FFA controversy swirls around Baltic Exchange

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IMO 2020, the switch to 0.5% sulphur fuel on 1 January 2020, is almost universally seen as a seismic event for shipping, commodity markets, refining, and bunkering. Now, the consequences are becoming clearer – and more ominous – for another sector: freight derivatives.

A battle is brewing between some of the largest groups trading forward freight agreements (FFAs) on one side and the Baltic Exchange on the other. FFA volume and pricing are already reportedly being affected by the IMO 2020 issue. And going forward, tens of millions of dollars in FFA trading outcomes may be at stake, as well as the reputation of the Baltic Exchange within certain corners of the FFA marketplace. That, in turn, could put future FFA liquidity at risk, a key issue to watch for shipowners and charterers using FFAs to hedge their positions in the physical market.

The Baltic Exchange prices the indices against which FFAs settle. Index levels are based on confidential assessments of prevailing route rates for 'benchmark' ships. In the case of the dry bulk timecharter market indices that underlie the majority of traded FFAs, the benchmark ship definition includes a fuel specification currently listed as '380 cst, no diesel at sea'.

The decision on how to respond to IMO 2020 will be made by the Baltic Index Council (BIC). There is now intense concern among some FFA market participants that the benchmark ship fuel definition will be changed to 'compliant fuel' or fuel with sulphur content of 0.5%, given that ships using this type of fuel will represent the majority of vessels sailing all routes after the regulatory change.

They believe that if this revision is made, the redefined benchmark ships burning much more expensive low-sulphur fuel would earn considerably less than vessels using high-sulphur fuel and a scrubber. Thus, all else being equal, they believe this

change would depress the indices, and consequently related FFA values, in relation to levels they would have achieved if the fuel definition was not changed. They believe such a decision by the BIC would unfairly shift trading profits from those who are ‘long’ dry timecharter FFA positions to those who are ‘short’. In other words, they claim FFA investors would not be getting what they had originally paid for.

They argue that to be fair to market participants with open FFA positions settling in 2020 and beyond, the Baltic Exchange should keep the fuel definition as-is and create transitional parallel indices for compliant-fuel-using vessels, following the transitional parallel-index protocol the Baltic has used in certain circumstances in the past.

Fairplay is told that if the Baltic changes the fuel definitions of benchmark ships for the dry timecharter indices that underlie existing open FFA contracts, FFA market participants opposed to the move would not accept this quietly, and would pursue redress, to the extent possible, through regulators, the courts, and by shifting liquidity towards derivatives not based on Baltic indices.

There are two starkly different sides to this debate, and the issues involved are highly complex. To obtain one side of the story, *Fairplay* held extensive discussions on condition of anonymity with a fund manager who is a major FFA market participant. In addition, public comments have been made on the issue by Filimon Antonopoulos, a managing director at Tallon Commodities, in an article published by *The Telegraph* on 5 November. FFA player perspectives were also obtained from comments from two Baltic members who spoke during the members’ working group meeting in Singapore on 14 November (*Fairplay* was not in attendance but was provided an audio tape of the full proceedings by a member). In the Singapore meeting, references were also made to FFA trader arguments posed in the Baltic’s open forum held in Copenhagen on 27 September.

The contrasting Baltic Exchange perspective is presented through the comments of its chief executive officer, Mark Jackson, who voiced his views during the Singapore working group meeting.

The FFA players' perspective

If the Baltic were to change the fuel definition for indices that currently underlie FFAs and not conduct transitional parallel reporting, the fund manager maintained to *Fairplay* that "the effect on FFAs would be that the index is not reflective of the reality of the market" because "a two-tier market" would exist and "continue to exist for some time after 1 January 2020. The effect on existing FFA positions – open interest – taken out on the basis of current index methodology is that these are then subject to massive potential differences in value of the underlying instrument, given the effect that the difference in fuel prices will have."

That open interest is substantial. "The notional value for all Capesize, Panamax, and Supramax FFAs, including futures only, not options, for 2020-2022 is around USD1 billion, with Capesize FFAs being near half of that," he said. Asked how much of that sum could potentially change hands as a result of index fuel redefinitions, he responded, "Estimating how much losses might be is difficult and depends on several factors. However, if we estimate that the average fuel-differential earnings, based on current 2020 fuel spreads, for Capesizes is likely to be USD8,000/day and that current open interest as of 12 November is around 28,500 lots for FFAs expiring 2020-2022, then the loss for these Capesize-only futures, assuming the daily USD8,000 [fuel differential] is reflected 1:1 in the index, could be USD228 million."

In his comments to *The Telegraph*, Antonopoulos of Tallon Commodities said, "In the case of the 2020 fuel new specifications, so far the Baltic Exchange has not managed to convince the industry that they are treating the affected indices fairly, creating a potential USD500 million headache."

Fallout related to the looming Baltic decision has reportedly already begun. There should theoretically be two consequences of uncertainty about the future fuel definition: lower volume due to FFA investors being unsure of what they are buying or selling, and downward pressure on FFA values as investors price in the chance that the Baltic will switch the fuel definition and depress the underlying index.

The fund manager told *Fairplay*, "There is definitely significant uncertainty in the market regarding these index changes, which has been reflected in both volume and liquidity for any contracts post-2020, and downward price pressure. To be fair, you can't simply quantify how much of the index change is priced in, but if you speak to the brokers who trade FFAs daily and globally, the single answer you will get is that for the post-2020 contracts, liquidity has dried up." Antonopoulos told *The Telegraph* that the Baltic's current approach is "driving down liquidity".

Asked about potential future consequences if the Baltic changes its indices' fuel definition and does not do parallel reporting, the fund manager warned, "The franchise of the Baltic Exchange would be under massive threat if they did this. Other index providers are already looking at and are active in this sector. If the Baltic were to lose the support of major FFA players, who provide the lifeblood support – the liquidity – of the index, the likelihood is that they [FFA players] would support another index provider whose index management is deemed more professional, adhering to global best practices and the regulatory environment, and respecting the standardised contract."

He continued, "This is not just a massive issue for the FFA and freight markets. It is a huge issue for the exchange-traded derivatives markets. If an index provider can simply change the composition and construction of an index that has derivatives traded on it and that change has serious implications for the value of existing contracts based on the initial specification, every index future in the world is then potentially subject to investor scrutiny and lack of trust, not to mention the susceptibility to manipulation."

FFA market participants are already taking their case to regulators, although not in the United Kingdom. The BIC is scheduled to be registered with the UK regulator, the Financial Conduct Authority, in early 2019, and the Baltic plans to demonstrate compliance with the EU benchmark regulation by 2020, but until then, it is not a regulated financial firm. However, the clearinghouses dealing in FFAs, such as those in the United States, are regulated. US FFA clearinghouses such as NASDAQ are regulated by the Commodities Future Trading Commission (CFTC). *Fairplay* has been told that FFA market interests held multiple meetings with high-ranking CFTC officials in early November to express their concerns.

Asked about potential recourse against clearinghouses via regulatory channels, the fund manager responded, “The exchanges and clearinghouses have a duty to protect their clients’ financial interests. If they acquiesced and did not use their market-intervention powers in order to do this, the respective regulators would ask serious questions.”

The Baltic Exchange perspective

As Jackson explained at the Singapore meeting, the BIC approached the Baltic’s management in early 2018 and sought input on the IMO 2020 issue. Since then, there have been four advisory council meetings on the topic, five open forum meetings, and one members group meeting (the Singapore meeting) with a second to take place in London on 22 November.

“What we are hoping to be able to do is go back to the index council and actually publish our position based on the decision in December. If there is something new or if something gets in the way, that might be delayed until January, but we are really trying to get something out by December,” said Jackson.

The BIC decision boils down to whether IMO 2020 is handled as a so-called ‘scheduled change’ or as a ‘major change’. Both categories are explicitly defined in the Baltic’s Guide to Market Benchmarks. Major changes, which would allow for transitional parallel reporting for up to two years, are those that “are acknowledged to have the potential to create serious market disruption” and “would include completely new vessel descriptions or changes to routes where there is significant FFA and options open interest”. Scheduled changes are defined as “those where the impact is expected to be minor but is not certain. This might include an adjustment to the vessel specification for a timecharter route in response to the introduction of new regulations, or the suspension of a route or index.”

“We don’t believe that the IMO changes are a major change [under the guide definitions] because we are saying that there is not going to be a completely new [vessel] description and there are certainly no changes being proposed on the actual routes themselves. We think this is a scheduled change, which is effectively

triggered because it’s an adjustment to a vessel spec for a timecharter route in response to new regulations,” said Jackson.

He also argued against parallel reporting of both scrubber/high-sulphur-fuel ships and vessels using low-sulphur fuel from a practical perspective, insisting that there would not be enough timecharter scrubber ships to effectively price the high-sulphur index in 2020.

During the Singapore meeting, one member in attendance ('Member 1') asked Jackson, “In the Copenhagen forum, Demetris Polemis [the portfolio manager of Parolos Fund] suggested to have a second index, a new index, which is going to be the non-scrubber index, and use the current one as a scrubber index. Why is this proposal not here?” A second member in attendance ('Member 2') added, “Demetris Polemis trades more than half the market, he has been around for 15 years, and his opinion doesn’t count for anything?”

Jackson responded that Polemis’ proposal was not on the table “because we didn’t believe it was possible, because of visibility of the 180 scrubbers [the 180,000 dwt Capesizes equipped with scrubbers as of 2020]. The majority of scrubbers in the Cape sector appear to be going to Newcastlemaxes [200,000 dwt], which are predominantly doing voyage [charters] and therefore the rate is being captured through the voyage routes,” not the 180,000 dwt timecharter routes used to price the Capesize index.

“What we require is enough volume to give us visibility across all our routes. We are saying that we would find it hard to meet our criteria at the beginning of 2020, even in the Cape market, when trying to price a scrubber [index],” said Jackson.

He also maintained that “scrubbers are a design change” and because of this “they shouldn’t be included in the current timecharter assessment”. However, he acknowledged that significant scrubber adoption within the larger bulker category could lead to the creation of a new scrubber (high-sulphur-fuel) index for Newcastlemaxes.

“The Baltic will most probably have to produce an index for scrubber vessels post-2020. There is a chance for this,” said Jackson. “This would most likely be one of our normal size changes, whereby we will change the index from 180 to 200 [benchmark ships from 180,000 dwt Capesizes to 200,000 dwt Newcastlemaxes] and at the same time, if the scrubbers are the dominant thing in there, we would be taking the scrubbers on board. For that, we’d probably be looking at the end of 2020 [to start discussions] and that would follow the normal process [for index vessel-size changes].”

Weighing the two conflicting views

For the BIC decision on IMO 2020 – is it a scheduled or major change? – a complicating factor is that some parts of both definitions apply, but not all parts of either definition. IMO 2020 does not seem to meet the ‘minor impact’ criteria of a scheduled change, nor does it meet the vessel-route change or ‘completely new vessel’ criteria of a major change.

Jackson was asked at the Singapore meeting whether the specific wording in the Guide to Market Benchmarks was the basis for the Baltic’s view that IMO 2020 did not qualify as a major change.

“So you said it is a legal thing?” Member 2 asked. Jackson responded, “No, no, I said the actual interpretation of whether something is a major change or not was under the BIC, and that I’m not asking this group to make that [determination].” Member 2: “Why? You’ve asked us to vote for other things. Why should this happen behind closed doors and you take the responsibility of what is a major or minor change when the spread of the fuels is USD10,000-12,000/day right now in the futures contract?” Jackson: “I’m not objecting to a vote.” Member 2: “Good. I would love for the group to be asked if this is a major change.” A snap vote was then taken on three options: scheduled change, major change, don’t know. Following the vote, Jackson reported that around 56-57% of respondents in the room thought IMO 2020 represented a scheduled change, implying that a significant minority, around 43-44%, thought it was either a major change or didn’t know.

Towards the end of the Singapore meeting, Member 1 aggressively pressed Jackson on whether IMO 2020 would have a major impact on index levels, given that this would conflict with the definition of a scheduled change having a minor impact. “Do you expect the impact on the [index] rate reported to be minor? It’s simply a ‘yes’ or ‘no’,” he asked. “We expect the impact on the indices will reflect the market today. What it will do in 2020 in terms of pricing, I don’t know,” responded Jackson. Member 1: “You didn’t answer my question. You expect the impact on the rate reported to be minor? It’s a yes or no.” Jackson: “I do not know.” Member 1: “Yes or no?” Jackson: “I do not know. How can I say?” Member 1: “Mr. Jackson, I’m sorry, you are saying in a scheduled change, it says it’s expected to be a minor impact. So you cannot answer?” Jackson responded again: “I don’t know”, then thanked everybody for attending and closed the meeting.

Meanwhile, Jackson’s argument that it would be too difficult for panellists to price an index for ships using high-sulphur fuel in 2020 and thereafter hinges on how many ships actually install scrubbers and how fast they do so. In this regard, the trend appears to be moving in favour of the Baltic’s critics. Scrubber estimates keep rising and the trend is moving towards smaller vessel classes.

On 14 November, DNB Markets significantly increased its projections for scrubber installations, to around 3,500 by the end of 2020 for all vessel classes. It now estimates that 662 or 37% of Capes will have scrubbers by 2020, up from a 35% penetration estimate in its September report. It estimates that 420 Panamaxes (16% of the total, up from 9%) will have scrubbers, and 359 Supramaxes (10% of the total, up sharply from 3% in its previous estimate).

Commenting on revisions versus its previous estimates in September, DNB analyst Nicolay Dyvik wrote, “For dry bulk, we have added around 500 scrubbers and primarily lifted our estimates for mid-size bulkers due to uptake in these segments increasing faster than we expected.” During a Capital Link forum in New York on 9 October, Dyvik pointed to the large number of scrubber orders placed in September and October.

In a report issued in September, Goldman Sachs estimated that there would be about 3,125 scrubbers installed by 2020 and 4,450 by 2022, with bulkers representing a quarter of the total. The investment bank noted that the risk to its estimate was to the upside and that it saw a "compelling scrubber opportunity for around 7,000 vessels".

Goldman Sachs's Christian Lelong, one of the authors of the September report, said at a Marine Money forum in New York on 14 November, "Since we published that report, we've seen a decent amount of new orders. It's tracking to our expectations or maybe a little ahead." The twist, he said, is that "we assumed scrubbers would mostly go to big ships and we see that, in fact, smaller ships are also having scrubbers installed".

During the Capital Link forum, Safe Bulkers president Loukas Bamparis asserted, "It's very clear that we have the development of a two-tier market. You will have ships with scrubbers and ships without scrubbers. If there is a substantial percentage of ships with scrubbers – let's say you have 30% of Capes with scrubbers – then it would be a very good idea to have two indices."

With all of these issues in mind, *Fairplay* asked Jackson six specific questions by email regarding the issues brought up by FFA market participants: (1) Do you favour the scheduled-change interpretation because there are no route changes or completely new vessel descriptions, as specified under the major-change definition? (2) Do you believe that a major change in index pricing means that the major-change definition should apply instead? (3) If a third of the vessels in a route are scrubber ships and the index relates only to non-scrubber ships, do you believe the index reflects reality? (4) Is there a practical reason to not adopt transitional parallel reporting in this case? (5) Do you feel the Baltic has any ethical responsibility to those who trade FFAs to ensure that they are not at risk of significant losses as a result of a subsequent change in the definition of an index by the Baltic Exchange? (6) Do you have any concerns that a decision to change the fuel definition and not institute transitional parallel reporting would lead to reputational damage to the Baltic Exchange?

On 19 November, Baltic Exchange spokesperson Bill Lines called *Fairplay* and said that no responses could be provided to these specific questions due to the timing of the upcoming members' group meeting on 22 November in London. "We can't start having these arguments in the media," he said.

Lines did provide *Fairplay* with a written response that stated: "Any changes to the indices are led by a process based on the principles of the International Organization of Securities Commissions. The Baltic Exchange is currently assessing how its indices and route assessments should best reflect [IMO 2020]. Detailed evidence including scrubber penetration and low-sulphur fuel performance [is] currently being gathered from shipbrokers, traders, refiners as well as shipowners and operators. New low-sulphur fuels such as Exxon's 380 cst 0.5% sulphur fuel are also being carefully assessed. A final decision will be made at the end of the year."

Yet the final decision by the BIC may not be the end of the controversy. Far from it. If the Baltic opts to change the fuel definition of its indices' benchmark ships to low sulphur, and if opponents within the FFA community follow through with a pursuit of regulatory and legal remedies and a shift of future liquidity to elsewhere, then the story of how IMO 2020 affects freight derivatives may be just beginning.

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