Issue IV: July 2002

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In response to agricultural shippers, who rely on good market information and assistance, USDA created this semi-annual report as an update on the ocean container market's cost and service trends. The report is the result of input from large and small agricultural shippers, including shippers' associations, controlling over 220,000 20-foot equivalent units, split nearly evenly between dry and temperature-controlled (refrigerated and frozen). Input was also received from vessel and non-vessel operating ocean carriers, as well as freight forwarders, in key U.S. agriculture import and export trade routes. Although it is not a statistical sampling of the population of agricultural exporters, every attempt has been made to contact a broad range of shippers.

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Agricultural Ocean Transportation Trends

Issue IV: July 2002

Introduction

The economic trends affecting ocean transportation reported in USDA's *Agricultural Ocean Transportation Trends* (AgOTT) report, Issue III, December 2001, have continued into 2002. While global and domestic economic activity is expected to expand during 2002, the underlying ocean transport market characteristic--more carrier capacity than shipper demand--will continue, particularly for exports. On the surface, this trend would appear to be good news for agricultural shippers because it leads to low rates. Yet, beneath the surface, agricultural shippers face increasing uncertainty about the effects of low freight rates, such as diminished services offered by carriers. Additionally, much of the carriers' reaction to these low rates, including cost reduction and revenue enhancement measures, have been unacceptable to shippers. In contrast, however, in an effort to secure their business, shippers are finding that carriers are now becoming more flexible during contract negotiations, offering more inclusive clauses and service guarantees.

Aside from an uncertain economy, shippers also face a possible disruption of service on the West Coast due to the expiration of the International Longshore and Warehousemen's Union (ILWU) labor contract on July 1. Such labor action, combined with expectations of new security measures and ensuing disruption of shipping practices and increased costs, creates a remarkably unsettled atmosphere in the agricultural ocean shipping environment. This report reflects these concerns based on input from diverse sources, including shippers of forestry products, cotton, refrigerated products such as poultry, and processed foods such as potato products, representing nearly 220,000 20-foot equivalent unit containers (TEUs), 39 percent refrigerated (reefer) and 61 percent dry. Input was also received from ocean carriers, ports, and freight forwarders.

Trends in Freight Rates

Low Rates Concern Shippers

The U.S. economic recession has reduced domestic demand for imports, agricultural and otherwise, and the foreign economic slowdown and high value of the dollar relative to foreign currencies have further reduced demand for U.S. agricultural exports. Additional vessels were being delivered by shipyards to the major container lines, thereby increasing capacity at a time of slack demand. At the end of 2001, all of these factors pointed to reduced freight rates; at that time, agricultural shippers expressed uncertainty as to whether ocean freight rates, already at historically low levels, could drop any further. (See appendix for apple and cotton rates.)

The most recent interview of the agricultural shipper community indicated that rates have indeed fallen from 2001 levels, due to a continuation of the factors described above. (For more information about the trend in rates, see appendix.) However, rather than enjoying these low rates, agricultural shippers are becoming increasingly concerned for two main reasons.

The first and immediate concern is that low freight rates indicate continued weak foreign demand for many U.S. agricultural exports. No matter how low the freight rates go, demand for U.S. agricultural products will not increase unless the global economic situation improves. Until the U.S. dollar value decreases relative to foreign currencies, demand for U.S. agricultural exports will not increase.

A recent economic trend is a narrowing of the disparity between the U.S. dollar and the Euro, which previously had created a competitive advantage for European-based suppliers of competitive agricultural products. During the second quarter of 2002, the value of the Euro has crept up closer to that of the dollar, eliminating the competitive advantage. Nonetheless, relative to foreign currencies, particularly in consuming countries, such as those in Asia, the U.S. dollar remains high, rendering U.S. exports expensive and continuing to dampen demand. China is a bright spot as increased demand, even as that economy has cooled, has translated into increased U.S. agricultural exports for some products.

The second concern regarding such low rates relates to the viability of ocean carrier service. The *Journal of Commerce* recently reported that some of the world's largest ocean carriers, such as P&O Nedlloyd and APL, fell deeper into the red during the first quarter of 2002 since rates have continued to drop. As one agricultural exporter surveyed stated, "While service is currently unaffected long term, it is at risk if carriers fail to restore profitability either through cost reduction or revenue increases."

Carriers are trying to address financial conditions impacting agricultural shippers through cost reduction measures and carrier revenue enhancement initiatives. The remainder of this section will discuss the impact on shippers and shippers' reactions to such attempts.

Impact of Carriers' Response to Low Rates

1. Cost Reduction Measures Affect Carrier Services.

Carriers continue to reduce costs through consolidation of certain services, such as document processing, bookings, and routing, in locations away from high-labor-cost port areas. Agricultural shippers note that, instead of a local representative in the port cities, the shipper will be in contact with a voice at the other end of an 800 line, perhaps located many hundreds of miles away from the port. In addition, carriers are eliminating local sales representatives in favor of regional sales representatives working out of a single regional or even national office. As a result, shippers report that they are receiving less personal attention by the carriers to their individual needs.

Perhaps reflecting cost-reduction measures such as centralization, shippers perceive documentation as a remaining weakness for carriers. Specifically, tardy conveyance of bills of lading by the carrier and errors in bills of lading and other document information remain a persistent problem, as they have been for approximately 2 years. A majority of shippers indicate that the documentation problems remain unresolved and unimproved. While earlier proposals by the carriers for documentation surcharges, such as bill of lading surcharges, have fallen by the wayside under current ocean shipping market conditions, the quality of documentation service remains a persistent source of aggravation for shippers.

The other major area of cost control for the ocean carriers is actual service reduction. Carriers have determined that, due to slackened shipper demand in certain markets, they can no longer justify separate direct vessel port calls. Vessel sharing, including slot charter arrangements, is a continuing trend among carriers. In other cases, port calls are being completely eliminated by some shipping lines. For example, during 2001, certain major agricultural export ports such as the Port of Portland experienced a reduction in direct vessel calls by liner container operators. Portland handled 5 percent of all containerized agricultural products in 2001. (Source: *Port Import Export Reporting Service (PIERS)*, *Journal of Commerce*, New York, 2001) In addition, some of the lines have eliminated an entire vessel string, reducing service from weekly to biweekly in many cases.

It is important to note that, generally, the agricultural exporter and importer have accepted these changes in service largely because they have found that, even with the reduced vessel calls, there is sufficient service to ship their cargoes in a timely manner. Only one region in the country reports sporadic shortage of vessel capacity--the U.S. South Atlantic region where cargo is, from time to time, rolled or transferred to the next vessel calling on that port. However, agricultural shippers in these regions do not believe that this service shortage is related to the low freight rates.

2. <u>Revenue Enhancement Measures Unacceptable to Shippers.</u>
The above discussion related to carriers' efforts to reduce costs. The other way carriers are responding to the low rates is through attempts to increase revenues, an objective with which agricultural shippers have some sympathy.

In the current market environment, shippers remain concerned about the viability of ocean carriers, specifically their ability to maintain adequate service levels to handle agricultural export and import needs. Virtually all agricultural shippers believe that carrier revenue increases would be acceptable to assure continued viability of carrier service. As of the second quarter of 2002 and for the foreseeable future, however, there is no expectation that rates will increase. It appears that rate reductions are initiated by carriers seeking market share, as opposed to carrier acquiescence to shipper demands. Below are examples of recent carrier attempts to increase revenues and subsequent shippers reaction.

- *Rate Increases*

  The obvious revenue enhancement mechanism available to carriers is collective initiatives through talking agreements benefiting from statutory antitrust immunity such as the West Coast Transpacific Stabilization Agreement (WTSA), subject to agreements filed at the Federal Maritime Commission (FMC). However, even with the antitrust immunity which allows carriers to collectively discuss means of increasing revenues, the market conditions ultimately still control the fate of any joint carrier initiative. The result is that recently several efforts have been announced but then withdrawn in the major trade lanes--the transatlantic and transpacific.

  WTSA has recently announced scheduled rate increases for specific refrigerated commodities to take affect during the second and third quarters of 2002. Whether these increases will actually be imposed by the individual WTSA carriers or not will depend on market conditions. At this point, most shippers are skeptical. Rate increases may also depend upon whether there is a labor action on the West Cost (see “Other Trends” and “Issues” for more information). If there is a work stoppage, these reefer rate increases and possibly more will be paid by shippers.

As mentioned, the forecast for future shipping demand is uncertain. It is expected that for a number of commodities, such as frozen potato products, and for a select number of countries, such as China and Vietnam, shipping volumes will remain strong and become even stronger. For other U.S. agricultural commodities, such as cotton, demand will remain weak. In no case, is it expected that demand will increase to match available container capacity. The result will be increased vessel sharing by carriers to reduce capacity. In the hope of increasing export cargo, members of talking agreements are expected to continue to pursue cargo at rates and terms which differ from those agreed upon by the talking agreement of which they are a member.

- *Capacity Management*

An alternative to carriers' collective rate discussions and increases is collective capacity control and reduction. Reduced capacity translates into higher rates if the carriers adhere to the arrangement set by membership in a talking agreement. Shippers vigorously opposed capacity management because it does not reflect market forces.

This was particularly evident in a recent initiative by the WTSA targeting agricultural exports during the first and second quarters of 2002. The WTSA members agreed upon a refrigerated container capacity management scheme filed at the FMC. The objective was to stop further rate erosion for refrigerated cargo shipments by a system of charging penalties paid by carriers carrying more refrigerated containers during 2002 than in the prior 12 months but providing awards to those carriers who carried fewer refrigerated containers during 2002. The agricultural shipper community immediately responded by providing the WTSA and its member lines with an assessment of the disruption such a scheme would cause to U.S. agricultural exports. The FMC questioned the proposal, and the WTSA withdrew it.

However, as a consequence of this proposal, U.S. agricultural exporters requiring temperature- and humidity-controlled containers are now concerned about current and future reefer container availability and the disincentive that this episode created for new investment in reefer capacity. One response of shippers to this proposed manipulation of reefer container supply has been to mandate refrigerated container availability guarantee provisions in their contracts. (See "Service Contract Negotiations.")

- *Surcharges*

In the current market, in which shippers recognize the low revenue levels of carriers, shippers are willing to consider surcharges sought by carriers as long as they reflect legitimate new costs imposed on the carriers. Yet, agricultural shippers generally remain unwilling to accept a carrier's own assessment of increased costs. Over the past four quarters, a number of carrier surcharges have been questioned by shippers because they were not perceived to be truly cost-based. Examples include:

- The *Panama Canal Surcharge* was rejected by shippers, particularly by those shippers whose cargo was not transiting the Panama Canal.

- The *Documentation Surcharge* was rejected when carriers were not able to show that they were providing any new documentation services and when documentation quality had deteriorated. In fact, carriers were converting from paper to electronic documentation methods, which were perceived by shippers as a way to reduce costs, not increase them.

- The *Alameda Corridor Surcharge* has been generally accepted by shippers utilizing the Long Beach and Los Angeles ports. The WTSA has done what is generally perceived by agricultural shippers as a good job in assuring transparency for this particular surcharge, demonstrating that the carriers are passing on the actual additional cost being imposed by the Alameda Corridor Authority.

- The *Hull Premium Surcharge* was also rejected. Following September 11, a number of ocean carriers approached their contract shippers (who were shipping under a long-term service contract which provided protection from additional surcharges), requesting voluntary payment of a "hull insurance premium surcharge." The carriers claimed that insurance premiums had skyrocketed. A number of shippers responded by asking the carriers to disclose their actual premiums both before and after September 11. Shippers report that no ocean carrier was willing to share this information, and as a result, no agricultural shipper was willing to pay the surcharge since it did not appear to be based on actual cost increases the carrier could document.

Shippers will continue to look critically at any surcharge request, and in the current marketplace, carriers will continue to be required to document and justify any additional surcharges.

Trends in Service Contract Negotiations

Service contracts, though previously characterized as nothing more than discount rate deals, are now acting as true contracts for service. In the years following the enactment of the Ocean Shipping Reform Act of 1998 (OSRA), ocean contracts tailored to the needs of the customer have included numerous negotiated terms other than rates. The current shortage of cargo translates, not only into lower freight rates, but also into increased flexibility by the ocean carrier when negotiating the terms of the contract. The current environment nurtures the trend toward customization of negotiated contracts which has been developing since the OSRA. Several trends emerging include carriers being more flexible in contract start dates, offering contract service guarantees, expanding force majeure clauses, and accepting liability for cargo.

Being Flexible in Contract Start Dates

As recently as 2 years ago, ocean carriers tended to impose a uniform termination date on all contracts with all shippers, creating a negotiating season leading up to a uniform May 1 effective date. Today, such uniformity has been all but eliminated. Contracts are negotiated throughout the year according to the particular needs of the shipper, often reflecting harvest and shipping peak seasons for agricultural exporters and importers. Contracts are amended frequently to assure that the contract rate remains competitive in the current environment.

Offering Contract Service Guarantees

Service guarantees in the contracts are still only a slowly emerging trend. Virtually unheard of even for the champion accounts 5 years ago, ocean carriers are now willing to provide service guarantees, which are being demanded particularly by importers and exporters of high-value, refrigerated agricultural products. It is clear that the carriers are beginning to recognize the demands being placed on U.S. agricultural exporters and importers by domestic and foreign customers and are responding in a manner that facilitates their customers' business requirements. Whether this semipartnership reflects a new business model for carriers or the fact that with excess capacity, they are in no position to resist demands by the shippers for service guarantees remains to be determined.

Service guarantees typically involve the carrier's commitment to load on the next vessel after the cargo is received at the terminal, protection against rolled shipments, and a guaranteed timeframe for delivery, which involves the ocean carrier coordinating intermodal service transport mode by either rail or truck. Such service guarantees are more prevalent for imports, but they are increasingly finding their way into contracts for agricultural exports. In the area of agricultural exports, it is for refrigerated cargo shipments that service guarantees are most important. These include guaranteed temperature ranges--particularly when a cargo must be chilled, rather than frozen--or humidity control. Submission of reefer temperature logs to the shipper and measurable standards for the quality of the service element are also finding their way into service contracts. At this stage, it is not clear whether shippers are collecting penalties from carriers for failure to meet service commitments or not. It is an important trend since such service guarantees help to reduce shippers' costs and will continue to be monitored.

Expanding Contents of Force Majeure Clause

Shippers are making steady progress in improving the contract force majeure or exculpatory clause. The force majuere maritime clause was designed to protect the carrier from the obligation to fulfill commitments to carry cargo in case of war, weather disaster, crime, etc.; however, today it is increasingly providing similar protections to the shipper. Agricultural shippers are continuing to insert provisions designed to protect themselves from contract commitments in case of undesirable developments. An example of such a disruptive development facing agricultural exporters is government-imposed import restrictions on U.S. agricultural products. Such restrictions manifest themselves in various forms, including phytosanitary restrictions, onerous documentation requirements, and outright trade barriers. Other new additions to the traditional force majeure clause release the shipper from meeting minimum quantity commitments (MQC) in cases of harvest calamity, weather-induced crop damage, or currency devaluation. The latter provision, which protects the U.S. agricultural exporter from meeting an MQC, stems from the experience of poultry exporters when Russia suddenly devalued its currency, eliminating Russia's ability to continue to purchase U.S. poultry, even that to which it was committed under long-term purchase agreements.

Accepting More Liability For Cargo

If there is one term which carriers have been reluctant to incorporate into contracts, it is for cargo liability provisions that increase the carriers' liability beyond that contained in the bill of lading. Typically, the bill of lading limits carrier liability to $500 per package and, most significantly, contains the errors of navigation defense. This defense generally means that, unless it can be shown that the carrier intended to damage, destroy, or loose the cargo shipment, the bill of lading liability clause will excuse the carriers' failure to deliver the cargo in the condition in which it was tendered. The World Shipping Council, based in Washington, DC, and representing the interests of the containerized liner carriers serving the United States, agreed in early 2002, in principle, to increased liability, specifically increasing the per-package dollar limitation, as well as eliminating the errors of navigation defense. However, it will be a number of years before such change in liability finds its way into international treaties and statutes. In the meantime, despite shipper efforts to increase liability beyond the bill of lading limitations, such provisions are currently rarely included in agricultural service contracts.

Other Trends and Issues

Aside from the economic trends causing agricultural shippers to face an uncertain shipping market, other recent events are causing the industry to prepare for possible disruptions and cost increases, including potential work stoppages at the ports along the West Coast when the ILWU contract expires and possible disruptions and cost increases in ocean shipping due to the introduction of new homeland security legislation.

Potential Work Slowdown at West Coast Ports During Labor Negotiations

Currently, the paramount concern of the U.S. agricultural exporter and importer is the possibility of disruption to the supply chain due to West Coast ILWU contract negotiations. Agricultural exporters are closely monitoring the negotiations between the Pacific Maritime Association (representing the ocean carriers and the marine terminal operators) and the ILWU over issues relating to automation and technical modernization, employment security, and jurisdiction. Ports included in the potential disruptions are Los Angeles, Long Beach, and Oakland, which handle nearly 50 percent of all agricultural exports shipped by container from the United States (figure 1). For a listing by percentages of the top 10 agricultural commodities exported by these ports see table 1.

Dry commodities, such as animal feed and baled cotton, make up 30 percent of the commodities being shipped from Los Angeles, Long Beach, and Oakland. Perishable commodities, including fresh fruit, vegetables, beef, and poultry, make up 30 percent of the top refrigerated commodities being shipped from this region. The shipment of perishable commodities such as these will be heavily affected by any port disruptions.

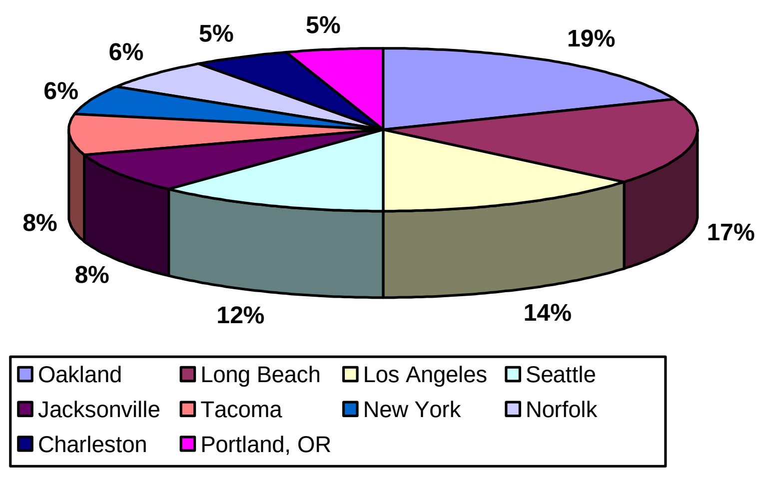

Figure 1. Top 10 U.S. agricultural container ports for exports in 2001

Table 1. Top 10 containerized agricultural products exported from the Ports of Los Angeles, Long Beach, and Oakland in 2001

Commodity	TEUs	Market share
Animal feed	121175	17%
Cotton	90411	13%
Fresh fruit	78350	11%
Beef	72212	10%
Foodstuffs	42782	6%
Leather/hides	33587	5%
Vegetables (frozen/fresh)	32478	5%
Wine	25955	4%
Poultry	23873	3%
Edible nuts	22204	3%
Other	160584	23%
Total	703611	100%

While the possibility of a slowdown or strike has all U.S. agricultural exporters and importers concerned, less than 50 percent of those surveyed appear to be considering concrete steps to change their supply chain. A few advanced their shipments in order to gain entry into West Coast ports prior to any work slowdown, and others are attempting to arrange alternative shipping routes via East Coast and Gulf ports and Mexico or Canada. While alternatives are being considered, actual changes in routing are not easily or quickly implemented and will not be undertaken unless forced by actual labor disruptions.

Though a labor strike is not likely since both sides have agreed to extend the existing contract on a day-to-day basis, shippers are currently most concerned that work slowdowns similar to those occurring during the 1996 and 1999 contract negotiations will occur. Agricultural shippers are especially concerned that such work slowdowns may result in perishable product being delayed and left unattended on the dock.

Possible Cost Increases and Shipping Disruptions Due to Security Legislation

It is anticipated that during 2002, Congress will enact new rules relating to cargo security. This legislation is expected to include new documentation and handling requirements to assure the security of the supply chain of cargo into and out of the United States.

Proposed legislation to address biohazard imports mandates full disclosure for all import cargo information 24 hours prior to loading. Other legislation would require full documentation to be submitted for all export shipments prior to loading and no later than 48 hours after delivery to the marine terminal. These requirements, at a minimum, will place more containers at the marine terminals further in advance of vessel loading, which could lead to port congestion. However, U.S. Customs initiatives such as the Customs-Trade Partnership Against Terrorism (C-TPAT) provide hope that at least some importers, including agricultural importers, can demonstrate that they are low-risk shippers and have a secure supply chain and will, therefore, be permitted to bypass additional import scrutiny, inspections, and delays.

The possibility that such security measures could impede the flow of cargo shipping, both export and import, is a major concern to the U.S. agricultural exporter and importer, especially those shipping perishable cargo. Significant potential logistical issues arise:

- First, depending on which proposals are ultimately enacted and the timetable in which they are implemented, documentation could be required as much as 48 hours prior to loading the vessel. The detail of information required could cause cargo to be denied loading privileges and to remain on the dock after the vessel sails.

- Second, should documentation for inbound cargo not be required until after loading but prior to arrival, it is possible that incomplete documentation for agricultural products in a container could cause the container to be denied prompt entry and transport to inland points.

- Third, additional security could lead to increased physical inspections of containers. For refrigerated and humidity-controlled cargo, an inspection can prove to be disastrous, essentially destroying the entire value of the shipment as a container is opened at the terminal and the temperature/humidity control is interrupted.

- Fourth, shippers expect that whatever security provisions are implemented will result in increased costs. Marine terminals are likely to impose increased charges on ocean carriers, which ocean carriers will pass on to the shipper, combined with the charges for increased costs for any additional responsibilities and inspections imposed on the carriers. In the second quarter of 2002, security surcharges are already being imposed in certain trade lanes, such as South America, and these are expected to spread. However, shipper reaction to security surcharges will likely reflect the current trend that the shipper will require the carrier to demonstrate that the surcharges reflect actual increased costs, not simply revenue enhancement opportunities, before agreeing to pay additional charges. (See “Revenue Enhancement Measures Unacceptable to Shippers--Surcharges” for more information.)

Summary

A variety of trends discussed in this report--overcapacity, weak overall demand, near historically low rates, possible work stoppages at ports, proposed security legislation--have resulted in agricultural shippers facing uncertainties regarding the costs and services in shipping their products overseas. As a result of a depressed economy, low rates are causing agricultural shippers to be increasingly concerned with the viability of continued service levels. Further, carrier efforts to increase revenue by imposition of surcharges and other methods will continue to be rejected by agricultural shippers unless the actual underlining cost can be documented by the carrier. On the other hand, the current environment is providing shipper leverage to be manifested in service contracts which are increasingly tailored to the need of the individual shipper, including expansion of terms such as the force majeure clause and more inclusive service guarantees. However, changes in cargo liability to improve upon limitations set forth in the bills of lading are not being achieved by the shipper.

Overhanging the entire ocean shipping environment through the foreseeable future is the possibility of the work slowdown or an ILWU strike on the West Coast during the summer of 2002. This, combined with concern as to possible cost increases and disruption caused by new cargo security regulations, means that agricultural shippers expect to continue to enjoy low ocean rates but at the risk of reduced service in a climate of uncertainty.

Appendix

The United States Department of Agriculture has been tracking ocean container rates to Asia since 1997 using the tariffs with the FMC and, since the implementation of OSRA, by the carriers electronically. Apple and cotton rates have been selected to act as the indicators of refrigerated and dry container rates, respectively, due to the amount of cargoes shipped each year and the number of Asian countries which receive both commodities. Rates are weighted and averaged according to each carrier's market share by commodity and by country. The resulting rate is meant to reflect the cost the U.S. exporter pays, on average, to ship apples or cotton to a particular country. Although roughly 90 percent of agricultural exports move under services contacts, carriers still adjust their tariff rates to reflect supply and demand in the shipping market.

Figure A-1 below shows the apples rates from March 1999 to March 2002. As discussed in previous issues, rates for apples witnessed a decline after the Asian crisis as demand for exports of U.S. apples and other goods fell.

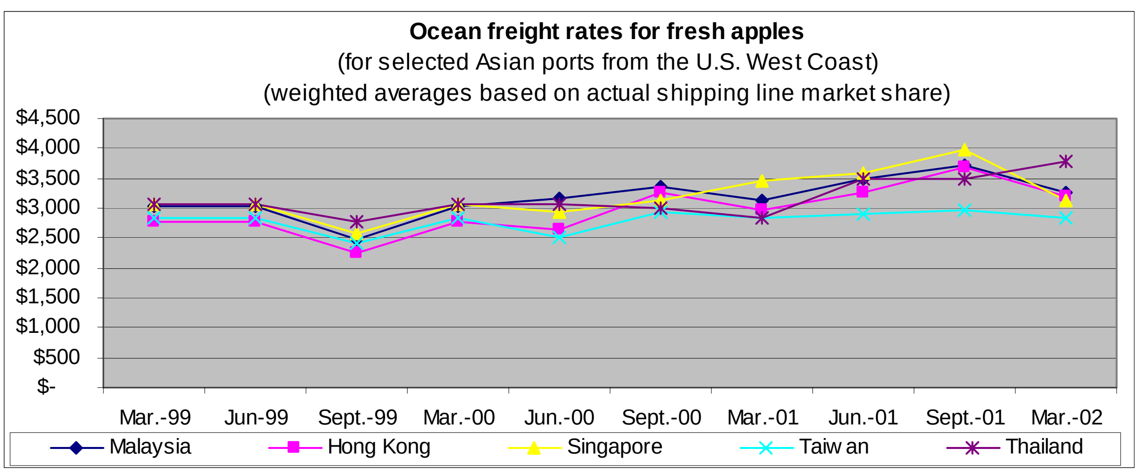

Figure A-1. Ocean freight rates for fresh apples

However, as the Asian economies began to recover in March 2000, ocean rates to the five representative countries remained steady until they began to rise in September 2001. While the overall cost for refrigerated shipments has been relatively stable, the cost of shipping apples declined in the first quarter of 2002 for most destinations. Due to the container imbalance of imports and exports between the United States and Asia, many ocean carriers must ship empty containers back to the United States, absorbing the repositioning cost to meet demand. Shippers may see increases in the second quarter of 2002 as the WTSA announced rate increases for summer fruit and vegetables. The rate hike is result of the high cost of using specialized reefer equipment and handling perishable commodities. The overall low rates on refrigerated shipments have created a disincentive to keep the specialized equipment and services in the transpacific trade.

Figure A-2 shows the average freight rates for baled cotton shipped to various markets in Asia. The cotton industry also experienced falling rates during the Asian financial crisis from 1997 to 1999 like most U.S. agricultural exports. However, baled cotton grew stronger in 2000 and the first quarter of 2001 than in the past. Rates to Vietnam showed especially significant increases after the crisis due to an increase in trade between the two countries. In March 2000, a 40-foot container was shipped at an average cost of $2,207, while the same time a year later, it had jumped to $2,954. Since the high of March 2001, rates to most of the countries have steadily declined because the market is flooded and shippers are competing with growers from other areas (see “Low Rates Are a Concern for Shippers”). Shippers of baled cotton and other low-valued agricultural products, such as animal feed, hay, and paper waste, will continue to see declining rates due to the trade imbalance as the ocean carriers try to supply more containers to Asia.

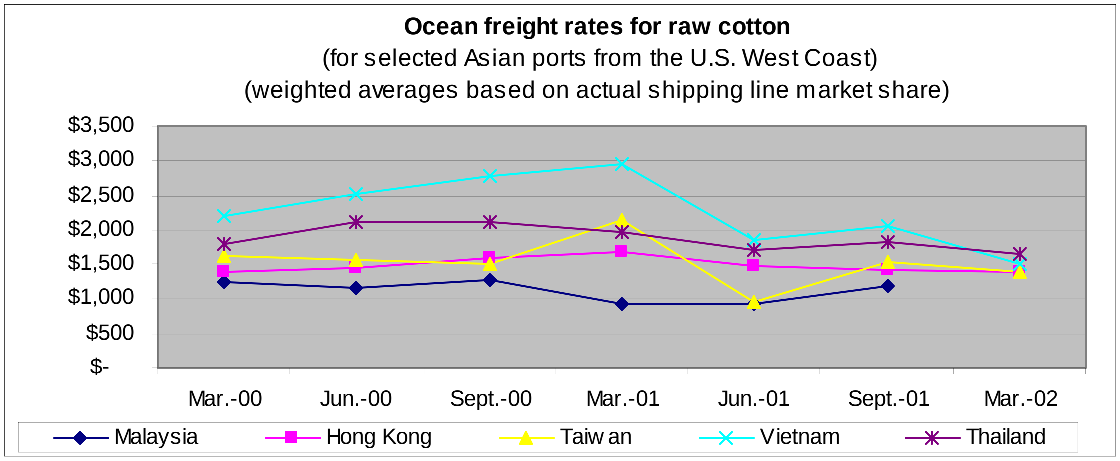

Figure A-2. Ocean freight rates for raw cotton