

# Distribution of wealth

Factory gate pricing is the latest attempt by retailers to maintain profit margins and reduce operating costs. Theo WM van Sambeek, director of the European division at the International Association of Refrigerated Warehouses, looks at the benefits of implementing a new distribution system.

**R**etailers are constantly looking for ways to improve the efficiency of the logistics chain and to reduce costs. For years, the focus has been on optimising secondary distribution: the process from the distribution centre to the store. Now that this process has been successfully reorganised, attention has shifted to primary distribution: the product flow from the manufacturing supplier to the distribution centre. This has resulted in the development of factory gate pricing (FGP).

FGP is a means of determining product costs without including the costs of transportation. The retailer takes over responsibility for primary transport from suppliers, as well as the cost of this transport. This is where FGP differs from backhauling (the concept of using delivery trucks to pick up return loads from the supplier). While backhauling is incidental, FGP is aimed at systematically organising transport from the point of availability (the manufacturer) to the point of delivery (the retailer).

## Process insight

FGP not only changes the function of suppliers, it can also influence the role of the logistics service provider. This has prompted the European Division of the International Association of Refrigerated Warehouses (IARW) to devote more attention to the subject. Recently, IARW member Duncan Watt, managing director of the UK-based company Associated Cold Stores & Transport Ltd, presented FGP as a topic at an international convention.

Since leading British retailers Tesco's and Sainsbury's introduced the concept in 2001, several British warehousing and distribution businesses have already had to face the consequences of FGP. Until then, individual suppliers did not have the ability to gain economic distribution rates and the retailer did not focus on the true costs of distribution and transport. With FGP, the retailer gains efficiency in distribution, as negotiations with the distributor are based on the entire volume of products provided by suppliers. Consequently, the retailer has a better insight into distribution costs, and can ultimately force suppliers to reduce their initial product prices.

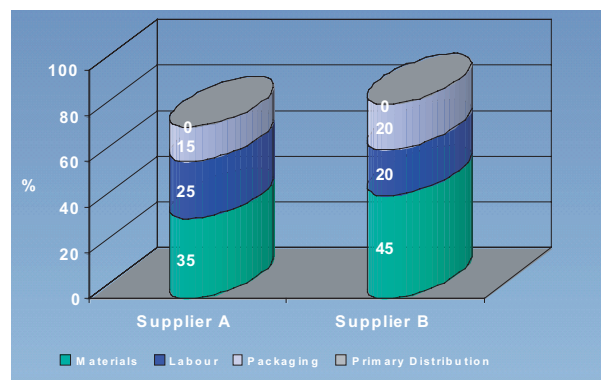
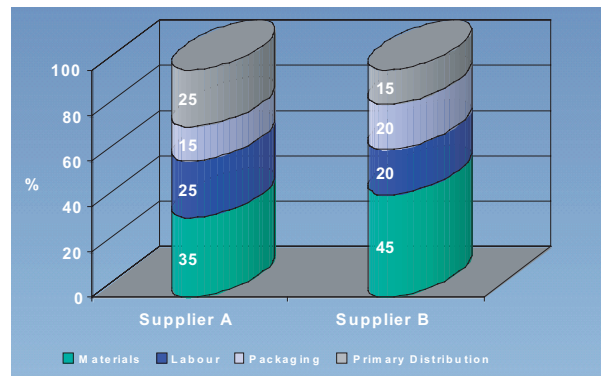


Figure 1 (top). Determining the costs of transport

Figure 2. Difference in product costs, without primary distribution

For logistic service providers, this can mean the loss of storage and distribution business to the retailer's distribution company, because retailers are now more inclined to choose one company as a consolidator for a particular geographical area. Suppliers concentrate on storage as close as possible to their production site or distribution company. Retailers, on the other hand, concentrate on storage in the vicinity of their distribution points, inducing a change of storage location. In terms of transportation, it also means that fewer distributors are willing or able to take on retail distribution. Inevitably, this puts more pressure on profit margins. According to Duncan Watt, different pressures are currently

encouraging FGP in the UK. Firstly, the competitiveness of the retail market makes it necessary to assess every element contributing to product price. Secondly, fuel wastage and vehicle emission restrictions (along with other transport issues such as road tax, congestion and an inefficient transport network) are forceful arguments for a re-examination of transport costs. Finally, labour shortages (particularly truck drivers) and the consequential rise of labour costs are further fuelling the need to find cost-reducing alternatives.

### Under pressure

These kinds of constraints are not limited to the UK retail industry, and FGP is currently being introduced in other countries too. In 2002, a German retail company implemented the system. However, the applicability of the FGP concept depends on several factors. The potential for cost reduction is largely determined by volume and location. FGP can create significant savings when low product quantities are involved, but the benefits are limited when product flow increases. FGP requires intensive cooperation between the retailer and the supplier. This means that previously

separate distribution processes now need to be geared to one another. If a large number of suppliers are involved in the chain, this process will become incredibly complex.

In order to successfully implement FGP, certain barriers will have to be overcome. From the supplier's perspective, the major obstacles include: transport inefficiency, cost increases for the remaining primary transport network, a negative influence on the internal process and new price negotiation. With regard to the product, characteristics such as shelf life, vulnerability, and marketability could also present a variety of problems.

Retailers usually initiate chain integration, as they stand to gain most from close cooperation. Private label manufacturers are in a particularly strong position, because their products' final destination in the distribution channel is already determined during the production process, while brand products are often divided between different distribution channels. Ultimately, it is the power of the retailer – in terms of market share, market knowledge and private label dominance – that will determine whether or not the obstacles currently facing FGP can be overcome. ●



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