WHAT IS PURCHASING?
A search after the core concepts of purchasing

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With the help of
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Dr. Howard Price, Director Praxis
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Practitioners (shortened) Version, excluding confidential names and business case
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GLOSSARY

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Buyer</td>
<td>For the purpose of this thesis, a buyer is anyone that conducts the act of buying, ranging from the CEO to the secretary.</td>
</tr>
<tr>
<td>Big Picture</td>
<td>Broad Perspective: there are different frameworks possible in which business can be conducted i.e. from a lawful environment to lawlessness environment. In each framework, other business principles to achieve business success, will apply.</td>
</tr>
<tr>
<td>Domain of Balance or lawful competition</td>
<td>The (legal) field in which business can be conducted, as structured by Governments like the USA and the EC. The major driver is to promote a healthy competition as to ensure more wealth to all citizens.</td>
</tr>
<tr>
<td>Pareto Efficient</td>
<td>Resources are said to be used efficiently when it is impossible by using them differently to make one household better off without making at least one other household worse off.</td>
</tr>
<tr>
<td>Perfect Market</td>
<td>The market as imagined by classical economists: information flows freely, economic actors are all alike and behave consistently</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>---------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>(rationally), full competition</td>
<td></td>
</tr>
<tr>
<td>TCE</td>
<td>Transaction Cost Economics = cost of doing business/managing contracts, a term from Coase (1937)</td>
</tr>
<tr>
<td>Warm Comfort Zone</td>
<td>Positive messages from employees put business leaders in a “comfort zone”, which distorts their vision about the real situation.</td>
</tr>
<tr>
<td>Operational Efficiency</td>
<td>Minimum input for maximum output</td>
</tr>
<tr>
<td>Production Possibility</td>
<td>At the frontier, this is the maximum output that can be reached with the given resources at a certain moment in time</td>
</tr>
<tr>
<td>Boundary/Frontier</td>
<td></td>
</tr>
<tr>
<td>Twofold view / duality</td>
<td>A buyer should focus on sourcing for the lowest costs and on competitive advantage but there is a trade-off between the two: if the expenditure constitutes a competitive advantage, the buyer should adopt different principles and most probably accept a higher cost price.</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreements on Tariffs and Trade. The organization was established in 1948 to provide the institutional basis for trade negotiations</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization, successor of the GATT in 1975, creating a permanent institutional and legal body responsible for governing market access and competition for both products and services</td>
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</table>
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I was privileged to have the support and advice of four brilliant and visionary leaders, all with a strong academic and practitioner background. As specialists in purchasing, strategy and economics, their valuable input was a huge benefit to my paper.

I am grateful to professor Andrew Cox for reading my paper and providing me with useful comments.
Professor Andrew Cox is director of the Centre for Business Strategy and Procurement at the Birmingham Business School. He is one of Europe’s leading authors in the field of purchasing management and published numerous articles and books.
Andrew is also director of his consultancy firm Robertson Cox.

I also want to express my gratitude to Howard Price, former partner of Solving International, consultants in strategy/purchasing & supply management, and currently heading his own consultancy firm “Praxis”, active in the field of purchasing. Howard is a practitioner with a strong academic interest. He wrote his Phd at the Bath University under professor Richard Lamming. I am sure Howard is glad my paper is finished so I will no longer harass him to discuss his feedback.

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Andrew holds a university degree in economics from the university of Queensland/Australia. Besides his broad interest and extensive knowledge in (neo)-classical and modern economy, he is a master of philosophy.
He currently is Managing Director of Vector Europe, market leader in multi-layer shrink casings and shrink bags for the food industry.
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EXECUTIVE SUMMARY

In times of economic recession, purchasing is put into the spotlight. Though purchasing is being viewed as a typical cost-cutting function, business leaders should be careful when applying world-class purchasing programs to their total expenditure: these excellent programs will reduce their unit cost price but might destroy certain assets that were making their company unique, hereby eroding the sales price. Few companies can now afford such one-dimensional view and CEO’s, CFO’s and strategic buyers should be aware that some resources are best not operating at maximum efficiency and that it is worth paying a premium for a competitive advantage: cost cutting programs might be well paying off in the short run, but might destroy the companies long term survival. It is of utmost importance that business leaders adopt such a dual mindset when assessing the total cost burden: an easy to understand and revolutionary two-dimensional Portfolio model has been developed to help them coping with this vital duality.

Managing however this duality, critical to the survival of companies, remains difficult and requires a thorough understanding of the core concepts behind “Cost Reduction” (reference Cost Model) and “Sustaining Sales Prices” (reference Value Model):

- COST REDUCTION
  The bible and foundation of sourcing for the lowest possible unit cost is derived from the classical economical doctrine of Adam Smith:

  **LAW 1:** IN A PERFECT COMPETITIVE MARKET, PROFITS TEND TO GO DOWN TO ZERO AND THE VALUE WILL BE PASSED FROM THE SUPPLIER TO THE BUYER

  **LAW 2:** THE COMPETITIVE MARKET FORCES EVERY SUPPLIER TO INNOVATE AND TO PRODUCE A BETTER QUALITY AT LOWER PRICES
Following this doctrine, purchasers in essence only need to bring their supply base in a competitive environment, which seems a quite uncomplicated task.

Yet Coase demonstrated in 1937 - through the concept of Transaction Cost Economics - that these classical economical assumptions of a free market are far from reality: in the real market we experience that even mutually beneficial trades fall apart as the act of transacting with another is not free. And Williamson definitely collapsed the concept of a free and rational market by adding two behavioral assumptions to transactions: bounded rationality and opportunism with guile. It is in this non-transparent environment that CEO’s, buyers and other managers issue reassuring cost-cutting plans and other feel good stories that put shareholders in a warm-comfort zone of “we are doing well”: in such environment it is difficult to assess the real value of these plans for the companies long-term survival.

This comfort-zone is often misleading, as there is a permanent tendency of industries converging towards a perfect competitive market. This happens bit by bit, almost unnoticeably for a lot of managers due to the non-transparency of the Coasian market. This process is quickened by the emergence of the internet, the diffusion of best practices like outsourcing, making industries looking all alike but more importantly through modern nations that translated the theory of the great Adam Smith into legally binding texts, hereby promoting competition and reducing the playing field in which business can be conducted.

Transaction costs are thus only a friction to the free market and will only delay its consequences: time is what keeps a Smithian and Coasian market apart.

Over time, many industries will thus approach the definitions of the (neo-)classical market, which is an ideal environment for purchasers aiming for a major cost reduction: they mainly need to align themselves with its principles and facilitate the process, wherever necessary. Quite a straightforward task given the support of nations like the EC and USA, however the sword cuts at both sides: the same market principles will wipe out all companies with a too high cost position. This puts a much wider responsibility on the purchaser than ever before, as he will now have to outperform his competitors in reducing his total costs burden!

Organisations sourcing for the lowest possible unit cost, should apply these learning’s in a two step process:

1. Develop alternative offers or BATNA’s (Best Alternative’s To a Negotiated Agreement), which means buyers have to make the market more competitive by introducing more competitors. The more and the better the BATNA ‘s, the more the balance of power will shift to the camp of the buyer, enabling him to appropriate value from the negotiation process.

2. Develop Strategic Cost Management initiatives, which require an intense buyer-supplier collaboration to reduce not only the price, but the total cost burden.
- SUSTAINING THE SALES PRICE

Pricing right is the fastest and most effective way for managers to increase profits. For example a price rise of 1 percent, if volumes remained stable, would generate an 8 percent increase in operating profits, an impact nearly 50 percent greater than that of a 1 percent fall in variable costs such as materials. A decrease of 1% in prices would have the reverse effect…

To sustain the unit sales price there is only one major approach: avoid a competitive market. All processes, products or services that make you different from possible competitors and hence that impede free competition are called “value” (competitive advantage), as they act as a barrier against the creation of BATNA’s, avoiding a price erosion.

Crucial to this approach is the sustainability of the innovation: here Rumelt proposes a series of “Isolating Mechanisms” that will retard imitation, ranging from “patents” to “information asymmetry”. All of these mechanisms need to be truly understood by strategic buyers and managers focusing on competitive advantage.

The reason for setting these resources apart, in the value model, is that the focus of the buyer towards this expenditure will be completely different: from striving for a maximum of operational efficiency, he will now be aiming to protect and enhance the competitive advantage, all within the legal framework of modern nations.

But – and here is the duality – as all resources in the value model will be paid a premium, the strategic purchaser plainly needs to understand which resources support value and hence accept the burden of paying a premium only for those items (and not for the others!).

The power of this value model is embedded in two elements: first it should launch the discussion whether a supplier offers a competitive advantage. And only if the answer is positive, competition can be relaxed!

Secondly, it should make the company aware of the temporary character of monopolies, forcing it to act and to change the character of the relationship as soon as the competitive advantage has been eroded.

To conclude: Purchasing professionals should abandon intuition-guided purchasing and adopt a process-guided approach to purchasing, which is - fundamentally - quite simple:

- Sourcing for the highest competitive advantage through innovation and Isolating Mechanisms and
- Everywhere where there are no trade-offs, sourcing for the lowest cost through the development of a competitive market

Purchasing is a science, not an art! Business Leaders and strategic buyers should understand this very important lesson for long-term business success.
WHAT IS PURCHASING?

1. INTRODUCTION

1.1 Problem situation

Difficult conditions in the second half may lead General Motors to exert even more pressure on Opel to cut costs... "The difficult market forces us to double and triple our endeavours," ... Opel is now looking to save up to 7 per cent in annual purchasing costs rather than the originally planned 5 per cent cost cuts. Opel also said they may cut more jobs in addition to the 2,500 cut since 2001 (Harnischfeger, 2003, FT).

DaimlerChrysler conducted more than $3 billion worth of complex goods auctions through the e-marketplace in one week this past May, reportedly the largest auction to date on an Internet exchange. These auctions, originated abroad, involved five suppliers and 1,200 parts and reduced cycle time from several months to four days (Business Wire, 2001).

A slowing demand, intense competition, decreasing prices and margins, the pressure of stock markets … it all puts purchasing into the spotlight as witnessed by numerous articles in the Financial Times and similar media. It seems purchasers have found all the necessary answers with buzzwords like Target Costing, Lean Thinking, E-procurement, Outsourcing… all purchasing programs that should safeguard profits in these difficult times. It all adds to the perception that “Purchasing is being viewed as a cost-cutting function” (Russel, 2001, 12).

In October 2001, I was struggling to define a strategy for a major expenditure and I realized that an important cost-cutting program for this expenditure could be detrimental to our sales price: I did not share the perception anymore that purchasing was only about sourcing for the lowest possible costs. I experimentally discovered that

- In some circumstances, purchasing is indeed a cost-cutting function and purchasers should reduce their cost burden to its minimum level.

↑

- In a limited number of circumstances however, an application of some excellent purchasing programs – to reduce to costs to its minimum level - would wipe out certain competitive advantages, making them available to the rest of the market: this would erode our sales price.
This dualism towards the cost of running a business is not new and has been discussed by Porter (1996), Cox (1997, 280) and Hughes (1998, 117) to name a few.

In this thesis I will explore the fundamentals of purchasing to gain a thorough understanding of what purchasing is all about. I will go beyond the buzzwords, paint the big picture and position purchasing within it.

The important factors of each part of the above-mentioned duality will be investigated. Furthermore, a strategic portfolio model, easy to understand, to use and to remember by practitioners – to visualize and manage the duality - will be presented.

I will also discuss the importance of such twofold view, very often not recognized by buyers, CEO’s or other managers.

In general, the research will give the reader a strategic view of how to achieve business success from a purchasing perspective.

If I refer to “buyer” in this document, I do not mean only the person responsible for the purchase department. For the purpose of this paper, a buyer is everybody that does the act of buying, ranging from the CEO to the secretary.
2. ESSENCE OF BUSINESS

2.1 Maximization of Profit

The goal of each business leader, as described by economists, is profit maximization i.e. to make as much profit as possible (Lipsey, 1987, 21/46). From a shareholder's point of view, this is the essence of doing business.

Although there might be other reasons for running a business, the profit maximization behavior is assumed to be the major driver for all organizations referred to in this work.

“A profit maximizing firm must pay attention to both its costs and revenues” (Lipsey, 1987, 213): indeed profit is derived from a combination of costs and revenue and Dolan&Simon, lecturers at the London Business School on Pricing (Dolan&Simon, 1996, 18), depict the drivers of profit as follows (see figure):

![Figure 1: Profit Drivers](image)

The figure shows the profit system in a simple hierarchical form. Scanning downward at the first level, profit drivers are sales revenue and costs.

The sales revenue is, in turn, price times sales volume. The different profit drivers may influence each other: a higher price typically implies a lower sales volume, thus producing an offsetting impact on profit. Price may also impact costs e.g. a higher sales volume resulting from a lower price may induce a decrease in unit costs due to economies of scale or learning curve. (Dolan&Simon, 1996, 17).

In this paper, the sales volume is assumed to be one and hence sales revenue equals price (reference figure 4): the drivers of profit are thus “price” (per unit) and “cost”.

In the following chapters, I will demonstrate
- the fundamentals of each element
- the value of each element for profit maximization
- a relationship between cost and price i.e. it is not always possible to achieve both a maximum price and a minimum cost
2.2 Differences in Economic and Organizational definitions

Definitions of profit, as well as of costs or prices vary depending upon whether they have an economic or organizational background: economists and managers have a fundamentally different understanding of costs and profits. As I will use economic as well as organizational sources throughout this document, it is important to understand them, before reading any further.

Profit:
From an organizational point view, increases in profits can be achieved by measures for reducing costs or increasing revenues. These could be rationalization programs (e.g. investment in equipment with higher efficiency, reorganization of process, standardization), measures for quality improvement or marketing activities for increasing sales. In economics, profit is maximized by increasing the volume of production and sales up to that point in which marginal costs i.e. the cost of one additional unit produced and sold, are equal to the marginal revenue generated with this additional unit. Production systems and processes remain unchanged. From an economical point of view, maximum profit does not result from an optimal and cost-effective design of all organizational processes, but from production and sales at the optimal level in the existing organizational situation.

Innovation:
For an economist, innovation will enable firms to produce cheaper. In an organizational context, innovation might also lead to a competitive advantage.
3. COST

In this chapter, only the cost part of the profit equation will be explored: ceteris paribus, profit maximization occurs when the costs are reduced to their minimum level. When I refer to the act of purchasing in this chapter 3, it will only be in the light of a cost reduction.

The central question in this chapter is to discover and discuss the core concept that guarantees the lowest cost. In research, a reasonable amount of books have been written on purchasing and supply management but few are touching the real fundamentals of purchasing. I have been overwhelmed by terms like JIT, Target Costing, Lean Supply to name a few (Van Weele, 2001), (Hines, 2000), (Slagmulder, 2000), (Hughes, 1998). These are all good and valuable concepts but no more than tactical tools and thus of no interest for this thesis.

The real eye-opener was the work “Business Success” (Cox, 1997) but more important my old study book “Economics” (Lipsey, 1987). This large volume on macro and micro-economics explains that economists are focused – given the scarce resources – upon the correct allocation of available resources so as to create the maximum of wealth. Their core thinking is based on economic efficiency i.e. producing the most at the lowest possible cost. They claim that a free market, which is driving prices and accelerating innovation, is an ideal environment to achieve this status of maximum economic efficiency. From a managerial point of view, this idea of economic efficiency is exactly what each purchaser should address.

In the following chapters the concept of a free market with its limitations and its virtues will be explored.

3.1 The classic Economic Doctrine of a Free Market

05 may 1721. A remarkable day as it marks the birth of one of the greatest intellectuals in history. It is a day that should be celebrated by nations and citizens as for the last few hundred centuries, nations throughout the world have applied his brilliant concepts to increase the welfare of all people.

17 July 1790. A remarkable day as it marks the death of one of the greatest intellectuals in history. It is a day that should be celebrated by all business leaders as for the last few hundred centuries, business leaders throughout the world have seen profits fade away through societies that have applied his concepts.
Off course, the above statements are a caricature but there is a message: what is good for society might not always be good for a business leader.

This 69 year period encompasses the life of the great Adam Smith who expressed his visions in “the Wealth of Nations” in 1776 (Smith, 1991). This remarkable book was published at a time when the power of free trade and competition as stimulants to innovation and progress was scarcely understood. Governments granted monopolies and gave subsidies to protect their own merchants, farmers and manufacturers against 'unfair' competition. The guilds operated stern local cartels: artisans of one town were prevented from travelling to another to find work. Local and national laws forbade the use of new, labour-saving machinery. And, not surprisingly to us today, poverty was accepted as the common, natural, and inevitable lot of most people.

Adam Smith railed against this restrictive, regulated, 'mercantilist' system, and showed convincingly how the principles of free trade, competition and choice would spur economic development, reduce poverty, and precipitate the social and moral improvement of humankind. And so persuasive were his arguments that they not only provided the world with a new understanding of the wealth-creating process; they laid the intellectual foundation for the great era of free trade and economic expansion that dominated the Nineteenth Century. (Butler, 2001).

By reading carefully the work “Wealth of Nations”, it is my view Adam Smith has touched the origin of purchasing, which can be pinned down to two laws:

**LAW 1: IN A PERFECT COMPETITIVE MARKET**, PROFITS TEND TO GO DOWN TO ZERO AND THE VALUE WILL BE PASSED FROM THE SUPPLIER TO THE BUYER

>“The natural price, or the price of free competition ... is the lowest which can be taken, not upon every occasion indeed, but for any considerable time together...[It] is the lowest which the sellers can commonly afford to take, and at the same time continue their business.”

(Smith, 1991, 65)

**LAW 2: THE COMPETITIVE MARKET FORCES EVERY SUPPLIER TO INNOVATE AND TO PRODUCE A BETTER QUALITY AT LOWER PRICES**

>“... and, where competition is free, the rivalship of competitors, who are all endeavouring to justle one another out of employment, obliges every man to endeavour to execute his work with a certain degree of exactness... Rivalship and emulation render excellency, even in mean professions, an object of ambition, and frequently occasion the very greatest exertions. “

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1 Remark from author: A. Smith never talks about “perfect competition” but rather about natural liberty (free trade, competition and choice).
These two simple laws, derived from Adam Smith, are the bible and foundation not only of purchasing but also of our modern business society. Although some later economists may have changed the governments view on the details of the “laissez faire/invisible hand” economy, especially the work of Keynes (Eyskens, 1988, 188-195) is worth noting, governments still apply the fundamentals of Adam Smith’s theory: in a competitive market

- Suppliers will innovate and produce better quality in order to survive
- Suppliers are passing value to the customer and their prices will be reduced to their long-term marginal production costs
- Less efficient companies will fail and will be replaced by more efficient companies
- This superior resource allocation leads to more wealth for all citizens

“A firm maximizing profits is making the best allocation of the resources under its control, according to the firm’s evaluation of its alternatives. Economic profits and losses provide important signals concerning the reallocation of resources. Profits earned in an industry provide a signal that more resources can profitably move into the industry. Losses show that some resources have more profitable uses elsewhere and serve as a signal for them to move out of that industry” (Lipsey, 1987, 170).

According to this theory, in a free market more suppliers will thus compete for the same goods and services creating a huge competitive pressure. As a result, supplier’s prices will be reduced to their short-term marginal fixed production cost. In the long run however, the best companies will innovate and achieve a superior cost advantage, lowering their (previously short-term fixed) production costs.

In other words, thanks to this competitive pressure, firms have been able to push the production possibility boundary outward (Lipsey, 1987, 7).

The quest for survival however will continue, reducing supplier’s prices finally to their long-term marginal production costs. That is where equilibrium and economic efficiency is achieved: the resources are allocated in the best possible way and the maximum of wealth is created.
Any government could probably see the advantages of a free market to the community as a whole. The disadvantages for shareholders would be clear to any business leader.

3.1.1 The driving principles behind the free market

The fundamentals of free competition can be brought back to a few simple principles:

- Pursuit of self-interest

  'All systems either of preference or of restriction, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way...' (Smith, 1991, 208).

- Doctrine of Comparative Advantage:

As discussed, free competition aims to achieve a better resource allocation. This resource allocation is necessary as there are not enough resources to produce all the goods and services that can be produced. Due to this scarcity, it is necessary to allocate the available resources among their various possible uses and in so doing to choose what to produce and what not to produce.

Resources are said to be used efficiently when it is impossible by using them differently to make one household better off without making at least one other household worse off. This is also called the Pareto Optimality – in honor of the great Italian economist Vilfredo Pareto (1848-1923).

Furthermore, according to economic theory, in a perfectly free market, the allocation of resources is said to be efficient when each commodity’s price equals its marginal cost. Profit maximizing behavior – for economists - is all that is required to assure productive efficiency in a market economy.

It is through aiming at such free competition that a superior allocation of the world’s resources is realized, promoting economic growth and hence achieving an economically superior outcome. David Ricardo (masternotes B1, 2002), who advanced the doctrine of comparative advantage in 1817, demonstrated this principle very clearly:

Ricardo develops his argument through example and uses a simple model which considers the production of cloth and wine in England and Portugal.

Without trade each country divides equally its labour between the production of the two goods. England produces 50 units of cloth and 20 units of wine, whilst Portugal produces 60 units of cloth and 50 units of wine. In this instance, Portugal has an advantage in the production of both goods but has a comparative advantage in the production of wine. By specialising and using all labour resources in the production of the good in which the country has a comparative advantage total world output is increased. In this example, Portugal would produce 100 units of wine and England would produce 100
units of cloth, thereby increasing total world output from 180 units to 200 units. If the countries then trade with each other at an exchange rate which is mutually beneficial both countries gain from specialising production in the good in which they have a comparative advantage and importing the other good. Extrapolating from this two-country example and applying the principle of comparative advantage it is concluded that all countries will be better off specializing production and trading with other nations rather than attempting to become economically self-sufficient and avoiding (international) trade.

3.1.2 The Free Market and its application by Nations

States and Economic Communities like the European Community and the USA have applied this theory of the free market into legally binding texts, defining the limits of (non)competition and hereby reducing the playing field in which business can be conducted. This reduced and artificial world of lawful competition, shaped by our governments to create more wealth for all citizens, is only one part of the total picture. This is a very important doctrine: understanding there is a bigger picture and realizing why we only operate in a part of it and which impact this reduced zone has on running a business, will make the current blind buyer a visionary and will help him to take the appropriate actions to achieve business success. I call this zone of lawful competition the “Domain of Balance” as nations try to marry citizen welfare with the interest of the individual entrepreneur, who wants to appropriate as much money as he can in return for his risk-taking entrepreneurship (COX, 1997 / Smith, 1991, self-pursuit: book IV, chapter 9).

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Figure 3: The Big Picture

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2 Domain of Balance: term by Raf Verheyden, July 2003
An extension of the “Domain of Balance” and further away from Smith is the “Domain of Agreements”\(^3\). In this domain of lawful coercion, competition is relaxed and prices are being fixed: coercion and non-competition are not only allowed, but expected. This might be economically less efficient (not Pareto efficient) but here other drivers play a more important role. In the “Domain of Agreements”, we find businesses like

- Government bodies, which were established because the market did not perform or because other than efficiency goals are pursued (example clean air might be rated more important than maximum efficiency).
- The OPEC who sets quota’s to influence the price of oil.
- The guilds in the 19th century

A last extension is the “Domain of Lawlessness”\(^4\), which is a zone with virtually no rules, it is a chaotic society without a government setting regulations and developing structures like investments in roads, telecommunication or schools to promote competition and innovation. Nations in war or countries with a high degree of corruption fall under this category. The law of survival of the fittest will be the overwhelming regime and probably most of the civilians will be left in poverty.

There is a last domain, the “Domain of Smith”\(^5\): it is the “Domain of Balance” but working “very well” from the viewpoint of the whole community. It is like a perfect free market with information flowing freely and economic agents being all alike and acting rationally. This market might feel unreal but I will soon demonstrate the “Domain of Balance” approaches the “Domain of Smith” i.e. the classical economic assumptions might be roughly correct.

In each domain, different (economic) principles will apply and a strategic buyer has to understand this and adopt different strategies, depending in which domain he is operating!

In recent years, the largest and most spectacular attempt to apply this concept of free competition and to build a free market was the creation of the European Union (EU15), which has created the world's largest domestic market with 375 million customers (Masternotes, B4, 3):

The EU has pursued a policy to encourage competition by creating an environment and common framework, supported by EU law, where firms might operate without facing unfair restrictive practices. The EU claims this has significantly reduced barriers to trade and has contributed significantly to growth and employment. They claim

\(^3\) Domain of Agreements: term by Raf Verheyden, July 2003  
\(^4\) Domain of Lawlessness: term by Raf Verheyden, July 2003  
\(^5\) Domain of Smith: term by Raf Verheyden, July 2003
competition is an incentive for firms to modernize, to become more efficient and improve the quality of products.

The competitive environment rewards businesses that are efficient and forces less efficient firms to exit, giving the opportunity to invest the scarce resources in areas where they would be more efficiently employed.

To achieve this environment, the EU introduced two famous articles (Masternotes, B7):
- Article 81, which seeks to maintain competition in the EU by preventing the issue of anti-competitive behaviour by two or more businesses in restraint of trade. Restrictive practices include market sharing, price fixing and production quotas.
- Article 82, which prohibits businesses in a dominant position, that is with significant market power, including monopolies, from exercising their powers in restraint of competition and affecting inter-state trade.

The European Competition Commission summarizes it as follows: “...Competition policy aims to ensure wider consumer choice, technological innovation and effective price competition, thus contributing to both consumer welfare and to the competitiveness of European industry. This is achieved by ensuring that companies compete rather than collude, that dominant companies do not abuse their market power and that efficiencies are passed on to final consumers”. (Citizen's Guide to Competition Policy, 2003)

Although the principle might be crystal clear to everybody, nations still hold a protectionist view when it comes down to really promoting a free market. The difficulties of the GATT and later the WTO (masternotes B1, 2002) to implement free trade reveal that the road towards a free market will be long and full of objections.
- “To expect, indeed, that the freedom of trade should ever be entirely restored...is as absurd as to expect that...Utopia should ever be established in it. Not only the prejudices of the public, but what is much more unconquerable, the private interest of many individuals, irresistibly oppose it.” (Smith, 1991, 368).
- “The WTO talks in Cancun 2003 remind me that free trade is like getting to heaven: everyone wants to get there, but not too soon”. (Butler, 2003)

In addition to the conflicts between nations, there are numerous examples of conflicts between nations and their firms, all with relation to the distortion of a competitive market. Microsoft – one of the most profitable companies in the world - is for example constantly playing at the edge of the “Domain of Balance”. The latest attempt is to monopolize the video and audio stream market.

*It may already be too late to curb Microsoft’s dominance of the software that you need to play music or video from the internet on a PC. By bundling its Media Player with Windows, Microsoft has taken the lead: its software is estimated to handle 50-65 per cent of all media streamed from the internet, reducing the incentive for music or movie companies to support other formats such as RealNetworks or Apple's QuickTime.*
But to the software company's rivals, the European Commission's latest salvo in its long-running antitrust saga could mark a subtle turning point. By requiring Microsoft to "unbundle" the software from Windows - or, conversely, to bundle rival products - the Commission has set an important precedent that challenges one of the company's core business tactics, according to critics.
(Waters/ Morrison/Chaffin, FT 2003)

Volkswagen for example has crossed the border of the “Domain of Balance”:
The European Competition Commission found Volkswagen, Europe's largest carmaker, tried to prevent German customers from buying cheaper VW and Audi brands in Italy during the mid-1990s. They insisted the German carmaker had to pay a €90m ($101m) fine for restrictive sales practices (Harnischfeger, FT 2003)

Our nations have understood that the creation of a legal framework to support the doctrine of a free market, will reduce costs and the citizens (buyers) will appropriate the majority of the value. In other words, this policy of a free market that will reduce prices, is an ideal environment for purchasers aiming for a major cost reduction: the system (society) is already doing the work for them, they only have to facilitate the process.

Some might opt this concept of a free market is only a theoretical approach, and the above-mentioned principles do not apply in the real world: in the following chapter, the efficiency of the “Domain of Balance”, which is the framework that most modern nations have chosen, will be explored.

3.2 Transaction Cost Economics: a true but misguiding concept

It is often understood that all orthodox economics since Smith assume that markets work perfectly when left alone – or at least perfectly enough to ignore the exceptions. Mathematical models representing the arguments of Smith and classical economists (“neo-classical” models) list such assumptions as “perfect competition”, “perfect information” and “perfect rationality”. One feels immediately this approach by classical and neo-classical economists lacks reality.

This chapter will discuss a more realistic market. In the end, I will assess if the assumptions of the free market, and hence the two laws derived from Adam Smith (see chapter 3.1), being the fundamentals of purchasing, still hold true.

It was only in the nineteen thirties that modern economist questioned the assumption of a perfect (rational) market, through the concept of transaction costs. The transaction costs economics added some depth to the classical economic thinking as they proved that the
market was not perfect. The concept has first been published by Coase in 1937 in his ambitious article the “Nature of the Firm” (Williamson, 1993, 18-33).

Markets provide strong incentives for trade: if buyers and sellers could gain at all from transacting with one another, we suppose they would do so. In other words, we implicitly assumed the market operating smoothly, so that trade making buyers and sellers better off would always be completed.

In fact this is a huge assumption as recognized by transaction costs economics. Markets often fail to function smoothly: to make a trade in the real market, buyer and sellers have to find another, negotiate terms, write contracts, swap goods, and so forth. All of these actions are expensive. When these transaction costs overwhelm the gains from a market trade, the market breaks down and opportunities to make both buyers and sellers better off routinely go untapped, as the cost of using the market rises too high (Bharat A., Khanna T. and Rivkin J., 2000).

Mutually beneficial trades thus fall apart as the act of transacting with another is not free, as supposed by classical economics: there is a cost of using the pricing mechanism. In short, we can say that transaction costs are analogous to friction: they are dead weight losses that reduce efficiency. They make transactions more costly and less likely to occur.

Oliver Williamson refined the concept of transaction costs by introducing 2 critical behavioral assumptions:

- **Bounded rationality:**
  - A concept Williamson took from Simon (Simon, 1978): human actors are intendedly rational (take decision based on self-interest) but only limited so as they lack the intellectual capacity, information, … to do so effectively. As a result, (complex) contracts are by definition incomplete.

- **Opportunism:**
  - Due to incomplete contracting, many firms will act in a self-interested manner with guile. This includes all calculated efforts to mislead, deceive or confuse. This concept can be brought back to the fact that supply markets are imperfect markets and decisions are always liked with uncertainty. In general, sourcing decisions simply must be uncertain because the buyer never knows all aspects of the performance of his suppliers and their development in the future. Combined with the fact each company will try to maximize profit (at least in the long run), economic agents are disclosing information in a selective and distorted manner and will take an opportunistic view whenever possible.

*Example 1*: when company X wanted to change to another adhesive supplier, the preferred supplier claimed company X would take serious risks as only their product contained the patented “NORU” technology.
After several months of research, company X discovered this NORU terminology was only a marketing term.

Example 2: A Belron distribution center returned a badge of glass to the supplier for reasons of bad quality. Several months later, the same badge was delivered to another distribution center, known for its lesser attention to incoming quality control.

Although the first insight of transaction cost economics was to explain the existence of the firm, it also brought new insights about just how inadequate” standard (neo-)classical economics was: firms are not identical, information is not free and the economic actor is not rational.

Coase and Williamson’s vision radically changed our view on markets, firms and actors, and their positions are now widely accepted:

- 54 years after his ground-breaking article, the economic community recognized Coase by granting him the Nobel Price in 1991 for his work on transaction costs.
- Simon received the Nobel Price in 1978 for his work on bounded rationality.
- In 2002, the concept of the rational homo economicus was again brought down by Amos Tversky and Daniel Kahneman, who received the Nobel Price for their thesis on prospect theory: they discovered there is a system in the madness and that the rational homo economicus makes mistakes, that are even predictable.

Example: although they were cheaper, the buyer did not want to grant the telecom expenditure to Belgacom, the incumbent telecom operator for many years in Belgium: the buyer claimed Belgacom had been charging too much money in the past and now they should be punished by not granting them the contract.

These concepts appear to be good news for business society: this real market, in which resources are not allocated solely by prices, is less violent and prices do not tend to be caught in a downward spiral to reach the long-term marginal production costs. The market as shaped by modern states to promote a healthy competition, is not working as it should. A logical conclusion could be that companies need buyers that do different things than aligning themselves with the free market?

It can be argued that by even increasing the transaction costs - through for example the diffusion of obscure information - the market will become less transparent and - more important – even less competitive, thus securing prices. People’s (buyers) behavior – and this is new in comparison to neo-classical economics - can thus have an impact on the survival of the company.

In practice, the vast majority of managers (that I have come across) believe their remedies are positively impacting the survival of the company in the long-run. These can be therapies like cost-saving initiatives, opportunism as described by Williamson, marketing campaigns, …
British Airways chief executive Rod Eddington said the airline could follow Swissair Group and Sabena into bankruptcy if unions prevent managers from cutting costs... it needs to cut costs to cope with increasing competition ... (Financial Post – Canada July 28, 2003)

ATARI, a video game leader of the pioneering days understood marketing, which is critical when consumers have no background with a product. But as consumers became more sophisticated, and others launched better games, ATARI lagged on its product range and instead threw even more funds at marketing (Luesly, 2002, FT).

Ford expects to get rid of 1,700 staff in Germany as the US carmaker begins another round of cost-cutting in Europe under Lewis Booth, its recently appointed chief... (Financial Times, 30/9)

Is this true? Will these programs protect the company in the long run, as some managers would like us to believe? In a free market, this would only be the case if the buyer reduces the costs more than the competition does but as discussed... the free market does seem to exist only in the mind of neo-classical economists and not in the real world?

I assert this might be a large mistake as I feel there is a tendency of industries converging towards a competitive market, or at least a market close to the Smithian ideal: the process is only less pronounced and it will materialize slower than in the Smithian world but the process is taking place. “Market imperfections are market failures only in the sense that they are departures from the model of perfect competition” (Williams, 1994, 230).

And yes, information might still be costly (but already less costly than before through the emergence of the internet), economic actors may not act rationally, ... but these transaction costs are only a friction to the perfect market and will only slow down the journey (see figure) towards the “Domain of Smith” (which is in essence the extreme of the “Domain of Balance”). This process will happen probably sooner than later as the journey is facilitated by modern nations through the domain of lawful competition. This is a concept that should be understood by strategic buyers that are investigating the cost part of the profit equation, as put forward in the beginning of this chapter 3: it might take
some time (months/years) but through the application of the right processes, the fundamentals of a free market will apply and prices of suppliers will be brought down to their long-term marginal production costs.

The free market works despite managers, not because managers know more than anyone else. The most brilliant buyers among us will observe this and align themselves with this process and hence try even to speed up the supplier’s journey towards the free market.

So Smith is not dead, he is alive and in the 21th century, the market is perfect … over time and all efforts to save costs to a lesser extent than the competition, opportunism … will only postpone – but not stop - the execution of the Smithian process and kill margins and … companies. “Time is the important mechanism that keeps everything from happening at once” (quote by Alfred Marshall in 1890, Williams 1994, 244).

This “free-market” policy of modern nations is supporting the purchaser but can also be working against him (at least against his company) as a perfect market tends to wipe out all companies with a relative high cost position. This is an important remark and puts a much wider responsibility on the purchaser than ever before.

Just saving costs is thus not good enough. If buyers do not influence their fixed short-term production costs before the competition will do, their companies will go bankrupt (at least under conditions of a competitive market …which is a condition that might be reached sooner than later, as there is a tendency of markets to move to a competitive market. In addition, the “Domain of Balance” is an ideal setting to achieve this state).

The business society is full of examples of this theory:

A recent study of Hannah (Hannah, 1997, 3), examines the fate of the 100 largest industrial firms in the world in 1912 over the period to 1995.

The firms in the study were large even by today’s standards: the largest (US Steel) employed 221,025 workers in 1912. These British, German, American, … firms were also firms that already stood the test of time, being on average 32 years old. They were, on the whole, firms that contemporary stock market analyst considered attractive and safe because of their consistently reliable record of generous but sustainable dividends. Hannah demonstrates half of these firms did not exist anymore in 1995, 1 out of 3 went bankrupt and only 21% can still be categorised as top 100 firms.

The average lifetime of an S&P quoted company has been falling dramatically from an average 75 years in the 1920’s to 20 years today and a projected 15 years in the next 2 decades (Cap Gemini/Ernst&Young, 2002, 3).

In 1978, around 10,000 companies failed in the US per year. By 1994, the number was 100,000 a year. In 1950, 10,000 new companies were started up; by 2000 the yearly average had reached 800,000. Though the figures are generally higher for the US than in Europe, the trends are nearly identical (Cap Gemini/Ernst&Young, 2002, 3).
Following these examples, I share the view of researchers like Cox (Cox, 1997, 162) that over time, the majority of these companies have been put in a competitive environment, pushing sales prices below their marginal production costs, which they have not been able to change more than the competition.

All these examples demonstrate the “Domain of Balance” is working much better than it ever has before, probably accelerated by the so-called information age, the movement toward free trade and the emergence of consultants...

I assume the above-mentioned companies had put forward, before they went bankrupt, cost-cutting programs to safeguard their margins? Probably a fairly large number among them had also celebrated early successes like price-down deals with suppliers. Probably some buyers have proclaimed that they have done the greatest negotiation of their life? And most probably, CEO’s have announced reassuring cost-cutting plans to the stock market.

- Ford cuts 3000 jobs or third of workforce at plant in Genk/Belgium. The stock of Ford increased after the news was issued (Het Belang van Limburg, 2003).

I believe all these reassuring messages have put a lot of decision makers and shareholders in a warm “comfort-zone” of “we are doing well”. This warm comfort-zone distorts the vision of business leaders and the danger is they are not able to see the only truth for long-term business survival anymore: change the long-term production costs more than the competitors. As a result of all good news and actions combined with the non-transparency of the Coasian environment, they forgot the price pressure of a free market still applies: it may just have been slowed down (if lucky) but it may also have been speeded up, for example through the introduction of such world famous concepts like supply chain integration and outsourcing, making certain assets available to the rest of the market. These concepts may have changed the short-term production costs but may have pushed the production possibility boundary outward for the whole industry, and not only for themselves.

“Through the rapid diffusion of best practices by consultants, management books, employees … entire industries were adopting the same management techniques. As a result, the productivity frontier (goods are produced with lesser inputs) have shifted outward, effectively raising the bar for everyone but with relative improvement for no one” (Porter, 1996).

In my practice and in the panel of companies I interrogated, I found numerous examples of “feel good stories”, issued by “False-Comfort” managers:

- A buyer, being very proud he prevented his supplier – supplying already 100% of his consumption for the last 8 years – from applying a 3% price increase: “it was a great negotiation and we will keep our costs stable which is against the market.

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6 Comfort-Zone: Alexis Brooks in a face to face discussion with author, Mastercourse Maastricht 2002
7 Term by Raf Verheyden, August 2003
trend” as soon as the ownership had taken away from him and a competitive environment had been created, a 28% price decrease had been achieved (2003).

- A buyer claimed a deal for 800,000 Euro of savings, again an achievement that was celebrated throughout the whole company. One year later, the deal is still not implemented (2003).

- The investment in a particular product would bring a strong increase in sales volume with very attractive margins, said the salesman. An ex-post measurement one year later revealed ... no sign of extra sales and thin margins on that particular product (2003).

In order to determine the effectiveness of a buyer (when economic efficiency is the goal), one should apply the notion of operational effectiveness as defined by Porter (Porter, 1996, 4): “Operational Effectiveness is performing similar activities better than rivals.”

Having said all this, many gains by the so-called false-comfort managers are very necessary and they are indeed worth celebrating. But in most cases, they are only a catch-up with their competitors. And a CEO or at least a strategic buyer should have the understanding to judge how important the action is for the long-term survival of the company.

*Mr Messier, chief executive of Vivendi Universal from November 1994 until July 2002, led what was once France's largest private sector employer to the brink of bankruptcy with a string of deals and stock repurchases. (Michaels & Johnson, 2003, FT).*

To conclude: a purchaser is responsible for reducing costs to the same or higher level than the competition. In his aim for cost reduction, a legal framework set-up by the government to promote a healthy competition, is supporting him. Once the purchaser can reach the stage of a free market, an almost automatic process will force the supplier to innovate, pushing the productivity boundary further outward, achieving lower long-term marginal production costs. At the same time, the newly created value will be passed to the buyer. Throughout this process, transaction costs and warm-comfort zones will be a (seriously) disturbing factor. Transaction costs are real but the concept can be misleading as it hides the underlying principles of a perfect market. Coase is right, but so is Smith. We can see it as a Short Term (Coase) and Long Term (Smith) process. In the end, the price mechanism, although made less efficient by transaction costs, will allocate resources.

False Comfort zones would not exist in a Neo-Classical market, as the impact of actions would be clear and understood by everybody. It is Coasian Transaction Cost Economics, which helps us apply economic theory to the real world, that explain how it is that business leaders get misled into “warm comfort zones” by “false comfort managers” and feel good stories.
“Under condition of perfect competition, opportunism would not have been possible” (Cow, 2002, 198).

3.3 Portfolio Model part I: COST Model

3.3.1 The Model

Having acquired a thorough knowledge of the origin, position and the inevitable migration path of costs, we are now in a position to propose a portfolio model.

Research (Gelderman and van Weele, 2002, 1) indicates the Kraljic Portfolio Model (Kraljic, 1983) is the most popular portfolio model amongst strategic buyers.

In this model, Kraljic brilliantly explains the different strategies a buyer could adopt, depending upon which of the 4 boxes an expenditure would be classified in (see figure): Leverage items allow the buying company to exploit its full purchasing power through negotiations, target pricing and product substitution. Strategic items require intense relationship with the supplier like for instance accurate demand forecasting, logistics and inventory control in order to safeguard the supply. Non-critical items require product standardization, efficient processing, order volume and inventory optimization. Bottleneck items require safeguard of supply (at cost premium if necessary) and vendor control. The general idea of the model is to minimize supply vulnerabilities and make the most of the buying power (Kraljic, 1983, 112).

One box of this excellent model however might give the wrong impression, especially in the light of our discussions so far; the box “strategic” refers to all expenditure that is large and – more importantly - that has only 1 (or a limited number of) supplier(s). From the previous chapters, we can conclude that in absence of competition, prices will not be driven to their long-term marginal production costs and the supplier
will appropriate much of the value from the association.
In essence, all expenditure in this box will be paid a too high price from the point of view of buyers aiming for economic efficiency. One can hardly call this “strategic”.
For reasons of perception, I renamed the “Strategic” box of Kraljic into “Burden” (= problem): by calling this expenditure “burden”, it is my view and experience there will be an internal pressure to critically assess the real value proposition of the supplier. Suppliers that are called “strategic” are much less challenged as the word “strategic” gives the impression of being crucial to the business. It is like saying “do not touch as it is too dangerous”. I however assert that suppliers that offer the same value proposition to the competition and that charge you a too high price, are perhaps necessary, but not strategic.
In certain circumstances it will be difficult to change or challenge such a supplier as he might have a monopoly position. But this call for action might start a (long-term) campaign to develop alternative offers and - if successful - this will yield a lot of money.

Within Belron, we have a famous example of the power of perception: just by changing the name from “strategic” to “burden”, the board challenged – which they had never done before – a major expenditure and urged the director of purchasing to take further action, even if this would put the supplier relationship at risk (Corrigan, 2001).

3.3.2 The Cost Model in practice: a quest for operational efficiency

The aim of continuous cost reduction, to finally achieving the lowest cost of production, is also called “operational efficiency” (Masternotes D5, 2002) i.e. the minimum input against the maximum output.

What follows is a conceptual and 2 step approach for organizations to reduce their major costs (reference the top part of the model) to the long-term marginal production costs. It is based on the concept that the (perfect) market is driving prices and stimulates innovation to reduce costs.

The next chapter 3.3.2.1 will explain the organizational approach to achieve a price reduction, followed by chapter 3.3.2.2 to achieve a total cost reduction.

Figure 7: Price Down, Cost Down Model
The model proposed by Jon Hughes (Hughes, 1998) on tactical and strategic cost management offers a good framework (reference figure).

This model is widely and successfully applied within the Belron group.

The model excels through its simplicity and all understand quickly the advantages of this segmented approach: first take the low-hanging fruit (quick wins/price down) and only then apply strategic and longer-term cost management projects.

3.3.2.1 Step 1: Develop BATNA’s

“Competition leads to cheaper prices” (Financial Times, 2002).

Although Smith is right and competition is the way to pass value from the supplier to the buyer, his theory is only empirically based. Researchers in negotiation dynamics have overcome this and have brilliantly demonstrated the concept of competition and appropriating value, through their in-depth scientific research.

Van Poucke and Goovaerts (Goovaerts, 1999, 172), in my view the top European researchers in negotiation dynamics, claim the single most important component of any negotiation is to develop Best Alternative’s To a Negotiated Agreement (BATNA’s\(^8\)). In Smithian terms: “Make the market more competitive by introducing more competitors” (BATNA equals competitor).

The more and the better the BATNA ‘s, the more the balance of power will shift to the camp of the buyer, enabling him to appropriate value from the negotiation process.

Fundamentally, the most important goal of a buyer – aiming for economic efficiency - is to develop BATNA’s and to move as much spend as he can into the leverage quadrant.

This is not always as easy as it seems: in some cases the competitive pressure in the market will be modest but in other cases internal demands will impede the creation of a BATNA.

Example: The 0800 telecom supply is offered by min. 3 parties in most European countries but the specifications, set by IT directors, are so stringent they always end up with the incumbent.

Example: The newly appointed group buyer from company x was allowed to conclude a European deal on PC’s but only with Compaq, as the internal stakeholders were not ready to change to another brand.

\(^8\) BATNA: Term from Fisher&Ury, first published in 1981 in “Getting to Yes”
3.3.2.2 Step 2: Cost Down/Cost Out

Productivity ... flourishes when competition becomes so intense that managers must innovate and competitors must adopt innovations quickly (Farrell, Terwilliger and Allen, 2003).

Having acquired a BATNA or even better a buyer dominant position, one is able to commence phase 2: drive costs down/out. In case the supplier would have the dominant position, phase 2 is still worthwhile to explore, although the results will probably be somewhat reduced (Cox, 2000/van Weele).

Strategic Cost Management initiatives typically require much more innovative thinking and time than simple price-down projects. Here we refer to world-class purchasing concepts like supplier integration, lean thinking, TQM, target costing or other tools that require an intense buyer-supplier collaboration.

“Effective and sustainable cost reduction is not just about applying pressure on suppliers (it is necessary but it goes beyond that). That is only a tactical, short-term solution to an immediate problem that a company faces. In some circumstances it can be a complete failure, particularly if the buyer has little power over the supply base. The only successful way forward is to transport purchasing activity fundamentally from its often, narrow functional focus into a more strategic and business driven process”. (Hughes, 1998, 120)

3.3.2.3 A paradox?

The strategic cost management approach requires intense buyer-supplier relationships, as illustrated by most current world-class purchasing tools. Referring to the previous chapters, for some Western readers it may sound paradoxical one needs a BATNA or a buyer dominant position in order to successfully develop such relationship, it is not: within the concept of supply chain thinking, the concept of true collaboration like for example “partnership” implies, first the existence of a coordinated attempt to eradicate waste and unnecessary cost in order to enhance the value delivered to the end customer.

Second, and here is the difference between the Western and Japanese method, true partnership in Western Society implies an equitable distribution of gains and pains generated between the members of the association. In short, partnership implies a balance of, or an absence of, power between those involved in the exchange. In the Japanese model however, where a lot of these supply chain projects have been invented and successfully implemented, no such balance exists. Japanese assemblers exchange loyalty for performance. Particular suppliers will enjoy a preferred status and will be retained on an ongoing basis, but this is on condition they are able to engineer year-on-year improvements in their output.
What keeps the supplier incentivised, however, is not simply the carrot of the promise of continued work, but also the stick or the threat that if the supplier does not perform they will be replaced with another.

If a component is considered commercially critically to a vehicle, a Japanese assembler will take an equity stake in a supplier. Where an assembler does not own an equity stake, however it rarely opts to single source. Instead it will choose to source from 2 suppliers simultaneously, so that if one supplier underperforms, then it knows the business will go instead to a second supplier.

The scope for Western opportunism is further reduced because the Japanese assemblers insist upon cost transparency. Thus because Japanese assemblers have fewer suppliers to manage, the costs associated with monitoring them for opportunism are correspondingly lower (Cox, 2002, 199).

In addition to the work of Cox, Prof. van Weele & Anderson (van Weele) claim in their study that there exist very few successful partnerships in the Western world. They discovered that partnerships have more chances to be successful if they are not on a basis of equal power.

This competitive environment is even set between companies from the same group. All Ford production facilities in Europe are constantly being evaluated against each other. Each period, KPI’s per plant like the number of cars per person, the cost per car, ... are published in each plant. The least performing plants may miss a new model and hence the prosperity of future work...
4. PRICE

After having explored the “cost” part of the profit equation in chapter 3, chapter 4 will be devoted to the “price” part.

4.1 Introduction: The importance of Price

At few moments since the end of World War II has downward pressure on prices been so great. Some of it stems from cyclical factors—such as sluggish economic growth in the Western economies and Japan—that have reined in consumer spending. There are newer sources as well: the vastly increased purchasing power of retailers, such as Wal-Mart, which can therefore pressure suppliers; the Internet, which adds to the transparency of markets by making it easier to compare prices; and the role of China and other burgeoning industrial powers whose low labor costs have reduced prices for manufactured goods. The one-two punch of cyclical and newer factors has eroded corporate pricing power and forced frustrated managers to look in every direction for ways to hold the line.

Pricing right is the fastest and most effective way for managers to increase profits. Consider the following table (Dolan & Simon, 1996, 24) with the different profit drivers depicted:

<table>
<thead>
<tr>
<th>PROFIT DRIVER</th>
<th>A 10% improvement</th>
<th>PROFIT IMPROVEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Old</td>
<td>New</td>
</tr>
<tr>
<td>Price</td>
<td>100</td>
<td>110</td>
</tr>
<tr>
<td>Var. Unit Cost</td>
<td>60</td>
<td>54</td>
</tr>
<tr>
<td>Sales Vol.</td>
<td>1</td>
<td>1.1</td>
</tr>
<tr>
<td>Fix Cost</td>
<td>30</td>
<td>27</td>
</tr>
</tbody>
</table>

Table 1: the impact of each profit driver

To be read as follows: a 10% improvement in price brings price up to 110. With everything else unchanged, this increases profit by 10 to 20 million.

The above table is also being confirmed by analyzing the average income statement of an S&P 1500 company: a price rise of 1 percent, if volumes remained stable, would generate an 8 percent increase in operating profits (see figure) an impact nearly 50 percent greater than that of a 1 percent fall in variable costs such as materials and direct labor and more

Figure 8: influence of price on profit
than three times greater than the impact of a 1 percent increase in volume. Unfortunately, the sword of pricing cuts both ways. A decrease of 1 percent in average prices has the opposite effect, bringing down operating profits by that same 8 percent if other factors remain steady. Managers may hope that higher volumes will compensate for revenues lost from lower prices and thereby raise profits, but this rarely happens; to continue the examination of typical S&P 1500 economics, volumes would have to rise by 18.7 percent just to offset the profit impact of a 5 percent price cut. Such demand sensitivity to price cuts is extremely rare. A strategy based on cutting prices to increase volumes and, as a result, to raise profits is generally doomed to failure in almost every market and industry (Marn, Roegner, and Zawada, 2003).

A leading agrochemical company had adjusted its prices downward to competitive levels. Later, unhappy with the resulting thin margins, the firm gave consideration to possible price increases: this led to a thorough value analysis, which showed that farmers valued the firm’s insecticide at 20% more than competitive levels. The analysis proved to be correct as a 20% price increase was implemented with no sales volume decline, yielding a fivefold profit increase. This was possible because its perceived value, measured in money terms is greater than the price. If selecting from several alternatives, the customer prefers the one offering the highest net value i.e. the greatest differential of perceived value over price (Dolan & Simon, 1996, 25).

4.2 Price & Competitive Advantage

In this chapter, we will be looking for ways to support the unit sales price, especially from a purchasing point of view.

From the above, we learned a modification in sales price has much more impact than a similar modification in costs. In the previous chapters, we also discussed the market (at least the market as depicted in the “Domain of Balance”) plays a constant attack on the sales price, which will finally be leveled down to its long-term marginal production cost:

- The market system is working much better than it ever has before, and as described earlier where there is maximum (market) efficiency, there is no profit. In fact, it is only through market imperfections that profit opportunities occur.
- Without market imperfections, ... firms can only hope for normal returns (Peteraf, 1993, 179-191).
- Economic rents can only be derived as long the there is ex ante uncertainty (Peteraf 1993, 179-191; Rumelt 1987, 137-158).

In the light of this knowledge, the quest for cost savings seems to have become an issue of minor importance for companies.
It is hence of utmost importance to protect the sales price and a buyer, who has to source from third parties a spend equaling on average 60% of the companies turnover (Hughes, 1998, 120), should assist here.

*Belron has a similar spend profile with a bought-in expenditure of 65% of its turnover.*

Various tactics might be offered to sustain the unit sales price but there is only one major approach, which is the opposite of what has been discussed in chapter 3: *avoid a competitive market* or - in other words - avoid your customers will develop a strong BATNA. Marketers would name this approach USP (unique Selling Point), modern strategists identify it as a competitive advantage, economists have called it monopoly. I call it VALUE.

The reason for adopting the word “VALUE” is again the same reason for changing the word “strategic” into “burden” in the COST matrix in chapter 3.3.1: it is all about perception. Suppliers are misusing the word “value” and buyers might take a passive line. This view is confirmed by my experience (DOW case, see below) as well as by the experience of several teachers from the master course like the senior purchase leaders from Akzo Nobel (Bartelse, 2001), HP (Perrigault, 2002) and Hughes.

In most cases, the so called “value” is being offered to the competition as well, hence the buyer is not better off than anybody else in the industry by collaborating with that supplier.

All mechanisms and products or services that make you different from possible competitors and hence that impede free competition deserve to be called value, as they would act as a barrier against the creation of BATNA’s, *avoiding a price erosion.* Ideally, a company would be different in more than 1 feature.

There is one exception: if the companies strategy is cost leadership (Porter, 1985, 11-26), price erosion is accepted and “value” would be called all items which lower your costs – on a sustainable basis – more than the competition.

To judge whether a feature will close markets and hence create value will demand experience from the decision maker and goes beyond the current training of most buyers (Study Notes, chapter D11). It is about taking decisions under circumstances of uncertainty (what will the reaction of the competitor/customer be?) but that’s how business success is achieved: entrepreneurial decision under uncertainty balanced against a possible high reward through value appropriation from your relationships, upstream and downstream (Cox, 1998).

*Fred Hassan CEO Pharmacia concerning the integration with Pfizer, creating the world’s preeminent pharmaceutical company, for about $53 billion in stock : “My primary concern was to make sure that the driving functions in the business stayed in good shape. In our business, that means R&D and marketing and sales”...”Lately, I*
have been putting the greatest part of my time into the product flow area, which, as I noted earlier, is the most important value driver in the business” (Hassan, 2002).

4.3 Isolating Mechanisms

“The rapid diffusion of technology may be good for economies, but companies derive the greatest advantage from innovations when competitors can’t adopt them quickly. Once many companies in a sector have implemented for example a set of IT applications, they become just another cost of doing business, not sources of competitive advantage (Farrell, Terwilliger and Allen, 2003).

The central theme for the purchaser has become how to develop competitive advantage(s) and avoid imitation by competitors, all within the legal framework of a modern state (“Domain of Balance”).Indeed, the sustainability of a competitive advantage relates back to its inimitability/substitutability. If a resource is easy and cheap to replicate, then it is likely to be offered by a large number of companies i.e. the resource will not be scarce anymore.

Routes to prevent imitation from happening have been developed by several key thinkers like for instance Porter with his famous five forces model (Porter, 1985, 11-26), in which he claims a company competitive position varies with the degree of substitutes and barriers to enter.

In my view, the most striking research can be found in the “Resource-Based View” literature, initiated by Penrose (Penrose, 1995), which takes the firm’s resources and capabilities as a principal basis to create a competitive advantage and the primary determinants of the firm’s profitability.

The theory suggests that the possessors of rent-generating assets should erect barriers to imitation. It is Rumelt who offers an answer to this barrier question. He borrows the biological term “isolating mechanism”, importing it into the organizational context, and defining it as any impediment to the imitative dissipation of rent (Rumelt, 1987, 145) i.e. isolating mechanisms retard imitation and prohibit a market from becoming competitive.

While innovation - in the organizational context - is the key to becoming different and initiating a competitive advantage, isolating mechanisms are the key to make it more sustainable.

In the following tables, horizontal and vertical isolating mechanisms have been listed.
The horizontal isolating mechanisms protect resource scarcity from imitation by horizontal competitors.
The vertical isolating mechanisms, based between firms involved in a vertical buyer-supplier relationship, prevent a market even be created.
**HORIZONTAL ISOLATING MECHANISMS:**

**PROPERTY RIGHTS**
- Licence/patents
  - The state or another legitimate authority grants a licence or a patent to guarantee exclusive ownership or control of a relatively scarce resource for a specified period and under given conditions.

**FIRST MOVER ADVANTAGES**
- Economies of Scale
  - If the minimum efficient scale of a business is comparable to the size of the market, and if the assets required are specialized to this use, a situation of natural monopoly arises. Additional entrant would be unable to cover their fixed costs while pricing competitively.
  - Examples are Nuclear Power Plants and telephony distribution by the first local telecom operators
- Information Impactedness
  - This means the knowledge on which an innovation is based remains largely tacit and uncodified. It is difficult for potential competitors to obtain critical knowledge under these circumstances, unless a key employee decides to defect.
- Causal Ambiguity
  - This occurs if the basis of an innovation is particularly complex and patch dependent. At the limit, even the innovating firm may be unable to trace the precise causality of its innovation. In these circumstances, imitation is impossible. Or in other words, if the cause of innovation is transparent, then imitation will follow quickly and opportunity to earn rents will be lost.
- Reputation Effects
  - Buyers cannot accurately evaluate many products and services until after they have been consumed. A supplier’s reputation therefore plays a critical role in its ability to sell such “experience” goods/services. First movers can obtain reputational advantages because the strength of a supplier’s reputation depends largely on the length of time is has been providing satisfactory goods or services.
- Buyer Switching Costs
  - If early buyers of a new product find it subsequently costly to switch to a competitor’s offering, then the first mover has an advantage. These costs are high when the buyer must make substantial dedicated investment in people or equipment in order to use the product.
- Buyer Search Costs
  - These are high when the buyer is required to invest substantial amounts of
time and money in understanding the complexities of different supply offerings. Firms seek to economise on these costs by free riding on the presumed analyses of the well informed and buying the market leader’s product or service. This provides a first mover advantage as long as followers’ products are not significantly better.

- Communication good Effects
  - These effects arise when a product of service acts as a means of social coordination between different users (e.g. telephone networks, PC software). When a communication good is also an experience good, as in the case of software, then there is a need for standardisation and “reputation bonding”. The first mover’s product or service thus become a de facto industry standard.
  - Example: Microsoft

**CARTELS**
- Oligopolies
  - Under conditions of oligopoly, firms often cooperate on sourcing, pricing and output decisions. Potential market entrants are blocked by a coordinated response.

Table 2: Horizontal Isolating Mechanisms

<table>
<thead>
<tr>
<th>VERTICAL ISOLATING MECHANISMS:</th>
</tr>
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<tbody>
<tr>
<td>- Information Asymmetry</td>
</tr>
<tr>
<td>- The seller is better informed than the buyer. This Isolating Mechanism refers to Transaction Costs Economics, especially the notion of bounded rationality and opportunism.</td>
</tr>
<tr>
<td>- <em>Pilkington, Belron’s</em> most important glass supplier, <em>is trying to convince Belron that the windscreens of other manufacturers are cheaper because they are not made to the same standards and hence are of lower quality. Belron is now conducting extensive laboratory tests to check this argument ...</em></td>
</tr>
<tr>
<td>- Existing Relationships</td>
</tr>
<tr>
<td>- Sales Managers often develop very good relationships with their clients, offering them end-of year presents, tickets to events and in some cases even holidays. As a result, a relationship is being developed and competition is relaxed and the buyer does not look for alternatives. He will find millions of arguments not to change and in the worst case, even sabotage a tender.</td>
</tr>
<tr>
<td>- <em>Although the category waste services is a major expenditure for company X, it has not been tendered for the last 8 years, although prices have been increased year on year.</em></td>
</tr>
<tr>
<td>- Reluctance to Change (including ownership)</td>
</tr>
<tr>
<td>- This I.M. is even more important than “existing relationships”. It refers to the theory of Nobel Price Winner 2002 Kahneman (Kahneman, 1994, 71-78):</td>
</tr>
</tbody>
</table>
“tell me what you will loose and I will predict your decision”. People are reluctant to change. They value loss twice as high as a possible gain.

- When the Lead Buyer approached the HR director of a local business unit to discuss the possibilities for a European consolidation of our group insurances, the HR director said: “Very good idea, I would love to discuss it but before we start, I will never change to another supplier as the current one is excellent and delivers a very good service”.

- Although a world-wide PC deal with IBM was approved by all IT directors in a conference call, a local IT employee bought 90 Dell PC’s: “Yes I agreed not to do so, but I find it pleasant to discuss and negotiate with suppliers”.

- When finally, under a lot of pressure, a tender on waste services was jointly issued by company X and Y (see higher), company X stayed with its old supplier, although financially they should have changed. Only company Y did change to a new supplier. The main difference between the 2 companies was that the previous stakeholder of company Y had not been involved in the tender process as he had been promoted to another function...

### Table 3: Vertical Isolating Mechanisms

The first vertical isolating mechanism – Information Asymmetry – is taken from Andrew Cox (Cox, 1997), the latter 2 – Existing Relationships and Reluctance to Change - are taken from my practice as a Strategic Sourcing Manager for a multinational company, managing quite a diverse scale of categories. Many times I have come across these latter two isolating mechanisms, which are often neglected by practitioners and academics, but are very important: it is my view that these two – especially Reluctance to Change - are among the main reasons that large multinationals often have to address huge communication programs before implementing consolidated buying across several countries. They are one of the important elements that render these central cost-saving programs a complete failure. My view is being confirmed by numerous other sources like for example DHL (O’Brien, 2003), Q8 (Hindori, 2003), AT Kearney (Klapwijk, 2002), Proctor&Gamble (Collins, 2003), Nestlé (Wanner, 2003).

For strategic buyers, it is important to understand the power of these mechanisms and apply them on all VALUE resources i.e. products/services/superior organizational routines… that make your company unique.

Remark: The isolating mechanisms can also serve as a guideline for buyers sourcing for operational efficiency (reference chapter 3): they might have to conquer these isolating mechanisms in order to make their supply base more competitive.

(The use of the term “resources” is taken from the Resource-Based View and relates to all resources of the firm like financial, human, tangible and intangible assets, capital assets etc.)
4.4 Portfolio Model part II: VALUE Model

Having acquired a thorough knowledge of the origin, position and importance of the price, we are now in a position to propose a second portfolio model. The reason for setting these resources apart from the cost model is that the focus of the buyer will be different: from striving for a maximum of operational efficiency, he will now be aiming to develop, protect and enhance the competitive advantage.

Here we need a different animal than the traditional purchaser, as the focus will be on entrepreneurship (doing what is new ≠ copying of what is already known) and relationship management. The competitive environment will even be relaxed and as a result, we will have to accept the cost price will not be reduced to its long-term marginal production costs, in other words all resources in the value model will be paid a price premium!

Value resources should be positioned as follows:

In the top part of the model, all resources with a High Value are placed. These are resources with a clear and direct link to the competitive advantage that closes the market.

In the bottom part of the model, all resources with a Low Value are positioned. These are resources with a blurred and/or indirect link to the competitive advantage.

Be aware that a large expenditure might be a low competitive advantage and vice versa.

Strategic Box:
- High risk but also high competitive advantage. In most cases, we will have only 1 supplier or produce the product in-house.
- The period (time) remains long because
  - There is only 1 supplier (or in-house) and the knowledge is only shared between 2 parties, preventing diffusion.
  - Due to the intense relationship, the supplier will not offer the value resource elsewhere (we hope)

Figure 9: Value Model
- Examples:
  - For years, Belron procured its adhesive from 1 company. The adhesive allowed the Belron customers to drive away within 1 hour. The competition was using an adhesive with drive-away times up to 24 and even 48 hours.
  - Consumers pay a premium to drive an Audi. The brand image should be handled with care as the price Audi could get for its cars without the premium image would probably collapse.
  - To safeguard its brand, Mercedes Benz, shareholder of Mitsibushi through Daimler-Crysler, has so far only allowed its motors in selected cases such as the PT cruiser and a few Jeeps to protect the brand image (Harnischfeger, 2003).
  - For the first personal computer, IBM decided to outsource the development of DOS to Microsoft: instead of having a strategic product, they ended up having a burden supplier.

Tactical Box:
- The risk is much lower (than the strategic box) as alternative suppliers can be found on the market or the competitive advantage can be replicated in a relatively short period of time.
- Examples:
  - PSA Citroen, the French carmaker, is known for its large number of alliances with rivals (Harnischfeger, 2003).
  - The publicity of the new BMW 5 (FT, website Sept. 2003) is centered around its innovative engine, developed by BMW engineers. It will give BMW a competitive advantage and confirms the brand as being innovative and sportive. However it will not take long for Audi, ... to develop a similar engine.
  - Volvo was one of the first to offer side airbags and it reconfirmed the brand as being safe. Shortly afterwards, other manufacturers offered the side airbags as well.
  - Belron was the first to offer a mobile glass replacement service. The risk was limited but the value resource has been copied in a relatively short period of time.
Conscious box:
- The risks are limited but so is the link to the competitive advantage.
- Examples are:
  - Expensive company cars lead to a higher employee satisfaction, which in turn might be considered a competitive advantage.
  - All our French fitters would kill for a set of Fiacom tools. Although we could easily source similar tools cheaper, we accept this premium and give our fitters such toolboxes as we believe we get a higher fitter satisfaction in return, which will finally lead to a competitive advantage (better service offering).

Dilemma box:
- This box is similar to the bottleneck box in the cost model. We are conscious about the value and accept the burden of having only 1 supplier. We should however constantly address the question if the competitive advantage balances correctly against the problems and costs involved in securing stocks.
- Examples:
  - the Fiacom toolbox of the French fitters, in case the supply would be a problem. In such case, it might be better to transfer this product to the cost model, in the leverage or non-critical box, and invite more suppliers to the table.

The power of this model is embedded in two elements: first it should launch the discussion of whether a supplier offers a competitive advantage. And only if the answer is positive, competition can be relaxed!
Secondly, it should make the company aware of the temporary character of monopolies, forcing it to act and to change the character of the relationship as soon as the competitive advantage has been eroded. In such case, the company should shift the resource to the cost model and adopt normal purchasing practices as discussed in the previous chapters. Neglecting this knowledge will turn the previous competitive advantage into a competitive cost disadvantage.
A strategic item for example might become a burden, just by the emergence of a competitive product. The firm should recognize this as soon as possible and either innovate or drive the supplier to the leverage box.

In my view, this is quite a difficult exercise but some companies have successfully adopted such strategies like for instance
- The mobile phone operator Ericson outsourced its manufacturing facilities of mobile phones and committed its scarce resources to new activities
- **IBM withdrew from the market for hard disks drives when it became a commodity**
  *(Business Wire, 2002 / Nairn, 2002)*

And even more importantly, the value items in the portfolio model should be **left as obscure as possible**, especially the strategic items! In such cases, benchmarking competitors will find it difficult to determine the exact causes of success.
5. TRADE-OFF between COST and VALUE

Cost (Operational Efficiency) and Value (Competitive Advantage) are both essential to superior performance (Porter, 1996 and Hughes, 1998).

“Some staff, particularly sales and marketing may be inclined to block or pay lip service to major cost initiatives. It is often argued that the customer facing front of the business is where executive attention should be concentrated. There are few sectors that can now afford such a one-dimensional approach. It is too easy to leave the back door of business wide open”. (Hughes, 1998, 118).

A company can outperform rivals only if it can establish a difference that it can preserve and purchasers are also responsible for this challenge.

Constant improvement in operational effectiveness is necessary to achieve superior profitability, however it is usually not sufficient. Few companies have competed successfully on the basis of operational effectiveness over an extended period, and staying ahead of rivals gets harder every day. The most obvious reason for this is the rapid diffusion of best practices through consultants, management books, …Competitors can quickly imitate management techniques, new technologies, … and superior ways of meeting customers’ needs. The most generic solutions – those that can be used in multiple settings – diffuse the fastest. And as discussed in chapter 3, this is the objective of the “Domain of Balance”.

And the more that rivals outsource activities to efficient third parties, the more they look alike: the isolating mechanisms fade away as these practices make the “value” element tangible and accessible to the competition. This is acceptable for resources in the Cost model, but not for resources in the Value model.

Few companies have noticed this and bit-by-bit, almost imperceptibly, management tools have taken place of strategy (competitive advantage): managers have let operational effectiveness supplant strategy (Porter, 1996).

In confusing the two, managers – doing the act of buying - have unintentionally backed into a way of thinking about competition that is driving many industries towards competitive convergence, which is in no one’s best interest and is not inevitable.

Strategic buyers must clearly distinguish operational effectiveness from competitive advantage. Both are essential but the two agendas are different. The operational agenda of the Cost model involves continual improvement everywhere there are no trade-offs. Failure to do this creates vulnerability even for companies with a good strategy.

A company must continually improve its operational effectiveness and actively try to shift the productivity frontier; at the same time, there needs to be an ongoing effort to extend its uniqueness while strengthening the fit among its activities (Porter, 1996).
A strategic buyer should thus position his spend either in the cost model, or in the value model. By putting resources in the value model, he accepts the burden of paying a premium. In other words, he should be aware he is making a trade-off between the lowest cost and the competitive advantage and that these trade-offs are essential to the competitive advantage. Simultaneous improvement of costs and differentiation is only possible when a company begins far behind the productivity frontier or when the frontier shifts outwards (Porter, 1996).

At the frontier, where companies have achieved best practice, the trade-off is very real indeed. This is a very important lesson for all decision makers: how big is the cost premium a CFO would accept for having a competitive advantage, which – by nature - is always difficult to quantify?

Example: Company x has its own distribution centers, which might give a competitive advantage. How far should company x go in developing suppliers and thus make the market more efficient in order to obtain a higher rotation and thus lower costs?

It is thus imperative to plainly understand which features support value and hence accept the burden of paying a premium only for those items (and not for the others!).

We should be aware of this very important lesson for business and the Cost-Value Portfolio model is a simple two-dimensional way of visualizing this phenomenon.

The model can be used only internally but can also be shared with suppliers as well: a buyer could ask the seller to position himself in one of the boxes. If the view of the buyer and the
seller is not the same, then this is perhaps the strongest driver for potential to create new value.

*Continental airlines tried to imitate the low-cost airline SouthWest and decided to straddle, i.e. compete in 2 ways, in trying to be low cost on some routes and full service on others. Continental – ultimately being grounded - paid an enormous straddling penalty. It was not possible to marry the low cost activities with the full service activities like standard travel-agent commissions, frequent flyer programs.... SouthWest airlines happens to be consistent with its low cost because its frequent departures are facilitated by a number of low cost activities (Porter, 1996).*
6. CONCLUSION

Unless a company constantly innovates, there is a clear tendency to approach a competitive market, which will shrink margins. This puts a burden on the purchaser, who has to excel in reducing the total cost of his company and at the same time, alongside with marketing and other functions, protect and develop competitive advantages.

Despite this duality, Purchasing is actually quite simple: it is
- Sourcing for the lowest cost through the development of a competitive market, an exercise that is facilitated by modern nations as they have created an ideal environment to do so.
- Sourcing for the highest competitive advantage through innovation and Isolating Mechanisms.

CEO’s, CFO’s and strategic buyers should be aware that some resources are best not operating at full efficiency and that it is worth paying a premium for a competitive advantage: cost cutting programs might be well paying off in the short run, but might destroy the companies long term survival.

All purchasing professionals should not leave too much room for intuition-guided purchasing but adopt a process-guided approach: Purchasing is a science, not an art.
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