Arthur D Little

Sustainability & Risk
Operations Management

Green Purchasing Power

Cost Reduction and Revenue Generation through Sustainable Procurement

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Executive Summary

What is sustainable procurement?

Sustainable procurement is an approach to purchasing products and services that takes into account the economical, environmental and social impacts of buying choices.

A sustainable procurement approach includes best value-for-money considerations, optimizing the price, quality, availability and functionality of a required product or service.

It also includes the impacts of the product or service on the environment over its entire lifecycle, and social aspects of the product or service's origin and use, such as poverty elimination, international equity in distribution of resources, labor conditions, and human rights.

What is it not?

Procurement is not sustainable if it is divorced from business tangibles. Nor can procurement be defined as sustainable if it is an effort to gain approval from unspecified or irrelevant 'stakeholders', regardless of whether that is at the expense of the business.

In this paper we explore the drivers behind a sustainable approach to procurement, its influence on CEO's overall accountability, and how such an approach can be placed in the context of the wider strategic choices facing a company. We outline the profile of a "sustainable" supplier and present a view of the spectrum of procurement strategies taken by today's companies.

Why Bother?

Regulation has had an increasing impact on the bottom line in the last few years. Drivers include European Union (EU) legislation and national government policies:

- Recently issued EU directives require disposal costs of white goods, automotive and an increasing number of other products to be included in a company's P&L.
- Since July 2006 the RoHS directive (restricting the use of certain hazardous substances) bans the placing on the EU market of new electrical and electronic equipment containing more than agreed levels of certain poisonous components.
- By the end of 2007, 20 EU Member States had already adopted draft Green Public Procurement National Action Plans – e.g. the Italian government's plan includes 11 product categories spanning a broad spectrum from stationery products to public lighting.
- EU manufacturers have an increasing obligation to label and actively communicate the "energy balance" (energy consumption) of their products during the manufacturing process.

Expectations – of customers, consumers and other legitimate stakeholders – continue to rise:

- Environment-friendly and sustainable attitudes (termed LOHAS – Lifestyle of Health and Sustainability) are spreading among consumers of most developed countries. Consumers, analysts and others attribute increasing value to the environmental and social performance of products and services, and that of the companies that produce them.
- While carbon and environmental footprints are a growing concern, much of the footprint that can be attributed to a company lies in other parts of its supply chain. As stakeholders become increasingly insistent that "promises made" by the CEO should be "promises delivered", CEOs will need to extract more innovation from suppliers as well as the company itself to deliver on commitments to sustainable performance.

Business benefits from a sustainable approach to procurement include positive impacts on:

- Costs – reduced by factors ranging from enhanced compliance with government regulation, lower consumption of energy and other resources, to enhanced return from capital investments.
- Risks to the business – lowered, for example, by a strengthened brand, enhanced reputation, improved community relationships, and/or reduced grounds for litigation; the risk of supply discontinuity can also be lowered by applying environmental performance metrics and targets into the supplier performance assessment process or during the contract renewal process, as these help to mitigate the risk of suppliers' non-compliance.
- Options – broadened by increased innovation scope, greater opportunities for premium pricing, possibility of engaging in emissions trading, and other new routes to revenue protection and revenue generation.
- Preferences – with the company being more highly valued by potential and existing customers, insurers, credit sources and others.

This is borne out by a recent Arthur D. Little survey of major Italian utility companies. The companies perceived the three most valuable benefits of a sustainable procurement system to be: protection from environmental risk or disruption; attraction of environmentally sensitive customers; and reinforcement of brand reputation.

Spotlight on the CEO Raises Pressure for the CPO

Purchased products and services account for more than 60% of the average company's costs[1]. When your supply chain's environmental and social footprint equals or exceeds your company's, the business' resulting exposure to supplier activities becomes enormous – as does its vulnerability to adverse environmental and social impacts caused by any suppliers.

The Chief Procurement Officer controls procurement, however, accountability for a company's ability to demonstrate sustainable procurement rests with the CEO, for at least three reasons.

One is that the CEO is accountable for the overall performance of the business. Therefore, the CEO needs to be aware of and managing any risks of damage to the business, its income and its reputation – including those risks caused by short-sighted efforts to cut costs in procurement.

As an example of how major such risks can be, the world's largest toy company was obliged to recall about 21 million toys manufactured by a supplier in China. The recalls resulted in a charge of about $40 million to the company, and disrupted its supply chain significantly.

Following a 2006 investigation into suspicious payments for consultancy services, a leading technology company's name was severely tarnished. Two top executives lost their jobs. Potential fines ran into billions of euros, and the company also faced the possible indictment of still-serving executives. To recover lost ground, it adopted a proactive stance, hiring its own legal and financial investigators who identified €1.3 billion in suspicious payments.

Second, the CEO is accountable for the business' overall response to stakeholder expectations. As the procurement budgets of the world's biggest companies exceed the gross national product of many nations, this makes procurement a major concern, not just at company level but among external stakeholders and society in general as well. Hence a more engaged approach is required of the CEO to deal with the risks and opportunities created by growing awareness and expectations among consumers, customers and governments that businesses will procure responsibly.

Evidence of rising consumer interest in green products/services comes from a report by the UK's Co-Op Bank, *Rise of Ethical Consumerism in the UK 1999-2006*. This report highlights the tripling of the UK's ethical consumerism market over the period surveyed. Conversely, nearly 60% of respondents said they had decided not to buy at least one company's products or services in the previous 12 months because of the company's behavior.

The third reason for CEOs' accountability for sustainable procurement is their duty to build the value of the company. There are several routes to this: value can be added through reduced costs, reduced risk, revenue protection and/or revenue growth.

As the many examples in a new series of Arthur D. Little publications show[2], success on any or all of these routes is enhanced by companies led by CEOs focused on achieving sustainable performance through integrity and innovation.

The CEO cannot delegate his or her accountability for sustainable procurement. But he or she typically delegates responsibility for making it happen to the CPO. And the pressure on the CPO to deliver the required results – from a CEO whose risk exposure in relation to supplier activities is as great as any the company itself presents, but whose control over those activities is much less – is likely to be intense.

1 Degraeve, Z and Roodhooft, F (June 2001) "A smarter way to buy" *Harvard Business Review*

2 *Integrity+Innovation=Sustainable Performance: the Sustainability Value Formula*, Arthur D. Little, 2007

Sustainable Performance: Delivered, Arthur D. Little, 2008

Part of a Bigger Picture

The CPO's role in procurement is essentially a balancing act – addressing and aligning the conflicting interests of keeping supply chain costs down, keeping operating costs and risks down, reducing lead times, maintaining or increasing quality, and optimising the balance sheet.

After all, the concerns of procurement are not only the cost, quality, technical specification and availability of products and services bought. Procurement externalities such as disposal costs, CO_2 implications, and other costs and impacts of operation must also be taken into account, as consumer expectations and government regulations relentlessly drive up their significance in day to day business terms.

For example, existing and planned legislation penalises high energy consumption and rewards emissions reductions. Such legislation is typified by the EU directive for 2012 that will include CO_2 in aviation and shipping as a cost.

The potential savings are clear from a recent assignment carried out by Arthur D. Little for an Italian multi-utility company. We estimated that replacing 250 Watt public lighting lamps with new-type 150 Watt lamps could result in an annual saving of €100,000,000 and avoidance of about 6,500 tons of CO_2 emissions, worth at current market prices, about €160,000 per year.

A wider perspective on procurement is also needed to recognise where higher capital outlay can be offset against higher performance and lower costs and risks of operation or use.

For example, retailer Wal-Mart saved $26 million in annual fuel cost from installing auxiliary power units to the truck fleet; enabling drivers to control cab temperature during mandatory ten-hour road breaks without idling their truck engines all night, wasting fuel.

Choices for companies

In this changing business landscape, companies have three strategic choices in relation to sustainable procurement.

They can adopt a **reactive** strategy, only moving in a more sustainable direction when forced to do so by regulation or loss of business. Companies that adopt this strategy constantly maintain a high risk of losing competitive advantage, incurring fines and other penalties, and losing customers and staff.

An alternative strategy is to **keep up** with regulation, and with your company's peers, in terms of sustainable procurement. This strategy allows revenue protection, but fails to encourage new revenue generation.

The third possibility is a strategy of **anticipation**, through systematic evaluation of the company's procurement options, followed by implementation of measures designed to maximize the business benefits delivered through procurement.

How can I Recognize a 'Sustainable' Supplier?

In Arthur D. Little's experience, one of the most challenging aspects of moving a company towards more sustainable procurement is identifying appropriate suppliers of the products and services required by the company.

In seeking these suppliers out, companies often turn for help to environmental consultancies. While well equipped to assess environmental attributes and issues in a given supplier or supplier community, such consultancies do not normally contain the business operations expertise required to also assess how well a supplier meets the supply chain needs of their client. Conversely, business consultancies tend to have in-depth understanding of supply chain issues, but lack the expertise to tailor a potential supplier's sustainability credentials to their client's business.

Genuinely sustainable procurement achieves coherence between sustainability and business issues. Decision making for sustainable procurement embraces all the different types of cost that surround different options.

For example, deciding to terminate a contract with a long-term supplier because it is not cooperating or meeting sustainability criteria can be a difficult decision, because the switching costs may be significant, or because switching will involve loss of technical know-how.

Alternatively, an existing or new supplier may have the capability to deliver a more sustainable version of a required product or service, but have delayed launching it because of low profit forecasts and/or uncertain market potential. In this case, costs for the procuring company may include both switching costs and incentives to accelerate the launch.

In a third possible scenario, a supplier may have the potential to supply a more sustainable product but need an investment injection to complete the development and/or add production capacity to achieve industrialization of the product. Here a route forward could involve a joint investment arrangement by the supplier and procuring company.

We find companies benefit significantly from working with advisors who have the capability and experience in both sustainability and procurement to help them identify the most appropriate suppliers and strategies for their business needs.

This combination enables us to provide a tailored analysis of business requirements and strategic imperatives, using international financial, environmental and social performance certification where it exists, and applying ADL technical competence where it doesn't.

"Genuinely sustainable procurement achieves coherence between sustainability and business issues."

Applying our approach to supply risk management, and proprietary methods for sustainable supplier and other business decisions, leads readily from findings and recommendations into an action plan that procurement departments and those with whom they interact can understand, internalise and enact.

Our approach also uncovers the hidden challenges of sustainable procurement, and allows them to be addressed explicitly.

For example, many companies underestimate the difficulties of controlling supplier standards at long distance. The longer and more articulated a supply chain is, the harder it is to control entirely. This becomes especially true when a "low-cost-country sourcing" (LCCS) strategy is pursued. The difficulty is often at least partly due to what we call the "sustainability gap" between producing markets (where goods are manufactured) and consuming markets – with marked differences in expectations about health, safety and the environment. LCCS effects can be even more serious when the strategy involves controlling second tier suppliers, of which the company has little or no visibility. Senior executives often do not realize how big the sustainability gap is in their own supply chain until it is too late – and their business suffers from public exposure by non-governmental organizations or other campaigners.

To address this, companies including Procter & Gamble, Unilever, Imperial Tobacco Group, Nestlé, Cadbury Schweppes and Dell are members of a group called the Supply Chain Leadership Coalition, encouraging suppliers to release reports about carbon emissions and strategies for battling climate change.

Difficulties can surface in a company adjusting its existing procurement processes and organization, and trying to manage the related change. Changing the requirements for procurement of goods and services can have a significant impact in many areas: e.g. on processes and systems for supplier selection, qualification, verification and performance assessment; on logistics and maintenance processes; and on the skills and competencies required of procurement staff.

Irrespective of any changes decided and planned, challenges can arise due to internal cultural or organizational barriers to adopting a full life-cycle cost perspective so that the external costs of procurement (disposal costs, CO_2 implications) are properly internalized.

Having an aligned, motivated and transformed internal organization is no guarantee of success. Market access to the sustainable version of some products can be difficult; and sometimes it is far from easy to discern a sustainable product from its competitors. In such situations, some innovative thinking around procurement procedures may be required – e.g. inviting suppliers and/or manufacturers to assess the availability of the product on the market, in order to be involved in the definition of the sustainability criteria, and to negotiate collaboration agreements.

Questions to Consider

An effective step towards more sustainable procurement is to identify:

- What are your stakeholders' expectations – not just clients and customers but also suppliers, NGOs, regulators etc?
- What is your business' ambition for this way of doing business?
- What are the barriers that prevent your company from adopting a sustainable procurement strategy?
- How does your company measure up against other organizations that are leading/lagging the field in sustainable procurement?

Comparing your purchasing strategy against your customers' preferences can help your company to get the best-fit positioning to meet new demand for sustainable products and services.

When it comes to **stakeholder** – in particular, customer expectations, a "sit and wait" approach is usually not the best. Use of hazardous materials, for instance, or working with suppliers that are not complying with health and safety or labor standards is not only costly (e.g. costs of legal action and non-compliance with regulation); it can cause serious disruption of trust and loss of customers. Recovering from such a disaster is difficult, as many examples in different industries have demonstrated.

A proactive company knows that aligning corporate values and goals with purchasing policies enhances stakeholder support, builds customer appreciation and ultimately can help win over new customers. An increasing number of retail consumers are shifting their buying preferences towards companies that have visible and valuable corporate social responsibility track records. These environment-minded consumers will support companies that are able to provide sustainable goods and services.

Acting proactively to meet customers' expectations of company social and environmental performance means injecting an 'outside – in' approach into the company's procurement strategy. To ensure their purchasing is consistent with consumer requirements and expectations, proactive companies do not wait for customers to ask; rather they ask customers what their expectations of a sustainable procurement policy are.

Aspects of **ambition** include how far you're prepared to push your company to grasp the opportunities afforded by sustainable procurement.

"An increasing number of retail consumers are shifting their buying preferences towards companies that have visible and valuable corporate social responsibility track records."

For example, a company with a reactive strategy (and hence quite a high tolerance for risk) is satisfied with patchy intelligence about sustainable suppliers, and incomplete criteria for assessing their appropriateness to the business' needs. Such a company keeps suppliers at a distance, rather than pursuing competitive advantage through collaboration and mutual support. Internally, understanding of the procurement strategy is confined to the procurement department.

In contrast, a proactive company seeks the benefits of anticipating the changing requirements of customers, regulators and other stakeholders. Such a company uses sustainability for product or service differentiation. Sustainability ambitions are integrated into the business strategy and procurement (as well as other) activities, and fully communicated within and outside the company. Collaboration with suppliers, with industry, and with customers is part of day to day business, to continually raise sustainability standards and performance.

Barriers to the introduction of sustainable procurement arise, above all, from the leading perception that this is a difficult strategy to implement. Arthur D. Little's research among Italian utility companies, mentioned above, showed that the potential lack of a sustainable supplier of goods and services is the most common constraint perceived when approaching a decision on whether to implement a sustainable procurement strategy. Another common myth highlighted by this research is the perception of a higher cost of sustainable products and services compared with alternatives.

"Collaboration with suppliers, with industry, and with customers is part of day to day business, to continually raise sustainability standards and performance."

A reactive company starts and ends by scouting its existing supplier base in search of already available sustainable products and services. Supplier switching policies are often not an option. The purchase price of products or services is the only metric used to conduct a cost-benefit analysis and to evaluate the overall economic merit of sustainable products. Environmental benefits calculations are seldom integrated into the analysis.

A proactive company, in contrast, knows that if it has significant procurement spend it can push the market towards the development of a more sustainable offering. Development of new products and services is hence pursued in tight collaboration with new or existing suppliers. Life cycle analysis thinking is "business as usual" in the procurement department.

Benchmarking your business against its peers, best in class or best in the world is about testing how well positioned your business is in relation to the opportunities presented by sustainable procurement, and how capable it is of dealing with the risks of not engaging.

A reactive company develops its business and product/service strategy without any consideration of sustainability issues in the supply chain. Monitoring of suppliers is piecemeal and lacking predetermined targets for sustainability, leaving the company open to risks.

A proactive company, meanwhile, operates a product/service strategy informed by considerations of the current and future abilities of the supply chain to meet sustainability objectives.

The company plays a leading role in driving industry collaboration to adopt the best possible standards and approaches, working with regulators, governments and standards agencies to ensure that regulatory, fiscal and other public sector interventions fully support sustainable procurement.

Where would you position your company on the 'reactive – proactive' spectrum? If you'd like to discuss your business's ambitions for sustainable procurement, or you are concerned about its capabilities in dealing with the opportunities and risks outlined here, please contact your local ADL office.

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If you would like more information or to arrange an informal discussion on the issues raised here and how they affect your business, please contact:

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Sustainable Mobile Phone

Nokia's "remade" concept for mobile phones uses recycled materials that avoid the need for natural resources, reduce landfill, and allow for more energy efficient production. The phone is made out of metals from upcycled aluminum cans; plastics from drink bottles form the chassis; and its rubber key mats are provided by old car tyres. Inside the phone are new more environmentally friendly technologies such as printed electronics. The graphics used on the display save energy without compromising on style.

Remade is part of Nokia's ongoing work to help people make more sustainable choices.

Arthur D. Little

Arthur D. Little, founded in 1886, is a global leader in management consultancy, linking strategy, innovation and technology with deep industry knowledge. We offer our clients sustainable solutions to their most complex business problems. Arthur D. Little has a collaborative client engagement style, exceptional people and a firm-wide commitment to quality and integrity. The firm has over 30 offices worldwide. With its partner Altran Technologies, Arthur D. Little has access to a network of over 16,000 professionals. Arthur D. Little is proud to serve many of the Fortune 100 companies globally, in addition to many other leading firms and public sector organisations. For further information please visit **www.adl.com**

Our Sustainability and Risk practice supports companies across the world to find performance through integrity and innovation. Our work is rooted in the origins of the firm. Since the days when Arthur D. Little himself advised clients on finding commercial uses for their process waste, we have combined our in-depth sector knowledge and expert advice in business strategy and performance, technology and innovation with a strong track record in advising companies on environmental and social responsibility.

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