



GENTLEMEN'S AGREEMENTS VERSUS INDEX-LINKED CONTRACTS

Global Liner Shipping Conference discusses the importance of a clear, written contract

Investment in proper contract drafting might look expensive, but can you really afford the consequences if your counterparty turns out not to be the 'gentleman' you thought he was, and tries to renege on your agreement? If nothing else, the recent 14th Global Liner Shipping Conference ("Conference") held in London, showed that this remains a hot topic and one which is likely to be subjected to ongoing debate within the industry for the foreseeable future. In our January 2012 logistics bulletin, we took a look at whether an 'agreement' actually constitutes a legally binding contract and particularly how this differs from unilateral offers, mere quotes and standing offers. In this briefing, we review the discussions that took place at the Conference and also whether there has been any particular movement since our article 'Watertight contracting', which appeared in the March 2011 issue of Containerisation International.

Michael Rainsford, a Freight Trader at Morgan Stanley Commodities, and Martin Dixon, from Drewry Shipping Consultants, delivered a joint presentation at the Conference on, 'Index-Linked Contracts: An Opportunity or Something to be Feared?'. The benefits of index-linked contracts were identified as guaranteed rates resulting in lasting long-run partnerships; efficiency gains - avoiding constant renegotiations and the associated drain on internal resources; individually tailored contracts with either fixed or floating rates, often within floors or ceilings; indexation providing flexibility, whilst creating a framework to hedge; and a greater focus on service as opposed to rate levels.

The speakers identified that shippers wanted competitive rates, transparency and simplicity, stability and predictability, and reliable and dependable services. Meanwhile, carriers were generally seeking profitable rates, simplicity, stability and consistency, and reliable and predictable cargo flows. Index-linked contracts were seen as one of a number of potential



tools which could seek to resolve freight rate volatility, itself being generated by fluctuations in supply and demand, and both carrier and shipper market behaviours.

It was advocated that index-linked contracts should be entered into for a minimum term of 12 months. The initial rate levels could be independently agreed or pegged to prevailing market rates, reflected by one of the published indices. The future adjustment mechanism for the rates could then be based around indices offering a tracking mechanism for contract rates to follow the spot market. Drewry noted that index-linked contracts did not remove exposure from freight rate volatility and that to do so would require hedging strategies.

A breakout session at the Conference on how freight rate volatility could be reduced, resulted in many well-known issues being raised - particularly the distinction between gentlemen's agreements and legally binding contracts. The issues of carriers and shippers "reneging on agreements" was highlighted, and the desire for mutual legally binding commitments reiterated by both sides. A number of potential solutions were identified by participants, such as the need to build trust and establish real service level agreements, along with the suggestion of a move to legally binding contracts to ensure greater predictability in the supply chain - to tighten performance and improve revenue visibility, which itself should be related to carrier performance. Hedging strategies were raised as a potential means to effectively fix freight rates at predetermined levels.

What does this mean for the industry?

So what, if anything, has changed over the last year or so since we authored 'Watertight contracting'? It is still evident that the industry remains cautious, although the concept of entering into legally binding contracts is starting to gain some momentum. The need for 'gentlemen's agreements', and contracts between shippers and carriers to be tightened-up so that both sides understand and honour their commitments remains. It is also evident that whilst some carriers are moving towards greater engagement with their customers, including in one case the establishment of a shipper panel that reviews and provides suggestions and initiatives, that generally better communication and understanding, and sharing of risk and reward, is needed in the industry.

Following our recommendation in the Containerisation International article, there are many parties which have started to look at whether the industry would benefit from the implementation of more standardised contracts. Amongst those that have been publicly announced are the Container Shipping Contract Service, launched by the Freight Transport Association. We also understand that other industry bodies are currently considering and/or developing forms of standardised, potentially index-linked contracts, and inevitably some of the larger carriers will be promoting the use of their own 'standard' contracts too.

In many cases, carriers will still wish to largely contract upon

their standard bill of lading terms and incorporate these into any new form of framework contract. In particular, carriers will wish to retain their existing liability regime, including limitations and exclusions. However, there is nothing to prevent shippers from seeking to negotiate precedence for their contracts and even to renegotiate certain bill of lading terms in such cases where their size and bargaining power may allow such. This may result in a review by carrier's liability (P&I) insurers, in certain circumstances, confirming that certain commercial provisions fall outside their standard cover and that these issues would need to be responded to by carriers on a commercial level. Carriers may therefore need to decide if they are effectively willing to underwrite any liquidated damages or other commercial compensation measures.

In terms of carriers' willingness to include and honour performance related components in their contracts, some remain wary, with limited commitment to liquidated damages or other commercial compensation measures. However, the apparent success of Daily Maersk, with its agreed compensation, resulted in increased market share, that Maersk Line claimed at the Conference to have won as a consequence. This appears to show the value of guaranteed reliability.

The challenges of accurate forecasting and no-shows by shippers remains a key issue for carriers. Discussions surrounding the level of commitment, tolerances and timeframes connected with forecasting and volume



commitments remain. Inevitably, the longer the timeframe the lower the level of certainty and the greater the resistance from shippers to commit to forecasts. The level of detail ideally required by carriers may also be difficult to deliver without long term fixed orders. One shipper at the Conference identified the differing nature of their cargoes: project cargoes that were more orderly and certain in volumes, and those product cargoes whose volumes fluctuated with end-user demand.

The use of index-linked contracts for reviewing rates, not only on an annual renewal basis, but also for regular ongoing rate review and adjustment throughout the term of the contract, appears to be a trend which may be developing. Whilst annual reviews are too infrequent and monthly reviews create too much administration, quarterly adjustments may be the natural progression. The general resistance of shippers against numerous ad-hoc surcharges throughout the term of contracts is growing and even some carriers seem confused at the bewildering number of acronyms that have appeared over recent months. However, given that bunker costs now constitute such a high proportion of carriers' costs, their separation from freight rates and independent adjustment is generally agreed. Some segments of the shipper market still resist this, despite the obvious economics that carriers cannot be expected to carry cargo at a loss in the long-term. The increased transparency that some carriers have adopted in unravelling how they arrive at bunker adjustment surcharges, can only be welcomed.

Our view

In our view, shippers and carriers should wherever possible ensure that they have clear, comprehensive written contracts in place, covering all the key essential commercial and legal terms in a single document. There are obvious longer term savings to be had for those willing to invest in the time and effort to prepare robust legal contracts, when compared with the commercial and legal costs of lengthy disputes arising from continuing with 'gentlemen's agreements'.

Links

Simplicity the key to index-linked contracts as interest grows
<http://www.lloydslist.com/ll/sector/containers/article396409.ece>

Gentlemen's agreements encourage container no-shows
www.lloydsloadinglist.com/freight-directory/searcharticle.htm?articleID=20017954138

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