Original Research Paper

Choosing the right trade terms with transportation considerations: a study of *Incoterms® 2010*

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Abstract

Incoterms is an internationally recognized standard that is designed to reduce confusion over division of responsibilities and obligations for traders during trade practice. It establishes clear and binding rules for the division of costs, risks and tasks regarding transportation, insurance, delivery and handling liabilities by defining different trade terms in a three letter abbreviation. Incoterms greatly facilitates international trade. For years, Incoterms has been successfully removed conflicts and difficulties arising from trade practice and it have been incorporated into

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sales contract worldwide. This paper tries to inquire into how transportation factors influence traders' choice of a particular trade term when they are contracting for business and thus help them make right decisions. This paper also tries to create some criterion that might be applicable to the choosing of the right term in trade practice.

Keywords:

trade terms, *Incoterms® 2010*, transportation, choice

1 Introduction

Incoterms is the most widely used rule in international sale of goods. The goal of Incoterms is to alleviate or reduce confusion over interpretations of shipping terms, by outlining exactly who is obligated to take control of insure goods at a particular point in the shipping process. Incoterms establishes clear and binding rules for the division of transportation cost, transport risk and handling liabilities by defining trade terms. A trade term is a three letter abbreviation that stipulates the rights and obligation of the buyer or the seller to avoid the conflicts and difficulties arising from trade practice. Incoterms becomes a unified rule guiding buyer and seller to fulfill their obligations during trade practice. Thus traders do not have to discuss over and over again for the obligations they should accomplish and include extensive agreement in the contract. Every contract should include a trade term (Jimenez, 2008).

Incoterms was published by International Chamber Of Commerce (ICC). ICC reflects practice of news changes and trends in business practices by periodically revising its versions. Since the first publication in 1936, Incoterms has been periodically revised in 1953, 1967, 1976, 1980, 1990, 2000 and 2010 to be better adapted to the changes in international trade practices. From its first appearance, incoterms have been used for over 70 years in trade practice. The current version is *Incoterms® 2010*, which come into force on January 1st, 2010. Unlike law, the old version lose its efficacy automatically when the new version appears, all the versions of Incoterms can be chosen and it is up to the seller or buyer that choose which version of the trade terms.

For years incoterms has been successfully reduced and removed uncertainties arising from different interpretation of trade rules in different countries. It is most widely accepted not only be traders, but also by government, banks, legal authorities, insurance companies and shipping companies. Now incoterms are used worldwide and incorporated into sales contract worldwide. Besides Incoterms, there are also *Warsaw-Oxford Rules 1932*, which is made by International Law Association and *Revised American Foreign Trade Definition*, which is made by nine American business groups in 1941.

2 Literature review

Since the appearance of the first version, Incoterms plays an important role in facilitating trade. With the application of trade terms, concluding a contract is greatly standardized. *Incoterms® 2010* provides a guideline for the evolution of Incoterms rules, categories and rights and obligation for the buyers and sellers. It also advocates the right use of trade terms. For the traders, to adapt the right trade terms is of vital importance (X., 2010; Gardner, 2012). Otherwise, problems will arise or remain if inappropriate terms are chosen (Ramberg, 1999). J.W. Richardson in his paper holds that the choice of the right trade term will prevents trade disputes (1997). Researchers also put forward the point that the choosing of the right trade term should be in accordance with other contract items, such as contract of carriage, method of payment, insurance and features of the goods been shipped etc.(C. Debattisat, 1995; Chen, 2009; Zhang, 2009; Shen, 2011; Hu, 2014). Some researchers try to explore the reason why ICC tries to advocate the use of multimodal terms instead of the maritime terms and provide some criteria for the traders to use the right trade term (Malfliet, 2011; Yang, 2011). Some researchers probe into the factors influencing the choice of trade terms and found the most important factors are volumes and characteristics of consignment, carriage conditions, geographical location, transportation cost, control over delivery, documents required, capabilities of arranging transportation, common practice and legislation obstacles(Cai and Liu, 2001; Olga, Zhang, 2009; Xu et al., 2011,). Some researchers investigate into the choice of trade terms for Chinese inland city companies, who should ship the goods from an inland city by road or rail transportation to the port of shipment, most of them “wrongly” choose the maritime trade terms instead of FCA, CIP or CPT(Li, 2010; Wang, 2008; Chu, 2007; Liu,2007; Han, 2009). To quest into the application and revision of *Incoterms 2000*, ICC conducted an inquiry in Belgium in spring 2008, and find Belgian traders choose the “wrong” trade terms frequently (2008). Some researchers also find that this problem is more significant for small and media-sized enterprises for their lacking of professional knowledge (Chevalier, 2003; Wu, 2006). Researchers find that the misuse of trade terms will harm exportation (Dooren, 2008) and international trade as a whole (Malfliet, 2011).

3 Structure of *Incoterms® 2010*

Launched in mid-September 2010, *Incoterms® 2010* came into effect on January 1st, 2010. There are 11 terms in *Incoterms® 2010*. Each of them stipulates the transfer of risks, transfer of documents, division of cost, delivery of goods, inspection of goods, and other obligation of the seller and buyer. Unlike previous versions, *Incoterms® 2010* are proposed to be used both for international and domestic trade. Like other versions, *Incoterms® 2010* has being successfully helped traders avoid misunderstandings by stipulating the risks, responsibilities, costs, and delivery. To change the abusing of maritime terms when multimodal terms should be used, trade terms are divided according to the criterion of “for any mode of transport” or “for sea and inland waterway transportation” in this version. *Incoterms® 2010* also introduced two new trade terms, that is DAT and DAP，and eliminated four previous terms, which is DEQ, DES, DDU and DAF. *Incoterms® 2010* set up new interpretation for all the terms for the division of risks and division of cost (Wang, 2010). Because of containerization in the current trade, *Incoterms® 2010* has security related information has been given to importers and exporters. The use of electronic documents is accepted the concept of ship's rail is removed by "delivered on board" (Zhang, 2011).

3.1 Terms for any modes of transport

3.1.1 EXW (Ex Works)

EXW means the seller fulfills his obligation when the goods are placed at the disposal of the buyer at the seller's premises or other named places (i.e., works, factory, warehouse, etc.). EXW represents the minimum obligation of the seller. The seller is not liable for clear for export and loading the goods on board the vehicles no matter the goods are provided by the buyer or the seller. Buyers should avoid this term when he cannot perform the export formalities in a foreign country for the seller is supposed to in a better condition to do this.

3.1.2 FCA (Free Carrier)

Under FCA, the seller is required to deliver the good to the carrier or the person nominated by the buyer. The delivery could be at the seller's places or any other named place. FCA is much advised by some researchers when the exporter locates in an inland city because the risk of loss or damage to the goods could be transferred to the buyer at the moment the goods are delivered. The inland exporter do not need to transport the goods by road way or railway to the port and thus risks are greatly reduced (Han and Yang, 2009).

3.1.3 CPT (Carriage Paid To)

CPT has two “critical points”. The risk of the loss of or damage to the goods passes from the seller to the buyer when the goods are delivered to the carrier named by the buyer at the agreed place. But the seller should pay the freight necessary to bring the goods to the place of destination.

3.1.4 CIP (Carriage and Insurance Paid to)

Similar to CPT, the seller should deliver the goods to the carrier or other person named by the buyer and pays the freight to the designated place. In addition, he should contract for insurance against the buyer’s risks.

3.1.5 DAT (Delivered At Terminal)

DAT is a new term which appears in *Incoterms® 2010*. It has almost the same obligation for the buyer and the seller as DEQ in Incoterm 2000. The seller finishes his obligation to deliver once the goods are placed at the disposal of the buyer in a terminal predefined by the buyer, unloaded from the arriving vehicle. DAT differs with DEQ in that the terminal in DAT is not limited to a quay in DEQ, but any terminal “a place as a quay, warehouse, container yard or road, rail or air cargo terminal” (*Incoterms® 2010*). Thus DAT replaced DAT.

3.1.6 DAP (Delivered at Place)

DAP means the seller delivers when the goods are put at the buyer’s disposal, ready for unloading on the arriving vehicle at the named place of destination. The seller bears all the cost and risk necessary to bring the goods to the designated place of destination, except the import clearance fees and taxes. DAP replaced DAF, DES and DDU in the previous version, and is very similar to the former DDU.

3.1.7 DDP (Delivered Duty Paid)

Besides the entire obligation performed under DAP, the seller should conduct import clearance procedures and bears all the costs and risk involved in bringing the goods to the place of destination under DDP. This terms could not be used when the seller cannot perform customs formalities in a country he is unknown or not familiar with.

3.2 Terms for sea and inland waterway transport

3.2.1 FAS (Free Along Ship)

Under FAS, the seller is required to deliver the goods alongside the ship vessel at the port of shipment. From that point on, the buyer bears all the risks and cost necessary to bring the goods to the destination. In FAS, the seller has to clear for export.

3.2.2 FOB (Free On Board)

FOB means the seller fulfills his obligation when the goods are delivered on board the vessel named by the buyer at the named port of shipment. FOB uses the term “placing” instead of “loading” as in FCA (Malfliet, 2011). The risks of loss of or damage to the goods transferred from the seller to the buyer when the goods are placed “on board” the vessel instead of “pass the ship’s rail”. This is one of the major change *Incoterms® 2010* made compared to the previous version.

3.2.3 CFR (Cost and Freight)

Under CFR, the seller should deliver the goods on board the vessel at the port of shipment. Thus the risk of the loss of or damage to the goods transfers from the seller to the buyer from that moment. But the seller should pay the freight necessary to bring the goods to the port of destination. There are two “division point” in CFR: one is the division of risk, which is the moment the goods are placed on board the vessel; another is the “division of cost”, the seller pays the freight to the port of destination.

3.2.4 CIF (Cost, Insurance and Freight)

CIF is similar to CFR but differs in that the obligation of seller extends to procure marine insurance to the port of destination. Under the circumstances, the seller is contracting for insurance against the buyer’s risk. Should the buyer want to cover a more extensive cover of insurance, he should purchase by himself or have an express agreement with the seller. The seller is only required to procure the minimum coverage.

The following tables illustrate the classification of *Incoterms 2000* and *Incoterms® 2010*

Table1. Classification of the *Incoterms 2000*

Groups	Trade Terms
Group E (Departure terms)	EXW Ex Works(...named place)
Group F(Main carriage unpaid)	FCA Free Carrier(...named place)
	FAS Free Alongside Ship(...named port of shipment)
	FOB Free On Board (...named port of shipment)
Group C (Main Carriage Paid)	CFR Cost and Freight (...named port of destination)
	CIF Cost, Insurance and Freight (...named port of destination)
	CPT Carriage Paid To (...named place of destination)
	CIP Carriage and Insurance Paid To (...named place of

Group D (Arrival)	DAF Delivered At Frontier (...named place)
	DES Delivered Ex Ship (...named port of destination)
	DEQ Delivered Ex Quay (...named port of destination)
	DDU Delivered Duty Unpaid (...named place of destination)
	DDP Delivered Duty Paid (...named place of destination)

Table 2. Classification of the *Incoterms® 2010* according to the terms of transport

Mode of Transport	**Trade Terms**
Any mode of transportation	EXW, FCA, CPT, CIP, DAT, DAP, DDP
Sea or inland waterway transportation	FAS, FOB, CFR, CIF

4 Transportation considerations when choosing a trade term

The exporter is in a better position to contract for international transportation (C. Murry, D. Holloway and D.Timson-hunt, 2007). Especially when exporters have comparatively larger sales volume, they are thought to have more bargaining power and are more capable of arranging transportation and strive for cheaper freight (Ramberg, 1982). In certain circumstance, an exporter can also charge a commission to the importer for the service of arranging carriage (Jimenez, 2008). Besides, the exporter knows how to arrange transportation for a certain type of goods for they are much familiar with the goods they are dealing with (Ramper, 1999). When the goods contracted have specific demand for temperature, container types, the exporters can have a better anticipation and possible control of the risks that may occur during the voyage. This happens especially when high value manufactured goods are contracting because the seller is more concern about the quality of their product during the voyage (Vercauteren, 1992). Furthermore, exporter’s arranging of transportation allows him days of tolerant of conjunct their preparation of goods with the pickup dates and thus stranding fees could be possibly avoided.

However, small and beginning exporters will prefer E group or F group terms and leaving the duties of arranging transportation to the buyers (Malfliet, 2011). The reason being that they are not sensitive to the fluctuation of freight and are not capable to estimate the freight that should be added to their FOB price when they are concluding a contract.

When choosing trade terms, it is advisable for traders to consider transportation factors. This may help them have a better control of the financial risks and transportation risks when contracting for business. The following factors are prominent when making choices:

4.1 Mode of transportation

According to UN/CEFACT, there are eight transport modes for international trade, namely maritime, inland water way, road, rail, air, fixed installation, mail and multi-modal transportation. Each mode of transportation has its unique features. Among them, sea transportation is most frequently used since over 70% of the earth is covered by seawater. It has certain features such as easy passage, adaptable to large volume of goods of different sizes, economical but relatively slow speed. According to the United Nations, maritime transportation ships over 80 percent of the goods in international trade by volume and 70 percent by value. By contrast, air transportation, which has the features of fast speed, good service but small shipping capacity, handles only 2 percent of world trade goods by weight but about 40 percent by value. Road transport can offer door to door service and is especially convenient for countries with smaller territory. Railway transportation can attain a relatively faster speed and is comparatively economical, but it is limited to tracks and terminations. Railway or road transportation is more likely to be used between adjacent inland countries.

Basically, trade terms should be chosen according to the mode of transport. In *Incoterms® 2010*, EXW, FCA, CPT, CIP, DAT, DAP and DDP could be used in any mode of transport whereas FAS, FOB, CFR and CIF could be used in sea and inland waterway transport. If the goods are transported by air or road transport, the use of FOB, CFR or CIF is not appropriate. The geographical location of the two countries is another important factor. For example, cargoes transported between countries connected by sea are much likely use maritime transportation if it is not needed urgently. Other factors, such as the geographical location of the warehouse, the available transportation terminals, cargo types, time of demand, and quantity of cargoes shipped also matter. If large numbers of cargoes are transported, sea transportation is much preferred since it has large capacity and better adaptability to different sizes of cargoes. Moreover, specific cargo types demand either the seller or the buyer keep an eye on the goods during transit. In the circumstances, the seller could use the trade terms that requires the seller to arrange transportation so that he can supervise the goods during the shipping process. If an exporter who is located in an inland city insists on using the traditional FOB, CFR or CIF, the goods are subjected to losses during the voyage from the warehouse to the port of shipment. The reason being that the risks only transfer from the moment when goods are placed on board the vessel at the port of shipment. The exporter has to bear the risks when the goods are shipping from his warehouse to the port of shipment. In this case, FCA is much preferred since the risk transfers from the seller to the buyer from the moment the goods are delivered to the carrier.

4.2 Transportation condition

In international trade, goods may suffer from various risks during long voyage. These risks include natural calamities, fortuitous accidents and many extraneous risks. If the goods are going through dangerous zones, they are much likely to suffer from losses, in this case, the party could choose the trade term in which transportation is arranged by the counterpart. For example, exporter could choose FOB and buyer can choose CFR. When goods are transported by container or multi-modal transportation, terms suitable to any modes of transport are more appropriate than FOB, CFR and CIF because the transfer of goods could be in a Container Yard (CY) or Container Freight Station (CFS) and a carrier can take delivery of the goods there. Thus the risks could be transferred rightly at the moment the goods are delivered to the carrier instead of at the port of shipment.

Moreover, the condition of the port of discharge varies a lot. Some ports do not have automation processing system and manual labor is used. Thus they charges comparatively higher port discharging fees. In the circumstance, trade terms such as CFR and CIF could be adopted when importing and terms such as FOB and FAS could be used for exporting so that the high port discharge fees could be avoided.

4.3 Risk control

Financial risk the most important issue traders will consider when they are doing business. In international trade, the exporter controls the goods through the process of the transfer of a title document, Bill of Lading, which is released to the buyer according to different conditions set forth. The seller may send the documents to the buyer or release them through a bank by his authorization. Then the buyer could collect the goods from the carrier with the title documents. In some cases, the buyer may stealthily contact the carrier and got the shipment from the carrier skipping the step of release from the bank. The buyer could either escape or announce bankrupt, causing the seller the suffering of loss of goods or non-reimbursement of payment. Sometimes the seller may collude with the carrier and present fake documents leaving the buyer no chance of getting the goods. If the buyer has questionable reputation, the seller may choose the trade term that insure safe payment from the buyer.

4.4 Cost control

Freight constitutes an important part of the price of the product. For bulk cargoes, freight is a major proportion of the price. When choosing trade terms, traders should consider the freight charged during transit and the trend of the freight. Freight fluctuates every day in international transportation. For example, if the exporter anticipates the freight tends to increase and the port of shipment or port of destination, he could avoid the use of group C and group D terms. Likewise, if he anticipates a surcharge is likely to be charged, for example Banker Factor Surcharges for the anticipation of increase of oil prices, he can choose group F terms to increase profit. If the freight tends to be lower, it is preferable to choose group C terms for the exporter and group F terms for the importer.

If either of the seller or buyer have the capacity to arrange transport and can get competitive offer from the shipping company, that party could apply the trade term that include to arrange transportation. Otherwise, if the trading company is small and have little bargaining power with the carrier and thus cannot try for lower freight, this party could choose the trade term that do not need to arrange transportation.

5. Conclusion

The chosen of trade terms is part of the business strategy (Vanheusden, 2005). In many cases, however, traders do not sufficiently consider all the factors that may affect their choice of the most appropriate terms. They would rather choose the trade terms according to their previous experience. However, the choice of the right trade terms may have great influence on the cost control, risk control, formalities to go through, division of liabilities and the profitability of the transaction. Transportation is the essential link between the exporter and importer and transportation factors are an important aspect to consider when traders are making choices. The chosen of the right trade may mitigate costs and associated risks. *Incoterms® 2010* set up a criterion of dividing the 11 trade terms by the mode of transportation used. It divides trade terms into two groups by sea or inland waterway transportation and other mode of transportation. But the choosing of the right trade term is not simply according to this standard. It is advisable for traders to carefully choose a trade term by considering all the factors. This paper is only a tentative study on the transportation factor that traders may consider.

Acknowledgements

The authors acknowledge that this research is supported in part by the National Science Foundation (NSF) under grants #1137732. The opinions, findings, and conclusions or recommendations expressed in this material are those of the author(s) and do not necessarily reflect the views of the funding agencies.

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Appendix

Allocations of Costs to Buyer/Seller according to Incoterms® 2010

Incoterms2010	Export customs declaration	Carriage to port of export	Unloading of truck in port of export	Loading on vessel/airplane in port of export	Carriage (Sea/air) to port of import	Insurance	Unloading in port of import	Loading on truck in port of import	Carriage to place of destination	Import customs clearance	Import duties and taxes
EXW	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer
FCA	seller	seller	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer
FAS	seller	seller	seller	buyer	buyer	buyer	buyer	buyer	buyer	buyer	buyer
FOB	seller	seller	seller	seller	buyer	buyer	buyer	buyer	buyer	buyer	buyer
CPT	seller	seller	seller	seller	seller	buyer	buyer/seller	buyer/seller	seller	buyer	buyer

CFR	seller	seller	seller	seller	seller	buyer	buyer/seller	buyer	buyer	buyer	buyer
CIF	seller	seller	seller	seller	seller	seller	buyer/seller	buyer	buyer	buyer	buyer
CIP	seller	seller	seller	seller	seller	seller	buyer/seller	buyer/seller	seller	buyer	buyer
DAT	seller	seller	seller	seller	seller	buyer/seller	seller	buyer	buyer	buyer	buyer
DAP	seller	seller	seller	seller	seller	buyer/seller	seller	seller	seller	buyer	buyer
DDP	seller	seller	seller	seller	seller	buyer/seller	seller	seller	seller	seller	seller