The right price

Deregulation of electric power is relatively new. This summer, power traded on the spot market reached $7,500 a megawatt-hour — more than 200 times the normal price. One of the reasons for the spike in price was a series of bottlenecks in the nation’s transmission grid. I wonder if other asset-based, network-operating industries were taking notice.

Price and network capacity constitute critical issues for many in the transportation industry today — railroads and steamship lines in particular. Even in an environment of fairly low interest rates and relatively inexpensive capital, companies are maintaining that rates must rise to support investment and infrastructure growth.

This will be difficult because, as the Trans-Pacific steamship lines have discovered, shippers take rate decreases for granted and rate increases personally.

Ten years ago, the intermodal industry undertook a study to determine actual shippers’ views. The Intermodal Index (as the study came to be called) showed that service, transit and reliability were the key factors for selection. Price was always somewhere on the list, but most customers claimed it was only a minor selection criterion.

Many industry observers attempted to rationalize these results. To the more cynical industry observers, this was an example of the disparity that often arises between polling numbers and actual voting results for an unpopular candidate or measure. To others, the feeling was that price was further down the list because the industry was in a period of relative overcapacity and shippers “knew” that they could command whatever rate was needed.

The spectacular success — and equally spectacular failure — of People’s Express supported this view. A low-service, low-cost airline was able to compete successfully with the high-service, high-cost airlines. However, once Bob Crandall was able to modify the fare structure so that American Airlines could appear as a high-service, low-cost airline, People’s Express was doomed. When price was not an issue, service became a tie-breaker.

Nevertheless, there is some evidence in today’s marketplace that the relatively low priority ranking of price to shippers may finally come to pass. Trans-Pacific carriers are finding an import market so strong that rates are actually being raised. Customers are resorting to a variety of price increases in order to ensure themselves equipment and space. In fact, the rate increase seems so precipitous, sudden and selective that the Federal Maritime Commission has convened an emergency hearing to review allegations of profiteering.

In the domestic market, rail intermodal customers are increasingly turning to truckload carriers. Although the price increase is severe, the service improvement is great. Most intermodal marketing companies have included truck brokerage in the service menu offered to their customers. Most have found it to be the fastest growing segment of their business.

I would propose that there are two forces driving such a change.

First, for many items — especially those in retailing and manufacturing — transportation cost as a percentage of the delivered cost is very small. An increase will not dramatically affect the price of goods sold.

Second, chief executives have become much more familiar with logistics and distribution issues. As supply-chain management awareness increases, it becomes obvious that cheap transportation procurement does not necessarily result in inexpensive logistics. Furthermore, in this strong economy, a lost sale is a much bigger problem than a transportation price increase.

Increasing rates in a strong economy and a capacity-constrained market is not difficult. Maintaining the increases is. The problem lies with cyclical transportation demand and capacity additions.

Asset-based transportation companies have a high degree of fixed costs. The theory has always been that given the possibility of moving assets empty — whether a vessel, train or truck — a load at low rates (that contributes to fixed overhead) is preferable to nothing.

On the other hand, pricing all traffic at such incremental levels will not allow for reinvestment. Investment has its own set of problems. Capacity is often introduced in large segments that result in temporary overcapacity.

Once again, the temptation to price “aggressively” to fill this new capacity is strong. This is especially true if senior management have received assurances that the new capacity will be immediately filled.

It is often difficult to prevent spot pricing from becoming the norm. Customers get used to the lower rates. Sometimes, a spot action will invoke contractual one-too provisions in other agreements, causing a cascade of rate reductions.

Pricing will surely be getting a fair amount of scrutiny in the immediate future. Customers will continue to be torn between the immediate benefit of lower rates and the long-term viability of their carriers.

Regardless, if investment provides capacity that improves service, the resulting network can continue to provide competitive service into the future — and we all will have won.

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