GOING UP!

Volatile oil and diesel prices, capacity shortages, another looming driver crisis, debilitating regulatory uncertainties, and an improving economy have lead industry analysts across all modes to one conclusion: Shippers will have to shoulder some of the burden associated with escalating transportation costs this year.

BY **PATRICK BURNSON**, EXECUTIVE EDITOR

The good news is that an economic recovery is clearly underway, with demand in goods and services keeping pace with the modest predictions *Logistics Management* presented six months ago in our 2010 mid-year forecast. But many analysts say that the overall economic picture in 2011 will begin with a whimper rather than a roar.

For shippers, this means tighter "spend management" when it comes to choosing modes and routing as they'll be called upon to shoulder some of the burden associated with escalating transportation costs this year.

In its most recent survey, the National Association for Business Economics (NABE) projects a sluggish start. "Projections for real GDP growth remain sub-par through the first quarter of 2011, but accelerate gradually through the forecast period," says NABE President Richard Wobbekind, who also serves as associate dean of the Leeds School of Business at the University of Colorado. "For next year as a whole, GDP growth is expected to be moderate."

Wobbekind adds that factors restraining growth include ongoing balance sheet restructuring by consumers and businesses, as well as a diminished contribution to GDP growth from inventory restocking and government stimulus. "Confidence in the expansion's durability is intact, but NABE panelists remain concerned about high levels of federal debt, a continuing high level of unemployment, increased business regulation, and rising commodity prices," he says.

Due to an uptick in consumer confidence at the end of last year, the NABE panel made modest revisions to its economic growth predictions for 2010 and 2011. Real GDP is now expected to advance 2.7 percent (year-over-year) in 2010, a figure with which economists outside of the NABE panel seem to be comfortable.

"While spending throughout the retail industry was varied, it appears that the fourth quarter of 2010 gave us a solid start," says National Retail Federation (NRF) Chief Economist Jack Kleinhenz. "Consumer spending continues to show marked improvement, even though we expect them to proceed with caution."

This cautionary note was also sounded by Chris Christopher, Jr., senior principal economist at IHS Global Insight. "Our worst-case scenario is a 'double-dip,'" says Christopher. "And we don't see that happening. But even our best-case scenario hardly makes consumers want to break out the champagne. It will be a very soft recovery."

Illustration by Chris Gall

FUEL

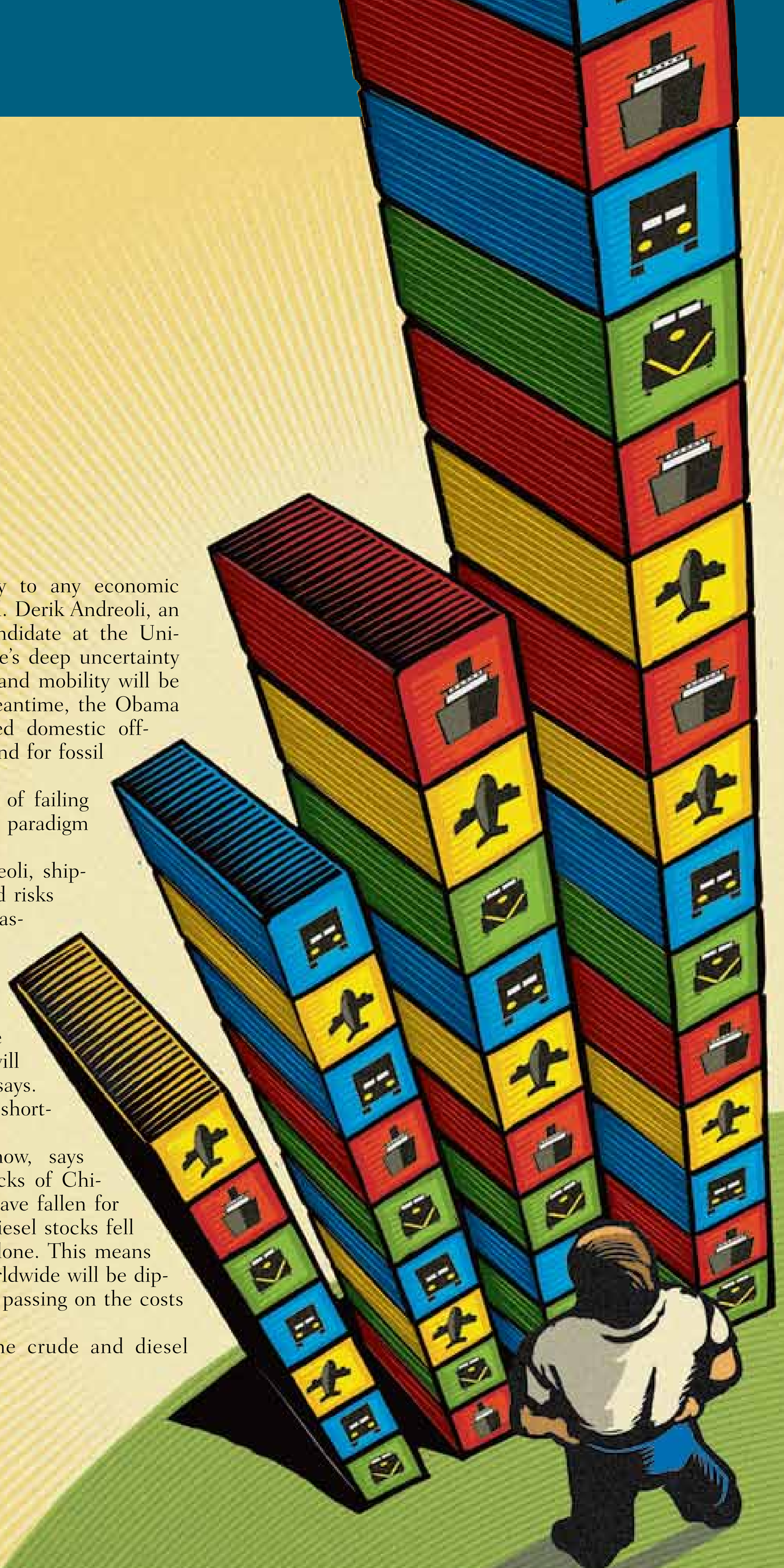
Analysts also agree that key to any economic rebound will be the price of fuel. Derik Andreoli, an energy analyst and doctoral candidate at the University of Washington, says there's deep uncertainty in how energy for power, heat, and mobility will be sourced and paid for. In the meantime, the Obama Administration recently curtailed domestic offshore drilling while global demand for fossil fuels continues to surge.

"The potential consequences of failing to plan for the unfolding energy paradigm could be catastrophic," he says.

At the same time, says Andreoli, shippers must address energy-related risks to supply chains and the increasing vulnerability of just-in-time models. "On my radar, the hot topic at the current moment is China's diesel shortage and how an increase in demand for diesel imports will affect prices through 2011," he says. "It is unclear whether the diesel shortage will reverse in the spring."

What shippers need to know, says Andreoli, is that refined oil stocks of China's two largest oil companies have fallen for eight consecutive months and diesel stocks fell by double digits in December alone. This means that transportation providers worldwide will be dipping into a common well, while passing on the costs to shippers.

Analysts also expect that the crude and diesel



markets will remain volatile due to the fact that the recession and the temporary drop in the price of crude caused some investments in transport assets to be put on hold. Meanwhile, in its short-term outlook, the U.S. Energy Information Administration (EIA) is calling for 2011 crude oil prices to hit $85.17 per barrel, thereby setting a new average.

TRUCKING

Stifel Nicolaus analyst John Larkin agrees that energy markets will be tight, and trucking fuel prices will continue to rise. "I believe the EIA's estimation on the price of oil is accurate, and if the LTL capacity remains restrained, shippers will have to accept the rate range given," says Larkin.

Larkin is among the many industry insiders who believes that capacity will come under even more pressure in the second quarter of 2011, with rates rising by as much as 4 percent. "With manufacturing of durable goods ramping up, it's only a matter of time before there's a surge in consumer demand for things like household appliances," he adds.

Larkin isn't only concerned about fuel and capacity issues impacting rates, however. He also points to pending changes in the current hours-of-service rules as well as the new Comprehensive Safety Analysis (CSA 2010) that many trucking analysts and insiders are predicting could push up to 300,000 drivers out of the current labor pool by 2012.

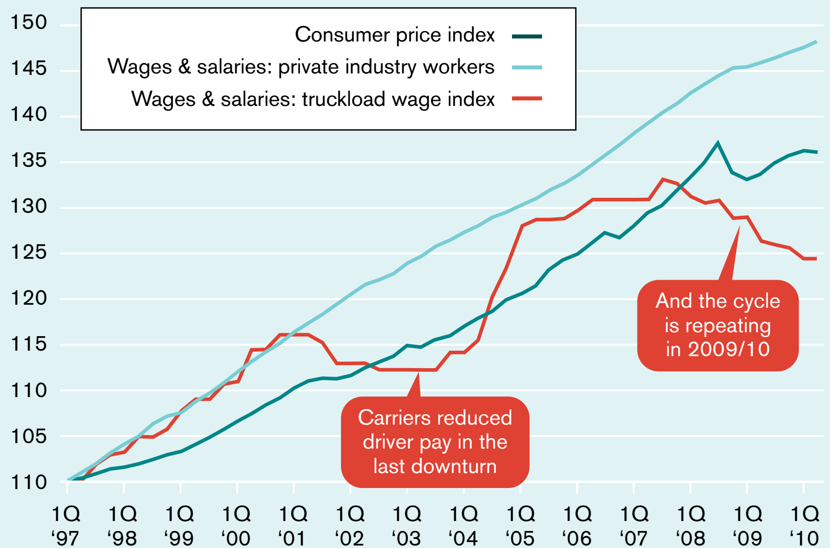
"Taking the hardest hit in 2011 will be the truckload (TL) sector which has more severe capacity restraints on drivers and equipment than the LTL side," adds Larkin.

For Brooks Bentz, a partner in Accenture's supply chain management practice, rumors of capacity issues in trucking are real, but should not push shippers to the edge of panic. "The long-term circumstance is that there's latent capacity in the trucking business that will appear when rates reach a point that make it attractive for that to happen," says Bentz. "This means that those carriers with assets idled by the downturn in volume, or those who have been reluctant or conservative in reengaging those assets, will begin to do so as prices make it an attractive business proposition."

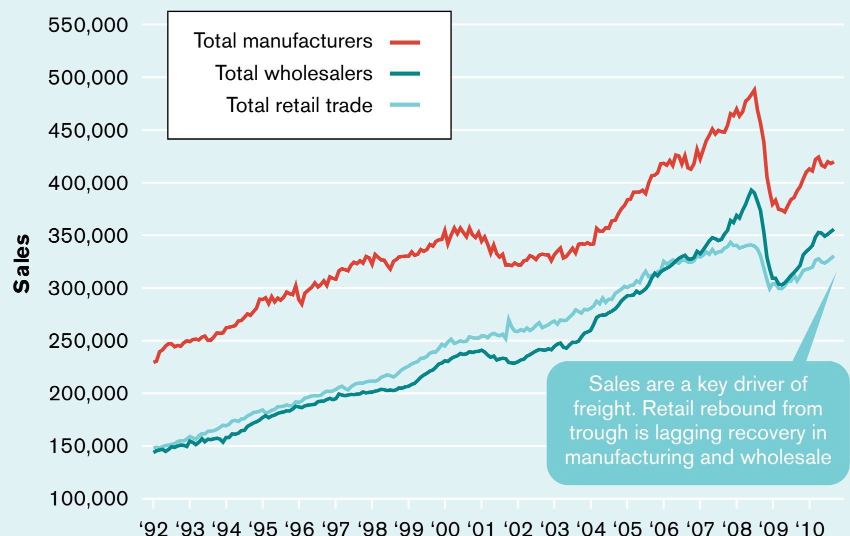
Bentz also notes that trucking has the lowest barriers to entry and the largest number of service providers. "As one of my former colleagues used to say: 'There's always someone new willing to go bankrupt.'"

RAIL

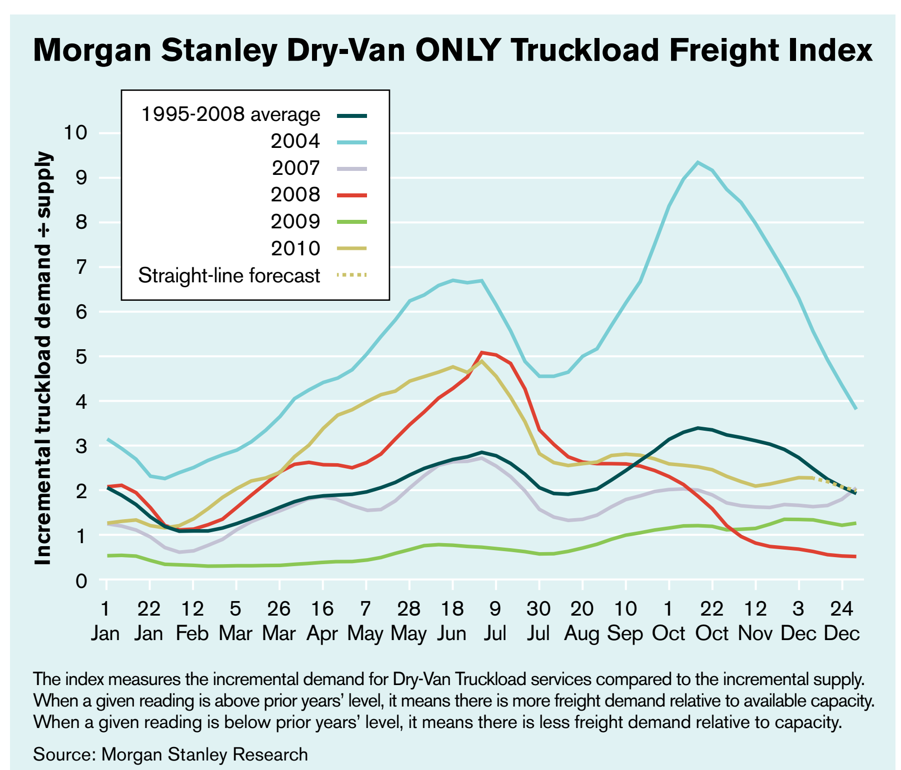
Bentz is equally confident about rail rates, which he sees rising, but



Source: National Survey of Driver Wages and Morgan Stanley Research



Source: US Census, Morgan Stanley Research



The index measures the incremental demand for Dry-Van Truckload services compared to the incremental supply. When a given reading is above prior years' level, it means there is more freight demand relative to available capacity. When a given reading is below prior years' level, it means there is less freight demand relative to capacity.

Source: Morgan Stanley Research

not steeply. "The large-scale unfunded mandate to implement Positive Train Control (PTC), coupled with the requirement to upgrade and expand network capacity, is going to require significant infusions of capital that are beyond the present ability of the carriers to privately fund entirely on their own," he says.

Benefits associated with PTC—such as increased fuel efficiency or locomotive diagnostics—bring added expense, Bentz adds, noting that wireless data systems contribute to operational cost. The consequence could be somewhere in the range of a 3-percent to 4-percent rate hike.

Anthony Hatch, principal of New York-based ABH Consulting, a transportation and financial advisory, says that shippers are considering adding rail service and "wallet share" to ensure capacity in the next cycle. "It will also reduce overall logistics expense, guard against another fuel price spike, and comply with coming carbon emissions changes," says Hatch. "Rail is on a modal share upswing, and shippers need to be ahead of the coming wave if at all possible."

However, Hatch says that domestic intermodal growth is entirely dependent on a higher level of service than the rails have ever shown before. "The railroads have proven that they are up to it, but not on a consistent basis," he adds. "Service levels are also the key to making investors happy, not just from above-GDP volume growth, but by creating operating leverage and making regulators content."

AIR CARGO

Air cargo shippers may expect to begin bearing some of the burden of higher fuel rates early this year, say some analysts. "There's no question that escalating prices for fuel will be passed on," says Charles Clowdis, managing director of transportation for IHS Global Insight. "And having managed their capacity well during the downturn, carriers can get the money to cover their costs."

Still, even when carriers raise rates by 2 percent to 3 percent, their margins will remain thin, he adds.

Unlike the ocean cargo sector, says Clowdis, capacity can be reintroduced without much retooling or redeployment. "Air carriers are using the same avionics and equipment parts," he says, "so getting a plane back in the air is not as tough as getting a ship out of the mothball fleet."

Over the course of 2011, Clowdis says that large volume air shippers may mitigate some of this cost by chartering dedicated freighters when they can. "Right after last year's Black Friday, American Eagle began using a direct flight from Shanghai to Pittsburgh," he notes. "Not every major retailer can get away with that kind of strategy, but if the demand is there, it's worth looking into."

And as of right now, demand appears to be surging. According to The International Air Transport Association (IATA), while the U.S. is spending more to boost its economy, Asia, outside of Japan, is barreling forward with high-speed growth, and Europe is tightening its belt as its currency crisis continues.

"The picture going forward is anything but clear, but for the time being, the recovery seems to be strengthening," says Giovanni Bisignani, IATA's director general and CEO.

OCEAN

Along with improved collection of floating bunker and inland fuel charges, all of the major ocean carriers are poised to hike rates by a significant margin in 2011.

Indeed, vessel operators comprising the Transpacific Stabilization Agreement (TSA) have "suggested" rate increases of $400 per 40-foot container (FEU) for cargo moving to U.S. West Coast ports and $600 per FEU for all other cargo are likely to be imposed by May 1, 2011.

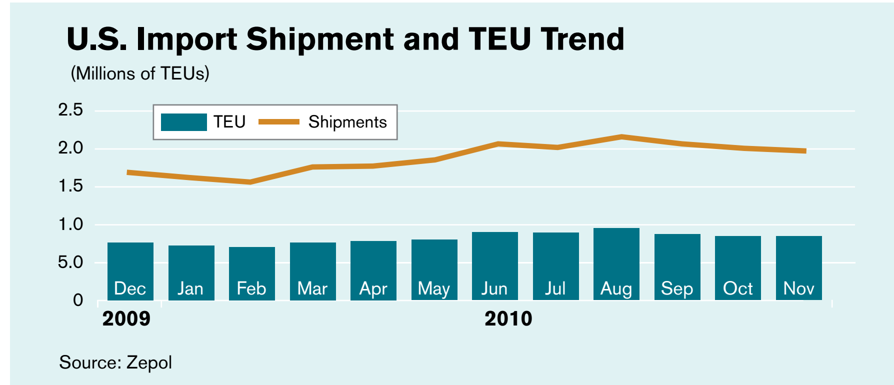
"It's unfortunate that this is being done before there can be any change to the Shipping Act," says Michael Berzon, outgoing chairman of the National Industrial Transportation League's (NITL) ocean cargo committee.

The Shipping Act of 2010, introduced

by Rep. James Oberstar (D-Minn.), would abolish carrier antitrust immunity and prevent carrier executives from convening so-called "discussion groups" used to formalize rate strategy. Unfortunately, for shippers, Oberstar failed to win re-election in last November's election and there's considerable doubt that the Act will be resurrected in 2011.

"Carriers can raise rates in lockstep now, without any concern that such behavior represents a violation of antitrust laws," says Berzon.

TSA lines have further recommended full recovery of costs for other equipment sizes, and as well as Panama Canal, Alameda Corridor, and other fixed accessorial charges. This comes at a time when the cartel admits that it has had "healthy revenues" over the past two quarters. Still, they say, an early end to the transpacific peak season has left that trade lane lagging relative to other Asia container markets, while operating costs continue to rise.



Late last year, carriers called for adjustments to store-door delivery rates as warranted to levels that adequately compensate carriers for rising costs in providing those services.

Finally, TSA is recommending a peak season surcharge of $400 per FEU, effective from June 15, 2011, through November 30, 2011, with those dates subject to adjustment based on changing market conditions.

Can shippers mitigate this cost escalation by relying on "all-water" deployment to U.S. East Coast ports? Most analysts don't believe that's a long-term fix. "It might pay off tactically, but it would be a bad strategic move," says Jon Monroe, president of Monroe Consulting in Shanghai. "Shipping through LA/Long Beach is always going to be the fastest route to interior markets in the U.S."

And with volumes still moving strongly out of China on head-haul routes, other analysts maintain that the rate hike will stick. "This would indicate that global trade has made a surprisingly speedy recovery," says Neil Dekker, an analyst with London-based Drewry Shipping Consultants Limited. "And this has allowed ocean carriers to re-deploy laid-up tonnage and work new-builds into their core east-west services with relatively few problems."

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PARCEL

Arguably, no other supply chain sector reflects the nation's economy better than the small package industry. And according to Jerry Hempstead, president of Hempstead Consulting, there are only two players in town. "Fedex and UPS control the domestic market completely; and as a consequence, expect the rates they demand collectively," he said. Indeed, both carriers have already announced hikes of 4.9 percent for 2011.

Furthermore, Hempstead says, both carriers closely monitor the pricing practices of the other: "So if UPS Ground announces a rate increase, it's closely followed by our friends in Memphis, and vice versa."

Of greatest consequence to shippers in this year, says Hempstead, is the way both carriers are calculating dimensional charges. Beginning this month, the dimensional weight will ramp up to 47 pounds and the rate will rise to $109.91.

While the increase seems reasonable when factoring in the fuel surcharge, says Hempstead, it represents a whopping double-digit hike. "The increase you're paying over your current charge is actually 18.7 percent," he says.

Hempstead is also alarmed by the duopoly's new position on third parties, which is quite simply to ignore them. "Today, if the shipper has employed a third party parcel negotiating company to work on their behalf, both FedEx and UPS will walk away from the deal," says Hempstead. "They can afford to do this now if it makes a statement."

Which means, he adds, that this in turn signals at least one positive perception: The nation's economy may indeed be on the mend. □

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