A Coordinated Revenue-Sharing Contract for a Two-Stage Supply Chain with Linear Stepwise Inventory Holding Costs

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ABSTRACT

In this paper, the authors focus on examining the coordination mechanisms for a two-stage supply chain comprising one supplier and one retailer. The authors consider such a channel relationship that the transaction quantity between the two members is sensitive to the supplier’s inventory level and that the supplier's unit inventory holding cost has a linear stepwise structure. They devise a coordinated revenue-sharing contract with bargaining so that each party's respective profit is better than that resulted from the simple sequential optimization mechanism. The key contract parameters, namely the supplier’s inventory level and the retailer’s revenue-sharing fraction, are obtained and analyzed. Numerical illustrations of the contracts are given and shed lights on how the supply chain should coordinate in order to gain better performance.

Keywords: Bargaining, Nonlinear Optimization, Supply Chain Coordination, Supply Contracts, Stepwise Cost

INTRODUCTION

A supply chain is a complex network consisting of multiple inter-dependent members that often have conflicting goals and objectives. As such, to improve a supply-chain wide performance and to achieve a win-win, mutually beneficial situation, coordination mechanisms are imperative and valuable. It has been proven in the literature that supply contracts provide an effective vehicle to achieve coordination, which leads to an increased profit of not only the entire chain but of each chain member as well (e.g., Tsay et al, 1999; Cachon, 2003). In addition to serving a coordination vehicle between related parties, a contract specifies the courses of actions the
involved parties should take and outlines the responsibilities of each member. As a result, how to
design an effective contract has received immense attention from the supply chain management
professionals over the past decade.
Commonly used supply contracts have multiple formats, including buy back, quantity flex-
ibility, revenue sharing and sales rebate contracts – to name a few (Simchi-Levi, Kampski &
Simchi-Levi, 2004; Bose, & Anand, 2007). These contracts differ on the basis of the contractual
clauses between buyers and suppliers and primarily concern quantity, time, quality, and price.
Of the existing contract models, revenue-sharing contract is relatively simple for design and
administration and has been studied widely in recent years. When applied to a two-stage supply
chain consisting of a single manufacturer (or supplier) and a single retailer, the revenue-sharing
contract aims to align the two parties’ interests and courses of actions with the supply chain
system’s objectives by having the retailer share a portion of its revenue with the supplier. As a
result, the supplier’s willingness to cooperate should increase, thereby improving the supply-
chain wide performance as well as each party’s resulted benefit.
Coordination through revenue-sharing contract is a basic strategy and applicable in a
wide range of situations. One key issue is to determine the revenue-sharing fraction for bigger
coordination possibilities as well as for higher levels of profit. Addressing this issue can be ac-
complished in various contexts of supply-chain configurations. In this paper, we consider such
a supply chain that the transaction volumes depend upon the supplier’s inventory level and that
the supplier’s unit inventory holding cost has a linear step-wise structure. This type of channel
relationship is suitable for numerous kinds of supply chains, such as those for daily required
merchandise, consumer products and industrial commodities, all of which usually have large and
steady demands that increase with the availability of the products. With respect to a supplier’s
unit inventory holding cost, as the supplier rents or uses larger warehouse space, the cost may
not stay constant as often assumed in the literature; rather, it may possess a stepwise structure (e.g.,
Bayındır, Birbil & Frenk, 2007).
We examine the coordination effectiveness of the revenue-sharing contract in the supply
chain described above. In particular, we analyze the feasibility of coordination in such a revenue-
sharing contract that through bargaining and mutual agreement, the retailer would offer a higher
share of revenue and the supplier would have sufficient incentive to choose a higher inventory
quantity, thereby improving both parties’ profits. We obtain the solutions of the two contract
parameters, namely the retailer’s revenue-sharing fraction range and the supplier’s inventory
volume. Numerical examples that we have conducted indicate that significant improvements
can be accomplished by the proposed contracts.
The remainder of the paper is organized as follows. Section 2 summarizes the literature
related to revenue-sharing contracts. In Section 3, we obtain results from basic centralized and
sequential optimization mechanisms, which will be used as a basis for subsequent analysis
and comparison. Section 4 considers how to better coordinate the two parties through revenue
sharing and bargaining. The range of the revenue-sharing fraction for bargaining as well as the
desired inventory level is derived. In Section 5, we provide numerical examples to demonstrate
the effectiveness of the coordinated revenue-sharing contracts. Finally, concluding remarks and
directions for future research are given in Section 6.

LITERATURE REVIEW

The revenue-sharing (RS) contracts have been studied widely as possible mechanisms for achiev-
ing supply chain coordination since the turn of the century. Cachon & Lariviere (2005) offer an
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