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## Buy as you sell

### A SYSTEMATIC APPROACH TO BETTER PROCUREMENT

*Most businesses know the importance of efficient procurement, but good buying attracts less strategic attention than good selling. Frontier's experience advising companies provides some simple principles that will help buyers think about how suppliers' markets operate and the implications of striking different types of supply contracts.*

It is no secret that procurement efficiencies can have a substantial impact on a company's bottom line. In many businesses, how you buy may be as important as how you sell. But companies do not always know the markets in which they buy as well as the markets in which they sell, particularly those markets in which they venture infrequently to buy long-term services (such as accountancy) or infrastructure (such as store fit-outs). A few simple principles, based on economics, can provide a framework for thinking about all kinds of purchasing, from the daily buying of fresh food to service contracts lasting for many years.



### UNDERSTAND THE VALUE CHAIN

Most suppliers will cite rising labour costs or commodity prices to justify price increases (or resist price-downs). Without knowing the relative importance of the different inputs that went into the products and services you buy, you are at a disadvantage when it comes to negotiations and cost planning. Understanding the relative significance of different inputs to your suppliers will equip you to distinguish unavoidable cost increases from special pleading.

The more significant the inputs and activities to the goods or services supplied to you, the more detail it is useful to know about them. It is worth understanding:

- the degree of control that your suppliers have over the cost of their inputs;
- the extent to which these individual costs vary with the scale of an individual order that you may place with them;
- the extent to which these costs vary with each supplier's scale of production; and
- the degree to which that production depends on large sunk investments.

Understanding the value chain enables you to see where costs lie, value is being added and profits are being made. This can help you understand whether clipping your suppliers' prices will merely squeeze their margins or drive them out of business. It can also help test the viability of alternative sources of supply.

### CREATE COMPETITION

Generally, the more competition there is between the suppliers of a particular product or service, the more profits are squeezed down to "reasonable" levels and the harder suppliers work to improve their offer. Intelligent customers can try to stimulate competition between their suppliers to drive out excess profits from the supply chain.

The threat of competition can be as powerful as the reality. To make it work, you do not need to be in a state of continuous contract renegotiation. What is important is making sure your suppliers know that they are in a race they can one day lose.

In this, it is useful to place a distinction between competition *in* the market, and competition *for* the market. The former is the familiar process of continually competing for customers. The latter takes place when players compete for the right to supply a customer for a period of time – e.g., when bidding for a long-term contract. Both processes can deliver the benefits of competition. But in the latter, there may be important knock-on effects from one "round" of negotiations to another. For example, signing a large long-term contract with an existing supplier might be less appealing if it will discourage other suppliers from bidding for subsequent contracts.

The degree to which your suppliers compete may be damaged if they think that:

- winning now increases the chance of the same supplier winning tomorrow;
- being big helps to win;
- prices cannot be compared by buyers;
- buyers are prevented (by, for example, government intervention or regulation) from going to the "best" supplier;
- new ideas cannot get into the market place; or
- the biggest suppliers can act together to fix the race (even if the competition authorities might eventually catch up with them).

As these examples show, creating – and preserving – competition also means knowing what else is going on in the market. The competitive process can be changed by external changes in regulation and technology, and by the knock-on effects of changes in upstream (input) markets and downstream (buyer) markets.

Buy as you sell

### KNOW YOUR POSITIONS

A buyer's ability to obtain a good deal – and the amount of effort that may be needed to secure it – will vary according to the relative position of the buyer and the supplier. Market position depends not just on scale, but on the answers to two questions:

- How important are individual suppliers in their market?
- How important are you, as a purchaser, to them?

To answer these questions, you need to start with some others, helping you to identify the market in which you are operating as buyers and sellers, and your positions in it.

- Who can currently supply the product/service to you?
- Could anyone else credibly become a supplier in the near future?
- Who else do these suppliers sell to?
- What proportion of output does each supplier account for?
- What proportion of each supplier's output could you buy?

Working through this simple checklist will give you some indication of how competitive the relevant market really is. At the extremes, these answers are obvious. If your current supplier is one of only two or three major players, and you only buy a small proportion of its output, you are clearly in a weaker position than if many similar suppliers were competing for your business and it would represent a major contract for any of them. However, a small supplier to a large buyer may still have a strong position if it provides a bespoke product that is hard for other suppliers to replicate.

Drawing together insights on the relative positions of buyers and suppliers helps to inform buying strategies, as illustrated by the simple matrix below.

		Nature of supplier's market	
		More competitive	More concentrated
Buyer's relative position	Important customer	<p>Are you getting a better price than other buyers?</p> <p>Are you cross-buying effectively from the same suppliers in markets where you are a less important customer?</p> <p>Are you fostering supplier competition?</p>	<p>Do you understand how the "game" is best played in this highly complex battle?</p> <p>Can you find ways of stimulating market entry to improve competition?</p>
	Minor Customer	<p>Are you getting the same price as your rivals?</p> <p>Can you use buying power in another market to improve your position in this one?</p> <p>Can you free ride on a major customer's product specification?</p>	<p>Can you use regulatory tools to force more supplier competition into the market?</p> <p>Can you find opportunities to fill marginal capacity amongst suppliers?</p>

Figure 1: A little less concentration, a little more action?

### UNCERTAINTY IS COSTLY

Nearly every transaction entails some degree of uncertainty, for either buyer or seller or both, which clearly affects the value they each ascribe to it. A simple sale or return contract transfers risk from the buyer to the supplier, and so the supplier will expect some premium that reflects this risk. In others, the effect is less clear. A contract that grants the buyer exclusive rights to distribute a product creates additional risk for the supplier, whose fortunes are now tied to the buyer's. How should the loss of ability to hedge across multiple buyers be priced? One useful idea is that of an expected value, described in the box overleaf.

Buy as you sell

Thinking about contracts in this way shows how value can be created for one party by transferring risks away from them – or created for everyone by simply removing any unnecessary uncertainty in a deal. For example, sharing information with suppliers about the likely nature of future demand may reduce uncertainty for them. In return, the buyer might reasonably expect a lower price, at little cost to itself.

### *Great expectations*

The less certain the outcome of a transaction, plainly the less it is worth to the buyer. How can this be quantified? Economists, statisticians, gamblers and others who commonly evaluate uncertain events often think in terms of an expected value, where:

Expected Value = Probability of Reward \* Value of Reward

For example, a contract clause that imposes a fine of £1000 on the supplier for late delivery of goods would have an expected value of £200 to the buyer if the probability of late delivery was 1 in 5 (£1000 x 1/5 = £200). This value would of course have to be weighed against the consequences for the buyer of a late delivery.

When thinking about ways to transfer or reduce risk it is, however, also important to think about the extent to which different parties are prepared to bear risks. In practice, businesses may be prepared to pay more than proportionally to avoid certain risks, particularly those that might be life-threatening to the company. So, for example, small suppliers may be more willing than large ones to discount to gain certainty in a contract.

The issue of where risk most appropriately lies – i.e., where it is least destructive of value – has been a hotly-debated issue in private finance contracts and public-private partnerships for transport projects and hospitals. The principle that government should bear policy risk (since only government can manage this) while the private partner bears market risk, seems sensible, but still leaves plenty of scope for argument.

### **(NOT) THE END**

This bulletin has set out four simple principles for efficient buying:

- Understand the value chain in order to engage effectively in pricing arguments.
- Foster competition amongst suppliers both in the market and for the market.
- Set procurement strategies in light of your position in different supplier markets.
- Minimise uncertainty where you can do so at no cost to yourself, and maximise supplier payment for the benefit.

There is no substitute for a thorough understanding about the economics of the markets that you buy in and the people that you buy from. Whether you are trying to introduce supplier co-operation agreements or get more out of e-auctions, thinking hard about the principles above will help you to make better decisions. Frontier has found that relatively straightforward approaches to value chain analysis, modelling of suppliers' businesses and competition assessments can provide powerful insights.

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