



# **Assessing the Motor Carrier Industry and Its Segments: Current and Prospective Issues, 2006**

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## *Executive Summary*

This report updates the **Motor Carrier Industry Profile: An Update 2004-2005** to reflect recent changes in the motor carrier industry. This document relies heavily on industry trade journals, company annual reports and other industry surveys as sources. The focus of this paper is to identify the major issues that trucking firms had to face during 2005 and industry response to these events. Special attention is paid to how different firms were affected by these events.

The major events in 2005 were: continued growth in the economy, the continuing driver shortages, the high diesel prices, and the increased state and local government taxation and regulation. Growth in the economy helped most firms realize increased demand. The driver shortfall has led to a state of under capacity in the industry, which has helped some firms increase their margins. However, labor costs are likely to increase for all firms, as recruitment and retention of qualified drivers tends to be expensive. Fuel prices have been extremely high; yet, this has had different effects on different companies. Larger firms have been, for the most part, successful in passing fuel costs along to customers in the form of fuel surcharges. This has not been the case for smaller firms, and they have suffered disproportionately as a result of high fuel prices. Finally, there has been a general trend in the government, both state and local, towards greater taxation of the trucking industry. Increased road tolls and new EPA regulations have had the effect of raising firms' costs, and the move towards reducing speed limits for commercial trucks has had the effect of lowering productivity and decreasing capacity.

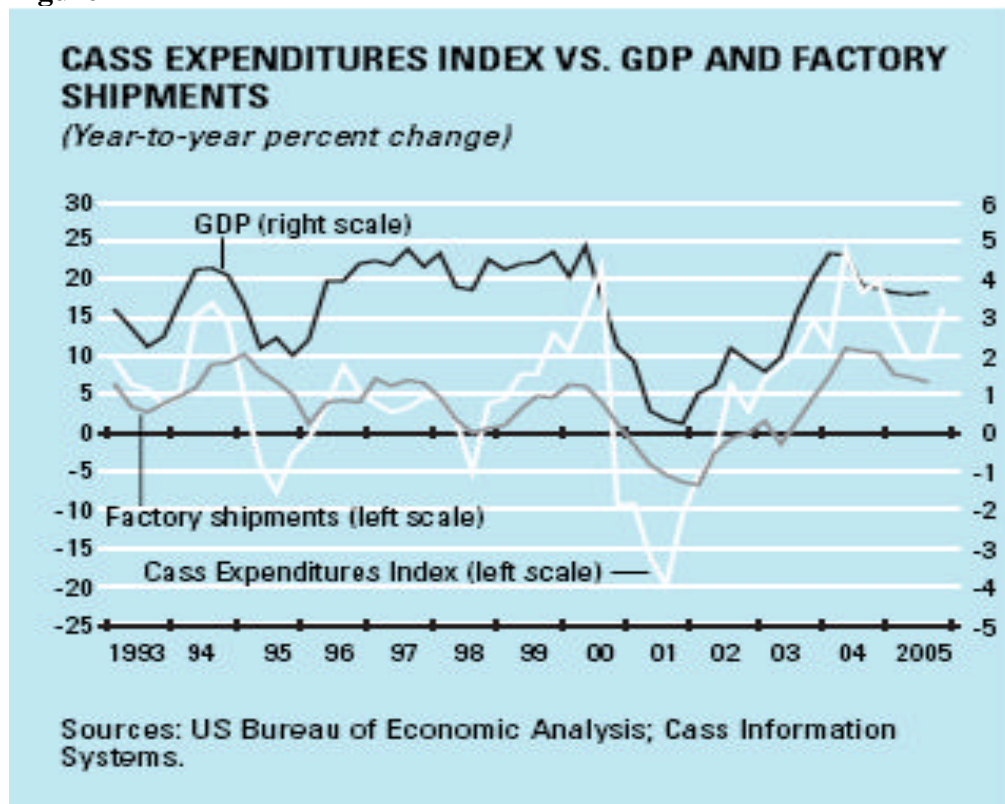
Also included in this report is a section on the stock market performance of major publicly traded trucking firms during the 2005 calendar year. The firms are subdivided

into different groups and indexed in an effort to discount the effect of splits, mergers and equity purchases/issuances. This section serves as a supplement to the **Assessing the Motor Carrier Industry and Its Segments: Current and Prospective Issues, 2006**.

## Overview

The trucking industry accounted for over 87 percent of the total expenditures for U.S. domestic freight movements during 2004<sup>1</sup>. Thus, trucking industry revenues will rise and fall as do total domestic freight shipments. It is obvious that total domestic freight shipments will move along with trends in the nation's gross domestic output. When economic activity increases, freight shipments will increase. When freight shipments increase, trucking revenues will rise as well. Conversely, business downturns will have a negative impact on domestic freight shipments and on trucking industry revenues as well. In short, trucking revenues slow when the economy declines, but revenues benefit from improvements and growth in the economy.

**Figure 1**



<sup>1</sup> West, Andrew. **Transportation: Commercial.** Standard & Poor's Industry Surveys, February 9 2006.

As shown in **Figure 1**, the Cass Expenditures index, a measure of total freight outlays, generally reflects the pattern of the GDP index and the factory shipment index. Thus, if there is a decrease in the percentage change in GDP index and the factory shipment index from one year to the next, there is a decrease in the percentage change in the Cass Expenditures index. Increases in the percentage change in GDP index and the factory shipment index from one year to the next also are tracked with increases in the percentage change in the Cass Expenditures index. However, the percentage changes from year to year in the Cass Expenditure index are substantially higher than are the percentage changes in the GDP index from year-to-year. Between 2000 and 2001, the GDP index increased less than 1 percent (a decrease from the previous period), while the Cass Expenditure index fell 20 percent. Between 2003 and 2004, the GDP index increased 4.5 percent from the previous period, while the Cass Expenditures index increased 25 percent.

### ***The Economy and Industry***

During 2005, the United States economy realized strong growth considering it suffered the fuel, infrastructure and overall economic shocks of Hurricanes Emily, Rita and Katrina. After significant GDP growth of 4.2 percent in 2004, the U.S. economy seemed to shrug off all the negative events of 2005 and grow at an estimated annual rate of 3.6 percent. According to Standard & Poor's, GDP growth for 2006 and 2007 is projected at 3.5 percent and 2.6 percent, respectively.<sup>2</sup> While economic growth looks as though it may level off, the trucking industry should continue to see positive demand in shipments in the near term.

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<sup>2</sup> West, Andrew. **Transportation: Commercial.** Standard & Poor's Industry Surveys, February 9 2006.

Yet, even with increased demand, the industry still has had to deal with the fuel and labor shocks which have split the industry into two segments – those carriers able to pass on the higher costs and those unable to do so. The carriers without the economies of scale to pass on the increased costs are either being bought by the larger carriers or closing up shop altogether. This is a sustainable trend moving into 2006.

### ***Capacity vs. Demand***

The continued and strong economic growth realized over the past year has caused an imbalance between the demand for and supply of trucking capacity. Due to several factors, this imbalance should continue into the near future. First, trucking companies are unable to attract new drivers and, in some cases, keep the drivers they currently employ. Second, the fleet sizes remain somewhat stable even with record sales in large and medium sized trucks as these purchases are simply replacing aging fleets. Finally, as larger, stronger carriers are able to pass the effects of higher labor and fuel costs onto their customers and weaker carriers are unable to do so, the industry continues to see consolidation leaving fewer firms to compete for an abundance of business.

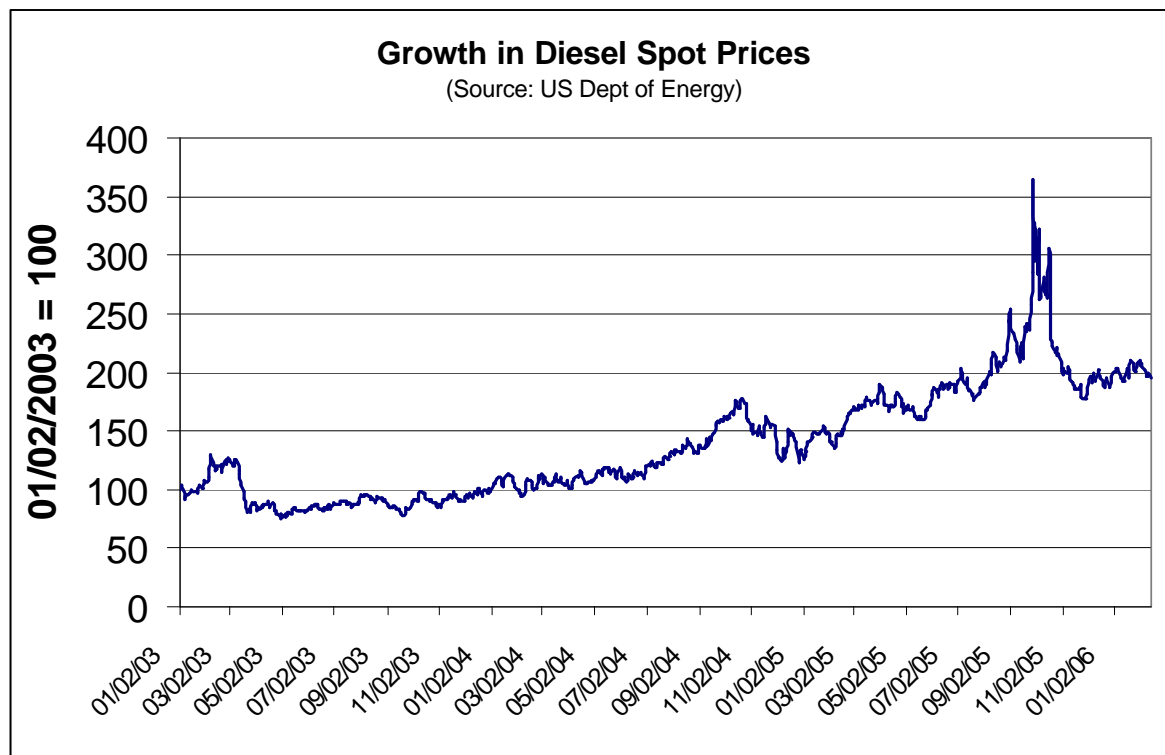
### ***Future GDP***

As previously mentioned, Gross Domestic Product is forecasted to grow at a decreasing rate over the next several years. As long as the economy does not fall into a recession, the industry should remain strong due to the imbalance between demand for and supply of capacity. However, as business activity slows (and therefore demand slows) margins should decrease as well.

## Fuel Prices

Fuel prices have been receiving an extensive amount of media attention in the last two years. As tensions in the Middle East, supply disruptions, and increased global demand have pushed up the price of crude oil to new highs, diesel prices have increased significantly as well. In 2003, the average price of diesel fuel was \$1.51/gallon<sup>3</sup>. In 2004, the average price rose to \$1.81/gallon.<sup>4</sup> The situation in the Middle East and supply disruptions due to Hurricane Katrina caused diesel prices to spike to \$3.16/gallon the week of 10/24/2005 before settling down to the yearly average of \$2.41/gallon.<sup>5</sup>

Figure 2



<sup>3</sup> West, Andrew. **Transportation: Commercial**. Standard and Poor's Industry Surveys. February 9, 2006.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.



The trucking industry burns approximately 700 million gallons of diesel fuel per week. As a result of increased prices, the industry spent \$247 million more on fuel for the week of 2/27/06 than it did the same week a year earlier.<sup>6</sup>

The effect of higher diesel fuel prices on the industry has been substantial, but it has had a differential impact on individual firms. The change in fuel prices has had a much more negative effect on truckload (TL) carriers than on less-than-truckload (LTL) carriers. Estimates by Standard and Poor's are that total fuel costs for TL carriers will increase from approximately 13.5 percent of revenues in 2004 to 16.5 percent in 2005.<sup>7</sup> This is a substantial increase in an industry that has historically been able to generate extremely small profit margins. LTL carriers, on the other hand, have seen fuel costs remain constant at about 7 percent of revenues.<sup>8</sup>

Many carriers have been attempting to pass these added fuel costs along to shippers by imposing fuel surcharges; however, the results of these attempts have been mixed. Larger carriers have been much more successful at imposing surcharges than have smaller carriers. LTL carriers, who have been implementing fuel surcharges since 1999, have been more successful at imposing this new round of fuel surcharges than have TL carriers, who have just begun implementing surcharges. As a sector, LTL carriers have been able to recover about 75 percent of the increases in their fuel costs.<sup>9</sup> However, some major carriers have been able to recover *more* than the increased cost of fuel from shippers. According to CNF's 2005 annual report, fuel surcharges have been a source of profit:

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<sup>6</sup> Guido, Daniel W. **Fuel Climbs \$0.016 to \$2.471**. Transport Topics. March 6, 2006.

<sup>7</sup> West, Andrew. **Transportation: Commercial**. Standard and Poor's Industry Surveys. February 9, 2006.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

CNF cannot predict the future movement of fuel prices, Con-Way's ability to recover higher fuel costs through fuel surcharges, or the effect that changes in fuel surcharges may have on Con-Way's overall rate structure. **Con-Way's operating income would likely be adversely affected by a rapid and significant decline in fuel prices as lower fuel surcharges would reduce Con-Way's yield and revenue.**<sup>10</sup> (Author's emphasis)

However, smaller and mid-sized carriers have not yet been able to pass along fuel costs through surcharges. This fact is likely due to intense competition for smaller contracts among small and independent firms. The result has been an upsurge in bankruptcies of small and mid-sized firms. More trucking firms declared bankruptcy in the first nine months of 2005 than in all of 2004. There is little evidence that this trend will abate.<sup>11</sup> The most notable of these bankruptcies was Allied Holdings Inc, which was the largest domestic auto hauler. Increased fuel costs, combined with the inability to pass along fuel surcharges to General Motors (Allied's single largest customer) led to a Chapter 11 filing on 7/31/2005.<sup>12</sup>

The consensus as to whether or not carriers will be able to continue to pass along these fuel costs is mixed. According to Standard & Poor's, there is concern that shippers will begin to balk at paying fuel surcharges that have resulted in double digit increases in shipping rates.<sup>13</sup> The larger carriers have a better position to dictate terms to shippers, as only the larger firms have the capacity to handle the needs of large clients. This economy of scale limits the entrance of new, smaller competitors that could drive down the fuel surcharges and rates. Therefore, it is unlikely that the surcharges will go away entirely.

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<sup>10</sup> CNF 2005 Annual Report.

<sup>11</sup> West, Andrew. **Transportation: Commercial.** Standard and Poor's Industry Surveys. February 9, 2006.

<sup>12</sup> Ibid.

<sup>13</sup> Ibid.

Unfortunately for both carriers and shippers, fuel costs are unlikely to go down any time soon. Industry estimates indicate that diesel prices are likely to increase approximately 5-6 percent this year up to \$2.54/gallon.<sup>14</sup> In 2007, fuel prices are expected to decline slightly to approximately \$2.41/gallon.<sup>15</sup> However, oil prices have recently entered a phase of high volatility. Any new political developments, natural disasters, changes in global demand, or any other unforeseen events can have dramatic effects on the cost of diesel at the pump and, therefore, have an effect on the profits of motor carriers.

### ***Technology***

Technological developments might help improve fleet efficiency in the future. There has been much recent press attention to the promise of biodiesel, which is diesel fuel processed from organic materials as opposed to crude oil. Some states have begun mandating that a small percentage of the overall quantity of diesel fuel sold must be biodiesel. However, this technology is still unproven and has met with some stumbling blocks relating to fuel quality. Biodiesel may someday help dampen diesel prices, but that time is not likely to be in the near future.

Another technology that is gaining attention is the use of Telematics. Telematics is the use of computers to monitor driver behavior that is wasteful of fuel (i.e. excessive idling times, unnecessary heavy acceleration etc.) This technology has been common in Europe for the last decade and has been very successful despite driver objection to ‘Big

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<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

Brother' type scrutiny from managers. This technology originally took root in Sweden and Britain, where diesel prices range between \$6 and \$8 per gallon. It was largely ignored in the U.S. until the recent surge in diesel prices. According to a study done in Europe, one fleet saw its fuel economy increase from an average of 7.8 miles per gallon to 8.5mpg, a 9.3 percent increase in economy.<sup>16</sup>

### ***Labor Trends and Shortages***

A major trend that continues to plague portions of the trucking industry is the shortage in drivers. Beginning in 2000, drivers saw wages fall below their counterparts in construction and other blue-collar jobs prompting many drivers to leave the long-hours of the trucking industry for more traditional 9-to-5 positions that allowed for more time with family.<sup>17</sup> According to an American Trucking Association (ATA) study, the shortage is only going to get worse. At the end of 2004, their study estimates that the industry was 20,000 drivers below equilibrium with the void increasing to approximately 111,000 in 2014.<sup>18</sup> Beyond the wage gap between truck drivers and similar blue-collar jobs, the driver shortage is perpetuated by increasing security regulations, reduced working hours, and recruiting pools.

### ***Driver Turnover***

One of the largest cost burdens associated with the driver shortage is turnover (particularly in the truckload sector). Standard & Poor's estimates that some employers are realizing turnover rates of 100 percent or greater. Having drivers move into and out

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<sup>16</sup> Shires, Will. **Euro Truckers Corral Fuel Use with Onboard Telematics**. Transport Topics. February 20, 2006.

<sup>17</sup> Urbina, Ian. **Short on Drivers, Truckers Dangle Stock and 401(k)**. The New York Times. February 28, 2006.

<sup>18</sup> Bearth, Daniel P. **Demand, Rates and Operating Costs All Rose in '05**. Transport Topics. Weeks of December 19 & 26, 2005.

of positions so frequently is costing the industry approximately \$3 billion per year with the per driver replacement coming in at \$3,000 on the average and \$9,000 to \$24,000 for senior drivers. The cost is even higher when replacing senior drivers with less-experienced applicants due to increased insurance, accidents and claims paid for damaged cargo.<sup>19</sup>

According to the ATA, the typical truck driver is a white male between the ages of 35 and 54. The ATA suggests that this demographic is declining and will continue to do so over the next 10 years.<sup>20</sup> Furthermore, the industry is suffering from the same reduction in senior employees as most industries in the U.S. There are more “Baby-boomers” retiring than there are new, young drivers graduating from driver school. Finally, there remain restrictions on driver age. A carrier cannot employ a driver requiring a commercial drivers license (CDL) who is younger than 21-years-old.

Compounding the shortage problems is the increased scrutiny placed on each applicant. The post 9/11 era has brought with it a greater focus on security in all industries and the trucking industry is no exception. Now, carriers are using advances in technology and changes in federal laws to thoroughly check each driver’s background. Whereas in previous years, a driver could hide his or her past, companies can now find red flags such as drug or alcohol issues, criminal records or major traffic violations. Additionally, carriers are able to check the accuracy of applications allowing for fewer “false” applications to get through. Therefore, the pool of applicants is not smaller than it would be otherwise, but the pool of qualified applicants has decreased as a result of increased scrutiny.

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<sup>19</sup> West, Andrew. **Transportation: Commercial**. Standard & Poor’s Industry Surveys, February 9 2006.

<sup>20</sup> Ibid.

Many of the larger, stronger carriers have attempted to deal with the driver shortage by increasing the pay and by investing in “in-house” driver schools. However, for those companies without the capital to create such schools, another viable option is to poach those trained drivers by offering higher wages and non-traditional incentives such as 401(k) plans and stock options.

In order to keep their drivers from being poached, some companies have turned to more nontraditional, innovative perks. For instance, some companies are installing satellite radio/television in truck cabs. They are also instituting programs to allow drivers to bring pets and even spouses in some cases. Allied Holdings has even gone so far as to hire chaplains to monitor its driver morale.<sup>21</sup>

Due to the high cost nature of poaching, trucking companies continue to look for new pools of prospective drivers. One way is to look outside the traditional white demographic that companies focused on to fill its open positions. According to the Department of Labor, the number of truck drivers who are not white males has increased 30 percent in 2004, an over 3 percentage point jump from 2001. Similar to the increased population in the U.S. overall, Hispanics now make up nearly 15 percent of all current drivers as compared to 12 percent in 2001.<sup>22</sup> In addition to nontraditional demographics, carriers are looking to lure retired drivers and Iraq War veterans, both of which already have the skills necessary to hit the ground running, by offering many of the perks used to deter high turnover.

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<sup>21</sup> Urbina, Ian. **Short on Drivers, Truckers Dangle Stock and 401(k)**. The New York Times. February 28, 2006.

<sup>22</sup> Urbina, Ian. **Short on Drivers, Truckers Dangle Stock and 401(k)**. The New York Times. February 28, 2006.

Unfortunately, many of the measures taken to reduce the driver shortage have done little to solve the problem. The ATA has estimated that turnover has increased for all sectors of the trucking company, in some cases to nearly 136 percent.<sup>23</sup> With labor being one of the largest costs facing the trucking industry, such high levels will continue to hurt carriers. It appears that even a significant decline in turnover will still leave industry players feeling the sting of labor costs.

### ***Intermodal Transportation***

Intermodal transportation, moving shipments by more than a single means of transport, has grown dramatically in popularity in the last few years. A number of intermodal firms have been purchased by larger trucking companies in the last few years.<sup>24</sup> However, intermodalism is unlikely to have all the answers to some of the trucking industry's problems.

Shipping freight over long distances by rail and then using trucks for the shorter regional trips would ease some of the burdens on the trucking industry. Driver-hour restrictions, the increased cost of diesel, and labor shortages have led to freight companies making better use of rail transport. However, the US rail industry is reaching its maximum capacity and rail companies are somewhat hesitant to add new lines.<sup>25</sup> As a result, severe rail delays have become common, and there is growing frustration on the part of freight companies.

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<sup>23</sup> **Driver Turnover Rate at Large Truckload Carriers Rises to 136%.** Transport Topics. <http://www.ttnews.com/members/topNews/0015004.html>. March 20, 2006.

<sup>24</sup> **Universal Buys Four Intermodal Firms.** Transport Topics. February 13, 2006.

<sup>25</sup> Guido, Daniel W. **Rail Executives Say Rail Should Invest More.** Transport Topics. February 13, 2006.

A standoff is developing between freight companies and the rail lines, as to who should have to pay for additional rail capacity.<sup>26</sup> Rail companies bear a substantial risk when they allocate billions of dollars to adding capacity. They are concerned that when diesel prices drop, the surging demand for intermodal traffic will evaporate.

Going forward, it appears that some capacity will be added to existing rail lines. However, intermodal freight companies are likely to be assessed 'taxes' by the rail companies in an effort to defray the substantial costs of adding new tracks.<sup>27</sup> Therefore, it is unlikely that, in the future, intermodal transport will be able to enjoy as substantial cost saving as it has in the past.

### ***Labor Regulations***

The most significant regulation to take effect in the last two years pertains to the number of hours a truck driver may work during a week. The Federal Motor Carrier Safety Administration initially proposed new rules to take affect January of 2004, but the rules were overturned by courts. New, revised rules were put into effect in late 2005. The new rules permitted a driver to work for 11 consecutive hours (10 hours were the max under the old rules). However, loading and refueling were not originally counted against the work day and now they are. Additionally, drivers are not allowed to work

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<sup>26</sup> Ibid.

<sup>27</sup> Ibid.



more than 70 hours per 8 day cycle, and they must be given at least one 10 hour break per 14 hours on-duty.<sup>28</sup>

In many cases under the previous pre-2003 hours-of-service (HOS) rules, time spent waiting for a truck to be loaded could be logged as off-duty time. Because the new regulations do not allow the workday to be extended by way of logging rest breaks throughout the day, some initial estimates noted that a given driver will now see his workday decrease from in excess of 15 hours down to 14 hours.<sup>29</sup> The initial reaction from the trucking industry was somewhat negative. Carriers were concerned that productivity and labor costs were likely to decline. Drivers were concerned the rules could have a harshly negative effect on their earning power.

However, according to Standard & Poor's, most large carriers saw little or no disruption in their operations and did not see dramatic declines in productivity.<sup>30</sup> In fact, some noted better coordination at logistics hubs and better driver retention.<sup>31</sup> However, as is often the case, smaller and mid sized firms appear to have not fared as well as many of the larger firms; some small firms saw productivity declines as steep as 20%, which they attributed to the new labor regulations.<sup>32</sup>

### ***EPA Regulations***

Starting in 2007, all new trucks must be equipped with diesel particulate filters (DPFs). These filters are designed to cut soot emissions by 90 percent. However, this technology is not without its drawbacks, and some industry experts believe that it has not

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<sup>28</sup> IBIS. **General Freight Trucking, Long Distance in the US.** IBIS World Industry Reports. November 29, 2005.

<sup>29</sup> West, Andrew. **Transportation: Commercial.** Standard & Poor's Industry Surveys, February 9 2006.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

been fully tested and can lead to equipment malfunctions.<sup>33</sup> Freightliner was forced to recall 1,250 urban busses in 2005 due to DPF malfunction.<sup>34</sup> Freightliner has improved the DPF design, but there is still much speculation as to whether or not truck owners will see increased maintenance costs as a result of this new technology.<sup>35</sup> Additionally, truck owners need to be prepared to see an increase of \$7,000 to \$10,000 added to the price of a new truck as a result of the DPF.<sup>36</sup>

As a result, 2005 was a record setting year for new truck purchases in the US.<sup>37</sup> Trucks sold in the calendar year 2005 and 2006 do not have to be fitted with the Diesel particulate filters, and firms are rushing to replace their fleets with new trucks before the year is out. This would have the effect of favoring the relatively more cash-rich larger firms that can afford to make such a large capital outlay. Smaller and mid-sized firms, or those that do not have the cash or access to capital that is required to replace a fleet of trucks on relatively short notice, may see both their truck acquisition costs and maintenance costs increase as a result of having to buy the 2007 and later model year trucks.

### ***Local Regulation and Taxation***

Cash strapped local and state governments have begun substantially raising tolls and taxes on freight trucking. Measures that would increase the taxes on diesel fuel have been defeated due to popular anger in several states, but road-use tax and toll increases

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<sup>33</sup> Gilroy, Roger. **Soot-Filter Performance is Key to Success of 2007 Engines**. Transport Topics. February 13, 2006.

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Ibid.

<sup>37</sup> Guido, Daniel W. **January Truck Sales Rise 5.3%; Analysts See Gains Through '06**. Transport Topics. February 20, 2006.

have been met with far lighter resistance.<sup>38</sup> The toll hikes are taking place all across the country, but the most severe are taking place in the Northeast Corridor, on the West Coast, and in major cities in the Midwest. Truckers using the New York State Thruway may see the toll rise as much as 135 percent, depending on the shipment size and the method of payment.<sup>39</sup> However, many other states outside of those previously indicated areas have legislation pending that would raise tolls on existing roads or introduce tolls on new roads.

This will affect different carriers in different ways. Regional carriers in high-tax areas will be affected more than those in low-tax areas. Additionally, LTL carriers might be forced to pay more due to their increased number of loading and unloading points, relative to TL carriers.

There is a growing national trend towards lowering the speed limit for trucks on the highways as a way of ensuring highway safety. Many states have 'dual speed limits' that prevent trucks from traveling the same speed and passenger cars. The American Trucking Association recently supported a bill that would have speed governors on new trucks that would prevent them from traveling faster than 68 mph.<sup>40</sup> However, some states have taken much more drastic measures in lowering the speed of trucks. Many have established speed limits for trucks that are as low as 55mph, and many others are considering similar legislation.

These measures are being passed in the name of safety; however, they may have the unintended effect of reducing trucking capacity. During a 10 hour shift, a truck that

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<sup>38</sup> Guerrero, Thelma. **Toll, Fuel Tax Hikes Add to Trucking Costs; More Increases Proposed.** Transport Topics. January 2, 2006.

<sup>39</sup> Ibid.

<sup>40</sup> McNally, Sean. **ATA, Citing Safety, Endorses 68MPH As Maximum Speed for Large Trucks.** Transport Topics. January 20, 2006.

can travel at 68mph can cover 680 miles, and a truck that can only travel 55mph can cover 550 miles. Therefore, a 3,000 mile journey would take a full day longer with the reduced speed limit. This means that the truck involved has to spend more time on the road, and is unavailable to receive a new shipment until a full day later. A freight company that is under a time squeeze will now have to send a second truck out with the new shipment when it cannot afford to wait on the original truck that is still en route. Therefore, freight companies, in order to meet the time sensitive needs of customers, will have to keep additional trucks available to fill shipment orders in a timely fashion.