A Better Way to Negotiate

Two Ways We Engage with Suppliers

As Purchasing professionals, we use two main approaches to establishing prices with suppliers.

The first is through a **bidding process**. We prepare formal documents and invite several suppliers to participate – a tried-and-true best practice for engaging with suppliers. We know that promoting competition between suppliers is a reliable and effective way to achieve good results.

The second approach is through **direct (one-on-one) negotiations** with current suppliers. We know that this method is akin to the Wild West, with few tried-and-true best practices. We are usually on our own to achieve good results.

"Why not just use bidding all the time?" an observer might logically ask. Good idea in theory, but not in practice. Bidding is rigorous and time consuming, and few Purchasing departments (including governmental ones) have enough staff to bid everything, all the time.

> *Direct negotiations, without the benefit of competitive pressure, are a fact of life.*

There is good news! The West is becoming less wild. Below we describe a better way to negotiate with suppliers, by taking advantage of the growing phenomenon of cost transparency.

The Golden Rule of Negotiations

So what's a professional to do? How can we achieve competitive pricing without the pressure of competition? The answer – apply pressure another way, by following the Golden Rule of Negotiations.

> ***Never enter negotiations without first researching what has happened to your supplier's costs.***

Luckily, emerging Internet technology has made tracking these cost trends easier and more transparent.

Why is Knowing Suppliers' Costs So Important?

First, because *falling costs* mean opportunities to negotiate price decreases.

A supplier has little choice but to agree when confronted with the facts. After all, raising prices when their costs go up is common practice. Refusing to accept the same logic when costs go down would paint the supplier as greedy and unfair, something far worse for business than simply agreeing to a (reasonable) price decrease.

> *The pressure to reduce prices comes from suppliers' natural desire to preserve their good name.*

Secondly, you can prevent *price creep*.

Once suppliers realize you track their costs, they stop playing the price creep game. Even when their costs go up, knowing you are watching ensures price increases remain reasonable.

Track Commodities

Commodities are a window into your suppliers' direct costs. Follow market trends for the commodities that represent the raw materials, energy and labor your suppliers use to make the things you buy.

Direct costs, such as raw materials, energy and labor (all are commodities) can be important factors. For example, a cardboard shipping box, worth say $1, costs suppliers about 60 cents for the paper to make it. Similarly, metals used to fabricate components typically account for half the selling price.

A Practical Example

Let's say you buy parts made from steel and your supplier has just asked for an increase. He claims steel costs are up 13% and wants a 6.5% increase for his parts. The chart below shows that steel costs are indeed up about 13% over the past few months.

But is his request reasonable? Cost transparency answers the question. The graph also shows that prices fell for 5 months before rising and, in fact, are only about 4% higher now than 12 months ago. The last time prices were negotiated was in January and so, unless your supplier reduced his prices as steel costs fell, he has no justification to raise them by 6.5% now – 2% would be more reasonable. Transparency means seeing the whole picture and revealing the really important data, namely ***changes to his costs since the last time prices were negotiated***.

Going forward, managing supplier relationships becomes easier. Knowing you are watching usually stops suppliers from requesting unsupportable increases.

Digging Deeper into the Data

What about the past? Good news here too. You can remedy possible unjustified increases from the past, by digging deeper into historical data.

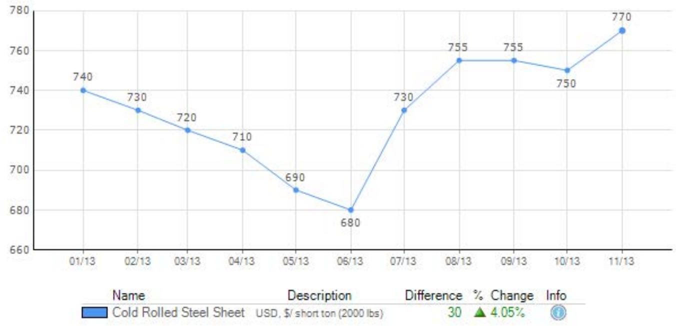
Figure 2 on the right shows a 2-year steel graph.

Interesting! The price of steel today is about 5.5% lower than it was at the beginning of 2012. This means that the 2% increase discussed above may not be justified – a 3% *decrease* is more reasonable, over the last two years.

Why stop at 2 years? Going back to April 2011 (the latest price peak) shows steel prices nudging $1000. Suppliers' costs are down over 20% since then. Your next step is to find out what you paid back in April 2011 and uncover any bias your supplier has had for only raising prices since then. You may have a good argument for a 10% decrease!

Cold Rolled Steel Sheet
Last 12 Months

Figure 1



Cold Rolled Steel Sheet
Last 2 Years

Figure 2

Cold Rolled Steel Sheet
Since April 2011

Figure 3

A Better Way to Negotiate

Emerging technology is making suppliers' costs more transparent. This puts Purchasers in the driver's seat, arming them with better tools and information for more success in direct negotiations.

Remember the Golden Rule.

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