



Total Cost of Purchase™ White Paper



An Auditel white paper

The Total Cost of Purchase™ : procurement for sustainability

Executive summary

This white paper exposes the flaws in traditional approaches to the procurement of essential business services within organisations throughout the UK. It explains the theory behind the Total Cost of Purchase™ approach to procurement, and demonstrates how this new model enables organisations to take into account a wide array of issues beyond the 'headline' cost of the services they rely on.

This document will argue that taking the Total Cost of Purchase™ into account will help organisations of all sizes, across both the public and private sectors, to lower their cost of doing business. In addition, adopting the Total Cost of Purchase™ model will enable these organisations to minimise their financial exposure to an increasingly volatile marketplace.

Finally, this paper will argue that it is only by adopting the truly holistic Total Cost of Purchase™ model to essential business costs that sustainability can be achieved.

This sustainability comes in two forms. On a purely financial level, it means being able to make ongoing incremental savings over time, freeing up funds for further investment in core business activities. And on an ecological level, it means tying together both commercial and environmental sustainability.

Essential business costs: the traditional approach

It is one of the facts of the commercial world that organisations need to spend money to do business. Premises-related business overheads, fixed and mobile telecommunications, information technology, utilities, waste management and finance such as insurance and bank borrowings are just some of the essential operational overheads that affect all organisations.

Without them, no organisation could function. And yet they cost money: billions of pounds annually within the UK economy alone. Given the vast expenditure involved, organisations need a way of identifying all the potential service providers in the market and assessing their respective offerings – not only in terms of price, but also in terms of whether they can meet the required levels of service.

One way to do this, of course, is to hire a full-time in-house specialist. But the vast majority of organisations simply cannot afford to do that. Those organisations that have the resources to employ their own procurement experts, however, invariably need to focus on recruiting specialists in their core procurement activities. A plastics manufacturing business, for instance, needs experts in

the procurement of raw materials and plant specific to its business activities.

What this means is that decisions around procurement and cost management for essential business overheads are routinely left in the hands of individuals whose expertise in fact lies elsewhere within the organisation. In many smaller to medium-sized businesses, this will be the Office Manager; in the case of larger organisations, it tends to be the individual or team responsible for core business-related procurement activities. Given that they are 'procurement specialists', these individuals are routinely tasked with the procurement of services that, whilst essential, are not directly related to core business processes or their own skill set.

As a result, the vast majority of businesses throughout the UK decide to opt for what appears on paper to be the 'cheapest' supplier.

Adopting this purely headline-cost based model may seem logical, but it fails to take into account a wide variety of additional factors that contribute to the overall total cost of purchasing an essential business service.

Business costs in the UK

Fixed telecommunications: £44.6bn
(Ofcom 2004)

Gas: £26bn (Auditel estimate April 2006)

Electricity: £17bn (Auditel estimate April 2006)

IT: £15bn (Computing Marketing Intelligence Nov 2005)

Mobile telecommunications: £12.9bn
(Ofcom 2004)

Water: £7bn (Auditel estimate April 2006)

Waste: 1% of GDP per annum £18.5bn
(National Statistics, May 2006)

Finance: £100bn plus

Premises, Facilities Management £105.7bn
(MBD Press release March 2006)

The cost of these key service areas is high today, but it is set to grow even further. The energy, waste and water markets, in particular, continue to face significant pressure in light of global and domestic factors. This increasing market volatility is adding to organisations' recognition of the need to work with an experienced, impartial and trusted advisor to reduce their financial exposure.

Similarly, the cost of waste management to businesses in the UK is set to grow significantly. Research indicates that it will grow from 1% of annual GDP to 1.25% by the year 2012 as European and UK domestic legislation increases the compliance burden on UK enterprise. (Confederation of British Industries)



A flawed model

"Because it fails to take into account the time and expertise involved in making effective, informed decisions in the procurement and management of essential business services, the traditional approach to service procurement is fundamentally flawed. So flawed, in fact, that it results in businesses throughout the UK spending more on their essential business services than they need to." Chris Allison, Managing Director of Auditel (UK) Ltd).

Against this backdrop, it is not surprising that reducing operational overheads is more critical to business than ever. This is not only because the vast majority of essential business services are becoming more expensive, however; it is also because organisations increasingly recognise just how valuable it is to make savings.

Consider, for instance, a company with a gross profit margin of 25 per cent, making a saving of £100,000. To make an equivalent profit through day-to-day operations, that company would have to generate £400,000 in additional sales.

Utilities privatisation

Since utilities privatisation, the offerings of potential suppliers of energy have continued to become more convoluted and confusing. Each service provider has an ever-growing list of offerings – and many have branched out from their core activities to provide an ever increasing range of services. As a result, it is more difficult than ever before to compare different suppliers on a 'like-for-like' basis without expert insider knowledge.

Communications convergence

The Communications and IT market is similarly characterised by ever-growing sophistication and complexity, driven by two key technologies: broadband and convergence. Today's rate of progress means new technologies such as Voice over Internet Protocol (VoIP) telephony, for instance, are arriving with growing rapidity. Alongside the complexities of communications and IT, people are confronted with more and more complex and sophisticated marketing, which makes the decision-making process all the more confusing.

Successfully evaluating such technologies depends on a highly sophisticated level of understanding. To make the

right decision, organisations need to be able to assess the potential benefits of the technology in terms of cost; they also need to have a detailed understanding of how the technology could impact existing business processes – either to the good or to the bad.

Finance

Finance, too, is a highly mature and sophisticated marketplace, presenting organisations with a greater number and wider variety of financing options than ever before in key business areas such as commercial insurance, lending, employee benefits and leasing to name a few.

The overall market in essential business services is therefore characterised by an ever-increasing complexity. As a result, gaining the comprehensive level of understanding of each market that is required to make the right business decisions is well beyond the expertise of the majority of individuals charged with making purchasing decisions.

True cost of purchasing services

Furthermore, those organisations that task key individuals with such decisions are incurring even greater cost, as taking someone away from their core competency translates directly into reduced efficiency in their main area of responsibility. In addition (and all too easily overlooked) is the material cost of making these decisions: every worker comes with a salary and a desk cost to the business. This translates into an hourly rate, and it is essential for organisations to calculate this expenditure into their Total Cost of Purchase™ when it comes to calculating how much it actually costs them to make savings. Many organisations underestimate the time it takes to acquire the knowledge needed to become a competent cost and purchase management specialist and to keep up to date with ever-changing markets and services.

Outsourcing

This is why more and more organisations are turning to outsourced providers of cost and purchase management services. By doing so, they can access specialist insider knowledge of the respective markets, eliminate the financial loss to the organisation of taking key individuals away from their core responsibilities, and take advantage of a methodical and thorough analysis of their expenditure, without incurring any upfront costs.

Costing the earth

As well as having to take into account the complexity of utilities, IT and tele-communications, premises and finance, organisations are also facing a new and hitherto underestimated essential business cost: waste and environmental compliance management.

Environmental change remains high on the legislative priority list, and the European Commission continues to implement a wide variety of new directives to enforce more ecologically sound business practices. Such legislation has historically had its biggest impact in the world of manufacturing, but this is no longer the case. For instance, smaller and medium-sized businesses across all sectors now need to comply with the EU Packaging Waste Directive. As the directive becomes more stringent over time, the costs of compliance are set to soar. A typical high-street stationer paying £1,000 in waste management today will be facing a bill of as much as £6,000 by 2012.

According to waste management expert Mark Horner, MD of Worktwice Environmental, approximately 120,000 businesses throughout the UK are facing increasing waste management costs in the near future as a result of the Waste Electrical Electronic Equipment (WEEE) (2002/96/EC, Directive). This makes ecologically sound business practices more than just a 'feelgood' issue: the growing cost of regulatory compliance means that doing business whilst paying respect to the environment makes hard-nosed commercial sense.

In this area organisations are becoming more reliant on external agencies with a thorough working knowledge of the issues involved in waste compliance and the legislative framework that surrounds it. Outsourcing this responsibility to a specialist enables them to do two key things. Firstly, they gain peace of mind knowing they will not incur any stiff penalties for non-compliance. And secondly, they can significantly reduce the associated ongoing cost of compliance, as well as the cost of developing the in-house ability themselves.

Other considerations

When it comes to waste and environmental compliance, there are a number of other factors organisations need to bear in mind. Continuing to do business in a 'throwaway' society is not just irresponsible and unsustainable – it is also bad for business.

- *Being able to demonstrate ethical purchasing practices is becoming increasingly important, both to customers and shareholders.*
- *Natural resources are not infinite, and yet energy management alone will not solve the problem: organisations need to think now about ensuring their investments help develop viable alternatives.*
- *As the legislative environment tightens to enshrine environmentally sound business practices in law, choosing not to do business in an ecologically sound manner is becoming the expensive option.*



An alternative approach: introducing the Total Cost of Purchase™

To embrace a holistic approach to procurement and cost management means adopting the Total Cost of Purchase™ model to essential business costs. By working with a trusted adviser across each of the key service areas that represent ongoing and significant operational overheads, organisations can manage their costs and reduce the amount of financial and material waste to which they are currently exposing themselves – as well, of course, as the associated monetary risk.

Implementing the Total Cost of Purchase™ model

The Total Cost of Purchase™ is a holistic approach to the procurement of essential business services, and it involves a rigorous analysis of a number of key business costs.

1. Benchmarking the cost of existing services to the business

Lowering the Total Cost of Purchase™ begins with identifying the needs and requirements of your organisation, and fully engaging with the overall business strategy. For example, an expanding retail business opening a number of new outlets would be well positioned to negotiate a bulk deal for its business costs. Similarly, if there is a great deal of telephone contact between different sites, new technologies such as Voice over IP (VoIP) telephony may be the most cost-effective choice.

In order to make savings, organisations need to identify precisely where they are spending money at the moment. Crucially, however, they need to assess whether the services they currently pay for are strictly necessary to their business.

2. Retrospective audit to assess the historical accuracy of billing

Any thorough analysis of expenditure on essential business costs involves a detailed examination of previous billing history to identify areas of over-charging.

3. Identifying savings by claiming rebates for over-charging

Once billing and service anomalies have been identified, organisations are in a position to claim rebates – sometimes entering into the thousands of pounds – on any services for which they have been over-charged. This phase also includes the evaluation of existing Service Level Agreements to ensure they meet the real requirements of the business.

4. Reducing future essential business costs

Other elements that need to be considered at this stage include:

- *Future savings opportunities*
- *Any remaining over-specification of services*
- *Making the strategic move to invest in assets that depreciate more slowly*
- *More efficient methods of alternative funding*
- *Efficiency, conservation and environmental issues*

A detailed sign-off procedure needs to be followed when all recommendations are implemented to ensure a comprehensive audit trail is left. This procedure ensures there is a clear understanding of projected savings for subsequent evaluation.

5. Implementing Recommendations

Once the initial savings have been made, organisations need to transfer their service contracts to the identified supplier of choice.

6. Ongoing monitoring to ensure value is maintained

Even once all recommendations are implemented and certain key savings made, the job has only just begun. The market is perpetually changing and what is the best deal for an organisation today will, at some point, cease to be the most appropriate for its needs. For this reason, it is essential that organisations retain a 'watching brief' over their business costs.

Sustainable benefit can only be achieved if organisations undergo a regular monthly review of each of their essential business services, with a keen eye on market developments. This is especially true in heavily regulated sectors such as telecommunications, energy and waste management, where updates to existing legislation can have a radical impact to businesses overnight.

The 'watching brief' also entails ongoing monitoring to ensure mis-billings are identified straight away, and evaluating the changing requirements of the organisation. As circumstances and requirements evolve over time, the best deal, too, may change.

The Total Cost of Purchase™ in action

Ystrad Mynach College

Founded in 1959 to provide essential training services to local coalminers, Ystrad Mynach College now provides education services for over 8,000 part-time and 2,400 full-time students.

Like many educational establishments, the College is under pressure from Government to reduce its energy consumption. Using the Total Cost of Purchase™ model, however, Chris Baker was able to make significant savings on a wide variety of its essential business costs.

Category	% saving	£ saving p.a.
Waste management	9%	£1,070
Electricity	3%	£1,605
Energy efficiency audit	20%	£14,000
Landlines	36%	£11,078
Water and sewerage	34%	£4,424
TOTAL SAVING		£32,177

ADAS

A former government agency providing agricultural advice, ADAS now delivers independent scientific research, agricultural advice and contracting services to more than 20,000 clients in the UK and overseas.

The organisation engaged Auditel to review its communications expenditure as part of a wider Total Cost of Purchase™ project. By taking a holistic view of lowering ADAS' business costs, Auditel made significant savings across the spectrum.

In their first audit, Auditel consultants Jonathan Hotopf and Ashley Carr reviewed over £437,000 of communications-related expenditure and found £74,400 of savings through a variety of measures including changing suppliers for landline and mobile calls, reviewing fixed costs and eliminating redundant services and unnecessary discount schemes. When they carried out a second review two years later, they found another £59,500 in savings, some of which were against the new prices implemented in the initial audit.

Category	% saving	£ saving p.a.
Mobile communications	56%	£61,101
Fixed telephone assets	25%	£32,600
Landline communications	21%	£42,900
Water and sewerage savings	32%	£4,925
Leak rebate (one-off)		£3,009
Sewerage rebate (one-off)		£10,400
TOTAL SAVING		£154,935

Conclusion

The Total Cost of Purchase™ model is a holistic way of reducing and managing the cost of doing business for your organisation. By evaluating not just the price of those services, but every aspect of the procurement lifecycle, the Total Cost of Purchase™ model enables organisations to lower their business costs year-in and year-out.

Because examining the Total Cost of Purchase™ involves assessing all these factors, it allows organisations to reduce their overall operational expenditure to a significantly greater extent than merely selecting the supplier with the lowest 'headline' cost.

Author: Chris Allison, Managing Director, Auditel (UK) Ltd.

Auditel has over a decade's experience in cost and purchase management consultancy within the UK and Ireland. With our unique Total Cost of Purchase™ approach, we have already achieved significant savings, both in time and money, for thousands of organisations.



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