

Factoring “Risk” into Transportation and Logistics Sourcing

In the face of continued economic uncertainty and heightened cost and margin pressures across all industries, many shippers are taking a hard look at their transportation and logistics spend. With excess capacity across most transportation modes, a wave of strategic sourcing is beginning to emerge. Shippers are looking to obtain favorable rates; carriers are looking to strengthen relationships and secure volumes. This round of sourcing, however, looks and feels different. Beyond the classic issues of carrier cost, service, and reliability, shippers for the first time are asking themselves questions about risk as part of their sourcing strategy:

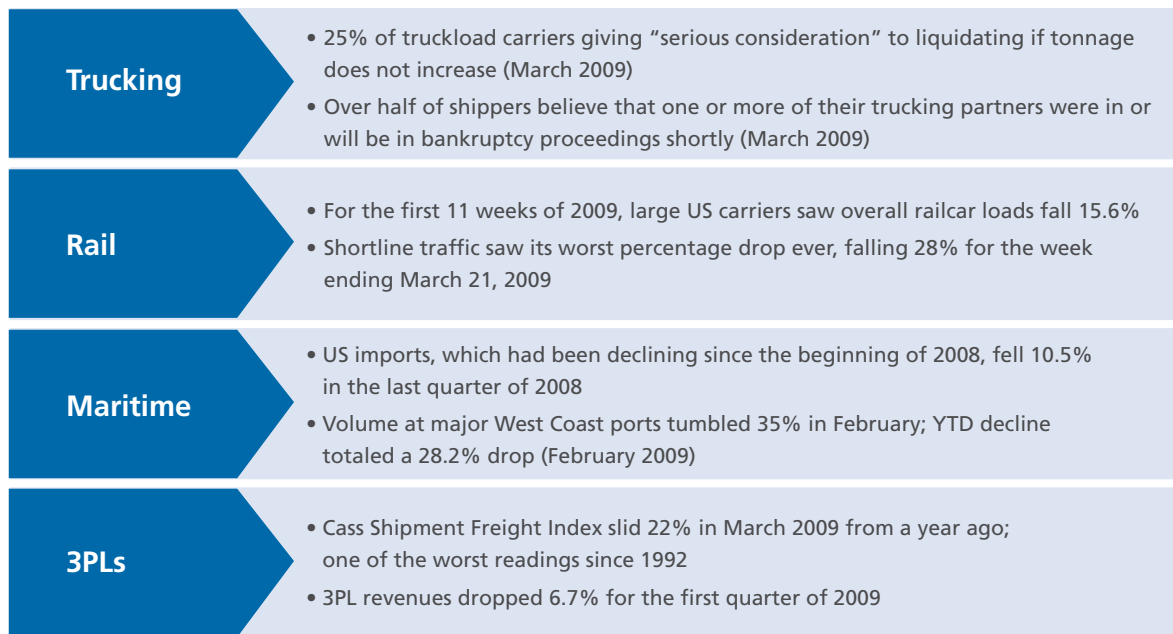
- “How do I minimize the risk of disruption across the end-to-end supply chain?”
- “What carriers can I rely on through these turbulent times—which will emerge stronger?”
- “Can I both reduce costs and minimize risks—at the same time?”

These are all critical questions—answering them will require companies to “do their homework” and explicitly factor risk considerations into their overall sourcing and negotiations strategies with carriers.

Current Status of Carriers and Logistics Operators

Recent declines in demand and economic pressure on carriers have led to significant disruption on the supply side. Service levels and operating costs are becoming more volatile as carriers aggressively cut costs and reduce capacity, and consolidation of carriers is increasing across all modes. A review of recent headlines only serves to reinforce these concerns (Exhibit 1).

Exhibit 1 Recent status of transportation providers



Source: Journal of Commerce, Transport Capital Partners, PIERS Trade Horizons, AAR, RMI Rail Connect Index, Cass Freight Index, Armstrong & Associates survey.

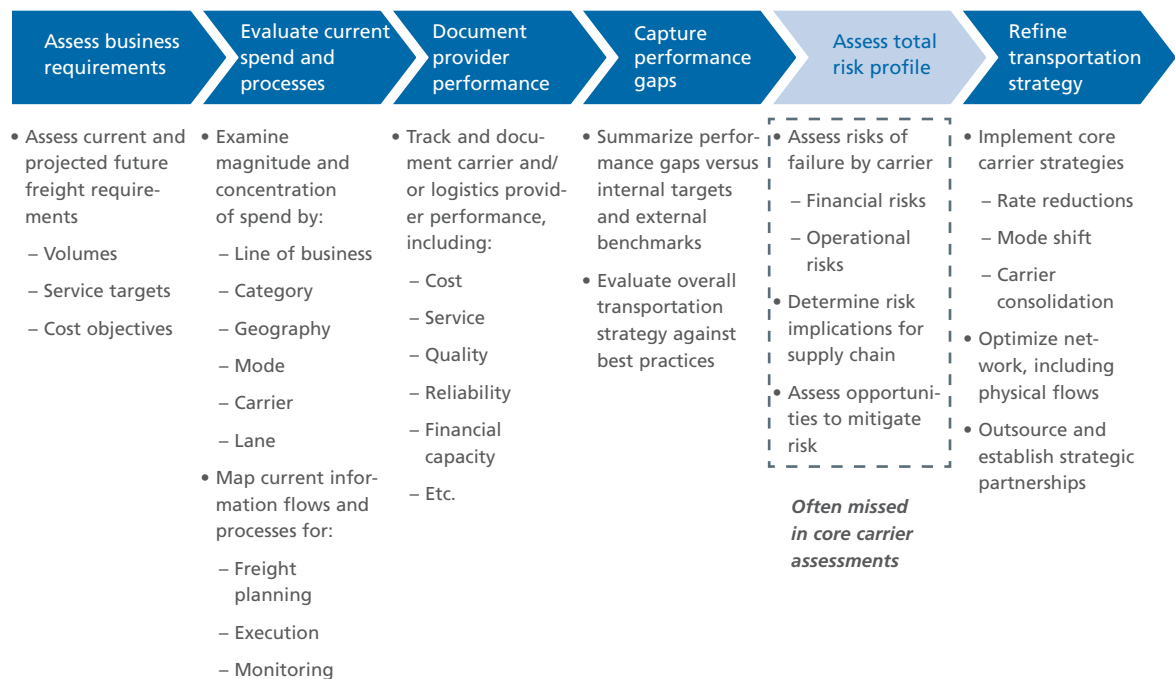
The challenges are projected to continue in the months ahead and carriers are expected to continue to cut back on operations. Most predict that we’ve yet to see the worst and that normalcy in the freight markets won’t return until 2010.

Risk Management and the Supply Chain

As shippers actively rethink their overall supply chain strategies, their relationships with carriers, and the costs associated with transportation and logistics, risk management will become increasingly critical. The financial viability of the carrier base as well as of their key suppliers (including the risks of financial default), the potential for major operational disruptions, and the ongoing challenges associated with lead time and performance volatility all need to be understood and managed appropriately in the context of any shipper's supply chain strategy.

As a result, core carrier programs—where shippers look to better leverage their freight spend with a consolidated set of carriers, ease administration and processing costs, and improve reliability—will be as critical a component of shippers' logistics strategies looking ahead as they have been in the past. While determining the appropriate mix of carriers and best contracting mechanisms to meet the needs of the business will remain top-of-mind, the traditional approaches to analyzing and strategically managing freight spend will need to be integrated with a proactive risk mitigation mindset. This holistic approach includes six steps, as shown in Exhibit 2.

Exhibit 2 Core carrier program: recommended approach

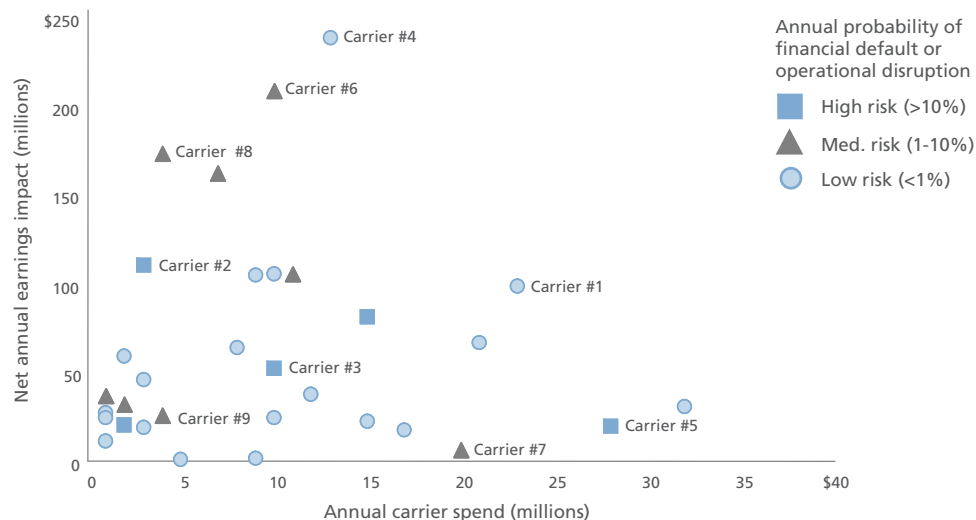


In response to supply chains becoming more sophisticated and mounting uncertainties regarding the carrier base, Oliver Wyman has developed a “total risk” approach that focuses quickly on the quantification of both the financial and operational risks for carriers and identifies implications related to the overall supply chain strategy. Specifically:

- Financial risk should include the probabilities of default over time—based on internal company data, third-party credit ratings, and financial/credit modeling for unrated carriers.
- Operational risk should include the probability of major operational disruptions as well as the volatility of performance (minor disruptions)—based on carrier performance history as tracked by the shipper, self-reported carrier performance, and public reporting of fleet and labor volatility.

Priorities and risk mitigation implications can then be determined by mapping carriers to projected company earnings and physical supply chain flows, as shown in the “heat map” below. These types of risk analytics—originally developed and applied by Oliver Wyman in industries with supply chains as complex as aerospace and aviation—have begun to see broader application across all industries.

Exhibit 3 Example carrier “heat map”



In many cases, the highest risk carriers may not necessarily be the largest or most visible. An analytical approach as outlined above has been proven to help shippers and manufacturers:

- Highlight susceptibility to carrier defaults and disruptions in their operations
- Enable better risk oversight and monitoring of existing carriers
- Support strategy formulation regarding future supply chain development

In today’s market, a total risk approach also can help expose potential shortfalls in “good deals” during rate negotiations and can be used to negotiate lower prices with transportation and logistics providers. Such an approach enables shippers to prepare a “Plan B” to

de-risk the supply chain and avoid the potential of a catastrophic event or supplier failure. Establishing redundancies in critical lanes, implementing alternative network designs and physical flow paths, investing in a balance between private fleets and common carriers—these are just a few examples of risk mitigation techniques applied by transportation managers across industries.

Once an assessment of risks has been undertaken, an integrated transportation and logistics strategy can be established. In our experience, aggressive sourcing of transportation and logistics can yield a baseline 5-15 percent in annual cost savings and potentially more in periods of excess capacity, such as we are experiencing now. These savings are typically driven by a mix of actions, including but not limited to:

- Carrier consolidation
- Mode mix optimization
- Rate benchmarking and lane-by-lane cost reductions
- Reduced expediting of freight
- Network and physical flow rationalization
- Third-party outsourcing

In addition to providing cost savings, a holistic approach increases strategic control and can lead to more integrated relationships with key carriers, thus helping to minimize the risk of supply chain disruption and ensuring that shippers continue to deliver cost-competitive, reliable service to their customers. Once the current economic downturn ends, such strengthened relationships and the associated confidence in the supply chain will be critical in supporting future growth and expansion.

Oliver Wyman's Sourcing Improvement Capabilities

Oliver Wyman is uniquely skilled in assessing transportation and logistics sourcing risks, with industry-leading capabilities in enterprise risk management and risk analytics, supply chain strategy, and transportation and logistics optimization. Oliver Wyman's proven methodologies have helped to facilitate the incorporation of risk identification, analysis, reporting, and mitigation planning into overall strategic planning and sourcing decisions. We can redesign core carrier programs and distribution networks as well as help shippers de-risk supply chains and select partners to reduce the likelihood of operational disruption and provide a sustainable advantage.

For more information on Oliver Wyman's perspectives on strategic sourcing and reducing transportation and logistics sourcing risk, please contact your Oliver Wyman account partner or one of the following partners.

Eric Vratimos, Chicago

+312.902.7972

eric.vratimos@oliverwyman.com

Jeff Elliott, New York

+212.345.3038

jeffery.elliott@oliverwyman.com

Mark Robson, Toronto

+416.868.2814

mark.robson@oliverwyman.com

Oliver Wyman

With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, corporate finance, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC].

Oliver Wyman's Surface Transportation Practice

Oliver Wyman's Surface Transportation Practice, with a professional staff of more than 100 partners and consultants worldwide, is one of the largest consultancies in the world dedicated to the transportation industry. It provides a comprehensive set of services and capabilities to transportation carriers, and to the users and regulators of transportation services, across the full range of the transportation sector. The Surface Transportation Practice also offers capabilities in international market research, evaluating new business opportunities, developing strategic and marketing plans, organizational and process redesign, and implementing transportation services.

Oliver Wyman's Corporate Risk Practice

Oliver Wyman's Corporate Risk Practice helps corporations apply analytical measurement techniques for capital, risk and value management. We work with leading organizations in multiple industries to effectively manage risk so they can achieve their business objectives, improve performance, and increase shareholder value. In particular the Corporate Risk team offers capabilities in treasury and trading strategy—providing strategic advice to organizations to optimally trade or take positions in financial market and commodity risks in accordance with their risk appetite; risk analytics—understanding an organization's risk exposure across the value chain through robust quantitative and qualitative analysis; portfolio risk management—enhancing decision making by combining organizational risk profiles with capital allocation and strategic planning to ensure optimal risk and reward trade-offs across the corporate portfolio; and enterprise risk management—defining a sustainable framework to identify, prioritize, and manage risks and opportunities and then aligning governance, process, and infrastructure to optimize value across the organization.

www.oliverwyman.com