Reframing procurement’s strategies, priorities and deliverables, part 2: Accelerating cost down initiatives – unlocking the missing 20%

This article is the second of an exclusive five-part series of articles produced for DILForientering during 2011, which position the maximisation of value, the minimisation of cost and the balancing of risk as guiding propositions for procurement as a driver of change across both the private and public sectors.
procurement cost savings are the one deliverable that all senior managers understand. While not defending a simplistic position, our pragmatic view is that high-quality, well-structured and sustainable cost management is an enduring core competence of procurement that needs continually to be strengthened and re-energised by CPOs and the procurement leadership team. It should be one of our top three objectives, while simultaneously pursuing a strong focus on value maximisation and risk mitigation.

Throughout this series we advocate a holistic and properly integrated set of strategies closely aligned with organisational goals, metrics and business requirements. Figure 1 illustrates this as a downward cascade driving the focus of procurement on to value, risk and cost as well as upwards reporting of the deliverables secured through a wide range of procurement initiatives. In this article we will argue that procurement’s maturity can be measured along a continuum spanning three broad scenarios which comprise a wide range of different tools, techniques, value levers and change models. Each of them provides opportunities for considerable cost down — what we have termed the “missing 20%”. There are still organisations and sectors (most notably in government) that have barely moved forward on the adoption of modern procurement and cost management (“laggards and early improvers”); then there are an encouragingly large number of companies that have built a solid platform for further procurement progress, which are extending and renewing their processes and capabilities (“credible achievers”); and finally the much smaller number pioneering new cost paradigms which call for innovation in operating models, organisational and business structures (“pathfinding innovators”). To bring this to life we have populated this article with real life case studies highlighting the progress being made.

1) Laggards and early improvers: Launching and rapidly accelerating cost control
In laggard organisations, procurement is fragmented, unfocused, under-resourced, under-led and with no proper, disciplined processes or defined ways of working. Considerable change, though, can be achieved particularly with the appointment of high quality procurement leaders who go after rapid savings, immediate financial contribution and demonstrable results that quickly build credibility in the eyes of top management. In these early days of procurement transformation

**Figure 1.** Source: © Jon Hughes, Duncan Brock & Simon Brown, Future Purchasing, 2011
it is particularly important for the CPO to be internally persuasive, secure the backing of main board level sponsors and have a credible rationale for the launch of accelerated sourcing campaigns.

UK public sector: Total government expenditure is £70bn, or 48% of GDP, and is now entering the longest and deepest period of sustained reduction since the second world war. Annual expenditure with third party suppliers is well in excess of £250bn. The government has imposed 25% departmental spending cuts by 2014/15, triggering significant reduction in service provision, dramatic constraints on demand and a much greater readiness to leverage government scale in supply markets. Centrally driven, mandated, pan-government collaboration in procurement is being launched, with more radical initiatives likely to follow (see Hughes & Day, 2011).

LG Electronics: May be one of the world’s biggest producers of hand sets and flat screen TVs, but its sophistication in electronics was not reflected in procurement until recently. Having set a goal of reaching “the world’s top level” by 2011, they achieved it with over $5.5bn of savings, 17%+ cost down, closely integrated supplier development with their top 50 suppliers, global commodity councils, quarterly structured reviews, weekly commodity updates and strictly defined development and performance coaching for the core procurement team.

Figure 2. Source: © Jon Hughes, Duncan Brock & Simon Brown, Future Purchasing, 2011

10 X 10 VALUE LEVER FRAMEWORK FOR ACHIEVING A 20%+ COST DOWN STRATEGY ACROSS TOTAL THIRD PARTY SPEND OVER A FIVE YEAR PERIOD

LEVEL 1: VALUE LEVERS
Cost down impact is at the business model, organisational and process level

1. Business alignment and stakeholder engagement
   - Active CEO/board director support
   - Strategic plans include procurement
   - Part of formal planning cycle
   - Tied in to MBO/executive remuneration

2. Organisational structure, governance and operating model
   - Integrated “one procurement” structure
   - Managed governance and collaboration
   - Well developed steering groups
   - Aggressive programme management

3. Leadership, people development and team strength
   - High quality CPO and leadership team
   - Real credibility in eyes of board
   - Major focus on people development
   - Well resourced coaching and upskilling

4. Process discipline, executional excellence and technology
   - Well adopted category management
   - Strong focus on supplier management
   - High levels of compliance
   - Organisational knowledge transfer

5. Category management and supplier value management
   - All major categories and suppliers covered
   - Up-to-date sourcing strategies
   - Well defined supplier strategies
   - Mandate to cover all spend

6. Reform of the supply chain and operational excellence
   - Business strategy for supply chain
   - Operational excellence well established
   - Lean practice well established
   - Supplier value auditing well established

7. Outsourcing, offshoring, LCCS and right sourcing
   - Outsourcing and offshoring accepted
   - Regular strategic review of this area
   - Defined goals for in-/outsourcing
   - Centre of excellence established

8. De-risking the supply chain and volatile commodities
   - Supply chain transparency on risk
   - Strategic supply chain risk auditing
   - Volatile commodity management in place
   - Extensive use of commodity analytics

9. Product, process and relationship innovation
   - Open sourcing well regarded
   - Strategic innovation plan
   - Strategic supply chain projects in place
   - Top-down led and resourced

10. Ethical sourcing, CSR and corporate reputation
    - Focus on sustainable cost down
    - Strong CSR and ethical framework
    - Framework followed closely in bids
    - No trade-off of cost down for risk

LEVEL 2: VALUE LEVERS
Cost down impact is at the individual sub-category sourcing and supplier level

11. Competitive leverage and supplier negotiations
    - (Re)negotiation of contracts and prices
    - Comprehensive use of bids and tenders
    - Extensive use of RFx and e-auctions
    - Obtain favoured customer pricing

12. Volume leverage, consolidation and aggregation
    - Consolidate volumes across organisation
    - Consolidate volumes across categories
    - Reduce number of suppliers
    - Redistribute volumes amongst suppliers

13. Internal demand management and compliance
    - Reduce/stop internal demand
    - Apply systems to channel demand
    - Increase preferred contract compliance
    - Demand and compliance transparency

14. External demand management and compliance
    - Optimise internal/external allocation
    - Manage demand timing with suppliers
    - Exploit supplier economics of demand
    - Share forecast and planning data

15. Price benchmarking and price analysis
    - Align prices downwards across units
    - Price list and quotation analysis
    - Purchase price and cost analysis
    - Negotiate directly up supplier chain

16. Price renegotiation and price restructuring
    - Change length of supply agreement
    - “Should be” pricing and cost modelling
    - Change supplier remuneration model
    - Hedging/contracts in volatile commodities

17. Specification simplification and complexity reduction
    - Standardise business requirements/specs
    - Simplify specifications: reduce complexity
    - Remove over-specified costs
    - Optimise total/life cycle costs

18. Supplier led product, service and value re-engineering
    - Change service/product delivery method
    - Expand supplier scope and role
    - Design to cost and margin
    - Target costing

19. Lean supply and supply chain waste reduction
    - Map and simplify supply chain
    - Redesign supply chain
    - Work in supply chain consortia
    - Reduce inventory and complexity

20. Supplier collaboration and cost improvement
    - Contract driven cost improvement projects
    - Improve integration and joint processes
    - Strategic cost innovation projects
    - Supplier/supply chain cost transparency
roles, responsibilities and accountabilities across their 2,000-strong team.

Lanxess: This speciality chemicals company has a raw materials spend of 70% of its $5bn sales turnover, but was a laggard in procurement with little focus or transparency on spend. Governance has been transformed recently through a global category management structure and a procurement group that meets six times a year, has board reviews every six months, bi-monthly with business units and monthly with their executive sponsor. All this is supported by a strategy database and a procurement “radar screen” covering almost 1,000 contracts and supplier renegotiations.

Henkel: This German consumer goods and adhesives group launched a number of business initiatives, including procurement transformation, to close performance gaps with competitors such as P&G, BASF and Reckitt Benckiser. They introduced globally standardised processes, a “passport to purchasing excellence” and a purchasing campus emphasising advanced tools and breakthrough thinking. One theme addressed cost management, building deep financial awareness of purchasing’s impact on Henkel’s market value while examining the full skills spectrum from leveraged price management through to major cost restructuring, with detailed coverage of cost drivers, purchase price and cost analysis, target costing, total cost modelling, supplier cost structures and supply chain mapping.

2) Credible achievers: Extending, sustaining and renewing cost management
This is the heartland area of enterprise-wide category management, strategic sourcing and supplier value management, as well as procurement being a full participant in initiatives such as collaborative demand management, lean supply and new product development. The latest Aberdeen Group report into strategic sourcing highlights the considerable differences (often three to four times) between laggards and best-in-class organisations. It lends itself to benchmarking in terms of percentage spend under management; penetration of standardised category management processes; number of documented and fully implemented category plans; contract compliance; visibility of enterprise-wide spend and quantity of the savings pipeline. Colleagues in Vantage Partners and Future Purchasing (Hughes, Webb et al, 2010) have also shown that as category management matures, so a number of its critical enablers – particularly programme management, project management, governance and internal collaboration structures – are increasingly being applied to post-contract supplier value management as well as extending core sourcing into new or ignored areas in indirect and services spend as well as outsourcing and contract management.

Value levers 1-5 at level 1, as shown in figure 2, are especially important in sustaining and renewing cost management discipline at the organisational and process level. Equally, ten further clusters of value levers are highly relevant in the execution of sub-category level strategies and these are summarised from 11 to 20 in order of increasing sophistication and requirement for collaborative working with suppliers as opposed to reliance on volume leverage and market competition. They provide a powerful checklist for evaluating the comprehensiveness of a category plan and the likely quantum of savings and other value added benefits that will be delivered from it. Furthermore, as shown in figure 3, the way in which different initiatives, tools and techniques are deployed within category strategies can vary enormously, depending on the overall maturity of procurement, the business support for it, and the competence of the team. Tactical category plans often concentrate only on competitive leverage and price management, whereas more strategic and transformational sourcing impacts the underlying cost drivers and even the business structures behind them.

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British Airways: Recently launched its Procurement Excellence Organisation to raise the competence standard of its 1,300 staff worldwide, impacting a $25bn spend through an upgrading of core procurement processes. A full-time internal team of 70 change agents is deployed on this initiative, which also involves their top 400 suppliers.

Unipart: Translated the concept of total acquisition cost into a highly practical framework driving continuous improvement, lean supply and process discipline. Their Ten(d) to Zero programme mapped ten critical requirements such as zero lead time, zero defects, zero transaction costs, zero environmental damage, zero cost constraints, on a 0-10 scale with 10 being completely unacceptable. Supplier improvement was then tracked in a quantified way from 10 down to zero, which represents their world-class standard for performance.

BASF: With €21bn of third party spend covering 500,000 differently specified raw materials and technical goods across chemicals, plant, construction and maintenance services, spend transparency and continual monitoring of raw materials price risk has been a critical feature of their procurement operations. They have adopted a multi-dimensional approach to mitigating this price risk, including drawing on a dedicated market intelligence team in China and India.

Caterpillar: Recently launched its Value Levers programme to bring about transformational procurement change and value-based decision making. They translated the concept of value levers into a highly practical framework driving continuous improvement, lean supply and process discipline. Their Transformational Sourcing framework driving continuous improvement, lean supply and process discipline. Their Ten(d) to Zero programme mapped ten critical requirements such as zero lead time, zero defects, zero transaction costs, zero environmental damage, zero cost constraints, on a 0-10 scale with 10 being completely unacceptable. Supplier improvement was then tracked in a quantified way from 10 down to zero, which represents their world-class standard for performance.

Dixons, Currys and PC World, and is mid-way through a financial turn-around
project to drive up pre-tax profits after several years of loss. Procurement has been a key initiative, despite their team being reduced in numbers. They have tracked return on investment closely at the individual buyer level. Every pound spent on salary created a £25 saving on their bottom line during 2009/10, up from £9 in 2008/09. This has been particularly noticeable across non-traditional, services spend areas such as marketing.

Lloyds Banking Group: In the banking sector a widely-acknowledged performance metric is the cost income ratio, which procurement impacts dramatically wherever there are well-structured cost improvement programmes. Lloyds’ executive committee raised business-wide annualised cost savings goal to £2bn from 2011, with procurement identified as the largest contributor after staff cuts. Savings have been monitored through a bespoke database, “Procurement Benefits Online”, with all savings closely tracked before reinvestment in Group-wide projects. Over 600 staff are receiving regular procurement-related training through their Supply Management Academy.

Shell: The business cost base was cut 10%, 2009/10, with top management determined to secure more predictable profitability and earnings while planning to invest over $100bn in 20 major projects over the next four years. Procurement is expected to make a full contribution by extending its competence well beyond traditional category management into more disciplined contract and supplier management. They have adopted a “top 100 supplier” framework to achieve this.

3) Pathfinding innovators: Pioneering new cost paradigms and business structures

A small number of organisations are pursuing more fundamental and deeper transformation in procurement, designed to secure greater leverage of scale, scope, volumes, processes, capabilities and competencies. It is impossible to do this without applying level 1 value levers since there is a fundamental requirement to innovate at the business model, organisational and structural level. Examples include the reconfiguration of worldwide manufacturing networks with outsourcing and contract manufacturing taking over from internal production; creation of new models for service delivery in the public sector, relying on external suppliers to deliver services rather than more traditional internal provision; active participation in procurement consortia as well as the merging of procurement organisations; development of Asia sourcing hubs and relocation of procurement resource from the US/Europe to them;

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well-planned phases of change over several years. Category management has been streamlined and embedded as the core process driving cost down and value up across 70+ spend categories. Radical financial goals have been built into their multi-billion pound capital investment spend. Up-skilling and professionalisation of their team incorporated external research into best practice with practical application of innovative cost analytics and gain share contracting. There has been a step change in the cost base, with £1bn+ reduced on like-for-like costs, approximating to 20% cost down while dramatically improving specifications, quality and service. Having acknowledged the critical role of high quality procurement expertise, they have decided to outsource a significant part of their procurement to third party experts in order to maintain their transformational momentum.

21st Century Supply Chains: Traditionally the UK supply chains in defence and aerospace, despite generating £30bn of annual revenue, were adversarial and wasteful, and a prime candidate for supply chain reform. An ambitious modernisation programme was kicked off in 2006, supported by global players such as BAE Systems, Agusta Westland, Thales, Airbus and Rolls Royce. CEOs have to sign up to the programme’s scope, set a target date for implementing a sustainable improvement plan and commit to supporting lean initiatives with suppliers, where relationships are mapped on over twenty defined attributes. 580 companies have signed up as well as recently launching an aerospace and defence academy “Buyer of the Future” learning programme.

France Telecom-Orange and Deutsche Telekom: £1.3bn of annual savings will be generated by leveraging global scale, harmonising technologies and sharing best practice in a 50:50 joint venture combining their customer equipment, network equipment, service platforms and IT infrastructure procurement from Q4, 2011 out of operational bases in Paris and Bonn. As well as significant cost savings and streamlining efficiencies, the venture will be revenue enhancing as it drives innovation and shapes technological development in response to rapidly-changing customer needs.

SAB Miller: The world’s second largest brewer has set up a global centre of excellence, Trinity Procurement, in the very tax-efficient jurisdiction of Steinhausen in the Canton of Zug in Switzerland to manage a spend in excess of $10bn by 2016 across brewing materials, packaging, capital equipment and non-production. It has been designed to operate economically, fiscally and entrepreneurially with mark-ups on cost of goods sold and fees for service delivery to operating units. It interacts with regional hubs in South Africa, Colombia and Hong Kong. In parallel, local businesses are focusing on value engineering, value analysis and taking waste and cost out of operations with suppliers.

While great strides have been made in procurement over the last decade, we believe that any organisation, no matter what the sector, can still identify and capture in excess of 20% cost down if they are prepared to redefine procurement’s business structures, operating models, processes, skills, tools and techniques. This may be a bold assertion but it is to be hoped a convincing one, in view of the many case examples demonstrating that reframing procurement in this way opens up a rich vein of additional cost down opportunity. /