SEALING THE DEAL

ALTHOUGH CANADA’S SEAL hunting season started on Nov. 15, most seal hunting takes place in late March and early April. This activity generates intense emotions. Greenpeace and other organizations have made it their mission to convey the brutality of seal hunting by displaying images of baby seals beaten to death for their pelts.

Like seal hunters, ocean carriers use a variety of punishing techniques on their vendors — especially in tough economic times. At one extreme is the “clubbing” technique. Lines establish a price-reduction target — 10 percent is a popular goal — and seek to impose their will on vendors. Over time, however, most vendors turn a deaf ear to carrier requests or demands to cut their prices in “the name of partnership.” In the past, such proposals have led to financial distress, and even bankruptcy.

Once susceptible to this pressure, today’s railroads recognize there is basic market inertia. If one ocean carrier loses business, another will carry it, so price reductions (to attract or maintain market share) are unnecessary.

Because only two railroads serve most markets, a 50 percent chance of retention exists. Some may view this as a duopoly exercising market dominance; others understand capacity is constrained and no economic incentive exists for railroads to act like ocean carriers and price services at marginal — rather than average — cost.

This represents a paradigm shift. Seeking line-haul economies of scale, ocean carriers have mortgaged their futures to mega-vessels. But they have frequently “shared” these economies in the form of lower customer rates. Other parts of the transport chain do not enjoy these economies.

In fact, there may be diseconomies of scale. A vendor once explained to me that a customer (a consortium of lines) needed to pay a higher rate because it represented 70 percent of his business — and therefore needed to support his company’s ongoing viability. Individual carriers were indignant that they could obtain lower rates by themselves and they were incredulous that more volume did not automatically translate to lower rates.

There are exceptions. Vendors dependent on cash flow are still vulnerable. Marine terminals that have invested in capacity in a soft market or needing to service high debt costs from an acquisition are willing to price marginally. So are leasing companies facing increased equipment returns.

The rate-vs.-expense challenge is much larger. Amid all the talk of logistics and supply chain management, joint carrier-customer approaches for overall expense reduction are rare. The truly innovative supply chain strategies, (e.g., inventory deferral and distribution center bypass) focused on minimizing overall costs rather than just cutting rates, can be counted on one hand.

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In the face of diminishing returns from the “clubbing” technique, it’s a wonder more carriers haven't turned to the “gunshot” strategy of focusing on specific targets. I suspect a focus on individual cost components, rather than true activity costing, prevents carriers from achieving significant savings.

A classic example is chassis. A pool might provide a chassis for $5 a day; however, a line refuses that option because they have a daily cost of $4. Unfortunately, the line’s chassis utilization is 50 percent, so its actual daily activity cost is $8. The former minimizes the rate, the latter minimizes total expense. Most lines will select the former and miss the true savings from the latter.

Some cost-saving efforts seem wildly misguided. Carriers may negotiate an untenable rate with a vendor — a mechanic’s hourly cost, for example — knowing the actual cost will be much higher because the vendor will just bill more hours for the same work. Carriers will proclaim savings on the rate and ignore the higher total expense of the latter.

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Most carriers with logistics divisions treat their subsidiaries as distinct from the liner business to avoid any hint of conflict. Likewise, most customers treat transportation, warehousing and inventory as separate cost centers. The consultative sell necessary to change the paradigm is either too complex for the existing sales force, or takes longer than the rate renegotiation cycle.

Perhaps everyone is so busy working hard that nobody is working smart. But significant expense reduction opportunities are still possible. The first line to stop repeating the past, and expecting different results, will be the big winner. joc

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