SECTION 1 – Strategies of Integration

Introduction

In Unit 2 we introduced the concepts of integration (expanded organisational activity along the supply chain) and de-integration (focused organisational activity) and considered how such activity proved to be defining phases in the automotive industry as with many others. In addition, we saw that if an organisation is the first within its sector to pursue either integration or de-integration due to positive competitive benefits, rivals will also assess whether they should alter their levels of integration in a similar way.

In this section we return to examine horizontal and vertical integration in greater detail and explore their role as corporate level strategies. We start, in Section 1.1, by considering some of the factors which influence whether an organisation decides to undertake vertical integration: these factors include transaction costs, asset specificity and transfer prices. In Section 1.2 we discuss some of the advantages and disadvantages of vertical integration, and in Section 1.3 we look at horizontal integration. We then go on, in Section 1.4, to look at two forms of virtual integration: licensing and franchising.

1.1 Integration, Costs and Governance

TRANSACTION COSTS AND ASSET SPECIFICITY

The decision as to whether or not to pursue a strategy of integration depends upon a number of factors. Perhaps the most obvious of these is the cost of the alternatives to such a strategy. For example, if a company which assembles televisions is considering vertical integration by beginning to manufacture component parts, the company will need to know how much it costs to obtain these components from its suppliers (market prices) as compared to manufacturing them for itself (transfer prices). In addition to the prices charged by its suppliers for the components, there are additional costs associated with entering into relationships with organisations. These are known as transaction costs.

All organisations carry out transactions, whether internally through the value chain, or externally in buyer–seller exchanges. The major strategic consideration is whether it is best for an organisation to have a market relationship with upstream and downstream firms, or to incur the immediate costs of vertical integration followed by the costs of increasing the size and structure of the organisation. In addition to costs, the strategic decision-maker will need to consider the possible effect of making the organisation dependent on its suppliers and its customers.

Williamson (1975) suggests that six types of costs combine to create the transaction costs associated with a contractual relationship with an external organisation upstream or downstream:

- search and information costs (for initially selecting suppliers or buyers)
- drafting, bargaining and decision costs
- costs of safeguarding an agreement (legal expenses)
- monitoring and enforcement costs
- bonding costs (learning about the supplier)
- maladaptation costs.

These transaction costs should be evaluated alongside switching costs and transfer prices.

Q ACTIVITY 1: QUESTION

Look back at the six types of transaction cost identified above. Copy and complete the table below by identifying which type of transaction cost is involved in each of the following situations. The first one has been completed for you.

Situation	Type of transaction cost
A software company employs a legal firm to draw up a contract to govern its relationship with distributors of the product.	Costs of safeguarding an agreement.
Two employees in the purchasing department of a plastics manufacturer spend two weeks trying to identify a new supplier of specialist dyes.	
A manufacturer of furniture encounters assembly problems when it changes from one supplier of hinges to another.	
A manufacturer and retailer establish an intercompany committee to agree upon marketing and promotional activities.	
A supermarket has assigned an employee to supervise the quality control of meat at its supplier's abattoir.	
A travel operator spends several months of negotiations to convince a chain of travel agents to sell its package holidays.	

A ACTIVITY 1: ANSWER

Your completed table should be as follows.

Situation	Type of transaction cost
A software company employs a legal firm to draw up a contract to govern its relationship with distributors of the product.	Costs of safeguarding an agreement.
Two employees in the purchasing department of a plastics manufacturer spend two weeks trying to identify a new supplier of specialist dyes.	Search and information costs.
A manufacturer of furniture encounters assembly problems when it changes from one supplier of hinges to another.	Maladaptation costs.
A manufacturer and retailer establish an intercompany committee to agree upon marketing and promotional activities.	Monitoring and enforcement costs.
A supermarket has assigned an employee to supervise the quality control of meat at its supplier's abattoir.	Bonding costs.
A travel operator spends several months of negotiations to convince a chain of travel agents to sell its package holidays.	Drafting, bargaining and decision costs.

Another cost relates to asset specificity. This exists if some of the assets and resources of an organisation are uniquely associated with servicing a specific supply relationship with another firm, and cannot be put to alternative use without significant modification and cost. These idiosyncratic assets have the highest level of specificity. Locations can be asset specific, as in the case of a supplier that situates its factory next to a buyer's warehouse to reduce transportation costs. Human resources can also be asset specific: for instance, where an employee has been trained exclusively to meet the needs of a single client or customer, such as in marketing and corporate finance companies. As a general rule, if an organisation repeatedly undertakes transactions with a high level of asset specificity, it may find that vertical integration can be more cost-effective.

Our discussion of the choice between market exchange and internal control and coordination informed by transaction costs has so far focused on the extremes of vertical integration or a pure market relationship. Hybrid relational approaches have in recent times sought to balance the benefits of both approaches, with a move from coercion to commitment. In the automotive industry, for example, asset specificity has evolved. Traditionally, the notion of asset specificity related to assets which were specifically designed for use in exchanges with a single buyer organisation. The supplier bought and owned the assets. A recent development is for car assemblers to pay for the tooling costs and own the equipment used by suppliers of components and situate them in a dedicated production cell: the tooling cannot be adapted to produce parts for other buyers. Ownership of the tooling assets by the buyer allows the buyer to repatriate the equipment from the supplier's factory in exceptional circumstances. In this case, idiosyncratic assets are owned by both the supplier (the production cell) and the buyer (the tooling).

ACTIVITY 2: QUESTION

Make a note of three buyer–supplier relationships where you think asset specificity might be an important factor. Here is an example to help you.

A company which bottles soft drinks situates a new bottling plant near the factory of one of its major clients. If the major client relocates or takes its business to another company, the company will be of lower value to its owner.

ACTIVITY 2: ANSWER

There are lots of examples that you might have identified. Here are three that we thought of.

1. A manufacturer of electric components purchases specialised equipment used to supply an assembler with specific components. If the supply contract is not renewed, the supplier is left with equipment which cannot be put to use in supplying another assembler.

2. A retailer buys promotional materials for a specific product. If the product changes or the supplier no longer wishes to supply the retailer, the value of the promotional materials disappears.

3. A distributor invests heavily in information technology to facilitate electronic ordering and logistic management for its main customer, a manufacturer. However, the manufacturer has taken the decision to adopt the system used by the majority of its own suppliers. The two systems are incompatible, and the distributor is left with an investment of little value.

We have already encountered the difference between transfer prices and market prices, and seen how these highlight differences between internal and external suppliers. We also know that organisations can differ (often widely) in their levels of efficiency and quality. These are two considerations in the make-or-buy decision.

Transaction costs take into account seven other factors which incur costs in market exchange relationships, such as search and information costs, bonding costs and so on. These are the hidden costs of carrying out market exchange relations. Asset specificity adds to the notion of transaction costs by considering investments made by a supplier which increase the compulsion to sustain a supply relationship.

TRANSFER PRICING

The decision to integrate activities within an organisation or to outsource them to external parties should be informed by a number of distinct yet interrelated factors. These include:

- the proprietary value of activities which are subject to what is known as a 'make-or-buy decision'
- the availability and capability of external sources of supply
- the strategic impact of the activity in the context of the organisation's core competencies
- the differential between market prices and transfer prices.

Whereas market prices are the actual prices charged by the supplier, transfer prices are internal prices charged within the organisation as throughputs pass along the internal supply chain. Where the transfer price of a component or product is less than the market price, vertical integration can be justified in terms of direct financial benefit. In circumstances where the transfer price is equal to or greater than prevailing and forecast future market prices, the GM/TMT must consider opportunity costs. For example, should an organisation retain possession of activities in order to enhance proprietary knowledge and prevent asset erosion?

Transfer prices are normally found in organisations with divisionalised structures which operate a profit centre approach to internal financial control. Transfer prices can be determined in two ways. In the first, prices are determined on the basis of market prices. Here divisions simply trade throughputs between themselves, charging prices to the receiving division which reflect external prices for equivalent throughputs. The problem surrounding this method is that, while creating a relatively uniform and well understood approach to setting prices, it does little to encourage improved linkages between divisions. The second method, using cost-based accounting measures, enables managers to measure the actual cost of throughputs traded between divisions in the internalised supply chain. From this analysis, managers can identify inefficient practices and activities and initiate improvement measures.

Standard costing methods also ensure that an upstream division does not inflate its transfer price in order to create the impression that it adds greater value than other parts of the internal supply chain. In particular, those divisions which are located downstream would face the predicament of receiving parts from upstream which already have an inaccurate and inflated transfer price. Do they set their own transfer price incorporating the already inflated transfer price charged to them upon receipt of goods from upstream? This would maintain their contribution to the transformation process but exacerbate the problem as they subsequently charge a transfer price to a downstream division receiving its outputs. Alternatively, they could set their transfer price at a level which reflects the true value of the goods produced thus far within the internal supply chain (if they knew the amount by which their upstream division had inflated its prices). In so doing, this would lower the apparent contribution made by this division within the context of the overall transformation process, which is something that few divisional managers would be prepared to accept. Clearly such divisional behaviour leads to inaccurate reporting and inaccurate comparisons between divisions, and the potential for conflict increases.