

CHAPTER 10: Establishing the Proper Profit Margin for a Dedicated Fleet

In the previous chapter, dedicated fleet margin was determined based on a target operating ratio requirement such as a standard of 88.0%. While this method is very easy to apply, operating ratio fails to account for all of the necessary variables for establishing proper margin levels and accurate pricing. A standard operating ratio pricing rule is fairly accurate for fleets where there are no unusual equipment requirements and where the expected utilization falls into a typical range of 1,900 to 2,500 miles per truck per week. However, even on some “typical” deals, the standard operating ratio method is not entirely accurate.

Many dedicated fleets are specialized solutions that often contain unusual equipment requirements or extreme utilization levels.¹ Pricing that is based purely on a standard operating ratio or cost-plus approach does not fully capture the financial and investment implications of the unusual requirements. The standard operating ratio approach also fails to fully account for the efficiencies of high utilization and the inefficiencies of low utilization. This chapter demonstrates the weaknesses of the operating ratio method and provides a more sophisticated approach based on the application of common financial analysis tools for evaluating capital investment decisions.

Note: The concepts presented in this chapter assume that the carrier purchases and owns the fleet of trucks and trailers. In arrangements where the carrier utilizes owner-operator tractors or leased equipment, the analysis process is much different and certain concepts shown here will not necessarily apply. The key financial and pricing considerations in these types of non-ownership of equipment arrangements will be discussed at the end of the chapter.

The Risks of Operating Ratio Based Pricing

Dedicated pricing that is based purely on the operating ratio method represents a simple cost-plus pricing approach. A cost-plus approach is often appropriate for an on-going business such as a new product line for a retail store or a new menu item at a restaurant. However, a cost-plus approach is not always appropriate for a new, incremental investment such as a new fleet of trucks and trailers. The key difference is that the purchase of the incremental group of trucks and trailers requires the carrier to make a substantial capital investment in the new equipment. The fleet will also have unique operating characteristics, particularly utilization, that must also be taken into account within the pricing strategy and analysis.

In order for the proposed dedicated fleet to be profitable, revenues must exceed operating cost. However, for the *capital investment* to be profitable and justifiable, profits and cash flows from the investment must meet or exceed a minimum required return on the invested funds. As will be illustrated in this chapter, an operating ratio of 88% (or any

¹ Specialized deals may require 10 trailers per tractor, utilization of only 900 miles per week, or utilization of 5,000 miles per week. Deals of this type require special margin considerations.

static operating ratio level) does not always result in an acceptable return on investment. In other cases, an 88% operating ratio can also result in a return on investment that is far too high, resulting in unnecessarily high pricing.

Using a static operating ratio level to price every fleet will often result in one of two critical pricing mistakes. The first and most costly mistake occurs when a carrier prices an undesirable opportunity too low. The most common mistake of this type would involve a low utilization fleet that requires a high number of trailers per tractor being priced too low. Not only is the fleet potentially unprofitable, but because of the low pricing mistake, the carrier also stands a good chance of being awarded a fleet that produces poor financial results.

The second mistake occurs when a carrier prices a very attractive opportunity too high and fails to provide competitive pricing for the business opportunity. A common mistake of this type might occur when the shipper requests a fleet of dedicated trucks and drivers but the entire trailer fleet is provided by the shipper. Carriers that do not adjust pricing and margin downward by the appropriate amount will be priced too high and miss out on this financially attractive opportunity. The most critical mistakes are outlined below.

Critical Operating Ratio Pricing Mistakes	
Under-pricing a Less Desirable Dedicated Fleet Opportunity	Over-pricing a Highly Attractive Dedicated Fleet Opportunity
<p>The most critical error is to price a dedicated opportunity too low by not properly adjusting for extremely low utilization levels or extremely high investment requirements such as a high trailer-to-tractor ratio. Operating ratio does not consider the significant capital investment required by a fleet with an above average trailer-to-tractor ratio.</p> <p>Inaccurate, low pricing could result in the carrier being awarded the potentially unprofitable dedicated fleet. In reality, the fleet is actually not as profitable as it may appear when the evaluation of financial performance is based only on operating ratio.</p>	<p>In opportunities that offer above average utilization or below average equipment (trailer) requirements, an operating ratio pricing approach will often result in a price that is too high and not competitive. The operating ratio approach does not fully adjust for the benefits of the high utilization or reduced trailer investment levels.</p> <p>Over-pricing will result in an uncompetitive proposal and the loss of an otherwise profitable opportunity. In the long run, over-pricing may also cause the carrier to be excluded from future opportunities with a shipper because of past pricing being consistently too high.</p>

This chapter provides the tools for avoiding these mistakes by creating dedicated pricing using an investment-based approach. The next section illustrates the basic weaknesses of the operating ratio approach. Later sections will outline a more suitable, investment-based analysis approach to facilitate accurate, competitive and profitable pricing.

These pages are a sample from the 464-page book:

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By Leo J. Lazarus

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