

SUPPLY CHAIN STRATEGY

BY BILL DIBENEDETTO

Leonard Sahling sees performance-based logistics as “the next big thing” in supply-chain management.

In an industry noted for its vague jargon, performance-based logistics is pretty much what its name indicates. The concept works like this: A third-party logistics provider and a client establish a collaborative partnership at the outset of their relationship. The client articulates as precisely as possible what it really wants to accomplish. The 3PL finds the best way to achieve the goals and is paid accordingly.

“It fits into the whole movement toward effective and successful collaboration,” said Sahling, first vice president, global, at ProLogis, the big warehouse and distribution-center 3PL.

Most current logistics contracts are transactional in nature, based on the number of phone calls, for example, or orders filled, or the number of pallets or containers moved. The 3PL gets paid regardless of whether the client feels the 3PL is reaching the client’s goals.

Under performance-based logistics, payments to the 3PL are based on its success in delivering outcomes. “The client does not pay for unit transactions of such support services as warehousing, transportation, spare parts, repairs or hours of technical support,” said a recent report in the ProLogis Supply Chain Review.

When a 3PL succeeds under such a contract, “service providers will be rewarded with increased profits, longer-term contracts and the opportunity to earn even greater profits through a variety of incentives,” the ProLogis report said.

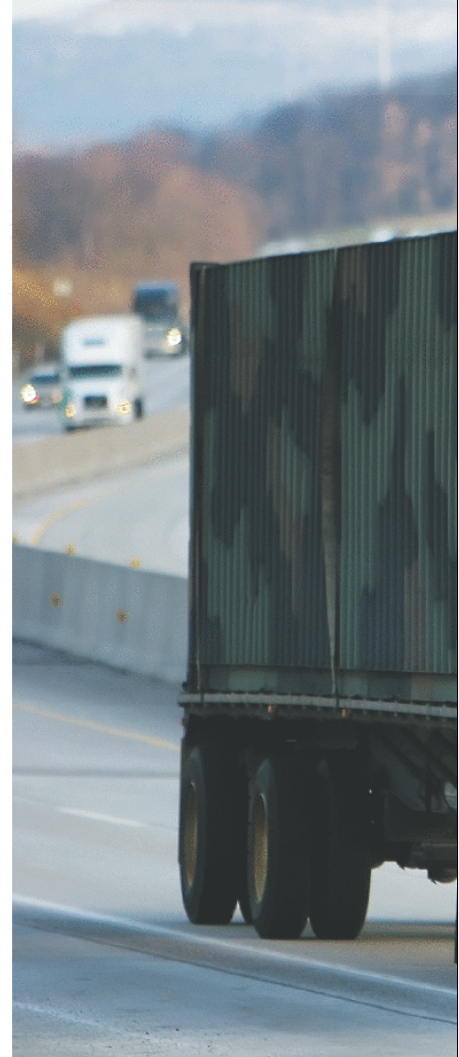
Comparing the traditional contract approach to the performance-based logistics contract reveals sharp differences in structure and pricing. ProLogis said the traditional 3PL contract length typically is one to three years. A performance-based contract’s length is tied to the “pay-back period” for the service provider to recoup its investments.

Pricing models in the traditional contract are usually one of three varieties: fixed-price per transaction, fixed-price per transaction plus incentives, or cost-plus with fixed margins per transaction. Under a performance-based contract, pricing is usually fixed-price for the solution with a monthly management fee, or fixed price plus incentives.

Under performance-based contracts, “the traditional relationship is turned on its head,” Sahling said. “The 3PL is paid on the basis of achieving the goals. Basically, you stop defining goals on a transactional basis.”

The ProLogis report, written by Kate Vitasek, managing partner of Supply Chain Visions of Bellevue, Wash., and Steve Geary, a partner at Supply Chain Visions, describes performance-based logistics as “a new collaborative business model designed to align the interests of both the client and the logistics service provider.”

The Defense Department has embraced the performance-based logistics approach for logistics services. The ProLogis report said the military has used the concept to improve performance and cut costs of logistics support for weapons systems, as well as parts such as tires and subsystems such as engines.

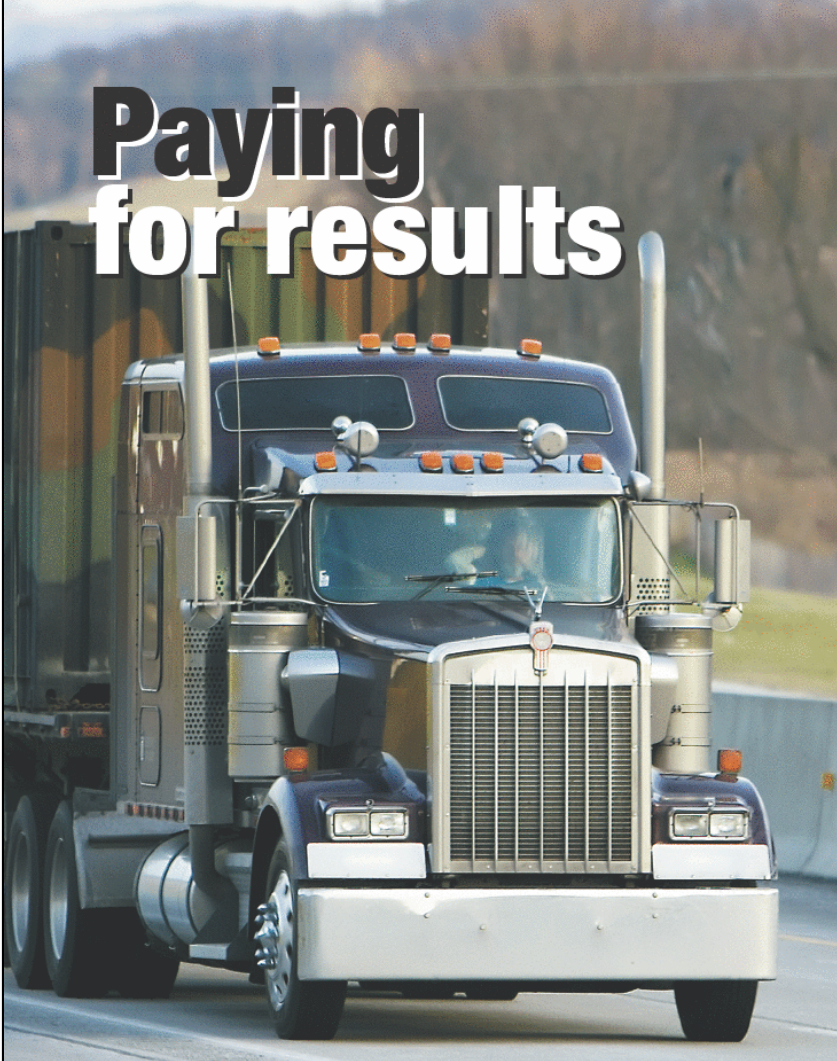


A recent example of the process was evident in the U.S. Transportation Command’s huge Defense Transportation Coordination Initiative contract awarded to Menlo Worldwide — worth potentially \$1.6 billion. For the first time, Transcom will use a private 3PL to manage most of its freight movements in the continental United States.

DTCI is widely described by those involved as not an outsourcing

Performance-based logistics
is widely used in the military
and is gaining commercial acceptance

Paying for results



initiative but as a long-term, strategic partnership. "DTCI is a team effort . . . Menlo will utilize best commercial practices to enable load consolidation and optimization, use of more efficient intermodal means of transportation and tailored scheduling to meet the customer requirements," said Air Force General Norton A. Schwartz, Transcom commander.

Transcom's contract with Menlo has three phases, with specific implementation and performance goals at each step.

"In our view, one of the key lessons is about planning — with a project like this, an organization must clearly define every detail,

including regulations, performance metrics, frequency of measurement, data input and data management, and integration protocols," said Robert L. Bianco, senior vice president of Con-way Inc. and president of Menlo Worldwide. "The term 'outsourcing' really doesn't apply."

The Pentagon's use of performance-based logistics has grown dramatically. The Navy first used it for a \$35 million contract in 1998; last year, the Navy had more than \$800 million in performance-based logistics contracts. An October 2006 Defense Department directive outlined the DOD's intention to extend the concept to all of its major procurement categories.

Companies considering performance-based logistics should realize they are entering into "de facto partnerships with their logistics services providers and that these partnerships cannot be created overnight," the ProLogis report said.

If performance-based logistics is so good, why isn't it more widely used? Sahling said the concept is simple, but execution is difficult. "It takes a high level of collaboration at the outset and throughout the 3PL-client relationship," he said. "It's human nature — it's difficult for us to collaborate with each other."

Sahling noted that 3PLs and their clients "often have testy relationships. Usually the client has to beat its 3PLs over the head to get costs down." Sahling said many 3PLs and customers have "kind of a landlord-tenant relationship," with little trust. Performance-based contracts "require a change in the way each side thinks about the relationship," he said.

Managing risk is one of the main issues that supply-chain managers face. The ProLogis report said a properly designed performance-based contract will use improved collaboration to reduce both partners' risks, "thereby eliminating uncertainty and the associated drag on effectiveness and operating costs."

"It smacks of common sense to me," Sahling said. "It addresses the problems that have prevented true collaboration from taking off so far. The DOD approach is something we would like to see applied in the private sector. We're proselytizing for this and trying to get people to think differently." ♦

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