

Getting Real on Costs: Transactions Cost Thinking

Overview

A transaction cost is a cost incurred in making an exchange. In market theory (and practice) they influence *if* an exchange takes place by their size relative to the value of the exchange. We would argue that business decisions today are not based *enough* on transactions costs, for a number of reasons including willingness and ability to capture them due to convention and the organizational nature of actors.

Through re-focusing on transactions costs at a very basic and low level in business, we would contend there are substantial savings and efficiencies to be gained.

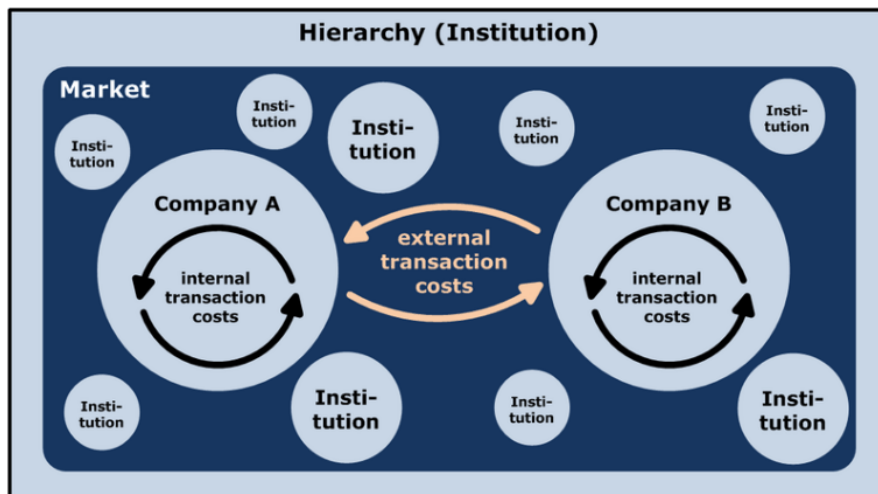
Transaction Costs defined

Transaction costs are most often defined in economic terms, being the ‘cost associated with the exchange of goods and services due to market imperfections’. Such costs include money, time and other measures (as appropriate to measure value) . The market imperfection is the fact that the buyer and seller have to locate one another, to agree on the value of what is exchanged, and once exchanged that the exchange lasts. This is equally true in the job market as it is for eBay or the wholesale oil & gas market. These costs are often broken into three different groups:

1. Search and Information costs – *determine availability and quoted prices*
2. Bargaining Costs – *time, effort, and value given up to reach a contract*
3. Policing and enforcement costs – *maintaining the agreed contract terms*

Common examples for a consumer include shopping time, or commission costs, while for a business they may include contracting time and cost. All of these can influence the final outcome. This thinking has even been extended to daily emotional interactionsⁱ.

For large organizations, markets can be internal, as well as the organization itself participating in external marketsⁱⁱ:



What is the Problem?

In common with much of the economics discipline, Transaction Cost incentives work well in theory. That is, the exchange will only occur if the value to the buyer equals or exceeds the price they pay to the seller, plus their transactions costs. Similarly the seller will not part with the service or good unless their value does not equal or exceed the amount they receive from the buyer plus their transaction costs.

However, many events may occur in reality, including:

- Contracting expertise and time delays are absorbed by a corporate 'overhead' cost center
- Purchasing is required to buy from a specific vendor due to a quota requirement
- Promotional 'no fee' financial loans

In all of these, the full weight of the decision is removed from the transaction level, to a higher (company wide) level. The thinking is that this is, overall, more efficient and lower cost. For the first, the assumption is that overhead is appropriately apportioned back to the business (and ultimately transaction). For the second, the assumption is that a lower per unit price is achieved over the course of the contract. For the final situation fees are normally absorbed into the service price itself, and may also be from an overhead fund purposed to increase the volume of business.

For all of these incentives have been altered, and if it was possible to cost all of these back to the transactional level, the theory is that the same decisions would be made. However, we know such efficiency is not a given, which is why there are movements such as time based Activity Based Costing to get us closer to decisions based on individual transaction costs. With better data capture, measurement, and reporting, we may get closer in years to come.

Of cost types that may be most actionable today, we should concentrate on those related to time. **Time** is most actionable at the transaction level rather than slow moving accounting conventions or company strategy.

Opportunity Cost as Transaction Cost

When transaction costs are of time (negotiation time, delays), there is the additional 'cost' of value that was not created during that period. This **opportunity** cost can be a substantial addition considering the speed of market change today, contraction of product development times and real time flow of information.

Company internal initiatives are good examples where staffing, orienting and training of employees is a time cost which hands opportunity to the competition. This overall cost may make outsourcing to specialists a more prudent option.

Case Study: Call Center Creation

A Pharmaceutical Distribution company identified a market opportunity in providing generics drugs to the market by creating a call center distribution channel. Its existing enterprise IT system group quoted a timeline of years and cost of millions of dollars to set up this new channel. Needing a more immediate solution, the business went decided on a lower cost flexible custom solution implemented in weeks. The entire cost to staff, equip and integrated the call center was \$3.5M. Once the new channel was in operation, a major competitor was forced to acquire a Call Center operation to compete, at the cost of \$40M. The first mover had effectively assessed the opportunity cost and decided based on the lowest total transaction cost.

Transaction Costs – A New Way to Save

A common refrain heard in large companies is that certain steps, processes, or delays are “a cost of doing business”. Unlike in the past, enterprise transaction systems in place today are able to capture many more data points which make modeling the full set of cost drivers more possible than ever before. Similarly, calculations on the time value of money for organizations allow better capture of the opportunity cost in the accelerated markets of today. How are you spending your time handling materials and service, and what are the costs involved?

Some simple first steps:

1. Know your costs
 - The complete landed cost per item including vendor fees, external and internal handling, special storage requirements
 - The annual (or periodic) cost representing the item throughput (volume)
 - For services this should include *time* cost based on comparison with benchmarks (example: skills based services have a time/cost tradeoff ⁱⁱⁱ; ramp-up costs associated with vendor changeover)
 - Segmentation of items by spend – higher spend items need more detail
 - Intangible cost components related to time (example components: negotiation, processing, variability of delivery)
2. Understand the Finance treatment of your costs
 - The way Finance interprets your costs dictates how management views your performance and sets goals
3. Pilot Cost modeling over time
 - A month pilot study on one material for all its known cost components
 - Analyze differences in costs collected in the study against what is captured by Finance
 - Recommendations based on differences – what are the business implications?

How we can help

Organon Professional Services can assist in facilitating your cost thinking by starting from what data you have available and accessible today. From there, we can partner with you to define how transactions costs should be defined for your organization. Often this means gathering data from disparate functional silos which may be possible with existing applications, or we can help define and build an appropriate technology solution.

About Organon Professional Services

For the past 12 years, Organon has focused on building custom Decision Support, Business Intelligence, and Supply Chain Optimization solutions that have not only resulted in exceptional returns for our customers but have also improved our customers' competitive and strategic positions within the healthcare marketplace. We bring to our projects a diverse set of skills that include industrial engineering, financial analysis, and statistical analysis. Organon is a small and nimble organization, working collaboratively with our clients to deliver real ROI in short and contained engagements.

Why Organon?

Our heritage is in high volume, diverse channel Pharmaceutical distribution, which encompasses many of the complexities in decision modeling. Our work has required flexible solutions in a regulated environment, driven by massive volumes and constant structural changes to the market. We are well positioned to carry our expertise on building data driven decision making processes and tools under accelerated market driven deadlines to your organization.

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ⁱ Oliver E. Williamson (1983), *Markets and Hierarchies: Analysis and Antitrust Implications*

ⁱⁱ Graphic from Wikipedia Commons

ⁱⁱⁱ Are the services you contract for a commodity or skills based, and if skilled, what level of skill for what cost? If you pay half as much, will delivery take twice as long or conversely, will a higher skill level reduce internal transaction costs and save you money?