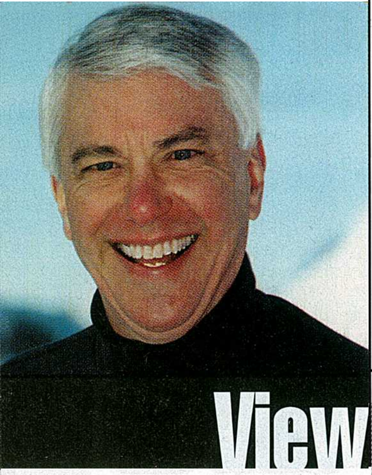

Viewpoint

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Reducing Supply Chain Costs: Spend More to Save More

Managers who want to reduce supply chain costs need to spend more on transportation. The key to lower supply chain costs is holding less inventory. Buying more transportation lets you reduce inventory safely.

The greatest mistake that manufacturers make today is equating transportation cost reductions with total available supply chain savings. In fact, transportation savings do not even correlate with overall supply chain savings. The largest economies come from inventory reductions that often result from buying more transportation.

Inventory is the Issue

Inventory levels, not transportation costs, drive supply chain savings. For most manufactured products, transportation is only two to five percent of total cost. In contrast, raw materials, components, and subassemblies typically constitute 55 to 75 percent of total cost. This reality helps explain why large cost savings result from complete supply chain solutions that reduce raw material and finished goods inventories.

Actual experience in managing supply chains highlights the strong correlation between total supply chain costs and inventory carrying costs. The 2001 *Logistics Cost Survey* conducted by Herbert W. Davis found that "the difference between the 20 percent of companies that reduced cost and the 50 percent that had an increase was almost fully explained by the inventory level performance."

Current economic pressures, however, are causing some companies to buy transportation for the lowest possible price and neglect inventory management. Mismanagement and mismeasurement are two factors encouraging this dysfunctional behavior.

Most companies concentrate on reducing transportation costs because that goal fits how they manage. Even today, most transportation departments are cost centers that are not involved with inventory management. For them, success is defined as negotiating greater discounts from carriers.

Companies that concentrate on optimizing transportation discounts miss out on larger inventory savings. These companies often trade down on service levels. The most common strategies are to ship less often or to switch to slower, less-reliable modes.

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Each of these actions increases inventory holdings. The costs of this extra inventory more than offset any transportation savings. Thus, cutting transportation costs is a sub-optimization that produces false savings.

Another reason why companies focus on reducing transportation costs is that changes are easily measured. In contrast, measuring amounts of inventory and calculating changes in inventory carrying costs are much more difficult tasks. Companies often fail to go after inventory savings simply because they cannot measure the amount of inventory in their supply chain.

Companies can lower their supply chain costs by using new management strategies to reduce inventory safely. First, they must stop treating transportation as a management "silo" that is separate from inventory management. Second, companies should install technologies that provide detailed inventory visibility throughout their supply chain. These are the prerequisites for lowering inventory and achieving supply chain cost reductions.

Avoiding False Savings

The largest required management change is a willingness to pay higher transportation costs in exchange for lower inventory levels and carrying costs. To succeed, managers must focus on the total cost of the supply chain rather than just transportation costs. To avoid false savings, managers must measure and manage all costs together.

Transportation decisions that do not account for changes in inventory will often result in overall cost increases while delivering apparent savings. It is imperative that companies broaden their performance measures to include inventory investment and carrying costs so that total expenses are managed. Then, buying fast, reliable transportation will allow managers to operate supply chains with the lowest possible safety stocks. ■