Choosing the right sourcing model for third-party logistics outsourcing agreements

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Abstract

Modern outsourcing is more than a typical make–buy decision. Rather, there is a wide range of sourcing business models that today's practitioners can choose from. Unfortunately, the fundamental nature of how goods and services are procured is not keeping pace with best practices of tapping into more mature sourcing business models; many business professionals wrongly assume that a transaction-based business model is the only way to architect a supplier contract. This paper provides an easy-to-understand framework for classifying the various contracting approaches along a sourcing continuum. A key goal of the paper is to help organisations understand the various models and see examples of how they are used in practice.

Keywords

sourcing, sourcing business models, logistics service provider (LSP), third-party logistics (3PL), supply chain management (SCM), outsourcing, Vested outsourcing, performance-based contracts

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INTRODUCTION

For the last 28 years, Dr C. John Langley has surveyed shippers and third-party logistics (3PL) providers as part of a comprehensive 3PL study.[1] The 2024 3PL study shows that organisations spend 37 per cent of their total logistics expenditures on outsourcing. Organisations outsource a variety of logistics services, with over 50 per cent of organisations outsourcing warehousing, domestic transportation, customs brokerage and international transportation. The list of logistics-related services is quite significant, however, and also includes many value-added services, such as cross-docking, reverse logistics and transloading, to name a few.

With so many organisations outsourcing logistics support services, the question arises: are organisations using the most appropriate sourcing business model for their outsourced logistics services? This paper sets out to address this question.

We start this paper with an overview of why it is essential to look beyond a simple 'make versus buy' decision when outsourcing and instead to consider which sourcing business model is most appropriate. We then provide an easy-to-understand framework for comprehending the various sourcing business models available to procurement and supply chain professionals. This framework is especially helpful for those who might be new to 3PL outsourcing and may not be familiar with each model. Here, we summarise each model and provide an example of each in practice. We also provide a simple summary that compares each of the models.

Whether you are new to outsourcing or have many deals under your belt, this paper provides excellent insight to ensure you are making the right decision on which sourcing model is most appropriate.

SOURCING AS A CONTINUUM

For centuries, organisations have thought of procurement as a basic 'make versus buy' decision. This was especially true as organisations initially explored outsourcing. Many falsely assume if they 'buy', they should use competitive market forces to ensure they are getting the best deal. This default approach uses a transaction-based model, which works well for simple transactions with abundant supply and low complexity where the market can correct itself. After all, if a supplier does not perform, just rebid the work.

As organisations outsource more complex and strategic services, however, the once tried and true transaction-based sourcing business logic falls short. Why? As buyers have more strategic outsourcing relationships, they become co-dependent on suppliers, switching costs are high, and suppliers have a 'locked-in' position.

But that does not mean you should simply toss up your hands and forgo creating more strategic relationships. Rather, it means you should rethink how you are outsourcing and align your sourcing business model with the intent of your relationship. Oliver E. Williamson, Professor of Economics at the University of California, Berkeley, was one of the first to challenge the traditional view of sourcing relationships with his work in transaction cost economics beginning in the late 1970s. He received the Nobel Prize for his work in 2009. One of Williamson's key lessons is that organisations should view sourcing as a continuum rather than a simple market-based make versus buy decision.[2]

A good way to view Williamson's work is to consider free-market forces on

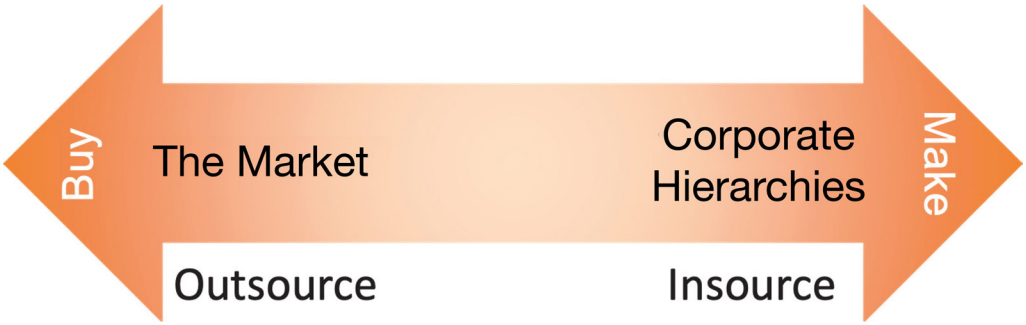

FIGURE 1 Simplified sourcing continuum

one side and what Williamson refers to as 'corporate hierarchies' on the other side (see Figure 1). In the middle, Williamson advocated that organisations should use a 'hybrid' approach for complex contracts.

The organisations that move along the sourcing continuum to more sophisticated sourcing business models are able to drive process improvements and even innovation through closer collaboration as they bring 'relational' aspects into their supplier agreements. Figure 2 is an expanded sourcing continuum where University of Tennessee researchers have 'mapped' seven common sourcing business models against Williamson's continuum.

The concept of shifting up the sourcing continuum is something that will likely appeal to organisations that outsource 3PL services. Why? Let us return to the 2024 3PL study. Eighty-four per cent of

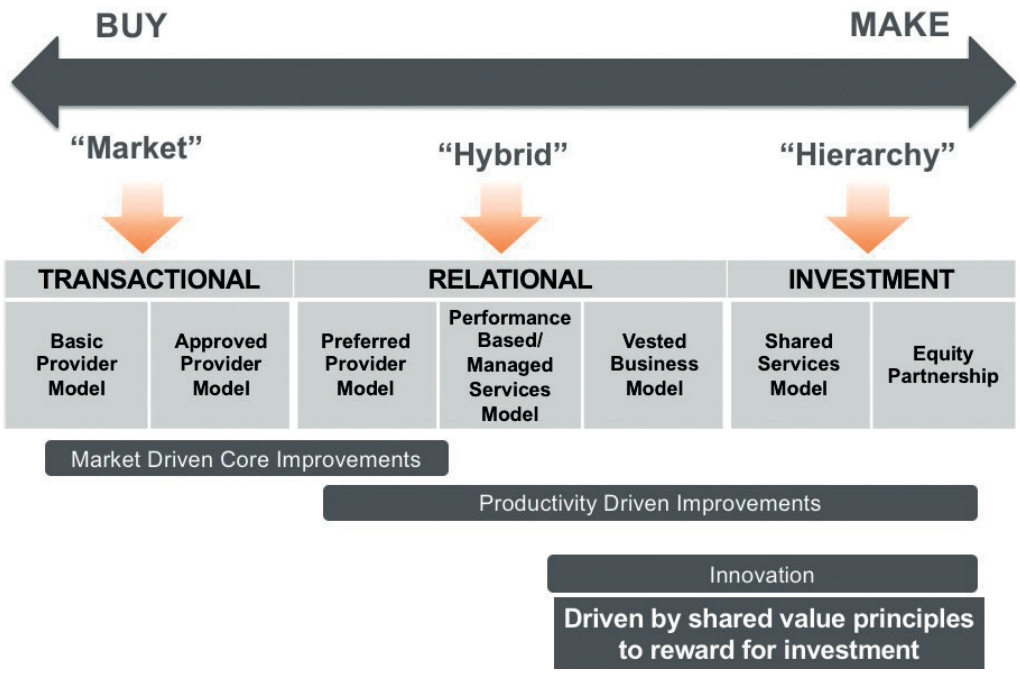

FIGURE 2 Expanded sourcing continuum

shippers and 97 per cent of 3PLs agreed there is a need for more strategic and longer-term agreements to drive collaboration and innovation. In fact, 92 per cent of shippers and 96 per cent of 3PLs stated the need to place greater importance on collaboration and information sharing.[3]

One reason for this is they are seeking more advanced IT solutions and more innovation from their 3PLs. For example, some shippers are looking for warehouse automation solutions to improve service levels and operational throughput. To justify these investments, especially asset-specific investments, 3PLs need longer-term contracts to enable a fair return on investment (ROI).

Mark Baxa, Council of Supply Chain Management Professionals, shared his perspective in the 3PL study report. 'Shippers want long-term relationships with providers, and 3PLs are asking for the same thing. They are saying, "I want to be a partner that owns the responsibility for delivering warehousing and supply chain-oriented solutions".'[4]

AN OVERVIEW OF THE SEVEN SOURCING BUSINESS MODELS

No single sourcing model is better than another. It is about which can best meet the needs of what you are trying to achieve. This section summarises each model and is especially helpful for those who might be new to outsourcing 3PL services.[5] A short example is also provided, showing how each model has been effectively applied in 3PL outsourcing.

Basic provider model

A basic provider model is used to buy low-cost, standardised goods and services in a market where there are many suppliers and switching suppliers has little or no impact on the business. Buyers typically use frequent competitive bidding, often aided by automated procurement processes and tools such as pre-established electronic auctions. A purchase requisition usually triggers transactions that signal that the buying company agrees to buy preset quantities of goods or tasks.

The buyer–supplier relationship is based largely on a review of performance against basic criteria. For example, did the transportation company deliver the shipment on time and damage-free?

Example

An automotive parts manufacturer (APM) had a need for local and interstate deliveries of varying amounts of product. APM had used a sole source supplier relationship with a transport company (TC), which included a multi-year contract for both local and interstate transportation requirements. TC used subcontractors to provide deliveries for the shipping lanes it did not serve.

APM's procurement team questioned the need for a sole-source supplier relationship. After a review, feedback from internal stakeholders revealed that APM was only using TC for commodity transport services, and their services were not a differentiator from their point of view.

APM's procurement team further analysed if using the spot market to buy transportation would lead to savings. As part of the analysis, APM believed they could save money by shifting to the spot market, which could be used for both TC shipments as well as TC's subcontracted shipments.

One worry from making the shift to using multiple spot market suppliers

was increased contract administration. To streamline contract management, APM set up an online portal where it would post the required shipments and the transport companies could bid for the particular shipments. A one-time purchase order would then be issued to the winning transport company for the shipment concerned.

Approved provider model

To create a seamless and readily accessible supply chain, many organisations develop lists of approved providers. A pre-approved list saves time when seeking particular goods and services. The approval process also ensures parity between qualified suppliers. As an organisation selects its approved provider list, it moulds the required qualifications to its unique business objectives and strategy.

Typically, approved providers are identified as pre-qualified options in the pool of basic providers. To reach approved status, suppliers typically provide some level of differentiation, such as a cost or efficiency advantage for the buyer. The differentiation could come as a geographical location advantage, a cost or quality advantage or status as a minority-owned business. An approved provider may or may not operate under a Master Agreement, which is an overarching contract with the buying organisation.

Example

A multinational industrial company created a newly formed corporate supply chain group (CSCG) to oversee all inbound and outbound supply chain activities across the company's multiple business units (BUs). The CSCG had a hunch that one area where they could save money was to consolidate the various 3PL contracts into a smaller number of regional contracts.

As part of the strategy, CSCG wanted to mandate the BUs to use the regional 3PLs to ensure the largest amount of volume consolidation. After discussions with BU logistics leads, CSCG decided to use a more flexible strategy where the BUs could 'opt-in' using the regional contracts for two reasons. First, the BUs were separate profit centres and did not want to lose their autonomy to use suppliers they felt were most appropriate in certain situations. In addition, BUs sometimes had ex-works terms of trade where some customers controlled the shipments.

With the strategy agreed, CSCG conducted competitive bids to select the limited number of approved 3PLs in each region which BUs could choose from. In addition, they negotiated volume price discounts and created a rate card with a menu of ad hoc services such as loading and unloading containers.

There was a high take-up of BUs shifting to use the approved 3PLs for several reasons. First, the cost was lower because CSCG negotiated better pricing by leveraging consolidated volume across the BUs. Secondly, CSCG had already done the task of qualifying and carrying out due diligence on the 3PLs. Finally, if there was a need to resolve issues or concerns, the BU had access to the CSCG's global clout.

Preferred provider model

Many organisations find themselves wanting to use more value-added logistics services such as product labelling and packaging, cross-docking, trans-loading or working with a 3PL to provide asset-specific solutions. When more complex services are needed, organisations should shift to using a preferred provider model.

In a preferred provider model, the buyer has made the choice to move to a supplier relationship where there is an opportunity for the supplier to add differentiated incremental value to the buyer's business to meet strategic objectives. Most preferred provider relationships have multi-year contracts using Master Agreements that let them conduct repeat business efficiently.

The more strategic nature of a preferred provider model almost always integrates the supplier into the buyer's business processes, which creates the need for a more collaborative 'relational' approach. While preferred providers still use transaction-based economic models (eg they charge per mile, per unit, per hour, per shipment), the parties consider how the supplier can provide value-added services to drive productivity efficiencies or higher service levels. For example, a preferred provider may have superior software that interfaces with an organisation's own system, streamlining operations.

Example

A consumer packaged goods (CPG) company had just successfully transitioned from its 'start-up' phase and was beginning its growth phase. During the start-up phase, CPG outsourced warehousing and distribution to a 3PL, which enabled them to focus on their core competency of manufacturing and marketing. The arrangement had been very successful, and for the end customer, integrating the consumer goods company and the 3PL was seamless. The contract between the parties was a simple fee for each order shipped, a cost pass-through for consumables and a cost per pallet per week for storage.

A key part of CPG's growth phase was market expansion. Rather than seek out additional 3PLs in each market, CPG and 3PL agreed that they would work together to set up warehousing and distribution capability in each new state and territory. A key advantage of extending the relationship with the existing 3PL was the time and cost of the ramp-up. The 3PL was a national player and already had locations and capacity in the locations that CPG was hoping to grow. In addition, CPG would benefit by working with a supplier that used a single system across their network — making the integration of the new sites much more efficient. As such, CPG could leverage 3PL's system as their point of record for inventory while still maintaining control of managing the forecasting and inventory. In addition, the parties could leverage a single pricing structure of the 3PL's service and have consolidated invoicing across all sites.

Performance-based/managed services model

A performance-based model (also sometimes referred to as a managed services model) is generally a formal, longer-term supplier agreement that combines a relational contracting model with an output-based economic model. The sourcing decision is based not only on a supplier's ability to provide goods or services at a competitive cost but also on its ability to drive productivity improvements in terms of cost savings and increased service levels based on its core competencies. Performance-based agreements shift thinking away from activities to predefined outputs.

A performance-based agreement typically creates incentives and/or penalties based on a supplier's ability to meet pre-agreed service level agreements (SLAs) or key performance indicators

(KPIs). Typically, a supplier puts a portion of their management fee 'at risk', with payment tied directly to the supplier's ability to perform against the SLAs.

It is important to understand that a performance-based agreement should hold a supplier accountable only for what is under its control. If the SLAs or KPIs are not clearly defined, it can lead to misalignment in client goals and supplier performance.

Performance-based agreements require a higher level of collaboration than preferred provider contracts because there is a higher degree of integration between the supplier and the buying organisation. In addition, the buyer and supplier need to apply a more formalised governance structure to review performance against objectives and determine the incentive or fee-at-risk component of the contract.

Example

A vehicle assembly manufacturer (VAM) in Melbourne, Australia, signed a multi-year agreement with a 3PL organisation to assist it with operating its just-in-time (JIT) inbound parts operations. The goal was to create a highly integrated and seamless delivery of parts to the VAM to facilitate smooth production where the 3PL would provide daily/hourly deliveries of parts in 'line load order' (parts specific to a vehicle moving down the line are delivered in kits just in time).

As part of the strategic relationship, the 3PL set up a dedicated accumulation and sortation facility next door to the VAM. Thousands of component parts would be delivered from suppliers around the country in both full and less-than-truckload deliveries and were warehoused at the 3PL. The component parts were managed on a min–max inventory system with a supplier schedule driven by reorder points in the 3PL company's facility.

Every day, the VAM would provide a daily line load schedule for the next day's production schedule. The 3PL would then pull the required parts from stock and set them up for delivery to the specific points on the production line. The 3PL had full responsibility for ensuring all parts were delivered on time and in full. If there was a shortage of a part because of a supplier's failure to deliver, then the 3PL was responsible for engaging with the VAM's procurement team, who would expedite the component parts. Late deliveries were the responsibility of the 3PL to expedite the receiving process and get the items to the required point on the production line.

The VAM's and 3PL's commercial agreement included pre-agreed SLAs with penalties for performance failures. Parts misplaced on the line load delivery or missed off the shipment could incur a penalty. The logic for the penalties was to allow the VAM to recoup the cost of downtime and lost efficiency of their assembly line due to a parts shortage. While most penalties were nominal because missing parts were expedited from the 3PL stock next door, on rare occasions missing parts resulted in the VAM stopping the assembly line for the day. In this case, the penalties could amount to several hundred thousand dollars.

If extra work was required to meet the requirements of the VAM due to a planning failure by the VAM, then the 3PL was able to recover these costs.

Vested sourcing business model

A Vested sourcing business model is a hybrid relationship that combines an

outcome-based economic model with a relational contracting model. The Vested model also incorporates Nobel Prize-winning concepts of behavioural economics and the principle of shared value. Using these concepts, companies enter into highly collaborative arrangements designed to create and share value for the buyer and supplier above and beyond the conventional buy–sell economics of a transaction-based or performance-based agreement.

The Vested model demands a high degree of collaboration and transparency because the organisation outsourcing and the supplier have an economic interest in each other's success. In short, the parties are equally committed (Vested) to each other's success.

A Vested business model is best used when an organisation has strategic transformational and/or innovation objectives it cannot achieve by itself or by using conventional transactional sourcing business models (basic provider, approved provider, preferred provider) or a performance-based agreement.

These transformational or innovation objectives are called 'desired outcomes'. A desired outcome is a measurable strategic business objective that focuses on what will be accomplished as a result of the collaboration. Desired outcomes are not task-oriented or output-focused SLAs but are strategic in nature and often can only be achieved with substantial collaboration between the buyer and provider and/or with investment by the supplier.

Example

Intel[6] historically used a well-crafted and resourced supplier development programme (SDP) to drive capability and competition between its transportation suppliers. The goal of the SDP was to always have at least three capable, competitive suppliers for all segments of Intel's business, with the rationale that it mitigates supply risks while ensuring adequate competition during the bid process.

Years of sourcing 3PL services led Intel to question the conventional competitive bid process: what if Intel began to work more collaboratively with logistics suppliers to drive lower total costs — not just reduced price? Their effort led to Intel's piloting its first Vested agreement with DHL in Costa Rica. What started as a simple pilot became a radically altered mindset in how Intel and DHL worked in Costa Rica. As part of the shift to a Vested relationship, the parties created the following shared vision:

> To create a logistics operation that continuously improves on cost while improving or maintaining other key operational indicators.

They also agreed to abide by a code of conduct of social norms (known as a Statement of Intent). The Statement of Intent drove behaviours that promoted trust to create a highly cooperative and collaborative environment. Together, the companies agreed on five key desired outcomes:

- Maintain on-time-delivery (OTD) performance.
- Maintain shipment damage indicators.
- Maintain safety indicators.
- Maintain customer satisfaction indicators.
- Improve Intel cost and DHL profitability.

The parties went on to restructure their agreement to make the desired outcomes

the focal point of the agreement and carefully constructed metrics that aligned with the desired outcomes. They also restructured the economics of the partnership from a transactional fee (cost per shipment, pallet storage, full-time equivalent [FTE]) to a pricing model with incentives that rewarded DHL for helping Intel achieve the desired outcomes. This included a monetary incentive for reducing Intel's total cost of ownership as well as a non-monetary incentive of an earned contract extension.

In addition, Intel shifted from a conventional 'vendor management' mindset to putting in place a comprehensive governance structure based on insight versus oversight.

The results were exceptional. Within the first two years after signing their win–win Vested agreement, all performance goals were exceeded, including an increase in on-time delivery from 95 per cent to 98.56 per cent, a transit time reduction from eight days to six days, and a reduction in outbound shipment damage by .05 per cent and inbound by 6 per cent. In addition, the parties collaborated to achieve impressive cost savings 59 times higher than the highest recorded cost savings achieved in previous years of the contract, exceeding aggressive targets by nearly four times the anticipated rate. It is equally impressive, however, that DHL achieved significantly higher profit margins due to the incentives and contract extensions it earned.

Shared services model

Organisations that struggle to meet complex business requirements with a supplier can always invest in developing capabilities themselves (or insource). One approach is to develop an internal shared service organisation (SSO) to centralise and standardise operations that improve operational efficiencies. A shared services model is typically an internal service organisation that acts as a supplier to internal customers. Using this approach, processes are often centralised into an SSO that charges business units or users for the services they use. In some instances, SSOs are formed externally to the company (such as a subsidiary).

SSOs typically act like outsourced suppliers, performing services that 'charge' their internal customers on a per-transaction or actual cost basis. SSOs generally mirror conventional preferred provider models. The main difference is that the SSO is an internal supplier rather than an external supplier.

Shared services models are most popular for outsourcing administrative-type operations such as human resources (HR), finance operations or administrative services. For example, large organisations may centralise HR administration into an SSO to provide benefits management to their own employees and even external clients. Small enterprises can benefit from a shared services model by joining forces to create specialised service centres that economically provide a functional service to each of the smaller firms. Co-ops are also a form of SSO.

Example

In the logistics sector, Restaurant Supply Chain Solutions (RSCS) is an example of an SSO.[7] RSCS is the world's largest purchasing co-op in the quick-service restaurant industry, and provides logistics services to well-known brands such as Taco Bell, Pizza Hut and KFC, which operate as part of Yum! Brands, Inc.

RSCS provides core services of sourcing food, packaging and equipment. It also provides ancillary services that

offer discounts on everything from mobile phones to safety shoes. But RSCS is not just a middleman for goods. Customers can access strategic services, such as packaging design, logistics and distribution support. RSCS also offers commodity risk management for several key supply categories, such as poultry, beef and dairy products.

Co-ops are structured so that there is an overarching democratic governance system that keeps things fair and honest. For example, in the Yum! Brands co-op, restaurants are required to become members and own stock in RSCS for the 'concept co-op' based on the brand they represent. The stock requirement for operators who own a store is a US$10 fee plus US$400 per store. As member-owners, they have a voice in the leadership selection of RSCS. Members in good standing also qualify for an annual patronage dividend (if one is paid). Each concept co-op generally pays patronage dividends annually out of net income. Patronage is based on eligible food, packaging and equipment purchases, which have a volume incentive benefit tied to the supplier pricing. The dividend amount is tied to the amount a member spends through the concept co-op, RSCS suppliers or participating distributors.

The RSCS co-op offers many member benefits. The primary benefit is competitive pricing for individual restaurant owner-operators who would pay higher costs without the benefit of RSCS's buying power. From the franchisee viewpoint, small restaurant owners have an equal say; nobody gets the incremental benefit unless all of the franchisees get it.

Equity partnerships

Some organisations decide they do not have internal capabilities, yet they do not want to invest in a shared services organisation. In these cases, organisations may opt to develop an equity partnership such as a joint venture or other legal form in an effort to acquire mission-critical goods and services.

An equity partnership creates a legally binding entity. Equity partnerships take different legal forms, from buying a supplier (an acquisition), to creating a subsidiary, to equity-sharing joint ventures or entering into cooperative (co-op) arrangements. Equity partnerships are best used when an organisation does not have adequate internal capabilities and does not want to outsource.

Equity partnerships bring costs 'in-house' and create a fixed cost burden. As a result, equity partnerships often conflict with the desire of many organisations to create more variable and flexible cost structures on their balance sheets. As Williamson notes, 'The internal organisation is usually thought of as the organisation of last resort'.[8] The rationale is that bringing cost structures in-house for non-core activities creates inefficient 'corporate hierarchies' that lead to inefficiencies.

Example

The same global VAM previously mentioned took a different approach to addressing its JIT requirements in Thailand. Again, it needed to create the capability to deliver components to the production line in line load order on a JIT basis. An analysis found there were no fully capable 3PLs present in Thailand at that time. The challenges were also greater because the majority of components for the vehicles to be manufactured were imported into Thailand in 20ft and 40ft shipping containers. This meant the task of de-stuffing containers and storing

large amounts of stock was an added complication.

Rather than engaging with an international 3PL which had limited experience in Thailand or in vehicle assembly operations, the VAM decided to form a joint venture with a local 3PL and to staff it with a mix of VAM and 3PL staff. The resulting organisation successfully supported vehicle assembly operations. Any visitor to the facility would be hard-pressed to tell whether the staff member was originally from the VAM or the 3PL.

DETERMINING THE APPROPRIATE SOURCING BUSINESS MODEL

What is the most appropriate sourcing business model? It depends. Figure 3 compares each of the models across various attributes.

As illustrated in Figure 3, transactional models are a good fit when procuring simple commodities with abundant supply and low complexity. Transactional models, however, fall short for more strategic, complex sourcing initiatives where a buyer and supplier can benefit from added collaboration and investment. In this case, a more sophisticated performance-based (managed services) or Vested sourcing business model is likely more appropriate.

Shifting along the sourcing continuum allows organisations to move from 'value exchange' to 'value creation' because the deal architecture is designed to motivate suppliers to invest in continuous improvement, transformation and/or innovation geared to reducing cost structure or other strategic business outcomes.

The authors want to stress no single sourcing business model is 'better' than another. Rather, the point is to use the sourcing business model that is most

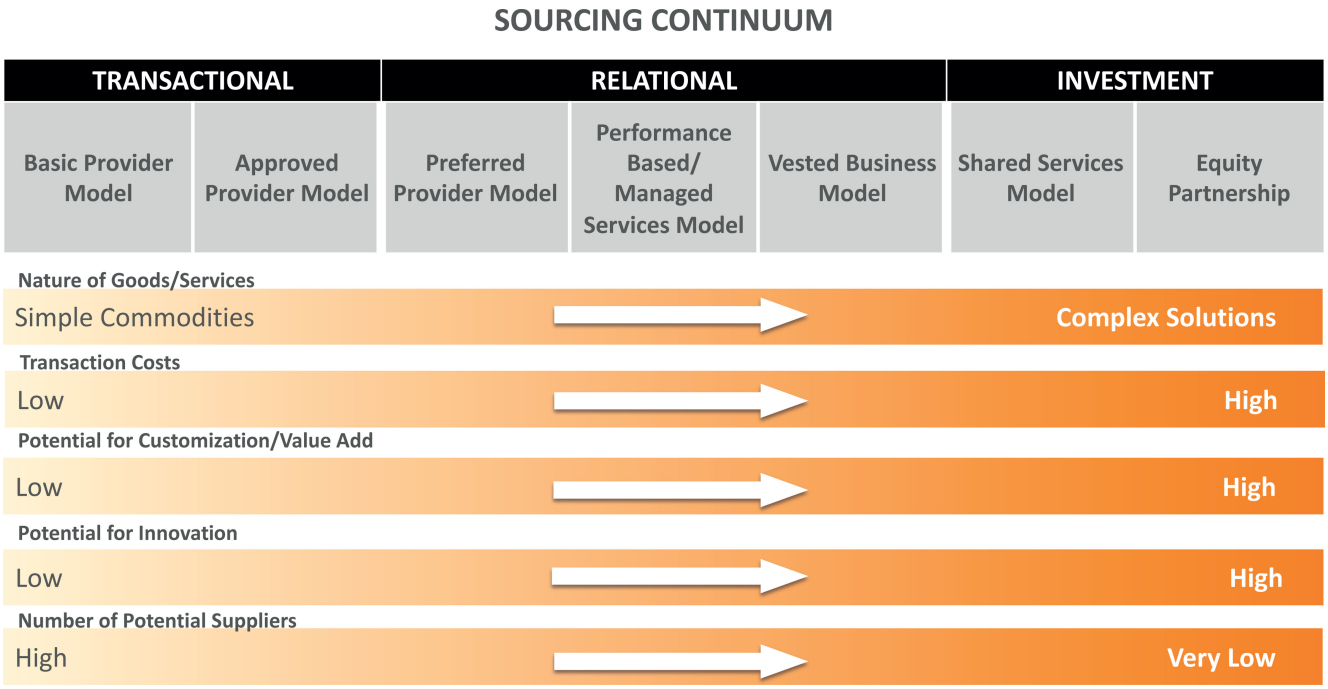

FIGURE 3 Comparison of sourcing business models across the continuum

appropriate for the business situation. For example, the same Vehicle Assembly Manufacturer used a performance-based agreement in Australia and an equity partnership model in Thailand. Most organisations use multiple sourcing business models depending on what they are sourcing. Organisations can also evolve, and the sourcing business model used should change as business needs and events change. An organisation might start with an approved provider and later shift along the sourcing continuum to a preferred or, later, even a performance-based or Vested model as business needs change.

In the next issue, we will follow up this article by profiling a business model mapping toolkit that can be used to determine which sourcing business is best for various situations.

CONCLUSION

The examples above show how each of the seven sourcing business models can add value to an organisation's 3PL outsourcing efforts as their needs evolve. For simple transactions with abundant supply and low complexity, a transaction-based business model is the most efficient model. But as your 3PL needs evolve and become more complex, transaction-based models fall short when any level of complexity, variability, mutual dependency or customised assets or processes come into play. For this reason, it is imperative that organisations consider the benefits of shifting along the sourcing continuum to a performance-based or Vested model.

Unfortunately, the fundamental nature of how 3PL services are procured is not keeping pace with best practices of tapping into more mature sourcing business models; many business professionals wrongly assume that a transaction-based business model is the only way to architect a supplier contract.

It is time to modernise 3PL partnerships. The future will be won by those who embrace more sophisticated sourcing business models designed to create value and harness the power of highly collaborative relationships with suppliers that can help drive transformation and innovation in your organisation. Start by understanding all the tools in the sourcing toolkit. This means understanding the fundamental differences between each type of sourcing business model and consciously striving to pick the right model for the right environment, ultimately picking the right tool for the right job.

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