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Brand Investment Traps

The proven antidote is an integrated approach to brand management and brand science

By Andrew Pierce and Adrian Slywotzky

Brands have become increasingly fragile and difficult to sustain. Failure to invest in the right mix of activities at the right time risks eroding the brand. On the other hand, those companies that anticipate and avoid the common investment traps can reap superior growth in brand value over a long period of time.

When Mercedes Benz USA announced its 2004 sales this past February, the volume was the highest in its 40-year history. Spurred by investment in the entry-level C-Class line (priced as low as \$26,000), overall sales rose 5% percent for the year. Yet five of Mercedes' high-end luxury models actually posted sales declines of up to 25%. Mercedes has slipped in the U.S. luxury car market, falling to third place behind Lexus and BMW, and its management has been wrestling with the tradeoff between preserving equity in a luxury brand and raising volume at lower price points, which risks diluting the value of the brand.

History shows that even great brands, from A&P to Howard Johnson to Polaroid to Zenith, are vulnerable to sudden collapse or to slow and devastating erosion. While each troubled brand has its unique story, the common theme that unites them is "misinvestment"—the company's failure to invest wisely for long-term growth of brand equity.

Some organizations ignore the necessity of brand investment altogether, using the brand as a cash account from which value can be drawn to improve the next quarter's numbers. The lack of visible bad effects in the short term encourages more borrowing, so that after years of deferral the cost to rebuild the brand becomes enormous. Failure to invest leads to a point of no return, where the cost or time to revitalize or reposition the brand outweighs the expected additional revenue. Such neglect may destroy the brand and even the company, since for many firms brand equity—the price or volume premium enjoyed by the branded product or service over a non-branded equivalent—can translate into as much as one-third to one-half of the company's total market value.

Failure to invest is just one of the common traps that can kill brands. The wrong mix of investments, the wrong investment sequence, failure to adapt an investment strategy over time, and other traps can also push brands toward the point of no return (see Exhibit 1).

The proliferation of investment traps over the past decade has made brand management quite complex. Branding has moved beyond the traditional sphere of packaged goods to become vital in almost every business sector, as indicated by the explosion of ad spending

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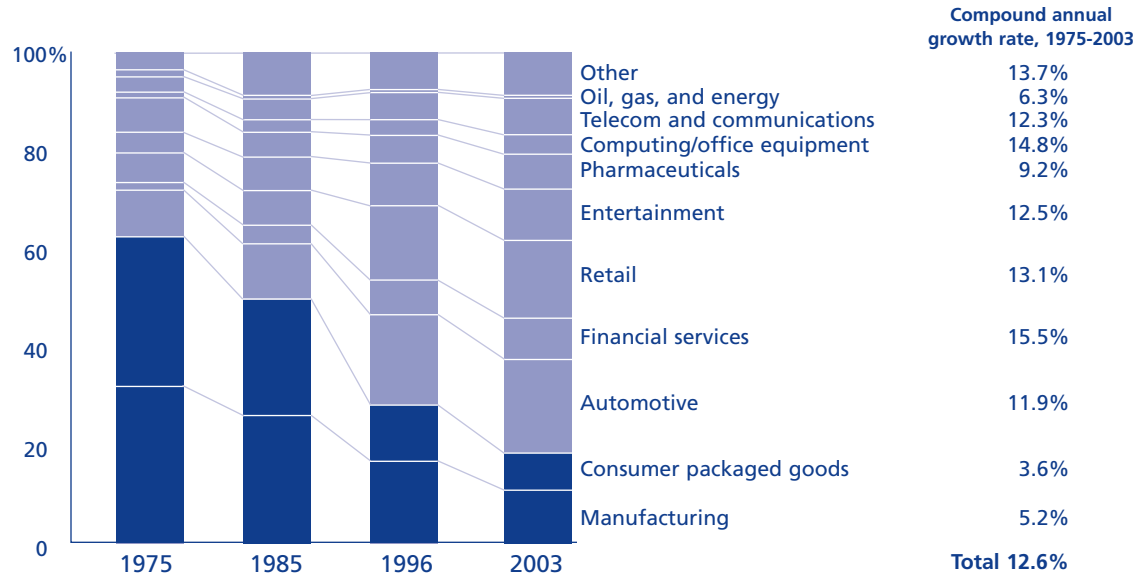
Exhibit 1 **Brand investment traps**

Trap	Description
1. Failure to invest over time	Assuming that the brand's value is largely self-sustaining, a mine to be exploited rather than an asset to be nurtured
2. Wrong investment mix	Overinvesting in advertising, promotion, sponsorships, or product marketing programs that do little to create brand value and distract from more urgent needs
3. Wrong sequence	Investing in marketing initiatives with a lower expected payoff in terms of increased customer revenue versus programs with a greater expected payoff
4. Myopic focus	Focusing only on a narrow set of brand dimensions or audiences, while ignoring other factors that are essential to building brand value
5. Wrong touchpoints	Investing to improve customer touchpoints of marginal relevance while neglecting others that are crucial to building brand equity
6. Wrong positioning	Emphasizing components of brand equity that do not drive customer behavior, while ignoring other components that do
7. Failure to adapt	Emphasizing brand dimensions that have become irrelevant to customers over time or have taken on negative connotations among customers
8. Spending too little on too many brands	Spreading investments across too many brands with minimal value, that operate in stagnant or shrinking markets, or that are rapidly becoming commoditized
9. Overstretching the master brand	Maintaining a single overarching brand to save money when several brands focused on different markets would attract more customers
10. Dilution	Licensing the brand to gain market share and access to new customer segments but diluting price premiums
11. Wrong metrics	Failing to measure the key indicators of brand health; choosing measures that have little or no real significance; or ignoring, denying, or rationalizing the warning signs that the metrics reveal
12. Trying to turn around a dead brand	Trying to revitalize a struggling brand in a situation where a new brand could achieve greater visibility and acceptance among customers in a shorter time and at lower cost
13. Failure to follow through	Overlooking the need to support a brand after a successful revitalization has occurred

by the telecommunications, pharmaceuticals, financial services, and other industries (see Exhibit 2). Other developments have further complicated brand management, including the multiplication of channels for advertising, marketing, and sales; the emergence of powerful new competitors thanks to globalization, venture capital, and technological advances in communication and logistics; and greater access to information among customers, suppliers, and competitors. As a result, brand premiums have become increasingly fragile and difficult to sustain.

Exhibit 2 Branding for all

Percentage of total measured U.S. media spending by industry



Note: Media spend for telecom and financial services based on industry revenues multiplied by estimated industry ad spend-to-sales ratios.

Source: LNA, Schonfeld & Associates, Lippincott Mercer analysis

In this tumultuous environment, the classic model of brand management falls short. It assumes that brands matter primarily in packaged goods; yet, as we’ve seen, branding applies to most business sectors. In the classic model, brand management is a stand-alone function centered in the marketing department; as we’ll explain, *integrated brand management* now must involve many other parts of the organization. Traditional brand management tends to focus on advertising and other traditional marketing or communications media, and it assumes that once funds have been allocated for next year’s ad campaign, the brand investment strategy is complete. We’ll show why this approach is short-sighted, because today’s investments must be made in the context of a company’s overall business design.

Finally, the discipline of brand management has been largely qualitative, the province of image-makers and pulse-takers. Creativity remains important, of course, but it should be supplemented with quantitative tools drawn from the emerging field of brand science, which allow companies to measure the strength of specific elements of their brand equity, brand value, and branded customer experience with greater precision than in the past.

This more effective integrated brand management approach combines sophisticated metrics with analytically based investment decisions and ties them directly to the company’s busi-

ness design and economics. The approach also helps managers not just to anticipate and avoid the traps that can destroy their brands, but also to grow the brand's value over a sustained period.

The elements of brand equity

Integrated brand management starts by defining which elements of the brand create differentiation and influence customer behavior. This knowledge emerges from market research or in-market experimentation that shows how existing and prospective customers make choices in a competitive marketplace. This data can be augmented with brand image and customer experience data, which captures how customers perceive the brand at each touchpoint. Once collected, the list of 50 to 100 image and experience dimensions can be winnowed to a subset of six to ten of the brand's equity elements—attributes that shift the demand curve, all else being equal.

Certain equity elements apply to any brand, such as trust, reliability, and ease of doing business. Others apply to particular brands or types of brands. For example, innovation is an essential element of Sony's brand equity, but not of Coca-Cola's; family friendliness matters to Disney, but not to Harrah's; upscale image is crucial to Louis Vuitton, but not to the Gap. It's important to define the equity elements accurately and precisely as they apply to a given market. For example, in the automotive space, performance means something different to most European drivers (defined, agile, smooth) than it does to U.S. drivers (adroit handling and raw power).

Each equity element can have a positive or negative value, depending on whether it makes an individual customer more or less likely to buy. For Sony, innovation has a positive value to the extent that customers associate it with "the best and latest products"; it has a negative value if customers think of "products that are complex and hard to use." For Disney, family friendliness has the positive meaning of "fun for the whole family" and a negative meaning of "too bland for single, young adults." Getting the equity elements right is a critical prelude to the subsequent aspects of integrated brand management.

Having accurately defined the equity elements that matter most for the brand, it's also essential to monitor how their relevance changes over time and adapt the brand strategy as needed. The long-term decline of the venerable Oldsmobile and Plymouth brands occurred because General Motors and Chrysler did not adapt to the steady decay in the relevance of their brand attributes. Consumer perceptions of Oldsmobile and Plymouth didn't change drastically, but over time the number of car buyers who cared about their brand elements dropped consistently. GM's and Chrysler's marketing spend on those brands could have been put to more productive use for other brands in the portfolio.

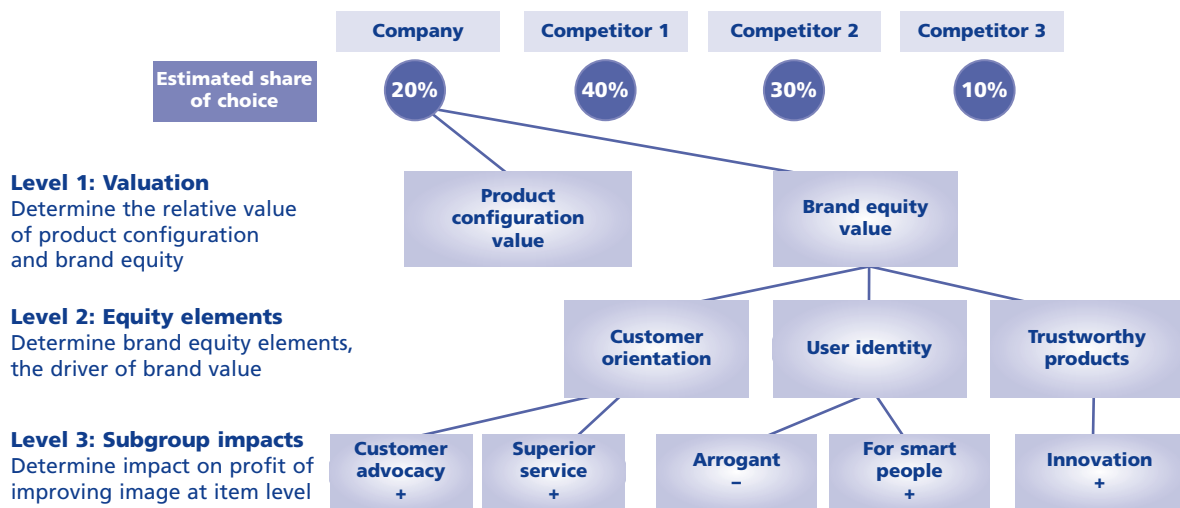
Customers' priorities vary, so one must distinguish the attitudes of different segments of existing or prospective customers toward the equity elements. Loyal and high-value customers who love a brand form a core group. Around that center, regular customers occupy the next ring; prospective customers the third ring; and those who have rejected the brand a fourth outer ring. Moving out along the successive rings, how quickly do positive perceptions about the brand fall off? At what point do negative perceptions dominate? Are there specific positive or negative attributes that pop up at a particular point?

Addressing such questions can help define the extent to which it is possible to expand the customer base and extend the brand without alienating the loyal core. To take an extreme case, when considering the polarizing Hummer brand of SUV, the outermost circle of rejectors contains people who dislike the Hummer for being huge, gas-guzzling, and militaristic. While it's unlikely that the Hummer brand could be reconfigured in a way to satisfy these people, GM was successful in building a brand that has broader appeal without running the risk of brand dilution.

Defining the brand's key equity elements and the value they have for specific customer groups (see Exhibit 3) thus reveals the many dimensions of the brand and informs decisions about extending it to new products, customers, or markets.

Exhibit 3 How brand equity analysis works

Determine which equity elements actually influence customer choice (illustrative)...



...then optimize investments in those equity elements

Customer segment size	Customer segment name	Equity elements	Five-year NPV (net assets)
2%	High value	Customer advocacy	[Bar chart showing NPV contribution]
8%	Active investors	Superior service	[Bar chart showing NPV contribution]
15%	Mass affluent	Innovation	[Bar chart showing NPV contribution]
65%	Mass	For smart people	[Bar chart showing NPV contribution]
10%	Retiree	Arrogant	[Bar chart showing NPV contribution]

The right metrics to track brand health

With the profile of equity elements in hand, managers then need a system of metrics to track the brand's vital signs.

Just as established tools and guidelines track debt, working capital, and other components of a firm's financial health, there is a developing science of brand metrics that offers powerful diagnostic tools for measuring and monitoring changes in brand health. These tools go beyond the traditional measures of awareness, consideration, and preference to include data on brand premiums, brand as a percentage of shareholder value, brand extendability, and employee commitment scores. Well-designed metrics allow managers to measure the value of a brand, the return on marketing investments, and the elements of the customer experience that build or dilute equity in the brand. Thus, they can help managers take corrective measures or reallocate investments for the greatest positive impact on the customer experience.

For example, the Microsoft brand is widely respected in the software arena, including business-to-business markets. But certain metrics tracking perceived trust and perceived corporate intentions have revealed the danger lurking in one component of the brand's value. Executives from some other companies have publicly voiced their opinions characterizing Microsoft as a rapacious competitor and a dangerous ally. This reputation makes it harder for Microsoft to develop the partnerships it will need to succeed in new arenas such as entertainment. As one possible move, Microsoft might invest more in its relationship with an important constituency, and it could potentially benefit from improving its brand metrics system and developing a range of responses to the early warnings that the system raises.

Leading indicators of brand health, when correctly identified and assiduously monitored, can unearth very valuable information. For example, based on studying ten years' worth of customer data, one leading manufacturer of electronic components can define how customer loyalty, employee commitment, and brand equity are interrelated, and can link these relationships to operating and financial measures. As the company invested more to communicate its business strategy, it also saw a rise in employee commitment, customer perceptions of sales force knowledge, and brand consideration. Now the company knows that if employee commitment slips in the first quarter, customer satisfaction will slip in the second quarter and brand value will decrease in the fourth quarter.

Metrics point to the areas that need investment at any given moment. As the brand moves through its life cycle, as new competitors enter the market, and as customer priorities shift, the way a company invests in its brand will need to change. For instance, Hewlett-Packard is pushing deeper into digital entertainment as a brand known best for printers and PCs. The company could spend differently to reposition its brand in this new space or leverage investments in the Photosmart sub-brand to pave the way. At the same time, HP's investment in certain sponsorships may do little to help push the brand into this space, and may also increase the risk of overstretching the master brand.

A recovered brand poses its own special investment demands, since revitalizations are remarkably fragile. From 1998 to 2001, Volkswagen simultaneously redesigned several of its car models, redesigned its dealer network, and launched an aggressive marketing campaign, thereby revitalizing its brand and increasing annual sales by 150%. Since 2001, however,

VW has launched no new models and has reduced its marketing investment by 25%. As a result, sales have begun to slip back toward the levels of six years ago.

As these examples illustrate, the dynamic nature of brands, as well the fluid environment in which brands compete, means that brand investment calls for continual rebalancing.

As the business design goes, so goes the brand

Brand management doesn't stop with investment choices. A common mistake that many companies make is failing to consider brand strategy within the broader context of the business design. All the marketing and advertising in the world won't build or sustain a powerful brand if the business design around which the company is organized fails to deliver on the brand promise. Conversely, a company with a great business design is capable of developing a powerful brand through excellent customer experiences, even without significant spending on marketing and advertising—but that will happen only if the business design and the brand are aligned.

It follows that for every change in the business design, there should be a corresponding change in brand strategy (see Exhibit 4). If you change the target customer set, refine the value proposition, change pricing strategy, or make an acquisition that changes your scope of the business, you must make a corresponding adjustment to the brand strategy. Fail to make those adjustments and you will end up with a business design and a brand that no longer match.

Exhibit 4 **Keep them in synch**

If you change...	How should you adjust...
<p>Business design components</p> <ul style="list-style-type: none"> • Customer selection • Value proposition • Value capture/profit model • Scope of business • Strategic control • Organizational systems 	<p>Brand strategy elements</p> <ul style="list-style-type: none"> • Target audience • Positioning • Brand architecture and portfolio • Brand identity • Brand experience • Brand metrics • Marketing mix

Consistency between brand and business design involves much more than marketing or advertising. It means adjusting investment in any area of the business that's dissonant with the brand promise. For example, when we studied ten years' worth of sales performance for all the brands competing in the mass-market, non-luxury U.S. automotive segment, we found that nearly 90% of the variation in sales among brands could be explained in terms of six key variables. Only two of these variables pertain to traditional marketing; the other four relate to product development and sales channel management. Yet all should be considered by automakers as they determine the optimal mix of brand investments, and all must be executed effectively in order to achieve sustained sales growth. The recent turnaround of Nissan in North America can be explained by Nissan's ability to use all six of the business and brand levers.

For many service companies, the most fruitful forms of brand investment may lie not in marketing but in areas such as R&D, customer service, or employee hiring and training. One bank that was struggling to revive the value of its flagging brand determined that the key problem was an inefficient complaint resolution process. A set of angry customers spread the word to others about their experiences. This crucial discovery surfaced only after the bank had identified its key customer points of contact and analyzed the relative impact of each touchpoint on customer perceptions of its brand. As a result, the bank could be confident that investing to fix the problem would yield a greater return than investing to expand the customer base through product introductions or advertising. Careful ROI analysis steers resources to those touchpoints that matter most.

Note, too, the importance of choosing the right sequence of brand investments. In the bank's case, if it had invested in marketing and advertising before improving its customer service system, the spending would have been counterproductive. Many of the potential new customers attracted by the marketing campaign would have been turned off by the bank's inability to serve them properly and would have abandoned the bank.

The tight link between brand and business design means that every strategic move must be considered in the light of its impact on the brand. A move that appears smart for the business in the short run might eventually hurt the brand. We see an increasing tension across industries between the need to redesign the business and the imperative to not change the brand.

The tradeoffs now being faced by the managers of American Express offer an illustration of this. In an effort to expand both the customer base and the merchant affiliations of its venerable charge card so as to compete more effectively against Visa and MasterCard, American Express has been making deals with mass-market retailers including Amazon, McDonald's, and Costco. These deals will open up large, low-cost customer acquisition channels, putting

■ Brand investment tradeoffs

Because brand investment choices are so complex, they often involve difficult and painful tradeoffs. Here are some classic dilemmas:

New versus old. Should a company extend an existing brand to include new product or service offerings, which risks diluting or confusing the brand image, or should it commit the resources required to build a new brand? Nissan and Toyota recognized the difficulty of extending their high-reliability, basic transportation brands into the luxury end of the market. They made the right decision and committed the necessary resources to build the Infiniti and Lexus brands instead, and Toyota recently added Scion to target young drivers.

Change versus continuity. As current customers age and new customer groups emerge, should a company emphasize change or continuity in its brand? IBM has adroitly managed the route of change over the past decade, transforming its brand image from "hardware maker with a tradition of conservative quality" to "information services provider with unmatched depth and breadth of expertise."

Promoting the brand versus escaping the box. An established company that has built a powerful brand may find itself boxed in by the brand. To expand its markets, should the company extend the brand or launch a new brand? On either course, how will it avoid alienating or confusing existing customers? Marriott realized that it could not reach the luxury market with the Marriott brand and decided instead to acquire Ritz Carlton.❖

pressure on the brand to resonate with several audiences. In addition, American Express is opening its network so that partner banks can issue American Express cards much as they currently issue Visa cards or MasterCard.

What impact will these moves have on the American Express brand, whose strength has long derived from its status as an exclusive, aspirational brand? When everyone can get an American Express card, issued by any bank rather than directly from American Express, and can use it to buy a cheeseburger rather than a Caribbean vacation, what will happen to the perceived value of the brand? The devil is in the details: Lacking careful measures, a strategic move that may be beneficial to the business in the short run can have a devastating long-term effect on the brand, one that may not become obvious for years.

A team sport

A brand is more than a promise. It's also a major financial commitment and, as we've seen, the mix of investments required to build and sustain a brand extend far beyond the traditional marketing sphere. If all the moving parts of the business don't synchronize to deliver the right experience to customers, then the long-term value of the brand surely will erode.

That is why brand management must be part of the senior executive agenda, starting with the CFO and CEO. And it is why the group designing an integrated brand investment plan should include people from human resources, production, finance, customer service, quality control, and other departments that contribute to delivering on the brand promise. The role of the brand manager expands as well, to be an educator and agenda-setter for an ongoing discussion about the brand.

Integrated brand management has become a team sport, not a one-department show. Even brand masters such as Richard Branson, who embodies his Virgin brand, cannot be truly effective unless all the moving parts of their business designs are fully aligned with the brand promise. Tomorrow's most successful companies will be those that integrate brand strategy throughout every department and level of the organization. ❖

Mercer Perspective

Top of the Commodity Cycle or Structural Shift for Sourcing?

Managing utility sourcing programs through a period of upward price volatility

Sourcing strategies have returned as a critical issue for energy utilities. External pressures on the supply base are raising new risks and fewer opportunities, and utilities that lack a truly strategic approach to sourcing will likely be surprised.

A unique set of cyclical price pressures in raw materials and labor markets is causing upward price volatility. If mishandled, these pressures might transform today's cost savings programs into tomorrow's cost avoidance programs. This *Perspective* discusses a strategic sourcing approach that can anticipate these developments while continuing to deliver major improvements the bottom line.

Cost-saving efforts today have a defensive quality, as rising fuel prices for utilities in all regions of the U.S. have put upward pressure on customer rates. Faced with intense legislative, regulatory, and consumer scrutiny, utilities hope that cost-cutting will protect their earnings outlook. Unfortunately, many components of rising costs lie outside utilities' direct control, notably including:

- Input fuels and purchased power
- Required power plant environmental investments
- Transmission capacity investments
- Employee health and welfare coverage and pensions
- Security and insurance premiums
- Raw materials (e.g., copper, steel) impacting purchased goods
- Emerging labor shortages impacting supplemental labor costs
- Regulatory compliance (e.g., Sarbanes-Oxley)

While the situation varies from one utility to the next, widespread cost escalation in raw materials and labor markets (Exhibit 1) means the industry needs to more carefully manage interactions with the supply base.

Exhibit 1 Key components driving utility cost increases

Supply base cost inputs	Illustrative components	Representative escalation	
		Period March 2000-Sept. 2005	CAGR
Input fuels	<ul style="list-style-type: none"> • Crude oil • Natural gas 	228%	16%
		197%	13%
Raw materials	<ul style="list-style-type: none"> • Copper • Steel • Industry chemicals 	215%	15%
		49%	8%
		56%	8.4%
Direct labor	<ul style="list-style-type: none"> • Labor cost index, wages and salaries 	117%	2.9%
Indirect labor	<ul style="list-style-type: none"> • Labor cost index, white collar wages and salaries 	118%	3.1%
Employee benefits	<ul style="list-style-type: none"> • Labor cost index 	135%	5.6%
Insurance and security	<ul style="list-style-type: none"> • Risk premiums • Security costs 	N/A	10-15%

Source: Bureau of Labor Statistics, Commodity Research Bureau, Yahoo Finance, Mercer analyses

The Appeal of Sourcing Strategies

An old cost-savings favorite, sourcing strategies, is back in vogue. Strategic sourcing has been practiced by utilities since the mid-1980s, and many have returned to this work with a vengeance. Cost take-out from the supply base holds appeal on several dimensions:

- Represents a significant component of utilities' cost structure and offers real bottom-line impact
- Spares upheavals and the loss of morale associated with eliminating employees (especially given complexities tied to an aging workforce)
- Benefits from widespread board support, since many directors have used supply chain initiatives in their own companies
- Constitutes significant synergy savings in horizontal mergers between utilities with overlapping supply bases

The traditional expectation for savings from addressable spend is 3-6% for commoditized hard goods (e.g., cable, conductor, meters, and distribution transformers) and 5-10% for services (transmission and distribution (T&D) line contractors, information systems contractors, and power plant supplemental labor forces). However, in the face of manufacturing capacity shortages, lower craft productivity, and labor shortages tied to an aging workforce, many observers now project these costs will increase. For utilities spending billions of dollars on goods and services as part of an infrastructure boom, these estimates translate into tens of millions of dollars of potential savings at risk.

Many sourcing efforts start with detailed spend summaries and a short list of spend categories and sourcing strategies for a one- or two-year forecast period. Our experience suggests that this traditional approach falls well short of anticipating today's dynamic supply markets. The lack of a truly strategic approach to sourcing stems from several tendencies:

- Lack of a big-picture view
- Prevalence of backward-looking, static tactics
- An inward focus that misses developments in core supply markets
- An ineffective overlay of sourcing strategies onto asset management programs

Separately, each of these influences will limit results. Together, they dramatically undermine the potential for cost containment while increasing the risk for cost escalation. Let's look at each in turn.

Understand the Big Picture

Strategic efforts, by design, need to consider a broad landscape in order to put sourcing initiatives in the context of value creation. Mercer Management Consulting routinely captures this view through intensive benchmarking of performance by individual purchase category and across the entire supply chain.

Findings from these benchmarking efforts have led to several strategic insights. On the quantitative side, examples include:

- Significant gaps in spend benchmarks suggest large potential savings when total purchases of goods and services are normalized per customer (for distribution) or per megawatt hour of production (for generation).
- These benchmarks point to 20-40% cost reductions per category for under-performing utilities, far better than the 5-10% reductions suggested by generally accepted practice.
- For many of utilities, these figures represent tens of millions of dollars in untapped savings potential.

Findings on the qualitative side reveal emerging trends that underpin the nature of

future spend. For example, in the distribution sector:

- Self-diagnosing distribution grids are on the drawing board, consistent with widespread deployment of two-way communication technologies.
- Line crews will work predominantly in a live-line environment, with repair crews expected to master new skills.
- Distribution circuits should perform much closer to design margins than previously.

Each of these trends has the potential to change the nature of a utility's relationships with its suppliers. Informed sourcing strategies will monitor and anticipate shifts to the operating environment.

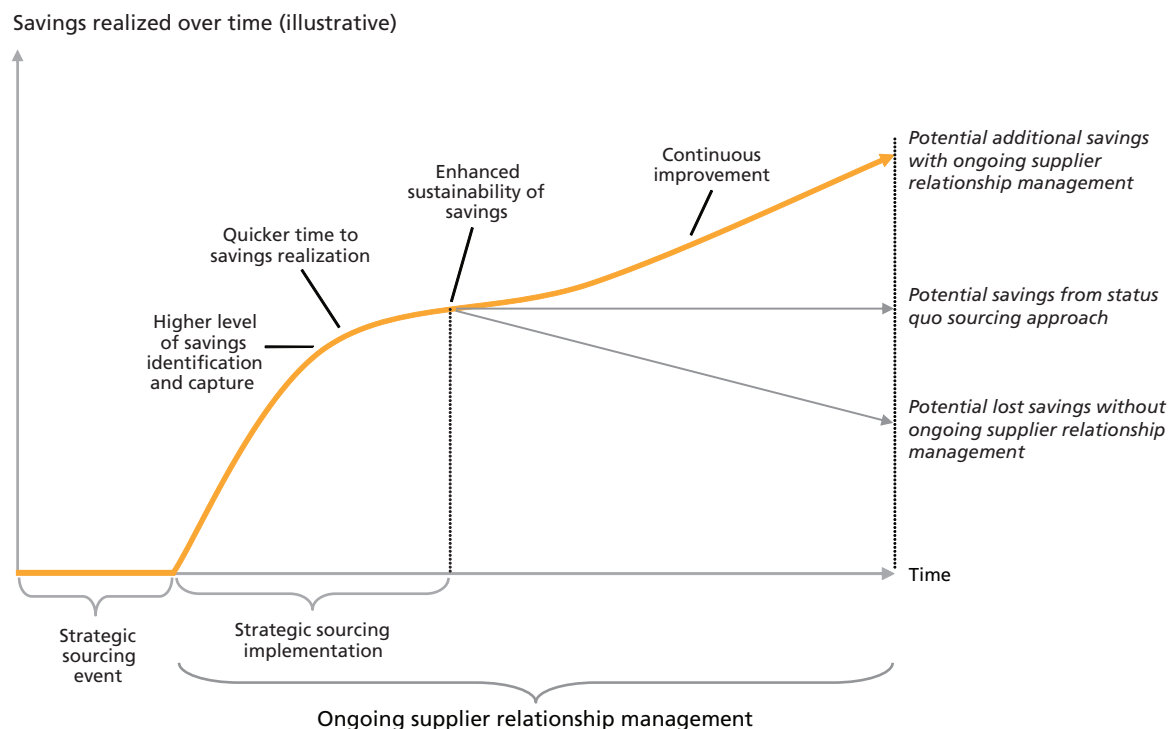
Take a Forward-Looking Approach

Strategic thinking pays close attention to future positioning and needs. Yet most strategic sourcing work is inherently backward-looking. It uses spend trees built with historical data to target savings, while forecasts of future needs and related spend on goods and services tend to be missing or inaccurate. Managers spend little time integrating forward-looking asset management strategies with strategic relationships in the supply base, such as the need for high-voltage line contractors in transmission build-outs. Moreover, strategic contributions from the supply base are rarely called out as a vital part of a utility's business design.

The net effect for most strategic sourcing efforts is a one-time contribution of cost savings, rather than a continual alignment of supply base relationships with asset investment programs. Supplier relations tend to focus instead on consolidating volumes and reducing prices, which hinders efforts to build longer-term partnerships.

As the industry increasingly needs to rebuild, reinforce, and expand infrastructure across the power sector value chain, a static view becomes especially limited; forward-

Exhibit 2 With suppliers, take the long view



looking supplier partnerships will become a key lever for sustainable value creation (Exhibit 2).

Cultivate an External Perspective

Sourcing work, by definition, requires an external focus and attention to emerging supply market developments that does not lend itself to internal discussions of planning criteria and annual budget reviews. Procurement teams often focus on providing superior service to “internal customers” and dwell on internal demand signals for goods and services. They lose sight of the depth and severity of changes occurring in core supply markets and fail to advise operating units of critical developments. The recent run-up in power transformer prices is a classic example (Exhibit 3).

For years, transformer manufacturers have experienced a wave of consolidation, removed excess capacity, moved their operations off-shore, and experienced dramatic run-ups in commodity metals prices. Clearly experiencing an upward price cycle over the past several years, shrewd procurement

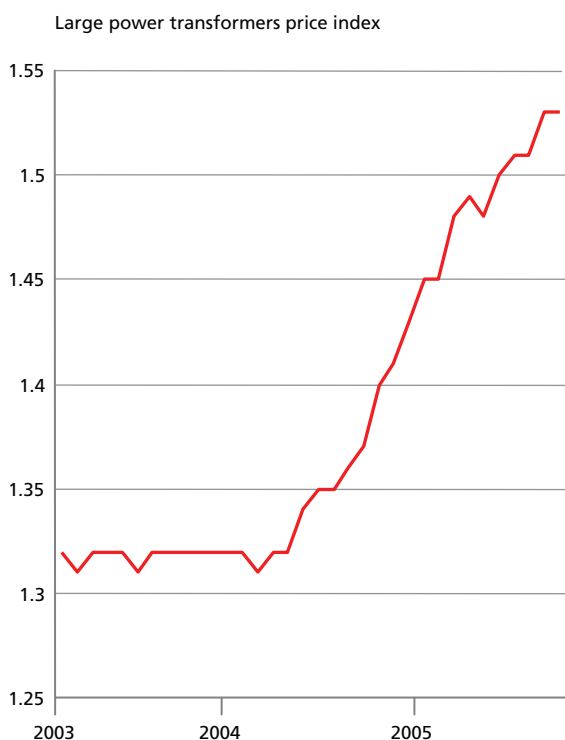
teams were refreshing their sourcing strategies and locking in volumes and price points two to three years ago. Those not anticipating these types of supply market shocks are being relegated to “price takers.”

Another wave of rising prices is now occurring in craft labor markets serving the power sector, where more workers are retiring just as the power sector build-out hits its stride. Conversely, service contracts with application software providers offer significant savings potential as they strive to link services with software to avoid commoditization of their product lines.

Integrate Asset Management and Sourcing Strategies

In many instances, senior supply chain executives are not intimately involved with the asset management strategy and asset investment plans are not tied into the evolving dynamics in supply markets. Furthermore, asset strategies tend to be more akin to spending programs than asset investment plans. The lack of clarity around asset investment plans can undermine supply

Exhibit 3 Power transformer prices accelerate



Raw materials price increases change year over year

	2004	2005
• Aluminum	19.9%	10.6%
• Copper	60.9%	28.4%
• Transformer oil	30%	N/A
• Steel	49.3%	-3.6%

Source: Bureau of Labor Statistics, Commodity Research Bureau, Yahoo Finance, Mercer analyses

chain management’s ability to make a substantial contribution. Factors such as the timing of large purchases, current supply market conditions, or the availability of supplemental laborers do not inform key trade-offs within asset management strategies.

As a result, sourcing strategies often fall out of step with core market conditions and utilities use procurement models that are aligned with past supply environments, which featured commodity and service excess capacity. Practices that maximized value in this environment, such as spot bidding, will not work well today when capacity shortages are looming. The inability to access certain construction services skills is already starting to effect the timing, duration, and cost of major projects.

Put Strategic Thinking Back into Sourcing Work

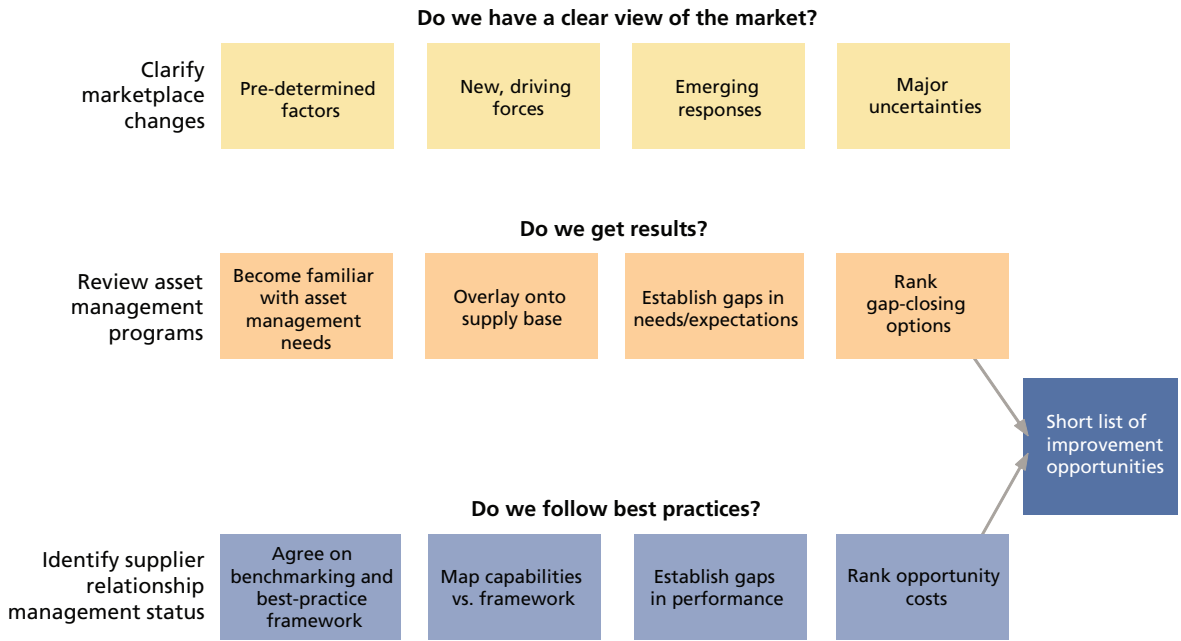
An early emphasis on the strategy of a utility and how asset plans intersects with vital supply markets allows managers to achieve significantly greater operating and financial results. Mercer backs this notion

with robust benchmarking databases that clarify the size of the opportunity for cost take-out (Exhibit 4).

Seven principles can help guide the effort:

1. **Define scope strategically.** Choose purchase categories consistent with your asset management strategies (e.g., in support of environmental retrofits or transmission build-outs) and adopt practices that start with internal customer priorities and use benchmarks to size the opportunity.
2. **Employ joint teams.** Use multi-function teams and involve suppliers to promote innovation and buy-in.
3. **Collaborate with suppliers.** Share information in a meaningful way and choose partners based on their track record for driving change within utilities.
4. **Use targeted, objective goals.** Focus on a short list of purchase categories with explicit targets for cost take-out. Avoid

Exhibit 4 Is the current response sufficient to meet future challenges?



long lists of tactical categories, vague sourcing strategies not tied to the market, or broad ranges of estimated savings.

Offer line units innovative ways to contain their escalating budgets and show them the value in supply base initiatives.

- Stick with the tried and true.** Since many companies source office supplies, wireless telecommunications, legal services, and servers, tap into known best practices by purchase category and extract value from tried and true methods.
- Bake targets into budgets.** Become part of the solution for lines of business like T&D operations and the nuclear fleet.

- Create governance models with “teeth.”** Establish business-unit led procurement councils that drive sourcing efforts, infuse teams with courage to challenge the status quo, and track progress. Strong councils fuel multi-year success.
- These principles, backed by rigorous analysis and solid data, will put the strategic thinking back into strategic sourcing.❖

Mercer Management Consulting

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