

Freight: Your place or mine?

FOB origin or destination: Do these terms have any real meaning in the supply chain?

By Pat Klancer

One of the most overlooked areas of significant cost in the healthcare supply chain today is freight. Freight is frequently ignored by Materials Management professionals because they have so many bigger fish to fry. One significant barrier to controlling this cost is that data on the cost of freight is frequently buried in the accounting system. Another issue is the lack of knowledge and full understanding of the meaning of the various freight terms used by the vendor community. Freight is not even on the radar screen for non-professionals: many purchasing staffers never see the freight costs which are routinely added to invoices by vendors. And for the clinical

staff who are very often the key drivers of the emergency order/overnight shipment cycle, freight cost is simply not a consideration in comparison to patient care or keeping the almighty surgeon happy.

Yet freight costs account for several hundred thousand dollars annually at the typical community hospital, and can easily exceed a million dollars at large teaching hospitals or IDN's.

The FOB Mystery

The term "FOB," or Free on Board has been around for years, but there is a lot of confusion on what it truly means. In fact, there is a common misconception that it means "Freight on Board," but all of the sources I found say this is a misnomer. The best definition I found came from a Purchasing Department at Colorado's Western State College.

Most healthcare professionals are also under the misconception that "FOB Destination" ensures the vendor pays for all of the freight costs, and assumes all risk. In reality, the modifiers and qualifications to this term are endless, and there is no such thing as a shortcut or abbreviation that covers all of the permutations. This fact was proven by a recent analysis of a large GPO's contract portfolio.

A summary of the GPO portfolio was prepared as a tool for the buyers to have a quick look-up of the contractual freight terms. Out of 400 contracts, there were at least 20 different categories for freight. The uses of the term "FOB" were extremely variable. Exhibit B provides a summary of these variations on the contract terms.

As you can see in the chart, the majority of the contracts still do pay freight costs for normal delivery (not overnight delivery), and under certain circumstances. However, there is no consistency in the meaning of FOB, and in some cases FOB Destination is qualified by the statement that the hospital assumes ownership

when product leaves the vendors' shipping dock. In other cases, FOB Origin was qualified to state the vendor would handle insurance and claims for damages.

Exhibit A shows the textbook use of the term FOB; Exhibit B shows the reality. As shown by the summary in Exhibit B, buyers are frequently offered free freight as an incentive to increase commitment, order sizes, or scheduled deliveries. More than a quarter of these contracts contained such requirements. If the requirements are not met, the customer is charged for freight under the "Pre Pay and Add" qualifier clause (PP&A).

If most of the contracts provide for free freight, why are hospital freight budgets so high?

Freight cost analysis

In analyzing the total freight budget for a large, well-respected community hospital in the southeast, it quickly became apparent that freight cost is indeed a difficult nut to crack. There are many small dollar amounts billed under a wide variety of circumstances. Most Purchase Orders are cut without a specific price for freight. The buyers will not be aware of the cost of freight unless they happen to look at the invoice, which typically only occurs for a small percentage of the orders.

An important key to unlocking the freight mystery is to have the freight costs captured in a separate expense classification by the accounts payable staff. This may or may not be occurring in many hospitals, because the A/P staff will find it easier to bury the freight cost into the total supply cost, by simply posting the total invoice amount into one budget class. Putting a stop to this practice is critical for two reasons. First, if freight cost is simply added to the inventory asset account, this will create a large variance to the inventory at the end of the year. Secondly, if these costs are buried into the supply budgets, then it will be impossible to analyze, control and reduce freight cost. By the same token, these individual freight amounts should be posted to separate expense sub-accounts for each department, not to one big catch-all department. As with any expense, if it is not seen by the department managers, then they will claim no responsibility for it.

Once total freight expense information is being captured appropriately, it can be provided

Exhibit A

FOB DEFINITION - SHIPPING TERMS OF SALE

FOB, Free On Board, is a transportation term that indicates that the price for goods includes delivery at the seller's expense to a specified point and no further. The FOB term is used with an identified physical location to determine 1) the responsibility and basis for payment of freight charges, and 2) the point at which title for the shipment passes from seller to buyer. The FOB location terms, Origin and Destination, may be qualified by modifiers. The modifier determines the payment of the transportation charges. Modifiers denote nothing about the title of the goods or filing of claims.

The three most common modifiers are: Collect, Prepaid & Add, and Prepaid & Allow.

Collect The carrier collects the transportation charges from the buyer.

Prepaid & Add The seller prepays the transportation charges, but adds the charges to the invoice for reimbursement from the buyer.

Prepaid & Allow The seller prepays the transportation charges and they are already included in the contract price.

TITLE & CONTROL OF GOODS

FOB Origin

The buyer assumes title and control of the goods the moment the carrier signs the bill of lading. The buyer assumes risk of transportation and is entitled to route the shipment. The buyer is responsible for filing claims for loss or damage.

FOB Destination

The seller retains title and control of goods until they are delivered and the contract of carriage has been completed. The seller selects the carrier and is responsible for the risk of transportation. The seller is responsible for filing claims for loss or damage.

Source: Western State College, Gunnison, CO, "Purchasing Guide: How to Make Purchases at Western State College" by Benay Muckleroy, 2001.

Exhibit B

SUMMARY OF CONTRACTUAL FREIGHT TERMS

Grade/Code	Description	General Terms	Risk	Quoted FOB	Number of Contracts	Percent of Total	
A	Great: Vendor Pays - Special Delivery	Vendor provides special services; expedited delivery at no charge	Vendor	Destination*	25	6.2%	
B	Good: Vendor Pays - Normal Delivery	Vendor Pays for Normal Deliveries; Distribution may or may not be an option	Vendor	Varies	213	53.0%	
C	OK: Vendor Pays - Under Certain Circumstances	Freight paid if: Minimum Order Value is met, or if Commitment Form signed and met, or for Standing Orders, or distributor pays freight, or special arrangements for special types of products; otherwise, PP&A	Varies based on level of purchase	Varies based on level of purchase	109	27.1%	
D	Fair: Hospital Pays, Low Risk	Hospital pays unless product is ordered through a distributor; vendor covers risk	Vendor	Varies	31	7.7%	
F	Poor: Hospital Pays, All Risk	Generally charged to Hospital, PP & A, see contract for detailed shipping fees	Hospital	Origin*	24	13.7%	
**Even for contracts which clearly met the traditional definitions of FOB Origin or FOB Destination, there were exceptions which quoted the opposite phrase and then qualified it.					GRAND TOTAL	402	100.0%

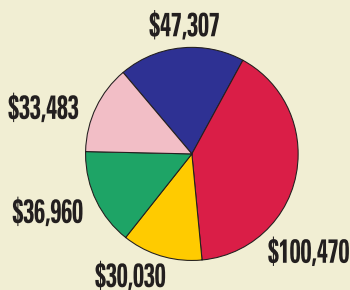
back to the materials management staff in spreadsheet form. The Purchasing staff should use this information to identify the high dollar freight vendors. As with all cost stratifications, a small number of vendors account for a high percentage of the overall freight costs. In our

Some vendors created freight charge calculations as part of their order entry process; product weights and other factors are captured in their automated systems so that the actual freight charges could be calculated and quoted to customers at the time of order. Other com-

Exhibit D is startling: 90% of the vendors charge a reasonable amount for freight: about \$18.00 per invoice. (By the way, this amount generally covers the cost of overnight shipment for a package weighing 5 pounds or less.) Yet the top 10% of the vendors routinely charge a fee which is double the norm, and the top 1% of the vendors charge almost 4 times the amount of the low tier.

Exhibit C

- The blue slice represents 2 vendors
 - The red slice represents 25 vendors
 - The yellow slice represents 27 vendors
 - The green slice represents 54 vendors
 - The pink slice represents 400 vendors
- The top 10% of the vendors, (blue, red, and yellow) represent 71% of the cost.



test hospital, Exhibit C represents the A-B-C analysis for freight costs by vendor.

Exhibit C

In this example, ten percent of the vendors represent about 70% of the cost. By working with about 25 vendors, the purchasing staff could impact more than 60% of the cost.

How do manufacturers price freight when passing this cost along to their customers? In healthcare, traditionally freight was paid by the vendor, and absorbed into the cost of the product. When the healthcare market became more competitive, manufacturers found a way to protect eroding profit margins by billing that cost back to the customer. For the reasons listed above, customers paid little attention to this hidden cost, and companies could charge whatever they liked with impunity.

panies set up simplified grids to charge a flat fee based upon the level of timeliness requested. Sometimes these fees are significantly higher than the actual prices charged by the shipper; in this way freight becomes a profit center rather than just a cost which is passed along to the customer. In the sample hospital, this practice became evident when the actual price per invoice was examined; see Exhibit D.

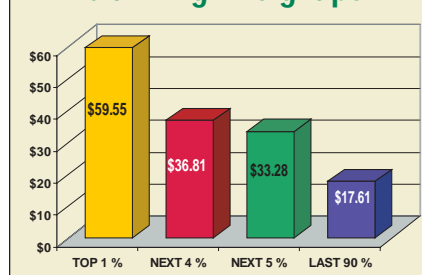
Exhibit D

This slide graphically displays the fact that a few vendors are using freight as a profit center. 90% of the vendors charge about \$18 per invoice. A small group of vendors charge premium prices for freight, or a flat fee which is significantly higher than typical freight costs.

International shipping

This article would be incomplete if the international freight designations were not mentioned. A whole different set of acronyms are in use for these shipping terms, many of which will be quoted when you purchase equipment which is manufactured overseas. One term we have seen in use in our industry is "CIF": Cost, Insurance, and Freight. This is part of the International Commercial Terms (INCOTERMS), which was developed by the International Chamber of Commerce (ICC, similar to our UCC). These terms were first published in 1936, and the most recent edition is INCOTERMS 2000.

Exhibit D-Avg. Freight per Inv.



See *FREIGHT* on page 80

FREIGHT from page 81

In conclusion, freight is an area ripe for cost reduction. Total freight expenditures have crept up to significant levels, and this is a cost that should be monitored. The Materials Manager can take the time to analyze their own experiences, and in so doing, educate hospi-

tal staff on how to minimize these expenses. As with all of our business, shortcuts do not always provide the protection needed on purchase orders. The term FOB must be clarified before the order is placed, and many times hospitals can meet the vendor requirements which will provide the freight at no extra charge. **HPN**

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Incoterms 2000 Descriptions

- **EXW EX WORKS** (... named place) "Ex works" means the seller's only responsibility is to make the goods available at the seller's premises, i.e., the works or factory. The seller is not responsible for loading the goods on the vehicle provided by the buyer unless otherwise agreed. The buyer bears the full costs and risk involved in bringing the goods from there to the desired destination. Ex works represents the minimum obligation of the seller.
- **FCA FREE CARRIER** (... named place) This term has been designed to meet the requirements of multimodal transport, such as container or roll-on, roll-off traffic by trailers and ferries. It is based on the same name principle as F.O.B. (free on board), except the seller fulfills its obligations when the goods are delivered to the custody of the carrier at the named place. If no precise place can be named at the time of the contract of sale, the parties should refer to the place where the carrier should take the goods into its charge. The risk of loss or damage to the goods is transferred from seller to buyer at that time and not at the ship's rail. The term "carrier" means any person by whom or in whose name a contract of carriage by road, rail, air, sea, or a combination of modes has been made. When a seller has been furnished a bill of lading, way bill or carrier's receipt, the seller duly fulfills its obligation by presenting such a document issued by a carrier.
- **FAS FREE ALONGSIDE SHIP** (... named port of shipment) "F.A.S." or "free alongside ship" requires the seller to deliver the goods alongside the ship on the quay. From that point on, the buyer bears all costs and risks of loss and damage to the goods. Unlike F.O.B., F.A.S. requires the buyer to clear the goods for export and pay the cost of loading the goods.
- **FOB FREE ON BOARD** (... named port of shipment) Under "F.O.B." or "free on board," the goods are placed on board the ship by the seller at a port of shipment named in the sales agreement. The risk of loss of or damage to the goods is transferred to the buyer when the goods pass the ship's rail (i.e., off the dock and

placed on the ship). The seller pays the cost of loading the goods.

- **CFR COST AND FREIGHT** (... named port of destination) "CFR" requires the seller to pay the costs and freight necessary to bring the goods to the named destination, but the risk of loss or damage to the goods, as well as any cost increases, are transferred from the seller to the buyer when the goods pass the ship's rail in the port of shipment. Insurance is the buyer's responsibility.
- **CIF COST, INSURANCE AND FREIGHT** (... named port of destination) "CIF" is CFR, with the additional requirement that the seller procure transport insurance against the risk of loss or damage to goods. The seller must contract with the insurer and pay the insurance premium. Insurance is generally more important in international shipping than domestic shipping, because U.S. laws generally hold a common carrier to be liable for lost or damaged goods.
- **CPT CARRIAGE PAID TO** (... named place of destination) This term means the seller pays the freight for the carriage of the goods to the named destination. The risk of loss or damage to the goods and any cost increases transfers from the seller to the buyer when the goods have been delivered to the custody of the first carrier, and not at the ship's rail. Accordingly, "freight/carriage paid to" can be used for all modes of transportation, including container or roll-on roll-off traffic by trailers and ferries. When the seller is required to furnish a bill of lading, way bill, or carrier receipt, the seller duly fulfills its obligation by presenting such a document issued by the person contracted with for carriage to the main destination.
- **CIP CARRIAGE AND INSURANCE PAID TO** (... named place of destination) This term is the same as "freight/carriage paid to (CPT)" but with the additional requirement that the seller has to procure transport insurance against the risk of loss or damage to the goods during the carriage. The seller contracts with the insurer and pays the insurance premium.

- **DAF DELIVERED AT FRONTIER** (... named place) "Delivered at frontier" means that the seller's obligations are fulfilled when the goods have arrived at the frontier but before the customs border of the country named in the sales contract. The term is primarily used when goods are carried by rail or truck. The seller bears the full cost and risk in delivering the goods up to this point, but the buyer must arrange and pay for the goods to clear customs.
- **DES DELIVERED EX SHIP** (... named port of destination) Means the seller shall make the goods available to the buyer on board the ship at the place named in the sales contract. The seller bears the full cost and risk involved in bringing the goods there. The cost of unloading the goods and any customs duties must be paid by the buyer.
- **DEQ DELIVERED EX QUAY** (... named port of destination) Means the seller has agreed to make the goods available to the buyer on the quay or the wharf at the place named in the sales contract. The seller bears the full cost and risks in delivering the goods to that point including unloading.
- **DDU DELIVERED DUTY UNPAID** (... named place of destination) Under these terms, the seller fulfills his obligation to deliver when the goods have been available to the buyer uncleared for import at the point or place of the named destination. The seller bears all costs and risks involved in bringing the goods to the point or place of named destination. There is no obligation for import clearance.
- **DDP DELIVERED DUTY PAID** (... named place of destination) represents the seller's maximum obligation. The term "DDP" is generally followed by words indicating the buyer's premises. It notes that the seller bears all risks and all costs until the goods are delivered. This term can be used irrespective of the mode of transport. If the parties wish to make clear that the seller is not responsible for certain costs, additional word should be added (for example, "delivered duty paid exclusive of VAT and/or taxes").

Source: www.airkargo.sia