

Discounting Retailer's DCs

Jeremy Howcroft from **AdvisorBase Ltd.** looks at the impacts that Woolworths Australia may have on centralised distribution in New Zealand and why suppliers need to understand their cost to serve when establishing supply chain based trading terms.



Many suppliers will be asking themselves what changes in current operating models are likely with Woolworth Australia's acquisition of Progressive Enterprises in New Zealand. Along with issues of trans-Tasman pricing, proliferation of house-brands and bundled discounts, the dynamics associated with centralised distribution are likely to be re-evaluated.

Change in the Market Place

International trends demonstrate retailers are continuing their advance up the supply chain. This assumption of responsibility for a significant part of the supply chain has direct implications on product pricing and the notion of FIS (free-in-store/DC) may no longer be valid, leading to factory gate pricing and delivery charges. The questions being asked in NZ are "What discount should be offered to retailers with centralised distribution?" and "What price to offer retailers who source product direct from the factory gate?" This poses the questions, "What is equitable?" and "How should it be determined?" Suppliers should be prepared to answer these questions when future trading terms are discussed.

Why do some retailers operate centralised distribution centres?

From an overall supply chain perspective, retailer distribution centres can contribute towards efficient product movement that benefits both retailers and suppliers alike.

Direct savings for retailers results from:

- Fewer supplier orders which reduces administration costs
- Fewer deliveries to stores which reduces congestion at stores and lowers back door costs
- Efficiency of store delivery freight costs (network effect).

Direct savings for suppliers from:

- Fewer retailer orders which reduces administration costs
- Less small unit picks reduces handling costs
- Larger orders to centralised locations mean improved freight efficiency.

Figure 1 illustrates the supply chain cost for a supplier and shows costs in a retailer's distribution system. Supplier savings from centralised distribution are unlikely to cover the full cost of operating a retailer DC. Retailers operating DCs recognise the significant additional savings at store level, plus the indirect benefits and savings that also occur from effectively being able to deliver every SKU to every store everyday. This frequency of service can:

Illustrative Costs as % of Wholesale Price		DSD channel	DC channel	Difference (DSD-DC)
Supplier Costs	Processing	0.5%	0.0%	0.5%
	PPD	0.6%	0.2%	0.4%
	Freight	1.5%	0.5%	1.0%
	Supplier Total	2.6%	0.7%	1.9%
Retailer Costs at DC	Processing (suppliers & stores)		0.2%	-0.2%
	Receive from supplier		0.1%	-0.1%
	Hold inventory		0.6%	-0.6%
	PPD for stores		0.6%	-0.6%
	Delivery to stores		1.2%	-1.2%
	Direct DC cost		2.7%	-2.7%
Retailer Costs at Store	Processing (suppliers or DC)	0.5%	0.2%	0.3%
	Receive (suppliers or DC)	0.2%	0.1%	0.1%
	Hold inventory at store	0.6%	0.2%	0.4%
	Store Total	1.3%	0.5%	0.8%
Retailer Total		1.3%	3.2%	-1.9%
Supply chain Total		3.9%	3.9%	0.0%

Figure 1 (Note: Cost data is illustrative not definitive)

- Reduce store inventory holding space requirements creating more space for retail.
- Reduce out-of-stocks to improve sales and shopper satisfaction.

Current grocery retailer DC practices are not necessarily best-practice and there is little evidence of cost reducing trends seen elsewhere, for instance:

- Cross docking, (X-DC or X-DSD) with the associated use of modern handling systems can greatly reduce retailer inventory holding space and funding costs.
- Optimised delivery planning, where suppliers deliver efficient loads (usually full loads of fast moving bulky product) direct to large metro stores and make all other deliveries to the retailer DC, saving the retailer DC handling and space costs.

So, do DC function discounts work?

Determining and structuring the most appropriate discount mechanism is important. Some New Zealand suppliers operate a functional DC channel discount with retailers' DCs - sometimes referred to as a 'warehousing allowance' or 'redistribution allowance'. It is a fixed percentage on all orders delivered directly to retailers' DC. The concept is that suppliers pass on savings, as a discount to the retailer, for use of the retailer's distribution system. The discount can be problematic for some retailers, as can the definition of what exactly is meant by a 'DC' and what is 'redistribution' - do distributors and wholesalers qualify?

Volumetric trading terms enable efficient choices

Functional DC discounts can be limited in their effectiveness if the discount percentage does not relate to the suppliers actual savings or the retailer does not behave as a true DC (e.g., places lots of small orders). Volumetric based discounts are more appropriate and reward those DCs that behave like DCs. Calculating the volume breaks and the savings achieved as

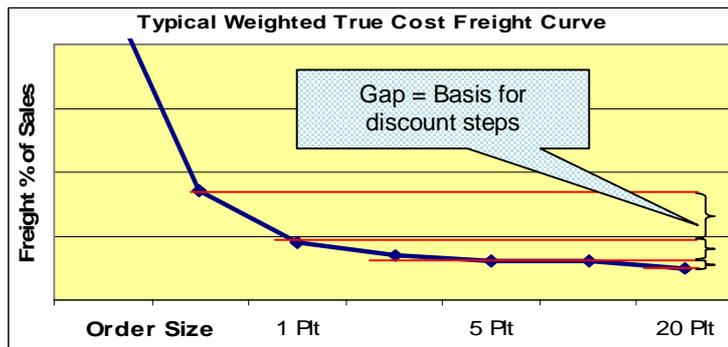


Figure 2

order size increases provides a sound basis for determining the appropriate discounts. Such an approach will ensure that trading terms reflect the suppliers cost to serve and will encourage cost saving behaviour from the retailer. Activity based costing provides a robust

methodology to understand cost to serve, combined with

an understanding of a supplier's weighted freight curve for different orders sizes (reflecting freight rates, retailer locations and consignment size), provides the best insight for establishing volume breakpoints and the cost savings possible at each of these points. Figure 2 is illustrative of a weighted freight curve for a supplier. The curve drops rapidly until the minimum freight charge is reached and then decreases further at the 20 pallet mark (or full truck and trailer). Volumetric savings (and therefore discount steps) are indicated by shifts in the curve.

Suppliers with product ranges that vary significantly in value (e.g., beer and wine, toiletries and detergent) should be cautious of applying percentage discounts on volumetric terms - unless all customers purchase the average product mix. There is the potential for cross subsidisation and inevitably suppliers will give away more discounts (or less) than are saved by the efficient behaviour. There is a valid case to offer fixed dollar discounts (e.g., \$ per pallet or tonne) so that discounts are directly tied to the cost to serve savings. The difference

between a percentage and fixed dollar discount for a factory gate discount is illustrated in Figure 3 for two products with differing product value.

	Prod. A	Prod. B	Avg
Pallet value	\$ 2,000	\$ 9,000	\$ 5,500
Freight Cost (per pallet)	\$ 30	\$ 30	\$ 30
Freight Cost % of Value	1.5%	0.3%	0.5%
Supplier savings if retailer collects (from Factory Gate)	\$ 30	\$ 30	
1. % disc. per pallet (0.5%)	\$ 10	\$ 45	
gain (loss) per pallet	\$ 20	-\$ 15	
2. \$ disc per pallet (@\$30/pallet)	\$ 30	\$ 30	
gain (loss) per pallet	\$ -	\$ -	

Figure 3 Simple example % vs. \$ discount

Be Prepared

Woolworths is most likely to continue with a DC model, but what improvements are made to the operating model remains to be seen. Those suppliers that understand their costs of servicing the retailers will be more able to create supply chain trading terms that promote cost savings (and therefore efficient product movement) and in turn will be able to reward retailers equitably.