

Empowering Purchasing Groups: Current Issues in Internet-based Supply Chain Management

A White Paper



260 Alpha Drive, Pittsburgh, PA 15238
412.968.5490
www.moai.com

Empowering Purchasing Groups: Current Issues in Internet-based Supply Chain Management

Ramesh Mehta, CEO, Moai Technologies Inc.

Introduction – a Brief Overview of Purchasing Groups

Group purchasing has been around since the beginning of the 20th century, with the strongest presence in the healthcare and education verticals. There are basically four models for group purchasing: organic co-op, professional group purchasing organizations (GPO), independent trading exchanges and hub-based group purchasing. Group purchasing is a cost management service that provides solutions to organizations or corporations looking to reduce expenses while optimizing revenues. It also offers the participants a complete array of equipment, supplies and services. Several aspects of group purchasing enable companies to utilize the following: the power of volume purchasing to lower the price of services and supplies available through the purchasing group, aggregating purchasing volume, and leveraged, negotiated discounts with manufacturers, suppliers and distributors. Purchasing groups usually aggregate the purchasing volumes of its participants and then negotiate deep discounts with manufacturers and suppliers. The participants access these contracts to reap the benefits of highly reduced pricing, including significant cost savings. Usually they charge an annual fee to participate, and most of them require mandatory participation into all the programs they offer.

Without group purchasing, organizations would not only have to face higher costs for every product purchased, they would also have to devote resources to support personnel to provide the same function as a purchasing group. Because of such benefits, many organizations and companies enthusiastically endorse group buying. For example, 80% of health care spending is done through GPOs [1] and industry co-ops are the main method of purchasing in the food services and hospitality verticals. A report by the Center for Advanced Purchasing Studies found that the firms who used purchasing groups realized an average annual savings of 13.4% or \$3.9 million [2].

Inefficiencies in the System, and How Technology Can Help (And in the Case of Public Exchanges, Didn't Help)

With the advent of the Internet and automated processes, the supply chain was poised to become even more efficient and cost-effective for purchasing group participants. However, even with this new technology, there are still lost revenues and unrealized savings within the supply chain. While purchasing groups using Web-enabled solutions can save their member companies money, there may still be problems within the supply chain that create inefficiencies and lost savings.

In many ways, Internet technology in the supply chain and in-group purchasing is a work in progress that is learning from mistakes in the past while keeping an eye to the future. One major mistake made by Internet startups was trying to bull their way into the market by dis-intermediating the purchasing organizations through web-based exchanges. This did not work because of the deep relationships entrenched between groups and the buyers and sellers. Few organizations were willing to give up a long-standing association with someone they could trust for a new kid on the block wielding technology that many of them did not understand (and

sometimes didn't live up to expectations). In many cases, the technology was not sufficient to meet their needs anyway, especially from companies that offered exchanges.

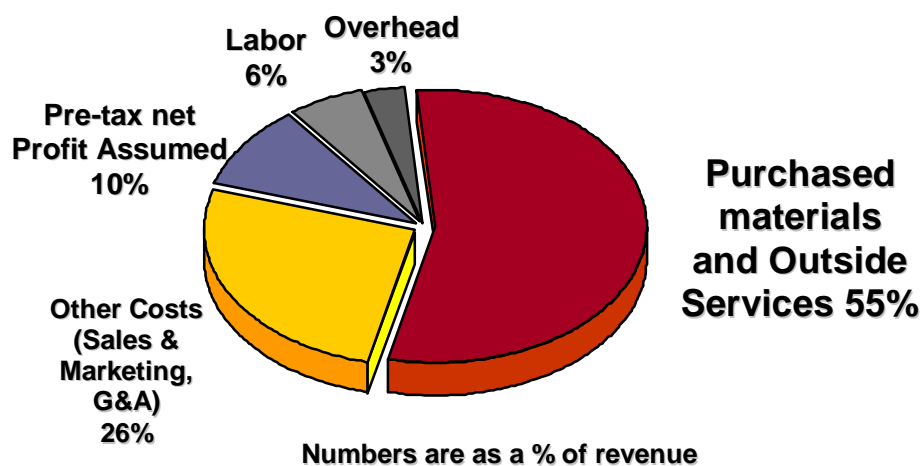
In systems that often are paper-based, even in this early part of the 21st Century, savings are often computed incorrectly, or even lost because partners within the supply chain have bad information on what items are covered and eligible for purchase under contract. Contract purchases made outside vendor agreements add to these problems, resulting in both reduced savings and rebates for providers. When delays happen in this process, off-contract purchasing can increase and cause even more losses. Present systems can be frustrating and time-consuming to the people who work with them. While technology is considered the "magic bullet" to solve these efficiencies, many purchasing groups have relatively poor technology support and are often lost in the maze of new innovations and new e-companies offering solutions.

E-procurement - Why It Didn't Work

One technology solution that promised huge benefits is e-procurement. A major problem is that e-Procurement technology does not meet the needs of many companies and organizations because it does not support the complex requirements for group purchasing. Purchasing groups must find a technology partner that offers the right solution to support its business model and not turn to a provider with a general, one-size-fits-all solution. Also, it often does not pay to try to ramp up a technology solution on your own. Some segments of the purchasing industry are just learning this. For example, only recently have many healthcare group purchasing organizations decided to partner with technology firms to come up with an effective e-Procurement functionality. On the other hand, mainstream e-procurement vendors have been slow to respond to the needs of the group buying market.

Meeting the Complex Requirements of Purchasing Groups and Their Members

Even the best company may not be able to help you because basic e-Procurement does not meet the complex needs of purchasing groups. When compared to a single corporation, the more advanced processes of group buying demands more advanced support. In fact, many companies and organizations have been taken for a ride on the e-Procurement highway – they simply are not reaching their goals of optimal savings and efficiency. The chart below shows a fairly healthy company, typical of a member of a purchasing group. They spend 55% of their revenues on outside purchased materials, 26% on sales/marketing and G &A, 3% on overhead, and 6% on direct labor. It makes a pre-tax profit of 10%, which is not bad in these difficult times.



E-procurement vendors initially promised companies, savings by addressing the following inefficiencies in the process:

- **Maverick Buying**
 - Non-adherence to negotiated contracts, suppliers or specifications
- **Unnecessary Buying**
 - Frivolous, even fraudulent, spending that would not be made under proper scrutiny
- **Inefficient Process**
 - Costs within the procurement cycle that can be reduced or eliminated through efficiency
- **Inefficient Systems**
 - Duplicate/legacy systems

The chart below demonstrates how e-Procurement projected its savings:

Assume \$1B in sales, 3rd party spend \$550M, Profit \$100M		
		<i>Savings \$M</i>
Leverage	10% improvement	55
Maverick Buying	20% imp. on 50% of spend	55
“Unnecessary”	Eliminate 5%	27.5
Process	200K transactions at \$90 ea.	18
Systems	Eliminate duplication etc.	10
Total \$165,500,000 per year!! (or maybe not)		

Procurement specialists used these promised savings to justify new software systems. However, it was soon evident that these assumptions were not correct. The numbers in the table below are closer to reality:

The reality of e-procurement		
		<i>Savings \$M</i>
Leverage	10% improvement on 10 %	5.5
Maverick Buying	10% improvement on 10%	5.5
“Unnecessary”	NIL	0
Process		0
Systems		0
Only \$11M per year? What happened to the big savings?		

As can be seen, an e-procurement solution could only deliver around 3-4% savings at the most. The net result is that the organization does not realize the “promised” benefits and sours on the deployment of technology. Many relationships and even some companies ended because of these disappointing results. There are many reasons why e-procurement has not worked, including:

- Double counting e.g. leverage and maverick buying.
- Much spending is not susceptible to leverage
- Maverick buying just does not stop overnight – old habits are hard to change
- Most e-procurement is aimed at indirect spending
- Process savings are ephemeral
- Savings on purchase order costs are offset by an increase in purchase orders!
- To put it simply, systems simplification just isn't that simple

What Does Work? e-Sourcing!

Web-enabled sourcing, or *e-Sourcing*, can offer major savings to purchasing groups.. e-Sourcing is the process of using the Internet to re-engineer a company or organization's supply base to reduce cost and gain competitive advantages, including improved quality, reducing lead-time, access to leading edge technology or design, improved delivery, and the ability to ensure availability when supply is scarce. These benefits allow buyers and suppliers to connect and contract quickly and efficiently, and offers an upside that simple e-procurement cannot offer. However, there are strategic sourcing processes that can realize considerable savings. For example, studies indicate that if such an organization conducted a spend analysis, the process would greatly improve the identification, qualification, selection and management of its suppliers. If an e-Sourcing solution is deployed, there is the potential for a 5-20% reduction in material costs [3].

e-Sourcing vs. E-Procurement

What are some of the differences between e-Sourcing and e-Procurement? While e-Procurement focuses on e-requisitioning as a main solution, e-Sourcing solutions focuses on enabling, embedding and speeding up the full strategic sourcing process. e-Sourcing powers elements that are specifically related to the actual strategic sourcing. The major elements include: spend analysis, which includes analysis of the current situation, identification and qualification of suppliers, and classification of items for spend activity; the RFx process, including sending RFQs and RFPs; running a sourcing event; selecting a supplier; negotiating and awarding contracts; creating, managing and automating contracts; and automatically tabulating bidding results using weighted scoring. Much of this process can be automated, however other parts may require outside knowledge, understanding of the particular market and use of consultants. The key to effective e-Sourcing is being able to implement complex and structured processes online. Effective procurement can then begin after all these steps have been completed.

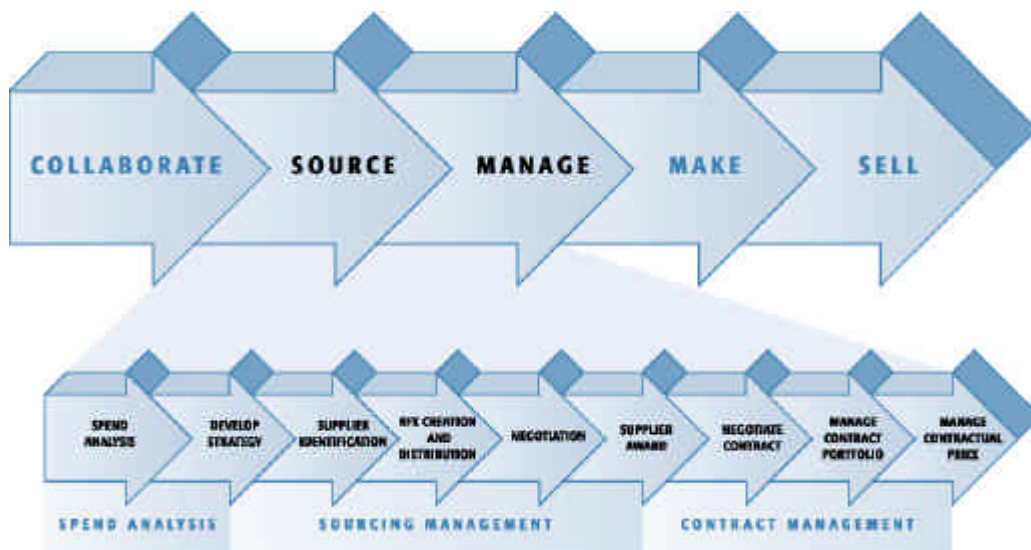
e-Sourcing is to an effective supply chain what a high-performance engine is to a race car. The benefits of e-Sourcing include improved quality, reduced lead time, access to leading edge technology or design, improved delivery and ensured availability when supply is scarce. [Some

of this is repetitive] Such features allow buyers and sellers to connect, communicate and contract quickly and efficiently.

e-Sourcing is the Wave of the Future

e-Sourcing is gathering momentum among the purchasing experts. According to a study conducted by The Center for Advanced Purchasing Studies (CAPS), The Wacht Group and A.T. Kearney, 73 percent of all potential savings in purchasing can be attributed to strategic sourcing [4], and e-Sourcing is the engine driving these savings. The average Fortune 1000 company has contracts with 20,000 to 40,000 individual vendors (up 20% in 5 years) and spends up to 50 basis points of its revenue administering contracts. Goldman Sachs estimates that contracting expense for these organizations could be reduced from 50 basis points to 10-25 by using automated contract management software [5]. AMR Research estimate the market for e-Sourcing will grow from \$275 million in 2000 to \$3.5 billion by 2005, so there are no signs whatsoever that e-Sourcing will go away anytime soon [6].

The Big Three: Spend Analysis, Sourcing Management and Contract Management

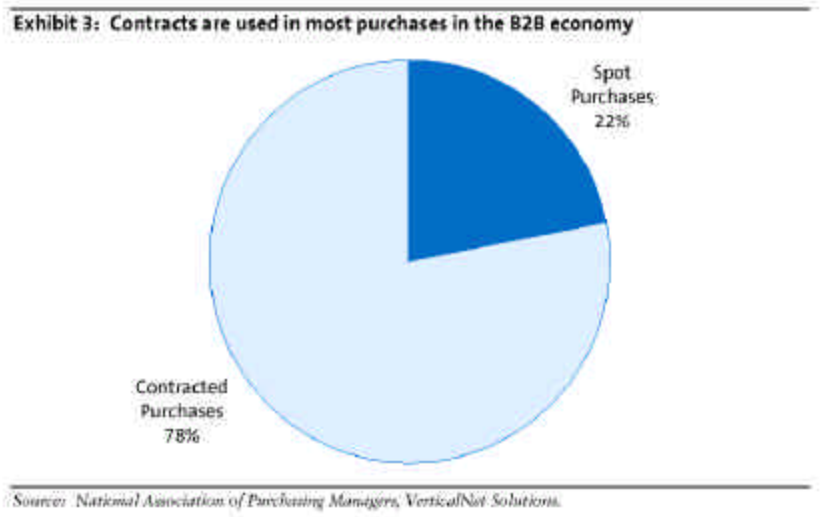


Spend analysis, sourcing management and contract management are vital segments of a complete sourcing solution. Spend analysis really should be job one, because if you don't understand what and how much you are buying, it is difficult to prioritize category-specific improvement projects. Simply put, you are blind to the saving opportunities without spend analysis. Spend analysis allows purchasing groups and their participants to get a real-time picture of their purchasing behavior, including the ability to quickly organize complex purchasing data, answer strategic questions, analyze relevant data and make better decisions. Also, quotes from prospective suppliers can be compared to determine economic order quantities, volume discounts and projected quantity discounts on future volumes. When properly utilized, purchasing groups and their members can quickly identify cost reduction savings, resulting in significant financial savings and reduced supply spending. An effective spend analysis tool needs to be comprehensive to be effective, ideally featuring the following segments:

- An ability to manage data from multiple data sources
- Supplier catalog and product content data management
- Complex manufacturer and distributor pricing data management
- Supplier data management
- Detailed standard and ad hoc purchasing activity analysis and reports
- Constant updating

Sourcing management provides groups with the flexibility to create online negotiation scenarios that are unique to a particular organization, business or industry. The components of sourcing management include supplier identification, RFQ, RFP and RFI creation, negotiation and supplier award. A good sourcing management tool will allow the user to create detailed RFxs using multi-line, multi-parameter bidding and a weighted scoring of parameters to determine the value offered by suppliers. Also, sourcing management makes traditional negotiation much more efficient. Real-world bidding gets done on the Web, creating an ability to negotiate on terms beyond just quantity and price. The benefits of sourcing management includes a 15-25% reduction in direct costs, reduced purchasing cycle time and increased control of the sourcing process.

Contract management simplifies what can be a daunting challenge for even veteran contract administrators, purchasing directors, and procurement analysts – carefully balancing multiple contracts simultaneously. This is especially important because most purchases in the B2B economy are done using contracts. Web-enabled contract management cuts the cost of this function while achieving greater savings. Most purchases made in the current economy are done via contracts.



Supply side contracts originate with suppliers who are typically contracted with during sourcing or procurement activities. The intricate contract management process can require a complex administrative process that is very expensive to maintain. To combat this, purchasing groups looking for an effective e-Sourcing solution should choose a vendor that provides contract management that properly manages supplier relationships and the resultant contracts, terms, conditions, nested obligations, and complex pricing. A system owner or purchasing administrator

using such a tool can enhance their business by increasing contract compliance through better price and contract designation and improved price record management. At the same time, the cost savings realized by e-Sourcing can help increase the value a purchasing group offers its customers.

The complexity of contractual relationships is especially apparent in today's global business environment. The contract management piece of e-Sourcing helps to offset the costs inherent in contracting and compliance issues found in decentralized organizations with far-flung offices. An effective e-Sourcing solution allows users in diverse regions to access needed contract information before making a purchase, reducing costly rouge buying by your remote offices.

Getting the Most Out of e-Sourcing

Making sure your group gets the most out of the solution for your members, two questions should be asked: What do you need to know about e-Sourcing and what should you look for in a solution? How can you utilize strategic sourcing software to achieve new process efficiencies and increased return on your investment?

A key component of any e-Sourcing solution must be flexibility. No matter how impressive the vendor's presentation, you must be able to unbundle the product to get the best solution for your purchasing group's needs. It is often a good idea to take a long look at how well a technology company services purchasing groups, because you may not like what you see. It is definitely not enough to assume that just because they have major customers they will work for you, because they might not have the customization abilities you need.

Another factor in finding the best e-Sourcing solution is the delivery option, as implementing an e-Sourcing solution into your supply chain should save you money, not add costs. Many purchasing group member organizations have legitimate concerns about their IT budget, and the first reaction to the thought of implementing a new software application is concerns about having to add people to the IT budget to manage it. However, going with a hosted option - where your vendor hosts the application and manages your servers - avoids this, allowing for quick time-to-market and efficient maintenance and monitoring.

Another point to take into consideration is the vendor's price structure. There are a myriad of models here. Some companies charge you based upon the amount of your spend. The more you spend, the more you pay. Other companies sell you a solution that you own. Often times a hosted solution or a flat fee for software is best, since your costs are predictable and known up-front.

While most purchasing groups are initially drawn to e-Sourcing because of the savings, they also find other less tangible, but strategically valuable benefits to their contracting processes. These include:

- **Better informed decisions** – e-Sourcing enables the taking into account of not only low prices, but also quality, supplier performance, brand reputation, serviceability, timely delivery and specific needs.
- **Lowering the cost of sourcing itself** – e-Sourcing eliminates hidden process costs and inefficiencies within the strategic sourcing process that eats away at any cost-savings.

- **Creating intense competition among suppliers** – A good e-Sourcing solution can make your purchasing group feel like the most charming person at a cocktail party – everyone wants to talk to you. e-Sourcing will motivate your suppliers to be more efficient and valuable since complacency is eliminated because of increased competition. In addition, you can also discover new vendors and new innovations that can directly help your group better serve your customers.
- **Get faster and more flexible sourcing** – Instead of waiting days or even weeks for a critical strategic item, e-Sourcing moves at the speed of the Internet. This adds to the flexibility of e-Sourcing, allowing purchasing groups to quickly find competitive supply sources and to reformulate requirements.

Purchasing groups face several challenges – inefficiencies in the system, lost savings, limited resources, but e-Sourcing offers the solutions these organizations are looking for to remain viable. I believe the following rules will ensure successful supply-chain management through e-Sourcing:

- e-Sourcing will support and enhance e-Procurement through increased ROI and increased and real sourcing cycle time reductions
- You don't have to reinvent the wheel, just automate it – there's no need to end long-standing relationships with vendors
- There must be a mix of solutions based on the type of procurement
- Spend analysis, contract management and sourcing management hold the keys to success for e-Sourcing

Even though the initial Internet Revolution has come and gone without reaching its lofty goals, technology still has a place in the future of purchasing groups. E-procurement never lived up to its promises, but e-Sourcing certainly looks like it will live up to the hype.

REFERENCES

[1] *Crossing the Quality Chasm: A New Health System for the 21st Century* (2001) Institute of Medicine

[2] *Purchasing Consortiums: Horizontal Alliances Among Firms Buying Common Goods And Services - What? Who? Why? How?* (1998) Center for Advanced Purchasing Studies

[3] (2000) Aberdeen Group

[4] *Automating Strategic Sourcing - Understanding and Evaluating e-Sourcing* (2001) Inside Sourcing

[5] *Time To Manage Those Contracts* (2001) Goldman Sachs

[6] *Strategic Sourcing Technology – A Language for Buyers and Suppliers* (2001) Goldman Sachs,