WHITE PAPER

Logistics Management Solutions

The Prescription for a Healthy Freight Budget

A White Paper on how to cope as rising transportation costs threaten your bottom line.

Over the next two years, changes will take place in the transportation market which will yield challenges for motor carriers. To meet these challenges, the carriers will pass on cost increases to the shippers they service. This White Paper addresses how shippers can overcome the threat of rising costs to meet and maintain a healthy freight budget.

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The Prescription for a **Healthy Freight Budget**

Over the next two years, changes will take place in the transportation market which will yield challenges for motor carriers. To meet these challenges, the carriers will pass on cost increases to the shippers they service. To a certain extent, the factors that will drive the steep rise in transportation costs are beyond the control of carriers and shippers; but that will not be an excuse to not be prepared.

This White Paper outlines today's environment, what to expect in the future in regards to price escalation and price volatility, and how to modify and meet your current budgets to maintain a realistic approach for your organization.

The Threat on Your Freight Budgets

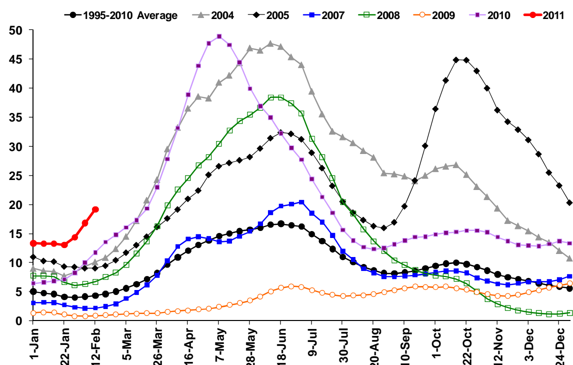
Never before have we witnessed as many issues all hitting at one time that are outside the carrier's ability to control the cost of managing their business as we are seeing now. With respect to carrier increases, shippers are just beginning to see the effects of what we refer to as the "reality of rising costs." What we mean by this is that it costs more to run a truck today than it has in the past; and it will cost more to operate a truck in the future than it does today. When you couple this with the fact that the carriers have restrained their capacity, you have an environment in which the carriers can more easily pass along these increased costs in the form of higher rates. We look for this trend to continue over the next two years.

There are three primary reasons for the impending strain on shippers' transportation budgets: The transition from a buyers' to a sellers' market; the sudden and steep increase in the price of fuel and the escalating costs of acquiring and maintaining equipment; and transportation legislation.

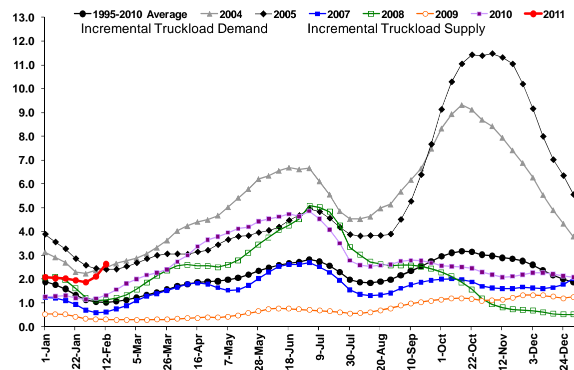
A SHIFT IN THE MARKETPLACE

We have moved from a recession in 2009 to beginning to see growth in the overall economy in 2010 and 2011. In 2009, carriers were in survival mode, offering service rates just to cover their variable costs. Carriers closed terminals and rationalized their facilities, equipment and personnel to survive. As we see the economy recover, and new business becomes available to the carriers, we have not seen them replace what has been depleted to any great extent, and as a result we are experiencing tightened capacity for all shippers. Their long term financial viability is dependent upon their ability to recapitalize the business.

The Morgan Stanley index indicates tighter capacity than in any recent year during Q1 for flatbed truckload services. Capacity is not as tight as Q2 2010 for dry van truckload services, though capacity is expected to tighten throughout 2011. The indices measure incremental demand for flatbed and dry van truckload services compared to incremental supply. The higher the index, the tighter is capacity relative to demand when compared to a prior period.



Morgan Stanley Truck Load Demand vs.
Supply Index 2/11/11 (Flat Bed)



Morgan Stanley Truck Load Demand vs.
Supply Index 2/11/11 (Dry Van Only)

Source: Morgan Stanley

Carriers are cautious about reinvesting in their infrastructure. They learned a very impactful lesson during the recession – too much capacity without corresponding revenue is a recipe for disaster. Carriers are not making investments without the appropriate levels of profitability (yield) to support their investments and they are now walking away from business in many cases that does not meet these requirements.

The marketplace has changed. Every major transportation Index points to increased freight demand and tightened carrier capacity; it has shifted from a buyers' to a sellers' market in which the carriers seek to earn more for their services, all while combating the pass through cost of rapidly rising fuel and the increasing cost of acquiring and maintaining equipment.

RISING FUEL AND EQUIPMENT COSTS

With respect to fuel surcharges, shippers are once again (similar to 2008) likely to experience significant increases as the price of fuel continues to escalate. As of the end of January 2011, the price of diesel had risen about seventy six cents ($0.76) in one year. It is entirely probable that for the remainder of 2011, the cost of diesel will continue to rise well above the Department of Energy's projected 2011 price of $3.43.

Many companies establish their freight budgets for the following year in the third or early fourth quarters. One of the key variables that companies use to budget for fuel surcharges is the projected price of fuel for the upcoming year. Many companies rely on the Department of Energy's (DOE) projected fuel numbers for the upcoming year.

Here is the problem: **The month in which you looked at the DOE's estimate will have a huge impact on your budget.** The projected annual number for fuel in September, 2010, was $2.96 per gallon. During the interim period between September and January 2011, there have been 4 revisions, resulting in a current fuel cost nearly 20% higher than the original projection.

The real question is: "How much higher should shippers have budgeted for?" Some large shippers actually budgeted for $4.00 per gallon for the average cost of fuel in 2011.

Projected Fuel Cost for 2011 per the DOE	
Projection Date	Cost
September 2010	$2.96 per gallon
November 2010	$3.14 per gallon
January 2011	$3.40 per gallon
January 31, 2011	$3.43 per gallon

As of February 14, 2011 Diesel is at $3.53,
$0.57 higher than projected in September 2010.

What will $4.00 diesel mean for your supply chain if you budgeted based on the DOE in September 2010? For starters, it would mean an 8-9% increase in your transportation costs over 2010 numbers. Additionally, an increase to $4.00 per gallon will likely result in higher rates to address capacity constraints. Many carriers, particularly small carriers, will have difficulty running their trucks with diesel at $4.00 per gallon.

Adding to the steeply rising cost of fuel, carriers are now grappling with the escalating cost to acquire and maintain equipment. For example, a tractor that cost $82,000 in 2000, cost $118,000 in 2010, or 43.9% more. Consider the EOBR ruling which will require carriers to incur an additional $1,500 – $2,000 one time cost per truck; or civil penalties of up to $11,000 for each offense that violates this EOBR requirement.

REGULATORY LEGISLATION

As noted above, the carriers are experiencing increases in their base operating costs - but that is only part of the story. The tightened capacity that is imposing a risk to freight budgets will soon be followed by the impending legislative and rulemaking environment that will have a significant impact on their operations. In our Supply Chain Tsunami White Paper, we discussed the major initiatives that threaten the cost of service by carriers. These items included:

1. **CSA 2010**, which will reduce the pool of available drivers.

2. **Proposed revisions to the HOS regulations**, which will shorten the drive time. The FMCSA has issued a draft of the proposed changes and is soliciting public comments. The proposed changes in the "restart" period as well as the potential loss of the 11th hour will impact how carriers can run their trucks and further constrict capacity.

3. **A Federal Highway Transportation Bill**. As of this writing, the Obama Administration is promoting a six year, $550 Billion Highway Bill. While the debate over how this will be funded (a.k.a. paid for) has yet to begin, any funding mechanism will make it more costly to run trucks on the nation's highways by imposing increases on interstate taxes and tolls.

4. **The Independent Contractor issue.** Many shippers (mistakenly) assume that this is just a battle over whether FedEx drivers are employees or independent contractors. But if John Kerry's Taxpayer Responsibility, Accountability and Consistency Act, or a ruling by the National Labor Relations Board regarding the card check issue were to become a reality, this would impact approximately 500,000 people who work for transportation companies. Carriers may be forced to incur the cost of personnel taxes and benefits for what were former owner/operators now becoming employees.

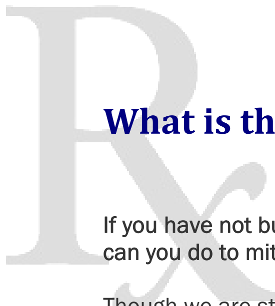
5. **Cap and Trade**, which adds an additional tax on trucks to compensate for consumption of non-renewable energy. This also includes **Clean Air Initiatives**, in which trucks are required to meet more strict emission standards that can only be met with newer, more costly equipment.

6. **EOBRs** (Electronic On Board Recorders) which will add costs for equipment installation and in some cases limit operational flexibility.

Each one of these areas will affect the cost of doing business for trucking companies. In addition to these regulatory categories affecting operating costs, we have the fundamental issue of driver shortage and maintaining qualified drivers. The American Trucking Association (ATA) has its plate full as there are unfortunately no shortages of issues that could adversely affect the trucking industry, and one major event in the Middle East could cause the price of fuel to spike overnight.

Individually, all of these challenges may be palatable. But combined, which is the manner in which these issues will impact the industry, it is going to cost a lot more to operate a truck in the future and will result in rate increases for shippers that will be 15-20% higher by the end of 2012. We understand that most shippers are not prepared for, or in other words, did not budget for **an increase of 10-12% in transportation costs over 2010 numbers.**

If you have anticipated these increases in your budget - fantastic. If you haven't, it would be prudent to inform your senior management of the implications of these market factors, begin to make adjustments to your current budget and address practice changes that can be implemented to secure long term transportation cost stability.



What is the Rx for a healthy freight budget and control over your transportation costs?"

If you have not budgeted for these increases, what is the remedy for an ailing freight budget and what can you do to mitigate the impact of increasing costs on your organization?

Though we are still only in the first quarter of the year, we have facilitated numerous meetings with customers to address their transportation budgets and look at ways to more aggressively manage transportation costs. During these meetings we highlight that there are uncontrollable and controllable variables that will impact their freight budgets.

The uncontrollable variables include for example, the price of diesel fuel, the impact of CSA on the pool of available drivers, and the overall economy. Budgeting for the impact of uncontrollable factors can be a real challenge. How do you budget for the price of fuel, which has risen far beyond what most people predicted as recently as the fourth quarter of 2010? Some companies have established a line item in their financial reporting systems to isolate and quantify the financial impact of these uncontrollable variables. Using this system, they can quantify the extent to which the fuel surcharge exceeds the amount that had been budgeted.

The controllable variables are the practices and processes your company uses in shipping and receiving freight. These processes and practices would include for example, the entire transportation procurement process, sales policies affecting freight costs or decisions regarding prepaid versus collect terms on inbound freight.

Based on experience, we have demonstrated that companies can drive significant savings to their bottom lines by more effectively managing their transportation practices and processes. We mention this knowing that there are two types of companies. The first type of company will accept this advice but continue to operate on a 'business as usual' basis. Perhaps there are more pressing priorities, lack of resources, or a reluctance to change. Whatever the reason, they are adverse to implementing new, valuable practices and processes.

The second group of companies understands that they cannot just continue to go to their transportation providers and demand lower rates. While this strategy (of demanding lower rates) worked in a buyers' environment where there was excess capacity and carriers were desperate for business, ultimately the market, as it has today, turns and the carriers regain leverage. Smart companies realize that if they continue to operate on a 'business as usual' basis in a sellers' environment, they will experience the full brunt of the price increases passed along by the carriers. With that thought in mind, we have some examples of what shippers can do to more aggressively manage their freight costs, and it begins with acquiring complete access to your data.

First, determine where you are before you plan where you are going. Collect the history of your organization's freight spend and your current freight spend. If you have budgeted on a macro basis, it is now critical to get down to the detail and dissect it on a micro level. Understand what you have spent by mode, by facility, by direction, by geography, by size of shipment and by length of haul. Keep in mind - your overall objective is to understand transportation as part of an integrated supply chain view. Align the total landed costs to meet specific department and/or customer service needs.

Next, allocate transportation costs to organizational departments that drive the service. For example, repositioning of inventory because of failure in forecasting or production should be assigned to the inventory planners or the manufacturing budget; sort and segregation charges as a result of the warehouses' inability to perform this function internally should be assigned to the warehousing budget; ineffective production planning resulting in premium transportation modes to fill demand should be assigned to the production planning budget. Put the costs where they belong, charge or identify the department or individual requesting the service so you have an accurate picture of who and what type of transportation is being used.

Finally, challenge the status quo:

1. **Evaluate the design of your distribution network** and whether it meets your market demands; review the number and location of facilities in relationship to your customers as well as your vendors.

2. Assess whether your inventory practices are supporting the initial network design:

   - Are specific products inventoried at given locations to service a specific region?
   - Are you unnecessarily incurring additional transportation expense through inter-company transfer of product?
   - Are you servicing customers from a non-primary location or using premium transportation to meet that demand?
   - Are your suppliers providing you product from their primary designated sourcing facility versus a distant secondary location with a higher freight cost?
   - Are your suppliers behind in delivery resulting in the use of premium transportation that you are absorbing?
   - Are you making multiple shipments to cover one order due to inadequacies of inventory to fill the initial order?
   - Have you explored the use of assembly or pool points?

3. **Ensure that you have carrier contracts with all of your carriers.** The spot market can make anyone a hero in a down market but it will have just the opposite effect in a growing market that we are in today.

4. Monitor compliance to utilize your preferred carrier and mode by shipment. Ensure that you are optimizing your transportation spend.

5. Evaluate your replenishment and sourcing policies to understand the related transportation costs in supporting these policies.

6. Evaluate customer and purchase order size, frequency and cycle time. Determine if there are opportunities to reduce freight costs, by increasing the average weight per LTL shipment.

7. Cleanse your customer and vendor databases to ensure correct ship to addresses.

8. Get off the 'GRI' elevator. Carrier based tariffs are subject to automatic carrier driven annual increases. **Establish a tariff of your own that meets your own needs.** Acquire contracts tailored to your particular freight characteristics and risk management needs, not based on general tariff language.

9. Review packaging to ensure your product is protected from the rigors of the LTL network as well as opportunities to positively affect your product density.

10. **Forge carrier relationships that gain you preferred shipper status.** Open the dialogue; demonstrate an interest and willingness in the way you interact with them through collaborative planning and execution:

    - Understand what the carriers' O/R is for your business and how that compares to their overall O/R.
    - Understand your carriers' need for "yield management."
    - What operational changes could you make that would reduce the carriers' cost-to-serve your business?
    - Expand core carrier thinking to think in terms of key service lanes that are cost effective for that carrier to service.
    - Utilize a freight payment process that provides accurate and timely payments to your service providers.
    - Work with your carrier to minimize pick up and delivery times and detention.

CONCLUSION

It is important to move forward with the following 3 takeaways: First, it is our expectation that it will cost a lot more for carriers to run a truck today than in the past. Second, as carriers' rates increase, the impact on shippers' freight budgets will depend on whether or not companies are willing to consider analyzing and adjusting their supply chain practices and processes. Third, for those companies willing to consider changing/improving their supply chain area, our 10 'R_X for a Healthy Freight Budget' tips will get you started in assessing your supply chain practices.

Hopefully this White Paper will encourage a dialogue within your company that addresses the accuracy of the transportation data as well as the ability to access that data to run, assess and act on detailed diagnostics. In managing your transportation spend, you can't manage what you don't measure, and you can't measure it until you see it, and see it accurately.

For this reason, data visibility is more important today than ever before. We encourage the creation of a consolidated data warehouse that includes transaction data at the shipment level detail for all modes you use. If you don't have this in place already, establish the process or find a service provider who can deliver this.

The best laid plans can sometimes falter without the tools in place to support sustainability. Be sure you have the infrastructure for reliable analytics for items such as comprehensive and accurate cost identification; execution, to support issues such as determining optimal mode and compliance to regulatory and security requirements; and payment and audit to ensure efficient cost allocation to proper business centers and data quality for continual process improvement

We understand many shippers have reduced headcount over the past two years due to the economic downturn. This may leave them without the ability to react and conduct these activities in a timely manner as the market is changing. That's why it is more important than ever to work with a service provider who understands what is going on in the marketplace and has the tools and talent to help you achieve your goals.

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Get started. We can take the first step with you.

TranzAct helps shippers reduce their transportation spend by providing the resources necessary to remain in control:

Freight Audit and Payment services provide timely, accurate payment of your freight invoices and flexible reporting that enables quick and convenient transformation of data into useful information.

Diagnostic Studies measure the health of your supply chain allowing you to make collaborative process and practice improvement decisions.

Customized Tariff solutions will provide you with an optimized base rate that you can present to carriers to negotiate rates that are designed for your organization, making it shipper-centric, not carrier-centric.

Technology offers a logistics warehouse, data mining and performance reporting that delivers actionable information for optimal cost control, process improvement, and overall management of your business.

For more information, or to speak with a transportation guidance expert at TranzAct, email us at results@tranzact.com or contact us at 630-833-0890.