

Understanding the Total Life Cycle Cost

By Ash Bedi

If you've read our previous paper on the levers of procurement value, ("What Drives Public Procurement Value?", available to registered members of Public Spend Forum), you know I outlined four areas where you can achieve the many goals of procurement while also fulfilling your mission needs. In other words, ways to get the most value out of the work you do. Those levers were split into four groups: price-based levers, total life cycle cost levers, demand management levers and supply base levers.

NON-PRICE LIFE CYCLE COSTS CAN BE MUCH LARGER THAN PRICE

While the previous article in this series described the many ways buyers can achieve great competitive pricing, this article will broaden our focus to the total cost elements that drive the true cost of a purchase over its entire useful life cycle. Life cycle costs beyond the initial purchase can be a substantial portion of costs for many buys. For example, first consider a general example that nearly all organizations buy: photocopiers. Photocopiers have an initial purchase price as well as costs associated with maintenance and consumables such as toner and paper over a number of years.

As another example, according to a Censeo Consulting Group study based on 2010 data, Sikorsky Aircraft Corporation sold the Black Hawk helicopter to the Army at an average cost of approximately \$14 million (including platform procurement and initial



spares). The average lifespan of the Black Hawk is 25 years. During every year of its life, a Black Hawk requires about \$800,000 of repair and spare parts purchases. As you can see, the total life cycle cost for the Black Hawk is dominated by these ongoing repair and spare costs, which are larger than the initial purchase price. Clearly, other costs relative to price can be a significant portion of the purchase for many buys, and therefore merit a deeper understanding to ensure the true desired total cost outcomes are being achieved. I'll stick with the photocopier example for illustration purposes as I describe the key considerations in developing a total cost view to make even better acquisition decisions.

I find it very useful to think about total life cycle costs relative to three key but fairly simple considerations:

- All costs associated with the initial purchase
- Ongoing life cycle costs of utilizing the purchase

- Purchase decisions that may influence internal costs associated with the purchase

ALL COSTS ASSOCIATED WITH THE INITIAL PURCHASE

These costs are perhaps the most obvious, but there are still factors that you need to consider. Outside the purchase of the photocopiers, for instance, there are other costs to consider, including any transportation or shipping costs, installation, any upfront consulting when it comes to sizing the number of copiers, etc. In addition, what type of photocopier do we really need for the organization's needs – this defines the specification and will most certainly affect the price paid. No need to pay for what you do not truly need. We can think of these as the “minimum costs”: all of the factors to consider when getting the copiers in-house. And we must check all of those factors when comparing across competing suppliers.

ONGOING LIFE CYCLE COSTS OF UTILIZING THE PURCHASE

This is where the photocopier example is particularly helpful. Life cycle costs represent the cost of using the photocopiers until they meet their ignoble end at the recycling center. We can make any assumptions we deem reasonable for the printer—how long it will be useful, how much it will be used—but we have to ensure that we apply those assumptions to all of the competing suppliers in the same way. And we'll need to recognize that the best-value supplier may vary depending on what life cycle assumption we make. Examples of the life cycle costs of a printer would be ongoing

maintenance (in-house or outsourced), toner, paper and energy consumption. The most effective purchasing decisions will include these types of costs at the time of the purchase.

ACQUISITION DECISIONS THAT MAY INFLUENCE INTERNAL COSTS ASSOCIATED WITH THE PURCHASE

Perhaps the most elusive area to consider: the internal organization costs associated with a particular purchasing decision. For instance, the decision around how many suppliers to award will impact how much time is required to manage those supplier relationships: The more suppliers, the more time required. That's no to say that sole-source is therefore the way to go, just to illustrate that there are always internal cost considerations.

WHAT YOU CAN DO TODAY

Regardless of what your organization is buying, you can start today by managing your total life cycle costs.

1. Identify all life cycle costs for your buy.
2. Work with your customers and stakeholders to clearly understand what influences these total life cycle costs
3. Engage your suppliers with a full view of these life cycle costs (and consider collaborating with your suppliers on how best to manage these costs)
4. Make sure to include life cycle costs as part of your solicitations

As you can see, a total-cost mindset can dramatically improve purchasing decisions by bringing into the decision-making process

costs that may be far greater than price itself. Total life cycle cost considerations are fairly simple but highly impactful on desired total cost outcomes. From here we'll move on to discussing demand management in the next article in the series.

Think I've missed something or even gotten something wrong? Open up a discussion on Public Spend Forum, and we can have a dialogue. I'd love to hear from you.

Note: Posting of this publication to any site or community server without written permission of Public Spend Forum is forbidden. However, we encourage you to share and post links to the content with your network.