WAREHOUSING BEST PRACTICES: 3PL PRICING STRATEGIES

When you decide to work with a partner for your logistics needs, there are a few constants that will always hold true. You'll want to vet their reputation, you'll want to make sure they have the capacity and ability to service your needs both now and in the future, and finally, you'll need to make sure all aspects of the pricing structure aligns with your partnership.

If you "chase a price tag" when deciding on an important partnership like a third-party logistics provider, you are more likely to end up penny wise and pound foolish than building a long-term fulfillment success story. That's because the monetary agreement is only a portion of the equation you should be relying on to find a company that works well with your strategic goals. The actual pricing structure, the often-neglected heart of how you will financially interact with your 3PL, is just as crucial as the "price tag" it's tied to. **Your pricing method needs to reflect not only the way your business is currently operating, but also the particular goals and motivations of your corporate culture,** or else you may deal with an unpleasant clash.

While we'll discuss specific pricing methodologies here, it's important to note that business can and should change as time goes on. Whether you add more customers and find your SKU count climbing, or you decide to restructure as a company and pare down your offerings, your 3PL pricing structure needs to follow suit. Don't let charges become so familiar and expected that they fade into the background—you wouldn't continue to pay a warehouse associate without verifying they were meeting your KPIs, or pay a vendor's invoices without checking their shipments at least periodically. Just as you want and need a hardworking employee and an accurate vendor order, **your business will work best with the right pricing structure in place**—and if this important task is neglected the difference may be very expensive.

So What Type of 3PL Pricing Model Do I Need?

Much like any other service—transportation, packaging, janitorial services, and so on—it all depends on the size and scope of your business. There are four basic pricing models, and the one that fits your company best today might be a poor fit in 2 or 3 years, depending on business and industry demands, so it's important to keep doing regular assessments.

Transaction or Unit Rate

Transaction or unit rate pricing ties costs to individual units or orders and is primarily used when shippers want a direct correlation between their volumes and costs. Volumes may fluctuate from month to month or season to season, but this method limits the risk of shippers missing their cost budget by outsourcing risk to the 3PL.

This model works well for start-up companies and those in shared or multi-client warehousing and fulfillment centers. It is also preferred in certain channels like B2C and e-commerce fulfillment companies, as well as for value-added services like kitting, assembly, and returns processing.

How It Benefits the Shipper

Engineering pricing and calculating profitability becomes considerably easier with transaction/ unit rate pricing. Assuming they can accurately forecast future volumes, shippers will know the price of storing their items in the warehouse, inbound costs, outbound costs, and so on. **The budgeting process can be more predictable when warehousing and fulfillment costs are priced to the unit or transaction level.**

How It Benefits the 3PL

This pricing model generally yields greater operating margins than a cost-plus style pricing method, and invoicing becomes easier as well. Everyone knows what to expect, and determining a fairly accurate cost is a simple matter of multiplying the known rate against the number of orders or units moving through the warehouse.

> **The pricing is predictable and straightforward, without inviting room for misinterpretation or “sticker shock” on the part of their customers.**

Potential Risks Inherent in the Transaction/Unit Rate Pricing Structure Method

While there's a higher margin to be had for the 3PL, there's also a considerable risk if forecasts are inaccurate: trained staff lying idle in the warehouse, poised to move orders that never manifest, or not having enough staff to support unexpected volumes, which can lead to service failures. Their training and retention become a resource drain, **which is why high-accuracy forecasting is an important skill to cultivate for businesses opting for this 3PL pricing method.** For the shipper, if forecasts and shipment profiles change (or are wrong) than distribution costs will need consistent adjustments. This can make budgeting very difficult.

When to Use Transaction/Unit Rate Pricing

Use this pricing structure when your highest priorities are budgeting precisely and minimizing risk. You are able to prioritize accurate forecasting and are willing to pay a higher margin to achieve this goal.

How to Manage Transaction/Unit Rate Pricing

A company using this pricing structure will need to consistently evaluate their forecast. To ensure the forecasting is accurate, they will need regular monitoring of profile changes and volumes. A process will be required to adjust rates to account for any business changes, such as new product lines, discontinued products, and general profile changes. In general, you should expect to have more frequent pricing discussions with your 3PL if a transaction/unit rate structure is used.

Scope Creep Defense

Clearly define what work is expected to be done in exchange for each transaction/unit rate and be ready to adjust the pricing for any extra steps or changes in volumes. Periodic check-ins will help nip scope creep in the bud if it starts to crop up.

Fixed/Variable/Reimbursable

Fixed variable pricing is a formalized way to acknowledge something of a hybrid approach to pricing—one that factors in costs that remain the same from month to month or week to week, those that fluctuate based on volume, and those that fluctuate but not necessarily based on volume. These costs are put into three "buckets" depending on negotiations between the shipper and their 3PL.

How It Benefits the Shipper

Through fixed variable pricing, clients can essentially customize how their pricing is handled and what is factored in. **It helps balance risk and reward** and brings pricing into better alignment with day-to-day operations in a warehouse or logistics center. Fixed costs typically include rent, forklifts, and salaried employees. Variable costs are those that move in direct proportion to volume. These typically consist of direct labor (employees who physically handle the product).

Reimbursable costs are those that those fluctuate over time, but not in proportion to volume changes. Common examples of reimbursable costs are those related to utilities, building and equipment maintenance, computer system support & supplies, training, office supplies, and hourly employees performing indirect functions such as inventory control and clerical support, Reimbursable costs are typically passed through as incurred with a markup added.

How It Benefits the 3PL

Under this pricing structure, the 3PL is protected against losses beyond their control. For instance, if volume drops, the 3PL's revenue drops in a unit rate environment. However, fixed and reimbursable costs haven't decreased and still have to be paid, which could put the 3PL in the position of losing money during a given time period. With fixed variable pricing, the 3PL assumes the risk of adjusting labor to match volume, which is typically what 3PLs are hired to do, but are protected against losing money on fixed or reimbursable costs.

Potential Risks Inherent in the Fixed Variable Pricing Structure Method

Forecasting will need a higher degree of accuracy. It is especially important so that direct labor variable costs can be planned to match volume.

When to Use Fixed Variable Pricing

This model works best for longstanding, reasonably stable company-3PL partnerships. It provides a good mix of control over both known and unknown aspects of operational and logistics costs while reining in the high price tag normally attached to uncertainty by defining its elements ahead of time.

How to Manage Fixed Variable Pricing

Don't be afraid to ask questions when negotiating your contract with a 3PL. Be clear about which items are considered fixed, which are considered variable, and which are considered reimbursable. Be sure to equip your staff with the necessary training and tools to accurately forecast.

Scope Creep Defense

Fixed variable pricing is especially susceptible to scope creep, due to those aforementioned cost "buckets" sloshing over. You should always keep a written record of which costs belong in each bucket. This will help keep both company and 3PL on track despite challenges.

Cost-Plus

In this pricing model, the shipper is charged for the 3PL's costs, as well as a management fee—hence the name "cost-plus." This structure is ideal for those shippers who have limited data or historical information that is needed for a 3PL to establish unit rate or fixed / variable/ reimbursable pricing. This model also works best for businesses experiencing change within their business model and/or distribution network.

How It Benefits the Shipper

This model is the most risk-averse pricing structure. Because of this, there are typically lower margins assigned by the 3PL.

How It Benefits the 3PL

Cost-plus pricing is ideal for new shipper-3PL relationships, especially those where limited historical data is available for the 3PL to base their proposal. Cost-plus pricing reduces 3PL risk, which usually is accompanied by lower margins, and it gives the 3PL the opportunity to collect data over time that can be used to migrate to a unit rate or fixed / variable/ reimbursable pricing structure if desired.

> **While the 3PL is given a helpful amount of discretion; it's important to note that they aren't getting an "open checkbook"—justification and approval for budget adjustments due to warehouse profile or business model changes are still needed.**

Potential Risks Inherent in the Cost-Plus Pricing Structure Method

With the responsibility for overages falling on the business client, a misstep on the part of the 3PL could end up being costly, particularly if it's made during a period of high volume movement. There can be a perception of less motivation for the 3PL to reduce operational costs as this typically means less profit dollars when management fee is tied directly to expenses incurred. Keep in mind, reputable 3PLs understand that retention of the business and opportunities to grow with the customer are more than enough motivation to keep them focused.

When to Use Cost-Plus Pricing

Cost-plus pricing is a solid choice for companies that struggle to forecast accurately, those who don't have access to accurate historical data, or those who operate in a very volatile or dynamic business market, such as the month-end pushes for retailers. It's also an excellent method for situations where transparency is a big plus (pun not intended) such as publicly-traded companies with curious stockholders that want to follow the money trail.

How to Manage Cost-Plus Pricing

The key to efficiently using cost-plus pricing is twofold: first, make sure all cost categories are clearly defined, and secondly, make sure you're taking full advantage of transparency by getting frequent updates from your 3PL partner. There should always be an opportunity to discuss large expenditures, particularly before they happen, so make yourself readily available before periods of high volume.

Scope Creep Defense

The cost-plus pricing model is a defense against scope creep risk for the 3PL because the more the customer asks of the 3PL, the more the 3PL will need to charge. It is a good pricing model to use if the customer expects the scope of responsibility to expand for the 3PL over time. It is always good business practice to make sure you and your 3PL are aligned on expected outcomes and to meet on a regular basis (quarterly), to review performance and communicate any expected business changes in the near future.

> **It may be beneficial to calculate the management fee using a volume-based measure, such as lines or units processed instead of simply applying a markup percentage to 3PL incurred expenses. This protects the 3PL from sacrificing margin dollars by reducing operating expenses.**

Outcome-Based Models

Outcome-based models like Vested Outsourcing are not a traditional type of pricing structure, but they're emerging as a solid contender in the complex web of needs found in modern businesses. At their core, **they represent two parties committing to work together for the long-haul to figure out a mutually-beneficial result.** Some of the "regular" rules of pricing are set aside in favor of cooperation, ideally enabling both the client and their 3PL partner to profit, prosper, grow, and evolve—effectively performing the old maxim, a rising tide lifts all boats. Therefore, the 3PL is incented to invest in the business since there is a clear path to earning an ROI. Likewise, they put a portion of their profits at risk if they miss targets.

How It Benefits the Shipper

As with any business relationship, trust is one of the most valuable products that will ever emerge from a supply chain. Knowing that your 3PL partner has effectively—and willingly—linked their fate to your own will help with peace of mind. Similar to stock options offered to high-level executives in the business world, Outcome-Based pricing models reward loyalty-based innovation with an organic boost to business and profits for a 3PL, rather than an overt tit-for-tat system.

How It Benefits the 3PL

Oftentimes shippers expect their 3PL partners to drive efficiency and innovation by investing their money and resources to improve business. This is a fair request, if there is a clear path to an acceptable return on investment. The challenge is that most shipper-3PL contracts are only for 3 years, and typically include termination for convenience language. It is difficult for the CFO of a 3PL to approve a large investment aimed at improving their customer's business when the customer could end the agreement on short notice.

> **There are many types of Outcome-Based models that allow for customization to your needs.**

> **Outcome-based pricing models clearly provide incentive for the 3PL to invest in the business to improve efficiency without fear of their customer walking away and leaving the 3PL with nothing to show for their investment. A properly structured outcome-based pricing agreement provides clear financial incentives to the 3PL for performance that benefits their customers and their customer's customers.**

Potential Risks Inherent in The Outcome-Based Pricing Structure Method

What goes up can also go down. If either side makes an unwise or reckless move without consulting the other, the fallout can go well beyond a few ruffled feathers. Outcome-Based pricing models are generally a better fit for companies that have a previous relationship. The 3PL and shipper are making a commitment to work together for the long term. This requires trust and a willingness to do what it takes to make the relationship work, much like a marriage commitment.

When to Use Outcome-Based Pricing

When budgets are tight, and the potential benefits for innovation and insights are high, these uniquely cooperative business relationships serve both sides well. Kenco is proud to share Outcome-Based pricing models with valued clients, including a 14-year customer. While our partnership with this company didn't begin with an outcome-based pricing model, as trust developed and a working relationship was established, we evolved the partnership to reflect a long-term commitment to work together, which culminated in an agreement to extend the contract for 10 years. **We've found the move allowed our conversations to focus on forward-looking strategy as opposed to backward-looking transactional information and KPI monitoring, with the former being far more useful than the latter.**

Certain Outcome-Based pricing models, such as Vested, shouldn't be taken on by newcomers. A certain amount of understanding, expertise, and maturity is required to make Vested work.

How to Manage Outcome-Based Pricing

To continue the allusion to a relationship, communication means everything. Don't be afraid to discuss what isn't working and pull in both teams for brainstorm sessions on how to overcome those obstacles. When you're "in it together," it needs to be a full-time attitude in both philosophy and practice, so don't shut out your 3PL partner by grabbing the reins unexpectedly.

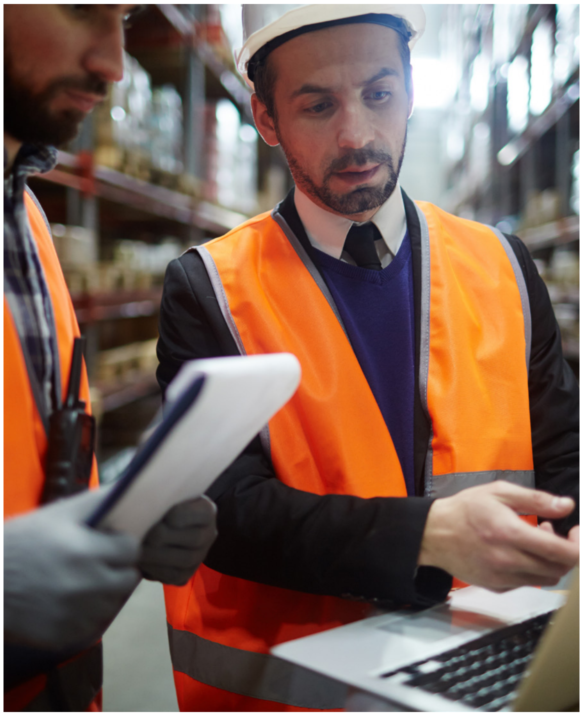
Scope Creep Defense

When working together in this pricing model, it's important to set KPIs and expectations at the beginning of the relationship. This will be your jumping-off point, moving forward.

Migration From One Pricing Structure to Another

As you're evaluating your relationship and contract with your 3PL, you may find the desire to switch from one pricing model to the other. How difficult will this switch be? Quite simply, it depends how much data you have collected and how much trust resides in the relationship..

The longer the relationship you have had with the 3PL, the more data you likely have. This will make the switch to another model easier because you will be able to predict costs and needs more accurately.



> **In general, be careful to collect quality data. This will make the migration to any model much easier.**

The "Perfect Fit" Comes From Collaboration

Which of these pricing methods will work for your company depends on a wide set of variables, but generally, **talking to your 3PL about your needs and expectations is a great place to start.** A brief caveat, however: make sure the brunt of your focus doesn't fall on cost and outsourcing risk—these are only two facets of a very complex and nuanced relationship you'll hopefully be building with your 3PL.

Likewise, don't over-emphasize punitive measures for failing to meet KPIs or goals. While some risk/reward is necessary to spur your 3PL to excellence, if working with you feels like a constant uphill battle, it's likely performance will reflect that.

To Sum It Up

In conclusion, talk to your 3PL about multiple pricing options and see which styles meet both of your needs. Your 3PL partnership will be a long-term relationship that should act more like an extension of your company than a service provider, so it's in your best interest to listen to what they have to say about their offerings. **Set goals that benefit both your business and theirs,** even if you don't elect to adopt an Outcome-Based structure: your commitment to a mutually-beneficial partnership will start your combined forces off on the right logistical footing.

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Best Practices for Selecting and Managing a 3PL

THIS FREE OFFER INCLUDES:

- Checklist for evaluating different 3PL companies and providers
- Information on how to develop a contract with a 3PL provider
- 8 point category/KPI scorecard
- Insight into the future of vested outsourcing

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