 Parties of the third part

Working smarter may eventually pay off for transportation intermediaries.

BY THEODORE PRINCE

One lesson emerging from the rapid meltdown of Enron is that trading services does not necessarily make money. It now turns out that the only way Enron could make a small fortune was by starting with a large one. Enron’s problems spread to their now defunct auditor, Arthur Anderson LLP. The implications of this saga even extend to the transportation industry.

Enron underwent a dramatic transformation from an asset-intensive company to one which sought to distance itself from its pipeline company past. Anderson was a global service organization providing its product for a wide variety of clients. The transportation industry, too, involves a wide range of participants. Some are asset-based carriers providing service through a network-operating format, while others serve customers without hard assets, relying on softer assets, such as knowledge, technology and qualified personnel.

Several factors contributed to the development of these third parties. Financial restructuring, which began in the early 1980s, drove the trend of outsourcing non-core business functions. Most companies have three business components: attracting and retaining customers, developing products, and operations. Financial reengineering forced companies to turn over functions that could be done less expensively to outside entities. Such outsourcing was often accompanied by personnel reductions and balance sheet enhancement. Carrier growth and transportation deregulation offered improved — but often increasingly complex — transportation solutions.

Other factors led to accelerated outsourcing. Globalization of industry required companies to conduct business worldwide. Once companies acknowledged the heightened demand for information technology solutions, they quickly found they could not realize their targeted results without help. Finally, economic softness forced companies to increase outsourcing.

There are some barriers (e.g., capital and technology) that prevent entering the outsourcing business. That is why some non-asset-based carriers are attracted to a simple business model, which resells service of asset-based carriers. Intermodal marketing companies and non-vessel operating common carriers provide the best examples of this. Years ago, these companies proliferated due to the limited barrier to entry. Anyone with a phone and established shipper relationships could — and did — enter the business.

Carriers supported this “wholesale” approach to actual customers out of economic self-interest. They enjoyed volume growth without having to provide extensive field sales, customer service or door-to-door transportation. Carriers found the expense — as well as the difficulty and commercial risk — could be outsourced. Many carriers felt they could retain the business by supporting a variety of these intermediaries so that even if one lost the business (to another wholesaler) the carrier would keep the volume.
Although the concept was sound, these resellers would often compete among themselves on price — and the carrier frequently found itself competing against its own interests, as the same business was “won” at ever-lower prices. Carriers who wished to deal directly with actual customers sometimes found themselves up against their former intermediaries.

It is interesting to observe recent developments in this area. In intermodal, U.S. railroads are sending conflicting messages. They are modifying their product offering so that equipment management (and risk) is shared with the IMCs. In fact, several IMCs have become legitimate asset owners (e.g., Hub), or asset owners have added an IMC offering (e.g., J.B. Hunt). Meanwhile, even though railroads have consolidated into a handful, new IMCs still continue to enter the market — usually started by people who previously worked for other IMCs.

In the ocean shipping world, NVOCCs and freight forwarders continue to proliferate. The successful ones have tried to transform themselves into specific industry specialists (e.g., chemicals or perishables) or to broaden their spectrum of service offerings. Global scope is paramount as sourcing moves to more remote locations. Logistics support, customs brokerage, and freight financing are services that can only be provided by strong companies with highly qualified people. Financial strength for non-asset companies is important — as evidenced by the implosions of several well-known intermediaries (e.g., WorldPoint Logistics.) Information technology is also crucial. When U.S. Customs implemented the 24-hour advance loading requirements, several lines found they were unable to meet the requirements — but their NVOCC customers were.

Any discussion of the challenges currently testing freight transportation intermediaries is helped by a brief look at other transportation modes. The airline industry offers several intriguing parallels. Perhaps the most interesting one involves the changes affecting travel agents. Similar to forwarders and shippers agents, these entities formerly managed the confusing transactional interfaces between customers and the actual carriers, and they profited from commissions paid by the carrier. Last year, Delta Air Lines entirely eliminated travel agent commissions for tickets sold in the United States. This was the ultimate conclusion of a trend started in 1995, when airlines first imposed a $50 commission ceiling on domestic tickets.

While e-commerce Internet transactions may not have become as widespread as was originally expected, they have proven fairly successful with travel. Disintermediation between customer and carrier has become quite common. Several major airlines formed their own Internet venture, Orbitz, to retain the benefits being earned by Travelocity and other travel Web sites. Hotel chains are planning to do the same.

Travel agents found that cost cutting and efficiency was not enough. Surviving companies have essentially reinvented themselves. This exercise has often involved unbundling various charges previously absorbed by the airline commissions. (e.g., account expense management and per-ticket charges may be billed separately). The reinvention has been accompanied by a strategy of growth — often through acquisitions of smaller, less-profitable competitors.

Transportation intermediaries are following similar strategies. However, the acquisition path is not clearly consistent. Some companies (e.g., Expeditors) have followed an internal growth strategy, whereby existing global providers (e.g., FedEx, UPS and Deutsche Post) have filled specific product niches. They have succeeded, unlike companies such as Fritz and WorldPoint Logistics, which disintegrated in merger chaos which was largely encouraged by investment bankers looking for deals (and fees).

Market relationships may be changing. To date, the social contract between third parties and carriers has been one in which the former sells (to their customer) what the latter wishes to provide. The term “shipper’s agent” might then be better described as “carrier’s agent. Tomorrow, third parties may truly have to help their customers buy not only what is beneficial — but what is necessary. For example, recent IMC business growth has
developed from highway brokerage — not more rail loads.

Ultimately, the intermediary market path may be one that resembles the outsourced logistics business. 3PLs are today subjected to greater price pressure, as services become increasingly commoditized. Meanwhile, professional service firms advocate for more “strategic” 4PLs, which add knowledge value rather than rely on transaction arbitrage. This model may indeed become the standard for transportation third parties. In any event, the good news is that working smarter may finally triumph over working harder in the transportation industry.

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