Operating Strategies
by Tim Laseter, Alex Kandybin, and Pat Houston

Marketing and Operations: Can This Marriage Be Saved?

Marketers worry about top-line revenue, while operations people fret about cost. Differentiated Service Policies allow them to coexist.

Ongoing battles between marketing and operations provide fodder for everyone from humorists to organizational behavior specialists. Cartoonists mock the narrow-minded views of each discipline, while organization experts propose new compensation schemes to drive alignment. CEOs often laugh at both.

The stark truth is that marketing and operations do have fundamentally different perspectives — and for very good reason. Marketing focuses on top-line revenue and, accordingly, seeks product variety (available on short notice) from well-stocked inventory pools. Operations worries about cost, looking for efficiencies in manufacturing and the supply chain. Seldom does either function seriously examine *value* as perceived by the customer. This being the case, conflict is inherent, and organizational incentives alone cannot solve the problem (though a good cartoon can sometimes reduce the tension).

Rather than debating binary options from functional points of view, companies must seek to balance the trade-offs between costs of different service options and their value to customers. We refer to the decisions resulting from these explicit trade-offs as Differentiated Service Policies. Although they are a powerful tool, few companies fully understand them, and even fewer apply them appropriately. More often they fall back on "the way we do things" that reflects long-forgotten compromises.

Cost/Value Trade-Offs

Remember the last time you ordered a book from Amazon.com? You might recall that Amazon.com Inc. offers a variety of different shipping promises, such as "usually ships in 24 hours," "ships in three to five days," or "special order." The reason? The economics of inventory. Although Amazon offers some 4.5 million titles, it can't afford to keep all those books in inventory.

Amazon holds the most popular titles in its own distribution centers and typically can ship those books in 24 hours. A second tier of books is stocked by book whole-

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salers. Some wholesalers can fill an order in 24 to 48 hours, enabling Amazon to meet its promise of "ships in two to three days." Other wholesalers may take a few more days, so Amazon promises "three to five days." At some point in the life cycle of a book, wholesalers stop carrying inventory and only the publisher can fulfill an order — usually from inventory, but sometimes through a new print run. The longer lead time from the publisher forces Amazon to extend its promise to "one to two weeks."

So, a simple Differentiated Service Policy — in this case, based on lead time — allows Amazon to address the inherent conflict between marketing and operations. Marketing wants to offer the broadest possible array of titles to reinforce Amazon's positioning as having the "Earth's Biggest Selection," and to deliver those titles instantaneously to reinforce the convenience of online shopping. Operations, on the other hand, cannot support such a proposition — at least not cost-effectively. So, by examining the economics of inventory and understanding the value of lead time to customers, Amazon sets shipment lead times to define the appropriate compromise between marketing and operations.

Airline pricing offers another familiar example of Differentiated Service Policies. As any frequent traveler knows, airlines offer widely varying prices for the same seat depending on when the consumer books a reservation. The lowest prices are intended to capture incremental sales to travelers who might not take a trip otherwise — but without cannibalizing the sale of higher-priced tickets to business travelers who may not have a choice. To ensure that the low-cost seats go to incremental travelers, the airlines traditionally have imposed Saturday-night-stay requirements that the typical business traveler rarely meets. Over time, the airlines have become quite sophisticated in pricing the seats, dynamically adjusting the quantity of openings allocated to each price option based on real-time demand patterns from the reservation system.

Originally developed by American Airlines Inc., this price differentiation program is based on ticket booking rules and travel policies, and represents another example of Differentiated Service Policies designed to optimize the trade-offs in cost and value between the provider and the consumer.

B2B Applications

Of course, Amazon's shipping lead time and the airline industry's pricing program represent just two examples among many elements of service with the potential for differentiation. Service policies can also include factors such as fill rates, delivery methods, quantity, and price. A variation on "Pareto's Law" or the "80/20 rule" — derived from the observation of Italian economist and sociologist Vilfredo Pareto (1848–1923) that 80 percent of the wealth tended to be concentrated in 20 percent of the families — offers the key to one of the most common but least publicized techniques for Differentiated Service Policies.

Employing this concept, inventory managers apply an "ABC segmentation" to the items on hand: "A items" encompass the 5 to 10 percent of items accounting for the majority of sales, "B items" capture the next 10 to 15 percent of the items, and "C items" cover the 80 percent of items that typically generate only 10 to 20 percent of sales. The classification allows the inventory manager to set "safety stock

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levels" based on different expected fill rates that balance inventory-carrying cost against the potential lost margin from missed shipments.

For example, distributors typically set safety stock levels to fill orders immediately 99 percent of the time for A items, 95 percent of the time for B items, and 90 percent of the time for C items. Though seldom explicitly communicated to the customer, such a policy provides another example of differentiation in service policies that offers a cost-effective compromise between marketing and operations.

But unit sales volume represents merely one option for segmentation. World Kitchen Inc., which manufactures and markets kitchenware, including such brands as Corningware, Chicago Cutlery, Oxo, Pyrex, and Revere, recently implemented a policy differentiating between regular replenishment orders and special promotional orders. World Kitchen offers a five-day replenishment lead time for normal orders shipped from finished goods inventory, but requires a firm order 90 days in advance for the special requirements of a promotional order. The extra lead time allows the company to place the necessary special orders directly with suppliers and avoid any unnecessary inventory-holding cost, while simultaneously increasing the service assurance to the customer, effectively to 100 percent.

Menu Pricing

Menu pricing takes the same concept to a more sophisticated level by identifying customers by *how* they buy as opposed to differentiating them by *what* they buy. Increasingly common among manufacturers of consumer products, menu pricing explicitly addresses the cost/value trade-offs in the retail industry value chain. Through menu pricing, manufacturers offer better service or significant price discounts, sometimes both, to encourage their retail trade customers to change buying behavior and improve the economics of the overall value chain.

With menu pricing, customers choose their preferred buying practices but incur additional costs when selecting less efficient options. A wide array of retailer ordering practices significantly affect the manufacturer's and the overall supply chain costs:

- Full truckloads minimize transportation costs compared to partial truckloads.
- Full pallets eliminate case-pick costs for creating mixed pallets.
- Factory-direct shipments bypass warehouses and the associated costs.
- More predictable and level orders reduce inventory costs.
- Vendor-managed inventory improves planning and supply efficiency.

The manufacturer sets prices to

reflect the underlying economics and thereby encourages the customer to choose the more economical options, but still allows the customer to decide based on the perceived (or quantified) value of the various options. Using price to drive customer behavior ranks among the most successful techniques — but one that's underutilized by most companies.

According to a July 2000 Booz Allen Hamilton survey of manufacturers of consumer products, 70 percent now have menu-pricing programs in place or in development, as opposed to only 30 percent in 1996. A leader in the development of menu pricing, Procter & Gamble Company introduced its first program in 1994, under its Streamlined Logistics (SLOG) initiative. By reducing inventory, transportation, and administration costs, the program generated $50 million in supply chain cost savings. Other consumer products companies, such as Kraft Foods Inc. and S.C. Johnson & Son Inc., developed similar programs in the ensuing years and even extended their scope beyond the original concept developed at P&G.

Early adopters have continued to expand and evolve their menu-pricing practices by identifying new trade-offs in cost and value. For example, P&G's program has undergone at least three major evolutions and currently addresses everything from compensation for returned products to funding for retail promotions. The wider array of service dimensions leads to better Differentiated Service Policies.

From Theory to Practice

The examples above demonstrate the potential of Differentiated Service Policies. But converting ideas to action demands rigor and forethought. Our experience shows us that companies seeking to develop Differentiated Service Policies should consider five principles:

- Optimize the trade-off between buyer value and seller cost.
- Build on detailed economic modeling.
- Use simple and straightforward policies.
- Bundle choices into a predefined set of options when possible.
- Anticipate changes and evolve policies to accommodate them.

The best service policies optimize the value to both customer and manufacturer by balancing the service cost incurred by the manufacturer with the value received by the retailer. Retail buyers must understand the relative value of the multitude of desirable service offerings, because choices regarding which services to purchase can drive costs (or even revenue loss) within the retailer's operations. Manufacturers, too, incur specific costs related to each option provided, and the service policies must accurately reflect these costs to ensure the appropriate trade-offs. Menu pricing — a technique designed to remove joint supply chain waste — offers the most sophisticated and best example of this principle.

Detailed economic understanding is an essential part of developing effective service policies. Consider, again, Amazon. Holding a book to meet a 24-hour shipping policy can impose significant costs when the sales volumes are low. For high-volume titles, like a new Harry Potter release, Amazon can order full pallets of the book and move them in only a few days. For a low-volume book, a single carton of 24 books could represent multiple years of sales, which would tie up capital and warehouse space but produce very little return. Of course, Amazon also applies roughly the same effort in placing an order for one book as it does for one carton of books. Furthermore, the wholesaler often charges a premium for a "split case order" (an example of Differentiated Service Policies at the wholesaler). Amazon must conduct a careful analysis of these cost trade-offs based on the forecasted demand for each title, coupled with an understanding of the consumer's valuation of faster shipment, to define the best service policy for each of the 4.5 million titles it sells.

Though the economics of Differentiated Service Policies can be complex, simple and straightforward policies do work best. Too much complexity confuses the customer, making value trade-offs difficult to comprehend. Lipton, a division of Unilever PLC, made its initial foray into menu pricing in 1996 with the introduction of an innovative menu-pricing program. Known as the "Lipton Cube," the program offered retailers the flexibility of a long list of choices. However, the program also had extensive participant requirements and such a complicated structure that many customers were confused and ultimately chose not to participate. Worse still, some customers began "cherry picking" certain offerings that generated profits for themselves but losses for Lipton. Fortunately, Lipton quickly learned from its mistakes and discontinued the first program, introducing a new menu-pricing program in 1999. The new offering, though simpler, was built on a detailed understanding of supply chain economics. To date, it has proven popular with customers and profitable for Lipton.

Option bundling offers a particularly powerful way to keep policies simple. Let's look back at the airline industry. In addition to pricing differences, the airlines offer a host of different services to customers paying premium prices. Not just different seats, but different check-in lines, plush lounge areas, advance boarding, and, of course, different food service on board. Clearly some customers might pay more for early boarding — but unbundling the range of options would create too much complexity and probably disrupt operational execution.

As customers develop a clear understanding of the options, more complexity can be added to further differentiate customer segments, offering more value by better matching specific needs. The best companies keep a forward eye on changing economics and customer value perceptions to anticipate these trends in each new evolution of their programs.

How to Begin

The variety of examples cited highlights the power and far-reaching applicability of Differentiated Service Policies. And the five principles offer experience-based guidance to developing appropriate policies and evolving them over time. But with such a broadly applicable tool, where does a company begin? The answer lies in our original observation that marketing and operations seem always in conflict. Look at those conflicts — which often emanate from debates that have gone on for multiple years — and consider how Differentiated Service Policies might offer a compromise that meets the needs of both disciplines. In the process, you might create an industry-changing model that better addresses customer value based on an appropriate economic understanding. +

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