

supply chain strategy

A newsletter from the MIT Center for Transportation & Logistics

Don't Fall for Divided Logistics Contracts

Lowest-cost logistics might not deliver

SUPPLY CHAIN MANAGERS NATURALLY want to get the best price when buying logistics services, particularly when such services represent a high proportion of total costs. Volatile fuel prices and the economic downturn are adding to the pressure to trim logistics budgets. But how far can managers keep a lid on prices without undermining the service elements that add value and, ultimately, cut overall costs?

Not much further, according to many third-party logistics services providers (3PLs). The providers argue that downward pressure on prices—driven to a great extent by the increasing involvement of procurement departments in the buying process—has become counterproductive because important value-adding services are being left on the table.

When operations and finance are not aligned on what they want from 3PLs, the company can pay a high price both in terms of logistics costs and service quality. To avoid such mismatches, all parties need to be more aware of their respective goals and the penalties of negotiating flawed logistics contracts.

Difference of Opinion

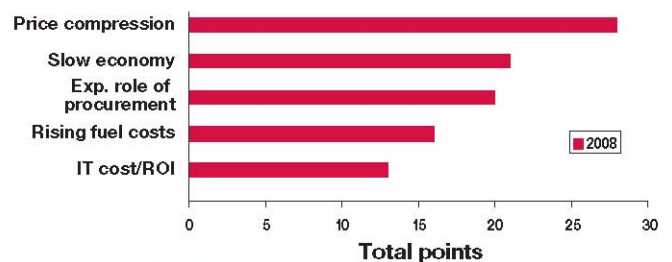
The commoditization of 3PLs services was one of the top concerns highlighted by the 2008 3PL Provider CEO Perspective survey carried out by Northeastern University's College of Business Administration and 3PL Penske Logistics (see the article "Do You Value Your 3PL?" in the October 2008 issue of SCS). The 20 3PL CEOs in North America and 10 in Europe interviewed for the survey rated the involvement of procurement in the buying of logistics services as a top concern (see charts). Dr. Robert Lieb, professor of supply chain management, Northeastern University, Boston, and one of the survey authors, said the trend is "one of the major dynamics of the business."

The dynamic Lieb referred to often starts with the CFO, who wants the logistics budget shaved in response to the rising cost of

The Expanded Role of Procurement in Selecting 3PLs Is One of the Top Dynamics in the Industry

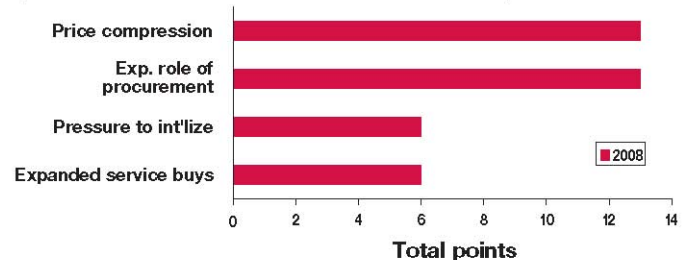
North American Survey

Industry dynamics highlighted pricing pressures, the slow-growth economy, and the expanded role of procurement in the 3PL selection process



European Survey

Industry dynamics highlighted price compression, the expanded role of procurement in selecting 3PLs, and pressures to internationalize service offerings



(Source: 2008 3PL Provider CEO Perspective Survey)

key elements such as transportation. Procurement is brought into play to achieve the savings. The problem is that procurement managers may not have the expertise to judge the true worth of bundled logistics services. They focus on awarding contracts to the bidder that offers the lowest price without giving due regard to service elements that provide paybacks in other ways.

“The centralization of procurement away from the users and toward a purchasing function” is a major challenge for the industry, agreed Chris Caplice, executive director of the Cambridge, Mass.-based MIT Center for Transportation & Logistics. Evaluating the purchase of a product according to certain attributes is relatively straightforward; services are more difficult to assess because their attributes are not as clear-cut, he said.

“When you are buying a lead logistics provider, you are buying brainpower and not just a commodity,” said Kevin McCarthy, director of logistics services, at C.H. Robinson Worldwide Inc., one of the largest non-asset-based 3PL companies in the world, headquartered in Eden Prairie, Minn. For example, a company might decide that it needs 100 trucks equipped with satellite tracking to replace a private fleet. The purchasing department puts out a bid for the lowest-cost fleet “instead of asking the real question, which is whether 100 trucks is the right size fleet,” McCarthy said, or looking at options that optimize the company’s capacity needs and takes account of changes in distribution patterns. “You can’t necessarily do that through a hard procurement exercise,” he said.

“You also need to have the right tools and know how to run the fleet efficiently day to day. You cannot just look at cost per truck. If you run the fleet well, you may only need 50 trucks while another provider may need 70 trucks,” continued McCarthy.

Buyers can counter that 3PLs obviously have a vested interest in selling consultancy-type services that offer higher margins. Rick Kapsner, director of corporate sales, C.H. Robinson, acknowledged that some offerings—such as the provision of no-frills warehousing space and certain truckload services—do lend themselves to being broken down as commodity-type services. However, a more detailed analysis of a company’s logistics spend often yields savings that outstrip these basic costs, he said. That could involve the application of transportation management software or more cost-effective load consolidation, for instance. “What we will charge you for [basic] services is usually a relatively small part of the logistics/transportation spend, maybe 1 percent or 2 percent of it,” he said.

Procurement may not be aware of such nuances, while operational folks are under pressure to deliver cost savings regardless of the efficiency implications. The 3PLs are positioned in the middle of this tug-of-war. The result can be unsatisfactory for all sides. Here are some examples.

Reaching for Value

A dividing line between the aspirations of procurement and operations forms when logistics has higher service goals than procurement is willing to pay for. If the paybacks associated with value-added services, along with the importance of a strategic logistics strategy and how that supports the company goals, are not effectively communicated to procurement, sharp differences of approach often materialize.

This can occur when operations folks “are looking at how they can use logistics and supply chain to increase sales and increase value to the company, and that usually means buying more than minimum services,” explained McCarthy. “Sometimes they [operations] have a hard time articulating that to finance or procurement.”

Limited Life

Translating every part of a service package into a commodity that can be negotiated on the basis of the lowest price devalues the deal, and it has a short shelf life after being signed and sealed. In many cases, this can result in 3PLs circling back when the deal fails to offer the more comprehensive solution that was proposed originally. Concluding a contract is one thing; managing it in practice is another. Kapsner said, “It can be difficult to focus all the parties involved on the same results. The operations people may see that things are not going as planned, but the procurement people have already moved on to the next project and may not be interested in fixing this one.”

Providers that low-ball a contract might simply be incapable of meeting the contract terms. “Truckload carriers used to call this ‘winning the bid but losing the business,’” said Caplice. The low-cost carrier wins the contract but fails to deliver, and subsequently a “white knight” carrier offers to save the day with a higher-priced proposal. The shift toward the commoditization of these types of services will promote such flawed deals, Caplice believes.

Another reason for contract failures of this kind is that they run aground on internal resistance. Procurement may have negotiated terms that meet its cost-control targets but fall short of what operations wants. Over time, dissatisfied logistics managers undermine the deal. When this outcome occurs, too often the buyer can acquire a harmful reputation for striking deals that do not stick.

Sales

The inclusion of procurement professionals in the sales cycle lengthens it, or at least makes it more complicated. Regardless of whether finance and procurement groups are involved in the initial sales presentation, C.H. Robinson proactively adds an return-on-investment dimension to its proposal that is geared to the needs of financial specialists. The 3PL provides the logistics buyer with the information it needs to discuss the proposal with the appropriate people in finance and procurement. In most cases, the sales cycle involves collaboration with finance as well as operations. McCarthy added, “We understand that each area’s approach can have different objectives. Our goal is to make sure we communicate the value offered to all groups.”

Removing Barriers

The pressure to control logistics costs is unlikely to abate in the current economic climate, so how can operations managers work with procurement to develop buying strategies that satisfy their respective needs?

One route is for supply chain and logistics professionals to learn the language of finance. This is worthwhile not only from a buying perspective. There is wide acceptance in the industry that supply chain professionals need to broaden their skills base to encompass financial disciplines. Educating procurement on the intricacies of logistics services with particular regard to the potential paybacks of collaborative arrangements would help also.

3PLs can play a part by adapting the sales cycle to the needs of financial as well as operational goals. In such situations, C.H. Robinson provides information on ROI possibilities and brings relevant subject matter experts to the table. It also illustrates important trade-offs such as the service quality gains possible with a higher logistics spend.

The commoditization phase often occurs early on in negotiations, when procurement wants to ensure that the deal is on track. After successfully negotiating this phase, discussions on service value can take place. “But sometimes getting through that first hurdle can be difficult even if you have a really good solution,” said McCarthy. ♦



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