

## An Assessment of CWB Demurrage and Despatch



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## Demurrage and Despatch

Ocean freight vessel owners charge for the use of a vessel on the basis of a daily rate covering all time required as described in the “Charter Party” (the freight contract); the more time (days) the shipper needs the vessel, the more it pays. When negotiating the price, the owner factors in the time to get to the load port, the time in port, the time to sail to the destination, and the time to discharge (unloading)<sup>1</sup>. The same daily rate applies regardless of whether the vessel is loading, sailing or discharging. It follows that the total cost will be lower if the vessel can be loaded or discharged faster.

For example, in simple terms, if the owner of a 50,000 tonne vessel charged \$60,000/day and a specific voyage including all port times (loading and discharging) was estimated to take 25 days, the negotiated cost of the vessel for that voyage would be \$1,500,000. The effective per-tonne rate would be \$30.00/tonne. If it was determined that the total time required for the voyage was say, 30 days, the effective per tonne rate would be \$36.00/tonne.

The Charter Party stipulates a guaranteed rate of loading – say, 5,000 tonnes/hour – which determines the amount of time specified within the contract to load and discharge the vessel. The contract also includes incentives to act within the time prescribed or quicker; these incentives are demurrage and despatch.

Demurrage is a penalty for taking longer to load or unload the vessel than what was stipulated in the contract; it is usually charged at a rate equal to or somewhat less than the full daily rate of the vessel on that voyage. Using the example above, an extra two days in port to load (over what was specified in the Charter Party) could cost the shipper as much as an extra \$120,000.

Despatch is a rebate paid to the shipper for loading or unloading the vessel quicker than what was stipulated in the Charter Party; it is typically paid at half the demurrage rate. Using the example above, loading two days quicker than what was contracted could earn the shipper a despatch rebate of say, \$50,000<sup>2</sup>.

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<sup>1</sup> Other factors such as the cost of fuel and the general condition of the market – the relative supply and demand for dry bulk ocean freight – are important factors in determining the actual rate charged, but are not material to this analysis.

<sup>2</sup> The actual despatch rate is part of the negotiations with the vessel. At half the demurrage rate, shippers advise that despatch is usually less than ½ the daily rate equivalent. For illustrative purposes, our examples will assume the despatch rate is about 40% of the daily vessel rate.

Despatch is considered by most shippers as a partial rebate of money already spent. The net result of earning despatch is a bottom-line cost equal to more than half the freight rate for the time in question; in our example, the shipper paid for two days of vessel time he did not use; he paid \$120,000 on freight to earn \$50,000 in despatch. The net result is an unnecessary cost of \$70,000.

There are two basic factors that influence whether a shipper is charged demurrage or earns despatch. First, in negotiating the terms for the vessel, the shipper stipulates the time it requires to load. This will influence the effective rate of the vessel; more time to load will mean a higher freight rate and less time will mean a lower freight rate. Typically, the shipper's decision will be based on the expected performance of the logistics system (level of rail service to port terminal, handling and loading speed of the terminal(s), number of terminals used to load, shifting times, etc). Shippers try to estimate the expected amount of time in port in an effort to minimize both demurrage and despatch.

The second factor is influencing loading times is the performance of the logistical system. At times, the system can be stressed to the point of not performing as expected. For example, rail service taking grain to the port terminals can be disrupted for various reasons, forcing vessels to wait in port for the right grain to arrive and be ready for loading, possibly causing demurrage. Alternatively, at times the system performs better than expected and the amount of time in port is reduced, allowing despatch to be paid to the shipper.

Combined, these two factors – the negotiated load terms and the logistical performance – have a direct impact on whether a shipper experiences either demurrage or despatch. The first is within the control of the shipper and the second is often considered to be outside of the shipper's control, although most shippers can (and do) exert a certain amount of influence on the logistics system.

## Demurrage and Despatch to a Trading Company

When a trading firm engages in originating grain and selling it overseas on a CIF (delivered) basis<sup>3</sup>, it engages in all aspects of the trade. It negotiates all terms; price and terms of grain to be loaded on the vessel, sale price and terms to the receiving customer, and all ocean freight arrangements. Efforts to maximize returns and minimize costs feature in all negotiations. Therefore, when negotiating loading terms, the trading company will stipulate a load rate that it feels will minimize its total cost, including minimizing both demurrage and despatch.

Even if the firm is selling on a FOB basis<sup>4</sup> (transfer of ownership takes place as it is loaded onto the buyer's vessel), negotiated load terms (including demurrage and despatch) will still apply to the FOB seller.

Any additional costs or reductions of costs will affect the profitability of the trade for the trading firm. When a trading company is hit with demurrage charges for example, they go directly to its bottom line as an unexpected, unwanted cost.

When a trading company earns despatch, it sees it as partial rebate of money spent on freight time that was not used. Although a trading company will welcome despatch whenever possible through execution of the trade, it will also do whatever it can to minimize the upfront freight costs when putting the deal together in the first place; it will match the negotiated loading terms of the freight contract to its loading expectations.

If a trading company consistently earns despatch, it recognizes that it is buying freight time that it is not using and so its (freight) cost structure is too high. It recognizes that if it is regularly earning despatch, it is paying more than it needs to for freight.

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<sup>3</sup> CIF stands for Cost, Insurance and Freight, meaning that the price consists of the cost of the commodity, insurance while in-transit and the cost of the freight to get it to the destination.

<sup>4</sup> FOB stands for Free On Board, meaning all costs up to loading the vessel are for the seller's account; all costs beyond that are for the buyer's account.

## Demurrage and Despatch to the CWB

When the CWB engages in selling grain on behalf of western Canadian farmers, it typically sells on a FOB port basis and sometimes on a CIF basis. Either way, it negotiates price and terms of grain to be loaded on the vessel, sale price, and vessel loading terms.

Similar to a private trading firm, the CWB operates in a competitive market for offshore sales, competing with other origins of wheat and barley. In the event that that CWB sells on a CIF basis, the rates it pays to ocean vessel operators are also based on competitive forces.

However, the CWB is not a trading firm; it is an agent representing farmers and all the commercial arrangements it makes are on behalf of farmers. Its relationship to farmers is quite different than the relationship between a grain trading company and farmers.

The fundamental difference is that because the CWB has single desk authority over exports of wheat and barley it does not compete for farmers' grain; the price received by farmers from the CWB is simply the net result of all commercial arrangements the CWB makes on behalf of farmers minus the administrative costs of the CWB. Since the CWB does not compete for farmers' grain, there is no farmgate price discipline function being exerted on the CWB. Therefore, demurrage and despatch are passed on to farmers and therefore affect farmers' net returns.

Although the CWB's stated mandate is to maximize returns for farmers, there is no market factor that forces the CWB to ensure its costs are the lowest and/or competitive; the CWB could enter into logistical or handling arrangements that could be considered non-competitive from a cost perspective and these higher costs would simply be passed on to farmers. This is not to say the CWB does this, just that there is no competitive mechanism to ensure that it does not.

This is an important issue regarding despatch. If it is assumed that a trading firm makes a profit on selling and shipping grain, it is clear that it has an incentive to minimize all costs, including demurrage and despatch. However, the CWB is not working for a trading margin; all marketing costs are for the farmers' account. Therefore, any assessment of despatch earnings must include the cost of the unused freight time that created the despatch earnings in the first place.

The table below shows how despatch is a partial rebate of freight costs and how load terms can change the actual cost of loading a vessel. These calculations are based on the assumption of a daily rate for the vessel of \$60,000/day and the assumption that the vessel is loaded in four days. Demurrage is assumed to be 80% of the daily rate and despatch equal to half the demurrage rate.

### Load Term Net Cost Comparison

Daily rate		\$60,000		
Actual load time		4 days		
Charter Party load terms	2 days	4 days	6 days	
Cost based on the Charter Party	\$120,000	\$240,000	\$360,000	
Demurrage: loading took an extra 2 days	\$96,000			
Despatch: loading took 2 days less			\$48,000	
<b>Net cost to load (vessel time)</b>	<b>\$216,000</b>	<b>\$240,000</b>	<b>\$312,000</b>	

This analysis shows how when despatch is earned, the actual net cost is higher.

The CWB is in a position to negotiate vessel load terms that provide excessive (long) loading times that would dramatically increase the chance of earning despatch, skewing the demurrage/despatch balance in favour of reporting net despatch. However, these load terms would unnecessarily increase the cost of the vessel by specifying more time required to load; since the CWB cannot force the buyer to pay a higher price to cover higher freight costs, and the CWB itself does not bear the burden of these higher costs, and the CWB's price to farmers does not need to be competitive, earning despatch translates into lower returns to farmers.

## The CWB's Track Record

In annual reports until 2001-02, the CWB reported demurrage and despatch (demdes) on a net basis in the pool accounts. The table below shows the net results for each pool account; when demurrage exceeds despatch it is shown as a negative and when despatch exceeds demurrage it is shown as a positive.

**CWB Net Demurrage and Despatch: 1994-95 to 2001-02 (millions)**

	Wheat	Durum	Malt Bly	Fd Bly	Combined
<b>94-95</b>	(\$4.6)	(\$0.5)	(\$7.1)	(\$0.4)	(\$12.7)
<b>95-96</b>	(\$9.9)	\$0.8	(\$0.3)	\$0.01	(\$9.4)
<b>96-97</b>	(\$18.8)	(\$1.3)	(\$4.1)	(\$0.3)	(\$24.4)
<b>97-98</b>	\$3.7	\$0.7	\$0.5	\$0.04	\$4.5
<b>98-99</b>	\$5.4	\$1.2	\$0.01	\$0.06	\$6.7
<b>99-00</b>	\$4.6	\$1.2	\$0.01	\$0.03	\$5.8
<b>00-01</b>	(\$5.0)	\$0.6	(\$1.8)	\$0.1	(\$6.1)
<b>01-02</b>	\$2.8	\$1.3	(\$0.02)	\$0.03	\$4.2

Source: CWB Annual Reports

For the annual report covering 2002-03, the CWB changed its reporting of demurrage and despatch:

*The Net Demurrage (Despatch), Drying and CWB hopper car categories have been grouped with other categories due to their relative low dollar value. Demurrage and hopper car expense is now included in other direct expense.*

*Revenue represents grain sales at contract prices, gains or losses on foreign exchange and commodity hedging activities, as well as other direct operating income such as despatch and tendering income<sup>5</sup>.*

This change effectively hides demdes from review. Moreover, considering despatch as revenue or “operating income” underscores the CWB’s failure to recognize the associated cost of excess freight.

Upon request, the CWB provided its demurrage costs and despatch “earnings” for the years 2003-04 to 2008-09. (See the table below).

<sup>5</sup> CWB 2002-03 Annual Report, page 25

**CWB Demurrage and Despatch: 2003-04 to 2008-09 (millions)**

	03-04	04-05	05-06	06-07	07-08	08-09
Demurrage	(\$1.8)	(\$12.8)	(\$5.8)	(\$13.3)	(\$19.0)	(\$7.6)
Despatch	\$14.8	\$11.9	\$10.5	\$17.4	\$17.5	\$15.0
Net	\$13.0	(\$0.9)	\$4.6	\$4.1	(\$1.5)	\$7.4

Source: CWB, personal communication

In the last six years, the CWB has paid out a total of \$60.3 million in demurrage charges. As noted previously, demurrage is as much a function of the load terms negotiated with the vessel operator as it is a function of logistical efficiencies. For example, if the CWB negotiated aggressive load terms (with a short time allotted for loading), and there were no logistic delays in loading the vessel, any demurrage charged would simply reflect the actual time used in excess of the negotiated load time (in other words, it would not necessarily be a penalty).

Conversely, if the CWB negotiated generous load terms (allowing more time to load than what should be required), it could load a vessel without any demurrage, even though there were in fact logistic delays.

As is the case with demurrage, despatch is as much a function of the load terms the CWB negotiates as it is a function of logistic performance. As stated previously, the CWB is in a position to set load terms generously, increasing the chance of earning despatch regardless of actual logistic performance.

In the last six years, the CWB has received a total of \$87.1 million in despatch payments. Assuming that despatch is paid out at less than half the daily rate of the vessel<sup>6</sup>, this means that the CWB incurred over \$174.2 million in excess freight (excess loading times) over what was actually used. Since \$87.1 million was repaid to the CWB as despatch, the net result of the CWB's negotiated load terms is a net excess cost of more than \$87.1 million.

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<sup>6</sup> In discussions with the CWB it was confirmed that despatch is less than half of the effective daily rate of the vessel.

## The CWB Uses Flawed Logic Setting to Earn Net Despatch as a Target

Starting with 2005-06, the CWB began reporting demdes as a performance measure:

*In September 2006, the CWB's board approved the corporate performance measures (CPM) results for 2005-06. Operational effectiveness measures, one subset of the 2005-06 CPM, include: percentage of grain marketed; sales price comparison; contribution from other revenue sources; and net demurrage/despatch.<sup>7</sup>*

**Net demurrage/despatch reported by the CWB (millions)**

	Target	Result
2005-06	Net zero	\$4.6 net despatch
2006-07	\$4.5 net despatch	\$4.1 net despatch
2007-08	\$4.5 net despatch	\$1.5 net despatch
2008-09	\$4.5 net despatch	\$7.4 net despatch

Source: CWB Annual Reports

In 2005-06, the CWB had a stated target of achieving a net zero balance between demurrage payments and despatch receipts; it is assumed that it had similar targets in years previous to that year. In 2006-07 and since, the CWB has had a stated target of earning despatch payments in excess of demurrage payments by \$4.5 million annually.

In these four years, the CWB has had a cumulative goal to earn \$13.5 million in net demdes (despatch minus demurrage). In the same time, the CWB reported net demdes earnings of 17.6 million<sup>8</sup> and data provided by the CWB directly (table in previous section) shows total despatch payments of \$60.4 million. Based on input from the CWB, \$60.4 million in despatch translates to over \$120 million in excess (unused) freight.

Reporting net despatch earnings may provide the impression that the CWB is adding value to the farmgate return; the CWB apparently sees it as incremental revenue, often reporting it as a “benefit” to farmers. For example, in a February 10, 2005 news release<sup>9</sup>, the CWB states:

*Transportation savings were up significantly over the previous year, at \$51 million, generated by a combination of freight and terminal rebates, CWB financial penalties for non-performance and tendering.*

<sup>7</sup> CWB 2005-06 Annual Report, page 40.

<sup>8</sup> Although the 2007-08 Annual Report indicated \$1.5 million despatch, data provided by the CWB indicated \$1.5 demurrage; using these figures the net demdes results for the last four years is \$14.6 despatch.

<sup>9</sup> Source: <http://www.cwb.ca/public/en/newsroom/releases/2005/021005.jsp>

*The CWB also returned to farmers a record \$15 million in despatch savings, paid to the CWB when ships leave port ahead of schedule.*

There is no indication in any CWB report that despatch “savings” or “earnings” come at a high cost to farmers in extra, unused freight time.

The appropriate approach for the CWB is to minimize demurrage and avoid despatch altogether. By targeting to earn despatch, the CWB is targeting higher than necessary freight costs – borne by farmers.

However, trade sources report that the CWB actively sets generous load terms. For example, when loading at a terminal that can load a vessel in two days, the CWB may stipulate that it requires as many as six days to load. In other words, it sets itself up to earn despatch.

Because there is no commercial reason to set generous load terms, the only apparent reason is to facilitate the reporting of net despatch (rather than net demurrage).

If we accept that the CWB should not target to receive despatch at all (because of the increased net cost), the CWB despatch experience cost farmers unnecessarily in excess of \$60.4 million over the last four years and more than \$87 million over the last six years.

## Conclusions and Recommendations

1. The CWB has a target, or Corporate Performance Measure (CPM), of earning despatch in excess of demurrage payments. However, earning despatch comes at a significant cost and so all reasonable steps should be taken to avoid despatch completely.
2. It appears that the CWB may be engaged in negotiations regarding load guarantees that are aimed at facilitating despatch payments in excess of demurrage on an annual basis. These arrangements would not be considered to be commercial and would cost farmers millions per year.
3. The CWB is reporting demdes in a manner that is misleading farmers, suggesting it is providing value through despatch payments. In reality, the CWB is incurring much larger costs than is being reported and these costs are reducing farmgate returns accordingly.
4. The CWB should negotiate terms for loading vessels that keep despatch to a minimum.
5. It is recommended that the CWB adjust its Corporate Performance Measure on demdes to reflect an approach that fits with its mandate of minimizing costs for farmers.
6. It is recommended that the CWB report both demurrage and despatch separately (not on a net basis) and visibly (not combined with other items) in its Annual Reports. This will facilitate farmers' ability to more effectively assess the CWB's commercial performance on their behalf.

## References

CWB Annual Reports: 1994-95 through 2008-09

<http://www.cwb.ca/public/en/about/investor/annual/>