## Your Bonus Pack PART 1

# OUTSOURCING SUCCESS GUIDE

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*I've been involved in Logistics Outsourcing since 1994, and have assisted dozens of companies through the process since then. Across all industries.*

*I hope that this information will help you in your own Outsourcing Success and in particular with getting the right structure to pricing mechanisms.*

***ROB O'BYRNE***

# Outsourcing Transport and Warehousing:

# Pricing, Honesty and Contentious Issues

*(From an Australian Industry Perspective)*

In the article above I outlined reasons why companies outsource and described key drivers for successful third party logistics (3PL) relationships. In this volume I briefly describe five pricing options which are commonly used in Australia and how to ensure that the 3PL is honest, together with the four most contentious issues confronting customers as they enter 3PL contracts.

## Pricing Options – Warehousing

There are five common pricing scenarios used in 3PL warehousing and transport contracts.

### *1. Fixed Price*

**In a fixed fee contract the price is held for a specific term regardless of volume fluctuations. The advantage for the customer is that it knows precisely how much it will pay for services rendered.** For the 3PL, it can accurately plan its cash flow and resources to service the contract. The disadvantage for both parties is that if the contracted work varies beyond reasonable expectations at the time the fees were set; one party may suffer while the other thrives. For example, the 3PL may struggle to make a reasonable margin, while the customer experiences low cost operations.
Conversely, the 3PL may be banking large margins, while the customer languishes with a higher than expected cost base. Needless to say, fixed price arrangements eventually transition to other pricing methods.

### *2. Percent of Sales Value (or goods value)*

In the early days of outsourcing in Australia many relationships were formed with minimal information available from customers. **And dare I say, it seems that some 3PLs did not really do their homework to fully audit and understand their prospective client's business.**

Oddly, it was relatively easy for a 3PL to convince a client that say 6-8% of sales value would suffice as a fee for logistics services. Not that the 3PL is entirely guilty of driving this. Some clients actively pursued percent of sales value pricing. Although, over time a number of transport companies discovered that they were losing money on such deals. Ironically, their customers perceived that the 3PLs were skimming the cream off very lucrative warehouse rate structures. Regardless of whether they were or not, it was common for the parties to fall into dispute and call in consultants to mediate. Today, there are very few companies using percent of sales value pricing.

### *3. Activity Based Rates*

The advent of public warehousing in Australia has seen growth in the use of Activity Based Rates. These are akin to ‘piece rates’ where a charge is attached to actual volumes handled. Activity rates are common for short term storage arrangements and can be lucrative for 3PLs who are able to manage effective public warehouses.

**For longer term agreements, customers tend to apply pressure on providers to reduce their rates, which makes activity based pricing less attractive and risky for the 3PL, especially if volumes are low or erratic.** For customers, variable rates can be an appealing means of paying for services, especially if they run a business with highly seasonal products. The advantage for customers is that they can minimize cost, but this is often at the 3PL’s expense since their ability to make reasonable margins is low. In other cases the advantage can flow to the 3PL, particularly when volumes exceed expectations and revenues go wildly beyond expectations. The downside of long term use of activity rates is that both parties eventually commence arguing over which party has advantage or disadvantage from incumbent activity rates. At this point is not uncommon for the parties to establish an alternative, which is normally the ‘hybrid’.

### *4. Hybrid – Part Fixed, Part Variable*

Blending activity and fixed rates is becoming more popular in contemporary relationships, especially where the parties have been working together for some years. The fixed cost component normally includes the charges for warehouse space, leasing of mobile and static assets, information technology and management overheads.

The activity rates or variable fees are derived from actual warehouse activities movements of product and are typically invoiced on a weekly or monthly basis.

The benefit of the hybrid is that a low fixed cost structure is supplemented by realistic volume fluctuations. The downside for the 3PL is that they have to employ assets and labour resources to support the contract, even in low periods. A common practice is for the 3PL to employ permanent labour based on minimum or average volumes, while adding casual labour to the mix as volumes increase. While customers do not disagree with this practice in principle, they are often the first to complain when KPIs are below par, or customer service suffers. **These days some 3PLs place 'peak period' exclusions into their agreements which effectively net out service failures at peak periods e.g. Easter, Christmas, End of Month, Financial Year End etc. Even so the hybrid is becoming more common and is typically used in 'mature' outsourcing relationships.**

### *5. Free of Charge Service (supplemented by other services)*

**Believe it or not, there are some 3PLs who provide free warehousing services to clients who are prolific users of freight forwarding or transport services across the four modes (rail, road, air and sea). How do they do this?** They simply incorporate the warehousing charges into the transport rates and make sure there is sufficient overhead and margin recovery to pay for the contract warehousing services. The advantage for the customer is that an all inclusive price can be negotiated into a single transport card. Yet, the downside is that customer can remain dubious about the efficacy of the rate card particularly if it perceives that the 3PL is too prosperous. In such cases transport benchmarks are used to gauge rate integrity, and / or consultants are hauled into to arbitrate.

## Keeping your 3PL Honest

Now that I have outlined the pricing options, a common question put by many customers of 3PLs is: **"How can I trust the 3PL's pricing basis?"** Well, in forging customer and 3PL contracts agreements there are two common occurrences.

### *Closed Book Relationship*

In closed book relationships, the 3PL does not divulge its operating costs, overheads and margin to its customer under any circumstances. Customer audits are not allowed and the 3PL maintains its financial privacy. Any price adjustments are subject to negotiation until the customer is satisfied with the value received and/or market competitiveness.

### *Open Book Relationship*

The open book relationship in colloquial terms is a ‘show and tell’ method of ensuring that the 3PL is being honest in its operations and pricing of its customer’s business. The 3PL allows the customer to examine books or calculation methods used for pricing to check if charges are well founded. Open book reviews can be useful for any of the above pricing options and are frequently used for Hybrid operations.

The question of which is most suitable is debatable. While some customer’s respect their 3PL’s right to privacy, others perceive advantage in combing through the 3PLs pricing mechanisms and profit and loss account to check fee integrity. Amazingly, and despite a high number of customers who elect open book arrangements, few actually audit or review 3PL cost structures once an agreement is in place.

## Entering Contracts

**Many managers wonder how to structure their 3PL relationship. This answer is complex, but the short answer is that it should always be under written agreement with full specification of operations, forecast volumes, rate cards and terms and conditions.** There is much to cover in this area, and too much for this article, so in the following paragraphs I will allude to the four most contentious issues which cause angst, debate and posturing during negotiation of customer/3PL contracts.

**_1. Liability_**

Strangely, companies that outsource can assume that the entire risk of the product for loss and damage should be with the 3PL, regardless of whether goods are warehoused, or in transit. Practically this is unworkable, as 3PL's are merely service entities who gain their income from fairly thin service margins. Most simply cannot sustain the total risk of products worth large multiples more than the margins they are making on the warehouse or transport service itself.

What then is the 3PL liability (in transport) for negligence, willful damage or theft by an employee?

In Australia most transport companies are 'private carriers' as opposed to 'common carriers'. By default, they reserve the right to accept or reject offers for carriage and enter contracts with set terms and conditions. Consequently, transport companies tend to specifically exclude liability for loss and damage caused by negligence and/or willful acts by employees in their contracts, or accept a very low limit of liability in such instances. Yet, at common law, the principle of negligence applies a mandate to the transport company to handle goods with reasonable care and to accept liability for damage, loss or delays resulting from negligence or misconduct of employees. Should an incident be presided over by a court, such exclusions by the 3PL may be judged as invalid in the face of State and Federal fair trading laws. So what does this mean? For the customer its worthwhile negotiating an annual allowance in contracts to cover negligence, willful damage and theft. For very large claims, the onus will be on the customer to litigate for resolution.

**_2. Ullage_**

Ullage is a term which historically refers to the quantity of liquid within a container that is lost, by leakage, during shipment or storage. The word has now developed a wider logistical meaning and is often used in contracts to define inventory losses in a warehouse facility which are unexplainable. For example, short deliveries that were not picked up, inaccuracies resulting from miss counts, over supply or under supply to a customer, pilferage and data entry errors. While clients want perfect inventory management the reality is that there is no such thing.

Most companies suffer inaccuracies in the range of 0.1-2.5% of stock value. Accordingly, warehouse providers may insert a ‘no liability’ clause in their contracts that specifically excludes them from ullage responsibility. Customers, however, typically have difficulty accepting ullage allowances, believing that their 3PL should be accountable for anything short of 100% inventory accuracy. So the pre contract debate can be hot on this issue.

### *3. Ownership*

In the majority of 3PL warehousing operations, the goods handled always remain the responsibility of the customer until passed into the hands of the end user. By implication it is the customer’s responsibility to take out ‘all risks’ insurance to protect themselves against partial or total loss or damage. In some cases 3PLs, may enter into re seller or joint venture arrangements and accept requests to take out ‘all risks’ insurance on their client’s behalf. Although, it is normally more expensive for 3PLs to secure such insurance than their customers. Additionally, it becomes complicated when insurance claims are made for losses by both the ‘handling party’ and ‘owner’ of the policy, so these arrangements are best avoided.

### *4. Consequential Damages*

This is indeed a contentious issue. Consequential damages can be demanded by customers of 3PLs for compensation due to loss, damage and poor performance. E.g. late or no delivery, inability to supply due to damage caused by the 3PL, below par results against KPIs. Compensation sought by customers can relate to loss of sales revenue or margin, market share, reputation, and/or goodwill. However, nearly all 3PLs who contract for both warehousing and transport will not accept consequential damages under any circumstances.

This can infuriate customers, especially if they expect their 3PL to care for their products better than themselves. But the reality is that acceptance of consequential damages by a 3PL is extremely risky and akin to giving the customer an open cheque book. If they do accept consequential damages, rest assured that the customer will pay for it, either via greater margins, or contract contingency sums in favour of the 3PL.

## Conclusion

**In this short article I have outlined five cost options available to customers entering contract agreements with 3PLs. Each of which can operate in a closed or open book manner. In addition, I've touched on the four most significant issues to be aware of when drafting contracts. There are others, but by now you may appreciate that entering outsourcing arrangements can be both time consuming and complex. Therefore I recommend that both customers and 3PLs do their homework before negotiations commence so that expectations and issues are handled professionally and without angst or misunderstanding.**

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## Third party warehousing contracts
## – Heading North or rapidly South?

***As I sit at the Airport awaiting my flight, I ponder over the meeting I have just had with yet another company, who is dissatisfied with their Third Partly Logistics (3PL) service provider and outsourcing contract.***

***Some times I feel like a marriage counsellor as I listen to these tales of woe. "They don't understand us, they don't respond to our needs, our customer service levels are way below expectation". Sound like a similar outsourcing story? Well take heart, the future need not be doom and gloom.***

I have heard many similar stories over the years that I have been consulting in the area of Logistics outsourcing. When I hear these stories, it is often because the customer has reached such a stage of frustration that they want to re-tender their logistics contract, and are seeking assistance through the outsourcing process. Such was the tone of the meeting today. But at the close of the meeting, the customer was feeling more optimistic about the future of his 3PL warehousing contract.

Firstly, most 3PL contracts that appear to be underperforming, can be resurrected. It just takes open communication, willingness, and a focus on the key issues. An independent audit of the contract, is in itself, often a sufficient wake up call for the parties involved to improve. But in 90% of cases, I would say that contract under performance, does not lie solely with the 3PL.

In many cases, contracts have been awarded and outsourced in haste, without the necessary attention to detail that underpins outsourcing success. Such was the case today. The customer had provided inadequate information regarding their needs to the 3PL, who in turn had under resourced the contract. The result? Escalating costs and finger pointing. Both parties needed to shoulder responsibility on this count.