

Transportation and Logistics

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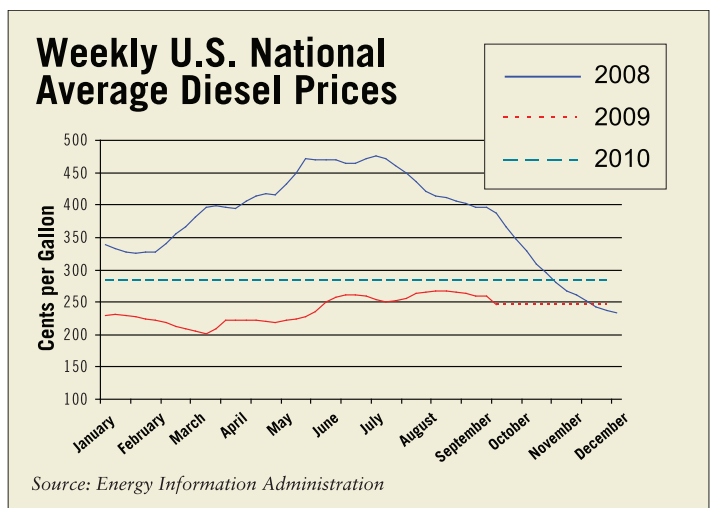
EXECUTIVE OBSERVATIONS

After a year of volatile supply and demand struggles, many analysts feel the transportation industry has bottomed out and is on the road to recovery, and there are now tangible signs of small steps toward increasing demand and pricing. So what should shippers expect to see over the next few quarters? Inventory and sales levels should start to very slowly increase over the next few months, continuing the pattern observed recently that suggests that the retail “destocking” practice, which has had a large impact on trucking and small parcel, may be over. To the consumer, this means the chance of the hot new holiday present being out of stock is much smaller. However, we should be cautious about their optimism for the peak shipping season. Many experts have noted that the economy may have bottomed out, but it will be a significant time period before consumers are spending in a meaningful way. The sluggish consumer spending is just one reason, along with low import levels and fears of slipping back into a recession, that conditions should remain ideal for sourcing initiatives across all transportation modes in the foreseeable future.

In the third quarter of 2009, Ariba observed a steady flow of sourcing projects as activity remained high for Transportation and Logistics. The following modes in particular saw a high amount of traction: Small Parcel, Ocean Freight and Less than Truckload. Outside of the standard sourcing projects, Ariba assisted several customers with face-to-face negotiations and completed several operational studies that will drive savings through behavior changes.

The U.S. Department of Energy (DOE) held its forecast for diesel fuel for the remainder of 2009 steady at \$2.46 per gallon, however it did revise its prediction for 2010 to \$2.84. The change in prediction should not have a large impact on the industry as the revised price is still almost two dollars lower than the highs seen last summer. The DOE also lowered its prediction for crude oil

to \$59.94 per barrel, which should bring relief to all types of transportation fuel, especially bunker and jet fuel.



The American Trucking Association (ATA) has recently reported that truckload driver turnover is now at its lowest level in 14 years. The turnover rate is at 52 percent for large carriers and 42 percent for small carriers. Turnover also remains low for Less than Truckload and currently stands at six percent. With low freight levels leading to industry-wide layoffs, drivers are reluctant to switch from one carrier to another as easily as they had been in the past. With driver turnover predicted to remain low along with the DOE’s prediction of low diesel prices, the normal factors that trucking carriers have used in the past to justify price increases are now gone, which enables shippers to truly focus on the service levels provided by each carrier.

Lastly, if the transportation industry has hit rock bottom, shippers will be able to observe a new landscape when the dust settles from the recession. Every quarter we have seen more carriers exit the market (Jevic), reduce service (DHL) or change ownership (Velocity Express), and the list is not finalized. Besides the carriers

that have already gone out of business, many carriers have been barely surviving and the turnaround in the industry may not happen soon enough.

Top Areas for Sourcing

- 1) **Less than Truckload: Seven to 13 Percent Savings** – The theme facing the LTL industry is one of uncertainty. What will prices do? Will YRC survive? Will shippers start to increase the amount of freight shipped? Conflicting reports exist that predict rates will both go up and continue to decrease. Market statistics support the fact that carriers cannot raise rates by saying the industry is picking up. According to the ATA, seasonally adjusted tonnage fell by a half of a percent in July. This marks the twelfth-straight month of declines, bringing freight levels to the lowest since July 2002. Since the LTL industry can be classified as “mature” with slow growth, that means carriers are not competing for new business—they are looking to take market share away from their competition. In the past few quarters, it has been observed that some carriers are being extremely aggressive with their pricing in order to secure freight; however, after several months of operating at such discounted levels, the carriers realize that their rates are unsustainable and are trying to raise them. Shippers should examine the financial performance of their incumbent carriers in order to arm themselves if they are approached by their incumbents for rate increases. Shippers should avoid being perceived as inflexible to the plight of their incumbents and potentially risk being dropped when the market turns around. The biggest uncertainty in the industry is the survival of YRC. Many say that if the company can survive the first quarter of 2010, when freight typically slows down from the holiday rush, they should survive in the long run. If YRC does not survive, the impact should not be immediately felt, as the extra capacity in the industry would be able to cover their freight; however when freight demand does increase, their exit would be an impetus for rate increases.
- 2) **Ocean Freight: Six to 12 Percent Savings** - Through the rest of this year, import traffic is expected to be weak due to the slow peak season. The traditional slump that is seen after the holiday season should allow for shippers to have an

extended sourcing season compared to the four- or five-month window that has been seen in past years. The two busiest ports in the United States have been down for almost two years now. This year alone, the Port of Los Angeles is down 16.3 percent year-to-date, and the Port of Long Beach is down 18.3 percent year-to-date. In the latest Port Tracker issued by the National Retail Federation and HIS Global Insight, predictions for year end results have been revised from 12.3 million twenty-foot equivalent units (TEUs) to 12.5 million TEUs. Even if the predictions hold true and the year end results turn out to be better than expected, annual volumes will be down 17.7 percent annually and at the lowest levels since 2003. Reflecting the low volumes, carriers have been aggressive with freight rates during negotiations. However, implementation times have been reduced to less than 30 days, as carriers are eager to move freight as quickly as possible.

While the overall ocean freight industry remains a shipper's market, just like other modes there are several critical items that shippers need to be aware of. Spot rates are extremely volatile right now. As many carriers have right-sized their fleet to meet current market demand, shippers are being forced to pay a premium through spot rates to secure capacity. Even though the peak shipping season is expected to be sluggish, carriers are implementing a peak season surcharge in order to guarantee capacity, since many of the large or mega vessels have been parked in favor of the small, more economical vessels. Additionally, ports are reducing their hours of operation to help minimize losses, which has affected gate times and in turn will affect overall transit times moving freight inland. Lastly, many carriers who negotiated rates in good faith have realized the agreed-upon rates are just unsustainable and have tried to issue multiple General Rate Increases (GRIs). Shippers need to be aware of the validity of their contracted rates, while balancing the relationship with their incumbent carriers and understanding their plight could eventually affect service levels.

- 3) **Small Parcel: Five to 11 Percent Savings** - Similar to other modes of transportation, the small parcel industry has reflected signs of recovery. However, the landscape of the

industry in this category has forever been changed by the recession. The shift from air to ground that originated from cost-cutting methods is trending towards a permanent change, which means air density will not likely return to its highs. Factors that will impact the recovery of small parcel that shippers should monitor include global trade and business-to-consumer shipments. International packages are predicted to grow faster than domestic shipments, but this is clearly dependent on the health of global trade. Low-margin business-to-consumer shipments are showing a stronger growth pattern than business-to-business, which will directly impact carriers' margins. Savings may be eroded from other areas to make up for losses. Despite these factors, the negotiating power will continue to reside with the shippers, but it is important to be diligent and knowledgeable about the factors that will directly affect the recovery of the industry. Shippers should pay even closer attention to accessorial costs, as these charges are how carriers can quickly make up for lower freight rates.

4) **Air Freight: Seven to Nine Percent Savings** – The air freight industry had seen month-after-month decreases, but in the last few months those decreases have dampened. For the first time in several quarters, all global regions saw an improvement in demand in August compared to July. Latin America and the Middle East saw actual increases in demand of 3.9 percent and 3.0 percent respectively, while the rest of the regions saw improvements in declines. Asia Pacific improved month-over-month from minus 9.5 percent to minus 9.0 percent. North America improved to minus 12.1 percent, European carriers improved to minus 14.5 percent, and African carriers have improved to minus 5.1 percent. As freight seems to have stabilized, many carriers have stopped the massive rebalancing of supply and demand that has plagued shippers over the last year. Shippers will need to still monitor capacity, particularly on major trade lanes, but it will be less critical than in the past year. The International Air Transport Association (IATA) has even predicted growth of 5.5 percent in 2010.

5) **Truckload: Five to 10 Percent Savings** – The truckload industry seems to be on the path toward recovery—albeit a

slow recovery. The American Trucking Association's seasonally adjusted For-Hire Truck Tonnage Index increased 2.1 percent in August, which was the same increase seen in the previous month. The overall index stands at 104.1, the highest level since February 2009, yet still almost 10 percent

Additional Active Categories

Category	Avg. Savings	Comments
Dry Bulk Ocean	2 - 10%	The Baltic Dry Index has been declining over the third quarter and is hovering around 2,000 points, which is significantly lower than where the index stood this summer (4,291 points). Two major factors are affecting this industry. First, port congestion in China and Australia that had tied up capacity has now been resolved. Second, steel prices have been declining in China, which has caused many steel companies to cut down their production hence the decreased demand for commodities such as iron ore. Analysts are predicting that the dry bulk index will decline even further before it shows signs of improvement.
Flatbed Trucking	2 - 12%	While the truckload industry has shown signs of recent recovery, the flatbed industry is still fluctuating, leading analysts to ponder if the flatbed industry has bottomed out. With recent improvements in the housing industry, the flatbed industry should see some relief. However, the freight levels are still at a record low. Shippers who have contracts that are expiring soon or shippers who have not examined their contracts in the last year should take advantage of market conditions before the improvements in the housing industry cause rates to rise.
Drayage Services	4 - 7%	This industry competitiveness is highly tied to the shipping industry. With trucking and ocean freight shipments at an aggressively low level, the drayage industry has reflected savings for shippers which have been a reversal from historical trends. This industry is regionally focused, so the competitiveness level may differ slightly from region to region. But overall the industry has available capacity. Historically, another key price driver has been driver turnover, and with turnover at an all-time low, this is now a non-factor.

below last year's levels. Many are taking these increases as signs that the industry is back on the right road, even if the pace of increases are moderate. Carriers should expect to continue to see slight increases, and maybe even a few decreases in freight month-to-month, as the economy tries to steady itself. However, analysts are predicting that the road to recovery will be a long one. Based on previous recoveries after economic crises, supply and demand should not reach equilibrium until early 2011. As it stands now, the industry still has excess trucks on the road, and carriers are hesitant to remove any additional capacity for fear that they will not be able to capitalize on market changes fast enough when freight demand does start to pick up. This leaves the truckload market a shipper's market, with shippers in firm control of pricing.

Market Buzz and Trends to Watch

UPS in Labor Talks with Maintenance Workers

UPS is currently in labor discussions over a new contract with its 1,200 mechanics who work on UPS's fleet of aircrafts. Although the workers represented by the Teamsters have overwhelmingly voted to approve a strike, UPS has stated that their vote is typically a negotiation strategy and that the company is not alarmed. The two sides have been in talks for almost three years, several rounds of negotiations have taken place between the two sides, and even more negotiations are scheduled to settle outstanding issues. A strike would be difficult for the union to implement due to the U.S. government classification of the negotiations covered by the Railway Labor Act (RLA) and the National Mediation Board (NMB), which place specific hurdles via unlikely conditions that must exist before members can legally strike. But if a strike does take place, it would affect approximately 16 percent of UPS's 15.5 million daily deliveries that are made by air.

***Ariba's Take:** It is surprising that UPS has allowed these negotiations to continue into the peak shipping season of the fourth quarter. While a strike is not likely, it is not impossible. When the freight industry is clearly a shipper's market, some shippers are alarmed at any risk that may cause a disruption to service, and are quick to put a contingency plan in place that moves freight to the competition. In an industry that tends to perceive that FedEx's core competency is their air freight movements, it is even more surprising that UPS has let this situation linger.*

***UPDATE:** This labor negotiation also calls to mind the labor battle between UPS and FedEx. In last quarter's Ariba SupplyWatch, the battle between FedEx and UPS was detailed out, and many were anxious to see if the Senate would back the House of Representatives and pass the FAA Reauthorization Act—permanently affecting the labor landscape of the industry. The Senate announced that it would not pass the bill by the time the current bill expired at the end of September, but intends to vote on the bill by the end of this calendar year.*

Safety Report Comes Back on Mexican Truckers

The long-awaited report from the Department of Transportation to ensure the safety of Mexican trucks crossing the U.S.-Mexico border has stated that the Mexican trucks' out-of-service rates were similar to those of the United States' trucks. The report states that in 2008, 21.2 percent of inspections of Mexican trucks resulted in taking trucks out of service, while 21.8 percent of inspections of U.S. trucks resulted in trucks being taken out of service. During those inspections, 1.2 percent of Mexican drivers were taken out of service, while 6.9 percent of U.S. drivers were taken out of service. One item that was highlighted in the report was the lack of consistency in reporting of traffic convictions incurred by Mexican truck drivers. Although the inspections were done in the same manner in which Canadian drivers are compared to U.S. drivers, some groups have questioned the validity of the inspection process, since the inspections mainly took place in U.S.-Mexico commercial zones instead of randomly throughout the U.S.

***Ariba's Take:** Earlier this year, Congress chose to end a Bush Administration-sponsored test of long-haul trucking between Mexico and the U.S. Many argued that the program needed to be ended due to safety concerns, yet this recent report would indicate that Mexican truckers are at least as safe as domestic truck drivers. This report does make one ponder the true reason for the cessation of the program. Was it because of job protectionism? Was it due to the recession? Were there safety issues that this report doesn't reflect? No matter what the true reason was, it's hard to deny the results of the DOT's report, and the industry should be eager to see what type of program the Obama Administration intends to promote.*