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Primary freight – A primer in the New Zealand context

Content Overview:

Topic		*Page*
1	**Terminology** – clarifies the terms used and highlights the key features of the main primary freight models.	…2
2	**The attraction of primary freight for the retailer** – looks at the basis for economic benefit from the retailer's perspective.	…3
3	**Benefits of industry body involvement** – proposes a role for the FGC that facilitates the introduction of primary freight into New Zealand.	…4
4	**Downstream effect to be wary of** – a cautionary note highlighting the risk and stressing the importance of negotiating 'future proof' primary freight terms and adopting a robust calculation methodology. Downstream effects addressed are national pricing, changes in freight costs, secondary distribution, DSD delivery and cross docking	…6
5	**Establishing primary freight pricing/charges** – addresses the main risks involved, listing factors to take into account when developing primary freight pricing/charges and provides a pre-negotiation checklist.	…8
6	**Appendix:** Relative merits of different primary freight models – compares factory gate pricing with general primary freight arrangements.	…10

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1. Terminology

The terminology surrounding primary freight can be confusing, so first to some definitions.

Primary freight, itself a somewhat misleading term, applied in this context, relates to the freight movements between a supplier warehouse and a retailer distribution centre. The term *primary freight* is therefore used here from the perspective of a retailer; suppliers would refer to this as secondary freight (i.e., warehouse to customer).

There are different models of primary freight that can be adopted. The key to understanding the differences is to understand the actual role of the retailer – are they being a freight provider or are they buying product differently? One model is for the retailer to provide and manage the primary freight carrier for suppliers and to be paid for the freight by the supplier in the form of a freight contract, charge or rebate. We call this a **Primary Freight Arrangement (PFA)** and it is the basis for the models used by Coles (a national rate per SKU) and Woolworth's (freight rate by route) in Australia with both deducting primary freight from remittances, albeit differently.

Another option reflects how the retailer buys the product, that is, directly from the supplier warehouse at a reduced price. Here the retailer again manages and provides the primary freight carrier but does so at their own cost. The retailer takes delivery and ownership of the product at the supplier's warehouse when it is loaded onto their truck. The supplier reflects the saving in their freight costs with a reduced list price – the factory gate price. This is **Factory Gate Pricing, (FGP)** sometimes (and perhaps more correctly) called the FOB (free on board) price.

FGP, while a simpler and more future proof approach, has not been adopted in Australia, perhaps because it transfers future freight risk to the retailer**.** The models have different implications for suppliers and suppliers should not be indifferent to which is adopted. Table 1 (Appendix 1) summarises the main differences between FGP and PFA, highlighting the advantaged and drawbacks.

It should be noted that there are real differences between the situation in New Zealand and Australian and drawing a simple parallel may not serve anyone's interests. Certainly it would be useful for the industry if a single model was adopted in New Zealand, but if not, one can see the appeal of duplicating the two Australian models for trans-Tasman suppliers.

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2. The attraction of primary freight for the retailer

The initiative by Foodstuffs to adopt Primary Freight into their business model follows similar moves by retailers in Australia.

While the supply chain dynamics in Australia are different from New Zealand there is a view that significant benefits are available to New Zealand retailers from becoming active in primary freight.

Potential benefits:

- Economic benefit – lower cost to shelf. While the potential is significant it may be difficult to achieve:
  - Some suppliers have very competitive freight rates equal to or better than retailers, so simply substituting retailer freight rates is likely to yield slender pickings.
  - Principal retailer economic benefit derives from use of pre-paid surplus backhaul capacity. This assumes that the retailer has already covered the cost of vehicles returning empty to their distribution centre.
  - Supplier DSD delivery to large stores is often the most cost effective solution. Retailer primary freight can encompass this, but with added complexity.
- Other retailer benefits include better utilisation of loading dock capacity at DCs and visibility of the primary freight component of product costs.
- Retailer route-to-shelf strategy and associated freight cost is further brought under retailer control.
- Improved in-stock-on-shelf. Not an automatic or specific benefit of primary freight. It implies better retailer stock management at store and DC and may require more frequent, smaller orders.
- Strategic value – the supply chain is perceived to be a core competitive competence by some retailers and as such they hold to a belief that extended control thereof establishes a competitive advantage.

Potential drawbacks:

- Operational issues. While problems can be foreseen, one has to accept that retailers intend to operate a freight network to a professional standard, not withstanding a reasonable expectation of teething trouble, as with any change in freight provider.
- Impact on NZ freight sector. Depends on whether retailer seeks to be a major freight operator providing all capacity from within or if the retailer contracts out much of the capacity to current operators.
- Impact on suppliers' residual freight arrangements and pricing.
- Extension of primary freight to other retailer(s) with potentially different models requiring different list prices and/or discount/rebate structures.
- Lack of transparency between retailers leading to 'ping-pong' pressures from retailers to *equalise* their treatment.
- Effect on terms of trade (e.g. volumetric discounts, ullage) and possibly on national pricing.
- Extension of primary freight to a secondary distribution charge or warehouse allowance claim on suppliers.

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3. Benefits of industry body involvement

Although interesting to debate the merits of retailer entry into primary freight, in practical terms suppliers may have little choice in accepting the practice if a retailer decides to do business that way. *Given retailer commitment, choosing to oppose the adoption of primary freight may not a practical option*.
The question facing suppliers is more one of "Should the FGC be involved?" than "Should we support or otherwise the entry of retailers into primary freight?"

Certainly the industry body could lobby against the adoption of primary freight by retailers. Previous attempts to introduce primary freight into New Zealand have floundered largely on supplier resistance and the resultant complexity of managing diverse and uncooperative supplier implementations. The industry body can also play an observer role and report developments back to members as it becomes aware of them. However, recognising the possible inevitability of retailer primary freight the opportunity exists for the industry body to play a positive role in protecting supplier member interests by working towards a smooth and equitable introduction of the practice in New Zealand.

Industry body involvement provides benefits at two levels; At an industry level and individual supplier level.

At an industry level these include:
- Advocating for the primary freight model that is most equitable – in our view FGP.
- Development of a costing/rebate setting methodology acceptable to retailers and equitable to suppliers.
- Address retailer internal charging and the possible impact on National Pricing.
- Address issues regarding possible adoption of primary freight by PEL/Woolworths as well as Foodstuffs.

The FGC can also address issues relating to the process each supplier will go through in adopting primary freight, to avoid each supplier having to 'reinvent the wheel' and to ensure a smoother negotiation and implementation path by enabling:
- A confidentiality shield to avoid the stress of suppliers being asked for confidential freight contracts and sales data.
- Honest broker to attest to the validity of supplier pricing and rebates in accordance with agreed methodologies.
- Economic access to professional advice for members to reduce the economic and operational risk of what amounts to a fundamental business model.
- Implementation 'check lists' and support.
- Problem resolution procedures and protocols.

Such an approach will minimise supplier resource commitment to the process and the risks associated with implementation.

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A co-operative approach between the retailer(s) and suppliers offers real advantages and is more likely to produce an outcome that:

- Produces a result that is at worst cost neutral to suppliers and preferably results in a sharing of benefits.
- Uses a common methodology and approach for suppliers, but produces individual solutions that recognise members' diverse business and product characteristics. This would mean minimum cost and resource commitment by suppliers and ensure that individual suppliers (in particular smaller members) are not disadvantaged.
- Allows time to establish a mutually beneficial arrangement – time to get the numbers right.
- Delivers a future proof solution – avoiding re-negotiating at every turn.
- Incorporates KPIs for performance of retailer freight operator.
- Pilots the introduction with co-operative suppliers to iron out problems.

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4. Downstream effects

a) Impact on national pricing

There need be no impact on supplier national pricing when moving to a retailer primary freight model, although it may be an opportunity for suppliers to try to adopt regional pricing if they so wish. On the other hand internal charging by the retailer may establish de facto regional pricing.

In determining a primary freight rebate, or a factory gate price list, suppliers can either work on the basis of equal pricing from any/all of their distribution points, typically Christchurch and Auckland, or on a basis that reflects possible differences in supplier costs associated with supply from each supply point. The former has no effect on national pricing.

Beyond supplier control is the method that the retailer adopts to internally recover primary and inter-DC freight. For example, consider the case where the retailer uplifts all supplier product from the supplier's warehouse in Auckland and then tranships it to retailer DCs in Palmerston North and Christchurch. The retailer may charge its regional operations in the other centres for freight, effectively increasing their purchase price of the product and allow this to be reflected in price. Alternatively, to maintain National Pricing equilibrium the retailer may seek financial support from suppliers to cover this *secondary distribution* operation by retailers.

The National Pricing strategy is clearly a matter to be discussed with the retailers and an understanding reached

b) Possible extension of primary freight initiative to encompass secondary distribution

The question of reimbursing the retailer for their secondary distribution is a potential issue to be aware of.
Similar to a 'warehouse allowance', a retailer may look to suppliers to cover the supply chain costs downstream of primary freight, that is:

- Retailer warehouse costs.
- Retailer inventory holding costs.
- Retailer inter-warehouse freight movements.
- Retailer delivery to store.

Faced with such a request the methodology used to determine the financial parameters and the structure of the supplier PFA or FGP itself is critical as it determines the extent to which the supplier has provided for secondary distribution.

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c) Cross-docking and DSD delivery strategy

The economies associated with direct store delivery (DSD) of full loads direct from the supplier warehouse and the cross-docking of smaller loads has to recognised by retailers. At some future point it is likely that the primary freight regime will incorporate these practices.

When adopted they (cross-docking in particular) can have a material impact on the economics of primary freight for retailer and supplier. Unless potential developments such as these are recognised when primary freight is established it unlikely that the costs and benefits will be equitably shared by retailers and suppliers. FGP and PFA provide very different platforms for addressing changes such as these.

d) Changes in freight charges

There are a number of factors that can change, or more specifically increase the retailer cost of primary freight. Some of these are directly under the control of the retailer such as freight efficiency and fleet utilisation, others such as fuel charges are not. It is not inconceivable that over time the retailer may seek to reflect increases in their cost of primary freight in the charges/rebates of suppliers. While this is may be more difficult under FGP it is implicit in a PFA.

Unlike in a conventional supplier freight provider relationship where the relative power of the parties in centred around freight, with retailer primary freight this is not the case with a far more complex and extensive relationship in place. As such suppliers would benefit from addressing these issues (both in the methodology employed to arrive at the charges/rebates/price and in the contract itself) prior to implementing primary freight with the retailer, rather than at a later date.

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5. Establishing primary freight pricing/charges

Establishing the appropriate FGP price list or PFA rebate/charge is a complex matter with considerable associated risk.
While it is superficially simple and hence appealing to divide total freight costs by number of cases shipped to come up with either a primary freight per case rebate or list price case reduction for FGP, there is considerable risk in doing so.

There are a number of factors to be taken into account when establishing FGP or PFA terms, including:

- Calculation methodology should be robust and preferably acceptable to retailers.
- Confidentiality of supplier freight contracts and overall supplier volumes should be protected.
- Transparency or equity in treatment of retailers should be maintained.
- Rebate IS NOT automatically equivalent to list price reduction, a different methodology is used to arrive at each.
- Mechanism to address future changes in freight practices and charges should be incorporated into PFAs.
- The possible need to migrate the FGP or FPA to the other major retailer should be recognised and incorporated into the calculation methodology, particularly if other retailer is likely to operate on a different model.
- Possible impact on national pricing, either from the retailer or the supplier pricing.
- Ability to cope with extension of a primary freight platform by a retailer to secondary distribution or a warehouse allowance.
- Differentiation between DC and DSD retail operations.
- Future proofing for changes in product mix.
- Differentiation between suppliers with single or multiple supply points and supplier economics of retaining multiple supply points.
- Impact on residual supplier freight contracts and route to market model economics.

While neither FGP or PFA is the ‘simple alternative’, nor are they equal in terms of their implications for suppliers. Each approach has its own set of benefits and drawbacks for suppliers and retailers. Suppliers should therefore seek to influence which model (FGP or PFA) is adopted, either for them individually or for the industry as a whole.

Based on the Australian experience, a variant (or two) of PFA may be the most likely model adopted in New Zealand. Both the Australian models are akin to freight contracts. For the sake of apparent simplicity neither is a true or comprehensive freight contract. Aside from the commercial terms relating to performance and price adjustments the structure of freight rates is a complex matter. To be equitable, freight rates should recognise a diversity of product characteristics (mass, volume, cartons per pallet etc.), destinations and load sizes and allow for mechanisms to adjust charges as characteristics change. In the current environment provision should also be made for changes in fuel costs.

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Failure to recognise these variables when they exist results in risk to both the supplier and the freight carrier or primary freight provider, usually over a 12 to 24 month horizon (fuel cost changes over a shorter period). An extension of the risks are the problems associated with renegotiating the PFA once the impact of change is felt by one of the parties – a problem exacerbated by the potential imbalance in negotiating power of the parties.

A very real advantage of FGP over PFA is that there is a simple contractual path for the freight – it involves only the retailer and their carrier, the complexity of including the supplier is avoided. As a result the FGP is a future proof solution.

Faced with a technically challenging and financially significant change to their business, suppliers should recognise that avoiding the pitfalls will be a resource intensive exercise over more than a few weeks.

It is most important from a supplier's perspective to be well prepared for the negotiations. Specifically this involves an in depth appreciation of the:

- Role of freight in cost to serve and the drivers of freight costs.
- Composition, interaction between and value of, components that make up the existing discount and rebate structures applied to retailers.
- Implications for existing freight contracts of retailer primary freight.
- Drivers of freight costs and their variability.
- Impact of changes in some primary freight arrangements on all route to market costs and service levels.
- Impact of retailer primary freight on the economics of multiple supplier warehouse locations.
- Operational constraints and considerations of retailer management of primary freight access to supplier DCs in areas such as:
    - Warehouse pick pack and dispatch planning co-ordination and cost implications.
    - Warehouse loading dock operating times.
    - Inventory management (supplier warehouse and retailer DC).
    - Vehicle fleet utilisation.
    - Residual freight (non-retailer primary freight) pick pack dispatch and load efficiency.
    - Dynamics and costs of product or container returns.
- Mechanism for maintaining price points across regions with changes to discount, pricing and rebate structures.

For suppliers, managing, negotiating and implementing a retailer primary freight initiative is resource hungry and necessitates the involvement of key personnel from finance, sales and supply chain. There is unfortunately no way of avoiding this, the risks of not properly implementing primary freight outweigh the costs of doing it properly.

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Appendix 1

	Factory Gate Pricing - FGP		Primary Freight Arrangement - PFA	
FGP or PFA impact on:	**Supplier**	**Retailer**	**Supplier**	**Retailer**
Supplier revenue	GSV reduced by list price change. Impact on NSV depends on existing discount structures	n/a	GSV unchanged. Impact on NSV depends on existing discount structures	n/a
National pricing	Need not impact unless intended	May impact depending on internal charging	Need not impact unless intended	May impact depending on internal charging
Product change of ownership	When loaded onto retailer truck. Retailer purchases product for delivery onto their truck		On delivery into retailer DC. Retailer is providing a freight service not taking delivery at "facatory gate"	
Existing terms of trade	Depends on structure of existing terms, ullage should change		Depends on structure of existing terms. Ullage unchanged.	
Freight efficiency	Isolated from retailer freight cost efficiency/inefficiency	Full control of freight utilisation and route to store	Potentially exposed to retailer freight utilisation and route to store strategy costs	Full control of freight utilisation and route to store
Set-up costs	Preparatory analysis essential, complexity depends on existing terms, product mix and freight arrangements	Update list price & possibly terms	Preparatory analysis essential, complexity depends on existing terms, product mix, freight arrangements and individual customer locations	List prices unchanged adopt new terms
Structural complexity	Simple, likely to be unchanged from present unless separate 'Delivered goods' price list is also adopted	Simple to operate and maintain - same basis for all suppliers	To be equitable it is likely to involve different rebates by product category by retailer	To be equitable it is likely to involve different rebates by product category by retailer
Economic signals of freight component of product cost	n/a	Clear	Retailer back charge visible but supplier has no control over freight cost	Masked as freight component is difference between rebate and actual freight cost
Changes in freight charges	Supplier isolated from freight costs or efficiency	Cost to retailer	Cost to supplier as retailer likely to renegotiate rebate	Pass costs onto supplier
Future proof	Yes	Yes	Review for changes in product mix and packaging	Review for changes in product mix and packaging
Transaction processing	Simple, likely to be unchanged from present unless separate 'Delivered goods' price list is also adopted	Simple, likely to be unchanged from present	Additional rebate to included on invoice or processed via retailer claim	Reconcile supplier rebates on invoice or make additional claim on supplier
Transparency	Transparent and equitable to all customers	Transparency with competitors, compliance esay to monitor	Masked by possibly different rebates to each customer	Masked by possibly different rebates to each customer
Roll out to other retailers	Simple, same FPG price list for all FGP customers	n/a	Potentially complex as rebate may vary depending on customer location	n/a
Non FGP or PFA customers	Alternative of either FGP list price + freight OR separate delivery included list price	If FGP price + delivery adopted non-FGP customers see freight component signals	Limited to delivery included list price	n/a

Table 1: Overview of relative merits of Factory Gate Pricing (FGP) and Primary Freight Arrangements (PFA)

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