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**Logistics**

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# Discounting in the CEP Industry

**The Discrepancy between  
Theory and Reality**

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## Discounting in the CEP Industry - The Discrepancy between Theory and Reality

Anyone who analyzes the existing discount structures in the CEP industry will encounter quite systematic discount guidelines.

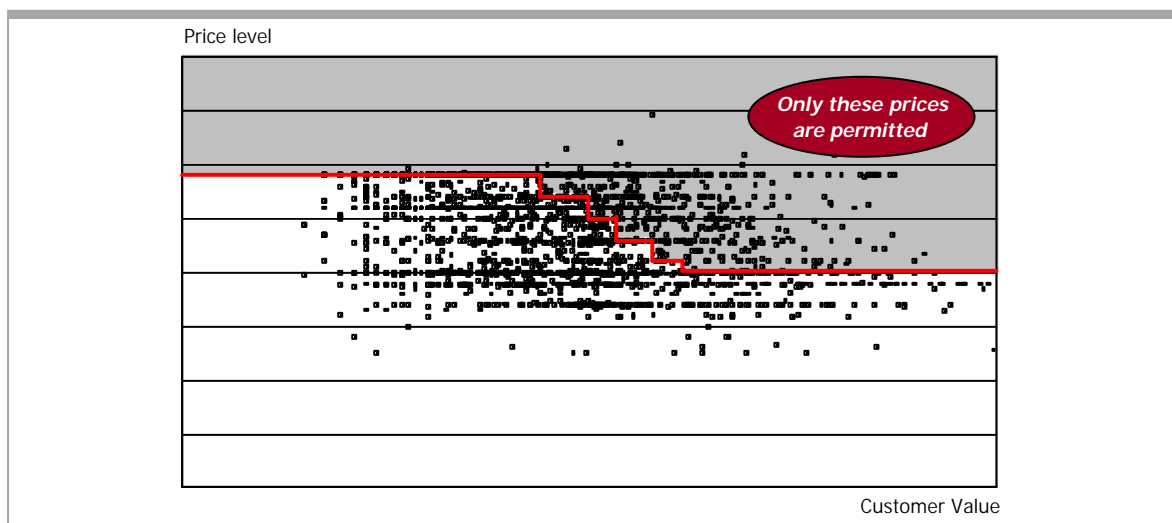
After a long period of two-digit growth rates, the CEP industry has come to a point of stagnancy. Market players are pursuing higher market shares and revenues by significantly reducing prices. The industry situation certainly justifies such behavior: enormous fixed costs have to be dealt with, and every additional shipment helps to cover these costs. Beyond this, maintaining a widely spread service network across many countries requires a high degree of capacity utilization, and thus, an immense customer basis. If this is not achieved, then it is hardly worthwhile to maintain the infrastructure.

The type of discounting structure and discount levels determines whether the company can control the price level or if the prices are at risk of being diluted.

### Status Quo

Anyone who analyzes the existing discount structures in the CEP industry will encounter quite systematic discount guidelines. Diverse price lists (rate cards), which vary in their discount levels depending on the size of their customers, are usually distributed. Clear rules regarding the assignment of rate cards to specific customer revenues (or shipment volumes, total weight, etc.) are also commonly given.

Yet those who dig deeper and analyze the actual prices in the market will find out that the discounts being granted are a far cry from what is stipulated in the guidelines. Picture 1 gives an example of an international CEP service provider's discounting behavior.



Picture 1: Theory and reality of discounts

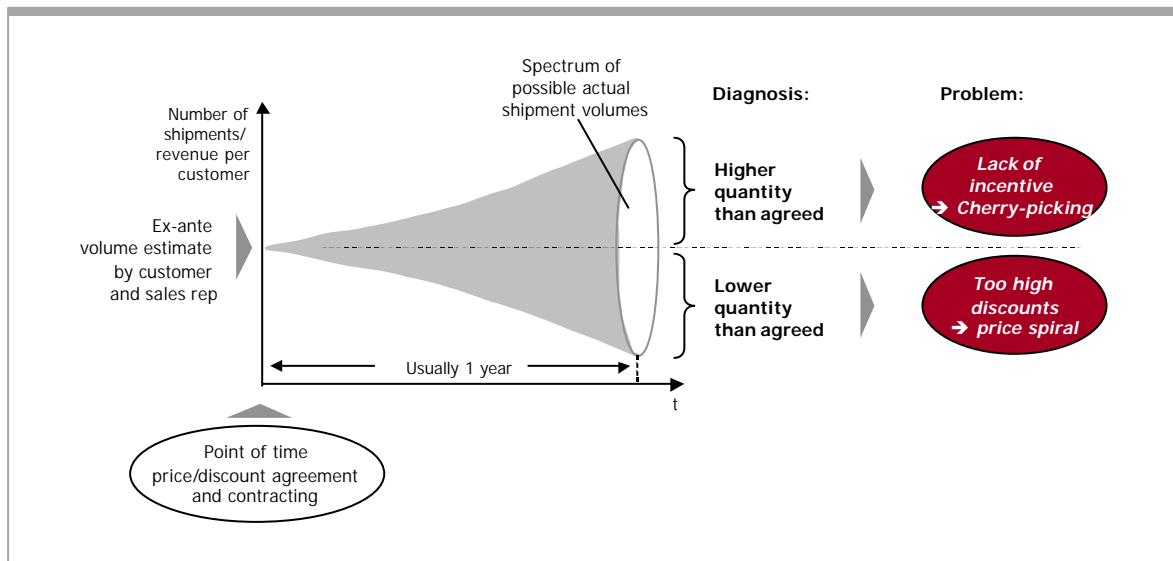
**Those who dig deeper and analyze the actual prices in the market will find out that the discounts being granted are a far cry from what is stipulated in the guidelines.**

Experience has shown that on average, about 50%-70% of all prices are below the level designated in the pricing rules, thus confirming the high level of autonomy in the sales force, despite the centrally given specifications. It also reveals the risk of price erosion, even in companies with a high degree of centralization.

Why is there such a discrepancy between theory and reality? In most cases, it is because of two co-existing reasons: Incorrect forecasts of future developments and unnoticed changes in the customers' shipment behavior.

Discounts in the CEP industry are usually negotiated and contracted between the customer and carrier on a regular basis. In these negotiations, the parties generally refer to the customer's future shipment volumes. Depending on whether or not the future development has been forecasted correctly, the customer receives the appropriate discount or, according to size, a too high or too low one.

As shown in picture 2, overperforming in shipment volumes in such a system is not automatically rewarded with lower prices. Consequently, the shipper has no incentive to send more parcels than originally planned. He will, however, also not be penalized if he produces lower shipment volumes than forecasted. As a result, every customer strives for the most optimistic volume estimates in order to receive high discount levels. Assuming that behavior is similar among all customers, this constellation leads to permanent price erosion.



Picture 2: Lack of incentive effect

Overperforming in shipment volumes in the current system is not automatically rewarded with lower prices. Consequently, the shipper has no incentive to send more parcels than originally planned.

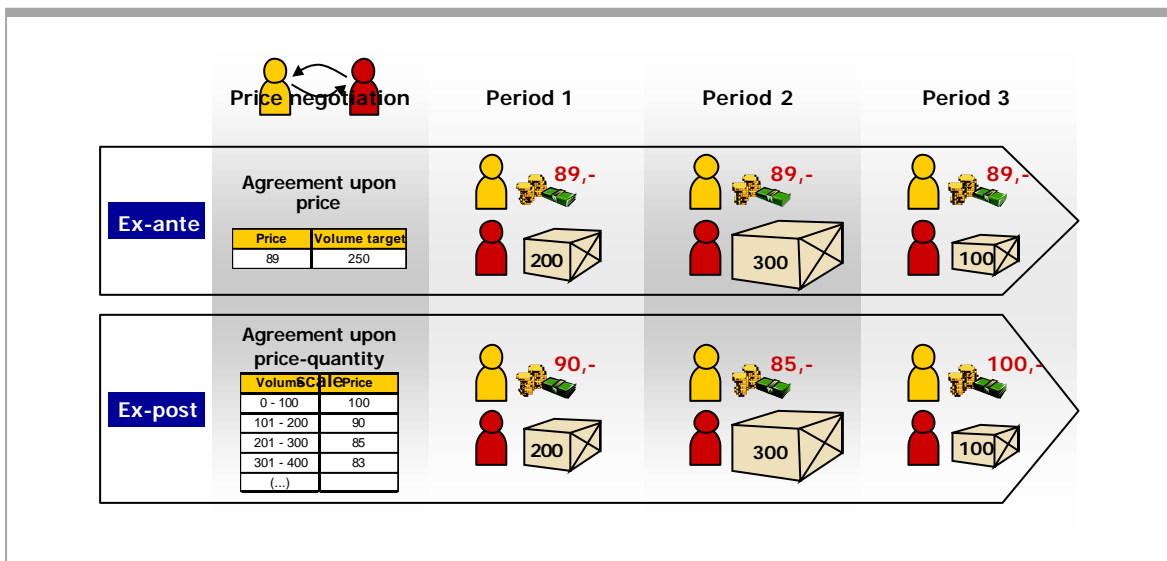
At the same time, the customers' true shipping behavior is rarely supervised in a systematic and consistent way. The fulfillment of certain discount level targets is monitored just as little as the customers' revenue development over time. Furthermore, the differences between sales teams' or sales representatives' tolerance of discounts are barely noted.

As a result, it is more the exception than the rule that the discount policy is consistently orientated on the company's targets in the pricing process.

### Discount Alternatives

What kinds of discounts exist? Basically, discounts can be characterized as ex-ante and ex-post (cf. picture 3). Both kinds entail certain risks – either price erosion or customer loss.

When granting the ex-ante discount, the customer's starting price is, as described above, already reduced prior to service use. Hence, the customer knows the price per shipment ahead of time. The amount of the price reduction is established based on a forecast of the customer's expected shipment behavior. As the customer tends to overestimate his shipment volume rather than underestimate it, the ex-ante negotiated price is attractive to him. In contrast, for the CEP provider who optimizes prices based on the existing cost and profit structures, these prices will be far below the optimum.



Picture 3: Ex-ante vs. ex-post discounts

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**Ex-post discounts are definite and fair - and afflicted with a big problem: when sending a shipment, the customer is not able to calculate the final price.**

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This problem can be solved by granting pure ex-post discounts. Instead of relying on forecasts, the customer's actual performance is reflected in a kick-back payment at the end of a period. This procedure is definite and fair – and afflicted with a big problem: when sending a shipment, the customer is not able to calculate the final price – which depends on the shipment volume he is going to send by the end of the reference period. And, instead of accepting such price uncertainty, the customer will choose a supplier who offers a sufficiently attractive price. The introduction of a pure ex-post discount system, in which only non-discounted rates are initially offered, combined with kick-back payments based on different shipment volumes, may therefore lead to a dramatic customer loss.

### **Concept Selection**

Which concept contributes to the improvement of a supplier's position in the stagnating CEP market? What kind of discount best encourages customer loyalty? And what are the advantages and drawbacks from the customers' point of view?

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Only rarely is a company in the CEP industry confronted with unique basic conditions regarding the discount design. Different markets, products, or customer groups require varying measures. Under no circumstances, however, can such a measure be defined without a clear definition of the company's strategic goals. The often heard phrase "revenue maximization" is certainly one possible goal – yet this goal can directly conflict with the maxim "profit optimization". The company has to take the initiative in deciding which target to focus on.

Price certainty and the opportunity for potential customers to directly compare price alternatives can only be guaranteed through an ex-ante discount system. However, the risk that a customer won't realize the anticipated shipment volumes is considerably large. Therefore, the strict monitoring of customer performances is a central success factor of this system. It requires not only the respective IT tools, but also additional staff: the monitoring activity itself, as well as follow-up tasks like customer talks or price re-negotiations, cannot simply be integrated into the current daily workload – at least not if it is to be done thoroughly. Unfortunately though, both IT tools and additional personnel

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**Merging ex-post and ex-ante discounts into an integrated concept is preferable to the alternative of a pure ex-ante concept with strict monitoring.**

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together are available only to a few suppliers. This makes the systematic monitoring of the entire customer base extremely difficult.

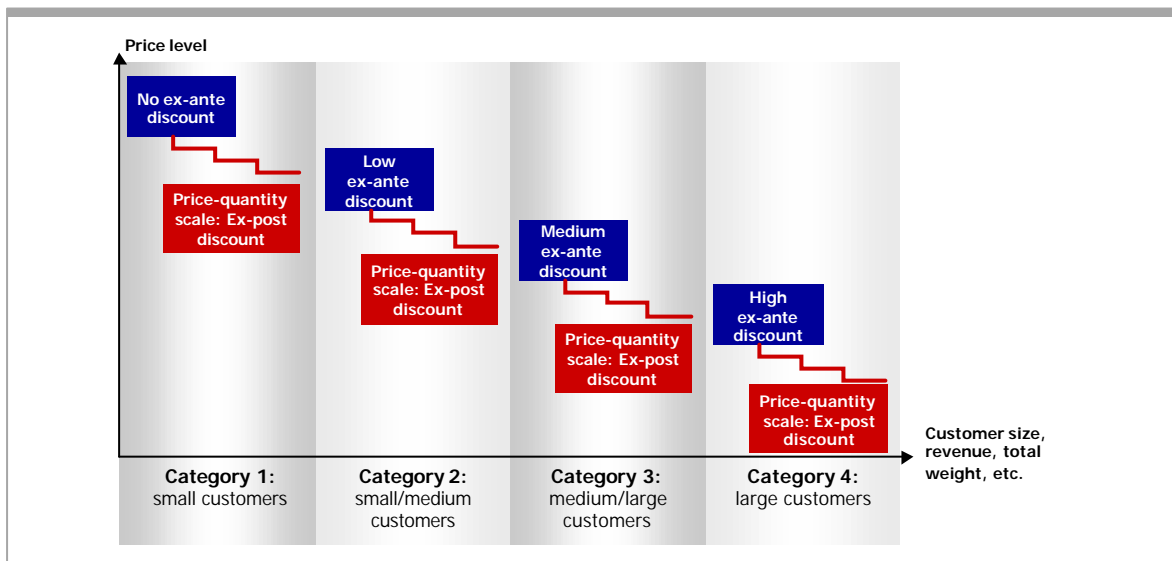
One means of avoiding this dilemma might be to differentiate discount structures by customer size. For small customers who ship sporadically, for example, a pure ex-post rebate could certainly be attractive. As these customers receive only low rebates, they feel less uncertain about the fact that the discount levels are not pre-defined. On the other hand, they can receive direct price reductions if they drop the current method of selecting the cheapest supplier for every single need, and instead concentrate on one supplier's offer.

If small customers could successfully be transferred into such a fully-automated ex-post discount system, then the ex-ante discounts, with their extensive controlling requirements, could be limited to the medium and large customers' segments. Although these segments still generate a major part of the total revenue, the number of customers declines to a fractional amount. At least in these segments, the customers' shipment and revenue development per market segment should be monitored systematically and thoroughly. Ideally, the CEP provider should have an IT-based monitoring application that, with the help of a traffic light function, automatically indicates if the customers have not fulfilled their targets or if they have not experienced revenue development. As a result, the system only lists the black sheep, and the sales force can address them specifically.

But again, such a system requires a monitoring process, probably followed up with customer re-negotiations. Even assuming that capacities for this task were available, the attempts to establish a more adequate price level can often be unsuccessful. In times of high competitive pressure, it is very difficult to increase prices among customers when revenue is decreasing. The reason for the revenue decline is either that these customers already do a significant part of their business with competition; or they have decreasing shipment volumes due to economic trouble. The probability that higher prices can be successfully enforced is low in both cases. Merging ex-post and ex-ante discounts into an integrated concept is therefore preferable to the alternative of a pure ex-ante concept with strict monitoring.

Although a certain discount level will also be negotiated prior to the shipping transactions, the underlying estimates for future shipment development are rather conservative. Thus, the ex-ante discount levels are lower – but they can be guaranteed to the customer, assuming that at least the conservatively estimated volume is being shipped.

For all shipments beyond the target, an additional ex-post discount is granted, according to a confirmed price-quantity-scale (cf. picture 4).



Picture 4: Merging ex-ante and ex-post discounts

The result is that risks are shared between both parties: the customer knows the approximate price in advance and can further reduce the price by increasing his loyalty towards the CEP supplier. Thus, the customer has a clear incentive to generate additional business, from which both customer and carrier benefit.

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**If prices are to cover the costs, they must be controlled by individuals in the company who have access to reliable cost information. Thus, profit-optimal pricing must be made centrally.**

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The CEP supplier reduces the risk of incorrect volume estimations and, subsequently, too high discounts. At the same time, the supplier can offer attractive prices to customers and increase their loyalty.

If, however, prices are to cover the costs, they must be controlled by individuals in the company who have access to reliable cost information. As such information is not readily available to the sales force, profit-optimal pricing must be made centrally. This will be the case as long as sensible cost information is not to be distributed across the entire company network.

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## **Conclusion**

Almost no company in the CEP industry will be able to operate completely without ex-ante discounts. Consequently, it is all the more important to put discounts into a clearly defined process which establish all required steps, starting with the definition of lower price limits up to the organizational assignment of monitoring tasks.

Furthermore, if the company at least partly succeeds in applying ex-post discounts, this will improve price enforcement as well as loyalty – assuming the customer can achieve direct price effects by concentrating all shipments on one supplier. In an industry where the golden age is starting wane, these goals are crucial and ensure profitability as well as market shares in the CEP market.

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*Kornelia Reifenberg and Dr. Jan Remmert are Directors with Simon ♦ Kucher and Partners Strategy and Marketing Consultants, Competence Center Logistics. In the course of numerous projects, they have gained much experience in the CEP industry and transformed their knowledge into solutions for optimized pricing.*

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