FedEx's contractor system has slashed employee and capital expenditures.

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Featured Article

Going to Ground

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As a worker who did odd jobs such as sorting mail for a construction company in Salinas, California, Luis Espinoza says he was frequently promised a promotion that never materialized.

When he learned that FedEx was looking for contract drivers to work in its rapidly expanding ground delivery operation, he eagerly signed up. With $2,000 down and $700 a month in payments, he leased a $50,000, 23-foot step van two years ago and began a FedEx Ground delivery route in nearby Santa Cruz.

It wasn't long until two more routes in the area opened up. He applied for and won the contracts, leased two more 23-foot vans and hired two subcontractors to drive them.

Today, the 33-year-old independent contractor says he grosses $200,000 a year in revenues, brings home $75,000, owns a four-bedroom, three-bathroom house and can't imagine ever returning to a more traditional job.

"I feel like I am working for myself," Espinoza says. "And the money's great."

Unlike traditional employees, he has no direct supervision, doesn't use company equipment and doesn't receive benefits. FedEx Ground drivers are treated like small-business owners rather than employees. The company doesn't provide health insurance, pensions or 401(k) contributions, overtime pay, paid vacations or holidays or stock-purchase discounts.

FedEx Ground--a division of Memphis, Tennessee-based FedEx Corp., which pioneered overnight package delivery--now has 17,000 contract drivers. And last year it brought in $3.9 billion in revenue.

Although their trucks and uniforms must display FedEx Ground colors and logos, contractors have to pay for them, as well as for gas, maintenance and insurance. Their pay is based on the number of packages they handle and their customers' satisfaction. But the money is good enough and the allure of independence so strong that thousands of drivers have joined the company, and the system has helped power double-digit annual revenue growth at FedEx Ground.

Risky route?

The success of FedEx Ground and its ability to incorporate its contract drivers into FedEx Corp., a company with $24.7 billion in annual revenue and 204,000 employees who receive benefits, has intrigued analysts and workplace trend watchers.

They see the use of contract drivers as a way for FedEx Ground to cut costs and use the competitive edge to win market share from rival UPS, the king of ground package delivery. Drivers for Atlanta-based UPS not only use company-owned trucks for deliveries, but also receive full benefits covered by a Teamsters contract.

Critics wonder if the contractor model is a formula for long-term success or simply a cost-cutting gimmick that provides a short-term advantage that can spur immediate and rapid growth but can’t sustain it. The independent-contractor method raises important societal questions about the role of corporations in protecting workers by contributing to health insurance, pensions, unemployment insurance and workers’ compensation, which together make up the safety net for American workers.

"From the short-run perspective, of course it is cheaper for the company to remove people from the payroll," says David West, executive director of the Center for a Changing Workforce in Seattle. "But every time a company like FedEx does this, they are undermining their own argument that we don’t need a comprehensive national health-care system.

"I think that is the larger policy issue. The same argument applies for the pension system."

Outsourcing jobs and costs to independent contractors also raises tricky legal issues that have tripped up companies in the past. Legally, independent contractors can’t be directly supervised, supplied with tools and workspace or otherwise treated like employees. After a decade of legal wrangling, the IRS and federal courts determined that Microsoft Corp.’s contract programmers were mislabeled employees. The computer giant had to pay back withholding taxes, overtime and $97 million worth of stock incentives to more than 10,000 contract programmers who were ruled to be functioning as employees in a series of legal challenges.

The case was settled in 2000 and cleared its final appeal in 2002. FedEx Ground has successfully defended its contractor system from several legal challenges. But in July, the company lost a round in California when Los Angeles County Superior Court Judge Howard Schwab ruled that about 80 contract drivers in California should be considered employees eligible for regular benefits. No damages have been decided, and FedEx plans to appeal.

"It is a risky strategy that FedEx is taking," says Cathy Ruckelshaus, litigation director at the National Employment Law Project. "The more they try to exercise direction and control, the less successful they will be if there is a complaint lodged."

In a business like package delivery, where logistics and on-time service are crucial, using loosely supervised contract route drivers might seem like a prescription for disaster.

FedEx says the opposite is true. The piece-rate payment method combined with bonuses for good customer service motivate independent drivers to help the company succeed, FedEx officials say. The harder and smarter they work, the more the FedEx contract drivers can make.

As a result, most work 10- to 12-hour days, without overtime pay, and they are constantly on the lookout for new business customers to add to their routes, giving FedEx Ground a built-in, cost-free extra sales force.

"The trick is that we don’t have to manage it at all," says Tim Edmonds, managing director of contract relations for FedEx Ground at the operation’s headquarters in Pittsburgh. "The contractors manage their (own) business."

UPS says it has no intention of following the FedEx lead and believes that its traditional system of company-owned vehicles and equipment staffed by company employees will never be replaced by a network of independent contractors. UPS’ ground service generates more than $16.5 billion in annual revenue, more than four times as much as FedEx Ground.

In the long run, UPS says that its investment in employees buys loyalty, and loyalty translates into a more consistent and higher level of customer service.

"As a contract employee, would you have the same loyalty to an organization as someone who gets a tremendous health and pension plan, as well as the highest wages in the industry?" asks Dan McMackin, spokesman for UPS at its headquarters in Atlanta.

For the moment, FedEx Ground contractors seem to be holding their own against UPS drivers in service quality. In 2002, FedEx Ground placed first for customer service in the J.D. Power and Associates ranking for ground parcel delivery. UPS recaptured the prize in 2004, also taking top honors for international and air delivery.

Curiously, it was a 1997 strike against UPS by the Teamsters that spurred FedEx to move into the ground package delivery business and to the contract driver method. At the time, FedEx was still primarily in the air package delivery business.

In 1998, FedEx bought RPS, a ground package delivery service based in Pittsburgh that had $1.9 billion in annual revenue. When RPS started in 1985 with limited financial resources, it had turned to contract drivers with their own trucks as a way to grow the business.

FedEx retained the contractor model after the buyout and kept the ground service headquarters in Pittsburgh, but renamed the business FedEx Ground. Using contractors saves FedEx Ground hundreds of millions of dollars annually in employee expenses and gas and hundreds of millions in capital costs for trucks and equipment.

"I would say that our growth has a lot to do with our independent contractors," Edmonds says. "It is one of the keys to our success."

How it works

FedEx Corp. is a collection of distinct business divisions including FedEx Ground and FedEx Express (the air shipping service). Each operates as a separate company. FedEx Ground is the only one that makes extensive use of contract workers for front-line jobs.

In this country, a lot of people are willing to give up security for the promise of financial independence as self-employed business owners. Companies like FedEx can go for quite a while as long as that ideology works for the employees.

FedEx Ground drivers are paid on a complicated piece-rate formula, with bonuses for good service. Drivers can make $40,000 to $70,000 a year, contractors say, compared with an average $51,000 annual base salary and up to $70,000 with overtime for UPS drivers. FedEx Ground allows one person to own up to four contracts, which can boost income to more than $100,000 a year.

As a result, existing contracts have become a commodity that can be bought and sold like businesses, sometimes at prices of $30,000 or more each.

The FedEx Ground fleet is a combination of new and used trucks--some owned and some leased, but all paid for by contractors. New delivery trucks can cost $40,000 to $50,000 each, which, if purchased outright, would cost $400 million to $500 million for every 10,000 trucks.

Contract drivers make those investments, leaving FedEx Ground to concentrate on logistics. The company is now spending $1.8 billion to expand its network of distribution hubs, sporting the latest technology to help coordinate its growing number of contract drivers. FedEx Ground already operates 27 hubs, where the company is increasing capacity while also adding 10 new sites--doubling its volume capability to 5.8 million parcels per day.

Fuel is another major expense FedEx Ground doesn’t pay. Espinoza says he spends about $450 a week per truck on gas. His gas costs are a little higher in California, but even at $400 per week, that’s $20,000 a year per truck. Multiply that times 10,000 trucks and the annual cost for fuel comes to $200 million; for 20,000 trucks, $400 million.

Then there are the personnel costs that FedEx doesn’t pay. If an employer pays an employee $50,000 per year and has to shell out for unemployment and workers’ compensation insurance, the benefits can cost a company about 7.5 percent of base pay, or about $3,750 per year for a $50,000-a-year position.

UPS pays 100 percent of driver health insurance premiums. Based on the national average for cost of health insurance to employers this year, that’s worth about $7,000, according to Hewitt Associates. For 10,000 employees, that adds up to $70 million a year. A company paying 80 percent of premium costs would still have to contribute about $5,500 per employee, or about $55 million for every 10,000 employees.

Contract drivers don’t get paid anything extra for working more than eight hours a day. Most, like Espinoza, put in 10 to 12 hours a day. For someone in a $50,000-a-year job, overtime pay for working two to three extra hours per day would add about $400 a week, or more than $20,000 in overtime pay a year. For every 10,000 workers, the cost to the company is $200 million annually.

Thus, for a hypothetical full-time, UPS-style employee with a base annual salary of about $50,000 and a 10- to 12-hour workday, those extra employer costs for overtime ($20,000), health care ($5,500-$7,000), workers’ compensation and unemployment insurance ($3,750) would add up to around $30,000.

That $50,000 employee is now costing the company $80,000. And that’s not counting pension benefits, a 401(k) plan, stock-purchase discounts, vacations, sick days, holidays and other perks.

Finally, in a UPS-style operation, the company would have to pay for gas, which, according to Espinoza’s estimate, runs about $20,000 annually. Add that onto the $80,000 estimated annual employee costs and the price tag for one route rises to about $100,000. And that figure still doesn’t include the cost to the company for trucks, uniforms and other equipment.

FedEx says that instead of paying for all those benefits and perks, it simply pays contractors more if they deliver more, and allows them to make their own arrangements for gas and supplies, health and welfare. Many piggyback on a working spouse’s health insurance.

Some simply choose to go without, pocketing the extra cash. Espinoza says he carries no health insurance, even though he has a wife and two children. He and his family members are young and healthy--at least for now. He doesn’t provide any benefits for the two drivers who work for him because they are his independent subcontractors. Edmonds says that FedEx Ground contractors handle health and welfare issues differently and that they tend to be fiercely independent.

"If they have an issue or concern, they stand on their own two feet," Edmonds says.

West notes that FedEx Ground emphasizes to drivers that they are independent business owners. "In this country, a lot of people are willing to give up security for the promise of financial independence as self-employed business owners," he says. "Companies like FedEx can go for quite a while as long as that ideology works for the employees."

The challenge for FedEx is to manage its contractors without seeming to supervise them like employees. One of the key government tests of whether a worker is a contractor or an employee is how much direction, supervision and assistance the company provides.

Edmonds says FedEx exercises minimal control over its contract drivers. FedEx Ground contract drivers go through an initial two-week training program and are then on their own. The company doesn't supervise their daily routines. It doesn't care how many hours a driver takes to complete a route, how many breaks he takes, how long he spends at lunch, how many personal phone calls he makes on his cell phone.

The company conducts continuous customer satisfaction surveys, and a driver with bad marks can see his bonus eliminated and perhaps his contract terminated. "We can't manage what they do during the day," Edmonds says. "We simply can manage the results. Did they delight our customers today? Did they provide the services expected from us?"

The California lawsuit drew a different conclusion. Filed as a state wage and hour violation case by three contract drivers in California, the suit was expanded to a state class-action suit but was limited to contractors with single routes. Contractors with multiple routes, like Espinoza, were deemed to operate more like businesses and were exempted from the suit.

In his 23-page ruling issued July 26, Judge Schwab wrote that the contract FedEx Ground drivers must sign "is primarily comprised of platitudes and guidelines." In fact, the company has almost "absolute control" over single-route drivers and how they carry out their tasks, the judge wrote, a situation that means they function as employees of the company rather than as independent contractors.

As Schwab pointed out, the contractors only have one client, FedEx Ground. They must drive trucks with company logos, wear uniforms with company logos and report daily to company distribution hubs. They attend regular briefings on safety and company issues. And their contracts can be terminated for any number of infractions. In effect, they can be fired for failing to follow company policies.

Thus, while the single-route drivers appear to be independent contractors, the "pervasive control" by FedEx Ground "creates an employment relationship," Schwab wrote. If his ruling holds up, FedEx will either have to convert single-route contractors into California employees or change the relationship to comply with the less restrictive control associated with an independent contractor.

"We respectfully disagree with Judge Schwab's ruling in this case, which applies to fewer than 80 single work area contractors in California only," FedEx spokesman David Westrick says. "FedEx Ground has been successfully operating with an independent-contractor model since its startup in 1985."

Contractors like Espinoza are counting on that success to continue. And so far, FedEx Ground hasn't let them down.

"We're just getting busier and busier," he says.

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