

# Supply Chain Management

Strategy, Planning, and Operation

SEVENTH EDITION

SUNIL CHOPRA

 Pearson



# SUPPLY CHAIN MANAGEMENT

## *STRATEGY, PLANNING, AND OPERATION*

Seventh Edition

**Sunil Chopra**

Kellogg School of Management



New York, NY

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## Dedication

I would like to thank my colleagues at Kellogg for all I have learned from them about logistics and supply chain management. I thank Peter Meindl for his collaboration during earlier editions of this book. I am grateful for the love and encouragement that my parents, Krishan and Pushpa, and sisters, Sudha and Swati, have always provided during every endeavor in my life. I thank my children, Ravi and Rajiv, for the joy they have brought me. Finally, none of this would have been possible without the constant love, caring, and support of my wife, Maria Cristina.

—**Sunil Chopra**

## About the Author

Sunil Chopra



Sunil Chopra is the IBM Distinguished Professor of Operations Management and Information Systems at the Kellogg School of Management. He has served as the interim dean and senior associate dean for curriculum and teaching, and the codirector of the MMM program, a joint dual-degree program between the Kellogg School of Management and the McCormick School of Engineering at Northwestern University. He has a PhD in operations research from SUNY at Stony Brook. Prior to joining Kellogg, he taught at New York University and spent a year at IBM Research.

Professor Chopra's research and teaching interests are in supply chain and logistics management, operations management, combinatorial optimization, and the design of telecommunication networks. He has won several teaching awards at the MBA and Executive programs of Kellogg. He has authored more than 50 papers and two books.

He has been a department editor for *Management Science* and an associate editor for *Manufacturing & Service Operations Management*, *Operations Research*, and *Decision Sciences Journal*. He has also consulted for several firms in the area of supply chain and operations management.

# Contents

Cover

Title Page

Copyright

Dedication

About the Author

Preface ix

## **Part I Building a Strategic Framework to Analyze Supply Chains**

### **Chapter 1 Understanding the Supply Chain 1**

**What Is a Supply Chain? 1**

**The Objective of a Supply Chain 3**

**Decision Phases in a Supply Chain 6**

**Process Views of a Supply Chain 8**

**Examples of Supply Chains 13**

**Developing Skills for Your Career 17**

**Discussion Questions 18**

**Bibliography 18**

### **Chapter 2 Achieving Strategic Fit in a Supply Chain 19**

**Competitive and Supply Chain Strategies 19**

**How is Strategic Fit Achieved? 22**

**Supply Chain Levers to Deal with Uncertainty 31**

**Expanding Strategic Scope 33**

**Discussion Questions 36**

**Bibliography 36**

**Case Study: The Demise of Blockbuster 37**

### **Chapter 3 Supply Chain Drivers and Metrics 40**

**Financial Measures of Performance 40**

**A Framework for Supply Chain Decisions 45**

**Facilities 47**

**Inventory 50**

**Transportation 52**



**Information 54**

**Sourcing 56**

**Pricing 58**

**Discussion Questions 61**

**Bibliography 61**

**Case Study: Seven-Eleven Japan Co. 61**

**Case Study: Financial Statements for Walmart Stores inc. and Macy's inc. 68**

## **Part II Designing the Supply Chain Network**

### **Chapter 4 Designing Distribution Networks and Applications to Omni-Channel Retailing 69**

**Factors Affecting Distribution Network Design in the Supply Chain 69**

**Design Options for a Distribution Network 74**

**Online Sales and Omni-Channel Retailing 88**

**Discussion Questions 97**

**Bibliography 97**

**Case Study: Blue Nile and Diamond Retailing 98**

### **Chapter 5 Network Design in the Supply Chain 103**

**The Role of Network Design in the Supply Chain 103**

**Factors Influencing Network Design Decisions 105**

**Framework for Network Design Decisions 110**

**Models for Designing a Regional Network Configuration 113**

**Models for Identifying Potential Sites in a Region 118**

**Models for Demand Allocation and Plant Location 121**

**Discussion Questions 129**

**Exercises 129**

**Bibliography 134**

**Case Study: Designing the Production Network at CoolWipes 134**

**Case Study: Managing a Merger at Lightning Networks 135**

### **Chapter 6 Designing Global Supply Chain Networks 138**

**The Impact of Globalization on Supply Chain Networks 138**

**The Importance of Total Cost in Global Networks 140**

**Risk Management in Global Supply Chains 143**

**Evaluating Network Design Decisions using Decision Trees 147**

**To Onshore or To Offshore: The Value of Flexibility in a Supply Chain Under Uncertainty 157**

**Discussion Questions 165**

**Exercises 165**

**Bibliography 167**

**Case Study: BioPharma, Inc. 168**

**Case Study: The Sourcing Decision at Forever Young 171**

**Part III Planning and Coordinating Demand and Supply in a Supply Chain**

**Chapter 7 Demand Forecasting in a Supply Chain 172**

**The Role of Forecasting in a Supply Chain 172**

**Components of a Forecast and Forecasting Methods 174**

**Time-Series Forecasting Methods 178**

**Measures of Forecast Error 188**

**Building Forecasting Models using Excel 191**

**Discussion Questions 199**

**Exercises 200**

**Bibliography 202**

**Case Study: Specialty Packaging Corporation 202**

**Chapter 8 Aggregate Planning in a Supply Chain 205**

**Aggregate Planning and its Role in a Supply Chain 205**

**The Basic Tradeoffs in Aggregate Planning 208**

**Aggregate Planning using Linear Programming 209**

**Aggregate Planning in Excel 217**

**Discussion Questions 222**

**Exercises 222**

**Bibliography 224**

**Case Study: Kloss Planters and Harvesters 224**

**Case Study: Smartphone Production at Quicktronics 226**

**Chapter 9 Sales and Operations Planning in a Supply Chain 227**

**Responding to Predictable Variability in the Supply Chain 227**

**Sales and Operations Planning at Red Tomato 231**

**Discussion Questions 238**

**Exercises 238**

**Bibliography 240**

**Case Study: Mintendo Game Girl 241**

**Case Study: Promotion Challenges at Gulmarg Skis 242**

**Chapter 10 Coordination in a Supply Chain 244**

**Lack of Supply Chain Coordination and its Impact on Performance 244**

**Obstacles to Coordination in a Supply Chain 248**

**Managerial Levers to Improve Coordination 252**

**Some Practical Approaches to Improve Supply Chain Coordination 258**

**Discussion Questions 263**

**Bibliography 263**

**Part IV Planning and Managing Inventories in a Supply Chain**

**Chapter 11 Managing Economies of Scale in a Supply Chain Cycle Inventory 264**

**The Role of Cycle Inventory in a Supply Chain 264**

**Economies of Scale to Exploit Fixed Costs 267**

**Aggregating Multiple Products in a Single Order 274**

**Economies of Scale to Exploit Quantity Discounts 282**

**Why do Suppliers offer Quantity Discounts? 288**

**Short-Term Discounting: Trade Promotions 294**

**Managing Multiechelon Cycle Inventory 298**

**Managerial Levers to Reduce Cycle Inventory 301**

**Discussion Questions 303**

**Exercises 303**

**Bibliography 307**

**Case Study: Delivery Strategy at MoonChem 307**

**Case Study: Pricing and Delivery at Kar Foods 309**

**Appendix 11A: Economic Order Quantity 310**

**Chapter 12 Managing Uncertainty in a Supply Chain Safety Inventory 311**

**The Role of Safety Inventory in a Supply Chain 311**

**Factors Affecting the Level of Safety Inventory 313**

**Determining the Appropriate Level of Safety Inventory 317**

**Impact of Supply Uncertainty on Safety Inventory 326**

**Impact of Aggregation on Safety Inventory 328**

**Impact of Replenishment Policies on Safety Inventory 341**

**Managing Safety Inventory in a Multiechelon Supply Chain 344**

**Managerial Levers to Reduce Safety Inventory 345**

**Discussion Questions 346**

**Exercises 346**

**Bibliography 350**

**Case Study: Managing Inventories at Alko Inc. 350**

**Case Study: Should Packing be Postponed to the DC? 353**

**Appendix 12A: The Normal Distribution 354**

**Appendix 12B: The Normal Distribution in Excel 355**

**Appendix 12C: Expected Shortage per Replenishment Cycle 355**

**Appendix 12D: Evaluating Safety Inventory For Slow-Moving Items 356**

**Chapter 13 Linking Product Availability to Profits 358**

**Factors Affecting the Desired Level of Product Availability 358**

**Evaluating the Optimal Level of Product Availability 362**

**Basic Managerial Levers to Improve Supply Chain Profitability 370**

**The Value of Speed in a Seasonal Supply Chain 372**

**The Value of Postponement in a Seasonal Supply Chain 377**

**Setting Product Availability for Multiple Products under Capacity Constraints 382**

**Discussion Questions 385**

**Exercises 385**

**Bibliography 388**

**Case Study: The Need for Speed at Winner Apparel 388**

**Appendix 13A: Optimal Level of Product Availability 390**

**Appendix 13B: An Intermediate Evaluation 390**

**Appendix 13C: Expected Profit from an Order 391**

**Appendix 13D: Expected Overstock from an Order 392**

**Appendix 13E: Expected Understock from an Order 392**

**Appendix 13F: Simulation using Spreadsheets 393**

**Part V Designing and Planning Transportation Networks**

**Chapter 14 Transportation in a Supply Chain 396**

**Transportation Modes and their Role in a Supply Chain 396**

**Transportation Infrastructure and Policies 402**

**Design Options for a Transportation Network 405**

**Mumbai Dabbawalas: A Successful Same-Day Delivery Network 411**

**Trade-Offs in Transportation Design 412**

**Tailored Transportation 420**

**Discussion Questions 423**

**Bibliography 423**

**Case Study: Designing the Distribution Network for Michael's Hardware 424**

**Case Study: The Future of Same-Day Delivery: Same as the Past? 425**

**Case Study: Selecting Transportation Modes for China Imports 426**

## **Part VI Managing Cross-Functional Drivers in a Supply Chain**

### **Chapter 15 Sourcing Decisions in a Supply Chain 427**

**The Sourcing Decision in a Supply Chain 427**

**Total Cost of Ownership 437**

**Designing a Sourcing Portfolio: Tailored Sourcing 439**

**The Impact of Incentives on Third-Party Behavior 443**

**Sharing Risk and Reward in the Supply Chain 445**

**Discussion Questions 456**

**Exercises 457**

**Bibliography 458**

**Case Study: Polaris Industries inc. 459**

### **Chapter 16 Pricing and Revenue Management in a Supply Chain 464**

**The Role of Pricing and Revenue Management in a Supply Chain 464**

**Differential Pricing for Multiple Customer Segments 467**

**Dynamic Pricing and Overbooking for Perishable Assets 474**

**Discounting and Peak Pricing for Seasonal Demand 481**

**Constructing a Portfolio of Bulk Contracts and Spot Buying 482**

**Some Practical Challenges When using Revenue Management 484**

**Discussion Questions 485**

**Exercises 485**

**Bibliography 486**

**Case Study: To Savor or to Groupon? 486**

### **Chapter 17 Sustainability and the Supply Chain 489**

**The Role of Sustainability in a Supply Chain 489**

**The Tragedy of the Commons 491**

**Key Pillars of Corporate Social Responsibility 495**

**Sustainability and Supply Chain Drivers 499**

**The Role of Incentives and Regulation for Sustainability 502**

**Discussion Questions 507**

**Bibliography 507**

**Part VII Online Chapter**

**Chapter A Information Technology in a Supply Chain**

**The Role of IT in a Supply Chain**

**The Supply Chain IT Framework**

**The Future of IT in the Supply Chain**

**Risk Management in IT**

**Discussion Questions**

**Bibliography**

**Index 508**

# Preface

This book is targeted toward an academic as well as a practitioner audience. On the academic side, it is appropriate for MBA students, engineering master's students, and senior undergraduate students interested in supply chain management and logistics. It can also serve as a suitable reference for both concepts as well as providing a methodology for practitioners in consulting and industry.

## New to this Edition

The seventh edition has focused on changes that enhance students' ability to sharpen their critical thinking and data analytics skills as they study with the book. All concepts discussed in the book are linked to strategic decision making in a supply chain, and all quantitative ideas are illustrated using spreadsheets that can be implemented in practice. Some specific changes in the seventh edition include:

- The link between supply chain decisions and the financial performance of a firm is developed in detail in **Chapter 3**.
- The concepts underlying the design of distribution networks are illustrated in the context of omnichannel retailing in **Chapter 4**. The evolution of retailing is used throughout the book to illustrate the link between supply chain concepts and strategic decision making in a supply chain.
- Each section of each chapter in the book is associated with a clearly identified learning objective that is summarized at the end of the section.
- We have added new mini-cases in **Chapters 5, 8, and 15**. Information in other cases has been updated to be current.
- New exercises have been added in several chapters.
- For all numerical examples discussed in the book, we have developed spreadsheets that students can use to understand the concept at a deeper level. These spreadsheets are referred to in the book and allow the student to try different "what-if" analyses. These spreadsheets are available at [www.pearsonhighered.com/chopra](http://www.pearsonhighered.com/chopra) along with basic guidance on how they may be created and used.
- We have continued to add current examples throughout the book, with a particular focus on bringing in more global examples.

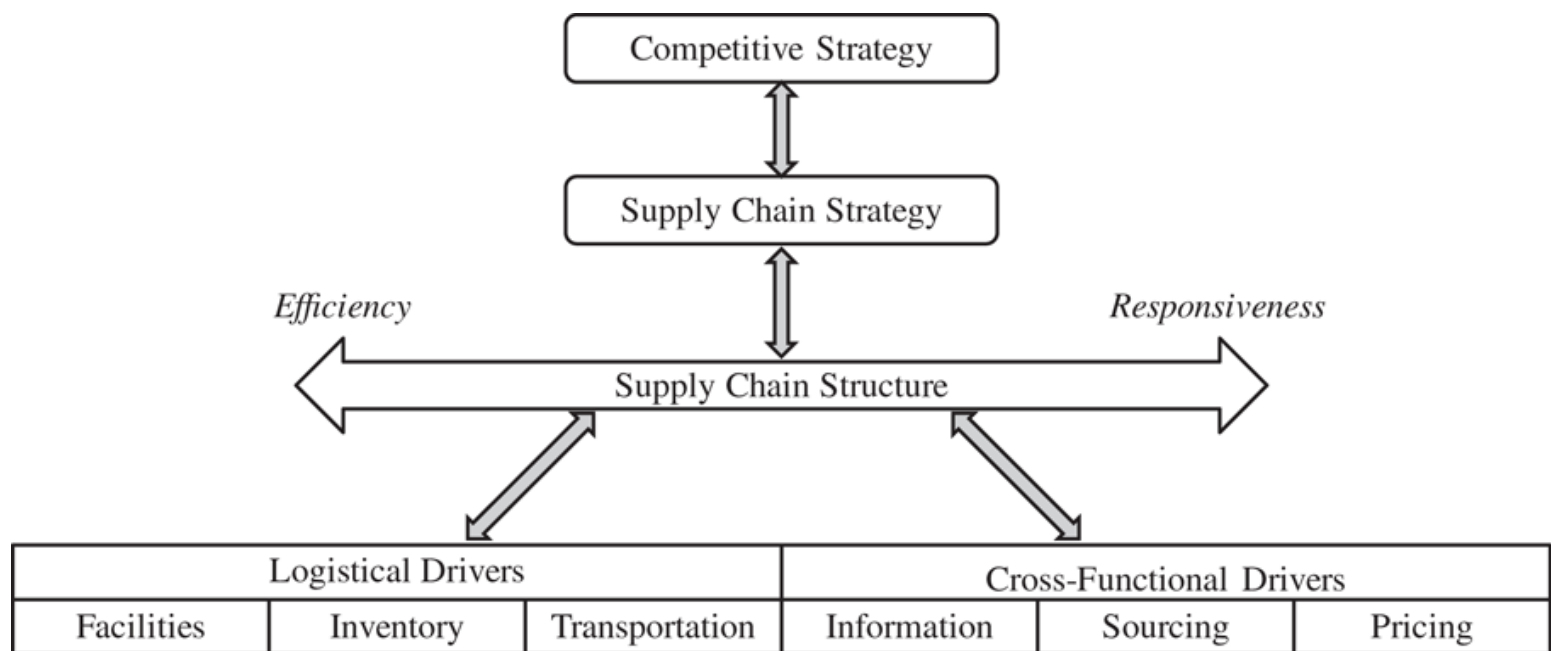
## Solving Teaching and Learning Challenges

To be successful, supply chain practitioners must be able to formulate effective supply chain strategy and be able to solve any resulting supply chain problems using the available analytical tools. In a supply chain class this creates the challenge of teaching students to think strategically while supporting their decisions with robust quantitative analysis. This book is designed to help faculty and students overcome this challenge through its conceptual and pedagogical structure. Conceptually, the book aims to develop an understanding of the following key areas and their interrelationships:

- The strategic role of a supply chain
- The key strategic drivers of supply chain performance
- Analytic methodologies for supply chain analysis

To illustrate the strategic importance of good supply chain management, we provide many current examples to show how companies have succeeded through effective supply chain management or

failed because of weak supply chain management. Our strategic framework, the use of Excel-based models to explain analytic methodologies, and several mini-cases to help students internalize the link between the analytic methodologies and strategic decision making provide pedagogical support for faculty using the book.



### A Consistent Strategic Framework

Within the strategic framework, we identify facilities, inventory, transportation, information, sourcing, and pricing as the key drivers of supply chain performance. The book is structured to dig deeper into each driver to understand its role in the success of a supply chain, its interaction with other drivers, analytic methodologies to support decisions related to the driver, and managerial levers related to the driver that help improve supply chain performance.

Every analytic methodology is illustrated with its application in Excel. Students have access to the associated Excel file along with instructions to construct and use the file. The Excel files help students deepen their understanding of the link between the analytic models and the strategic decisions they support.

## Mini Cases

Most chapters have mini cases that can be used by faculty to ensure that students can apply the concepts and methodologies in the context of strategic decision making for a business.

## Developing Career Skills

Skills learned in this book will be of great use no matter what path students choose to follow. The book is developed with the premise that good strategic decisions cannot be made without access to relevant analytics, and all analytics should be designed to support decision making. As a result, students will develop critical thinking, the ability to formulate and analyze problems, and support their recommendations with analytics that uses data literacy and computing skills.

- Every chapter in the book pushes students to think critically in order to define and solve supply chain problems. For example, [Chapter 4](#) develops a framework for distribution networks and then



pushes students to think about how retailing may evolve in the future as consumer preferences and technology change. The first part of the chapter teaches frameworks and concepts related to the design of distribution networks. The last part of the chapter then pushes the students to analyze retailing by applying the knowledge they have gained in order to decide how retailers need to change in order to succeed in the 21<sup>st</sup> century.

- All the analytics in the book are developed through the use of Microsoft Excel. This helps students develop data literacy, computing skills, and the knowledge of how to apply information technology to support decision making. The analytics that are developed in these chapters in turn support the framework laid out in **Chapter 4**. Whereas **Chapter 4** helps students to think conceptually about why certain retailing models have succeeded for selling jewelry while others have failed, the succeeding chapters help students quantify financial metrics for different retail networks. As a result, students learn how to use data and models to improve strategic decision making.

	A	B	C	D	E	F	G	H	I	J	
1	<b>Inputs - Costs, Capacities, Demands</b>										
2		<i>Demand Region</i>									
3	<i>Supply Region</i>	<i>Production and Transportation Cost per 1,000,000 Units</i>					<b>Fixed</b>	<b>Low</b>	<b>Fixed</b>	<b>High</b>	
4		N. America	S. America	Europe	Asia	Africa	<b>Cost (\$)</b>	<b>Capacity</b>	<b>Cost (\$)</b>	<b>Capacity</b>	
5	N. America	81	92	101	130	115	6,000	10	9,000	20	
6	S. America	117	77	108	98	100	4,500	10	6,750	20	
7	Europe	102	105	95	119	111	6,500	10	9,750	20	
8	Asia	115	125	90	59	74	4,100	10	6,150	20	
9	Africa	142	100	103	105	71	4,000	10	6,000	20	
10	<i>Demand</i>	12	8	14	16	7					
11	<b>Decision Variables</b>										
12		<i>Demand Region - Production Allocation (Million Units)</i>					<b>Plants</b>	<b>Plants</b>			
13	<i>Supply Region</i>	N. America	S. America	Europe	Asia	Africa	<b>(1=open)</b>	<b>(1=open)</b>			
14	N. America	0	0	0	0	0	0	0			
15	S. America	0	0	0	0	0	0	0			
16	Europe	0	0	0	0	0	0	0			
17	Asia	0	0	0	0	0	0	0			
18	Africa	0	0	0	0	0	0	0			
19											
20	<b>Constraints</b>										
21	<i>Supply Region</i>	<i>Excess Capacity</i>									
22	N. America	0									
23	S. America	0									
24	Europe	0									
25	Asia	0									
26	Africa	0									
27		N. America	S. America	Europe	Asia	Africa					
28	<i>Unmet Demand</i>	12	8	14	16	7					
29											
30	<b>Objective Function</b>										
31	<b>Cost =</b>	\$	-								

Cell	Cell Formula	Equation	Copied to
B28	=B9 - SUM(B14:B18)	5.1	C28:F28
B22	=G14*H4 + H14*J4 - SUM(B14:F14)	5.2	B23:B26
B31	=SUMPRODUCT(B14:F18,B4:F8) + SUMPRODUCT(G14:G18,G4:G8) + SUMPRODUCT(H14:H18,I4:I8)	Objective Function	—

## Excel Based Models

### Table of Contents Overview

Part 1	Building a Strategic Framework to Analyze Supply Chains
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	Ch. 1: Understanding the Supply Chain	Introduces the supply chain, the managerial objective, and key decisions
	Ch. 2: Achieving Strategic Fit in a Supply Chain	Discusses the need to align strategy with supply chain capabilities
	Ch. 3: Supply Chain Drivers and Metrics	Defines key drivers of supply chain performance and associated performance metrics
<b>Part 2</b>	<b>Designing the Supply Chain Network</b>	
	Ch. 4: Designing Distribution Networks and Applications to Omni-Channel Retailing	Introduces framework for designing distribution networks with an application to omni-channel retailing
	Ch. 5: Network Design in the Supply Chain	Presents analytic models that support network design
	Ch. 6: Designing Global Supply Chain Networks	Discusses risks in global supply chains and analytic methodologies that incorporate uncertainty in network design
<b>Part 3</b>	<b>Planning and Coordinating Demand and Supply in a Supply Chain</b>	
	Ch. 7: Demand Forecasting in a Supply Chain	Introduces techniques for demand forecasting and measuring forecast error
	Ch. 8: Aggregate Planning in a Supply Chain	Introduces methodologies to plan supply to meet seasonal demand
	Ch. 9: Sales and Operations Planning in a Supply Chain	Discusses how optimally managing both demand and supply can grow supply chain profits
	Ch. 10: Coordination in a Supply Chain	Discusses obstacles to coordination and managerial levers that help improve coordination in a supply chain

<b>Part 4</b>	<b>Planning and Managing Inventories in a Supply Chain</b>	
	Ch. 11: Managing Economies of Scale in a Supply Chain – Cycle Inventory	Introduces methodologies to obtain optimal batch sizes and discusses managerial levers that help reduce cycle inventory without hurting costs
	Ch. 12: Managing Uncertainty in a Supply Chain – Safety Inventory	Introduces methodologies to obtain safety inventory and discusses managerial levers that help reduce safety inventory without hurting product availability
	Ch. 13: Linking Product Availability to Profits	Discusses managerial levers that help increase profits in a supply chain
<b>Part 5</b>	<b>Designing and Planning Transportation Networks</b>	
	Ch. 14: Transportation in a Supply Chain	Discusses options and tradeoffs when designing a transportation network
<b>Part 6</b>	<b>Managing Cross Functional Drivers in a Supply Chain</b>	
	Ch. 15: Sourcing Decisions in a Supply Chain	Introduces the concept of total cost in the context of sourcing and discusses the benefits of sharing risk and reward in a supply chain
	Ch. 16: Pricing and Revenue Management in a Supply Chain	Discusses how differential pricing can help increase profits in a supply chain
	Ch. 17: Sustainability and the Supply Chain	Discusses the challenge to sustainability posed by the tragedy of the commons and the role of incentives and regulation for improved sustainability
<b>Part 7</b>	<b>Online Chapter</b>	

	Ch. A: Information Technology in a Supply Chain	Introduces a framework for the role of information technology in a supply chain

## Instructor Teaching Resources

At the Instructor Resource Center, <http://www.pearsonhighered.com/irc>, instructors can easily register to gain access to a variety of instructor resources available with this text in downloadable format. If assistance is needed, our dedicated technical support team is ready to help with the media supplements that accompany this text. Visit <https://support.pearson.com/getsupport> for answers to frequently asked questions and toll-free user support phone numbers.

This program comes with the following teaching resources.

Supplements available to instructors at <a href="http://www.pearsonhighered.com/irc">www.pearsonhighered.com/irc</a>	Features of the Supplement
<b>Instructor's Solution Manual</b> developed by the author	<ul style="list-style-type: none"> <li>• Case Teaching Notes and Worksheets</li> <li>• Spreadsheets for all quantitative examples</li> <li>• Discussion questions</li> <li>• Example figures</li> <li>• Additional exercises</li> <li>• Solutions to all questions and problems in the book</li> </ul>
<b>Test Bank</b> authored by Geoff Willis of the University of Central Oklahoma	<p>2000 multiple-choice, true/false, short- answer, and graphing questions with these annotations:</p> <ul style="list-style-type: none"> <li>• Correct answer</li> <li>• Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis)</li> <li>• Learning outcome reference</li> <li>• Topic covered</li> <li>• AACSB learning standard (Analytical Thinking; Information Technology; Application of Knowledge)</li> </ul>
<b>TestGen® Computerized Test Bank</b>	<p>TestGen allows instructors to:</p> <ul style="list-style-type: none"> <li>• Customize, save, and generate classroom tests</li> <li>• Edit, add, or delete questions from the Test Item Files</li> <li>• Analyze test results</li> </ul>

	Organize a database of tests and student results.
<p><b>PowerPoint Presentations</b>          authored by Jeff Heyl of the Lincoln University</p>	<p>Slides include all the graphs, tables, and equations in the textbook.</p> <p>PowerPoints meet accessibility standards for students with disabilities. Features include, but not limited to:</p> <ul style="list-style-type: none"> <li>• Keyboard and Screen Reader access</li> <li>• Alternative text for images</li> <li>• High color contrast between background and foreground colors</li> </ul>

## For Students

The following material is available to students at <http://www.pearsonhighered.com/chopra>:

- Spreadsheets for numerical examples discussed in the book. These provide the details of the example discussed, but are live and allow the student to try different what-if analyses.
- Spreadsheets that allow students to build every table shown in Chapters 5 through 16.
- Online chapter: Chapter A: Information Technology in a Supply Chain.
- Technical Note: Routing and Scheduling in Transportation. This note is also bundled with the Instructor’s Manual available on [www.pearsonhighered.com/irc](http://www.pearsonhighered.com/irc).

## Acknowledgments

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### **Sunil Chopra**

Kellogg School of Management, Northwestern University

# Part I Building a Strategic Framework to Analyze Supply Chains

## *Chapter 1 Understanding the Supply Chain*

### Learning Objectives

**After reading this chapter, you will be able to**

- 1.1 Discuss the goal of a supply chain and explain the impact of supply chain decisions on the success of a firm.**
- 1.2 Define the three key supply chain decision phases and explain the significance of each one.**
- 1.3 Describe the cycle and push/pull views along with the macro processes of a supply chain.**
- 1.4 Identify important issues and decisions to be addressed in a supply chain.**
- 1.5 Develop skills that employers have identified as critical to success in the workplace.**

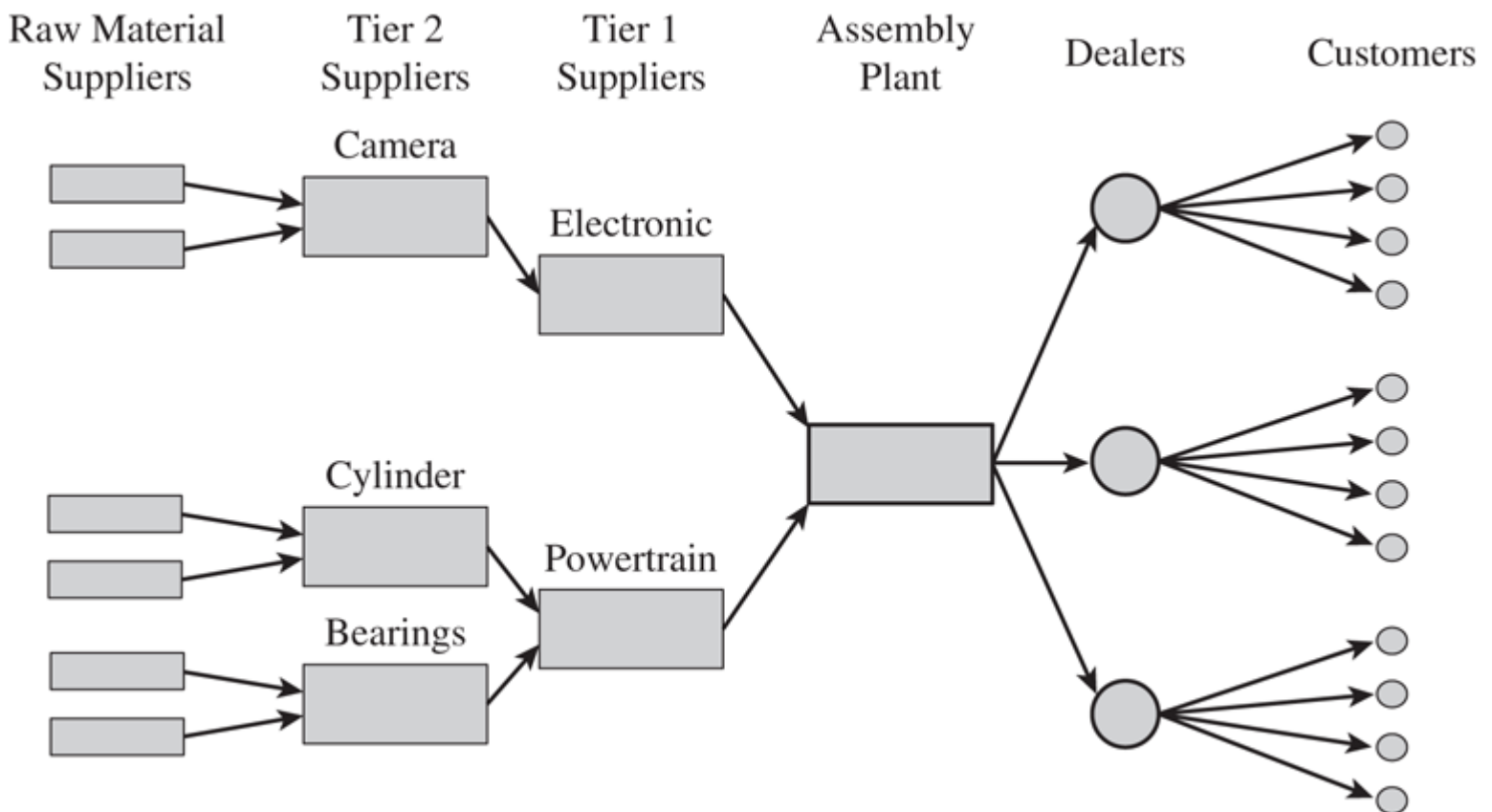
*In this chapter, we provide a conceptual understanding of what a supply chain is and the various issues that must be considered when designing, planning, or operating a supply chain. We identify the goal of a supply chain and discuss the significance of supply chain decisions for the success of a firm. We also provide several examples from different industries to emphasize the variety of supply chain issues and decisions that companies need to consider at the strategic, planning, and operational levels.*

# What is a Supply Chain?

1.1 Discuss the goal of a supply chain and explain the impact of supply chain decisions on the success of a firm.

A *supply chain* consists of all parties involved, directly or indirectly, in fulfilling a customer request. The supply chain includes not only the manufacturer and suppliers, but also transporters, warehouses, retailers, and even customers themselves. Within each organization, such as a manufacturer, the supply chain includes all functions involved in receiving and filling a customer request. These functions include, but are not limited to, new product development, marketing, operations, distribution, finance, and customer service.

Consider a customer walking into a Toyota dealership to purchase a new car. The supply chain begins with the customer and his or her need for a car. The next stage of this supply chain is the dealer that the customer visits. The dealer has several cars in inventory that may have been supplied from the assembly plant using trucks from a third party. The assembly plant, in turn, gets various modules such as electronics and powertrain from a variety of Tier 1 suppliers. Each Tier 1 supplier receives material from several Tier 2 suppliers. For example, the electronics supplier receives cameras from the camera supplier and the dashboard display from another supplier. Each of these suppliers receives raw materials from lower tier suppliers. This supply chain is illustrated in **Figure 1-1**, with the arrows corresponding to the direction of physical product flow.



**Figure 1-1 Stages of an Automotive Supply Chain**

A supply chain is dynamic and involves the constant flow of information, product, and funds among different stages. In our example, the dealer provides the product, as well as pricing and availability information, to the customer. The customer transfers funds to the dealer. The dealer conveys sales



data and replenishment orders to the assembly plant, which sends cars back to the dealer on a truck. The dealer transfers funds to the auto manufacturer after the replenishment. The manufacturer also provides pricing information and sends delivery schedules to each dealer. Similar information, material, and fund flows take place across the entire supply chain.

In another example, when a customer makes a purchase online from Amazon, the supply chain includes, among others, the customer, Amazon's website, the Amazon warehouse, the carrier who delivers packages to customers, and all of Amazon's suppliers and their suppliers. The website provides the customer with information regarding pricing, product variety, and product availability. After making a product choice, the customer enters the order information and pays for the product. The product is then picked and shipped from an Amazon warehouse. As its inventory diminishes, the warehouse places replenishment orders with suppliers.

A typical supply chain may involve a variety of stages including customers, retailers, wholesalers, distributors, manufacturers, and suppliers. Even though the term supply chain may imply that only one player is involved at each stage, most supply chains are actually networks where each stage receives product from several suppliers and sends output to several customers. It may be more accurate to use the term supply network or supply web to describe the structure of most supply chains.

A critical point to keep in mind is that the customer is an integral part of any supply chain. In fact, the primary purpose of any supply chain is to satisfy customer needs and, in the process, generate profit for itself. The functioning of a supply chain involves three key flows – information, product, and funds - as illustrated in [Figure 1-2](#). The goal when designing a supply chain is to structure the three flows in a way that meets customer needs in a cost effective manner. For example, Apple serves its customers in a variety of ways depending upon their needs. Customers can walk into an Apple store (or a third party store) or go online to purchase a product. Standard products are stocked at the stores and customers can leave the store with their phone or computer after paying the appropriate funds. Orders placed online can either be delivered at home or be picked up at an Apple store. The time taken for home delivery depends on whether the product is stocked by Apple at its warehouse or not. Personalized and custom-configured items take longer because they are not stocked at the warehouse but produced after the customer order arrives. Observe that Apple changes the flow of information, product, and funds based on the customer needs and product characteristics. The goal of this book is to develop concepts and methodologies that can be used to design supply chains that effectively meet customer needs while generating supply chain profits.

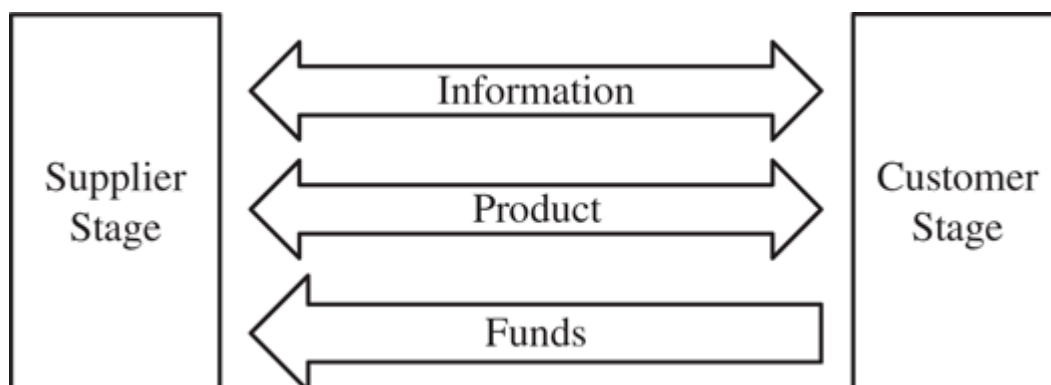


Figure 1-2 The Three Flows in a Supply Chain

## The Objective of a Supply Chain

The objective of every supply chain should be to maximize the net value generated. The net value a supply chain generates is the difference between what the value of the final product is to the customer and the costs the entire supply chain incurs in filling the customer's request. We will refer to this difference as the *supply chain surplus*.

Supply Chain Surplus=Customer Value–Supply Chain Cost

The value of the final product may vary for each customer and can be estimated by the maximum amount the customer is willing to pay for it. The difference between the value of the product and its price remains with the customer as consumer surplus. The rest of the supply chain surplus becomes supply chain profitability, the difference between the revenue generated from the customer and the overall cost across the supply chain. For example, the \$60 that a customer pays Best Buy for a wireless router represents the revenue the supply chain receives. Customers who purchase the router clearly value it at or above \$60. Thus, part of the supply chain surplus is left with the customer as consumer surplus. The rest stays with the supply chain as profit. Best Buy and other stages of the supply chain incur costs to convey information, produce components, store them, transport them, transfer funds, and so on. The difference between the \$60 that the customer paid and the sum of costs incurred across all stages by the supply chain to produce and distribute the router represents the supply chain profitability: the total profit to be shared across all supply chain stages and intermediaries. The higher the supply chain profitability, the more successful the supply chain. For most profit-making supply chains, the supply chain surplus will be strongly correlated with profits. Supply chain success should be measured in terms of supply chain surplus and not in terms of the profits at an individual stage. (In subsequent chapters, we see that a focus on profitability at individual stages may lead to a reduction in overall supply chain surplus.) A focus on growing the supply chain surplus pushes all members of the supply chain toward growing the size of the overall pie.

Having defined the success of a supply chain in terms of supply chain surplus, the next logical step is to look for sources of value, revenue, and cost. For any supply chain, there is only one source of revenue: the customer. The value obtained by a customer purchasing a car at a Toyota dealership depends on several factors, including the functionality and features of the car, the variety of options available, and the service offered by the dealer. The customer is the only one providing positive cash flow for the Toyota supply chain. All other cash flows are simply fund exchanges that occur within the supply chain, given that different stages have different owners. When the dealer pays Toyota, it is taking a portion of the funds the customer provides and passing that money on to Toyota. All flows of information, product, or funds generate costs within the supply chain. Thus, the appropriate management of these flows is a key to supply chain success. *Effective supply chain management* involves the management of supply chain assets and product, information, and fund flows to grow the total supply chain surplus. A growth in supply chain surplus increases the size of the total pie, allowing contributing members of the supply chain to benefit.

In this book, we have a strong focus on analyzing all supply chain decisions in terms of their impact on the supply chain surplus. These decisions and their impact can vary for a wide variety of reasons. For instance, consider the difference in the supply chain structure for fast-moving consumer goods that is observed in the United States and India. U.S. distributors play a much smaller role in this

supply chain compared with their Indian counterparts. We argue that the difference in supply chain structure can be explained by the impact a distributor has on the supply chain surplus in the two countries.

Retailing in the United States is largely consolidated, with large chains buying consumer goods from manufacturers. This consolidation gives retailers sufficient scale that the introduction of an intermediary such as a distributor does little to reduce costs—and may actually increase costs because of an additional transaction. In contrast, India has millions of small retail outlets. The small size of Indian retail outlets limits the amount of inventory they can hold, thus requiring frequent replenishment—a retail order can be compared with the weekly grocery shopping for a family in the United States. The only way for a manufacturer to keep transportation costs low is to bring full truckloads of product close to the market and then distribute locally using “milk runs” with smaller vehicles. The presence of an intermediary that can receive a full truckload shipment, break bulk, and then make smaller deliveries to the retailers is crucial if transportation costs are to be kept low. Most Indian distributors are one-stop shops, stocking everything from cooking oil to soaps and detergents made by a variety of manufacturers. Besides the convenience provided by one-stop shopping, distributors in India are also able to reduce transportation costs for outbound delivery to the retailer by aggregating products across multiple manufacturers during the delivery runs. Distributors in India also handle collections, because their cost of collection is significantly lower than what it would cost each manufacturer to collect from retailers. Thus, the important role of distributors in India can be explained by the growth in supply chain surplus that results from their presence. The supply chain surplus argument implies that as retailing in India begins to consolidate, the role of distributors will diminish.

## The Importance of Supply Chain Decisions

There is a close connection between the design and management of supply chain flows (product, information, and funds) and the success of a supply chain. Amazon, Seven-Eleven Japan, and Walmart are examples of companies that have built their success on superior design, planning, and operation of their supply chain. In contrast, the failure of many online businesses, such as Webvan, can be attributed to weaknesses in their supply chain design and planning. The rise and subsequent fall of the bookstore chain Borders illustrates how a failure to adapt its supply chain to a changing environment and customer expectations hurt its performance. Dell Computer is another example of a company that had to revise its supply chain design in response to changing technology and customer needs. We discuss these examples later in this section.

Seven-Eleven Japan is an example of a company that has used excellent supply chain design, planning, and operation to drive growth and profitability. It has used a very responsive replenishment system along with an outstanding information system to ensure that products are available when and where customers need them. Its responsiveness allows the company to change the merchandise mix at each store by time of day to precisely match customer demand. As a result, the company has grown total store sales from 1 billion yen in 1974 to almost 2.7 trillion yen in 2016, with profits in 2016 totaling 304 billion yen.

Walmart has been a leader at using supply chain design, planning, and operation to achieve success with its brick-and-mortar stores. From its beginning, the company invested heavily in transportation and information infrastructure to facilitate the effective flow of goods and information. Walmart designed its supply chain with clusters of stores around distribution centers to facilitate

frequent replenishment at its retail stores in a cost-effective manner. Frequent replenishment allows stores to match supply and demand more effectively than the competition. Walmart has been a leader in sharing information and collaborating with suppliers to bring down costs and improve product availability. The results are impressive. In its 2016 annual report, the company reported a net income of about \$14.7 billion on revenues of about \$482 billion. Despite its success with large Walmart stores, the company has had some difficulty being successful with small format stores as well as the online channel where they offer an expanded assortment. Over the years the company has realized that the supply chain structure that is effective for the brick-and-mortar channel requires modification to be effective for the online channel. Similarly, the supply chain that is very effective for large format stores is not so effective for small format stores.

The failure of many online businesses, such as Webvan and Kozmo, can be attributed to their inability to design appropriate supply chains or manage information, product, and fund flows effectively. In the late 1990s, Webvan designed a supply chain with large warehouses in several major cities in the United States, from which groceries were delivered to customers' homes. This supply chain design could not compete with traditional supermarket supply chains in terms of cost. Traditional supermarket chains bring product to a store close to the consumer using full truckloads, resulting in very low transportation costs. They turn their inventory relatively quickly and let the customer perform most of the picking activity in the store. In contrast, Webvan turned its inventory marginally faster than supermarkets but incurred much higher transportation costs for home delivery, as well as high labor costs to pick customer orders. As a result, Webvan failed in its efforts to compete with supermarkets on price. The company folded in 2001, within two years of a very successful initial public offering.

As the experience of Borders illustrates, a failure to adapt supply chains to a changing environment can significantly hurt performance. Borders, along with Barnes & Noble, dominated the selling of books and music in the 1990s by implementing the superstore concept. Compared with small local bookstores that dominated the industry prior to that, Borders was able to offer greater variety (about 100,000 titles at superstores, relative to fewer than 10,000 titles at a local bookstore) to customers at a lower cost by aggregating operations in large stores. This allowed the company to achieve higher inventory turns than local bookstores and with lower operating costs per dollar of sales. In 2004, Borders achieved sales of almost \$4 billion, with profits of \$132 million. Its model, however, was already under attack with the growth of Amazon, which offered much greater variety than Borders at lower cost by selling online and stocking its inventories in a few distribution centers. Borders' inability to adapt its supply chain to compete with Amazon led to a rapid decline. The company declared bankruptcy in 2010.

Dell is another example of a company that enjoyed tremendous success based on its supply chain design, planning, and operation but then had to adapt its supply chain in response to shifts in technology and customer expectations. Between 1993 and 2006, Dell experienced unprecedented growth of both revenue and profits by structuring a supply chain that provided customers with customized PCs quickly and at reasonable cost. By 2006, Dell had a net income of more than \$3.5 billion on revenues of just over \$56 billion. This success was based on two key supply chain features that supported rapid, low-cost customization. The first was Dell's decision to sell directly to the end customer, bypassing distributors and retailers. The second key aspect of Dell's supply chain was the centralization of manufacturing and inventories in a few locations where final assembly was postponed until the customer order arrived. As a result, Dell was able to provide a large variety of PC configurations while keeping low levels of component inventories.

In spite of this tremendous success, the changing marketplace presented some new challenges for Dell. Whereas Dell's supply chain was well suited for highly customized PCs, the market shifted to lower levels of customization. Given the growing power of hardware, customers were satisfied with a few model types. Dell reacted by adjusting its supply chain with regard to both direct selling and building to order. The company started selling its PCs through retail chains such as Walmart in the United States and GOME in China. It also outsourced a large fraction of its assembly to low-cost locations, effectively building to stock rather than to customer order. Unlike Borders, Dell is making a significant effort to adapt its supply chain to changing times. It remains to be seen whether these changes will improve Dell's performance.

### **Summary of Learning Objective 1**

The goal of a supply chain should be to grow overall supply chain surplus. Supply chain surplus is the difference between the value generated for the customer and the total cost incurred across all stages of the supply chain. A focus on the supply chain surplus increases the size of the overall pie for all members of the supply chain. Supply chain decisions have a large impact on the success or failure of each firm because they significantly influence both the revenue generated and the cost incurred. Successful supply chains manage flows of product, information, and funds to provide a high level of product availability to the customer while keeping costs low.

# Decision Phases in a Supply Chain

## 1.2 Define the three key supply chain decision phases and explain the significance of each one.

Successful supply chain management requires many decisions relating to the flow of information, product, and funds. Each decision should be made to raise the supply chain surplus. These decisions fall into three categories or phases, depending on the frequency of each decision and the time frame during which a decision phase has an impact. As a result, each category of decisions must consider uncertainty over the decision horizon.

- 1. Supply chain strategy or design:** During this phase, a company decides on the structure of the supply chain for the next several years. It decides what the chain's configuration will be, how resources will be allocated, and what processes each stage will perform. Strategic decisions made by companies include whether to outsource or perform a supply chain function in-house, the location and capacities of production and warehousing facilities, the products to be manufactured or stored at various locations, the modes of transportation to be made available along different shipping legs, and the type of information system to be used. Hyundai Motor's decision to build a second manufacturing plant in India in 2008 is a supply chain design or strategic decision. A firm must ensure that the supply chain configuration supports its strategic objectives and increases the supply chain surplus during this phase. The two Hyundai plants have allowed the firm to cost effectively serve the growing Indian market and also use its Indian plants to serve global demand for small cars. In 2015, Hyundai was the second largest automobile manufacturer and the largest automobile exporter in India. Supply chain design decisions are typically made for the long term (a matter of years) and are expensive to alter on short notice. Consequently, when companies make these decisions, they must take into account uncertainty in anticipated market conditions over the following few years.
- 2. Supply chain planning:** For decisions made during this phase, the time frame considered is a quarter to a year. Therefore, the supply chain's configuration determined in the strategic phase is fixed. This configuration establishes constraints within which planning must be done. The goal of planning is to maximize the supply chain surplus that can be generated over the planning horizon given the constraints established during the strategic or design phase. Companies start the planning phase with a forecast for the coming year (or a comparable time frame) of demand and other factors, such as costs and prices in different markets. Planning includes making decisions regarding which markets will be supplied from which locations, the subcontracting of manufacturing, the inventory policies to be followed, and the timing and size of marketing and price promotions. For example, Hyundai's decisions regarding markets supplied by its two Indian plants and target production quantities at each plant are classified as planning decisions. In the planning phase, companies must include uncertainty in demand, exchange rates, and competition over this time horizon in their decisions. Given a shorter time frame and better forecasts than in the design phase, companies in the planning phase try to incorporate any flexibility built into the supply chain in the design phase and exploit it to optimize performance. As a result of the planning phase, companies define a set of operating policies that govern short-term operations.
- 3. Supply chain operation:** The time horizon here is weekly or daily. During this phase, companies make decisions regarding individual customer orders. At the operational level,