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Railroads weigh insourcing terminal operations

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It's long been believed that three sets of analyses will always guarantee an outcome different from the current state: own vs. rent; build vs. buy; and in-source vs. outsource. A look at today's intermodal industry may underscore this rule.

The intermodal industry was essentially built on outsourcing of producers and consumers. The core transaction consisted of railroad linehaul substituting for truck. The appeal was the ability to provide door-to-door service between points where regulatory permission ("operating authority") was lacking. It was also less expensive for motor carriers to use rail than Teamsters labor.

Although the railroads originally provided a door-to-door product within a vertically integrated enterprise (often with their own Teamsters labor), the intermodal product quickly became a compendium of disaggregated service providers, which relieved the railroads from performing services they couldn't perform efficiently. Drayage, equipment, and ramp operations all became core suppliers to the nascent intermodal industry. Shipper agents evolved to compile a truck-like door-to-door product from the disparate pieces. As the business grew and evolved, they became known as intermodal marketing companies — and subsequently third-party logistics providers.

Although intermodal has become a rail industry behemoth over the past 20 years, for the previous 40 years, it was regularly starved of internal support and capital. Most original intermodal terminals were hand-me-downs from obsolete carload and passenger operations. Terminal improvement was justified primarily by cost savings resulting from consolidating multiple locations, which often resulted from cascading mergers; or transportation savings (eliminating switch crews necessary to ensure all cars faced a single direction for "circus" loading and unloading, for example). The handful of new facilities usually resulted from a more pressing need for the existing terminal real estate.

Railroads' intermodal outsourcing enabled major breakthroughs, without which the modern intermodal industry wouldn't have been possible. The industry's recent growth, however, may have changed the historical value propositions.

Equipment

TTX (nee Trailer Train), an industry equipment pool founded in 1956, enabled the industry to develop a national, free-running equipment pool, from which surplus equipment could be off-hired after five days. It was able to borrow money at favorable terms when its underlying members were

unable, or unwilling, to do so. This allowed industry standardization around an 89-foot flat car, giving rise to interline intermodal (when there were more than 50 Class 1 railroads and very little single line service.) Later, TTX overcame its initial reluctance to double-stack and provided the necessary capital to invest in this new technology.

Leasing companies such as Realco, XTRA, and Availco provided the trailers necessary for growth of railroads that were reluctant to invest in trailers when their boxcar supply was plentiful. These lessors offered a wide portfolio of financial terms — from long-term leases to free-runners. They also had the wherewithal to invest in new technology as the standard highway trailer grew from 35-feet to 40-, 45-, and 48-feet.

Although some railroads have acquired intermodal cars, TTX remains the industry's primary provider. Because the railroads are TTX's owners, this might not be considered outsourcing. The sourcing of other intermodal equipment has changed significantly, however.

Bimodals are providing their own containers, which cost significantly less than trailers. Trailers are almost exclusively private equipment deployed by motor carriers from their general highway fleets.

Railroad-provided equipment consists primarily of domestic containers in the EMP (Union Pacific and Norfolk Southern) and UMAX (UP and CSX Transportation) interline fleets. In 1994, the original EMP containers and chassis were leased (and managed by) Bay Cities Leasing. Since then, railroads have moved to source, and manage, most of this equipment directly.

Domestic chassis are another matter. Whereas UP and NS primarily provide their own chassis, other railroads have allowed TRAC Intermodal to provide chassis for them. TRAC is also the primary provider in major gateway cities such as Chicago. This is a good place to reconsider the need to insource or provide some competition. Many drayage providers believe there is a clear quality gap between railroad- and TRAC-provided chassis and the fear of migration double-dipping persists.

Terminal Operations

Over 50 years, terminal operating companies evolved from vertically integrated subsidiaries (first of railroads, then of lift manufacturers) to standalone outsourcers. Not only did these entities enable railroads to escape high legacy labor costs, but they also provided the capital for lift equipment by bundling the cost of ownership and operation into a simple per-lift rate. This was essential as railroads slowly replaced circus ramps with mechanized terminals in an environment where there was scarce capital available for intermodal.

Intermodal history has many examples of how railroads, lift equipment providers, and ramp operators transitioned the intermodal network from more than 1,000 diverse intermodal terminals into today's tightly integrated network supporting millions of moves annually. This occurred over two generations with a relatively unchanging cast of players that built close relationships and trust over time. It was win-win. Innovation in terminal design and operations flourished, and railroads were able to grow without expending capital and hiring union workers. Manufacturers and operators frequently got rich.

Today's railroad realities of strategic sourcing and frequent personnel changes has changed the dynamic. Decisions are no longer handshakes between individuals with long, personal histories. (In fact, such relationships may be viewed negatively as suspect.) Selection of terminal operators is now made on the basis of lowest-cost providers that survive a rigorous RFP selection process.

Unfortunately, terminal operators aren't fungible, so it's particularly curious that management of a \$100 million asset in this multi-billion-dollar business segment is entrusted to an operator selected on a miniscule price difference. A major intermodal terminal recently had the incumbent operator replaced with a lower-cost provider, who immediately replaced the majority of the experienced workers with lesser-paid employees. This move was necessitated by a need for lower operating costs, but although the railroad realized its cost savings, it experienced immediate operational degradation that severely impacted systemwide service. It's hard to believe that the resulting congestion and network disruption didn't cost many times the price savings obtained.

Many railroads are looking at insourcing terminal operations. The reasons are numerous:

- The need to maintain a balance between agreement and non-agreement personnel on the railroad is facilitated by adding new union-filled positions. This has been facilitated by a reasonable approach from unions such as the TCU.
- Implementation of increasingly sophisticated technology and operating models require retention of highly trained employees, so it's less expensive today to have personnel continuity.
- Recognition of the looming brain drain from retirement and embracing a need for internal, hands-on terminal experience. (It's hard to imagine a railroad's traditional operating departments lacking executives with field level experience. Intermodal has finally made a similar realization.)
- Increasing economies of scale in terminal operations that obviate many of the economic benefits provided by contractors.

Drayage

Since motor carrier deregulation in 1980, an independent contractor system of owner-operators has replaced the original model of company trucks and drivers (frequently Teamsters) performing intermodal pickup and delivery. This worked well as long as there was a reliable supply of used tractors and willing owner operators. But change is afoot.

Leading bimodals have reinstated vertical drayage integration, through organic growth (J.B. Hunt) or acquisition (Hub Group and Comtrak.) Their economies of scale enable them to deploy drayage assets for an entire day's tour. Not only does this provide economic benefit over the transactional, by-the-drink model, but it's also easier to call last-minute audibles when plans inevitably change through customer requests and operational challenges.

The requirement for clean trucks is a game changer. Not only is the tractor more expensive to acquire and operate, but it also requires more sophisticated maintenance. To achieve satisfactory economics, the drayage driver may need to "slip seat" the tractor to obtain more than just 60 to 70 hours a week of production. In some locales, such as Southern California, it enables the drayage operation to serve port and rail markets. Achieving this level of utilization requires company employee drivers operating company-provided tractors maintained by company mechanics.

The impending requirement of electronic logging devices is expected to slash the number of smaller trucking companies that haven't gone through this disruptive transition. It also will impact many drayage providers. Although the law allows a 100-mile exemption, this won't be a cure-all in major drayage markets with a scope of service much larger (the entire West Coast, Texas, Florida, and gateways such as Chicago and Memphis, for example).

Finally, when considering other pending regulatory initiatives, and the demographics and supply of truck drivers, it seems inevitable that a company employee model will be necessary to attract and retain quality drivers.

Many drayage companies already have moved to this model. Dedicated operators also are starting to provide an arms-length method of supplying company drivers.

The growth of intermodal has been dramatic over the past 20 years, and the attractiveness of insourcing is undeniable. That's not to say the outcomes described here are inexorable. If history has taught us anything, it's that change is like a giant pendulum and today's realities are tomorrow's questions. What is unchanging is the constant demand to improve service and underlying economics to protect the intermodal industry's hard-earned past growth, and to position it for future success.

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