Stage is set for mergers

Reform act will expose ship lines to market. Some will adapt, some won’t. Look for intermediaries to do fine, but future looks bleak for conferences — and for carrier alliances.

By Theodore Prince

The Ocean Shipping Reform Act will mark a major change in the fortunes of liner shipping companies. It will prove beneficial for some, fatal for others. But for all it will be traumatic.

The steamship industry has a ways considered itself somehow different from other industries, and outside the laws of economics. It has relied upon the traditions of the Phoenicians, who 3,000 years ago established practices that some seem to feel should continue for another 3,000.

Liner shipping companies are asset-based, network-operating companies. They are not immune to economic forces, and can expect to see the same trends that emerged post-deregulation in similar industries.

Economies of scope and scale

Regulations, as part of its mandate to protect over-capacity, often limited service scope. Service providers realized that economies of scope were at least as important as economies of scale. Being large was important, but so was providing service across an entire market. U.S. trucking companies found they had to offer 48-state service. Airlines and LTL truckers developed hub-and-spoke networks to provide scope while achieving scale.

Most steamship lines have already recognized the need to be global carriers. There is a difference between adopting this as an operating plan and successful commercial implementation of such a strategy. Cost economies of scope and scale are illusory without a corresponding commercial strategy to translate these into gains in revenue — and profitability.

Industry consolidation

Industry consolidation predates deregulation, but the need for economies of scope and scale inevitably accelerates the trend. Consolidation can take the form of merger, voluntary market exit or bankruptcy. In the case of bankruptcy, the assets don’t disappear — they are taken over by someone at a much lower cost base. This can allow the acquirer to price at a level that might drive other competitors into bankruptcy.

In line with economies of scope and scale, industry consolidation will drive out middle-tier and niche carriers. With very few exceptions, a deregulated industry becomes the land of the giants.

This trend — obvious in other deregulated industries — is already evident in liner shipping. Carriers are merging to become larger, global carriers. Lines serving niche markets are being swallowed up. If Australia cannot survive as a niche market, what trade can? Several mergers have given indications that intended economies have not been achieved. Rather than admit failed strategies, these companies may merge yet again, in pursuit of the elusive economies of scale.

Vertical disintegration

Historically, deregulation has required carriers to examine vertical integration — producing all the necessary components of the product. Many of these services were not part of their core competency, and quality declined while costs soared.

Deregulated carriers have been forced to consider alternatives. Railroads purchased “power by the hour” and outsourced locomotive maintenance and repair. Airlines divested themselves of catering subsidiaries and outsourced baggage handling.

Steamship lines have many opportunities for vertical disintegration. Divesting terminal operating subsidiaries represents an excellent opportunity. Outsourcing inland operations is another opportunity. In an industry where everyone wants to be second, but nobody wants to be first, the first line to take the step will achieve a competitive advantage. Although the advantage may be short-lived, it may be the difference between survival and extinction.

When market forces are unleashed on a protected industry, many assets with physical life remaining prove to have no economic life. This is the case with electrical utilities today. Fully 20 percent of producing capacity has been determined to be uneconomic in a free marketplace. Railroads had the same problem with low-density branch lines.

This is a real issue for steamship lines. Large vessels bought at the peak of the market may

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prove a devastating financial burden. These assets don't disappear, they just get recycled at a lower cost basis. (i.e., When U.S. Lines went bankrupt, Sea-Land bought the Econoships for less than 20 percent of their cost.)

This will also become an issue for ports. Facilities built for cost-based pricing may not survive with industry consolidation. Stranded port assets would probably lead to port debt default.

Customer needs, free markets

de-regulation forces companies to address customer needs. Rather than getting customers to buy what is being sold, companies must produce what customers want. This change often is very difficult.

Successful, deregulated transportation companies have had to develop staff who are commercially equipped to respond to these requirements. This meant that senior management had to recognize this need — or be replaced themselves.

Today's steamship lines resemble the U.S. railroad industry of 30 years ago. Sales remain largely focused on relationships based on entertainment. Marketing means pricing,conference activity (always a customer pleaser) and producing statistics — usually months out of date. It is a commercial void. Since most lines fail to recognize that the industry is fundamentally changing, most carriers will initially fail to fulfill customer requirements and will fall back on more traditional methods — including price competition.

The reality of a free market may also prove difficult for many ship lines. The current situation in Asia has underscored the fact that cronism and political influence are poor substitutes for real competition. Many lines will fail to realize, until it is too late, that they have missed their opportunity to obtain business.

When railroads and trucks were deregulated, carriers and customers had to learn about deregulation together, since there was no experience. Today, almost 20 years later, customers understand its benefits and how to use the tools to their best advantage. There are no rules other than what is agreed upon.

Some steamship lines pretend that experience in their other trade lanes will prepare them for commercial freedom in the U.S. trades. Wishing won't make it happen. Lines will be hard-pressed to respond to customer demands for terms that don't even exist today — but that customers require. Consider the following: ocean rates are a combination of factors that are valid for various time periods, but usually no more than a year. Customers may demand an all-in rate valid for multiple years. Steamship lines may well respond with a “deer-in-the-headlights” panic.

Global reach, local touch

While ocean transportation is a global business, customer interface is a local activity. The successful ocean carriers will be able to meld both aspects into a true multinational company. For many shipping companies, this may be impossible simply because of their national origins.

A truly global company stations people around the world based on the needs of the company — including customers. For example, a company serving the U.S. market, dealing with Americans throughout the world, needs American nationals stationed in key locations. Excluding U.S. carriers, this is not the standard in the shipping business. The nationals of the owner are placed around the world as owner's representatives, and they often make no attempt to understand the cultural and business requirements of other nationalities. This may help in dealing with nationals of the same country, but it ignores the global market. The result can be extreme confusion once specifically national issues threaten to interfere with the business.

The communication problem is exacerbated by the EDP Tower of Babel common in most shipping companies. The lack of a global information system makes it almost impossible for a line to serve customer requirements seamlessly across a geographic spectrum.

The end of conferences

To achieve passage of the legislation, shipping-reform supporters had to win the endorsement of the non-believers (mostly European and Asian lines). They did this by promising continued antidumping immunity for conferences. This was a brilliant move, as reform backers effectively used a meaningless concession to win a tough negotiation. The fact is conferences are doomed — and no legislative tinkering can preserve them. Up until now, conferences have been able to survive by a variety of means, but confidential contracts will eliminate all of these tricks.

The history of conferences shows us that conferences first prohibited any agreements involving traffic outside of their trade, including global contracts. Shipping reform will result in customers signing global contracts with carriers.

Second, conferences never addressed service issues. The benefit of a conference contract was the ability for a customer to sign a contract with multiple carriers in the hope that at least one or two lines could support their requirements. Customers will now be putting “service” back in service contracts. Specific contracts, tailored to individual customers, complete with incentives and penalties, will eliminate the need for multiple-line contracts. Even if customers decide to go with more than one carrier, they certainly won't need conference contracts.

Third, conferences enforced consensus by using intimidation. If a line strayed from the group position on a specific issue, it was threatened with retaliation on other traffic. With confidential contracts, a line can respond to customer initiatives without fear of conference punishment.

Some steamship lines feel that discussion agreements will replace the conference system. The success of the Transpacific Stabilization Agreement in raising Asian-to-U.S. rates this past year has given them a false sense of security. In fact, discussion agreements will disappear for all the same reasons as will conferences. Confidential contracts will deliver the final blow.

Alliances are fragile

Current alliances are extremely fragile, and in the next two years they will most likely disappear as mergers remove the need for them. The five or six existing alliances will be replaced by five or six surviving steamship lines that have merged,
acquired or absorbed the other lines.

The alliance system will probably be remembered as a ridiculous phase in the industry’s history. Unlike successful alliances in other industries, steamship alliances have been operating-based instead of marketing-based, with much of the need arising from the lines’ inability to fill space on the new mega-vessels. Lines have turned to their competitors to help fill the space, a move clearly not beneficial to customers. Further, because these alliances were formed with the understanding that they were finite in duration, no significant cost reduction or asset rationalization has been realized. Inevitable industry consolidation will end this charade.

Intermediaries will do fine

Many steamship lines have cheered the apparent demise of NVOCs and other ocean transportation intermediaries. The belief is that the NVOs’ inability to enter confidential service contracts with shippers will reinforce the power of lines and shippers’ associations. Deregulation in other industries would indicate otherwise, as would industry requirements.

NVOCs will be successful tomorrow for the same reason they are successful today. They can provide what steamship lines cannot. They offer sales and systems with a global scope and a local touch. This requirement will not go away; in fact, it will become even more valuable in a chaotic industry.

NVOCs offer a range of services beyond ocean freight. While their ocean freight rates must be filed, the real value add will be in other services such as consolidation, brokerage, consulting and supply-chain management. All of these services will be governed by confidential contracts.

Interdependent ecology

The industry is entering a period of great change. Ecologists have shown that a modification of any part of a food chain effects significant change throughout the chain.

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Free market is one that has no barriers to entry — or exit. In other words, business freedom is freedom to go broke.

Of the top U.S. motor carriers in 1980, 90 percent did not survive five years of truck deregulation. Pan Am, Eastern, Rock Island and U.S. Lines were venerable names that could not survive industry changes by history alone.

On the other hand, Conrail and Southwest Airlines are evidence that companies willing to take bold action to fulfill customer requirements will succeed, no matter how long the odds may appear.

It remains to be seen if the ocean carriers can overcome their institutional barriers to change and respond to market opportunities. If they can’t, the industry carnage will be great. But a new — and better — ocean shipping product will certainly arise.

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A harsh judgment

In his analysis of the effects of U.S. shipping reform (page 20), Ted Prince writes that the current system of ocean carrier alliances “will probably be remembered as a ridiculous phase in the industry’s history.”

That judgment sounds harsh, but it may prove correct.

The rapid reorganization of containership lines into alliances has been astonishing. Most large carriers have organized themselves into global alliances, sharing ships that provide daily sailings on several key routes.

In announcing these alliances, the carriers trumpet expectations of operational savings, economies of scale and “synergies” — that mushy word so beloved by consultants. And oh, yes, the announcements add, shippers will benefit from all of this.

That’s the problem with these alliances, and the reason many of them will be short-lived. Most current alliances seem designed to solve the problems of carriers, not their customers. Carriers have built huge ships that they can’t fill, so they’ve rushed to find alliance partners to share the space.

In a deregulated market, that approach won’t work. As Prince points out, deregulation puts the customer in charge. Companies must shift from an inward-looking, cost-based focus to an outward-looking, marketing-based approach.

Even if alliances provide operational savings, it won’t be enough to save the carriers that view customers’ needs as an afterthought.

And there’s question about whether alliances will provide carriers with their hoped-for “synergies.” Some of the current alliances appear to be shotgun marriages that won’t last long enough to produce real economies.

So Prince is right in predicting that the current alliances will be followed a wave of carrier mergers. In the long term, that’s not good news for shippers, who’ll have fewer choices. But that’s what happens in a market environment. Shippers wanted deregulation, and now they have it.

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