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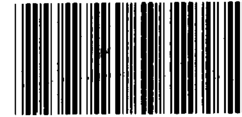
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT, LOGISTICS,
AND READINESS DIVISION

APRIL 28, 1981


115078

Rear Admiral Bruce Keener
Commander
Military Sealift Command AGC00053

Dear Admiral Keener:

Subject: Weaknesses in Negotiating Rates and Services for Commercial Containerized Sealift (PLRD-81-27)

We have completed our review of the management of commercial containerized sealift service and the process of negotiating rates for such service. We found a number of areas that offer potential for improving the service, while at the same time insuring the availability of the lowest and most advantageous rates. These areas include:

--revising your solicitation of offers to include information on expected volumes of shipments between specific pairs of points,

--allowing carriers to base their bids on traffic patterns,

--allowing rates to remain fixed until circumstances and cost factors dictate change, and

--allowing shippers greater freedom to choose between cost and service.

Details of our findings are set forth in the enclosure to this letter. The enclosure also contains recommendations designed to effect the potential improvements cited above. We would appreciate receiving your comments on our findings and recommendations.

We are sending copies of this report to the Secretary of Defense and the Secretaries of the Army, Navy, and the Air Force.

Sincerely yours,

Henry W. Connor
Associate Director

Enclosure

(943475)

WEAKNESSES IN NEGOTIATING RATES AND SERVICE FOR COMMERCIAL CONTAINERIZED SEALIFT

Contents

		Page
CHAPTER		
1	INTRODUCTION	1
	Objectives, scope, and methodology	2
2	RATE NEGOTIATIONS SHOULD BE MORE COMPETITIVE	3
	Competing for unknown requirements	3
	Inability to bid for specific traffic	4
	Unnecessary renegotiation	5
	Conclusions and recommendations	6
3	RATES AND SERVICE SHOULD BE MORE CLOSELY RELATED TO SHIPPERS' NEEDS	9
	Small container problems	9
	Shipper discretion lacking	11
	Conclusions and recommendations	12
APPENDIX		
I	OCEAN RATES BID OVER THE PAST FIVE YEARS	13

ABBREVIATIONS

DOD	Department of Defense
M/T	Measurement ton (40 cubic feet)
MSC	Military Sealift Command
MTMC	Military Traffic Management Command

CHAPTER 1

INTRODUCTION

In fiscal year 1980, the Military Sealift Command (MSC) spent over $320 million to provide DOD shippers with commercial containerized ocean transportation service. Containerized service, or containerization, is a relatively recent innovation in shipping which allows the loading of cargo into intermodal (land and water) containers for shipment from source to user over several modes of transportation without intermediate re-handling. Containerization is the principal means by which DOD supplies its forces overseas.

MSC obtains rates for the movement of containerized service through a system of competitive bidding. Twice a year MSC asks the U.S.-flag ocean carriers to make offers for handling DOD cargo. The bidding is based on commodity categories, land and ocean routes, and container sizes. Bids are subject to negotiation, but for the most part are accepted as offered. Bids are fixed for 6-month periods.

MSC's acceptance of bids results in container agreements. The agreements spell out the contractual terms between MSC and the carriers and are uniform, except for the rates themselves, among all carriers which make acceptable offers.

There are two major elements of each agreement. On the one hand, the carrier stipulates that it operates as a common carrier in international ocean service providing the service covered by its rates; that if it becomes the low cost carrier on any of the major ocean routes, it will reserve 25 percent of its capacity for MSC cargo (provided MSC releases what is not needed within an agreed period of time); and it agrees to participate in MSC's contingency sealift augmentation plan (the Sealift Readiness Program). On the other hand, MSC agrees to protect carriers holding agreements from competition from non-agreement carriers (provided they meet satisfactory service requirements) and stipulates that it will distribute cargo among carriers providing satisfactory service according to the least cost to MSC subject to certain maximum limitations on major routes.

The Military Sealift Command owns no cargo itself. The cargo moving at the MSC negotiated rates belongs to or is sponsored by a specific DOD supply system. Each system is responsible for budgeting and financing its own shipping costs. Although each system is required to use MSC as its agent for procuring the commercial sealift service, it deals with MSC through the Military Traffic Management Command (MTMC). MTMC, in effect acts as the shippers' agent with MSC.

The shippers place their day-to-day container requirements on MTMC, which reviews them and submits them to MSC. MSC books the cargo for a specific route (both inland and overseas) with a specific carrier, ship, and voyage. This information is relayed back to the shippers through MTMC. The shippers then contact the ocean carriers for the containers, load them, and prepare the initial shipment documentation, which is finalized by MTMC. The carriers arrange for the inland transportation to their ships, transport the cargo to the overseas ports, and arrange for the transportation to the consignees. MSC pays the carriers according to the MTMC documentation using the container agreement rates and is reimbursed by the shippers at MSC's industrial-fund billing rates.

OBJECTIVES, SCOPE, AND METHODOLOGY

The purpose of our audit was to find out how well MSC was obtaining rates and services for meeting DOD shippers' container requirements. We wanted to determine whether the present system of procurement was effective in getting the lowest and most advantageous rates and if it adequately considered the needs of DOD's shippers and the ability of the ocean carriers to offer such rates.

We reviewed the services covered by MSC's international container agreements and concentrated on the shipping routes outbound from the United States. We looked at what the shipper services did to move containers and how well they did it. We looked at the steamship lines in the same way--how well did they supply the service that DOD asked for. When we found conflicts or problems, we determined how likely it was that the present system would be able to solve them. Where were the incentives for the shipper services and steamship lines to (a) identify problems and (b) make changes in their own operations to solve these problems?

In conducting our analysis, we met with the major command activities of both the MSC and MTMC and we spoke with personnel representing each of the U.S.-flag steamship lines offering substantial container service to DOD about the negotiation process, the container agreements, and their service to non-DOD customers. Additionally, we held meetings with the Defense Logistics Agency, the Army Materiel Development and Readiness Command, the Air Force Logistics Command, the Naval Supply Systems Command, the Army-Air Force Exchange Service and the Defense Personnel Support Center. Finally, we contacted selected commercial vendors, railroads, and motor carriers.

CHAPTER 2

RATE NEGOTIATIONS SHOULD BE MORE COMPETITIVE

The Military Sealift Command could improve its process of negotiating rates so as to ensure maximum competition among carriers bidding for MSC's traffic. Currently it bases its competition on largely unknown requirements and refuses to allow carriers to bid for specific traffic. It also fixes the bids for arbitrary timeframes.

The effect of this negotiation is rates which are not based on anticipated demand for service, but rather on the carriers' guess. They are unilateral offers at levels which can bear little relation to demand for or cost of service.

COMPETING FOR UNKNOWN REQUIREMENTS

Although MSC buys service in containerload units between specific pairs of points, carriers have no idea at the time of negotiations how much service MSC intends to buy. Consequently, their rate offers are made with little idea as to the return these offers will have for them and how low they can bid to provide MSC the service it is seeking.

The request for proposals MSC submits to the carrier industry asks carriers to bid rates over approximately 50 ocean routes and 600 inland routes. It states that the cargo is "military cargo (not for resale in commerce) and mail with the usual characteristics of shipments in substantial volumes and varied consist". It offers an extract of the previous calendar year's traffic to the extent of the measurement tons shipped on each ocean route.

No data, however, is available on the amount of traffic previously moved over the 600 inland routes, or the inland origins and destinations of the traffic moved on the ocean routes, or on the size containers the cargo actually moved in. Also, no guarantee is made concerning future cargo movements.

In effect what the carriers are bidding on is a right to obtain a container agreement in return for submitting an offer to provide service, but with no assurance that any cargo will move at the offered rates.

The service that MSC is buying from the ocean carriers is containerload transportation from a specific point to another point over a given route. Without the rate solicitation, the charges to MSC for this type service would be a combination of charges for each mode of transportation involved in the through movement. This would include the surface transportation charges for getting an empty ocean container

inland to the shipper and a loaded container back to the port again, the over-ocean charges, and the inland charges overseas.

For the most part, rates which would produce these charges are available to MSC even without negotiation because carriers are required to publish their rates for all services they hold out to the public. But such rates are often no more than "paper rates", or rates which do not move any traffic. They are usually very high. Consequently, it is MSC's role to obtain rates which are commensurate with the nature of the traffic.

Here lies the problem. MSC does not make known what its requirements are. Carriers are asked to submit rates for routes over which they have no idea of the intended volume. They have no idea of how much a particular traffic pattern might yield to them in terms of revenue and against which they can estimate costs and ultimately their profits. The result is a series of unilateral rate offers which, depending on other carriers' bids and how MSC routes the traffic, may yield them substantial revenues or none at all.

INABILITY TO BID FOR SPECIFIC TRAFFIC

MSC does not allow carriers to bid rates based on traffic patterns--through routes from some inland United States location to an inland overseas location. The rates must be broken down by segments of the through route, even though MSC buys the service based on the charge for the entire through route. The segment rates in and of themselves are meaningless. What is important is the through cost. By requiring carriers to bid only on a segment basis, MSC adds an unnecessary expense to the bidding process.

An example of how carriers bid on traffic is the through route from New Cumberland, Pennsylvania, to Frankfurt, Germany. MSC in its request for proposals, asks carriers to bid four land routes from New Cumberland to the ocean port or ports (one to New York, one to Philadelphia, one to Baltimore, and one to Norfolk), an ocean route from the U.S. East Coast to continental Europe, and two inland routes overseas (one from all the German ports and one from all the Belgian and Dutch ports). To cover all the possibilities of how MSC might route this traffic, each carrier must bid seven separate rates. This is further complicated by the fact MSC asks for separate rates on the inland routes depending on the size container the carrier plans to use. Because most carriers have two container sizes, each carrier in effect must bid 13 separate rates for this one traffic pattern.

Further complications result from the fact that none of these 13 rates apply solely to the New Cumberland to Frankfurt traffic. Each rate can be used in conjunction with service to or from entirely different locations. For example, a rate

offered from New Cumberland to Baltimore, applies to every container moved between those locations even though some containers are destined to high volume destinations and others to destinations that may get only one shipment a year. The rate offered from the U.S. East coast to continental Europe applies not only to the New Cumberland to Frankfurt traffic, but to every other origin/destination pair served through East coast and continental European ports. The rate offered from the European ports to Frankfurt applies to every container moving between these ports regardless where the container originated or which ocean route is followed to get to those ports.

As previously stated, MSC does not route cargo on the basis of individual segments. If the cargo is offered to it on the basis of a through movement--inland U.S. through to inland overseas--it selects the route on the basis of the lowest aggregate set of segment rates, subject to the container minimum charges. The level of the individual segment rates by themselves is unimportant. It is the aggregate which is important.

The carriers, too, are more concerned with the through movement than with the route segments and they are more likely to offer lower rates over routes with high volume. There is no reason why a carrier should offer the same rate for every container from New Cumberland and Baltimore when some containers move in connection with high volume pattern of traffic, such as to Germany, and others in low volume patterns, such as to the Middle East. Yet, the carriers are forced to bid the same rates covering New Cumberland to Baltimore regardless of that fact. The individual route segments are in fact merely parts of a whole.

One of the reasons why MSC asks for inland rates is simply to get container service inland. In effect, MSC is telling carriers that if they want to handle the New Cumberland to Baltimore traffic in conjunction with through service to Germany, the rate that they bid will force them to handle New Cumberland to Baltimore traffic at the same rate in connection with every other East coast ocean rate. This forces carriers' rates in connection with one traffic pattern to subsidize the cost of service in another. Thus, the rates become composite rates and provide MSC no guarantee that they are the best for the service in question. Unless carriers are allowed to bid for traffic on a through basis and given an estimate as to how much cargo will move in each route, MSC will have no assurance it is allowing carriers to offer it their best rates.

<u>UNNECESSARY RENEGOTIATION</u>

Every 6 months MSC asks for or allows carriers to rebid rates for service they plan to offer. There is no basis why rates should be fixed for as long as 6 months or not allowed to stand for even longer. We believe, this regular renegotiation is unnecessary.

The MSC policy to allow renegotiation of rates every 6 months is a consideration it gave the carriers because of their complaints about the earlier system of negotiation. Prior to the early 1970's, MSC asked carriers to bid rates and fix them for 12 months. For the carrier industry this was unduly long considering the dynamic changes in their costs to provide MSC service over a 12 month period.

The underlying factors in ocean rate making are basically twofold: demand for the service and cost. Demand affects how high a carrier can offer a rate and still get the traffic. Cost affects how low the carrier can offer a rate and still make a profit.

The important demand factors in the case of MSC's traffic relate to volume of the traffic and competition of other carriers. The important cost factors relate to how much it costs the carriers to make containers available to the various shippers; how much it costs them, either by doing it themselves or hiring other modes to do it, to bring the loaded containers back to the carrier's ships; how much the ocean carrier's terminal and ship operating expenses are; how much the overseas transportation costs are; and how much it costs to bring a container back to the United States for the same shipper.

The reasons given for why a rate should be changed generally relate to a change in any one or a combination of these factors. If a carrier originally based its rate on an estimate of traffic that MSC does not provide it, either because MSC does not have the anticipated amount of traffic or what it has is going to another carrier, the carrier may want to change its original rate. Also, if any of the carrier's costs change, it may want to change its rate.

The role of MSC is to negotiate for relief when it feels the rate it already has is too high or to prevent an increase when the carrier wants to raise its rate. Yet in the MSC system of negotiation, this role is not played out. It merely forces the carriers to hold their rates for 6 months and then allows them to rebid.

It is important to note that while the carriers' rates are supposed to remain fixed for 6 months, there are ways by which carriers can change them. In submitting the ocean rates, carriers must warrant that the rates contain no element for the contingency of increases in bunker fuel oil prices, but increases or decreases are permitted monthly based on DOD's analysis of changes in these fuel prices. The same situation holds true with inland rates. The carriers must warrant that these rates contain no element for the contingency of increases in fuel prices, but increases or decreases are permitted whenever carriers can cite reference to Interstate Commerce Commission authorization for general rate increases applicable to specific traffic between territories involved in MSC's traffic.

Certainly any shipper wants to stabilize its rates for as long as possible so long as they look economical. But dynamics of the factors that go into rate making cause many changes. Many of these changes are beyond the control of either the carrier or the shipper. It is up to the shipper to make the best of them.

There is no indication that MSC's constant renegotiation has lead to stabilized rates or to lower rates. Appendix I shows the ocean rates carriers have bid (without fuel surcharges included) for 5 major ocean routes over the last 5 years. For the most part rates have been steadily increasing and there is nothing, given the present system of negotiations, to suggest MSC will alter that trend through its negotiation system.

CONCLUSIONS AND RECOMMENDATIONS

We find the present system for negotiating rates for commercial containerized ocean service does not ensure the maximum competition among carriers in bidding for MSC's traffic. Basically this is because MSC does not make known what its complete shipping requirements are at the time of the rate solicitation and it requires carriers to bid rates on route segments, not the through routes. Further compounding the problem is that rates must be fixed for set periods of time and allowed to be reset even though there has been no change to warrant it.

What MSC gets through its negotiations is a set of unilateral offers based on little information on the demand for the carrier's service.

To achieve more competition in bidding for its traffic and place itself in a better position to get the best possible rates, MSC needs to define its requirements in sufficient detail and to allow carriers to bid for specific traffic. All rates should be held to those levels until circumstances warrant changing them.

We specifically recommend that MSC:

--canvas each of its shippers to identify--in terms of origin/destination, volume of cargo over time and per container, and type of cargo--what their specific requirements are,

--review that data to establish what DOD shipping patterns exist,

--make these requirements known to the carrier industry,

--solicit rates that would meet those patterns in detail, and

--retain those rates until circumstances or events dictate they should be renegotiated.

CHAPTER 3

RATES AND SERVICE SHOULD BE MORE CLOSELY RELATED TO SHIPPERS' NEEDS

The Military Sealift Command could negotiate rates which more closely relate to needs of its shippers. An immediate area where this could be done is in the procurement of small container service.

MSC could also allow greater shipper discretion in choice of routing. This would allow shippers to better satisfy their needs without subverting the system.

SMALL CONTAINER PROBLEMS

For a number of years there has been a problem with the ability of MSC to provide its customers with an adequate supply of small containers--basically containers of 20 feet length. In early 1980, for example, less than 50 percent of the demand for small containers on the North Atlantic route was being met. The effect was that cargo was delayed awaiting containers or else loaded into larger containers and shipped at much greater cost to the shippers.

The demand for small containers is based on several factors, principal among them that:

--a shipper sometimes has insufficient cargo for a consignee to make maximum use of a larger container,

--a shipper has a small amount of cargo leftover from a large shipment and it is insufficient to make maximum use of a large container,

--the cargo is so dense (heavy and compact) that any more cargo that could be loaded in a larger container would exceed the safe weight carrying capacity of that container.

The ability to meet the demand for the small container is compounded by the problem that not all carriers have small containers and those that do, have relatively few. Except for the military, few other shippers have the need for small containers. Also, the carriers themselves do not believe they can make as much profit from the use of small containers as with larger containers.

The problem MSC's rate negotiation system creates for its shippers is that all the rates it has negotiated and the basis on which it bills its shippers are based on volume--volume related

to the cubic capacity of the container size the carrier furnishes. Shippers which cannot get small containers must delay their shipments or use larger containers and pay about double the price as if they used smaller containers.

An example of the added cost to both the shippers and to MSC can be shown with a typical shipment from New Cumberland to Frankfurt. Using the October 1980 rates for the major carrier offering both large and small containers on the route, the difference in cost to MSC is $1,028.55 a container. The difference in cost to the shipper is $2,125.49. Details are shown in the following table.

COST DIFFERENCE TO MSC

(WHAT MSC PAYS THE CARRIER)

Container size	Capacity (M/T)	Charge per M/T	Total charge
40 ft.	59.75	$47.32	$2,827.37
20 ft.	28.63	62.83	1,798.82
		Difference	$1,028.55

COST DIFFERENCE TO SHIPPER

(WHAT THE SHIPPERS PAY TO MSC)

Container size	Capacity (M/T)	MSC's rate per M/T	Charge to shipper
40 ft.	59.75	$68.30	$4,080.92
20 ft.	28.63	68.30	1,955.43
		Difference	$2,125.49

In effect, the shipper is penalized twice as much as MSC, but both suffer as a result of the present system of negotiation which is based solely on volume.

An available alternative is basing both the negotiation and the charge to the shipper on weight or a combination of weight and volume for types of cargo which "weigh out" before they "cube out". Rates based on weight are common in commercial practice. They allow the carriers to offer large containers in lieu of smaller containers without a penalty to the shipper for failing to use all the space of a container. They give shippers incentives to make maximum use of containers on whichever basis is the best.

SHIPPER DISCRETION LACKING

While shippers are charged with getting their supplies to destination in reasonable timeframes, they basically have little discretion in which carriers they can choose to meet their needs. This means they must live with MSC's idea of least cost service or else subvert the system.

It is MSC's policy to route cargo over whichever route is least costly to MSC, provided that route can meet the shipper's service requirements and conform to MSC's policy for distributing cargo among several carriers. For the most part service requirements are not stated in terms of the absolute maximum number of days a shipment can be in transit. Since transit times are generally several weeks long and most carriers provide weekly frequency of service there are few occasions when other than the least cost carrier, as defined by MSC, is chosen for a particular shipment.

Most shippers would prefer that their cargo be in transit the least number of days possible. This allows for less inventory in transit and lower inventory carrying costs. A one day savings in transit time may yield significant savings in inventory. Consequently, their incentives are mostly related to obtaining the fastest service.

MSC, on the other hand, has different incentives. These are essentially related to keeping its operating fund healthy. Since MSC bills the shippers through its industrial fund at the same rates for whatever container service it provides, it is to MSC's advantage to use the absolute lowest cost carrier capable of providing what MSC considers satisfactory service. Unless a shipper can certify to MSC that a delay awaiting the availability of the low cost or its inability to deliver within a certain date will have a detrimental effect on the purpose of that shipment, MSC will consider the low cost carrier capable of providing satisfactory service and book the cargo to that carrier.

It is rare that any ocean shipment has such urgency that a delay of a day or even a week will have a detrimental effect. But to the shipper, the economic cost in holding excess inventory may be significantly far greater than the saving in transportation costs to MSC.

The only way for the shipper to avoid use of MSC's low cost service is to give MSC a fictitious required delivery date that would mandate use of another carrier or to delay the shipment and seek a rebooking. Both situations, we found, are happening.

We do not believe it unreasonable for MSC to allow shippers to request service that MSC would not otherwise obtain. At the same time, we do not believe MSC should suffer a financial loss because it cannot bill the shipper the excess cost.

To improve the ability of shippers to get what they feel is the best service, both in delivery timeframes and in cost, and at the same time to prevent MSC from having to bear these excess costs alone, we believe shippers should have some discretion in requesting service they know MSC would otherwise not provide and MSC should be able to bill the shippers for excess costs. A shipper should be allowed to ask MSC for alternative routings whenever it feels the cost for delay or longer delivery time might exceed the savings to MSC in using the low cost carriers. MSC would be expected to provide shippers with the cost differences and allowed to bill them for such extra costs.

CONCLUSIONS AND RECOMMENDATIONS

We found the Military Sealift Command can better negotiate rates which most closely relate to the service its shippers require. MSC also should consider allowing sufficient shipper discretion in choice of carrier routing for meeting individual shippers' needs.

We believe MSC can improve on its service to its customers by negotiating special rates for certain customers and giving its shippers more discretion in choosing carriers for meeting its needs. We recommend MSC:

--negotiate rates based on weight or a combination of weight and cube in order not to penalize shippers whose cargo could fit into small containers, but for carrier problems must use larger containers, and

--allow shippers to choose other than the carriers MSC would otherwise choose for them, and allow MSC to charge the shippers for the higher cost service.

 APPENDIX

OCEAN RATES BID OVER THE PAST FIVE YEARS

	EFFECTIVE DATES OF SERVICE									
	July 1 1976	Jan. 1 1977	July 1 1977	Jan. 1 1978	July 1 1978	Jan. 1 1979	Apr. 1 1979	Oct. 1 1979	Apr. 1 1980	Oct. 1 1980
	(Rates per measurement ton)									
East coast to continental Europe										
Carrier										
SLND	$25.90	$27.02	$28.10	$29.12	$30.28	$30.28	$31.50	$32.98	$34.15	$31.95
USLX	27.04	28.66	29.56	31.04	33.24	33.72	34.65	34.65	35.16	33.15
AELX/FAAA	28.80	29.59	31.15	34.26	34.66	35.91	35.91	38.30	34.00	34.10
WATR	-	-	-	-	-	-	-	-	44.05	49.34
East coast to West Mediterranean										
Carrier										
SLND	38.72	40.65	41.30	42.47	44.59	44.59	46.10	48.20	39.95	39.95
LYKE	40.00	40.00	38.50	41.00	42.45	44.54	44.54	54.54	60.00	66.00
PRUU	40.00	40.00	46.50	51.50	51.00	-	43.56	41.11	40.11	46.65
AILX/FAA	41.25	42.07	44.38	48.25	48.25	48.25	48.25	48.25	48.25	49.15
West coast to Korea										
Carrier										
SLND	30.90	34.25	28.00	25.85	26.00	30.00	34.20	49.52	44.95	49.40
PFEL	32.37	27.25	26.59	26.24	28.60	-	-	-	-	-
APLS	34.50	30.00	29.50	29.50	28.00	32.00	40.45	48.00	45.00	51.00
SSCO	38.39	41.50	40.00	40.00	30.00	36.00	-	-	-	-
USLX	42.33	48.68	51.11	51.11	51.11	51.11	52.06	52.06	56.48	59.75
LYKE	-	-	-	-	-	-	37.00	46.09	46.50	41.00
West coast to Philippine Islands										
Carrier										
SLND	31.75	32.75	30.95	26.75	34.25	36.75	38.45	55.77	53.95	48.65
APLS	32.00	33.00	32.50	34.50	37.00	39.00	49.50	57.00	55.10	62.00
PFFL	33.37	29.10	28.25	28.25	33.00	-	-	-	-	-
USLX	44.55	51.23	56.35	56.35	56.35	56.35	56.85	56.85	59.64	-
SSCO	50.00	51.75	55.00	55.00	58.00	58.00	-	-	-	-
LYKE	-	-	-	-	-	-	59.00	65.50	65.50	65.50
West coast to Okiniwa										
Carrier										
SLND	36.00	39.95	34.70	34.70	34.55	38.25	38.25	57.77	53.95	50.85
SSCO	38.00	39.25	37.50	37.50	41.50	45.00	-	-	-	-
APLS	38.00	35.75	37.50	34.50	38.50	38.50	51.50	60.00	55.00	63.00
PFEL	-	-	38.50	38.50	-	-	-	-	-	-
LYKE	-	-	-	-	-	45.00	46.00	55.72	56.00	56.00

Note: Underlined rate indicates low cost carrier(s) on that route.