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Ocean Transportation Trans-Pacific Contracting

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Introduction

This paper discusses issues in the trans-pacific lanes surrounding the contractual process for securing transportation services from ocean carriers. The following material is intended to assist the reader in developing a general foundation of knowledge as it relates to the selection of ocean carrier providers and securing the best services for an organization currently procuring products from Asia. While we won't talk about the "art and science" of negotiation, we will highlight areas of opportunity and important details in the process of selecting and creating ocean transportation contracts.

Current Environment

Outsourcing from Asia Pacific continues to be the trend for more and more companies, allowing them to concentrate on their core competency issues of product management, marketing and distribution. However, the transportation of such goods remains a critical piece in the supply chain, as end-of-year volume pressures place more strain on an already stressed transportation pipeline across the Pacific.

The selection of service providers for ocean cargo will be dependent on the configuration of your organization's distribution network, domestic transportation requirements and the type and volume of products sourced. Once you have defined ocean as your primary mode of transportation, the time your products spend in transit has financial implications as well as obsolescence or market timing issues, which all have a direct impact on the value of these products.

Most companies will find that they can contract in two major ways, **self-managed or outsourced**. Selection depends on the level of involvement and management they wish to address throughout the import and transportation management process. The outsourced model and some of its variations, refer to the management of providers that execute all tasks in the transportation process from container equipment positioning at point of departure, inclusive of transportation to container removal at point of destination. However, companies tend to outsource more or less of each step in the transportation process, leading to in-house management for areas such as customs compliance, shipment bookings, freight payment, drayage and container management.

Self-Managed or Outsourced?

The first route is to contract directly with vessel operators also known as Operating Common Carriers ("OCC's"). Under this approach, you are establishing contracts directly with the vessel operators. As such, you will be looking at the availability and frequency of sailings from the ports that you require. A single vessel operator might not be sufficient to cover all your ports nor the frequency of sailings; therefore it is most likely that a combination of operators will be your best bet to maximize the coverage of sailings required, hedging the risk of delays due to missed sailings. Note that by using vessel operators directly, you may gain a lower shipping price, but could incur higher costs in the form of management, as your organization will be in charge of addressing

every step of the shipping process, from container placement at factories, capacity commitments, extraordinary issues and importation procedures. In addition, this route will present very little flexibility, as the services offered by these carriers tend to focus on the core competency of vessel management. However, contracted price through this avenue can be very sensitive to volume; furthermore, vessel operators will be less willing to operate without minimum commitments.

A second route is to leverage the services of Non-Vessel Operating Common Carriers ("NVOCCs"). The roles of these carriers have shifted from the classic consolidation of Less-than-Container load cargo, to becoming more and more, third party logistics providers ("3PLs"), offering a variety of services. There are many advantages for managing cargo via this model, such as reducing the in-house overhead associated with the management of cargo, multiple vendor management and invoicing, as well as simplified points of contact. The overall NVOCC model can help you by having a capable partner to handle unforeseen events; offering a reduction of risk through multiple carriers, and with larger NVOCCs, a larger negotiated floor rate with the carriers.

In terms of the minimum required services from a logistics management perspective, both types of operational contracting model provide cargo visibility. The use of direct vessel operators may lead to multiple Internet portals for specific carriers, as well as certain limitations on inland services, depending on your number of contracts.

The selection of carriers will depend directly on your distribution network and the requirements you impose on the provider. With more and more sales direct from factory, many companies prefer to "float" their inventory and assign it in transit. This re-routing will generally require a full service provider capable of responding to a change in the destination, and capable of delivering to any destination on short notice.

For companies with a large supplier base, the number of outgoing ports from China can be challenging, as each Operating Common Carrier (OCC) will have their own vessel(s) with their own schedule of callings. It is important to consider coverage and frequency of callings for the ports of source. A weekly call at port might be sufficient for sporadic shipments, but when dealing with frequent shipments, it might cause large ripples of volume through receiving procedures and warehouses at destination as containers might accumulate for the next sailing.

RFQ Process

The RFQ ("Request for Quotation") is the document that will be sent to each provider who will bid on your business. The normal season for going "out to bid" is prior to May for an award within the month, when carriers tend to close all their volume planning efforts and lock rates for the following 12 months. The information contained in this document is critical, as each provider will be basing their decision in terms of pricing on each requirement posted in this document.

Key aspects are the volumes committed to the providers, as well as service level expectations. Consider what will happen if your volumes are going to change during the year; either up or down. A sudden increase in volume can cause your provider to be unable to fulfill its commitments given the unplanned demand, but a decrease in volume can leave you exposed to penalties, particularly with carrier direct commitments.

Not only is it important to detail every item required, from points of contact, expectations for procedures and information system requirements, but it is also important to establish and maintain "must have" vs. "nice to have" requirements. Unnecessary requirements can cause the price of the overall service to be higher, as a provider might need to invest to satisfy specific requests.

The selection of service providers will be based on your industry and the specific characteristics of your business. Ports in the Chinese coast are usually centralized around main areas of production such as Shenzhen, in South China. However, many ports and loading terminals around Shenzhen such as Yantian, Chiwan or Shekou can carry the same cost, while allowing better proximity to your specific supplier for a reduced delivery-to-port cost. Your supplier's location relative to the ports will help to determine the carriers calling for direct vessel contracting. Always consider minimizing the transportation costs to port, while selecting carriers with the best service to the feeder ports selected. Some providers

will actually quote based on the South China ports, and add what is called an arbitrary cost, which reflects the incremental cost of providing service from a port, such as Shanghai or Ningbo, to the Shenzhen region.

For NVOCCs, selections are usually based on their capability and experience as it relates to your industry, competitors and similar industries. While large service providers tend to be aligned with multiple industries or are even "agnostic" in terms of specialty, other providers have been historically aligned with certain industries and therefore may be more in line with your industry. This is usually beneficial if the work is in particular regions of China, or even with common factories and manufacturers. Generally full service providers or NVOCCs, will have contracted large capacity, spanning many ports and providers, or at least will have access to such capacity before bidding on your business. However, it is important not to be led away from your preferred ports unless costs are balanced with inland cost reductions.

Certain terminology will be important at the time of rate definition. Specifically, four terms are commonly used:

- Port to port refers to an arranged delivery of cargo, packed, and delivered to the port, where the carrier will receive it for shipment.
- In a port to door transaction, the shipper will arrange delivery of fully packed cargo to the origin port or warehouse facility; while the service provider will

arrange ocean/air transportation to destination country as well as the destination services, which include normal customs clearance; delivery to residence; unpack and removal of debris.

- A door to port service implies the provider will execute all services at origin including pack, wrap and load, with transportation up to the warehouse at country destination.
- A door-to-door shipment is the most comprehensive service, where the provider will execute all moving and origin services, and destination services.

Risk Avoidance

Many companies currently use a variety of carriers to both obtain a suitable mix of services and callings, as well as to mitigate the risk of being centered into one single provider. The use of multiple carriers can help spread the risk of a provider's bankruptcy, deterioration of service or any catastrophic event applicable to one carrier, or any other disruption to their business. This risk reduction comes at a cost, however, which is a de-leveraged negotiation position with each carrier. Carriers in general will establish and maintain their best rates for those customers that work exclusively with them, allowing them some leverage to gain the remaining business that is not in their hands.

While many firms maintain a "bullpen" of carriers in order to manage risk and maintain competitiveness with their supplier base, risk can be further mitigated via the

use of 3PLs that can spread their cargo across many providers. The risk of an underlying carrier going out of business is outweighed by the higher number of carriers or NVOCCs you can keep under contract at any given time. In general, a client who commits to a single 3PL or NVOCC can even negotiate better rates as they work off the pre-existing relationships underlying the 3PL, and, service levels are usually assured as non-performing carriers are eventually pulled off the roster. Conducting business through 3PLs is not always conducive to a lowest cost structure as it relates to market rates. However, operationally, it presents several advantages, such a single focal point for accountability of service, management of all freight forwarding functions and capacity management, which is executed as a core competency.

Given the stress placed on the Atlantic lanes, capacity commitments are paramount to any negotiation. You will want to ensure your cargo is safely booked, and the carriers will want to ensure they maintain planned utilization. Any contract must ensure capacity during peak seasons and times of port congestion and operational interruptions. However, commitments on volume from an ocean standpoint are always difficult to set unless your firm is significantly stable. Commitments can be affected by changes in the supplier base selection, improvements in packaging with their respective capacity utilization effects, shifts in product mix and timing of purchases; all issues not controllable by Transportation Managers.

Certain carriers will go as far as requesting payment of penalties for capacity not fulfilled. If your volume is volatile, ensure your volume commitments are set in ranges to allow for swings in demand that do not negatively affect your committed rates.

In addition to volatility caused by the internal factors of your firm, you may also need to consider volatility from external factors. A common cause of disruption to be considered is labor stoppages, particularly those on the West Coast. Many transportation buyers hedge on this situation through commitments through alternative ports, such as Vancouver, which may be unaffected by US-based stoppages. Such early contractual arrangements will ensure your placement on vessels in front of other customers scrambling to bypass paralyzed ports.

Beyond Ocean

With the increased costs for transportation across all areas of the supply chain, ocean carriers have also identified areas of opportunity and cost reduction. For China-sourced products, your best opportunity for savings is on the ocean lane when terminating your cargo on the US West Coast. United States West Coast terminating cargo allows ocean carriers to turn around their container stock immediately without incurring large costs for the repositioning of vessels, as would be the case with inland cargo. Furthermore, during recent years, increases on inter-modal transportation have hit customers in the range of \$300 to \$600 per FEU ("40 Foot Equivalent Unit"), depending on the inland point and their

ability to negotiate with carriers. Carriers will be more aggressive in chasing this service, as it yields their best asset utilization. Many marketing firms have found that selling products on a collect basis from their West Coast facilities, allows them to mitigate volatility related to inland movements beyond the West Coast for both rail and ground, and instead focus solely on procurement of products and the ocean movement of goods.

While delivering to the West Coast can reduce costs, not all organizations can limit themselves to a West Coast distribution center, especially for those that must provide competitive service times to customers. For companies who can justify dual warehouse models, East Coast warehouses allow them to bypass expensive transcontinental moves and have cargo delivered straight to the East Coast, albeit at a higher cost of transit time. An East Coast location, if suitable to your distribution network, can also help mitigate risks associated to work stoppages on either coast. In general, customers who have booked capacity early will have preference during a work stoppage, so your company will have a better chance of bypassing affected ports re-routing to unaffected locations.

Business Trends

The buy-sell model undertaken by American firms is leading to further efficiency requirements by customers. Shippers have sought low cost jurisdictions for manufacturing, consolidated providers for procurement efficiencies, and streamlining of their supply chain.

In a new effort to create efficiencies, the Direct Shipment or Direct Import models, as they are known in industry, require suppliers to execute ships directly from the factories to the customers' door, bypassing altogether the distributor's network. Such a model forces the provider to deliver anywhere in the US at a competitive price for lanes that may or may not be planned in advance, depending on the stability of your sales demographics. Therefore, you should consider locking in or negotiating in advance your cost for direct delivery for those regions where volume might be seasonal or sporadic. It is easy to leave these "occasional" shipments under a special pricing term, but a sudden change in your customer's practices can leave you with uncompetitive rates for specific customers during the duration of your contract.

Available container sizes range from 20' to 45'. However, the market has shifted considerably to a 40' High Cube Container (for approximately 13% higher cube capacity). This allows shippers to execute freight movements at a lower cost per cubic foot. Container stock is generally available for this type of container, which in general will yield better dollar utilization than the standard 40'-45' containers. These containers, while generally quoted, can suffer sporadic availability shortages as peak seasons ramp up and hence might not be a reliable shipment offering unless specific commitments are arranged contractually.

As it pertains to fuel, the contractual portion of negotiation on this subject has become an extremely complex process. While 2008 begun with a marked spike in fuel surcharges as the price of oil surged, the latter part of the year has been affected with a marked drop in both oil prices and utilization of vessels, as economic indicators have pointed to a marked deceleration of the US economy. While most shippers will seek discounts in their rates, contracts might still be tied to a fuel index to maintain relief for carriers in the event of an economic recovery and price increase in oil.

Accessorial Services

Accessorial services remain a significant portion of the contract and total expenditure. Consider demurrage costs in case of delays due to the release of cargo from your supplier or your own firm. Addressing the capabilities of your provider, in those cases in which your cargo might be delayed due to US Customs inspections or paperwork delays is an important step in maintaining your costs according to plan. While most major shippers are C-TPAT ("Customs Trade Protection Against Terrorism") certified, such certifications are not necessarily a guarantee against high intensity security checks or importation audits.

In addition, consider using services, which bundled may increase the ease of managing your supply chain. Separating brokers from carriers may allow you to negotiate lower rates, but can reduce the accountability of each supplier and introduce an element of finger-pointing that

can be difficult to manage. Ensure that the processes that you deploy between providers at hand-offs are clearly and easy to validate in case of issues.

Payment Terms

Most transportation providers will not be able to provide significant floats on payables, as these are asset intensive types of firms. Direct vessel carriers might have terms ranging from 15 days on pickup to 15 days (at most), upon arrival to port. For inland moves this can translate into close to payment on delivery, or even payables prior to reception. The freight forwarder model usually helps to alleviate some of the pressures of payables, albeit at a cost. Under this model, your broker or customs clearing house will float the payment to the carrier, release cargo, and invoice you from the day of arrival, adding an additional two weeks or more depending on your arrangements. However, these floats can be masked through higher entry costs, so due diligence is always required when selecting this type of model.

Additional Services

Container availability is one of the most important issues when negotiating with your carriers. Assurance of equipment and equipment type are critical to maintaining an agile and responsive pipeline of product. One detail to ensure is the availability of equipment upon delivery. During peak seasons when your warehouse is at top capacity, unloading containers becomes a secondary priority when shipping to your customers. While container stock can help

mitigate the needs for real estate during space crunches, negotiating sufficient time for holding full containers in your warehouse yard can help shift some of the urgency for receiving to periods of overtime when shipping operations have been concluded, or even days later. For example, you may require 12 days for holding a container, which in addition can help reduce costs as it allows you to prioritize the unloading of product.

While material and physical services from a logistics standpoint remain the focus of the service contracted, it is important to consider services alongside transportation that facilitate management of the service and the provider. The carrier's ability to interface with your systems and maintain electronic reporting remains an integral part of the service requirements on providers. Track and trace capabilities have become standard for the industry, and the ability to pinpoint the position of cargo is relatively a standard practice. However, whether your carrier is able to provide you visibility from origin container yards, across the ocean and over truck and rail will be something that not all providers will be able to offer. Given the changing nature and need for reaction for certain shipments, adequate visibility and actionable capabilities throughout the journey is essential to remain flexible to an ever-changing environment.

Contract Management and Metrics

As always management of expectations in terms of pricing, service and overall reliability is the key to maintaining a sound

supply chain and procurement process. Contracts should always include guidelines by which to measure the service expected. The major worry for any importer is to ensure that none of their cargo is “rolled-off” a vessel, a term used to describe a reprioritization of cargo onto other vessels due to capacity. Roll-offs are costly as they impact the supply chain costs and create uncertainty as to availability of product at consumption point. Overall, transit time commitments are the key metric for any contractual agreement. However, measuring the efficiency of your provider can be done across multiple dimensions inclusive of billing accuracy, information transmission accuracy and timeliness, export and import paperwork compliance, cargo classification, and exception handling.

Summaries and Conclusion

With ocean transportation remaining one of the primary channels to market for what is now large percentage of goods on US retail shelves, careful consideration of the management model, contractual terms, rates and fine print can make or break your ability to compete through a flexible and agile supply chain.

The selection of both operational models and your supplier base to support such a model will have effects on your ability to deliver product to customers at a timely and effective manner. As such, careful consideration must be placed on this process to ensure it does not become an afterthought in the product management life cycle for your firm.

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Auxis can help you to adapt your supply chain for the benefit of your customers, business partners, and shareholders through service offerings such as strategic evaluation, sourcing and procurement, supply chain planning, supply chain network design, outsourcing, transportation, warehousing and distribution, and IT supporting infrastructure selection and deployment.

Auxis' Supply Chain team understands that a good plan is only half the story. What really matters is your company's bottom line impact from our work. Just ask our clients how our practical and results-focused initiatives have helped them. Our holistic, practical approach to supply chain excellence results in solutions that transcend business functional boundaries and achieve corporate objectives.

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