

Dawson

DIALOGUE

Assists business executives' awareness of critical logistics and supply chain management issues.

■ *Procurement*

'Process before Portals'

Introduction

The wide range of e-procurement products currently being promoted makes it easy to think that the path to major savings is little more than a few mouse clicks away.

Is it really that simple? Has the creation of electronic marketplaces and the development of Internet based tools such as reverse auctions swept aside the fundamentals that have underpinned good procurement practice in the past?

This paper explores the reality of modern procurement in an e-enabled world, challenges the myths that have emerged in recent times and maps out a path that organisations should follow in order to achieve optimal procurement outcomes. It is not surprising to find that in an e-commerce enabled environment the fundamentals of good procurement practice still hold true!

Procurement: A Major Source of Value!

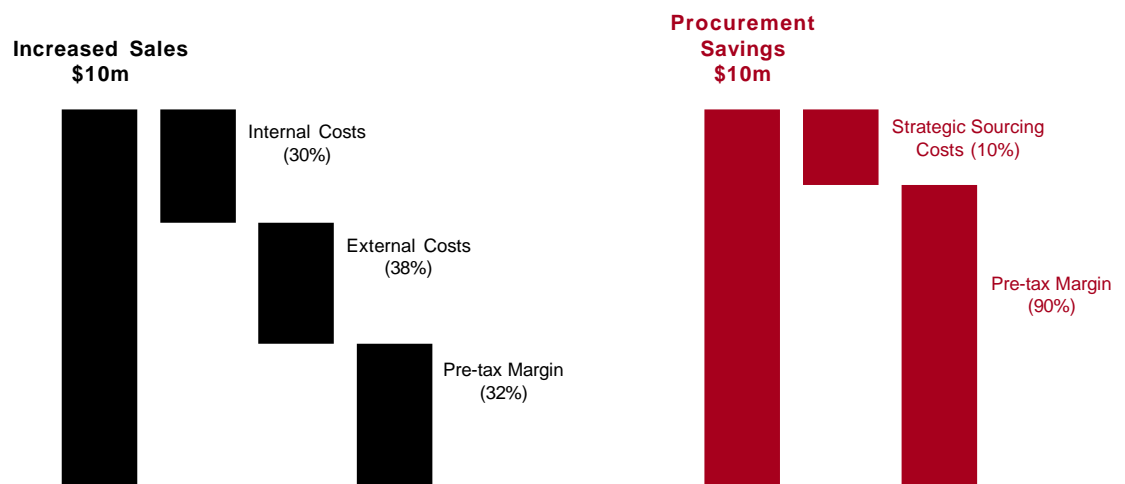
The challenge in procurement is to extract maximum benefit from the activity of acquiring goods and services. This challenge is more compelling when considering that the average company spends 50-70% of its revenue on external purchases.

Any reduction in procurement costs - whether through reduced prices, process efficiencies, or a more efficient supply chain - results in a dollar-for-dollar improvement in profits. Therefore, in many companies, procurement offers the single largest opportunity for an organisation to reduce costs, improve productivity and enhance overall performance.

DAWSON CONSULTING

a Dawson Group company

The Power of Procurement



As the diagram above illustrates, efforts centered on cost minimisation in the procurement of core and non-core goods will generate significantly more bottom line value than attempts to bolster sales.

The e-Procurement 'Revolution'

There is something seductive about a business model that reduces the procurement function to a series of basic steps or that promises benefits without having to do anything more than subscribe to a procurement portal or exchange. The reality is that such simplistic approaches rarely address the real needs of a business and at best can only deliver benefits at the margin.

A common example used to demonstrate the benefits to be gained is in the procurement of office supplies through leveraging the volume of procurement communities to achieve better prices. The demonstration of benefits focus on reductions in purchase price and often ignore the associated supply chain costs that in many cases swamp the direct purchase price savings. After transaction fees and other costs are taken into account it is little wonder that bottom line benefits fall short of original expectations. Despite this, there is little doubt there will continue to be significant growth in e-procurement activity. Research indicates the volume of such trade in Australia will grow by more than 13 times the current level in the next 5 years (from an estimated \$15 billion to over \$220 billion).

The business press has been full of the benefits that e-commerce is bringing to companies that have immersed themselves in the so-called dot-com "hot space". During the last few months many of these firms have discovered that the promised savings have failed to materialise. Has the new direction proven to be just a lot of hype peddled by those who saw an opportunity in milking the dot-com excitement that prevailed just 12 months ago? Or are there other more substantive reasons for the failure? The answer lies in the understanding that firms have of their procurement needs and whether or not they have adequately worked through a series of key issues, starting with the development of a procurement strategy.

Completing the Procurement Jigsaw

It is clear that e-procurement models are enablers in that they facilitate the execution of procurement transactions. The needs of business differ widely between firms and cover a broad spectrum of issues that many of the e-procurement models ignore. Consider the following points:

- *Today's e-procurement models assume a buyer's market and an abundant supply of goods; this is not always the case; seller's markets do exist.*
- *Some product markets are monopolies or duopolies.*
- *Supply shortages often exist and product is then rationed (generally by price, ironically!). If it is a key item a long-term contract might be judicious.*
- *A number of current e-procurement products focus on squeezing price. This can only go so far unless cost is taken out of the product or supply chain.*

- *Total supply chain costs are often ignored.*
- *Industry capacity to produce certain products can constrain supply.*
- *How can “cheating” on a deal be prevented – supplier qualification remains just as important as ever.*
- *Not all suppliers have an Internet presence and some that do choose not to be in the public domain.*

Because there are no contextual elements associated with the models the question of what is ‘right’ still needs to be answered.

In this regard there are a number of fundamentals that need to be addressed. It is only when these are fully understood that a business will be in a position to adopt the most appropriate methodologies to support its procurement goals.

The Fundamentals Must be Right

Procurement is not a mechanical process that can easily be applied without fully considering many linked factors. Despite the extravagant claims to the contrary, the few businesses that are extracting sustainable benefit from web based enabling tools are those who have understood that procurement fundamentals remain and must be in place before pursuing e-commerce based opportunities.

These fundamentals can be summarised to five main areas:

- 1. Procurement strategy**
- 2. Efficient processes**
- 3. Supplier selection**
- 4. Implementation**
- 5. Performance management**

Businesses that ignore the fundamentals are at risk of investing in solutions that deliver little benefit because of the mismatch between their business imperatives and the model adopted.

1. Procurement Strategy

Given the scale and business-wide impact of procurement in most companies it is important to ensure that the approach taken properly considers all relevant factors. Any business that is serious about achieving real benefits through procurement must develop a strategy that recognises the nature of procurement and how procurement fits into and supports the overall business strategy.

At the most basic level a firm must understand what it is buying and how much it is buying. This information provides a basis for segmenting the procurement task based on identifying the relative importance of what needs to be procured. Such characteristics as whether an item is core to the business vs. non-core, a service vs. a tangible good, requiring technical support vs. no support, etc are important to consider.

Based on this segmentation, an understanding of supply markets can be gained and from that a definition of approaches that will result in optimum outcomes in each segment.

There are few procurement segments in which buyers are indifferent to factors that distinguish one product from another. Even the choice between brands for seemingly generic items is important when performance characteristics can differ even though technical descriptions match. Differentiating factors become even more important in categories of complex items where proven product efficacy and after sales support services are critical.

While price is always important and is generally a focus of attention, it is nonetheless only one factor amongst many. Strategic sourcing requires that decisions be made based on multiple parameters in addition to price. Elements such as quality, delivery and past performance are often more important. Evaluation of product and supplier proposals needs to be based on the total cost of doing business with that supplier.

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2. Develop Efficient Processes

The procurement process in most businesses exists to satisfy a wide range of needs ranging from direct inputs and services used in production to indirect goods and services used by support functions.

Processes must be developed so that there is an effective and efficient flow of information from users through to suppliers who can satisfy requirements.

How does a request for goods get communicated, does it emanate from an MRP system or does a user requisition it? Does the requestor have authority to commit the business to the purchase? Are the goods specified clearly so that exact requirements can be fulfilled? Has a qualified supplier been selected and have terms and pricing been agreed? How will the goods be invoiced and what will be the process for validating delivery of goods and paying the supplier?

These and many other issues must be resolved and incorporated into an efficient process that works end to end through the chain of participants, both internal and external.

3. Supplier Selection

The decision process for choosing suppliers will depend on a number of factors including the nature of goods bought, the competitive market, the importance of product attributes, criticality as a business input, technical support requirements and many other relevant factors.

At one extreme is the purchase of widely available generic goods where the only differentiator is price outside of which a buyer is indifferent as to who supplies the goods. The other extreme is the supply of critical production inputs that are highly technical, in limited supply and supplied in a market with a limited number of suppliers. Under these conditions a buyer would seek to minimise risk by developing a long-term relationship with a supplier(s) supported by strong supply agreements.

For most businesses the problem of choosing suppliers falls somewhere between these two extremes and the task of identifying and qualifying suppliers that can satisfactorily meet their requirements is a major task within the procurement process.

4. Implementation

Once processes have been decided and suppliers selected the implementation of new or changed arrangements must occur.

Internally, people working within a business must be aware of processes, authorities and key elements of their involvement. Likewise, supplier staff must be brought up to speed on the agreed processes under which the exchange of information and goods will occur.

Poor implementation results in misunderstandings that detract from process efficiency and that can also result in costly errors. The consequence of poor implementation is that planned benefits are not achieved.

5. Performance Management

The majority of procurement arrangements either under-perform or fail completely when robust performance management is absent. It is important to ensure that benefits are sustainable in the long-term rather than being viewed as a one hit benefit.

Performance needs to be measured against internal standards to ensure compliance with plans and with external benchmarks to ensure the competitiveness of current arrangements. To achieve this, key performance measures for critical elements of procurement arrangements must be developed and the method of acquiring data determined. Key performance measures will not only be focussed on price but will cover other elements that are important, e.g. on-time delivery, quality, after sales service, and ongoing cost reduction programs.

Those businesses that get the fundamentals right will be in a position to adopt appropriate tools and technologies as they emerge. They will be e-procurement ready!

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The Need for a Multifaceted Approach to Procurement

Most businesses will discover from segmenting their procurement requirements that “one size doesn’t fit all” and there needs to be different approaches to procurement depending on the characteristics of each segment. The need to manage risks, price levels and transactional efficiencies will dictate the best fit model to be adopted and most businesses will find that running a combination of models matched to relevant segments will result in best outcomes.

For example, joining an e-marketplace may provide the best opportunity for the purchase of low value indirect goods such as office supplies whereas developing highly prescriptive supply contracts transacted over a B2B e-commerce platform may be best for critical production inputs.

In some situations the best approach may not be an e-procurement solution. Regardless, under these scenario’s there is little doubt that e-commerce will allow significant benefits in lowering transaction costs associated with procurement.

Current e-models

The progression of procurement to the Internet has led to the evolution of two basic models of procurement.

The e-procurement model reflects the traditional procurement approach of a single buyer dealing with a number of suppliers. This model has focused on automating the procure-to-pay cycle. This model has traditionally targeted non-strategic goods and services that were on contract and that adhered to static prices, although the scope exists to expand purchasing to include core goods.

These models push the selection and ordering of products to the desktops of frontline employees while ensuring that these employees comply with corporate business rules and adhere to contracts and static prices that the organisation has negotiated with suppliers offline. This approach can significantly reduce maverick buying, reduce administration cycles and costs and improve management of inventories.

The e-marketplace model, of which there are a few varieties, involves a number of buyers and sellers trading through an online marketplace. These models are differentiated by the orientation of the marketplace they serve. They can be vertical (providing goods and services specific to an industry) or horizontal (trading goods and services across many industries). The marketplaces are also differentiated by access to information, either public (allows open access for all buyers and sellers) or private (restricts information to select companies).

E-marketplaces generate revenue by charging transaction fees, although as the number of sites proliferate, competitive pressure is being exerted to reduce these fees thus putting revenue pressure on these sites.

Many of the marketplaces in Australia have been developed by large corporations pooling their investment wealth to develop a compatible system. CorProcure is one such example of an online marketplace founded by some of Australia’s largest companies including Coles Myer, BHP and Fosters Brewing Group.

In many instances, the e-marketplace acts as a buying consortium for participant companies attempting to leverage combined purchasing volume to reduce price.

Public e-marketplaces provide an open forum for connection of buyers and suppliers. Whilst generally providing a greater competitive situation, other factors important in the procurement process are often disregarded.

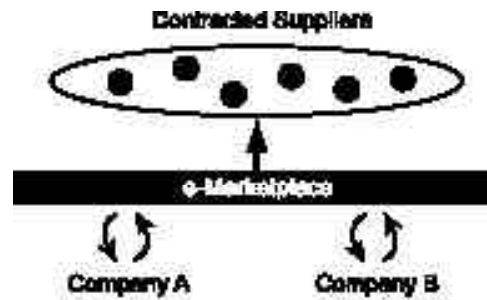
Private e-marketplaces differ in that the same system is used as other member corporations however access is restricted and dealings with suppliers are independent. Much benefit is derived through the marketplace’s set of standards and technology infrastructure.

The applicability of these models will vary from business to business and will be best determined by the procurement strategy that has been developed. For most businesses the best starting point for online purchasing is for indirect goods as they can yield significant process benefits (due to high transaction frequencies) with minimal risk.

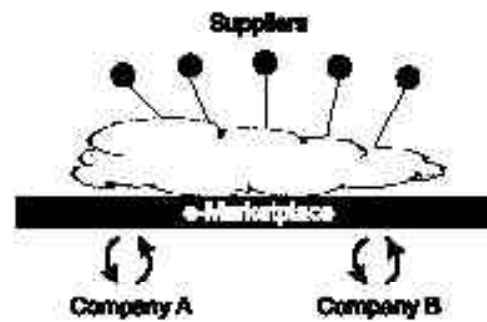
‘...there is little doubt that e-commerce will allow significant benefits in lowering transaction costs associated with procurement.’

e-Marketplace Models

Private
(such as e.conomy)



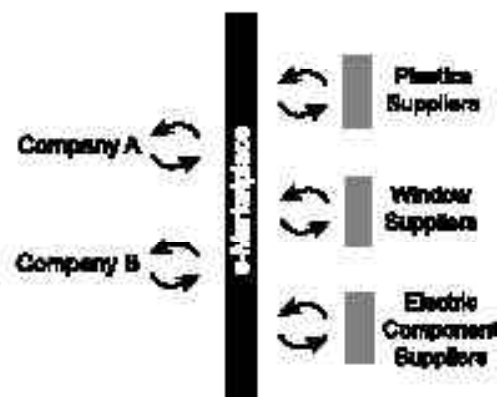
Public
(such as
FreightHub)



Horizontal
(such as Cyberlinx)



Vertical
(Such as AANX)



Future Trends

With the plethora of e-marketplaces currently existing in Australia (estimated at over 200) and given Australia's economic ability to support these there is no doubt that rationalisation will occur. It is too early to tell which of the e-marketplace models is likely to be the most successful. However, as with all businesses, it will be those with a strong and secure business plan that are most likely to succeed. Integral to this is providing a marketplace that focuses on more than reducing supplier margins. It must help buyers make 'upstream' decisions, provide unique domain knowledge and eliminate waste within the supply chain. Additionally, Australia e-marketplaces with large corporate backing are likely to have the required ongoing equity to realise longevity.

Longer term it is likely that companies will move away from e-marketplaces and look to consolidate the benefits of e-commerce internally. These companies are likely to utilise their learning from their initial involvement in e-marketplaces by extending beyond the reach of many of the e-marketplaces to core products where the largest benefit exists for most companies.

The Transition to e-Procurement

There are dangers in being a laggard and not taking up the opportunities to be derived from participating in e-procurement and, therefore, potentially being left at a competitive disadvantage. Equally there is a significant danger in making poorly considered moves into using e-procurement tools or models that are inappropriate.

As previously discussed, a good starting point can be with low cost indirect goods where the establishment costs and the risks are low.

As companies migrate their more complex purchases online, the degree of difficulty involved and the associated risk is much greater. For the purchase of moderately complex items – items that are not generic but can be supplied relatively easily by a large number of suppliers – it is likely that the use of a vertical marketplace would provide benefits. In this situation, suppliers that specialise in producing goods for particular industries (for example, electronic component suppliers) subscribe to the exchange and bid for contracts to supply buyers who are also members of the same exchange. Individual agreements are formed on a B2B basis.

In the case of highly complex items produced by few qualified suppliers or items that are in limited supply, a buyer would want to seek the protection of contracting with a supplier independently in order to lock in supply at a stable price. In terms of gaining transaction efficiencies, both buyer and supplier could use a private exchange as a common platform for executing individual information exchanges such as orders, invoices, payments, etc.

Clearly the move to e-procurement becomes a high-stakes activity that demands the fundamentals be in place. This is not to say that businesses should not be moving in an e-procurement direction but rather to say that there are many issues that need to be properly considered. In this regard, carefully matching the right e-commerce option with business needs is a critical aspect of making the transition.

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Conclusion

The emergence of web-based procurement tools and marketplaces has enhanced the opportunity to buy better in certain circumstances. Firstly, it is now generally easier to find suppliers who deal in particular markets and to engage those suppliers in exploring procurement opportunities. Secondly, there are procurement models that can address some of the procurement needs of businesses. Finally, the most obvious benefit to emerge is the potential for transaction efficiency between buyers and sellers to deliver cost savings. Over time there is little doubt that the functional richness offered by available e-procurement models will improve and become more relevant to the needs of business, especially with regard to the purchase of indirect goods.

Because of the evolution of these opportunities, businesses must be ready to move to take up these options and maintain their competitiveness.

Critical to the success of the procurement function, whether it be e-enabled or not, is to ensure that the fundamentals have been put in place. Once this has been done it is relatively straightforward to match procurement models to the needs of the business.

In today's rapidly changing business environment with the focus on opportunities emanating from developments in e-commerce, getting the fundamentals right is being e-procurement ready!



Dawson Consulting, part of the Dawson Group of companies, is Australia's largest management consultancy specialising in logistics, supply chain management and the application of eSupply Chain technologies.

*Dawson Consulting has a proven track record of generating significant value for its clients, having achieved **procurement cost savings ranging from 3% for direct goods to more than 40% for indirect goods and services**. If you are interested in exploring the benefits of a Procurement-related project, please do not hesitate to contact our Procurement Business Unit in the Melbourne office on 03 9326 7577.*

Sydney

Level 5, 153 Walker Street
North Sydney
NSW Australia 2060
Ph: +61 2 9964 9566
Fax: +61 2 9964 9588

Melbourne

First Floor, 21 Bedford Street
North Melbourne
Victoria Australia 3051
Ph: +61 3 9326 7577
Fax: +61 3 9326 7588

www.dawsonconsulting.com.au
info@dawsonconsulting.com.au