



Factory Gate Pricing – An opportunity to focus on cost and relationships

Factory gate pricing is the new big initiative for fmcg (fast moving consumer goods) distribution and logistics. The dominant retailers are taking control of their inbound logistics and seeking commercial terms from their suppliers to pay for it. The questions that arise for suppliers are related to the future trading model, its implications for margins based on the allowances that are negotiated and practical operational questions including trust that the logistics will still work and sales will not be damaged. This is a moment of risk, since a mistake could become a commercial millstone for years.

But it also an opportunity to step back a pace and review product and market channel strategy. Many fmcg firms have maintained less than profitable lines and customers to satisfy their goals of market share and customer relationships; under this new initiative, giving money away on already marginal lines is tantamount to commercial suicide. FGP makes logistical and operational sense for a significant community, but only if the slate is clean commercially.

LCP Consulting is uniquely qualified to support companies in transforming FGP from a threat to an opportunity. Here we provide an overview of FGP and its implications and provides a staged methodology for determining the approach a firm should take to considering how to respond to it.

Make no mistake – FGP is here to stay

The precedents for structural transformation are written large in the history of fmcg.

- In the last 25 – 30 years, fmcg has been transformed as an industry through retailer centralisation. Manufacturers initially treated this as a threat but eventually acquiesced. Now most large suppliers do 100% of their volume through national and regional distribution centres (as against store deliveries); they have dismantled their distribution infrastructures moving from as many as 20 depots to just one or two.
- Also in the same time horizon, the industry has seen the growth in own label from a situation where consumer brands were a marketing necessity to one where the retailers controlled as much as 35% of a category through own label supply

In the course of these changes, some suppliers experienced margin erosion as a result of allowances for delivering direct and from price comparisons with the own label lines. It is clear that this 'loss' has never been recovered. But has not been a complete tale of doom; costs have reduced through infrastructure rationalisation and volumes have increased dramatically for the survivors.

It is important to understand why the retailers went 'central'; quite simply they were unable to manage the scores of direct deliveries to their stores each day and the administrative costs were escalating as they experienced market place success. Centralisation provided a platform for consolidated deliveries to stores and a systematic management control process. The former Systems and Logistics director of TESCO told LCP some years later that *'we only realised later that we could ask the manufacturers for a contribution to cover the work we had taken off them'*.

It also allowed the introduction of own label products at higher gross margins to build the retail brand and offer savings in the retail basket; 'own label' depends on central distribution as they are bought directly from manufacturers without distribution capability.

Finally the effect of centralisation was to leave smaller competitors at a severe competitive disadvantage since their costs were higher and their suppliers were finding it more and more expensive to supply them.

The impact on the total logistical and supply chain costs has been extraordinary with costs in real terms falling by an estimated 70% over the 25 year period. And stocks have fallen across the chain as retailers connected with suppliers using EDI, and latterly the Internet, to compress order-to-delivery cycles and provide visibility of demand.

Centralisation is now a 'job done'. But the major retailers are planning further growth from networks that contain millions of square feet of capacity and which now struggle to manage the waves of in bound supply and outbound delivery. They are repeating the requirement to win control of the inbound delivery that they faced with their high street stores 25 years ago. And they need a new avenue for cost saving.

They have identified through national statistics and academic research that up to 35% of all truck miles are run empty and that the utilisation of trucks when loaded can be increased on average by 15%. The value of this waste has been estimated at €4 billion. With their buying scale and the knowledge that their trucks and those of their suppliers return largely empty, they are determined to exploit both the necessity for inbound control to maximise sites and the financial opportunity.

They have also studied other successful industries with similar issues and found the car industry working world-class inbound transportation programmes to synchronised line-side deliveries.

The retail vision is to change the buying terms to ex-works and to take control of the inbound leg using third party service providers. The implications for retailers of this vision are a substantial reconfiguration of their networks and facilities. Sainsbury's, who had the oldest and least efficient central network have mounted a £1bn programme to put in place huge high velocity 'fulfilment factories'. Others can be expected to follow in their own ways.

In addition sophisticated software solutions that can optimise transportation are being installed.

It will happen . . . the big retailers have no other options.

The Implications of FGP for Suppliers

The suppliers will have to face this challenge over quite a short time period as the basic retail infrastructure is in place to make the switch. As well a whole raft of practical questions that are covered in the next section, suppliers have to resolve their approach to some major implications of FGP.

1. How much can they afford to allow the retailers for the collection task?
2. How do they handle the different requirements of their retail customers who will move on FGP at different speeds?
3. How do they deal with their existing infrastructure and logistics contracts as volume is transferred to retail control – making it less cost effective?

4. What commercial, pricing and 'terms of trade' policies and structures are appropriate in this new era?

The principles of centralised deliveries and customer collections are well established. Retailers and their suppliers have been happy to negotiate allowances based on somewhere between full and marginal cost to the benefit of both parties; this has typically been handled in the logistics domain. Terms of trade did not change and the costs were transferred either as a customer specific discount or as a charge back from the retailer or his haulier.

The intent of FGP is ultimately to take control totally of transport and change the terms of trade to ex-works. An allowance of the full cost of transport as incurred by the retailer is the commercial position. But the indications are that some costs offered by retailers are in excess of those being paid by canny suppliers, who have found hauliers with established backhauls. The implication is that suppliers must be absolutely clear what their transport costs are by customer for each of his delivery points on both a full cost and marginal cost basis so that the discussions are informed by an accurate estimate of the net cost or benefit for the firm.

This is the starting point for question 1, but it is not the whole picture. Our experience at LCP is that the practice of average costing through the supplier's chain is disguising a wide range of unit costs and "customer and product viability"; when this is done recognising the real cost drivers, there are invariably some big losers in the portfolio. We think this is the moment to make sure that FGP does not make this loss bigger through a failure to recognise true profile of fixed and variable [avoidable and unavoidable] costs and the underlying viability of the portfolio. Any allowances through FGP can create some long term pricing and margin precedents as case-to-pallet ratios vary across the range and orders in both cases and layers may become more prevalent.

Retailers will adopt and implement FGP at different speeds; this will create organisational tensions inside supplier's organisations, as different processes will be needed to meet this multi-track world. Suppliers will need clarity of how this might look and feel in terms of the processes, resources and systems to support the transition and with parallel different systems. There will be inevitable costs with changes in responsibilities and these need both definition and mitigation to avoid mistakes.

The implications for existing transport and distribution arrangements may also be significant. Existing transport contracts may have both long horizons and volume conditions; hauliers may be unable to maintain the service at the cost when as much as 25% of the volume is taken away. This may translate into a complete renegotiation of the transport contracts with the risk of some break penalties and / or a premium for the residual business. Again it is essential to understand this and to plan the contingency and mitigation of any adverse impacts for the remaining business. Any cost increase is attributable to FGP and should become part of the consideration of terms.

Finally the commercial, pricing and 'terms of trade' will inevitably vary as a result of new supply agreements based on retailer controlled collections. There are a host of conditions that will require re-definition from passage of title, insurance responsibility, health and safety liability to questions of damages, and claims. But at its heart will be the commercial frameworks on which business is conducted and the re-synchronisation of retailers' and suppliers' terms of business. This will vary from firm to firm depending on the power balance. The opportunities for the lawyers to string this out are considerable which, of course, may become a negative in the trading relationship and impact volume.

So the big questions prompt the introduction of a well-drilled process in which strategic decisions are taken by the Boards of the suppliers and assertively implemented in their long-term interest. It is not about saying 'no' to their retail partners – but 'yes this is how we can meet your requirements'.

Some practical anxieties and questions

There are a host of practical concerns that arise from FGP and it is not yet clear a full operating model is in place which can be understood. When the retailers went central the message was *'you will deliver to these places within x days (or hours) and will negotiate a slot with the site management'*. Now the message is that *'you will have the order ready for collection by our transport in this time window'*. Suppliers are expressing a degree of disbelief since they have become used to endless delays at retailers RDCs, which gives no confidence that the service will work without damaging their product availability and service measures. The hauliers engaged by the retailers are no longer accountable to the suppliers and there is questionable visibility of performance criteria and penalties.

This question of control extends to the passage of title, responsibility for load integrity and damage and the handling of claims. The fear is that liabilities for problems (and costs) beyond the supplier's control will still end up on their doorstep; and they hate that type of aggravation.

At the operational level the warehousing and loading opening hours may change and the loading methods could vary, potentially without notice. For example, the difference between curtain sided and box trailers can be significant for some suppliers. The questions of who sets the operational schedule and specifies the equipment, and how collaborative that is, need to be answered.

Additional factors that will impact on the logistics group in the suppliers will be how service is measured in the future, and how the service will work in practice since the haulage market is very fragmented and requires constant management. The large haulage contracts implemented through e-business platforms that will be needed to secure the freight volume, make for a tighter market that may lead to higher prices than the freight market as a whole. The balance of retailer fleet and outside carriers is also a point of interest. Logistics people want to know that the network will function and how; it is their jobs on the line after all.

Addressing the FGP Challenge – a staged approach

So suppliers need a well-drilled approach for managing their way through the FGP challenge from the point of view that this is not an initiative they will be able to avoid in the end. So the goal is to turn it to a benefit. While every firm will have its own specific circumstances that will condition its position on FGP, the following is a staged approach that will catch the key issues and derive a strategic and operational response that will ensure the firm engages the initiative with a positive outcome (or, as a minimum, mitigates any negatives). The aim is to maintain a degree of control.

- 1 High level review of the {product – market} channels engaged by the supplier: i.e. volumes, share, trends, and plans for growth
- 2 Assessment of the product and customer profitability; is the attribution of costs accurate or averaged? If not, then a cost-to-serve analysis is required including a full logistics costing
- 3 Based on the true cost attribution to customers and their real return revisit the {product-market} channel priorities and reset if appropriate
- 4 Review the logistics contract arrangements and the operational cost impacts of volume switching to FGP to generate headline cost scenarios
- 5 Estimate the allowances that will be affordable compared to any FGP offers that have been made and determine the commercial position of the firm
- 6 In parallel with point 5 above, consider the terms of trade conditions that may apply and the service level agreements that will need to be implemented
- 7 In parallel with point 5 above, consider the systems and operating procedure impacts that will need to be addressed
- 8 Negotiate from a position of being well informed and understanding the commercial and operational scenarios
- 9 Assuming that agreement is reached, make the necessary changes to the physical operations, any third party haulage contracts, the systems and the commercial terms
- 10 Implement assertively to treat FGP as a positive rather than yet another initiative that has been 'bounced' onto the company.

The underlying tools and techniques that support the approach

About LCP Consulting

LCP Consulting is the leading specialist consultancy in supply chain and logistics. We work with retailers, manufacturers and service providers to unlock value in their chains through a combination of powerful analytical methods, extensive practical experience across the sectors, clear processes for projects and a willingness to support programmes to effective implementation. Our cross sector experience positions us ideally to work with all parties to deliver the challenge of FGP.

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