Best practices in 3PL and fulfillment contract procurement: A methodological approach to optimising 3PL rates and services

Received (in revised form): 14th May, 2021


Steve Givens

STEVE GIVENS
Managing Director, Shipware, USA

Steve Givens has served in numerous leadership roles in the third party logistics (3PL) industry for three decades and is the managing director of 3PL optimisation strategy and engagement execution at Shipware, an industry-leading consulting and technology company specialising in supply chain, 3PL and transportation solutions. He possesses extensive experience in 3PL fulfillment services contract optimisation and has held leadership roles overseeing procurement, finance, operations, sales and marketing for leading 3PLs, such as Archway Marketing, Harte Hanks and RightSide Up. Steve founded, built and executed exit strategies at multiple 3PLs over the past 25 years. Currently he leads the team at Shipware focused on value-based, adaptable sourcing strategies for 3PL and transportation optimisation. Steve is a Certified Public Accountant and has been a featured speaker at numerous conferences, including Council of Supply Chain Management Professionals, Internet Retailer Conference and National Conference on Operations and Fulfillment.

3PL Optimization, Shipware, LLC, 10815 Rancho Bernardo Road, Suite 200, San Diego, CA 92127, USA
Tel: +1 719-352-7125; E-mail: steve@shipware.com

Abstract

With the proliferation of online shopping, the e-commerce industry is growing exponentially. As a direct result, third party logistics (3PL) fulfillment support services are rapidly growing and considered a critical part of the customer experience. 3PL fulfillment support services are not only important to completing the last leg of the e-commerce and business-to-business (B2B) transactional process, but also have an impact on customer satisfaction, long-term customer loyalty and the overall brand experience. The 3PL fulfillment market has changed significantly over the last 50 years, and the scope of the support services has also changed throughout the decades. Overall direction of the industry changed forever on 5th July, 1994, when Amazon was founded and began operations. In the late 20th century, online commerce launched a modern-day gold rush and with newfound fortunes to be made, the fulfillment market was flooded with new companies from various industries that all wanted to stake their claims. Today, understanding the 3PL market options, pricing methodologies and service level agreements (SLAs) is critically important to selecting the best 3PL partner to support your current needs and help you scale your business for the future. The 3PL contract optimisation process starts with selecting the right partner, developing the appropriate contract terms and conditions, scope alignment and performance incentives to lay the foundation for a successful partnership. Ongoing contract optimisation requires a formalised process to evaluate performance, review market alternatives and deliver efficiencies. The ideal state of fulfillment services *contract optimisation is achieved when the 3PL relationship delivers maximum shareholder value from best-in-class pricing, outstanding service and long-term goal alignment.*

Keywords
third party logistics (3PL), fulfillment, optimisation, procurement, transportation

THIRD PARTY LOGISTICS MARKET OVERVIEW

The fulfillment services market has been evolving and adapting to changing market conditions over the past 50 years. In its infancy, the fulfillment services industry was primarily catalogue order pick and pack, point-of-sale distribution and product warranty support. In the 1980s and 1990s consumer rebates and direct response support services grew dramatically. During that period, these companies were commonly referred to as fulfillment centres rather than third party logistics (3PLs).

Little did these fulfillment industry pioneers know that their market, and the entire scope of the support services landscape, would forever change when Amazon entered the market on 16th July, 1995, selling books online and accelerating the emergence of the e-commerce channel.[1] During the late 1990s, e-commerce as we know it today was just getting started, but quickly adapted to consumer demand and changing market forces.

By the end of the 20th century, the future of the e-commerce market and the services required to support the accelerated market expansion became clearer. The need for efficient parcel and less-than-truckload (LTL) transportation solutions to deliver products to consumers and trade partners also increased. As the amount and complexity of these services became more dynamic, the business classification of fulfillment centre was no longer appropriate, and these companies were dubbed 3PLs.

At the start of the 21st century, with the e-commerce boom unquestionably taking shape, the demand for 3PL fulfillment services grew exponentially. It was a modern-day gold rush. Companies from all different industries that were seemingly well positioned to take advantage of this opportunity entered the market to stake their claims. The longstanding, traditional fulfillment companies quickly pivoted and retooled to meet e-commerce product fulfillment support needs. With new companies from a multitude of industries also wanting to capitalise on the growth of direct-to-consumer (DTC) and business-to-business (B2B) 3PL Market, the space became flooded. Printers, LTL and full truckload (FTL) transportation companies, and even e-merchants entered the market at a staggering pace. In addition, venture capital money was in abundance for these next-generation start-ups that wanted to profit from this growing industry.

Fast forward to 2021 and the 3PL market is now a complex, and different, landscape. Overall, the 3PL fulfillment services market is saturated, with over 700 3PLs in North America alone and over 90 per cent of those companies offering DTC fulfillment support services. Today, there are many kinds of 3PLs all trying to grow their piece of this multi-billion-dollar industry. There are micro, local, regional, national, North American and global 3PLs.

There are 3PLs that specialise in DTC, B2B or both. There are also industry-specific areas of specialisation such as apparel, health and beauty, Food and Drug Administration (FDA), hazardous materials, cold-chain and frozen foods. The market will continue to evolve, and if you are an e-merchant, you need a great 3PL partner. The ultimate key is to select the right partner and optimise that relationship over time.

SELECTING THE BEST 3PL FULFILLMENT PARTNER

One of the most difficult tasks in developing an outstanding 3PL partnership is selecting the best 3PL to support not only your current needs, but your future needs as you scale your business. It is critically important to your company, your customers and your shareholders to find a strong 3PL partner the first time. Selecting the wrong 3PL can have a negative financial impact on your business and adversely affect the customer engagement experience, increasing customer attrition rates. Companies end up burning valuable resources in managing 3PL issues that could have been deployed for more constructive purposes, such as growing their business. This situation can easily be avoided with the help of the proper industry experts to vet and help select the ideal partner.

Finding the ideal 3PL partner sounds easy, but there are over 700 3PL fulfillment options in North America alone. With so much choice, how do you best understand the market and your options? Clearly, you can use the conventional sourcing strategies of market research, leveraging your network and reviewing available data from trade associations. Unfortunately, for the 3PL fulfillment services market those methods will only yield limited benefit. Online market research will lead you straight to a relatively small number of 3PLs that do a great job with search engine optimisation and brand promotion, only to provide you with mostly biased marketing rhetoric. Leveraging your network of contacts is a good way to get referral recommendations; however, unless your contacts are experts in the 3PL fulfillment market and your specific support needs (which most are not), that will likely fall short of the desired goal. Trade associations can be an excellent source of unbiased market knowledge, but in the 3PL fulfillment market they are almost non-existent. The trade associations that are well positioned to focus on the issues important to the 3PL fulfillment industry primarily focus on the 3PL logistics and transportation segment of the market. As a matter of fact, if you search on Google for 3PL fulfillment trade associations, the results mostly yield the same 3PLs that you find when performing online market research for 3PL fulfillment services.

To effectively understand the 3PL fulfillment market and your options, the best source of unbiased, comprehensive market intelligence is the small number of consultants and subject matter experts (SME) who specialise in the space. The leading 3PL fulfillment marketing consultants include but are not limited to Shipware, LLC, Armstrong and Associates, Inc., F. Curtis Barry and Company and Sedlak Supply Chain Consultants. Consultants and SMEs can be an invaluable resource in helping you shorten the timeline and improve the results of your 3PL fulfillment market assessment and partner selection process. This strategic sourcing strategy will pay dividends that go straight to your bottom line.

Once you have identified a select

number of qualified 3PLs seemingly well suited to support your needs, it is important to have a formal vendor/partner selection process. This process normally starts with a formal request for proposal (RFP) or a less formal request for quote (RFQ). The RFP or RFQ should document, and clearly communicate, your support requirements, service objectives and relationship goals. Once you communicate your requirements, request a formal services proposal from each 3PL to better understand their capabilities, technology, value proposition, level of professionalism, fee structure and total cost of ownership. Getting to know and evaluating each 3PL is collaborative process that takes time, effort, ongoing dialogue and due diligence.

Once you better understand your options, there are several key considerations when evaluating prospective 3PL partners:

- Overall value;
- Culture;
- Willingness to invest in the relationship;
- Technology capability;
- Fee structure and pricing;
- Vertical market expertise;
- Geographic footprint;
- Size, scalability and infrastructure;
- Available capacity and expansion plans;
- Inbound and outbound transportation options and pricing.

After you select a 3PL, it is time to negotiate and execute the master services agreement (MSA) and statement of work (SOW). For the most part, standard 3PL MSAs are one-sided agreements, developed specifically to protect the 3PL's best interests. Also, they are among the most complicated agreements encountered in business.[2] Standard 3PL SOWs are typically much more bilateral and document the agreed-upon client fulfillment support requirements and specific operational workflows to achieve the desired results. In practice, many merchants do a decent job of incorporating their required terms and conditions into the MSAs. Overall, however, most agreements do an inadequate job of protecting both parties' best interests and clearly defining support requirements. It is vital to structure your 3PL contracts to clearly define the support requirements, memorialise the agreed-upon terms and conditions, and provide the foundation for future optimisation opportunities.

OPTIMISING YOUR 3PL CONTRACT

Once you have a 3PL relationship established, contract optimisation is a continuous process that requires commitment, focus and attention to detail. It is important to have a formalised and structured process that can deliver ongoing, incremental results over time. When developing and executing a formal 3PL contract optimisation process, the first step is to answer a few relatively simple questions (see Figure 1) to determine if further optimisation is required.

If you answered yes to all the above questions, congratulations. You most likely have an optimised 3PL relationship and contract. That being said, there may still be room for cost improvements. If you answered 'no' to one or two of the above questions, it is very likely that there is an opportunity for contract and relationship optimisation. If you answered 'no' to three of more of the above questions, your 3PL is most likely not a strategic business partner but a vendor, who is probably negatively

Question	Yes	No
Are you receiving significant value from your 3PL relationship?		
On an overall basis, are you happy with your 3PL's operational execution?		
Do you definitively know if contract pricing is best-in-class?		
Is your 3PL willing to make financial and operational investments to support your needs?		
Does your 3PL's technology capabilities and infrastructure meet your needs today, and are they in alignment with your future state goals?		
Is the current technology integration efficient and effective?		
Are your 3PL's reporting systems and performance analytics adequate to meet your needs?		
Does your 3PL deliver innovative ideas and strategic support solutions?		
Does your 3PL consistently look for opportunity to streamline processes and deliver operational efficiencies?		
Can you count on you 3PL to deliver relatively flawless execution and not negatively affect your customer relationships?		
Do you have agreed-upon SLA performance metrics established and memorialised in your services agreements?		
Do you get weekly or monthly reporting to track the 3PL's SLA performance?		
Is your 3PL meeting or exceeding the SLA minimum requirements?		
Do you have productive quarterly or semi-annual business reviews with your 3PL?		

FIGURE 1: 3PL fulfillment optimisation questionnaire

affecting your business, and there is a significant opportunity for improvement.

If you determined that contract optimisation is required, the first step is to identify the shortcomings and develop a structured plan. Are most of your areas for improvement related to cost, service, communication, or goal alignment issues? After you have identified the areas of opportunity, you need to develop the formalised action plan. Determine if you want to work on continuing the relationship with the current 3PL or change providers. You may not know at this point, but one thing should be very clear: if you are unsure if you want to continue your relationship with you current 3PL, you should perform a comprehensive market assessment to evaluate your alternatives.

Let us start with the assumption that you value your relationship with your existing 3PL and want it to continue. In that scenario, you should first identify the key issues that need to be addressed. Is your focus to reduce costs, improve service, have better goal alignment or a combination of those factors? Once you have identified the key challenges, develop a formalised plan to address those issues with your 3PL. It is very important to take a partnership approach to the process. If your 3PL is a true partner, they will openly help you improve areas of deficiency.

Next, discuss the issues directly and openly with your 3PL. If possible, have the meeting in person or, at minimum, by video conference, so you can see their reactions and read their body language. If they are receptive, engage in constructive dialog to develop of a formalised strategic plan to address your issues and the opportunities for improvement. If they push back, get defensive or make excuses, you may want to consider an alternative course of action.

Whether you want to change providers, evaluate alternatives or just gain leverage with your current 3PL, the next step is to perform a market assessment to evaluate your options. The process is the same as selecting the best 3PL partners in the section above, but you will need to decide if you want to perform a formal RFP process or take a less formal approach. Figure 2 highlights the major milestones of the 3PL optimisation process.

Since the main objective here is to focus on contract optimisation best practices, we will not get into details of the procurement tactics, but rather review the process for maximising the overall 3PL relationship value. Next, we will focus on working towards the ideal state of 3PL contract optimisation to achieve maximum 3PL relationship value.

3PL CONTRACT OPTIMISATION: COST AND VALUE

The value that you receive from your 3PL relationship is a function of three main factors: cost, service and goal alignment. We will elaborate on each of these factors in the next three sections.

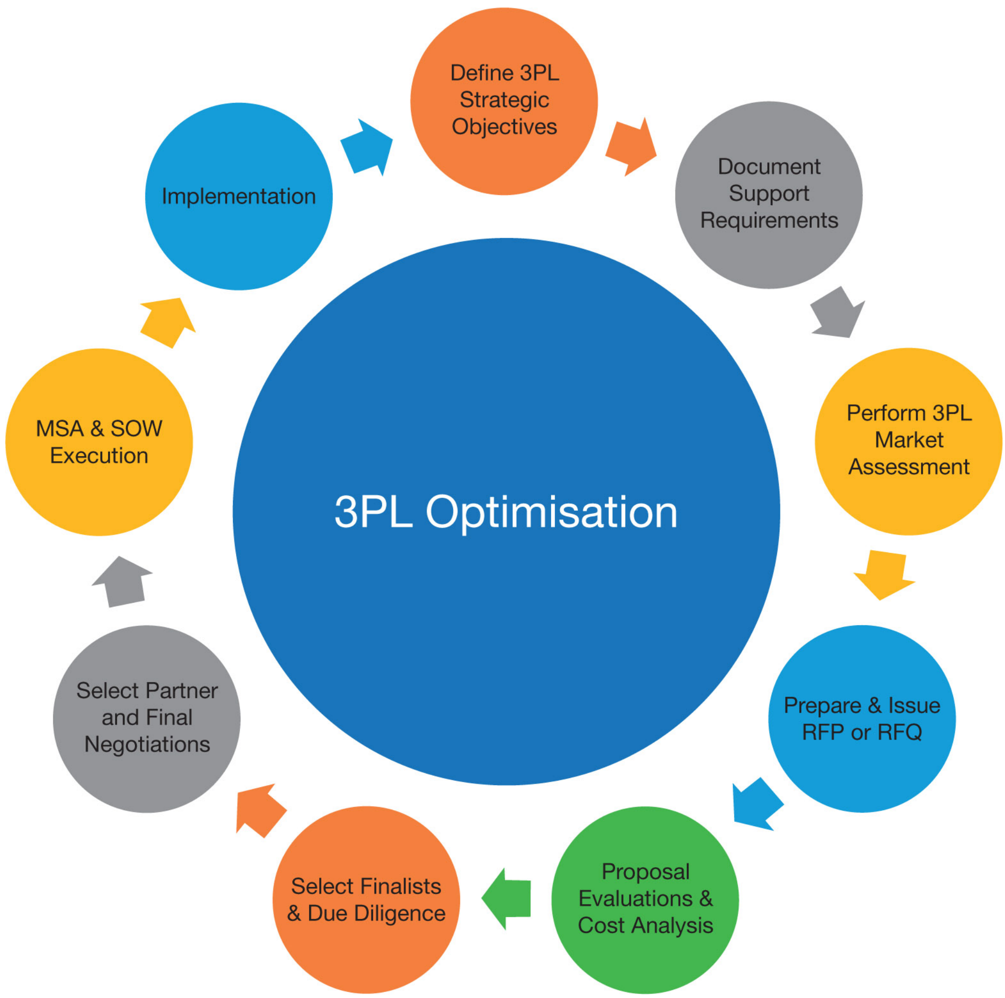

FIGURE 2: 3PL optimisation process

Let us start by reviewing the cost of 3PL fulfillment services. The overall value that you receive from your 3PL has a direct correlation to the overall cost and detailed transaction pricing for each of their services. Within the 3PL fulfillment services market, there are numerous pricing strategies, so it is important to understand the differences.

The various 3PL pricing strategies are not difficult to understand, but what is significantly more challenging is estimating and comparing the cost per order and total cost of ownership between the various pricing methodologies. As reviewed above, the 3PL market expanded rapidly when a host of companies from vastly different industries and market segments entered the fulfillment services space. These new market players brought with them their own set of pricing models and industry-specific best practices. Unfortunately, the are no formal industry standards regarding 3PL pricing guidelines and, as a result, there are numerous pricing strategies and hybrid models that have emerged over the years.

Some 3PLs price their services based on a detailed menu of services with specific line items, for example: receiving, storage, order processing, pick and pack, small parcel and LTL freight. Each line item includes a gross margin anywhere from 10–80 per cent.

Other companies use a bundled pricing model wherein they provide multiple services for a lump sum price per order. This model is appealing to some customers because they have a good understanding of their all-in cost per order.

Then there are companies that add literally no markup on their warehousing and pick and pack services and make almost 100 per cent of their margin on transportation services. These 3PLs tend to be the larger companies that have negotiated superior parcel and LTL contracts.

The last group of 3PLs are those companies that make 100 per cent of their margin on warehouse, pick and pack transactions and pass-through the parcel and LTL charges at cost. This group of 3PLs are typically fully transparent regarding their parcel and LTL cost structure.

The common denominator for all these pricing strategies is that they build profit margin into different aspects of their pricing models and it is not always easy to understand where, which is key to optimising and controlling your costs.

When cost reduction is a primary goal of the contract optimisation process, it is important to understand the various pricing models, and to focus your negotiations on the areas that will deliver maximum impact. Clearly, transportation costs (small parcel and LTL) are the single largest expenditure for most companies outsourcing DTC and B2B fulfillment services and should be a primary area of focus. It is important to understand how your 3PL prices their transportation cost and the easiest way to accomplish that is to ask them. In most cases they will be open and transparent; if not, that is a big red flag.

Some 3PLs have negotiated superior small parcel and LTL contracts and pass all, or part, of those savings onto their clients. In general, the larger 3PLs have more favourable carrier agreements, but they do not always offer the most aggressive rates to the customers. Furthermore, the amount of transportation spend does not always equate to high discounts off published rates. It really comes down to how effective the 3PL is at negotiating their own carrier agreements. Each 3PL has their own carrier contract 'sweet spots'. As an example, some 3PLs have great rates for lightweight shipments, while others specialise in heavier packages. Most have negotiated their carrier agreement based on their volume and unique package characteristics. It is important to take all these factors into consideration when selecting a 3PL partner and/or optimising your contact.

Regarding LTL rates, it can be difficult to compare 3PLs. When evaluating options, it is important to understand the 3PL's level of sophistication, carrier relationship and flexibility. You should work to understand which LTL carriers the 3PL works with, the nature of those relationships and how rigid or flexible those carriers are. Since LTL tariffs can vary widely, it is wise to price some sample shipments during the cost evaluation process.

Two other areas that can largely affect cost and an area for contract optimisation focus are storage and pick and pack fees. Storage fees can add up quickly and there are copious ways that 3PLs charge for those services. Current pricing strategies include, but are not limited to, cost per pallet, bin, cubic foot, square foot, etc. Pick and pack fees can also vary widely and can be a large component of your overall cost equation. Efficiencies such as pick-to-light, forward picking modules, robotics and conveyor systems can deliver efficiencies and lower costs.

3PL CONTRACT OPTIMISATION: SERVICE AND VALUE

The second component of the value equation is service. 3PLs are the last step in the e-commerce consumer engagement process and customers expect a seamless and efficient experience. If the fulfillment process is not executed flawlessly, it will negatively affect consumer satisfaction, long-term loyalty and the overall brand experience.

Receiving exceptional service from your 3PL starts with clearly communicated support requirements, followed by incorporating those requirements into your MSA, measuring service performance metrics and reviewing the results on a regular basis. 3PL MSAs memorialise the terms, conditions and services relationship between the parties. Therefore, it is imperative to have clear SLAs in the MSA to protect your best interests, but it is very common for contracts to lack key SLAs.[3]

To ensure that you receive maximum value from your 3PL relationships, every MSA should have focused and measurable SLAs. SLAs are not the 'big stick' of contract enforcement, but rather the guiding principles that ensure performance metrics are clearly defined so the 3PL is consistently working to achieve the common goals of the partnership.

In my experience, over 80 per cent of 3PL contracts have one of the following:

- SLAs that are not in alignment with relationship goals;
- SLAs that cannot be measured;
- SLAs that can be measured, but are not;
- No SLAs at all.

It is troubling that in today's day and age, everyone wants to talk about strategic partnerships during the sales process, but when it comes to mutually beneficial business goals and delivering services that are in alignment with those goals, many companies do not even take the time to develop thoughtfully focused and measurable SLAs.

SLAs should be formalised,

documented, measured, reviewed often and adjusted as support requirements change. SLAs will be slightly different for each business, but it important to structure them to support the business objectives and provide financial penalties for non-conformance. You may also want to consider providing additional, incremental compensation to the 3PL when they consistently exceed SLAs, especially during peak volume periods. Figure 3 highlights the industry standards regarding the minimum SLAs to incorporate into your services agreements.

Having specific and measurable SLAs will pay significant dividends throughout your 3PL relationship, ensuring goal alignment and a memorable customer experience.

3PL CONTRACT OPTIMISATION: GOAL ALIGNMENT AND VALUE

The final area of focus for 3PL contract optimisation is goal alignment, as it will deliver outstanding tangible and intangible, return on investment.

The goal alignment process begins well in advance of selecting a 3PL and is an ongoing process throughout the course of the relationship. Relationship goals can differ greatly, but are primarily focused on quality, continuous improvements and cost reduction or cost containment. As we have reviewed, quality is critically important to brand integrity, customer satisfaction and long-term growth. SLA compliance is a foundational requirement for quality, and must be defined, measured and reviewed often.

Continuous improvement is the ongoing effort to enhance services or processes, and requires consistent, incremental advancement over time. It is extremely difficult to deliver without a common foundation to build upon, so establishing that foundation is vital to successful 3PL partnerships. The foundation starts with clear relationship goals and objectives between all parties and will yield substantial results with clear communication and attention to detail.

Cost reduction or cost containment is much easier to achieved with goal alignment. By defining quality objectives and executing continuous improvements strategies, you will see cost reduction opportunities materialise over time. Add cost reduction goals into the MSA and provide 3PL financial incentives for identifying operational efficiencies that deliver service improvement and cost

SLA	*Minimum target*	*Description*
Dock-to-stock	99.0%	Inventory receiving, put away and available in the operational systems within two (2) business days
Order processing	99.5%	Same day order processing for orders received by 1 pm local time
Order accuracy	99.0%	All items in each order are packed and shipped correctly
Returns processing	99.0%	All returns processed within three (3) business days
Inventory accuracy	99.5%	Physical inventory matches system quantities
System uptime	99.8%	System availability other than scheduled downtime for maintenance and upgrades
Business reviews	100%	Business reviews performed at least two times per year and more often, if needed

FIGURE 3: 3PL fulfillment SLAs

reduction. Offering material financial incentives for creative cost reduction strategies will provide a platform for innovative ideas and workflow improvements. Another best practice is to encourage your 3PL to incentivise their employees as well. Financial incentives clearly motivate and encourage proactive ideation at all levels.

The most effective way to drive your quality, continuous improvement and cost reduction goals is to leverage periodic business reviews with your 3PL. Business reviews should be completed on a regular semi-annual or quarterly cadence, as needed. They should focus on strategic goals, SLAs, performance improvement opportunities and cost reduction strategies. Business reviews are a great opportunity to strengthen your partnership with your 3PL and improve overall results.

FINAL THOUGHTS

3PL relationship and contract optimisation is an ongoing process. It requires a clear understanding of goals and strategic alignment with your 3PL. It also requires proactive communication, attention to detail, and the ability to document, measure and review results regularly.

The most important consideration in measuring contract optimisation results is the value you receive from your 3PL relationship. Value is a function of cost, service and long-term goal alignment. Without all three of these value attributes, it is nearly impossible to deliver meaningful incremental benefits from your 3PL relationship. A formalised process and focus on continuous improvements will yield significant results. At the end of the day, an effective 3PL relationship and contract optimisation programme will deliver significant value for your company and your customers by increasing customer engagement, enhancing brand value and driving shareholder equity.

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