Creating a Self-funding Purchasing Department: A European Example

— by Lisa Ellram, Ph.D., C.P.M., C.P.A., Arizona State University and George Zsidisin, Arizona State University

Background
Cost containment and cost management continue to be top priorities for senior-level management. In some organizations, the value of the purchasing department has even come to be questioned. As this questioning occurs, purchasing may find itself outsourced, downsized, or spun off into a separate operating company to sell its services back to the organization. Several major companies in the Netherlands have found a way around the continual questioning of purchasing’s value: they fund themselves. Not the same as a profit center, these organizations make zero profit, nor do they charge user business units for their services.

The company that will serve as an illustration here is a technology company that supplies industrial systems and industrial services worldwide. This organization will be referred to as “Industrial Tech.” It employs just under 20,000 people, and has annual sales of approximately $2.5 billion U.S. dollars. It is made up of 85 operating companies that are organized into five market-oriented operating units. It is a highly decentralized organization. Each operating unit has its own functional personnel, including purchasing. At the headquarters, there is a Corporate Purchasing group, whose duties are listed in Table 1. The Corporate Purchasing group at Industrial Tech started funding itself last fiscal year.

While the Corporate Purchasing group at Industrial Tech sets overall policy, all actions of this group are on an advisory basis. None of the operating units is required to follow the policy set, the
suppliers selected, or the contracts negotiated by this group. Participation in Corporate Purchasing’s recommendations is strictly voluntary. Thus, Corporate Purchasing must be very persuasive and find programs that benefit the operating companies that want to participate. In addition, Corporate Purchasing must be very sensitive regarding how its services are financed. Because all of the operating companies are responsible for their bottom-line results, the operating companies scrutinize their expenses closely. They particularly dislike being charged “overhead or general and administrative expenses,” as the term carries negative connotations.

Self-funding Initiative
To address the concern of whether purchasing is truly a value-added function, the Corporate Purchasing group at Industrial Tech decided that it would pursue a goal of becoming self-funding. One of the overriding objectives of the Corporate Purchasing group is to look for synergy among the operating companies. A key source of synergy is through corporate contracts that leverage Industrial Tech’s volume across operating companies. Because none of the operating companies must participate unless it is beneficial to do so, a primary goal of Corporate Purchasing is to get better conditions so that there will be an incentive for them to participate. Due to the relative autonomy of the operating companies, there is limited volume assurance for the suppliers to Industrial Tech. Thus, many of the suppliers provide bonuses and incentives once Industrial Tech has achieved a certain overall volume level, based on turnover during the previous year.

Corporate Purchasing had the idea that it could keep some of those bonuses and incentives in order to fund its own administrative budget. The way that this operates is illustrated in Figure 1. Corporate Purchasing negotiates the best possible package in terms of price, delivery, quality, service, and other relevant factors. All of those benefits are passed along to the operating companies. As part of this negotiation, purchasing also negotiates a “bonus,” similar to a cash rebate, which is received when Industrial Tech surpasses a certain volume on the corporate contract. The average bonus is 0.5 percent, which covers Corporate Purchasing’s entire budget. There are fluctuations in the percentage, depending on the specific supplier and/or market conditions.

This is truly a win-win situation for all parties concerned. The Operating Companies get a
great bargain. If they don’t like the deal, they are under no obligation to use it. The supplier secures an excellent deal, and only gives Industrial Tech the discounts that are earned based on sales volume, not on “projections.” Corporate Purchasing gets an excellent arrangement because it “funds” itself, so that no one else has to pay for, and complain about its administrative budget.

5. There is a limit to how much Corporate Purchasing can “earn.” After it has covered its own operating/administrative expenses, all other funds are returned to the operating companies. Thus, there is no incentive to earn the money to make a “profit.” The incentive is to get the best deal for the company, which should always be the concern of Corporate Purchasing.

**Benefits Achieved by Corporate Purchasing Synergy**

All of the savings attributed to the Corporate Purchasing group are calculated and reported by the group Controllers, not by Corporate Purchasing. This helps to create a high level of credibility and visibility for Corporate Purchasing’s efforts. Last year, the group Controllers attributed approximately $25 million dollars of savings, in terms of better conditions, to Corporate Purchasing. This is huge, considering that total profits were around $100 million.

What is considered savings is agreed upon in advance. It includes items such as a price reduction, or a general cost increase to the market place that can be verified, but was not passed on to Industrial Tech. In general, these cost savings do not include cost avoidance.

**Where are Corporate Contracts Used?**

There is a general rule of thumb that is used by Corporate Purchasing in determining whether they should pursue the possibility of a corporate contract. The contract must have a potential spend of over $250,000 and involve at least five of the operating companies. The breadth of corporate contracts is quite wide. It encompasses more than $250 million dollars of spending. About two-thirds of the contracts are for non-production items with the remaining one-third for production items. A partial listing of some of the items covered is included in Table 2.

**Key Success Factors**

The Corporate Purchasing group at Industrial Tech has been very successful with its approach to “self-funding” its department for a number of reasons. First, Corporate...
Purchasing approached top management with its idea as a way to both save money and reduce internal battles and discussions about general and administrative expense allocations. This approach was sold initially as a win-win.

Second, rather than attempting to hide the fact that Corporate Purchasing was going to “keep” some of the incentives to provide funding, it made it very public. Again, it was approached very much like a win-win scenario. The operating companies would no longer see any direct charges for Corporate Purchasing expense. Instead, Corporate Purchasing would have to “earn” its keep by getting such good deals with suppliers that the operating companies want to use the corporate contract. In addition, any savings beyond paying the expenses of Corporate Purchasing are returned to the operating companies.

Finally, the suppliers only have to pay incentives if Industrial Tech earns them, based on volume. Thus, Corporate Purchasing entered this new way of doing business with support at all levels, including top management, internal customers, and the suppliers. Its approach has also been very beneficial in terms of saving the company money and creating visibility - Corporate Purchasing was even featured in this year’s Annual Shareholder’s Report as a source of significant value!

### Table 2

Examples of some purchases covered by corporate contracts

**Non-Production Buys**
- Cleaning
- Auto Leasing
- Insurance
- Office Supplies
- Energy
- Telecommunications
- Transportation

**Production Buys**
- Flexible Labor
- Stainless Steel
- Fasteners
- Hydraulics
- Pneumatics
- Raw materials

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Meaningful Involvement of Purchasing: The Case of Consulting Services

— by Joseph J. Schiele, University of Western Ontario, Richard Ivey School of Business

Executive Summary
A 1995 CAPS study* that surveyed 34 government organizations, found that in terms of the total dollar spend on consulting services ($522 million) only 5% ($27 million) included any input from purchasing.

Why has purchasing been excluded from these important purchase decisions? Perhaps it is because of the difficulties associated with purchasing consulting services? Or maybe it is because managers are simply unaware of the benefits that can result when purchasing is involved? If this is true, then additional work is needed to demonstrate how purchasing can be effectively part of the purchasing of consulting services and reassure managers that purchasing can in fact add value to these types of purchase decisions.

The following reports the findings from a study that examined cases where purchasing was meaningfully involved when municipalities purchased consulting services.

Background
In 1998, a pilot study was conducted, as part of a larger research study, within a municipal government setting where the purchasing department was part of the purchase of consulting services.

Total purchases for this municipality amounted to approximately $300 million. This amount included approximately $9 million for consulting services alone.

For this study two case examples were examined. For each case, interviews were conducted with the purchasing department manager, the purchasing agent, the specifier of the service, and for the second case, the consulting service provider.

The Meaningful Involvement Process
There was a typical process that was followed when meaningful involvement occurred when purchasing consulting services.

Need anticipation or recognition of a problem
When a need was anticipated or identified by a specifier they contacted purchasing to discuss topics related to the particular need, the value that purchasing could add to their purchase decision, and the activities involved. When the specifier decided to involve purchasing they then moved with purchasing to the next stage of the purchasing process.

Determination of the characteristics and the quantity of the needed consulting service
Once the need was identified purchasing worked with the specifier to:

1. understand the purpose of their particular consulting service need to the point where it could be well articulated and written into an RFP;
2. classify their needs versus their wants to ensure that priorities were established and costs controlled;
3. clarify the operating environment to ensure that it could be well articulated and included in the RFP, in order to ensure a better understanding by potential suppliers of the environment that they would be applying their consulting service to; and,
4. formulate functional requirements for the consulting service that would form the
basis for evaluating supplier bids and consulting service delivery quality.

Description of the characteristics and quantity of the needed item or service
The characteristics and quantity of the needed consulting service, as defined by the previous stage, were then communicated through a Request For Proposal (RFP). The RFP was prepared in a clear and comprehensive manner so that the request could be acted upon and understood by potential suppliers. At this stage purchasing discussed and established with the specifier delivery needs including timing as it related to the purchasing process and the delivery of the consulting service. Purchasing also discussed possible sources with the specifier, which included identification of any preferred sources.

Search for and qualify potential sources
Once the RFP document was complete, purchasing assisted the specifier in identifying external sources through a public posting and bidding process.

Acquisition and analysis of proposals
Once proposals were received by purchasing, they prescreened (short listing) with the specifier potential sources identified against the criteria established. Additional criteria were added at this stage to further evaluate short-listed suppliers.

Evaluation of proposals and selection of suppliers
Once a short list of potential suppliers was established, purchasing further evaluated proposals selected with the specifier. At this time purchasing arranged for presentations to be made by potential supplier’s in order to clarify proposals and get a sense of a potential suppliers fit with the organization. Purchasing generally chaired these presentations unless otherwise directed. During this stage, purchasing acted as a liaison and information provider between potential suppliers and the specifier. Purchasing then collaborated with the specifier towards a best buy decision, using a supplier evaluation matrix that scored and weighted the criteria determined previously.

Selection of an order routine
When a final decision was made, purchasing notified suppliers regarding the decision and arranged for delivery, payment, and terms.

Performance feedback and evaluation
The final stage of the purchasing process involved activities such as post delivery quality evaluation through end user satisfaction surveys, and corrective action if needed both during and post service delivery. Oftentimes purchasing debriefed unsuccessful suppliers providing advice on proposals, presentation styles, and skill sets that need to be improved in the future.

Overview
Both cases generally followed this meaningful involvement process but with some exceptions. With respect to the first case, purchasing was notified and asked for assistance as soon as the specifier had determined that they had a need to satisfy. For this particular case purchasing involvement was mandatory. In contrast with the second case, purchasing did not get involved until the specifier had began developing an RFP document (the third stage). The specifier was unaware that purchasing could assist them with this type of purchase and only decided to involve purchasing when he heard from another department head that purchasing was able to add considerable value to a similar acquisition process. For this particular case purchasing involvement was voluntary.

The specifier made the following comment regarding their decision to contact purchasing:

“I just was not aware of what they could do for me... having gone through this experience with purchasing, I would never do it again without them.”

An interesting observation can be made regarding the type of purchasing involvement that took place in both cases, concerning the...
clarification and development of the statement of requirements. When purchasing's involvement was mandatory, purchasing had limited involvement. The statement of requirements was far more developed and purchasing simply needed to review the statement of requirements developed by the client department and provide their approval of how it was prepared. In the second case, purchasing's involvement was voluntary but it spent considerably more time assisting the specifier with developing the statement of requirements.
With respect to the stage involving identifying or discussing potential suppliers, the specifier for the first case wanted purchasing to make sure that as many suppliers as possible were included in the bidding process. In order to meet the specifier’s request, purchasing sent letters to a number of select suppliers inviting them to present proposals.

The specifier for the first case made the following comment regarding purchasing's actions:

“We wouldn’t have had as many suppliers competing for the work if we didn’t get purchasing involved. I was comfortable that all options were being considered.”

**Benefits Resulting from Meaningful Involvement**

There was general consensus regarding the benefits that result from meaningful involvement of purchasing. These benefits can be classified into four categories including those attributable to the: organization, specifier, purchasing process, and supplier.

**Organization**

Several benefits were realized as a result of purchasing being meaningful involved:

1. improved performance by the consulting service that was attributable to suppliers who clearly understood what was required of them and through quality monitoring and correction activities by purchasing both during and after delivery of the service;
2. controlled costs that resulted from budgets that were well defined and extras that were accounted for; and
3. the reduction of risks associated with legal exposure and noncompliance.

**Specifier**

There were also benefits that were realized by the specifier: a better understanding of their needs; having available an extra resource to rely on; having access to information about the market place and the service; not having to organize and chair meetings; avoiding time delays as a result of purchasing’s expertise regarding the process; and having an unbiased third-party problem solver in the event that conflicts or problems occur.

With respect to the benefit of an extra resource one specifier commented:

“purchasing really took a lot of the work out of my hands ... fielding phone calls and questions, writing letters, setting up meetings... They really saved me time.”

**Purchasing Process**

The purchasing process included these benefits from meaningful involvement:

1. improvements to the purchasing process such as development of the statement of needs and RFP;
2. purchasing process facilitation; and,
3. fairer, more defendable supplier evaluations.

The purchasing manager commented on one of the benefits of having purchasing meaningfully involved in the purchasing process:

“We act as a unbiased third party... We help build a defendable credible document in a very political environment.”

**Supplier**

For the suppliers, purchasing helped them understand what was needed, helped them understand what they could do to improve themselves for future business, provided information regarding a specifier’s needs and expectations, ensured that all suppliers were evaluated fairly thus reducing the potential of bias towards one supplier over another, and acted as a single point of contact.

One supplier made an interesting comment regarding purchasing's involvement:

“Having purchasing involved allowed us to prepare better proposals, and presentations, and improve ourselves in the event we were not successful... I think we were able to perform our service better because of their involvement.”

“Benefits of meaningful involvement can be classified into four categories including those attributable to the: organization, specifier, purchasing process, and supplier.”
Summary
The findings from this study suggest that purchasing can add value to those decisions where purchasing involvement has traditionally been low. In addition, benefits that result from meaningful involvement of purchasing are associated with the consulting service purchased and the organization as a whole, the specifier, the purchasing process, and the consulting service supplier. Managers may want to consider these insights the next time they are purchasing similar services.

*An executive summary of the CAPS Focus Study, Purchasing of Nontraditional Goods and Services, by William A. Bales, C.P.M., and Harold E. Fearon, Ph.D., C.P.M. may be viewed at the CAPS website: www.capsresearch.org.*

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**The Center for Advanced Purchasing Studies Reveals an Innovative Program to Position Fortune 500 Companies for the Future**

The latest research endeavor created by CAPS, Project 10X is a comprehensive plan designed to provide leadership, strategies, and visions for Fortune 500 companies determined to position themselves as leaders in supply chain management. CAPS’ goal with Project 10X is to increase business performance by 10 times.

The project is headed-up by Dr. Robert M. Monczka, Director of Strategic Sourcing and Supply Chain Strategy Development for CAPS and the Director of Project 10X.

Companies wanting to push the envelope in supply chain management can team up with CAPS to identify current and emerging best practices, and develop future best practices, all catered to their organization. CAPS will then determine the roadmaps necessary to reach the companies’ goals within the next 5 to 10 years. Creating a vision for purchasing and supply chain management that is applicable and relevant across industries, Project 10X establishes strategies for future success.

**CAPS Benchmarking — Keeping Pace with Changing Needs**

CAPS constantly strives to address the ongoing needs of purchasing and supply chain professionals. For example, the Center hosted a series of focus groups in 1999 to assist in the expansion of benchmarking to include metrics on supply chain management.

The Center’s benchmarking reports are becoming increasingly global in nature. As companies continue to link all their domestic and overseas operations through internal computer networks, they also are able to provide CAPS researchers with benchmark data from around the world, not just the United States.

Recently released industry reports include:

- **Banking**
  (1999 report, 1998 data)

- **Higher Education**
  (1999 report, 1998 data)

- **Municipal Governments**
  (1999 report, 1998 data)

- **Aerospace/Defense Contracting**
  (1999 report, 1998 data)

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Best Value Procurement in Local Authorities

— by Martin Spring and Angel Domínguez-Ortega, Manchester School of Management, UMIST.

**Executive Summary**
European public procurement is becoming more professional, mainly because of the Best Value or Excellence strategies that are being implemented in public sector organizations. Partnerships, performance assessment, and the constant evaluation of indicators are the key elements of this process.

Best Value is defined by one local authority as the search to improve the relevance, quality, and cost effectiveness of all its activities. Europa Regional Council (ERC) (not its real name) offers one of the most relevant European cases of implementation of Best Value. Its approach to procurement is a balanced strategy between competition and the building of alliances in order to guarantee efficiency and quality, without hindering equality of opportunities for suppliers.

**Background**
Over the past 15 years or so, local government procurement in Europe has changed dramatically. Previously, public services such as refuse collection, parking enforcement, or ground maintenance had been provided by local government employees. A new emphasis on efficiency and competition during the 1980s led to new legislation that compelled local government to subject the procurement of such services to competitive tendering. While this raised the profile of the procurement activity, it also posed significant challenges. It became apparent that the “arm’s-length,” short-term relationships between buyer and supplier encouraged by this approach were not effective in delivering quality services.

A different approach was needed and “partnership sourcing,” practiced in the private sector, has been widely adopted to encourage innovation and collaborative problem solving.

Today, European Local Governments are trying to find the middle ground between the simplistic use of market forces and relying on the excessively “cozy” relationships with both in-house providers or protected national “champion” firms. This middle ground is known as “Best Value” and is used to discuss the experiences of Europa Regional Council.

**The Framework**
Europa Regional Council (ERC) is responding to a renaissance in public sector processes in Europe and elsewhere that is influenced by private sector experiences. The framework for procurement has shifted from a rigid European Public Procurement Regulation to a more flexible and less constrained policy/regulation that emphasizes continuous improvement. By focusing on continuous improvement, two key shortcomings of the previous model of arm’s-length, price-based contractual arrangements were addressed: (1) the inevitable political content of local government procurement decisions, and (2) opportunism that let to poor quality services.

In 1997, ERC passed a decree that established Annual Excellence Prizes for best practices in Public Services. Winning the prize implies an acknowledgment that the winner is delivering efficiently and is committed to the care of the citizens — a new agenda for procurement.
The Challenge
Within this framework, those responsible for procurement have to analyze whether the services provided by the government entity are still a priority and determine how to achieve more from them. New ways of packaging, procuring, and delivering services have to be researched, accomplished by collecting data from various vendors. In addition, a means of measuring and benchmarking procurement processes had to be developed to determine if these changes lead to better results in local government.

Employees of the local government and of the contractors are also citizens and, in a less direct sense, the citizens are concerned about employment - both in terms and conditions of employment and the possibility of job losses. These types of concerns make it necessary to manage contracting processes in continuous negotiation with other stakeholders such as unions and employers. By comparison, adversarial tendering processes had proved ineffective in delivering positive social outcomes.

The refuse collection and cleaning services in ERC is a successful example of business process reengineering. Since more collaborative approaches to procurement of these services have been undertaken, strikes have disappeared from the scene and efficiency gains realized. This is a result of allowing two contractors to share the operations within a competitive framework rather than delivering this service and the city/authority providing the employees. The new best value procurement directives allowed negotiations to take place between unions and other stakeholders, which ultimately created better services for the citizenry. The procurement council now focuses on being responsible for strategy and resource management and alliances rather than on operational roles (see Figure 1, Partnering Features). Consulting with the public and other stakeholders has been one of the core measures taken to pursue a successful approach to continuous improvement at ERC. This could not be left out of a new procurement strategy.

Contracting out a service is regulated by three possible public procurement regulations. The first one is the open procedure, which is promoted by European guidance and used when the market is well developed and the specifications of products and services are relatively easy to define. The council advertises a call for tenders (proposals), which is open to all interested suppliers.

The second is the restricted procedure in which there is a pre-selection or short-listing of suppliers who comply with the Council qualification requirements. This process was used most for complex services and construction works. It did not allow for variance in the specifications of services or products, or the discussion of mutual objectives.

The third one is used in exceptional cases — the negotiated procedure. It is problematic because it allows for the introduction of variants in the specifications and innovative approaches late in the procurement process. Because this procedure uses more subjective selection and awarding criteria it was thought to hinder competition. Limiting the use of the negotiated procedure is an attempt to avoid advantages gained by contractors discussing specifications with the local authorities.

Now a fourth, Best Value approach is being developed, which reflects the real need for consultation between buyers and suppliers, particularly in cases where the technology of service provision is complex. The partnering process has been reengineered in detail with...
special attention to regulation compliance and accountability. This includes the strategic stage that allows for discussion and inclusion of mutual objectives. (See Figure 2).

**Resolving Problems**

In 1997, new guidance in terms of European Procurement was released giving special considerations to problem resolution. A newer “Competitive Dialogue Procedure” is being prepared to substitute for the negotiated procedure and the use of framework agreements is promoted. The latter, already supported by legislation, enables much more flexibility in terms of price changes or introduction of innovation. Solving problems becomes an issue of communication and attitude. The main characteristics of the partnership model are set against the practices of the previous adversarial model and explained in Figure 3.

One of the best examples at ERC of excellence resource management is the alliance with Europa’s first telecommunications operator. The contract required (1) the supply of telephone services to a large internal network and (2) a continuous cost-savings program. The contract is managed under a partnering model where the price is a flat fee. The reimbursement structure of the agreement will be reviewed ranging between plus or minus five percent of the initial service level, taking innovation into account. The principal feature of the partnership is the externalization by ERC of the development of control and security within the system. The telecommunications operator is able to reduce operational costs because Europa shares strategic control needs such as hierarchical limited access to international or mobile calls. This agreement has already produced savings of 30 percent per year. The most important success factor in this partnering approach was to decide whether alternative suppliers were willing to offer worthwhile price reductions or value in exchange for operations volume and reputation, particularly in the newly liberalized telecommunications market. The relationship is based not on naïve trust, but on carefully designed and balanced incentives.

**Continuous Improvement**

A relevant example of the continuous improvement facet of the partnering model is a new system to manage documents filing in the civil works department. The users of the system were systematically consulted about

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**Figure 2**

The Partnering Process

<table>
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<tr>
<th>Advertise for expressions of interest (include background details and request outline information).</th>
<th>Sift applicants against prequalification criteria.</th>
<th>Issue information memorandum and request further details.</th>
<th>Short list against agreed criteria.</th>
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quality features such as availability, waiting times, and ergonomics. Users were consulted during the mapping of the document tracing process and the results were integrated into the specifications of the contracts (service level agreements).

For direct services, citizens were consulted regarding quality details using a model that measured the gap between perceptions and expectations for a wide range of factors. As a result of these types of consultation processes, equipment purchases now depend on users’ needs rather than managerial discretion, and the layout is designed according to the highest aesthetic standards and compliance with the surrounding environment. Quality is seen as a proactive mechanism for adapting the contracts to the needs of citizens or other stakeholders.

Conclusion
From the beginning it was found that linking strategy to contracting and purchasing practices in a quality improvement framework was not going to be an easy task. It is acknowledged that there is a long road ahead to achieve a fully optimized system. Political constraints on planning activities or commitments with stakeholders whose interests are not always the same as those of ERC are still a reality, and the elimination of relationships that are inconsistent with ERC goals is an objective for the lean supply management strategy.

Implementation of Best Value practices result in collaborative relationships that are more efficient and effective in terms of quality than arm's-length relationships. When given incentives within the financial constraints of contracts and targets, and expected outcomes of the relationship discussed well in advance, contractors to ERC achieve best value not only in delivery of their services and products, but also within their own operations.