Abstract. In order to sustain growth, businesses must execute effective cost reduction strategies. It is imperative to insure that procurement processes deliver value and achieve sustained competitive advantage for the global enterprise. One of the ways this can be accomplished is by building relationships with key suppliers.

Through well established, strategic relationships, significant cost savings can be delivered to the bottom lines of multiple business units. Enterprise wide solutions can focus on benchmarking supplier selection criteria, contract terms, spend and discount rate information, pricing, lead time, warranty and rebate information.

Several leading edge companies including Chevron, IBM, Nokia, Honda, Harley-Davidson and Nordstrom have worked to develop and execute cutting edge, innovative cost management strategies that have given them a competitive edge in their respective industries. This presentation will

(a) provide a roadmap of cost management strategies
(b) describe specific innovative strategies that have achieved shared cost reduction and value chain benefits for companies and their supply chain partners.
(c) list key factors required to establish and maintain long-term supplier relationships
(d) discuss challenges to sustaining these long term partnerships and

Following the presentation, supply chain professionals will be able to adopt specific strategies to strengthen their own supplier relationship management processes and identify strategic cost reduction processes that will contribute to their corporate bottom lines.

Background. Companies that wish to be best-in-class in the field of Supply Chain Management must understand that they cannot do so without a world class supplier base. World class suppliers are attracted to world class customers. These customers demonstrate a corporate vision that places strong emphasis on effective and strong supplier relationships and seek to drive value to its bottom line through effective supply chain management processes. This vision is rooted in fundamental principles of sound procurement service delivery. The driving force for this service delivery goes beyond price and includes technology, quality, safety, reliability, environmental awareness, on time delivery and total cost. While cost reduction is a key pillar of a Procurement organization’s overall vision, the focus should be on a cost management strategy versus short term “hits” though strong-arm negotiations.
Developing a cost management strategy – A Roadmap for Success. Before one develops a cost management strategy, it is imperative that all those involved in executing the strategy have a clear understanding of the words “cost”, “management” and “strategy”.

The word cost means different things to different people in the supply chain. To a person from marketing, the opportunity cost of lost sales is perhaps more important than the procurement view of purchase price of a product or service. Those in manufacturing and operations are more interested in throughput where a line shutdown would be considered an unacceptable cost. Logistics professionals think about cost in terms of speed of delivery and would much prefer to send a shipment by a slower mode of transportation. Finance looks at the cost of money and prefer to delay payments to suppliers in order to save on interest costs. From a quality perspective, one would consider the cost of warranties, rework, scrap, customer returns etc. In building a strategy one must consider these various perspectives that are commonly referred to as the total cost of ownership.

Managing cost is more than mere price reduction. It is a longer term strategy and requires a more holistic view of the business. The important point to remember is that any decision that helps reduce price must be one that is sustainable. Squeezing a supplier’s profit margin may bring short term benefits in the form of price reduction. However, unless there is a business process improvement plan, this strategy will not be sustainable in the long run.

This brings us to the term strategy. There are many tools at ones disposal in selecting an appropriate strategy to reduce supply chain costs. Typically these are broken into two phases: (i) negotiating cost and (ii) breakthrough ideas. Figure 1 shows the journey from leveraging volume to leveraging ideas (1).

**Figure 1: The Journey from Leveraging Volume to Leveraging Ideas**

<table>
<thead>
<tr>
<th>Negotiation (SCM)</th>
<th>Breakthrough (AIM&amp;DRIVE®)</th>
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<tbody>
<tr>
<td>• Leverage Volume</td>
<td>• Jointly develop written cost management strategies with suppliers (Cost Challenges)</td>
</tr>
<tr>
<td>• Price Analysis (CAMS™)</td>
<td>• Execute strategies with maximum speed</td>
</tr>
<tr>
<td>• Cost Analysis</td>
<td>• Create knowledge base to leverage ideas</td>
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Comparative Costs $  

Initial cost savings  

This is where we generate real cost savings  

Time
For most good supply chain organizations, the first part of the journey is creating robust category teams that focus on a sound sourcing strategy. Having narrowed the supply base for most key categories, it is a matter of trading volume for price. Clearly this is not rocket science but there are far too many companies that have not done this well. This is perhaps because it is difficult to get the various business units to see the value of a centralized procurement function for major areas of common spend.

The next step is to begin a price monitoring process to determine a company’s advantage against an industry trend. Using Anklesaria’s Cost Advantage Measurement System (CAMS™), tracking mechanisms are identified from public and private sources. These industry price trends are graphed and mapped against actual prices paid for specific categories of goods and services. The objective is to consistently “beat the market” trend. Some executives unreasonably expect their procurement departments to deliver price reductions year after year. This is simply not practical in many industries where prices go through business cycles. Particularly in the Oil & Gas business or industries dependent on steel and copper, prices for many categories are increasing. It is important to understand that in a market where prices are going up, your prices could go up but at a slower rate than the market. Conversely, when prices are going down in the market one would expect a good company’s prices to go down at a faster rate than the market. The difference between the rates of change of market prices versus a company’s prices is called competitive advantage or competitive disadvantage as the case may be. Management’s failure to understand this basic business concept causes a great deal of frustration for category managers who try to implement best in class processes. For example, managers who show that their average prices went up 4% in a market that went up 9% are chastised while those who demonstrate year on year savings of 4% when the market went down by 9% are given a bonus.

In addition to monitoring pricing trends, world-class procurement organizations benchmark absolute competitiveness once every two to three years. A company may choose to sponsor a study or participate in one. Typically, a number of companies with similar buying power for a given product or service will participate in a blind study to benchmark pricing and other terms. Results are shared with all participating companies without disclosing their respective names. It is then possible to gauge where a company’s prices and contract terms stand in comparison to others buying the same product or service.

Price monitoring is necessary but not enough to provide a total cost solution. In order to manage supply cost, one must first understand the cost structure of a supplier. Cost models are used by business units to conduct fact-based negotiation and builds credibility and respect for the procurement organization. Models could be created from industry statistics at the most basic level, to detailed process based models with site visits of suppliers. The objective of cost modeling is NOT to predict the exact price of a product or service but, rather, to give the buyer a better understanding of the composition of the supplier’s price. Once a buyer has this type of understanding, it is possible to negotiate from a position of strength.

A combination of price tracking and cost modeling is necessary when negotiating follow on contracts. During the term of an extended contract it is common for a supplier to request an increase in price due to inflation of one or more commodities in its cost structure. Many companies evaluate such requests using Anklesaria’s Price Discipline™ process. Price Discipline involves an understanding that the various elements of cost are not directly
correlated. For each major cost element, a suitable tracking mechanism is identified and those prices tracked over a given period. Material costs are adjusted for inflation, productivity, volume changes, technological advancements, yield improvements and currency fluctuations. Labor costs are monitored based on wage rate changes, productivity improvements, changes in skill levels and geographical location of the service provider. Overheads are viewed in terms of fixed and variable overhead and the impact of changes in volume.

**Example:** A supplier of nitrogen approached one of its customers with a request for an increase in price of almost 50% due to the fact that energy, one of the key cost elements in the production of nitrogen, had risen dramatically. A proper use of Price Discipline™ indicated that while prices had spiked during the summer, the average cost of energy had gone up by 25%. Since energy represented 40% of the supplier’s cost, the customer was not willing to increase the price by more than 10%. They also used the opportunity to discuss the impact of better yields and increased volume. The supplier accepted a price increase of 7% and appreciated the customer’s detailed analysis and immense knowledge of their industry.

Negotiation can only take you so far. There is a point in time when a good buyer has leveraged volume, tracked and beat market pricing, used cost models to further negotiate cost savings and then Price Discipline to prevent unreasonable changes in prices over time. The question that follows - “what next?” The answer is “breakthrough ideas”. This requires a culture of collaboration and a process that is easy to implement. One such process is Anklesaria’s AIM & DRIVE®; an eight step process designed to take cost out of the supply chain. This process is illustrated in Figure 2 below.

**Figure 2: The AIM & DRIVE® process**
AIM & DRIVE® has helped provide business process improvement as well as cement relationships with key suppliers. In many cases, the value to the respective companies goes well beyond cost savings. Ideas from suppliers included ways to improve safety, reduce cycle time, and ensure prompt delivery of product and services, quick repair of critical equipment and overall better business performance.

**Example:** A large multinational and one of its beverage suppliers convened a cross functional team including customer and supplier representatives that used the Aim and Drive process to increase efficiency of beverage delivery to the Company’s convenience stores. Delivery schedules were reviewed and adjusted resulting in increased vehicle utilization, increased deliveries per trip, and ultimately shared cost savings for the company and the supplier. These ideas were then leveraged to the distribution of other products. Thus, leveraging of ideas becomes the ultimate goal of a world class supply chain. However, there has to be a process of generating these ideas and a relationship based on collaboration not confrontation.

**Establishing and Maintaining Supplier Relationships.** Managing and sustaining effective supplier relationships can drive value in any organization if a strategic focus on supplier relationship management is employed. Many supply management professionals believe that “while we have been very good, if not great, at the sourcing process, where we may have faltered in our supply management process is in our failure to fully capitalize on cost savings, containment and innovative ideas from our supply base” ². World class companies achieve and sustain effective supplier relationships that are driven by (a) strong commitment (b) clear direction and alignment (c) leadership and governance and (d) shared values.

Both parties can demonstrate commitment by effectively deploying human and financial capital. For example, a large energy company has sponsored the staff of small and minority owned suppliers to attend the Management Development for Entrepreneurs (MDE) program offered by the Anderson School of Business at UCLA. The MDE program, jointly sponsored by several corporations and the United States Small Business Administration is a 4-day intensive program that allows entrepreneurs to sharpen their management, marketing and business development skills. Corporate commitment to the program is driven by the value proposition that suppliers with strong management skills will be able to provide innovative, cost effective solutions to the sponsoring corporations and their customers.

A clearly aligned, mutually developed mission and vision, identified at the onset of the relationship, can provide the direction needed to sustain the partnership over time. This allows for added value at executive levels, throughout middle management and most importantly, in business and operating units. Internal business partner / operating company engagement demands that this alignment and buy-in be maintained at all times.

Leaders in both organizations must set direction and ensure adherence to policy and procedures. Shared accountability for the success of the relationship rests with leaders of both companies. For example, many companies manage consulting services globally through a structured process of category management. Category managers, internal business partners and suppliers meet at regularly scheduled intervals to review mutually established metrics – customer satisfaction, on-time delivery, service level costs, etc. These meetings also provide platforms for continuous innovation, new ideas and fresh approaches to the relationship.
Diversity is a value held by many world class corporations. Supplier diversity has been an important procurement strategy for these companies over the years. Suppliers often share these values and work closely with the companies to ensure that diverse suppliers – small, minority and women-owned businesses - are able to compete effectively and deliver competitive value. Through an effective supplier development process, companies and their supplier partners can deliver training in key procurement processes. For example, the author has delivered strategic cost management seminars to women business owners at company-sponsored trainings. The shared values of diversity, supplier development and education bring many benefits to the companies as they leverage training resources to build organizational capability in suppliers and future employees. They also provide exposure to audiences outside of normal procurement channels for the suppliers.

Challenges to Sustaining Effective Partnerships. No matter how close the relationship is between a company and one of its suppliers, there is always room for improvement. Companies must challenge their key suppliers to maintain leading edge technology, world class quality, high levels of safety and reliability as well as competitive costs. The focus is always on creating sustainable processes. Reorganizations, mergers and employee turnover create internal change that can prove to be a challenge when attempting to maintain a relationship over time. Robust, standardized supplier management processes help to ensure continued focus on shared value delivery by each partner. These standard processes have allowed the suppliers and their corporate partners to continuously evaluate their relationship and seek ways to deliver mutual value over time.

There is no doubt that ethics plays a large part in making or breaking relationships. In large companies it is next to impossible to guarantee that every member of the organization will act ethically in every situation. The author has seen many cases where years of hard work in developing partnerships and trust have been ruined by a maverick buyer who looks for short term opportunities. In such cases suppliers need to know that there is an ethics officer or ombudsman to whom they can address these types of issues. All members of the sourcing team should be given frequent training on ethics and best practices and supplier surveys should be held annually in order to get timely feedback on the state of the relationship.

Conclusion: The journey to world class cost management and value creation is a long and tough one. It depends on having the right people, sustainable processes and strong relationships. With visionary leaders who see the long term benefits of strategy over short term fixes like price reductions, a company can reach the ultimate state of leveraging ideas across the extended supply chain. That is what will ultimately differentiate the winners from the losers.

References: