FUTURES AND OPTIONS
Air Cargo's Future?

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Every quarter I have to pull a new rabbit out of the hat. The problem is that I am running out of rabbits.". This complaint from a major shipper of electronic parts about not having much needed capacity is echoed by many who see the ups and downs of capacity, rates, and unpredictable surcharges as a major problem in the air freight industry.

Forwarders answer by noting that they rarely get advance information from shippers, which makes it hard for them to purchase freight ahead of time and plan for changes. Carriers have the least information about demand. They shoulder the bulk of the market risks and resort to survival strategies to mitigate their losses.

There are very few mechanisms and tools available today for participant\ to assess and manage risks arising from demand variability, supply or "no-shows."

Variations in demand or supply are not unique to the transportation industry. A well-established answer to a problem where costs and volumes vary wildly is to use a technique called Futures and Options.

A Future is basically a contract whereby a carrier commits to selling capacity to a forwarder. Futures require a commitment from both parties. An Option gives the right- and not the obligation-to purchase capacity at a prearranged date.

A few weeks before departure, futures and options are converted into a firm booking. Futures and options can be bought and sold on public or private marketplaces.

Workable shipper forecasts are the second key to a futures and option system. It is the information on which market participants rely in order to decide what the future holds for them. They tell forwarders and carriers what tonnage and volume to expect for a given lane and timeframe. A level of uncertainty is always a component
of the forecast, so it is important to assign some kind of certainty level to the forecast to make it usable. It tells
people how much they can rely on the information contained in the forecast.

Together, a forecast plus future and options creates a unique cradle of collaboration for all three participants in the transportation value chain by providing information and a

Let's walk through an example.

1. Shippers submit their forecast. All forecasts are combined to generate a picture of demand.

2. A forwarder receives its shippers' forecasts for the next two months, and then decides to secure 10% of that capacity as freight futures.

3. Carriers that are interested in getting a base load of committed capacity in order to predict their future revenue offer freight futures. Carriers could typically offer lower pricing to forwarders as an incentive to make the early commitment.

4. A matching engine does the work to find a "bid" by the carrier that exactly matches an "ask" from a forwarder. This is much like the way the stock market works- "bid-ask." Prices are not revealed

What will happen later if the shipper is forced to lower the forecast as the shipment nears? Will the forwarder find itself overcommitted?

Because Freight Futures are tradable entities, the forwarder can put them back to the market and maintain their goal of purchasing 10% of the forecast in advance.

In this example, the carrier has reached his goal of locking in some revenue early. This will give him more flexibility when comes the time to sell on the spot market. The forwarder has secured capacity and is somewhat protected against rate increases should an unpredictable event take place, such as a strike, a war abroad or any event that disrupts the flow of goods and creates rate increases. As forwarders and carriers repeat this example over time, shippers get better assurance of obtaining needed capacity at a predictable price.

The benefits of futures and options are many. All participants benefit from knowing "what's coming up."

Forwarders can segment their customers based on the quality of their forecasts, and establish stronger ties with the best forecasters. Carriers can better plan their revenues and perform cargo yield management. Both forwarders and carriers can better plan for future capacity, adding or removing freighter flights.

Shippers get better assurance of capacity and pricing. They are also able to start treating their forwarders and carriers as valuable partners who remove variability from the transportation value chain rather than serve as mere suppliers of capacity to be had at the lowest costs.

Other industries have benefited from the introduction of Futures and Options. Wheat farmers and consumers protect themselves from the vagaries of the weather that can make harvests plentiful or scarce. Oil producers and large consumers have long experienced the benefits of Futures and Options markets. Many airlines and train operators have used oil futures in order to limit the effects of price variations in fuel costs. The technique, called hedging, allows the buyer or seller of futures to create some reserves during the better days for use during the rainy days.

Another interesting feature of futures is their ability to predict spot prices. As futures are bought and sold every day, their prices get closer and closer to the spot price paid before departure. From this particularity arises many opportunities for carriers and forwarders. By looking at the prices of freight futures they can better plan their purchases or sales of futures and options so as to get the pricing that best fits their needs.

A carrier can release small portions of capacity over time at increasing price points so as to reward forwarders and shippers that plan and buy ahead and increase its profits on the spot market. Forwarders can get closer to the shippers that provide the highest forecast quality to take advantage of the lowest rates and win an edge over its competitors who are now forced to buy more at the last minute.

Shipper forecasts combined with a Futures and Options market are the foundation for better risk and revenue management in the industry. They provide the information and the financial infrastructure that allow all parties to have more sophisticated and profitable mechanisms for buying and selling capacity.

"Freight transportation companies have moved slowly to keep up with modern business practices," notes Ted Sapountzis and Lucio Pompeo, engagement partners at McKinsey Consulting. "Risk and revenue management could provide the boost the industry needs." .

The co-authors, Petere Miner and Pierre Laurent are the founders of FutureFreight, Corp., a company that is establishing the distribution of shipper forecasts and a Futures and Option market for air cargo. Petere Miner has 20 *year's experience with* HP *as director of global logistics, Pierre Laurent possesses business, financial and marketing experience, and, formerly was associated with Microsoft and Intel. They may be contacted at www.futurefreight.com or e-mail them at info@futurefreight.com Phone: 408-316-7794.*