

TRAVEL & TRANSPORTATION

Getting Back On Track Through Outsourcing

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Airlines have led the industry in strategic use of outsourcing as a mechanism to combat challenges.

A prevailing tendency for growth in corporate Sales, General & Administrative, or SG&A, costs to outstrip revenue growth threatens to side track the railroad, trucking, freight services and shipping sub-segments of the Travel and Transportation industry. Fortunately, these transporters may follow the lead of the major and regional airlines, which have successfully faced similar challenges. While burdened with bankruptcies, the effects of 9/11, SARS and rising oil prices, the airlines have led the industry in strategic use of outsourcing as a mechanism to combat such challenges. The results are undeniably positive: the airlines successfully have curtailed the escalation of their operating and overhead costs.

| | SG&A CAGR% 2003-2005 | Revenue CAGR% 2003-2005 |
|-----------------------------------|-------------------------------------|------------------------------------|
| Railroads | 44% | 13.3% |
| Trucking | 37% | 21.6% |
| Air Delivery and Freight Services | 1% | 10.4% |
| Major Airlines Major Airlines | -1% | 13.8% |
| Regional Airlines | 5% | 19.5% |
| Shipping | 94% | 12.6% |

(Source: Hoovers.com, TPI Contracts Database and Yahoo! Finance.com)

This paper describes some of the key challenges that Travel and Transportation companies face and indicates some of the information technology outsourcing (ITO) and business process outsourcing (BPO) solutions to address these hurdles, specifically examining the momentum in the use and impact of third-party outsourcing in the industry to date. In addition to this document, my previously published ISG position paper, *Have the Airlines Outsourced All that They Can?* Provides insight on the airline's history in leveraging outsourcing. (You may reference this paper at <http://isg-one.com/knowledgecenter/whitepapers/private/papers.aspx>.)

CHALLENGES IN TRAVEL AND TRANSPORTATION

Before we look at the breadth of challenges facing the industry as a whole, let's first focus on the specific tangle of complexities that a company that carries freight over railways confronts as part of its daily operations. Things have significantly changed for its business in recent years. Because of the North American Free Trade Agreement (NAFTA), the World Trade Organization (WTO), the European Union and similar associations, its customers are shipping beyond borders more often as part of a continually growing extensive, interconnected global supply chain.



Customers want transparency -- they want to know exactly where their shipments are at any time throughout transport.

Adding to the complexity, its customers want transparency — they want to know exactly where their shipments are at any time throughout transport. For example, Wal-Mart, the largest retail chain in the United States, and other companies are encouraging freight transporters to implement radio frequency identification (RFID) systems that are compatible with their own systems for tracking merchandise. These customers want flexible transportation solutions and the ability to divert and redirect shipments, if needed.

And because many of these companies have implemented a just-in-time approach to their inventories, they want their shipper to quickly transport stock for their retail shelves, or parts, as demand for product manufacturing heats up. Beyond these steep customer requests, the cost of fuel and infrastructure (for example, trains, trucks and tracks) continues to rise. Additionally, the transporter must direct shipments in as safe a route as the tracks or roadways allow, complying with an increasing number of U.S. Homeland Security regulations, while anticipating possible terrorist threats that evade institutionalized precautions.

Within the transporter group, the freight railways must constantly restore and renovate their infrastructure, driving significant additional costs. For example, North America's freight railroads invested a record US\$8.2 billion on track, locomotives, signals, freight cars, new technology and facilities in 2006. For the past decade, the freight railroads reinvested an average 18 percent of their revenues in infrastructure improvements. By comparison, this outpaced the comparable 3.5 percent revenue reinvestment in infrastructure in the manufacturing industry during the same period¹.

In the United States, freight railroads move 42 percent of the ton-miles of all U.S. freight, more than any other mode of transportation. However, major U.S. freight railroads are privately owned, and they receive little government funding – unlike U.S. passenger railroads and both passenger and freight railroads in other countries. While these privately owned freight railroads must fund their own infrastructure costs, they must also compete with trucks and barges that do not pay all of their infrastructure costs. Trucks and barges cover only a small part of the costs of publicly owned infrastructure through user fees, such as fuel taxes².

¹"A Record Investment from North America's Freight Railroads," *Get the Rail Facts*, Association of American Railroads, 2006

²"Overview of U.S. Freight Railroads," *Association of American Railroads*, January 2006, pp. 1-2

TRAVEL AND TRANSPORTATION



Basic concerns common to the freight transport companies also impact passenger railways, ocean liners, trucks and airlines in the Travel and Transportation industry.

Clearly, this description shows today's railway shippers are managing much more than efficiently getting something from point A to B.

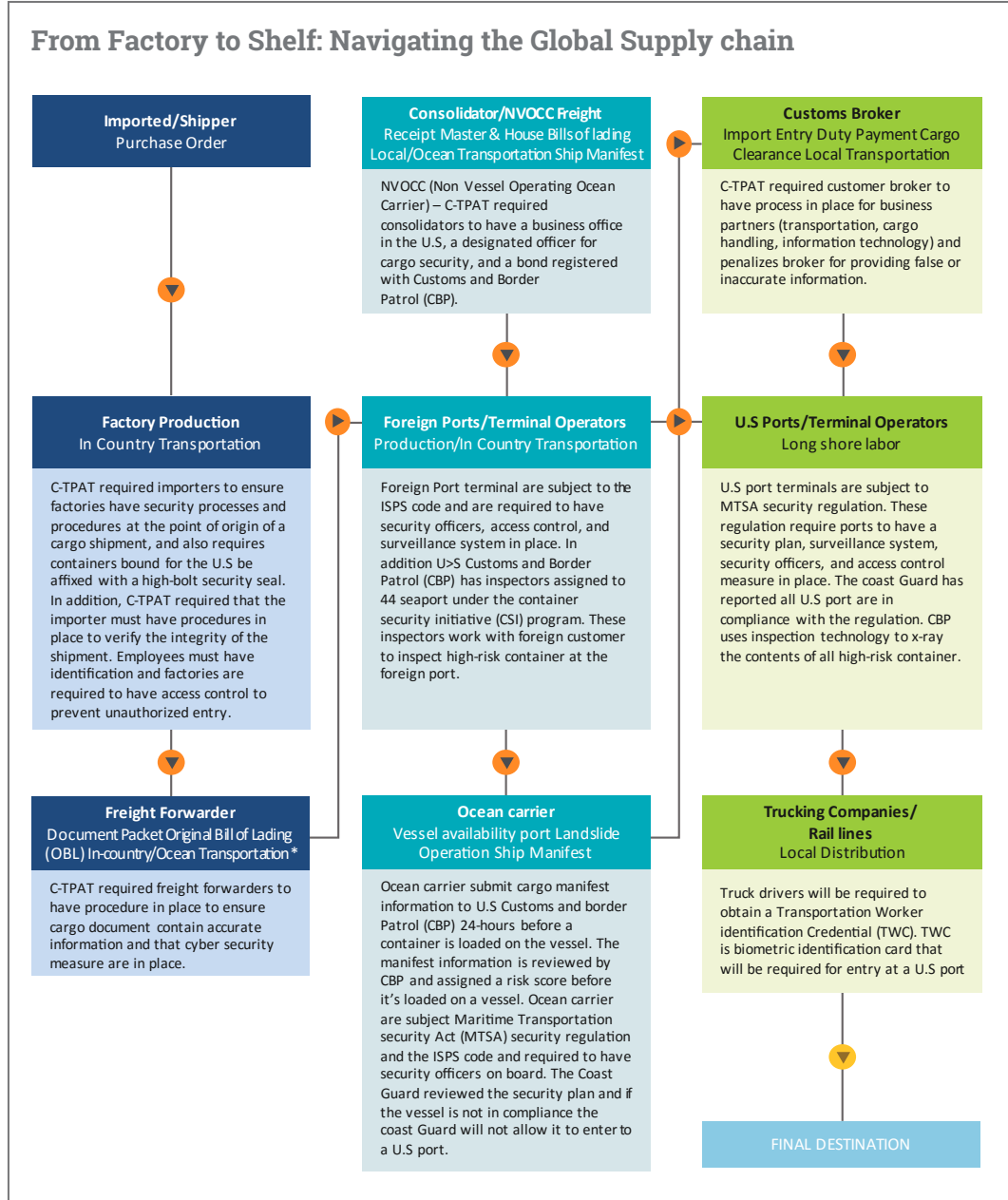
Most of these basic concerns common to the freight transport companies also impact passenger railways, ocean liners, trucks and airlines in the Travel and Transportation industry.

While global supply chains and travel logistics become more extensive, interconnected and expansive, they are also subject to more disruptions, threats and complexities. Demand for trucking, rail, maritime and airfreight and airline passenger services grew in 2005 and through 2006. These transporters faced more requests for their services, and this strong demand, in turn, resulted in constrained capacity and a tight labor pool, which, combined, enabled the transporters to charge higher prices. However, transportation company costs are rising faster than the rates these companies can actually charge for their services. Fuel costs have been especially high, particularly because of the impact of coastal hurricanes on the supply and distribution of fuel. This is true for all transporters. Labor costs also increased.

Some of the increasing costs for all transporters come from the challenge of tracking and securing the nation's transport system and its cargo. Terrorist threats and hazardous materials cargo vulnerabilities underscore the urgency of making air, road, rail and water cargo more secure. These concerns prompted a closer interaction and more cooperation between private transporters and public agencies responsible for Homeland Security. For example, the Transportation Research Board of the National Academies recommended and is attempting to mainstream an integrated, high level, all-hazard, National Incident Management System (NIMS). This is a responsive, multimodal risk-management process that will be integrated into major transportation programs and activities in the United States³.

The chart on the next page shows how the need for greater security impacts transporters at every step in the supply chain, including trucks, trains and ocean liner. Industry consolidation is another top challenge that Travel and Transportation companies face – consolidation as the industry continues to grow both organically and through acquisitions. The acquiring, growing companies often gain much-desired assets, improved product offerings and market positions, but they are also limited by overburdened IT infrastructures, which try to support the increased technology demands driven by growth. Often the IT infrastructure becomes strained to its limits, and – in the case of acquisitions – overly complex (driven largely by under-funded integration efforts). One of the larger consolidations in recent years in which a company benefited from considering outsourcing options was the Yellow Corporation merger with Roadway.

³*Hazard and Security Activities of the Transportation Research Board,* Transportation Research Board of the National Academies, October 2006



ITO AND BPO SOLUTIONS TO THESE CHALLENGES

As in most industries, Travel and Transportation companies that outsource gain from focusing company resources on core competencies, including:

1. Leveraging economies of scale in offerings.
2. Converting several fixed costs into variable costs.
3. Gaining access to the latest technology and optimization tools with costs shared among multiple outsourcers.

TRAVEL AND TRANSPORTATION



Travel and Transportation companies look to reduce costs by outsourcing functions such as call centers, internal business processes and IT shops.

4. Increasing the ability to respond to changes in market demand.
5. Improving flexibility in matching personnel to changing volumes and requirements.
6. Enhancing the ability to leverage expertise in compliance with governmental regulations, such as customs brokerage and security regulations.

Increasingly, Travel and Transportation companies look to reduce costs by outsourcing functions such as call centers, internal business processes and IT shops⁴. The specific kinds of tasks typically outsourced in the pioneering airline industry include passenger services and reservations; pricing and revenue management; crew rostering; logistics/freight management; customer loyalty and customer relationship management; maintenance and engineering; passenger facilitation, including check-in, load planning, boarding control and positive identification solutions. We anticipate that this list will grow as the trucking, railway and ocean shipping industries follow the airline industry's lead.

In addition to cost savings and strategic transformations, the introduction of ITO has enabled companies to implement quickly some of the latest technologies to solve the challenges highlighted earlier in this paper. Responding to the security challenges of terrorism, as well as the demands for efficiency and transparency, some Travel and Transportation organizations are adopting RFID solutions. The Department of Homeland Security and Department of State recently announced that it would expand the use of vicinity RFID at U.S. ports of entry. This technology, combined with the existing PASSport card, allows a travel document from a vehicle approaching inspection officers to be read from several feet away, speeding the process for truckers and other freight shippers, much like the vehicle going through the automated, pre-paid lane at tollway booths⁵.

RFID technology now includes scanners that are used in conjunction with remote devices. This means, for example, that a driver may sit in his truck while it is loaded and record the exact contents with his PDA or laptop software⁶.

RFID holds out great promise for the airlines, which are losing record numbers of bags — a daily average of 14,089 in August, according to the Bureau of Transportation Statistics. The airline industry is projected to spend US\$27.5 million in 2010 versus US\$11.8 million in 2006 on RFID baggage handling⁷. Other Travel and Transportation industry segments should also fare well by implementing this exciting innovative asset-management solution as well as global positioning systems. Companies choosing to adopt these technologies will drive operational excellence through lower cost and increased customer satisfaction.

⁴EDS Web site, "The Transportation Top 10 Trends," 2006.

⁵"DHS Proposes to Expand the Use of Vicinity RFID in Implementing Western Hemisphere Travel Initiative," Homeland Security Press Release, October 17, 2006.

⁶"RightTAG Unveils BT RightReader, Industry's First Bluetooth Scanner," Trucking Technology, March 9, 2006.

⁷According to ABI Research, as reported in "10 Technologies to Track," eWeek Strategic Partner, November 22, 2006.

TRAVEL AND TRANSPORTATION



The year 2017 should bring additional technological advances to the industry because the transportation sector has invested in research and innovations. Technologies that are rapidly increasing traction have been expanding the use of laptop computers and real-time GPS monitoring on cargo ships, trains and new roads to track real-time changes in their respective operations. We are also seeing advancements in alternative fuels, virtual reality simulators and dashboards, new ticketing systems to combat fraud, identity software to reduce internal fraud and sabotage, and efficient routing software. Wireless networks will also continue to be deployed both at transport hubs as well as on buses and trains for use by passengers and for a real-time view of congestion. These areas all present great opportunities for outsourcing service providers to provide their intellectual capital and products in supporting many of the innovative corporate outsourcing strategies.

OUTSOURCING TO DATE IN TRAVEL AND TRANSPORTATION

Travel and Transportation companies have not adopted outsourcing as rapidly or as extensively as have, for example, Manufacturing and Financial Services organizations. Possible reasons for the lag of outsourcing in the railroad, trucking and shipping sub-sectors may be recent merger and acquisitions taking place within their respective industries as well as homeland security concerns and related remediation activities in general. However, some major transportation contracts have been implemented. Nederlandse Spoorwegen, the main public transport railway company in the Netherlands, signed a mega deal (contracts valued at US\$1 billion or greater) in 1995. Contracts valued at greater than US\$500 million were executed by U.S. Railway Burlington Northern Santa Fe (BNSF) in the United States in 2002, Denmark-based container shipping giant AP Moller-Maersk in 2004, and U.S. government-subsidized railway Amtrak in 1994. 8 Global airlines set the pace among Travel and Transportation companies, signing some of the largest contracts on record for this sector, with seven mega deals among them. TPI advised on several large airline agreements, including the following:

1. Continental Airlines and EDS signed a US\$2.1 billion, 10 year full ITO contract in 1991.
2. United Airlines and EDS signed a US\$630 million Infrastructure Outsourcing contract in 2005.
3. American Airlines and SABRE agreed to a US\$250 million Applications Development and Maintenance (ADM) contract in 2002. In 2001, the airline enlisted EDS to provide a full-scope of ITO services for 10 years. The contract was valued at US\$2.2 billion.
4. In 2004, Qantas Airways selected IBM and Telstra to provide US\$1 billion in several infrastructure services during a decade.

Since 1989, 130 different Travel and Transportation companies (including those in the Hospitality sub-segment) completed 211 contracts, with a total contract value (TCV) of approximately US\$56.2 billion. The industry adoption pattern below shows that, to date, the

TRAVEL AND TRANSPORTATION



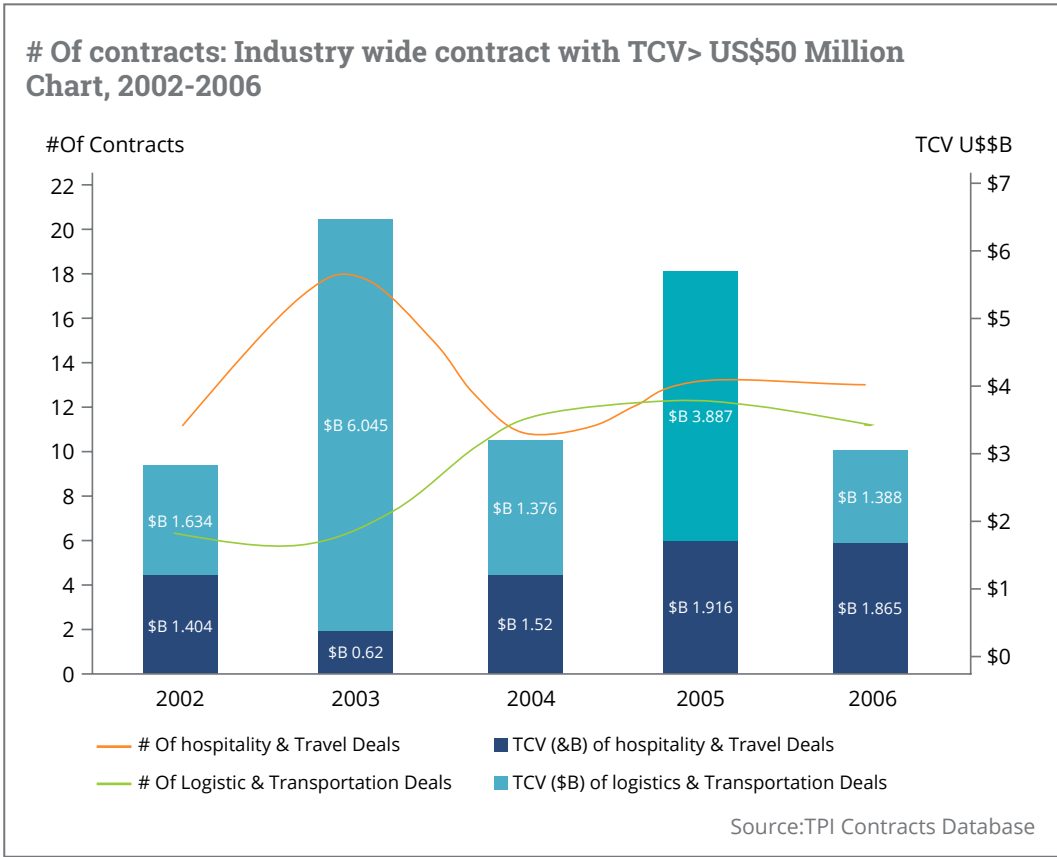
high point of adoption by value of contracts was 2003, and the high-water mark for number of contracts is 2005. It appears that 2006 did not shape up to be as strong as 2003 or 2004, but it still represents a substantial number of contracts awarded.

Adoption of outsourcing in Europe for this industry sub-segment almost equals that in the Americas. Since 1989, 112 (53%) Americas contracts, 78 (37%) European contracts and 21 (10%) Asia-Pacific contracts have been signed.

Most (180 or 85 percent) of the 211 contracts since 1989 were ITO contracts, with 31 BPO contracts (15 percent) among them.

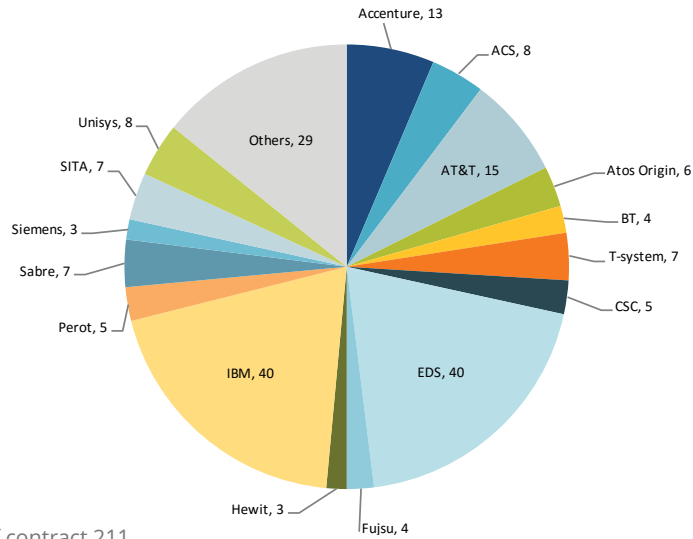
Which companies are signing these contracts? Nearly 70 percent, or 145, of the 211 contracts, were signed by Fortune Global 2000 companies. Sixty-three unique Forbes Global 2000 companies signed the 145 contracts, whose total value was US\$44.8 billion. They accounted for 80 percent of the total TCV of the US\$56.2 billion in TCV signed since 1989.

Among service providers, the Big Six providers (i.e., Accenture, ACS, CSC, EDS, HP, and IBM) – especially IBM and EDS – prevailed in winning the greatest number and value of contracts from 1989 through 2006.



TRAVEL AND TRANSPORTATION

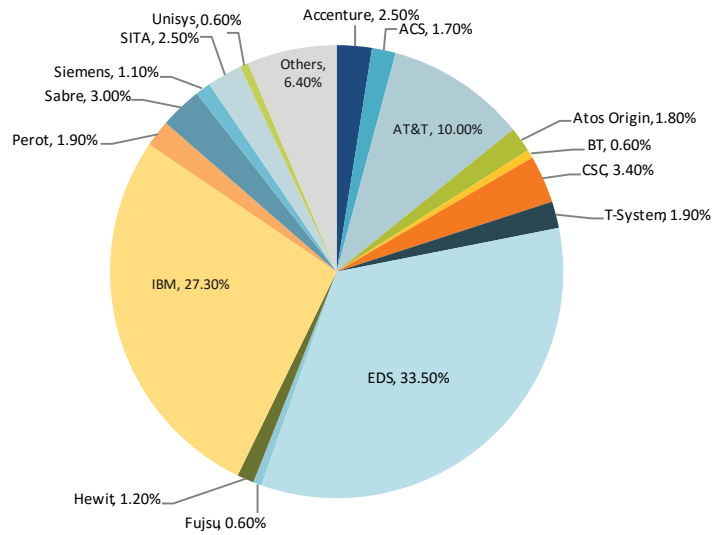
Predominant Services Providers in travel and Transportation by number of Contracts, 1989-2006



Total Number of contract 211
 Total Number of unique Services provider 42
 "Other" includes SPs with 3 contracts or fewer

Source:TPI Contracts Database

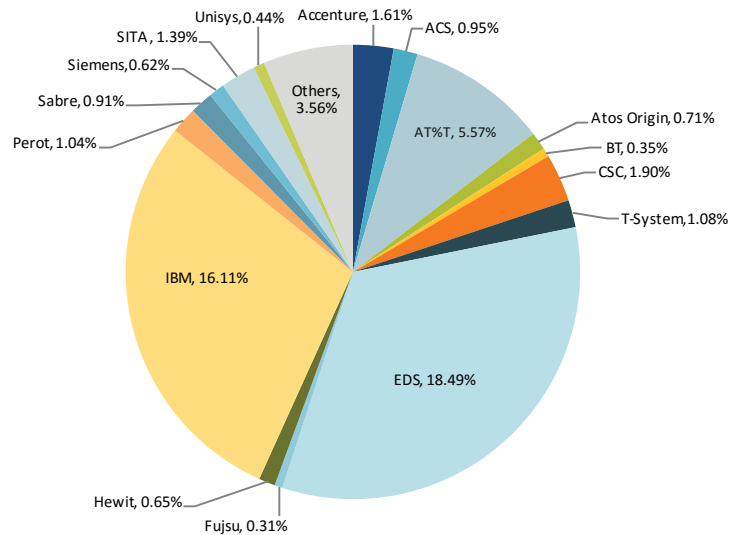
Predominant Services Providers in Travel and Transportation by % share of TCV, 1989-2006



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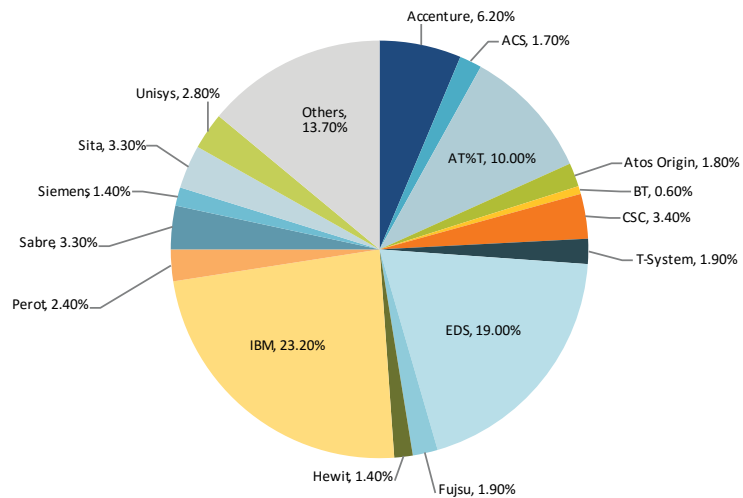
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Predominant Services Providers in Travel and Transportation by TCV, 1989-2006



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BENEFITS OF A SOURCING ADVISOR AND ISG EXPERIENCE

The journey taken by global corporations to outsource, either selectively or through a more comprehensive scope, became a widely deployed management tool used to implement strategic imperatives. A wide variety of demands drive outsourcing adoption, including securing cost savings, gaining access to additional skills or resources, focusing on core strategic areas, attaining a more variable cost structure, reinvesting sourcing-transaction savings into needed upgrades to their systems and application infrastructure, and improving quality and service-delivery performance.



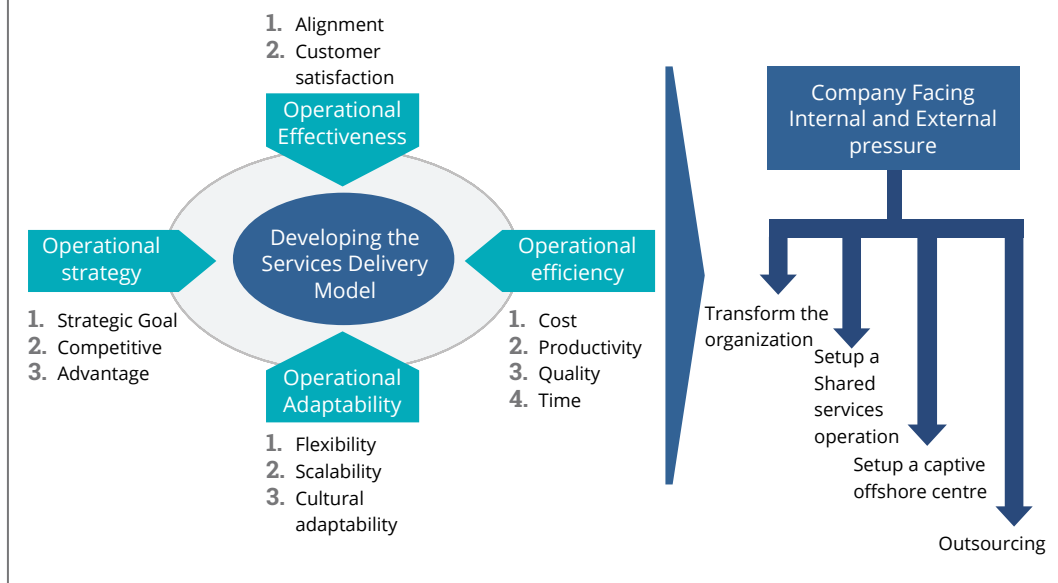
Enterprises seek sourcing advisors for their proven expertise, ability to mitigate risks, disciplined process and objective input on solutions to complex business challenges.

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Consider what a sourcing advisor can do to support a company's pursuit of any of these strategic imperatives:

1. Work with the client organization to evaluate sourcing strategies, such as organizational transformation, shared services, captive center, outsourcing and other models.
2. Identify what these sourcing strategies can do to help achieve corporate objectives.
3. Assess functions and processes for sourcing opportunities, including a quantifiable review of current spend as compared to market data.
4. Select and rank service providers.
5. Lead the development of requests for information or proposals, as required.
6. Evaluate proposals, service delivery options and service providers in terms of financials and of business objectives that can be achieved.
7. Negotiate or renegotiate sourcing contracts.
8. Assist in implementation and transaction activities.
9. Establish a governance framework.
10. Manage sourcing relationships.

TPI helps Travel and Transportation companies address all possible route to optimizing their sourcing delivery model



With a history of objectivity and client success, ISG helps Travel and Transportation clients optimize their sourcing delivery models.

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Since completing its first Travel and Transportation outsourcing contract in 1991 with Matson Navigation, ISG advised on 23 of 211 (10.9 percent) of transactions that went to contract in the Travel and Transportation subsegment. The firm advised on more than US\$18 billion in TCV, or about 33 percent of the TCV of all Travel and Transportation contracts (US\$56.2 billion).

Since 1991, ISG helped 37 unique Travel and Transportation enterprises with 117 different engagements (i.e., assessments, consulting, transactions and service management & governance). More than 370 innovative, experienced ISG advisors understand that clients want value (greater ROI and spending), speed to results (faster deployment of streamlined service delivery models) and risk mitigation (enduring solutions with manageable operating risk and disruption).

ABOUT THE AUTHOR

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With more than 25 years of experience in sourcing, Harvey is a sought-after global industry advisor with particular expertise in global sourcing strategies, digital transformation trends, governance and emerging service delivery operating models. He offers his clients insights gained from involved with some of the largest and most complex transformational sourcing initiatives in the industry. His experience includes working with the architecture of mergers, acquisitions and divestitures and designing creative transaction structures, such as cost-quality and outcome-based relationships. Harvey holds a degree in finance from Florida International University and an MBA from the University of Miami.



ABOUT ISG

ISG (Information Services Group) (NASDAQ: III) is a leading global technology research and advisory firm. A trusted business partner to more than 700 clients, including 75 of the top 100 enterprises in the world, ISG is committed to helping corporations, public sector organizations, and service and technology providers achieve operational excellence and faster growth. The firm specializes in digital transformation services, including automation, cloud and data analytics; sourcing advisory; managed governance and risk services; network carrier services; technology strategy and operations design; change management; market intelligence and technology research and analysis. Founded in 2006, and based in Stamford, Conn., ISG employs more than 1,300 professionals operating in more than 20 countries—a global team known for its innovative thinking, market influence, deep industry and technology expertise, and world-class research and analytical capabilities based on the industry’s most comprehensive marketplace data. For more information, visit www.isg-one.com.

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