



The Dilemma of Customer Service

HBSWK Pub. Date: Feb 3, 2003

Service differentiation is the solution to the high cost/poor service spiral. The dilemma of customer service can be resolved by thinking carefully about your customers' real product requirements, your customer relationships, and your supply chain economics.

by Jonathan Byrnes

Part V

Customer service is one of the most important levers of profitability, but one of the least understood. Most managers can improve customer service and lower costs at the same time, but this requires that they re-examine some important assumptions about how customer service is defined, measured, and managed.

The theme of my monthly columns is that the most compelling business opportunity for most managers today is to create more profitability from their current base of business. The key is to do this without capital investment, just with more thoughtful management of the details of their business. Customer service is a prime area for profitability improvement through insightful management.

Two frustrated managers

Consider the case of a vice president of distribution of a major industrial company. He was responsible for a wide product line and numerous field warehouses, but service was problematic and declining steadily. The lower the customer fill rate (percent of orders delivered on time), the more product he ordered to be sent to the field warehouses. Costs were rising out of control, yet it seemed that there was no way out of the spiral of escalating costs and worsening service.

The EVP of sales and marketing of the same company said to me, "Our customer service policy is like a pendulum. One quarter, we focus on costs and lower our inventories, so service falls and the customers scream. The next quarter, we load up our warehouses with products and costs go out of control. But the customers don't trust our service, so they keep tightening the delivery time, making it impossible to meet their service requirements. How do we get out of this cycle?"

Three steps to profitable customer service

Faced with the dilemma of escalating costs and problematic service levels, many managers react by trying to find the right balance of cost and service. What could be more logical?

The problem with this approach, however, is that the management actions with highest profit impact are not those that rebalance monolithic service standards and costs, but rather those that create *service differentiation*—setting appropriate service *intervals* (order cycle time) for different sets of customers and products. Given an appropriate set of service intervals, a manager can provide customers with near-perfect service at a reasonable cost.

The key question, then, is how to set appropriate, differentiated service intervals. A manager can develop a highly profitable service differentiation strategy by utilizing a three-step process.

Step 1: Understand real customer needs

This sounds simple enough—just ask the customer, right? There are two problems with simply asking the customer what cycle time is required. First, the customer may not know his or her own real needs, especially in companies where the purchasing group is separate from the operations group. Second, most customers will ask for shorter and shorter order cycle times if they don't trust the vendor to keep its delivery promises.

In fact, all products require flawless service levels, but different products need different service intervals. Consider the following examples in the hospital supply industry. Products such as IV solutions that are fast movers and costly to store require very tight delivery cycles. Products with critical stockout costs, like heart valves, also require very tight delivery cycles. However, many slower-moving products with adequate customer safety stock, such as

odd-sized bandages, as well as products with a prescheduled use, such as special scalpels that a particular surgeon may want to try, can easily accommodate slightly longer service intervals—as long as the delivery promise is always kept.

All products require flawless service levels but different products need different service intervals.

—Jonathan Byrnes

The only way to understand real customer needs is to spend time on the customer's premises observing the product inventory and usage patterns, and developing a joint understanding with the customer's operations managers on appropriate service intervals. While this requires an investment of time, the payoff in improved service and reduced cost is very high.

Step 2: Align service intervals with customer relationships

Not all customers have equal importance, although you'd never know it from most companies' distributions policies. In most warehouses, the standing rule is "first come, first served," unless severe rationing of a crucial product is necessary. In part, this policy reflects the fact that some companies' order systems are not set up to recognize and prioritize orders from specific groups of customers.

The problem with "first come, first served" is that it hurts important customers with established loyalty and high volumes. This is especially a problem when an intermittent customer places a large order, often because its primary supplier is out of stock.

Most order fulfillment and service measurement systems do not differentiate between important steady customers and intermittent customers. Both have the same implicit order cycle time commitment, and the service level measurement will appear to be the same regardless of which customer receives an incomplete delivery.

The only way to understand real customer needs is to spend time on the customer's premises..

—Jonathan Byrnes

Instead, managers must make hard choices in advance to set appropriate order intervals for different groups of customers, and to develop distribution systems and service metrics that are appropriate for each customer group.

Step 3: Align the supply chain with the service interval

Once a manager has defined appropriate service intervals for sets of products and customers, the next step is to align the supply chain to produce near-perfect service at low costs. A customer service matrix is a very helpful starting point. It allows a company's managers to integrate the sales and marketing perspective on products and customers with the supply chain perspective on distribution operations. The customer service matrix segments customers and products into four quadrants, and assigns appropriate service intervals to each quadrant. [Figure 1](#) shows a customer service matrix with examples of service intervals.

Core customers/core products. The core/core quadrant corresponds to important products ordered by important customers. Here, service intervals must be short because the customers generally keep minimal stock and stockout costs are very high. Generally, a supplier should keep these products in field warehouses near these customers.

Non-core customers/core products. The non-core/core quadrant causes the most customer service trouble. Here, a non-core customer, either an intermittent or small customer, orders core product. Often, the sales rep acts as an advocate for the customer, arguing that it is an opportunity to "get a foot in the door." The problem is that giving this critical product to the non-core customer often disrupts the rather steady product flow through the distribution system to the core customers with loyal order patterns. In most companies, this is the most common reason why important customers perceive problematic service, and in response, tighten their order cycle requirements.

The answer to this difficulty is to agree with non-core customers on a longer, but reasonable service interval. In the example matrix, core customers receive one-day service while non-core customers receive three-day service. This allows the supplier a margin of time to bring extra stock from a regional warehouse if an unexpected demand peak occurs. Most of the time, even non-core customer orders can be fulfilled more rapidly, but the extra interval time ensures that the supplier will always keep its service promises.

Core customers/non-core products. In most companies, high distribution costs are caused by inappropriate

non-core product service intervals, just as customer service dissatisfaction is often caused by non-core customers disrupting core product flow to core customers.

In the core/non-core quadrant, customers will accept a longer service interval, such as three days, because they keep ample safety stock and the product is not critical. Here, the extra service interval time allows a manager to keep most stock in a regional warehouse, and to use field warehouses as transit points. However, in this system, it is important to keep some field stock in order to respond on an exception basis to a core customer experiencing an unexpected crisis.

Service differentiation can create crucial competitive advantage in three ways.

—Jonathan Byrnes

Non-core customers/non-core products. In the non-core/non-core quadrant, service intervals should be set to enable the company to bring stock from a regional warehouse to the field warehouse for customer transshipment, or to ship directly from centralized stock. In the example customer service matrix, this interval is set at five days. The slightly longer interval enables a manager to give priority to the core customers if product supply gets tight on occasion.


Profitability lever

The dilemma of customer service can be resolved by thinking carefully about your customers' real product requirements, your customer relationships, and your supply chain economics. Service differentiation is the solution to the high cost/poor service spiral experienced by the two managers mentioned earlier, and it can turn many unprofitable accounts and products into highly-profitable ones.

Service differentiation, setting appropriate service intervals for different customers and products, can create crucial competitive advantage in three ways. First, service levels, especially for critical products and critical customers, will improve to near-perfect levels, tightly binding your best customers to your company. Second, most customers will willingly accept, and prefer, a company's flawless service at jointly-planned service intervals over its competitors' lower service levels. Third, the sales process can focus on moving customers from non-core to core status by obtaining higher order volumes and loyalty.

And what do you do when a sales rep asks for a fast service interval for a non-core customer as a "foot in the door?" Say, "Sure, just have the customer sign a volume contract, and we'll offer the same service interval as for our other loyal core customers."

By the way, how can you increase service and lower costs at the same time? By setting appropriate, differentiated service intervals, and watching profitability rise!

See you next month. 

Copyright © 2004 Jonathan L. S. Byrnes.

Jonathan Byrnes is a Senior Lecturer at MIT and President of Jonathan Byrnes & Co., a focused consulting company. He earned a doctorate from Harvard Business School in 1980 and can be reached at jbyrnes@mit.edu.

Figure 1			
The Customer Service Matrix			
Products	Core	3-Day Interval	1-Day Interval
	Non-core	5-Day Interval	3-Day Interval
		Non-Core	Core
		Customers	