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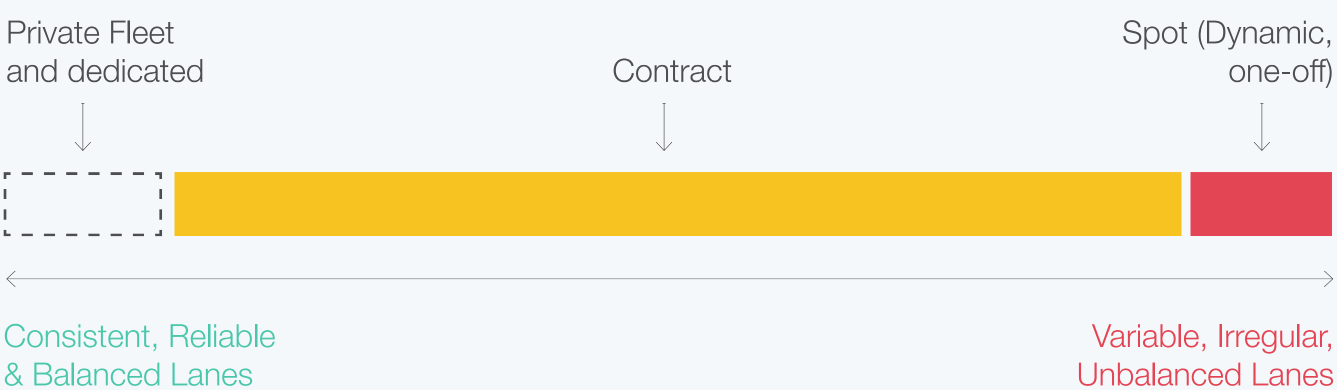
Apply a portfolio approach to freight procurement and avoid ‘ghost lanes’

Firms that outsource their transportation needs must decide the optimal mix of spot and contract.

Transportation buyers often rely heavily on contracts to mitigate potential price volatility and service uncertainty commonly associated with the spot market. However, a contract's non-binding characteristics summed up to post-pandemic market volatility can lead to misleading behaviour, which can impact relationships with carriers and ultimately cost them more.

The relationship between shippers and their carriers can take on many forms. These relationships lie on a spectrum (see Figure 1). At one extreme sits full vertical integration with a firm's private fleet, or partial integration with dedicated capacity. If available to a shipper, these options usually cover consistent, reliable demand. This represents stable business on both sides. At the other extreme is the pure transactional relationship in the dynamic spot market. This is often how variable, irregular demand is covered with dynamic pricing, determined by the current market. And in the middle, we have a wide range of contractual relationships, where the price for anticipated demand on each lane is agreed upon during the strategic procurement process.

Figure 1: Spectrum of transportation buyer-supplier relationships



(Source: Acocella A. and Caplice C. (2023), Journal of Business Logistics https://onlinelibrary.wiley.com/doi/full/10.1111/jbl.12333)

This is why a portfolio approach to freight procurement, incorporating different kinds of contracts and a strategic focus on the spot market – including more attractive and well-timed lanes – are so relevant. This leads to finding cheaper capacity for certain lanes and improved relationships with carrier partners, as contracts are honoured and empty miles reduced.

An important aspect of a portfolio approach to freight procurement is ghost lanes. On average, 70% of FTL contracts are never used, resulting in ghost lanes – which is where a contract is in place with a carrier, but no volume materialises. This creates problems for both shippers and carriers.

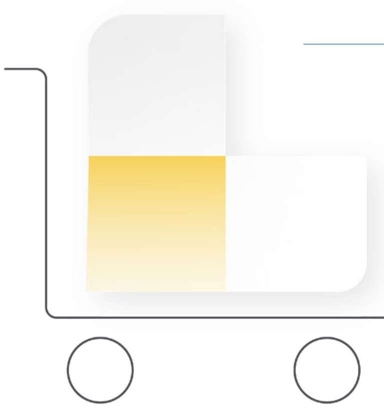
Carriers who are awarded ghost lanes expect business and the associated revenue for those lanes. Additionally, they may have built up their networks, including backhauls, around these lanes. They have also spent time and resources determining and submitting their bid prices.

For shippers, the efforts invested in the procurement event are significant: from forecasting demand on each lane, to sending out RFQs and closing negotiations. And the costs increase with each additional lane included. This means that by establishing contracts on unnecessary lanes, the shipper community is incurring upfront administrative costs in the hope that the cost, effort and time to find capacity later, for the few lanes that do materialise, would be much higher.

Research conducted by Dr. Angela Acocella, Researcher at Tilburg University and the Center for Transportation & Logistics at the Massachusetts Institute of Technology (MIT), modelled shipper and carrier behaviour to isolate the effects of ghost lanes. Major findings include:

- The strongest indicator of whether a lane will become a ghost lane is if it is new, meaning it was not included in the procurement event the previous year. In fact, 85% of ghost lanes were new that year. Also, lanes that typically have less outbound demand – and as a result have higher spot prices – are more likely to be ghost lanes. This suggests shippers are trying to lock in contract prices for lanes that they know will otherwise have high spot prices. Finally, ghost lanes tend to be more common during soft market conditions, rather than tight markets. This is because firms often create budget slack (i.e. by creating more contracted lanes) during these more economically favourable, soft market conditions, as a form of protection for potential future challenges.

- While shippers' intentions in procuring contracts on these lanes is to establish lower contract prices than the spot prices they would otherwise be exposed to, these contracts are priced higher than their lane-specific spot prices. New lane contracts are between 13% and 40% higher than spot prices, and lanes that are previously procured, but turn out to be ghost lanes, are between 7% and 11% higher than spot prices. This suggests that the uncertainty in volume demand for carriers on these lanes is being accounted for when they submit bid prices for contracts. Not only are shippers failing to see the cost savings they expect by establishing contracts on these lanes, but they're also overpaying.



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Shifting the traditional balance away from an extreme reliance on the traditional long-term, fixed-price contract, and taking more of a wait-and-see approach before setting prices, allows both shippers and carriers to better assess the demand and capacity needs as they become known. In this way, we can incorporate the spot market more strategically into the relationship portfolio. Once more information about demand becomes available, we can better determine if establishing contracts with carriers for lanes that do materialise is the best option and set a price that is more competitive and suits those lanes better.

Key takeaways

To reduce costs and optimise operations and carrier relationships, shippers should apply a portfolio approach to procurement and assignment. This approach involves incorporating different kinds of contracts, with a strategic focus on the spot market that includes more attractive and well-timed lanes. While contracts provide stability, their non-binding nature and post-pandemic market volatility can lead to inefficiencies and higher costs. Ghost lanes – contract lanes where demand rarely materialises – incur significant upfront costs for shippers and carriers. Shifting from fixed-price contracts to a more flexible, wait-and-see approach, enhances strategic use of the spot market, fostering better assessments and competitive pricing.