


The Law of Unitended Consequences ... and unrealistic expectations

General Rate Increases (GRIs), changes to accessorials and surcharges, and rating logic changes (like applying DIM logic to Ground service levels) are more important to your bottom line than ever before. Historically, GRIs have served as a way to offset cost increases related to inflation. Since the heat-up of the parcel market in 2002-2003, and continuing through today, the GRI has served also to offset per-package revenue dilution resulting from higher discounts. What this means to you as a shipper is that monitoring your discounts alone is not nearly enough. No longer can you make apples-to-apples comparisons from one year to the next, factoring in only a standard percentage increase.



In late October 2007, FedEx announced a 2008 Express list rate increase of 6.9 percent (4.9 percent adjusted for a corresponding 2 percent decrease in fuel surcharges) – the highest since 2001. Two weeks later, UPS followed suit and announced a similar increase on the Ground side. A recent survey of over 400 shippers conducted jointly by *Parcel Magazine* and Morgan Stanley indicated that shippers expected FedEx Express and UPS Air prices to increase only 1.5 percent and 1.9 percent respectively.

Why were survey respondents, and shippers across the country, unaware of these aggressive increases? It is believed that they based their assumptions on the competitiveness of the parcel market. One theory is that it may actually be that very competitiveness that is driving the unexpected year-over-year increases. In fact, a case can

be made that higher list rate increases should not only be expected, but are, in fact, inevitable. Moreover, a case can also be made that DHL will follow suit with aggressive rate increases for 2008, and that increases for the next several years will be aggressive as well.

In 1985, UPS achieved overnight delivery services to all 48 continental states, as well as Puerto Rico. While the UPS Express network was not sufficient to match the FedEx network, consistent and aggressive investment over the next several years changed that fact. In 1998, FedEx entered the Ground parcel business when it acquired Roadway Package System and the rest of the Caliber companies. Through these and other subsequent activities and acquisitions, the two companies have offered

remarkably similar suites of services since the mid-to-late 90s. Despite the resulting competition between the two companies, both companies maintained disciplined pricing strategies in the years since, with neither attempting to gain market share by significantly underpricing the other. Both UPS and FedEx followed unspoken strategies of selling service, rather than price. This was of benefit to both carriers. As a consequence of these strategies, the limited number of sizable small parcel carriers, and the industry's high entry barriers, parcel prices remained artificially high.

New market entry changes playing field.

The entrance of Deutsche Post/DHL into the domestic parcel market in mid-2003 through their acquisition of Airborne Express (then the third-largest carrier by revenue – though much smaller than both FedEx and UPS), put an end to this happy situation. DHL realized early on the importance of gaining a level of critical mass market penetration. As a result, DHL approached the US market with a slash and burn mentality.

In their drive to gain every package possible, DHL offered prices far below levels palatable to either UPS or FedEx. DHL was at first moderately successful in bringing on new business. From 2003 to 2004, DHL's revenues from North and South America increased

from 4,419M to 6,426M, an increase of over 45 percent. DHL clearly saw that resulting yields were unsustainable. In Chairman Dr. Klaus Zumwinkle's 2004 letter to shareholders, he put it cleverly:

In short, DHL had driven prices below what even a company of their resources could

“... we must continue to work on the success brought by our presence – in the United States. We have clearly recognized the ground we need to make up, and in the coming year we will lay the foundations for breaking even in the USA by the end of 2006. I am convinced that our services not only promote competition in the USA, they also strengthen our customers and therefore our Group in the long term.”

sustain. Possibly more important than the reduced rates themselves is the impact DHL's actions had on the strategies of UPS and FedEx. With DHL undercutting them by double digits, FedEx and UPS could no longer sustain the historically high price of small parcel distribution. Both could claim service advantages over DHL; however, with multiple competitors on most large accounts the result was increased discounts and massive dilution of per package transportation yields.

The era of “discounts”.

The time since has seen ever increasing competitive momentum in the marketplace.

All three primary parcel carriers (DHL now qualifies as a major player) participated in a race to the bottom. In the struggle to retain current business, to say nothing of gaining new business, the carriers seemed to indiscriminately throw discounts at the problem. By way of example, the average

business-to-business FedEx Express discount in 2002 (prior to DHL's entry) was 27 percent. The current average has climbed to 34 percent. As a former carrier pricing analyst, and now as a consultant, this author can say with confidence that these figures **understate** rather than **overstate**

the ever-increasing aggressiveness of carrier discounts. Bear in mind that the survey takes into account small and large shippers alike. It stands to reason that competitive pressures, and therefore discounts, are higher for large volume shippers.

So what does this information tell us?

Carriers' costs rise with inflation year after year. If transportation charges per package are falling, and costs are rising, then the carriers must be eating the difference, right? Wrong.

Average carrier yields continue to rise. The reason for this is two-fold.

- Carrier list rate increases consistently outpace inflation. As such, the impact of higher discounts shrinks year after year (assuming discounts remain constant over the measurement period). For shippers to keep transportation costs flat, discounts would have to be renegotiated every year. Otherwise, the carrier realizes an inflation-adjusted yield increase. General Rate Increases (GRI) are typically non-linear, meaning they do not apply evenly to all services, zones, and weights. The list rates for some services increase more than others – likewise for weights and zones. The non-linear nature of GRIs typically relates to increased understanding or reallocation of the carriers' cost factors.
- Accessorials and surcharges are the next factors. Over the past several years, the carriers have realized effective rate increases higher than the stated rate increases because of surcharge and accessorial changes increases. Let's take, for example, the Ground Residential Surcharge. In 2002, FedEx's Ground Residential Surcharge was \$1.10. The 2007 charge was \$1.85. This represents a cumulative increase of 68.2 percent. Over

the same period, the cumulative Ground list transportation rate increase has been only 17.2 percent.

The fact that carriers are relying more heavily on accessorials and surcharges, as opposed to transportation charges alone, to maintain or increase revenues is not arbitrary. Rather, these behaviors are understandable. Carriers have increased their understanding of what drives their costs of the past several years and are using accessorials and surcharges to pass those costs on to the shippers. However, in many cases, increases in surcharges outpace the increased cost, effectively making these factors profit centers.

What does all of this mean to you?

So we know that the carriers use annual GRIs and accessorials to offset the heavy discounts they offer in a highly competitive market. So what? If you take nothing else away from this article, understand this: Monitoring your discounts alone is not enough.

Changes to the underlying list rates can distort the end result of your negotiated discount programs. Discounts are only one factor in determining your parcel cost year-over-year. The other factors you absolutely

must consider include changes to minimum package charges, to the underlying list rates, to accessorials and surcharges, and to rating logic. Without capturing the impact of all of these factors, controlling your parcel shipping costs is impossible. Discounts are important, but it is important to remember that discounts are only one factor in your overall cost.

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Joe Wilkinson is a Senior Transportation Analyst at enVista. For more information, contact enVista at 877-684-7700 or via email at inforequest@envistacorp.com.