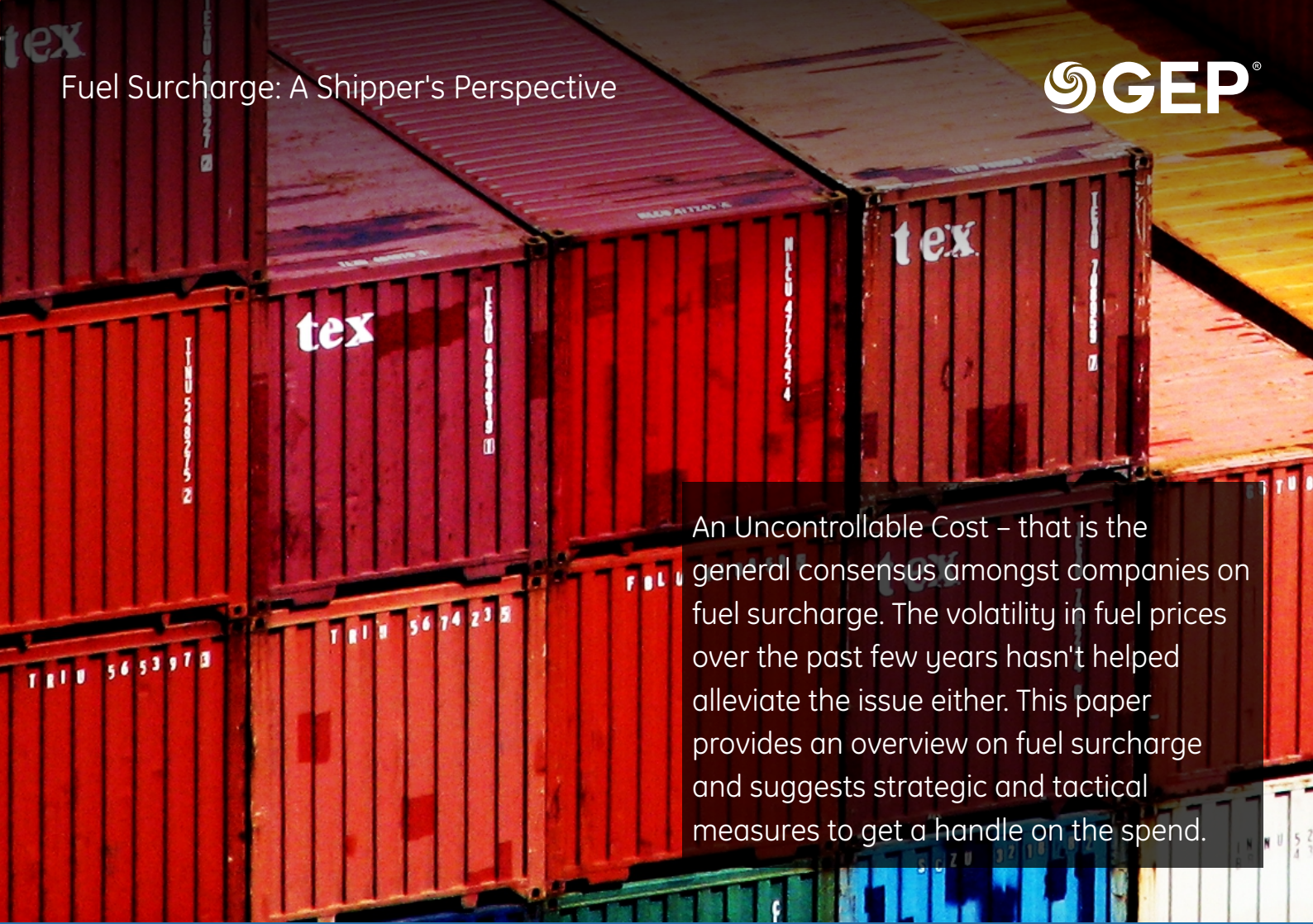




White Paper

Fuel Surcharge: A Shipper's Perspective





An Uncontrollable Cost – that is the general consensus amongst companies on fuel surcharge. The volatility in fuel prices over the past few years hasn't helped alleviate the issue either. This paper provides an overview on fuel surcharge and suggests strategic and tactical measures to get a handle on the spend.

Wal-Mart saved \$3.5 million in transportation costs by optimizing its packaging and thus reducing fuel costs. It has also committed to reduce packaging across its global supply chain by 5 percent by 2013.

Puma with its "Clever Little Bag" concept is aiming at reducing transport fuel consumption cost on the manufacturing level by more than 60 percent per year.

Trucks, bringing about 80 percent of consumer commodities to market, cost about \$1,200 to fill up as compared to \$900 a year ago further increasing the transportation component of the sales dollar.

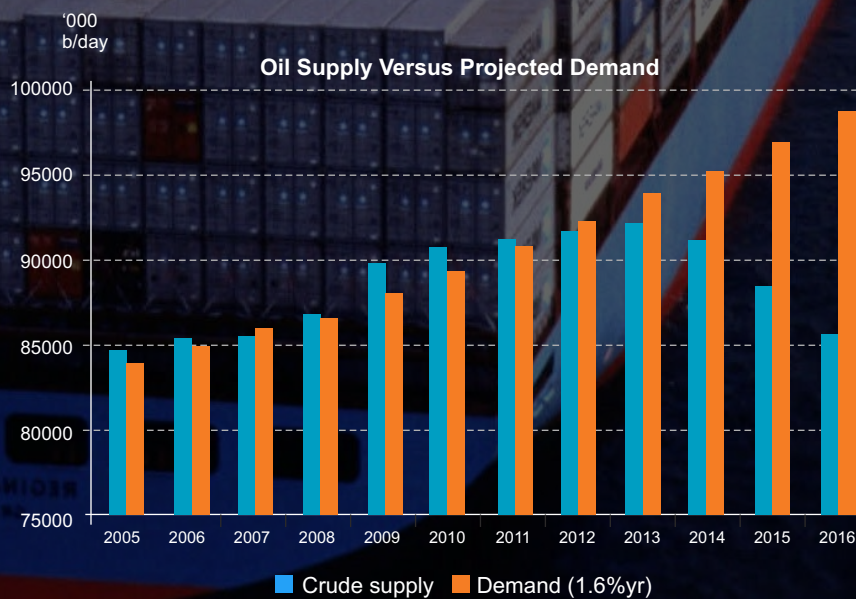
A common theme in these issues is that of spiraling fuel prices. Initially fuel price fluctuation was something a logistics company had to understand and incorporate into its cost structure. A shipper only touched upon the issue during contract renewal or negotiations. However today, with fuel surcharge accounting for nearly 40 percent of the transportation spend, it has become a cause of concern impacting all industries dependant on transportation.

Fueling the Problem

The US Energy Information & Administration (EIA) expects the world liquid fuel consumption to increase by 1.5 million billion barrels per day in 2011. The problem is further compounded by the disruption of oil supply and unrest in Middle East (especially Libya) and North Africa regions contributing to higher oil prices. In the past excess capacity and competition had prevented a large portion of these costs from being passed from carriers to shippers. But, capacity in all modes of transportation is either shrinking or static, and carriers are increasingly passing on their costs in the form of fuel surcharges.

With LTL freight carriers implementing complex variations of fuel surcharge rates based on weight of the goods, distance travelled and other factors, shippers today can no longer afford to ignore the issue and need to proactively seek out opportunities to achieve savings by establishing a greater control on fuel surcharge expenditure. GEP suggests a two pronged approach consisting of both strategic and tactical measures to mitigate this rise in costs.

Figure 1: World Oil Demand & Supply Scenario



1.A Solution Framework Addressing Fuel Surcharge

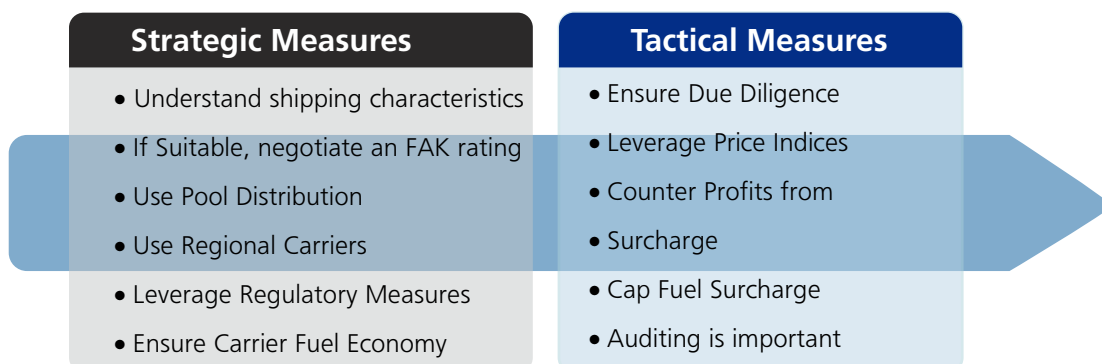


Figure 2: Solution Framework for Fuel Surcharge

1.1 Strategic Measures

By collaborating with the carriers, a shipper can analyze and determine ways through which he can ensure appropriate shipment charges and thus a lower fuel surcharge cost.

For LTL and Parcel carriers we have observed fuel surcharge percentages range from zero to 44 percent of the total shipment charge. Unlike the TL segment the fuel cost with LTL and Parcel carriers is largely driven by freight charge, freight class i.e. the lesser your freight charge, the lesser the fuel cost portion. The higher your freight class, the higher the freight cost, hence the more you pay for fuel as determined by a percentage of the shipment cost.

In case of a scenario where the shipper is unable to renegotiate a “per mile basis” fuel surcharge terms with the carrier it is imperative for the shipper to ensure the following

1. Lower freight cost
2. Appropriate freight class classification
3. Fuel Consumption Efficiency

1.1.1 Understand shipping characteristics

Develop a profile of your outbound and inbound shipping including the number of marketing orders, shipped orders, packages shipped, back order rates, ship alone, historical order and package shipped volumes by month with seasonal peaks and valleys, etc. The level of service used (e.g. next day, 2 day or ground), zone distribution, weight distribution, growth projections by year for three years. Many times there are assumptions made which prove flawed and change the actual versus budgeted costs. The carrier will have their own data collection forms but these are the types of data the carriers will use to develop your pricing proposal and estimate their profitability. By analyzing this data, you may also determine the opportunities for improvement.



Figure 3: Developing a Shipping Profile

Developing a Shipping Profile

1. Analyze the current per-unit costs of in-bound and out-bound goods, including the impact of mode changes for each segment
2. Understand the seasonality of inventory requirements
3. Analyze the impact of overall inventory levels and changing order volumes
4. Analyze the inventory and transportation costs as a per cent of sales for each major business unit
5. Ascertain qualitative aspects such as customer presentation and packing requirements, and delivery service requirements

Once these are in place, the approach would be to analyze existing carriers, identify their strengths and most efficient lanes, and then match-up with the shippers' existing distribution pattern. This would help achieve efficient freight cost and, thus, lower fuel surcharge cost. It would also help determine where the various methods fit into the shipper's strategy. For example, it would help the shipper determine which mode of transport (small package carriers, LTL, truck load, air freight, rail, consolidators or USPS) would best fit the strategy. Shippers can also determine whether there is an opportunity to leverage inbound and outbound strategies with the carriers.

1.1.2 If Suitable, Negotiate an FAK Rating

Shippers should negotiate FAK (Freight All Kind) rating. FAK negotiations allow shippers and carriers to agree on either a single commodity classification, or tiers of classifications for their product. Companies that ship different classes of freight can better negotiate a set class with a carrier, irrespective of the actual class of the freight. FAKs can offer huge savings as freight is frequently reclassified by a freight carrier, resulting in higher pricing adjustments.

1.1.3 Use Pool Distribution

Another effective strategy that GEP has successfully implemented for its clients to ensure fuel efficiency is "Pool Distribution". Taking advantage of significant volumes, shippers and carriers can work together to create "pool distribution" points, where shipments are pooled to a carrier's distribution center, then shipped out from the center to the final destination. This method can help the carrier and shipper avoid expensive line haul and break-bulk costs. LTL carriers collect freight from various shippers and consolidate that freight to fill trailers for travel to common destinations. An LTL motor carrier transports shipments that typically occupy only 5% to 10% of trailer capacity. As a result, LTL carriers collect and consolidate freight from various shippers to increase trailer utilization (load factor).

1.1.4 Use Regional Carriers

Using Regional carriers is an effective strategy because they operate more efficiently and have less overhead. Thus, they can be extremely competitive when it comes to pricing. They often have fewer surcharges and rules than national carriers. There usually exists a win-win relationship between the regional carriers and shippers as carriers benefit by increasing lane density, while shippers benefit by reducing overall expenditure.

1.1.5 Leverage Regulatory Measures

In January 2008, the Surface Transportation Board removed anti-trust immunity from the freight classification and rate bureaus to collectively set freight classification and LTL rates, which both determine your final cost. This ruling encourages competition. The last year of jointly-determined rates was 2007. Typically, carriers pay a fee to subscribe to standardized base rates and shippers typically pay a fee to use these base rates.

One advantage of independent rates is carriers have tuned or adjusted the rates to their own efficiencies, which can result in higher savings passed along to shippers. Also today, with the STB ruling; new pricing methodologies are available to shippers to leverage such as Truckload Rate, Pallet Rates, and Density Pricing. Unfortunately, most practitioners purchasing transportation services don't understand their alternatives; therefore, they go along with the carrier's desire to use the outmoded class-rate methodology.

1.1.6 Ensure Carrier Fuel Economy

Shippers need to work with the carriers to specify equipment designs that promote fuel efficiency. As much as drivers may disapprove, governing speed may be an effective fuel economy device. Paying careful attention to preventive maintenance, such as oil changes, tire pressures, and use of the right lubricants and additives, offers gains in fuel economy of about 1 per cent. Reducing engine idling by increasing throughput for loading and unloading (e.g., scheduling drivers for loading/unloading), and providing facilities for drivers to wait for loading and unloading also helps. Drivers should be paid by the activity (by mile and stop) and not by the hour.

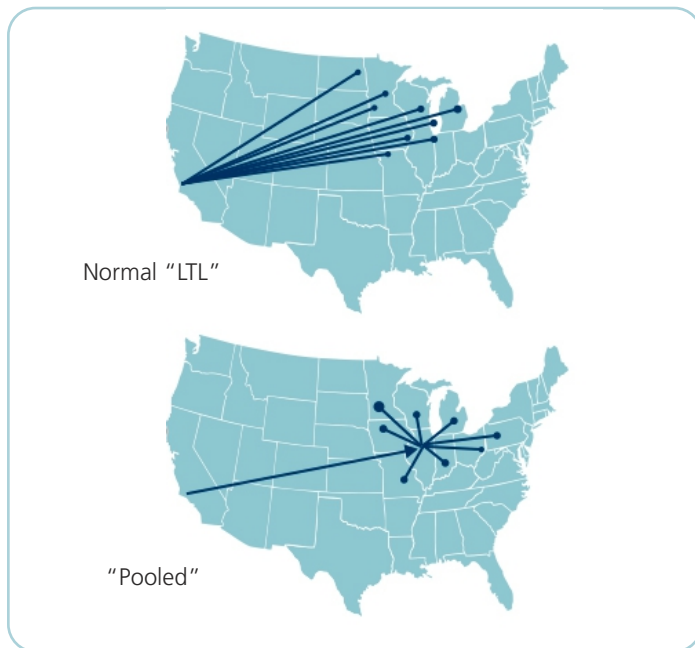


Figure 4: Pool Distribution

1.2 Tactical Measures

In depth analysis of the pricing models of carriers to ensure that carriers are not making undue profits through fuel surcharge programs is recommended.

1.2.1 Ensure Due Diligence

Before negotiating pricing with the carriers it is important to understand the value of your business to the incumbent as well as other carriers. Try answering the following questions:

1. Will your business qualify as a national or key account?
2. What are the local market conditions and competition for volume?

It is important to study the carrier management reports as well as year to date package volume, billings (revenue) by month this year and last year. Another key data point is the revenue per package shipped from which the carrier will judge their profitability.

1.2.2 Leverage Price Indices

The DOE publishes indices for 5 regions: East Coast, Midwest, Gulf Coast, Rocky Mountain and West Coast. Since 1994 the average

difference (basis) between the National Average and the Gulf Coast has been about 5 cents per gallon. In other words, the Carrier's actual fuel cost per gallon in a region may be quite different than the national average index. To avoid this, tie fuel surcharge schedules to appropriate regional price indices.

1.2.3 Counter Profits from Fuel Surcharge

If shippers' accept carrier-offered fuel surcharge programs blindly without investigating the underlying elements such as actual mpg they end up inflicting higher prices on themselves. If a shipper can leverage his volumes then the company's surcharge can be applied on a 'per mile' basis instead of being expressed as a percentage of the line haul transportation charges.

1.2.4 Cap Fuel Surcharge for Long Term Contracts

Depending on their capacity carriers will agree to a cap on fuel surcharges i.e. if the cost of fuel reaches a certain level and beyond, the carrier will cap the fuel surcharge for shippers willing to negotiate long term contracts. This will give additional cost certainty. Also having a fuel-hedging strategy arrangement with the carrier shall lower the overall average fuel spend.

1.2.5 Auditing is important

Just like auditing line haul costs on freight invoices, it is also important to audit fuel surcharges. Assuring that you have a quick payment discount is one easy and automatic method of cost reduction. Routine auditing of your invoices is critical to ensuring that you are invoiced correctly and that the carrier is performing to contractual service levels. It is conceivable that an audit of your invoices might identify invoice errors of 4% or higher in the carrier's favor.

2. Summary

Today, it is important to build a stable relationship with the carriers. Traditionally, transportation contract negotiation has been a win-lose situation, either by the carrier operating the account at a loss or the shipper paying inflated rates. By sharing information and collaborating with the carrier, a shipper can achieve improved service and competitive rates while the carrier maintains a profitable account. The most effective solution for the fuel surcharge problem would be to not only have an effective pricing contract in place but also optimize overall transportation, reduce fuel consumption, thus producing the very tangible advantage of reducing carbon emissions from the transportation process.

¹<http://www.scribd.com/doc/53716404/Unpacking-Transportation-Pricing-Final>

²<http://www.spendmatters.com/index.cfm/2010/8/2/A-Closer-Look-at-Fuel-Surcharges-in-Transportation-Part-1>

³http://www.hitachiconsulting.com/files/pdfRepository/WP_MktResponsiveDespiteRisingOilnTransportCosts.pdf



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