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3PL Contract Renewals: An Opportunity for the Taking

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The use of third-party logistics services providers (3PLs) has become commonplace in business today. In fact, the key question now for most companies is not whether to use outside logistics service providers, but rather how to use them well. An opportune time to reassess how well the 3PL relationship is working is at contract renewal time. Several options present themselves at this critical juncture. If the arrangement is working reasonably well, renewal presents an opportunity for fine tuning to make it work even better. If it's not working as hoped for, contract renewal time is an opportunity to address the fundamental changes needed to get the relationship back on track.

In either case, contract renewals mean opportunity. But how do you approach the renewal process to make sure that you capitalize on that opportunity? We recently completed a study to help answer that question. Our research took an in-depth look at nearly two dozen recent renewal situations—mostly in North America.

We reviewed each situation from two perspectives: (1) that of the 3PL, or logistics service provider (LSP) and (2) that of the buyer of the services, or the supply chain owner (SCO). The research approach involved face-to-face in-depth interviews with executives at the respective companies. These were extended discussions that allowed us to gain a better understanding of what actually happened in the contract renewal process, and why. In several cases, we saw both sides of the same renewal situation—that is, the buyer and the provider. We are grateful to the people and companies that participated in our project for sharing their experiences with us.

Renewals as Opportunity

Some of the renewal situations we looked at were fairly simple and straightforward. The supply chain owner's business had not changed much and the existing contract arrangement was working fine. Since there was really no reason to do business much differently, the same arrangement essentially was renewed—either by renegotiating a contract with the incumbent or by putting the existing contract out for bids.

Most of the renewals we examined, however, were not that straightforward. Here is an example of a typical more complex situation:

> The SCO operated a large national supply chain with three product divisions. It had contracts with one mid-sized and several smaller service providers, all of which were coming to the end of their term within months of each other. The SCO believed that it could achieve operating savings if certain basic changes were made. In one of the divisions, the SCO wanted to completely restructure the outbound facilities network; in another division, it sought to make basic process changes that would involve upgrading their information technology. The SCO also wanted to put a lead logistics provider in place to run all of their logistics and transportation contracts.

In this case, the SCO did not want to simply renew existing arrangements. It wanted to use the renewal process as a mechanism for initiating change and improvement. Here is a similar situation:

> One SCO that had been growing by acquisitions had contracts in place with three service providers—one large contract provider and two smaller ones. Things were working well from a service level standpoint, but the largest service provider had not been able to deliver the cost savings that the SCO wanted. In the past three years, the buyer had asked repeatedly for a plan to bring operating costs down, but had not received anything useful back. When the contract for the large provider came to the end of its term, the SCO put all of its business out for bids. It ended up awarding a single consolidated contract to a new LSP that offered an integrated solution, new facilities, new software, and substantial cost savings.

These situations highlight a number of issues that can surface at contract renewal time. Companies that are not satisfied with the existing relationship are typically looking for improvements along one or more of three dimensions: improving operations, reducing costs, and simplifying administration. (Exhibit 1 gives some typical activities that fall under each of these dimensions.)

Of course, there's no need to wait until contract renewal time to address these issues, as they can be dealt with during the term of a service contract. But it often

happens that day-to-day pressures get in the way of addressing these more fundamental issues. So for practical reasons, it's useful to put multiple items on a contract renewal agenda that can be addressed in a concentrated manner. In fact, the first order of business for the SCO's supply chain executive is to set the renewal agenda, detailing the basic changes that they want to make for the coming contract period.

When to Go Out For Bids

With the renewal agenda in hand, the SCO can evaluate whether to take the contract out for bids or negotiate a new arrangement with the incumbent.

Some SCOs may have no choice about going out for bids; corporate policy requires that they have an open bid at the end of every outsourcing contract. The companies with such policies in place argue that the discipline of going to the market is good for the operating people. They believe that the process forces the company to look at capabilities of other providers, provides a market price point, and avoids any possibility of "taking the easy way out" by simply renewing the existing arrangement.

In most situations, though, management is free to choose whether or not to go out for bids. When deciding which way to go, three key questions must be asked: How capable is the existing LSP? Do we like working with this provider? And are we getting good value for our money? Let's examine each one in turn.

Does your LSP have the required capability?

As your business changes, you may well require different things from your logistics services provider. Most of the companies that we studied had encountered a certain amount of change with regard to their market conditions and related service requirements. Effectively responding to these changes may challenge the capabilities of the incumbent to deliver. Here is an example:

For a number of years, a group of hospitals had been successfully contracting with an LSP for warehouse, pick, pack and distribution services. During this time, the hospitals looked at the possibility of central procurement. Specifically, they conducted a business case that led to a decision to (1) create a shared service procurement function for the group and (2) contract for both central procurement and central distribution from the same third party provider. Although the incumbent LSP was well thought of, it did not have the required procurement expertise and was not invited to bid. As it turned out, the LSP was able to align itself with the procurement group that won the business.

If the changes you are seeking are incremental, the question of your incumbent's existing capabilities may not be a huge concern. With a little work on both sides, the LSP can generally be brought up to speed. But if the changes are large or very specialized, you may have to go out for bids to get the right capability needed for the job.

Does your LSP relationship work?

SCOs can work with their logistics services providers in many different ways. At one end is the "arm's length" relationship in which the LSP has a fairly narrow operational task and is not called on for much of anything else. At the other end is a true partnering relationship, where the LSP not only plays a day-to-day operational role but also is actively involved in the SCO's business. (Exhibit 2 compares the two approaches.) The more an SCO relies on its LSP for problem solving, logistics expertise, and innovation, the closer the relationship moves from arm's length to partnering.

About 40 percent of the situations we looked at tended to be partnering-type relationships; the rest were closer to arm's-length. Note that real partnering arrangements require extra effort on the part of both the SCO and the LSP. In many cases, the extra effort required may not be warranted because the effort involved outweighs the payback. But even when partnering does make good business sense, not all organizations may have the kind of culture that values this approach and allows it to happen.

But whatever kind of relationship you have with your LSP, it should be one that works well for you. The service provider should understand your requirements, listen to your concerns, and execute its operations as you expect and require.

When there are problems with working relationships, most often the issue comes down to people. You should feel good about the people at your LSP; conversely, they should feel good about working with you. In most of the situations we studied, the SCO has the final word about LSP staffing. Normally, the provider's lead operations manager should meet SCO specs and should be interviewed and approved by the SCO. The lead manager's direct reports should be acceptable to the customer as well.

If a relationship is not working well, it should be improved. Sometimes that may require changing the people who lead your account and manage your operation. The LSP will likely go along with that because they understand that continued performance issues could result in a loss of business. Again, the SCO may normally not wait until renewal time to fix such problems. However, the frank discussions that take place at contract renewal time can be used to help improve staffing and address any other relationship management issues.

Are you getting value for money?

Even if the LSP is capable and the working relationship is fine, many contracts still go out for bids at renewal time. This was the case with more than 60 percent of the situations we analyzed. One big reason is that SCOs want to be sure they are not paying too much. They want to know if they could be getting the same service for less, or getting more for about the same price. Taking the deal to the market may also keep pressure on the incumbent to keep its pricing in line.

One problem with going out for bids, however, is that it can be a costly and time consuming exercise. The only way to get good high quality bids is to provide potential bidders with the complete information they need—and this takes time and resources. Unless there is some other reason driving you to go out for bids, you may normally only want to do so if the potential savings make it worthwhile. Identifying those potential savings must be a top priority for the SCO.

Unfortunately, it may not always be easy to clearly identify any potential savings. It's particularly difficult in multi-service, closed book arrangements where the service provider may not be obliged to show you its actual costs. Value for the money can be more easily gauged in open book situations in which the SCO has access to the LSP's costs and labor and freight rates. But even with these, the SCO must determine if unusually high service requirements can be the cause of higher costs and if productivity is where it ought to be. Here is a case in point:

An SCO was looking hard for cost savings in its national supply chain operations. Its current multi-service operation had several LSPs, all in closed book contracts. The company's internal assessment was that the providers' processes were weak, IT support was a generation behind, and operating cost savings should be available. The LSPs were asked to give their estimate of the savings potential; the responses cames back in the 5 to 15 percent range. On that basis the SCO invited incumbents and new players to bid on an overall solution that included IT improvements. After a lengthy nine-month process, all of their final bids came in—at a significantly higher cost than the current arrangements. On top of the one-time costs, straight operating costs were going to be roughly the same as before. In the end, with no appetite for a large investment and small gains, the SCO scrapped the IT upgrade and negotiated selective improvements with its existing service providers.

This case shows how tricky it can be to gauge your savings potential. The SCO had expected 5 to 15 percent operating cost savings, but had ended up with much less. At least the SCO now knew where it stood—but only after considerable time and effort. Here is another situation we saw that worked out differently:

An SCO had entered into its first contract with this LSP four years earlier based on certain volume growth assumptions that in fact had not materialized. The company's renewal agenda included adjusting both their capacity and costs downwards. Its first inclination was to go out for bids. As a first step, it held informal discussions with several possible alternate service providers. The SCO shared hard facts about its current level of IT integration (which was high), service levels, and cost targets. It turned out that none of the service providers they talked to felt they could do materially better than their incumbent was already doing. Knowing the lay of the land, the SCO entered into hard-nosed renewal negotiations with their incumbent that involved looking at actual cost and productivity information. In the end, both parties worked out a new lower capacity arrangement that was satisfactory.

The example shows the importance of getting a good estimate of the savings potential early on in the contract renewal process. It's reasonable to expect that improving your operations and using better processes and systems will result in operating savings. The key is to understand exactly where the hoped-for savings will come from—and what changes may be necessary to capture those savings.

A useful step is to prepare a sheet of key cost metrics for your current operation and then do some "tire kicking" and informal benchmarking with potential suppliers. That can help you decide whether going out for bids is likely to be worthwhile or whether there are any other reasons to open up the bidding.

In one case we looked at, the legal contract between the SCO and LSP actually specifies how the value for money and open bidding issues will be addressed. The agreement calls for a formal benchmarking study to be done jointly in the year before the end of the contract. If the study shows that the SCO is receiving value for money in the top quartile of the market, there is no open bid. The clause has come into play twice in the final year of two five-year contract terms. In both instances, open bidding was avoided.

The Bidding Process

If you go out for bids, here are several things to watch out for. First, be prepared to do a thorough job with the bidding process. You may be tempted to take short cuts to save time and cost. But by doing do, you run the very real risk of not getting good bids. Doing a thorough job also gives you more confidence in the results. One practical way to simplify your efforts is through a two-step process.

The first step is to narrow down a longer list of possible service providers into two to four top contenders. This can be done by issuing a request for information (RFI) to the long list and ranking the replies on criteria such as the quality of their client list, depth of their industry experience, their approach to contracting, their track record in the space you're specifically interested in, and any other relevant factors. From the responses, you can create a short list of the best candidates and invite them into the full bidding process.

As part of the evaluation and selection process, be aware that your incumbent may have an advantage in the bidding. Because the current provider knows your business, it can be much easier for them to prepare a quality bid. And, of course, you can avoid any change-over costs if you stay with them. In addition, you may have already developed personal relationship with the incumbent and you don't need to teach them your business. All of these factors combine to give the incumbent an edge in some situations.

To make the playing field more level, make sure to give your outside bidders the time they require to learn about your business. A savvy outside bidder may not get involved in a bid that doesn't give them a fair chance to understand your business, get to know your management team, and tell their sales story convincingly.

Trends in 3PL Contracts

In examining the renewal contracts between buyers and sellers, we identified a number of emerging trends. For one thing, contract terms appear to be getting shorter. A typical contract arrangement today is three years. The reason given for the shorter time period is that SCOs do not want to lock themselves in for too long a period. When large capital expenditures are made by the LSP, however, the contract typically extends beyond the three-year average. When the LSP must invest in specialized facilities and equipment, they require enough time to earn back the capital. Alternatively, the SCO may agree to assume the asset from the provider at a formula price at the end of the term.

Another trend is the movement of pricing away from fixed costs and toward variable costs. Increasingly, SCOs want their LSP to have the ability to ratchet costs down if volumes decline. The buyers believe that this is a good way to help make their supply chain more flexible and, as a result, more competitive.

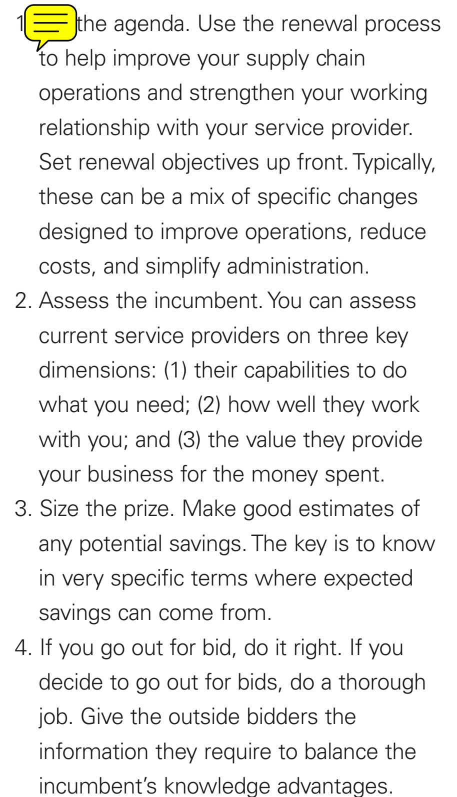
One interesting trend we spotted in several of the larger renewal situations that had been in place for many years is the withdrawal of performance bonuses. The SCOs argued that the bonus was required in the formative years of their relationship to help the provider get its priorities and culture right. But now the LSP and their people were firmly aligned with the SCO—they looked like, felt like and operated like SCO people—and they had well developed processes to measure and control operations. So the bonus was no longer needed, the reasoning goes. Time will tell just how well this approach works out (and if it sticks!).

Another development we noted was the inclusion of provisions in the contract to encourage productivity gains. An oft-reported problem in relationships is that the SCO wants an ongoing stream of ideas, suggestions and improvements from the LSP that can lead to better performance and lower costs. In some cases, the SCO feels that the provider is under-delivering in this regard. Part of the problem may be the disincentives inherent in cost-plus contracts. Although it is a short-sighted thing to do, LSPs may be reluctant to initiate changes that result in a reduction of their revenue and management fees. So several of the SCOs we studied have included a contract clause that keeps LSP management fees intact for a period of time, even though process improvements can result in lower overall operating costs.

The last trend we identified was a move toward more complex and legalistic contracts. The days of a simple deal sealed with a hand shake are long gone. Many told us that the time to work out the legal contract has increased sharply. In the words of one manager, you now need "a forklift truck" to carry all the necessary paperwork.

Steps Going Forward

For many supply chain owners, the process of renewing 3PL contracts actually brings greater challenges and opportunities than starting up new ones. Here are some initial steps you can take to help overcome the challenges and capitalize on those opportunities.



1. the agenda. Use the renewal process to help improve your supply chain operations and strengthen your working relationship with your service provider. Set renewal objectives up front. Typically, these can be a mix of specific changes designed to improve operations, reduce costs, and simplify administration.
2. Assess the incumbent. You can assess current service providers on three key dimensions: (1) their capabilities to do what you need; (2) how well they work with you; and (3) the value they provide your business for the money spent.
3. Size the prize. Make good estimates of any potential savings. The key is to know in very specific terms where expected savings can come from.
4. If you go out for bid, do it right. If you decide to go out for bids, do a thorough job. Give the outside bidders the information they require to balance the incumbent's knowledge advantages.

Authors' note: We have also written a companion article for logistics services providers titled "Making the Most of Your Contract Renewals," ~~to be~~ published in ~~LQ~~ in May 2008. Readers wishing to obtain a copy may contact nseiersen@kpmg.ca.

Snapshot of the Survey Sample

Some statistics about our sample of contract renewal situations:

- Service provider interviews — 55 percent.
- Supply chain owner interviews — 45 percent.
- North American situations — 87 percent.
- 2006/2007 situations — 78 percent.
- Management fees >$2 million — 45 percent.

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