CONTRIBUTED CONTENT & PRESENTATIONS

Handing Over the Keys? Consider Alternate Pricing Models for 3PL Outsourcing

JULY 30, 2018

Authors: Jonathan R. Todd

Source: Array

Enterprise shippers are often attracted to the opportunities presented by outsourcing certain operational functions. Credible third-party logistics (3PL) providers are available to run warehousing, distribution, fulfillment and last-mile operations seamlessly at the flip of a switch. These outsourcing strategies can permit enterprises to deploy time and resources elsewhere in the interest of advancing core competencies while yielding tangible benefits to the balance sheet. Outsourcing can also produce positive effects in inventory management and even expense management as savvy 3PLs exercise their core strengths.

Any outsourcing relationship is critical to an enterprise's value proposition. It is intended to be long-term and strategic in nature, which requires a great deal of trust between the enterprise that is "handing over the keys" to its supply chain and the 3PL that is receiving them. "Trust" is of course code for a heavily negotiated services agreement complete with all the key performance indicators, standard operating procedures and implementation planning necessary to ensure a smooth transition for the respective supply chain.

One of the key negotiation points at the heart of any such relationship is the pricing model. Any decision to outsource a supply chain function will depend in large part on the anticipated financial benefits, which can be significant. They may range from opportunities for improved visibility and planning, lower cost variance or lower total cost, and monetizing certain assets or transferring certain liabilities. Regardless of the desired financial objectives, their basic shape often takes form in the pricing model that is selected. The three dominant 3PL outsourcing pricing models in the market today are (1) Transactional, (2) Cost Plus, and (3) Gainshare.

Transactional Models - Transactional models are the traditional "retail" approach for pricing any single or combined supply chain services. Contractual rates and charges, including respective service commitments or volumes, are determined without regard to any profit margin that may be included in the pricing. Administration of transactional models is akin to traditional procurement and operational management, where pricing may be established at the level of product, service, lane, volume or other metrics. Penalties for failure to perform or to tender minimum volumes are negotiable as are possible bonuses for positive performance against key performance indicators.

Cost Plus Models - Cost plus models can be viewed as the "wholesale" approach to pricing. These require analysis of anticipated expenditures as well as negotiation of the 3PL's profit margin. An enterprise's experience with its own overhead and cost metrics helps to inform expectations for baseline costs following outsourcing. Some of those expenditures, such as equipment leases, may

be transferred to the 3PL depending on the nature of the operation. The expertise and economy of scale brought by a large 3PL provider may also offer lower baseline costs than those prior to outsourcing. Recordkeeping, real-time reporting, substantiation of certain expenditures, and periodic management meetings are some of the tools available to manage costs throughout the relationship. The 3PL's margin is set at a percentage of cost, or a lump sum, or a combination of the two.

Gainshare Models - Gainshare models are intended to be a "win-win" for both the enterprise shipper and its 3PL. These are often attractive for projects that are significant in scale due to the promise of mutually incentivizing operational performance. A typical gainshare will establish agreed-upon metrics for a baseline based upon historic financial performance. Real or contingent adjustments to the baseline may be negotiated to account for changes in economic conditions or market demands. These can include inflation adjustments, expense controls, and even ceilings on certain overhead costs. The parties then negotiate anticipated operational benefit in subsequent years based in large part upon the 3PL's analysis of opportunities for cost improvement. The 3PL earns its profits from its percentage of cost savings and the enterprise experiences lower total cost than it would otherwise incur.

These common pricing models for 3PL outsourcing vary widely in their complexity and administrative burden, with the key distinction of difference in the degree of cost controls and allocation of respective risk. Creative hybrid models are also available to draw upon the desired characteristics of each throughout the term of the relationship or changing from one model to the other at certain milestones or at the option of the parties. The choice of a pricing model ultimately sets the tone for the operational relationship, including the parties' roles and responsibilities. It also sets the tone for how that relationship will end. The cost of change, in particular, can be extremely high following a significant transfer of operations and a highly integrated gainshare model.

Jonathan Todd is Of Counsel with the national Transportation & Logistics Practice Group of Benesch, Friedlander, Coplan & Aronoff. He may be reached at (216) 363-4658 or jtodd@beneschlaw.com.