forward market across global container freight routes, risk management can spill over into other vital areas of the industry. Ship financing for example can incorporate the need for carriers to hedge a proportion of forward revenues on day one of financing a new order, and ship owners could potentially reduce the burden of high dividend yields as a result of reduced counterparty risk in the presence of a more stable and predictable market environment. In the backdrop of persistent volatility across global container freight trades, the need for industry participants to rigorously manage risk is key.

The birth of indices and risk management in the container industry are exciting and progressive and above all else, provide a real and tangible solution to a wealth of industry problems. Morgan Stanley supports the FMC's plans to develop U.S. export indices and we look forward to this initiative helping shape the industry of the future.

Yours Sincerely,

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