

Uncertainty abounds

BY JOHN PAUL QUINN, CONTRIBUTING EDITOR

A confluence of economic circumstances has caused the transportation industry to cast a cold and watchful eye on rate forecasts for the coming year. While top industry analysts have been reluctant to quantify predictions, here's what their gut instincts are telling them.

At the onset of 2007, nobody was predicting oil prices of \$100 a barrel, or the cataclysmic implosion of the U.S. housing market, or the precipitous decline of the dollar—and no one could have guessed how dramatically these occurrences would impact virtually every sector of the transportation industry.

The most troubling aspect of all this is that it's not likely to abate significantly anytime soon; and this is a matter of grave concern to the transportation community. So much so that a number of consultants and industry analysts have been reluctant to quantify in terms of percentages or hard numbers the rate picture for 2008, preferring to treat each market sector in terms of its own unique supply and demand situation.

With regard to the economy in general, there was growth of some 2.5 percent, and this is expected to be repeated this year, down from the 4 percent realized from 2004 to 2006, according to James Haughey, director of economics for Reed Business Information, *Logistics Management's* parent company. Most economists predict at best a weak performance overall in 2008, and some have started to use the dread "R" word, saying that the U.S. is dangerously close to the brink of recession.

"This doesn't bode well for any part of the freight transportation industry," says Paul Bingham at Global Insight, an economic and financial analysis firm. "The only companies continuing to do well are those that handle export traffic because shippers have become much more competitive in overseas markets due to the weakness of the dollar. But even in exports they're also exposed to rising costs if their operations are currency-exchange based."

But the single most threatening problem for carriers and shippers that surfaced in 2007, and one that's expected to continue through 2008, is the fuel surcharge issue. "This industry cannot absorb another increase in fuel charges

such as we experienced in 2007," warns Ted Scherck of The Colography Group, a research and consulting firm specializing in expedited transportation markets. "If you took the 2006 rate of increase and doubled it, you still would not have half of the charges that hit last year."

Brooks Bentz, a partner who oversees supply chain and transportation at Accenture, agrees: "Fuel prices will never go down significantly; there will only be adjustments and fluctuations. Shippers have to think more about alternative ways to move product."

Given the intricate interrelationships of all these problematic elements, and the overall uncertainty as to how they will play out, the only way to estimate what the transportation rate picture may look like through 2008 is to examine the industry sector by sector; so, let's take a closer look.

TRUCKING: RATES STILL ON THE SOFT SHOULDER

After years of under-capacity and driver shortages, things changed significantly on the roads in 2007. With the economy generally down and residential construction in particular still in rough shape, there has been a notable slackening of building material shipments to the big-box retailers. And obviously, with few new homes being built, there has been a consequent drop in household furnishings and appliance deliveries.

Another industry whose woes have affected the trucking business is automobile production. Sales declined in 2007 and are expected to do so again this year. This means a falloff in delivery of assembly parts to the factories and finished autos to dealers.

However, according to Global Insights' Bingham, with all these shipments curtailed, the driver shortage has slowly become a non-issue. "Since many drivers also periodically work in construction and gravitate toward where the income is, they are back in the driving force since they can't find work in home building," he says.

Trucking was one of the few sectors in which shippers enjoyed notable decreases in rates in 2007—in both truckload (TL) and less-than-truckload (LTL). Bear Stearns & Co., which tracks transportation sectors on a quarterly basis, reports a continuing decline in truckload activity, with no sign of any change in this trend.

"For the most part, the industry greatly underestimated how much trucking rates would fall last year," observes Paul Svindland at AlixPartners, a global restructuring, consulting, and financial advisory firm. "Shippers saw

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reductions of as much as 7-13 percent in TL, and 5 percent or more in LTL," says Svindland. "And for 2008, all indicators point to more of the same with rates staying in place or perhaps declining a bit more. I don't see a pickup in the trucking business until sometime in 2009."

He advises shippers that while rates should stay in line through 2008, they should make sure to cover themselves on the above mentioned fuel component and try to negotiate a reasonable buffer on surcharges, noting that if the pump price goes up 10 percent that could translate to a 3 percent increase in total cost for shippers.

Bingham at Global Insights believes shippers will be more successful in rate negotiations on the TL side, since LTL is a more consolidated industry—and with less competition they have more leverage in maintaining their pricing levels.

RAIL AND INTERMODAL: RATES REMAIN ON THE RISE

This was the sector that saw the most noticeable rate increases over the course of 2007.

According to David Jacoby of supply chain consultancy Boston Logistics, there were instances of shippers being hit with 20-30 percent hikes last year, and captive shippers saw rates double. Railroads still have constrained capacity and their management and shareholders will be reluctant to retreat from the rate increases they imposed last year.

Regarding intermodal, Jacoby sees rates going up this year from 7-10 percent because of strong demand for the service. "This need will continue, especially in the mini-landbridge area," observes Jacoby, "and railroads are not going to give up intermodal rate hikes—and Wall Street isn't expecting them to do so."

Bentz at Accenture expects long-term growth for both rail and intermodal because of their continuing penetration of intercity freight moving; and it's difficult for trucks to compete on price or service, especially on the cross-country lanes from the West Coast to the Midwest.

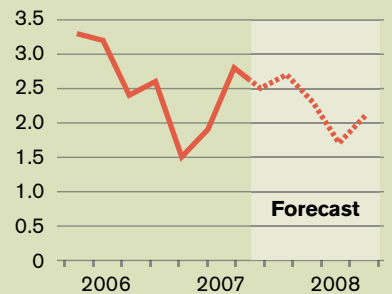
However, Svindland at AlixPartners suggests that the high rates imposed in 2007 were in many cases linked to the renewal of steamship contracts with intermodal carriers, which are now in place. He adds that with the overall softening in the U.S. transport market, there could be some rate reductions passed on to rail and intermodal shippers.

OCEAN: SEA ROOM TO NEGOTIATE

The only transport sector that has had soft pricing for three years in a row has been container shipping, according to Philip Damas, research director at Drewry Shipping in London. He points out how heavily weighted the intermodal portion of shipping from Asia to the U.S. interior is, noting that it costs a shipper about \$1,800 to move a container 7,000 miles by ship, but another \$2,000 to get it from Los Angeles to Chicago via intermodal.

GDP growth will slow to 2.2% in 2008

(percent change* in real GDP)



* % change from prior quarter at annualized rate
Source: Blue Chip Economic Indicators (Dec. 2007)

Damas says he expects ocean rates to increase by \$100-plus per container during the course of 2008. But given the expense of intermodal transport, he believes more shippers will be inclined to consider using either the Suez or Panama Canal routes and bring their goods into Gulf or East Coast ports. As a matter of fact, studies by Boston Logistics indicate that Asian traffic through the Suez Canal has been steadily increasing since 2001, topping 1.8 billion TEUs in 2006.

Another significant element in making this decision is the fact that the International Longshore and Warehouse Union's (ILWU) contract is up for renewal this summer. The last time this was being negotiated it resulted in the 10-day lockout of West Coast ports

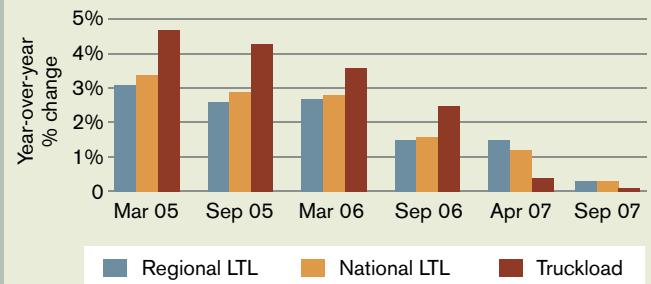
in 2002. However, while the situation bears watching, few observers believe there will be a repeat of the deadlock since both sides learned the hard way that the tactic diverted traffic—and in the process shippers gained experience in rerouting their cargo to East Coast ports.

With regard to capacity, there is plenty afloat and more on the way. Shipyards in Asia are working on 12,000-TEU-class vessels and larger, and there is no sign of existing fleets being retired. So in turn, rates are expected to be weak through 2008. "Shippers like the larger retailers can try to negotiate price on the basis of their own lessened volumes," says Bingham. "But they should expect the steamship lines to counter with arguments about already low rates and higher fuel costs, so a standoff could develop."

In terms of maritime transport, another option that many shippers are now considering is the short-sea alternative. This will probably become progressively more appealing as a means of cutting back on long-haul trucking, according to Bentz at Accenture. He foresees coastal links from Houston to Savan-

Shippers expect capacity, softer demand to slow LTL and TL rate hikes

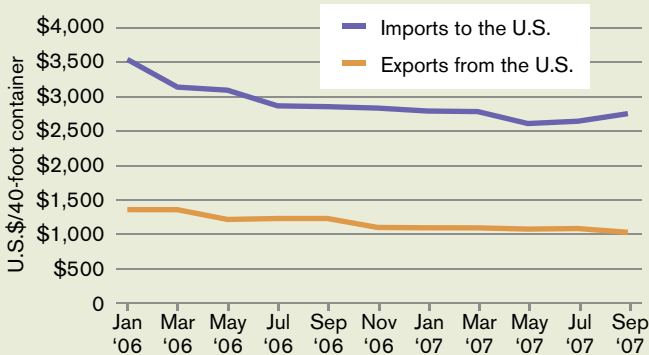
(Shippers' expectations for changes in LTL and TL rates [excl. fuel surcharges] over the next 6 months vs. the same period in prior year)



Source: Morgan Stanley *Freight Pulse* surveys conducted Sept. of each year

Container freight rate for U.S. imports and exports

(all-in port-to-port rates in U.S.\$ / 40-foot container)



Source: Drewry

nah, Charleston to Newark, and an increase in the barge traffic between Boston and New York.

AIR: NO BREAKING THE CYCLE

Shippers have learned from experience that air freight rates go through an annual boom-or-bust cycle. "The air carriers make their big scores from August to Christmas during peak season," observes Accenture's Bentz, "then rates hit rock bottom at the beginning of the year and slowly build toward the next holiday period."

There is little likelihood this pattern will change, Bentz adds. He advises that shippers should avoid shopping for rates and try to establish a stable relationship with a carrier or carriers in order to even out the wide rate swings, even if this means paying a little more during off-peak in order to be assured of a more reasonable price in high season.

Bingham at Global Insights suggests that shippers may be able to realize better rates if they deal with freight forwarders who buy wholesale space with passenger carriers, as opposed to dealing with pure air cargo companies. But the unavoidable problem with negotiating with air carriers is that their largest single operating cost is the price of fuel, a cost they insist they must pass on—and there is no sign that situation will change this year.

PARCEL: THE TIME TRADEOFF

Since 2001, significant portions of the air parcel business have migrated to ground transport, observes Scherck at Colography, with shippers basing decisions on what the real time of arrival has to be.

Over those years, he says that shippers have learned that they need to take a hard look at their product delivery schedules and decide what goods could arrive by the end of the day rather than by mid-morning; or, if the distance was within 500 miles, what goods could be trucked overnight.

Scherck urges shippers to continue to reevaluate their shipping timetables. "Remember, there is a good chance that probably only 20 percent of your product needs to go by air and the rest can move on the ground," he says.

But Global Insights' Bingham, warns that while the published base air parcel rates of industry leaders DHL and FedEx are not likely to be raised because of the intensity of competition, these companies may attempt to bundle in charges for ancillary services such as information systems linkages or customs brokerage.

In terms of rate stability, this is likely to continue, especially with the U.S. Postal Service joining DHL, FedEx, and UPS in this arena. This will be the first full year that the post office will be operating free of regulatory limitations and can compete with commercial carriers.

According to Scherck, no rate wars are anticipated and none of the players are expected to try to buy market share with predatory price cutting. He suggests that shippers would be better off to make their parcel shipment decisions on the basis of which carrier is most efficient at the type of delivery they need most, whether it be short-haul, intermediate, or long-haul.

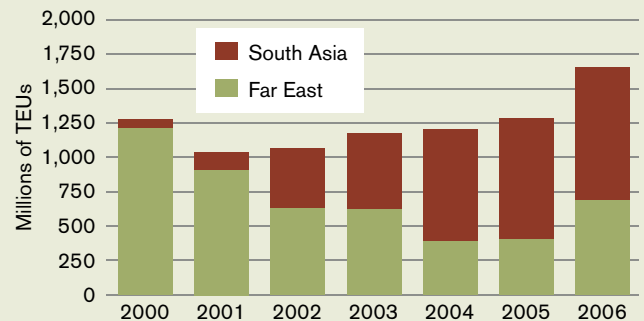
2008 AND BEYOND...

Despite the challenges currently facing the transportation industry, it can be argued that there are some positive aspects that can be found amidst all the uncertainty.

"Whenever an industry finds itself in a position like this...hit with fuel surcharges, supply chain interruptions, a domestic economy on the ropes, and global unrest the order of the day...people start to rethink the way they're doing things," observes Scherck.

He argues that this period is similar to the Y2K situation when there was an acceleration of capital spending earmarked for a couple of years into the future. This spending was one of the prime causes of the recession in 2000 that was then followed by 9/11. "These two events compelled carriers and

Traffic through the Suez Canal



Source: Suez Canal Authority, presentation to China Trade conference, July 2007

shippers to move into time-definite regional package distribution centers, an evolution that would normally have taken a decade," he says. "Necessity is the mother of invention, and economic forces and increased costs may be driving us to re-engineer current supply chain models, and may take us to the next step in deployment strategies."

John Paul Quinn reports on a broad range of business topics for journals in the U.S. and Europe.