SUPPLY CHAIN RESILIENCY

US PORT STRIKES — WHAT’S AT STAKE AND HOW TO MANAGE YOUR RISK

DECEMBER 2012
INTRODUCTION

A strike by longshoremen along the US East Coast and Gulf Coast could have devastating economic consequences as inventory depletion, rerouting, hoarding, and price speculation ripple through supply chains. Although the immediate threat of such an event was recently postponed, companies need to keep the possibility of such impacts in mind, especially given the port disruptions caused by Superstorm Sandy and the recent unexpected eight-day port strike at Los Angeles and Long Beach in California.

In this paper, we examine the potential shocks, their macro and industry-specific implications, and the role of proactive, comprehensive supply chain risk management. We outline strategies to improve visibility and evaluate risk mitigation and transfer options. We also provide a list of key preparatory questions that every organization should be asking to reduce vulnerabilities and thrive in the face of adversity.
SITUATIONAL ANALYSIS

The threat of a US East Coast and Gulf Coast port strike could become a reality on December 30, 2012. This strike was originally scheduled for the end of September, which could have crippled vital fourth-quarter sales and revenue. However, on September 20, the Federal Mediation and Conciliation Service announced that the International Longshoremen’s Association (ILA), representing port workers, and the United States Maritime Alliance (USMX), representing port operators, agreed to extend the deadline for contract negotiations through December 29.

Ports from Maine to Texas, including the critical ports of New Orleans, Houston, New York/New Jersey, Baltimore, Savannah, Norfolk, and Charleston, are all within the scope of the strike. The potential for a massive labor strike creates great uncertainty for shipping, especially for those ports still reeling from the effects of Superstorm Sandy. Organizations that import or export products, semi-finished goods, foodstuffs, and/or components could be challenged to defend against such a trade disruption considering that after just one week of a port work stoppage, manufacturing plants could be idled, inventories rapidly depleted, goods-in-transit shipments backed up at sea (leading to excessive inventory carrying costs), and supply chains crippled across the board. Rerouting of complex marine-based supply chains would also prove difficult and costly, as witnessed most recently with the shipment diversions that followed Superstorm Sandy and the West Coast port strike.

Atlantic ports serve 40% of all waterborne shipping in the US each year. With the potential strike’s focus on containerization work (approximately one-fifth of all waterborne trade volume), the affected volume includes nearly 15 billion cubic feet of cargo with an estimated value of more than $437 billion (see Figure 1 for more US shipping statistics). Port closures would impact a cross-section of industries, including electronics, machinery, clothing, retail, pharmaceutical, construction, food and beverage, and automotive (the latter requires roll-on/roll-off, or ro-ro, services staffed by would-be striking union members).

This potential crisis demonstrates why global businesses must be prepared for powerful and possibly crippling disruptions that can happen without warning. With the right portfolio of risk strategies (transfer, finance, and mitigation), organizations can more effectively protect themselves from crushing losses while simultaneously gaining market share from less prepared competitors.

BACKGROUND: THE PORT STRIKE THREAT

At the heart of this potential supply chain disruption is a classic labor-relations dispute. In US East Coast and Gulf Coast ports, the ILA has been at odds with the USMX. The longshoremen’s current contract expires on December 29, 2012. Negotiations thus far have been volatile, with both parties’ public statements ranging from divisive name-calling to more conciliatory rhetoric. The

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**FIGURE 1: SELECT ANNUAL US COASTAL SHIPPING STATISTICS (CARGO VALUE IN US$ BILLIONS)**

<table>
<thead>
<tr>
<th>Location</th>
<th>Cargo Value (US$ Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>WEST COAST</td>
<td>$275.7</td>
</tr>
<tr>
<td>NEW YORK / NEW JERSEY</td>
<td>$73.9</td>
</tr>
<tr>
<td>SAVANNAH, GA</td>
<td>$39.4</td>
</tr>
<tr>
<td>NORFOLK, VA</td>
<td>$28.3</td>
</tr>
<tr>
<td>CHARLESTON, SC</td>
<td>$19.6</td>
</tr>
</tbody>
</table>

conflict centers around a fundamental disagreement over the use of automation technologies for handling containerized cargo. For workers, this is an issue of job security in the face of a perceived “outsourcing” threat from management. For the ILA, it represents a desire to ensure that high-tech jobs in ports remain under union jurisdiction.

A potential strike would affect two areas of cargo in particular: containerized shipping and roll-on/roll-off. Trade in ro-ro cargo (such as automobiles) is predominantly East Coast oriented — more than half of all major ro-ro ports in the US are located on the Atlantic seaboard.3

The last port strike to hit the US East Coast and Gulf Coast occurred in 1977, while major port strikes took place on the US West Coast in 2002 and 2012. In 2002, for example, East Coast ports such as Savannah, Georgia had the capacity to benefit greatly from the increased traffic resulting from the slowdown in West Coast ports. Although West Coast ports are a viable option today, there are strained capacities in larger California ports such as Long Beach and Los Angeles, due in large part to a labor dispute that has disrupted trade coming through the Port of Portland, Oregon and the recent strike at both California ports. In anticipation of extra traffic from the US East Coast and Gulf Coast, West Coast ports are now imposing surcharges on shipments.3

POTENTIAL ECONOMIC AND SECURITY IMPACTS

The annual amount of affected trade in the leading US eastern ports of New York/New Jersey, New Orleans, and Boston numbers in the hundreds of billions of dollars. In industries like retail — whose fortunes are closely aligned with successful end-of-year profit margins and high-velocity cash flow — given the volume and value of trade affected, a labor strike could prove to be disastrous for many companies that normally have tighter supply chains and reduced sales during the next two quarters.5

These types of losses would impair the US and global economic outlook for 2013. Such market uncertainties put further pressures on organizations looking to maintain and increase profits and to satisfy investors. As port-dependent organizations and their partners seek to stem losses, there could be significant knock-on effects in the financial and employment markets. Combined with downward pressure from failure to avert the “fiscal cliff,” growth contraction could be compounded in these markets for the next two quarters.

A strike would also compound existing chokepoints caused by construction or security issues at certain ports, as seen in Figure 2. Furthermore, it would arise just as the US Northeast (particularly the port of New York/New Jersey)

FIGURE 2: GLOBAL SHIPPING — ROUTES AND CHOKEPOINTS

Source: US Energy Information Administration
is rebuilding and reestablishing full service following Superstorm Sandy, which disrupted area supply chains for an extended period. Sandy’s aftermath is indicative of some of the effects to be expected from a strike, including stranded container shipments and substantial delivery delays due to diverted rail and truck freight-shipping routes.\(^5\)

**THE MOST AFFECTED INDUSTRIES: RETAIL AND AGRICULTURE**

Port closures are painful to supply chains due to the sudden and severe backlog and rerouting pressures they put on organizations and their suppliers. For each day of backlog accumulated during a port closure, organizations need eight days to stabilize inventory levels within their supply chain.\(^5\) The cost and potential penalties of delaying or rerouting the cargo by air, truck, rail, and/or barge can be extensive.

Although global shipping disruptions affect many multinational industries, the labor standoff currently threatening to close US East Coast and Gulf Coast ports would hurt two sectors in particular due to their profit-driven need to keep inventory backlog low: retail (for example, clothing, toys, electronics, and furniture) and agriculture, food, and beverage (for example, fresh/frozen produce, seafood, meat, and packaged goods). Although they could be the most severely impacted by a potential strike, other sectors important to the functioning of the global economy could face adverse operational and economic impacts, including construction and technology, which both rely on component parts shipped via containerization.

**RETAIL IMPACT**

In an industry where products and materials are largely containerized for shipment, retailers should be very concerned about their organizations’ business health if there is a port strike. Already, several large enterprises within the retail sector are working to avoid any disruptions, making impassioned appeals recently to both sides of the labor contract dispute, urging them to return to negotiations. Aggressive lobbying by retailers has helped persuade both sides of the huge losses a disruption could create. Retailers now can claim to have successfully encouraged the parties back to the bargaining table.\(^7\)

In the meantime, industry leaders have indicated publicly that contingency plans already have been implemented due to the strike threat. Even with a contingency plan that could include advance inventory diversion, many businesses face difficulties in smoothly mitigating the impact of port closures, especially given the growing volume of orders right before the first quarter of 2013. Potential impacts are also magnified by the lack of recent experience with Atlantic seaboard-wide port closures, though the Sandy experience should provide some lessons learned.

**AGRICULTURE, FOOD, AND BEVERAGE IMPACT**

The agriculture, food, and beverage industry — already reeling from protracted US droughts affecting prices for such staples as wheat, corn, soybeans, and pork, and internationally from Caribbean crop damage from Superstorm Sandy\(^8\) — faces a new threat from the potential port strike. In a sector accustomed to direct government subsidies, but which has not seen much political support for current farmers’ production losses, the strike threatens to place additional downward pressure on agricultural products’ profit margins. This effect is based on the assumption that a Sandy-like natural disaster does not occur around the time of the port strike; in that case, the supply chain impacts would be geometrically multiplied in severity.
A port strike would be particularly painful in the Southeast US, where New Orleans and other ports have spent hundreds of millions of dollars for state-of-the-art facilities to protect shipments against natural disaster damage. New Orleans is an intermodal network hub, and a port closure there would be significant not only because of its facilities, but because of its importance as a hub at the mouth of the Mississippi River, a major agricultural shipping route in the US interior. In addition, the Port of New Orleans has more freight rail connections than any other port in the country, and its closure would consequently lead to longer domestic shipping times. New Orleans’ port closure would be the third such shock to agricultural shipments this year; shippers not only have avoided the Port of Portland, Oregon due to ongoing labor issues, but they then had to account for an eight-day closure of the Los Angeles and Long Beach ports.

In the agricultural industry, traditional mitigation strategies are often rendered ineffective in large part due to the nature of the goods involved. Agricultural products, many of which are highly susceptible to damage or spoilage by environmental factors, complicate the use of distribution centers and lower-cost trucking to avoid reliance on strike-affected ports. Additionally, the quality of agricultural/food products is vital to maintaining a low level of reputational risk; any spoilage in transit can, under extreme circumstances, create a public health crisis.

MANAGING THE RISK

TRANSFER AND FINANCING

Companies have many options when designing and implementing a risk management portfolio in light of a port strike (see Figure 3). Faced with a similar situation with the West Coast port strike in 2002, organizations added voyage frustration coverage to their existing insurance policies to make up for losses incurred from diverting from intended ports of entry.

Although they are able to cover some product/revenue loss, traditional insurance policies are not the most commonly used risk financing/transfer strategy in a port strike risk management portfolio today. Trade disruption insurance (TDI) is popular in the retail and agricultural industries; however, there are several factors that limit use of this and other traditional coverages. Many insurers specifically exclude labor strikes as a covered disruption unless physical assets are severely damaged as a result. This exclusion is due to several factors:

- Insurers narrowing of the scope of covered political/social risks — the largest TDI policies have limits in the hundreds of millions of dollars, well short of the multi-billion dollar impacts that could result from a port

**FIGURE 3: RISK MITIGATION PORTFOLIO OPTIONS**

Source: Marsh Risk Consulting
strike. In addition, losses from a labor strike are frequently excluded by both international maritime law and cargo insurance coverages such as general averages protection and delay in start-up (DSU) coverage.10

- The time deductibles written into many political/social risk policies favor crippling long-term damages over temporary losses.
- Insurers issuing such policies take an approach that involves geographic aggregation of supply chain risk.

Given the potential for massive, expensive diversions of trade away from US East Coast and Gulf Coast hubs, the costs associated with an insurance-only strategy weigh heavily on organizations that rely on timely, cost-efficient shipments. Emerging innovative insurance options, taken with standard insurance policies, may provide limited financial support to any port closure risk management strategy.

MITIGATION

Today, however, the most common port strike mitigation strategy is port of entry diversification, particularly for critical raw materials that would be most affected by disrupted shipping lanes. Implementing such a strategy represents one instance in which the impact of the looming end-of-2012 port strike might be a significantly smaller shock to national and global supply chains.

That said, diverting shipments around North American ports presents complex challenges. On the US West Coast, major ports in California already have strained capacities due to increased trade with Asia and recent strikes. Furthermore, transportation around the Americas remains difficult in the short term due to construction on the Panama Canal. In addition, alternative forms of transportation (especially air cargo shipping) would directly strain capacities at several global hubs (see Figure 4) and, in many cases, significantly add
to costs. High volumes of diverted cargo using alternate routes and transportation (such as trucking or rail) will thus heavily impact intermodal industries and trigger systemic losses in trade.

Other strategies within a company’s risk management portfolio that should be considered prior to and during a major port strike include:

- **Alternative sourcing and buying strategies:**
  - Advance inventory buildup.
  - Diversified, localized sourcing of raw materials to decrease/avoid reliance on shipping.
- **Substitution in manufacturing processes:**
  - Building local.
  - Moving sub-assembly into target sales market.
  - New/different product offerings that rely less on shipping-dependent materials.
  - Raw materials that are cheaper to import and/or more abundant in multiple markets.

When strategizing about a disruptive situation like a major port strike, organizations should strive for the following:

- **Increased data-driven visibility into the supply chain.** Organizations often entrust notifications of disruptions to known critical supply chain links to outside entities, leaving themselves vulnerable to chaotic “breaking news” alerts as events occur and limiting their flexibility in reacting to them. While such alerts may be a useful resource in a potential port strike situation, the greater value is in the evaluation ahead of time of key supply chain nodes used by one’s suppliers and by their suppliers and for distribution purposes, which can help direct supply chain risk mitigation strategies. Such visibility will also assist with an organization’s wider range of supply chain disruption contingency planning, allowing for better crisis decision-making and more flexibility, whether a natural disaster or human-caused event.

- **Strong data collection focused on:**
  - Transparency.
  - Seasonal/time-specific characteristics of the supply chain.
  - Profit margins and other company financial goals.
  - Knowledge of tax implications for each link in the supply chain.
  - Position of the organization within a global supply chain.
  - Understanding the organization’s tipping points and which supply chain disruptions could cause an organization to go “over the edge.”

- **Active monitoring that provides ample time to implement such strategies effectively and maintain essential production and distribution flows.**

- **A detailed official mitigation strategy that ensures quick implementation of a strong business continuity plan.**

**SUMMARY OBSERVATIONS**

The ability to move goods freely is an essential component of the global economy. As the world’s largest economic engine, the United States drives growth and sales for many multinational companies, particularly in retail and agriculture. A strike would have broad consequences, destabilizing global trade, business, and economic conditions at an inopportune time given low growth in key markets like the United States, Europe, and China. The potential consequences of a strike are straightforward: increased expenses, decreased revenue and profits, longer recovery times, loss of market share, and reputational damage.

For this reason, it is essential to invest substantial energy and capital into focused damage-minimization strategies. While organizations have realized the value of insuring their products against losses, many remain challenged by the limitations of coverage when faced with less predictable disruptions (political or social, for example) affecting critical supplier and distribution markets. Such limitations became highly evident following experience with unusual disruptions — whether a volcano in Iceland, an earthquake/tsunami in Japan, a debilitating cyber attack, or a superstorm.

In light of this, organizations must ask and address serious, pointed questions in order to adequately prepare for and withstand major potential impacts to their bottom lines:

- **Is there an updated and available analysis as to how supply chain disruptions affect the bottom line?**
Does the organization have the data, decision models, and other information required to quickly determine which risk finance/transfer and/or mitigation option is best to use?

Is the supply chain mapped with enough detail to see potential failures as they occur?

Is there enough data available to properly grasp how disruptions in one supply chain link affect the bottom line?

Have critical supply chain links been prioritized?

What is the expected impact of the disruption (in this case, a US East Coast and Gulf Coast port strike) to the organization?

How does the organization view and provide for risk mitigation?

A potential port strike demands that organizations find the answers to these questions and consider a range of supply chain risk mitigation strategies to yield optimal resiliency and recovery benefits.

Given the volatility of today’s global economy, companies must invest properly in a balanced portfolio of risk mitigation strategies that combine traditional measures (insurance) with customized options tailored to an organization’s specific needs, business objectives, and value.

In situations like a strike that lead to massive port closures, the potential effects on supply chains, revenue, and competitiveness require organizations to have a risk mitigation portfolio that is diversified enough to appropriately manage losses — and nimble enough to respond and adapt quickly to new crises as they arise.

1 American Association of Port Authorities. *About the Port* (July 2008 Fact Sheet).
10 Allianz Global Corporate and Specialty. General Average and Salvage Charges.
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