Vying with vendors

Industry squeezed between shippers’ demands for lower rates and pressures on cost structures.

BY THEODORE PRINCE

This month, United Airlines must make significant cuts to their operational costs to comply with the timetable established by their debtor-in-possession lenders. If United fails to achieve outlined savings, the company may be liquidated. Much publicity has been focused on the wage-and-benefit concessions sought from unions last month. If the company and unions cannot reach agreement, United will petition a bankruptcy judge to nullify existing union contracts as part of its Chapter 11 restructuring.

United’s cost structure is viewed as excessive by many industry observers. The current renegotiation process extends beyond the unions. All companies conducting business with United face this challenge. Airbus North America Holdings Inc., a unit of French airplane manufacturer Airbus Industrie, was named interim chairman of the creditors committee. This committee includes other industrial creditors, as well as equipment lessors. The airplane owners face the dilemma of drastically reducing their lease rates — or trying to place the United assets in a market which is already glutted with capacity.

While economists debate whether we are facing a period of deflation, most companies are finding themselves in a marketplace where they cannot increase prices to their customers. In some cases, prices have fallen due to increased — and often global — competition. The Internet and e-commerce marketplaces have made it easier for companies to find alternative sourcing options.

In most companies, external purchasing — of either specific components of production or of outsourced service — represents the largest source of spending. According to Mercer Management Consulting, these costs may account for two-thirds or more of operating costs for manufacturers to one-third of costs for service industries. Reducing outside spending can affect dramatic profit improvement. Mercer estimates that a 5 percent reduction in sourcing costs can be the equivalent of a 20 percent increase in sales.

Struggling auto manufacturers have seen the benefit of such reductions. Carlos Ghosn, the Brazilian-born president of Nissan Motor Corp., has almost miraculously transformed that company, in part, by applying tough sourcing practices he learned while working at Renault. Such hardball tactics do not always work. Consider one of the more bizarre examples, which occurred at General Motors in the early 1990s. Jose Ignacio “Inaki” Lopez de Arriortua was brought in from Europe to reduce sourcing costs. Before leaving for Volkswagen, Lopez reduced costs more than $4 billion by tearing up contracts and employing methods that enraged suppliers. When vendors started threatening to stop working with GM altogether, chief financial officer (now chief executive officer) Rick Wagoner offered a gentler
approach to retain cost savings and vendors. Wagoner understood that the institutional expertise retained by the vendors offered an invaluable asset to GM. Furthermore, extensive engineering research and development, essential to the product line, was now performed by the suppliers.

Today’s mass retailers have not been shy about using their size to demand lower costs and favorable terms. Suppliers and carriers who are awarded core carrier status by mass retailers love the steady volume it promises, but are haunted by concerns that their bid rate was too low.

The development of logistics awareness has certainly impacted our industry. Many retailers realize that revenue growth can be achieved through developing exclusive products in conjunction with suppliers. Faster time-to-market, and the desire to avoid stock-outs, also contribute to increased supply chain cooperation. Still, operating cost reductions are never far away. Just-in-time and vendor managed inventory (VMI) are often utilized to transfer the financial burdens of inventory carrying cost, warehousing and damage to the supplier.

These are some of the obstacles that are increasingly viewed as part of the basic costs of doing business. But customer loyalty and longstanding relationships may no longer be relevant in this faster moving economy. In many cases, when a contract expires, the incumbent is offered no special consideration in the contest with all other contenders. Although an incumbent may be invited to match the best bid in order to retain the business, this practice is increasingly viewed as a cynical ploy to extend (and lower) the bidding yet another round.

Although the incumbent may argue that there are “switching costs” inherent in a transfer of business, some further price concession is inevitably offered. In a 1999 Harvard Business Review article, Danny Ertel observed, “Without realizing it, many companies have systematically taught their customers the art of blackmail.”

One basic problem between shippers and providers may be underdeveloped negotiating capabilities. Each negotiation is viewed as a distinct event — unrelated to all the other transactional relationships that exist. Additionally, despite talk about forging partnerships with key vendors and customers, the success of a negotiation is increasingly measured by whether or not the lowest cost was achieved. Relationship building rarely — and barely — plays a role.

All of these vendor issues have direct impact on the transportation industry. In fact, most transportation companies face these matters daily. Carriers’ customers are constantly seeking lower rates — and this includes other transportation companies.

Transportation companies are increasingly finding themselves amidst a deflation/inflation paradox. Retailers and manufacturers are seeking lower transportation rates, yet in many cases, carriers are seeing inflationary pressures on their cost structure. Two of the most serious reasons are fuel and insurance. Some carriers may impose fuel surcharges, which offer a trailing recovery — carriers are always playing “catch-up.” Margins are continuously squeezed as prices rise. Increased pressure is placed on working capital because receivables are increasing. Insurance has been a problem for several years, and many carriers are simply doing with less coverage. (Some customers may find this a false economy in the event of carrier mishap and insufficient coverage.)

Safety is also diminishing carrier margins. Regulatory mandates imposed without government funding increase operating costs. Enhanced security may slow down the system and affect operating throughput — increasing average costs. As transportation worker security becomes more rigorous, there may be a smaller pool of acceptable job applicants — which will drive up labor expense further.

Fuel surcharges are now generally accepted. Customers can usually justify the variance to their management. But many carriers find that customers, accustomed to cost reductions, have established budgets that offer no increase at best. In such a situation, carriers — like all
suppliers — must decide whether to meet the market (and protect the business) or risk losing it.

In the past 20 years, transportation expense has decreased in real dollar terms. Deregulation, technology and consolidation delivered significant efficiencies that have been passed on to customers in a win-win world. The new challenge will be to resolve commercial relationships where one side is constantly paying more.

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