"Best Practices" Newsletter

About This Issue

This November 2002 edition of our newsletter contains more techniques to help our clients & colleagues accomplish their strategic procurement objectives.

Strategic Procurement Solutions is a consulting firm specializing in Strategic Sourcing, Training, and Organizational issues related to supply management. Robert Dunn, C.P.M. & Mark Trowbridge, C.P.M. are senior partners in the firm, and lead teams of professionals in supporting our clients.

Visit our web site at **www.StrategicProcurementSolutions.com** for more information or to contact us about our consulting & training services.

You are also invited to upcoming presentations we're making at the I.S.M. Services Conference in December - Scottsdale AZ ("Building Internal Customer Relationships") and the I.S.M. International Conference in May – Nashville TN ("Navigating Through Mergers, Acquisitions, and Re-Organizations"). We'd enjoy meeting you in person.

Strategies To Avoid Common Supplier Tactics…by Mark Trowbridge, C.P.M.

No matter how long one has been in procurement, we experience certain tactics used by salespeople. Today's "Strategic Procurement" organizations should position themselves to avoid such attempts.

Unfortunately, it is often because of ineffectiveness in the supply-management organization that suppliers resort to the following tactics:

Trick #1 – The Around-the-End Run. Suppliers often seek direct access to internal customer groups if Procurement personnel are (A) not open to the presentation of new product/ service offerings, (B) perceived to be a barrier to helpful communications, or (C) not working pro-actively with their internal customers.

Football teams defend against end runs by (1) positioning defenders where the run is aimed, and (2) hammering the offenders enough that they cease to attempt that particular tactic. Procurement teams can also build a quality defense against end runs.

"Strategic" supply management groups defend against end runs by maintaining professional and open communications with suppliers regarding their product/service offerings, and by building/maintaining proactive relationships with internal customers.

During strategic sourcing processes, the temptation is even higher for suppliers to try end runs when new contract awards hang in the balance. Especially during these times, it is critical for the cross-functional procurement team members to speak with one voice and to pro-actively inform their company's senior management of key project decisions.

Tactic #2 – Partial Proposal Scope. What *is not* included in a firm's proposal can be more important than *what is* included. There is nothing more frustrating than to act upon a proposal, only to find that the selected supplier has other costs associated with expanded specifications which were not reflected in their proposal.

Make sure RFQ and RFP solicitations contains wording that requires the supplier's proposal to reflect all pertinent costs. Wording we've seen used is "Bidder warrants and represents it has examined all RFP documents, the proposed engagement scope, and the work conditions in preparing its proposal. Bidder further warrants and represents that this proposal contains all pricing relevant to any future contract to be awarded by Company as a result of this RFP process."

Do not allow proposals that "dodge" questions or pricing requests, by using phrases like "To be negotiated by the parties", "TBD", or "Available Upon Request". Prior to proceeding with the review process, insist the supplier provide the information.

Tactic #3 – The Lost Leader. Grocery stores often offer certain products to customers at a loss. While the store may lose money on those items, they earn an overall profit by selling the same customers other items priced at a higher margin.

The same tactic is often used by sales executives to entice corporate customers. A limited number of products are priced close to, or below, the supplier's cost. The supplier makes a comfortable profit when additional products are added…at much higher mark-ups.

A foundational principle of strategic sourcing is to evaluate TCO ("Total Cost of Ownership") rather than only unit prices. This principle means that all costs must be considered, rather than just a limited number of unit prices. Don't commit until you understand all the costs

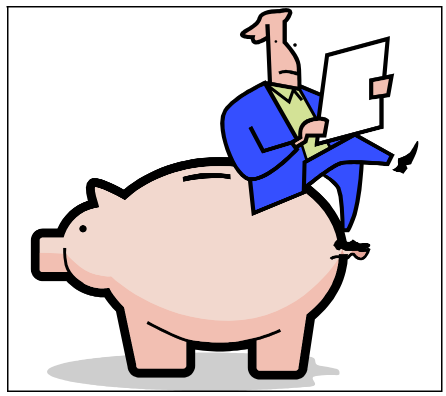
Tactic #4 – No Time Left. Time is a powerful weapon. When supply-management personnel are unprepared, they can be caught off-guard when a supplier tells them…

"The purchase order must be placed before the end of the quarter…or else we can't honor the price", or ***"The contract expires in one week and services will have to cease, unless a one-year renewal is signed"***.

Rather than being surprised, today's supply management groups must be proactive. Try the following:

- When soliciting proposals or quotations, require suppliers to guarantee their price for a specified time period. We recommend a 90 to 120 day guarantee period.
- Beat them to the punch. 90 days before a contract expires, ask them if they'll extend for a longer term at a lower price.
- Seek to understand the sales person's compensation program. They may have time-dependent commissions or objectives. Personal motivations can be a useful negotiating tool.
- Plan the expiration of contracts and blanket purchase orders to avoid co-terminous spikes. Spread out expiration dates. Don't allow contracts & purchase orders to all terminate on December 31st…when it's difficult to get a consensus on alternative sourcing from internal stakeholders.

Key Ingredients of a Cost Savings Program…by Patrick Soller, M.B.A.



There is no universally accepted definition of a "cost savings". Few major companies agree on a uniform standard. Individual firms are left to their own to define how they will calculate savings…and there is often disagreement between Supply Management and Finance as to what really is a "cost savings". So how does Supply Management track "cost savings"?

When developing your own definition of "Cost Savings", the following elements need to be considered:

Inclusion / Exclusion - As easy as it may appear, simply determining what is considered a true "save" is extremely difficult. Some organizations use a very conservative approach and only consider hard dollar savings, while others look at the total cost of acquisition and ownership. Most firms, however, agree that the following are truly savings:

- Unit price reduction
- Improved terms of payment
- Demand reduction

Elements that are less definitive are:
- Cost avoidance
- Acquisition process streamlining
- Cycle time reductions

Additionally, many companies wrestle with the area of headcount reduction. Some include fractional percentages of an FTE (full-time equivalent) while others only consider it a savings when a full position is eliminated.

Cost Avoidance - The subject of Cost Avoidance can be an area of controversy. This may be a commodity category that is escalating in cost, but through Procurement's efforts the rate of increase is less than that of the marketplace. Many financial people do not consider avoidances to be real savings. Some Procurement professionals consider them as part of the normal job of a buyer and as such do not count them. There can be, however, great hard-dollar value in avoiding cost increases. Examples might include contributions like (A) controlling employee health care increases below the market rate of increase, or (B) hedging or forward buying to delay the price impact of a future marketplace shortage. Each company has to determine how the benefit of these contributions will be recorded. Some firms report Cost Savings separately from Cost Avoidances.

Market Conditions - When costs are reduced based on current market conditions are they really savings? The conservative view would say that they are just part of doing business and without any value-added involvement on the buyer's part, they are not cost savings.

Duration - Once a basis for savings is determined, the next element to consider is the duration of the impact. The most comprehensive model is to report savings for the duration of the contract period. For example if a furniture contract is renegotiated for a 25% reduction over the previous contract, and the new term is for three years, then the savings should remain in place for the full three year term of the new contract.

Some finance groups, however, report financial improvements only during a particular annual period (calendar or fiscal year). These groups often focus upon incremental savings over the prior time period. Procurement can often be shortchanged by this approach because contributions are only calculated based upon the current period impact. For example if a $1 Million annualized savings is negotiated, but not implemented until the end of the 3rd Quarter, the current-year impact during that particular annual period would be just $250 Thousand. The danger of this approach is bifold: (A) Supply Management personnel may intentionally delay significant cost reductions until the start of subsequent time periods, especially if annual bonuses are based upon total annual savings achieved, and (B) Supply management personnel may negotiate annual rather than multi-year contracts with key suppliers, focusing on unit price rather than total cost reductions inherent in long-term strategic relationships.

Demand Management - Of all of the elements of a cost savings program, demand management is often the most difficult to define, measure and report. Savings can be derived from any of the following areas:

- Conversion of expenditures away from maverick suppliers to approved sources

- Substitution of generic, rather than branded products

- Insistence on standard, rather than premium products e.g., cloth vs. leather desk chairs

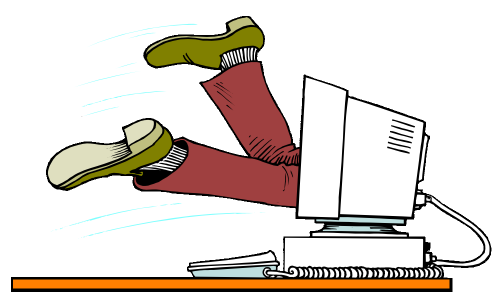
- Cascading desktop and notebook computer components, from high-need users to lower-requirement placements (for example, providing a 2.8 gig desktop to a marketing project manager who manipulates databases of a hundred thousand customers…and migrating their two-year-old 850 meg machine to a call center employee running standard software applications)

- Use of re-deployed or recycled products, rather than the purchase of new goods e.g., re-issued office furniture

- The complete avoidance of a purchase or the substitution of a viable alternative e.g., teleconferencing rather than the travel & related costs associated with an offsite business meeting

Regardless of the definition, all programs must be established on a firm baseline, which will be used in comparative analysis when reporting savings. Care must be taken in constructing cost savings programs. If the numbers are too conservative, they will fail to draw the interest of senior management. If the numbers are too liberal and include too many soft dollars, they will lack credibility with both the internal clients as well as senior management. Objectivity is also a critical element. It is imperative that an outside perspective be brought into procurement to both review and approve the program. Their continued support will be necessary as the impact of the program expands.

Leaping into eSourcing – Part 2…by Michael Zirkle, M.B.A.



In the September edition, we discussed Reverse Auctions as a key element in today's "eSourcing" software offerings. In this article, let's 'back up' a step and provide an overview of "eSourcing" and some thoughts regarding its role in helping firms achieve "best practice" procurement performance.

What is eSourcing and How is it Different Than eProcurement? eSourcing is the use of new software and Internet-based communications tools to improve, automate and integrate end-to-end strategic sourcing and procurement activities. "eProcurement" is now considered to be simply one "eSourcing" element or module focused on enabling purchasing transaction activities. eSourcing, in the broadest terms, includes in its scope all of the analysis, planning, sourcing, buying, and management activities associated with optimizing value from an enterprise's negotiable external spend.

eSourcing Activities Are Now Defined to Include:

- **Expenditure Analysis**
- **Strategic Planning (aggregate and individual category level)**
- **Supplier Evaluation and Selection:**
  1. Supplier identification and pre-qualification
  2. eRFx (i.e. electronic RFI, RFQ, & RFP functions)
  3. Reverse Auctions
  4. Negotiation Management

- **Purchase Transaction Support (traditional eProcurement)**

- **Monitor & Manage:**
  1. Contract Management
  2. Supplier Relationship Management
  3. Process Management, Collaboration, & Knowledge Capture
  4. Sourcing Performance Management

Why All Of the Interest & 'Buzz' Around eSourcing? One reason for the 'Buzz' is supply management's continually increasing visibility and recognition as a potential source for significant corporate cost savings and competitive advantage. This attention has been largely due to the success of manual strategic sourcing efforts and the enabling efforts of eProcurement technologies. This current e-Sourcing 'buzz' is amplified further by today's economy and increasing pressure for firms to better control and reduce costs. The main reason, however, for e-Sourcing's current popularity is the recognition that, in spite of past efforts, tremendous benefits and savings remain on the table in procurement.

AMR Research estimates that companies, on average, can trim purchased goods costs by 15% to 20%[i] and the Aberdeen Group estimates that eSourcing has the potential to save U.S. businesses more than $690 BB per year and reduce sourcing cycle times by 25%.[ii] In another recent study, CAPS, AT Kearny and The Wacht Group reported that 73% of all potential savings in purchasing could come from the e-sourcing function alone.[iii] These potential benefits result in predictions for tremendous growth and success for the winning eSourcing solution providers. AMR Research predicts that the market for eSourcing will grow from $275 million in 2000 to $3.5 billion in 2005[iv] and Gartner Inc. projects the dollar value of materials purchased online will grow from $75 billion to $3.1 trillion in 2003.[v]

These factors are impressive, however, must be understood in context. First, remember that the inclusion of "eProcurement" into the new definition of "eSourcing" bucket means that these forecasts include the values transacted through the more-mature market of eProcurement. Second, these forecasts may also include the value-added contribution of procurement (i.e. a discipline of strategic sourcing & aggressive supplier management) in estimating potential savings.

So What Are the Anticipated Benefits of eSourcing? It seeks to seamlessly integrate work and information flow across all activities in the procurement process and to put best practice tools and processes in place every step of the way. This integration, automation, information and integration of best practice will enable:

- Improved decision-making through better information & support tools;
- Improved operational efficiency through process automation & integration;
- Improved collaboration through streamlined communications;
- Improved operational control through better performance measurement; and
- Improved “best practice” implementation through standardized tools & disciplined processes

What is the Status of eSourcing Software and is it Market-Ready? At present the market and much of the software is still immature with one to two years predicted before competitors offer full breadth, depth and integration of services. As of now the players in the market (i.e. focused module, ERP, and eProcurement providers) seem to be focused on rapidly either building-out or partnering to acquire the full suite of capabilities. Those that cannot keep pace may be acquired or made irrelevant. This dynamic market and immature service suites makes it critical that you have a well thought out strategy before you leap into eSourcing software selection and module deployment. The same players today may not be leading the future marketplace.

So is eSourcing the ‘Silver Bullet’? We believe there is no single silver bullet. eSourcing has tremendous potential, but like any tool, will be successful only when applied in the right circumstance, in the right way, by properly trained persons. eSourcing promises to make the work of the skilled procurement professional more efficient and even more effective, but only when applied by skilled Procurement professionals as part of a well-crafted and disciplined Procurement strategy. We believe the critical success factors for eSourcing include:

- Develop a fact-based, module-by-module economic business case and implementation plan for e-Sourcing that is directly tied to your Procurement and business strategic objectives;

- Study the maturation of the eSourcing technology providers/offerings and select only those functions/elements that provide cost-effective value now;

- Select the eSourcing provider and deployment strategy (purchased package vs. ASP, big bang vs. module by module, etc.) that best meets your specific needs;

- Be prepared to devote a significant part of your resources and efforts on piloting, implementation and ongoing process improvement the selected package(s);

- Proactively engage and manage your internal customers and key suppliers in the implementation & refinement processes;

- Lead with 'best practice' processes and follow with enabling technology; and

- Through training & professional development, first build "best practice" Procurement professional capabilities that will be able to take advantage of the new technologies (having the fastest F1 Car in the world won't help if it's driven by the "Little Old Lady from Pasadena").

We believe eSourcing technologies are major steps in the right direction and will, when ready and used wisely, deliver the sustained performance improvement for which Procurement leaders are looking.

[i] "E-Procurement Explosion", by Michael A. Verespej, Industry Week, March 1, 2002

[ii] "Extending the Potential of Procurement with E-Sourcing", Supply Chain e-Business, May 2002, by Jeff Brooks and Donavon Favre

[iii] Emptoris "ePass" website

[iv] "My Turn: Being Selective About Your e-Sourcing", by Marc Osofsky, iSource online, article _id=2154.

[v] "E-Procurement Explosion", by Michael A. Verespej, Industry Week, March 1, 2002

Editor's Note: **Strategic Procurement Solutions**' objective is to provide top quality supply management services to client organizations in the private & public sector, and to enable those clients to exceed their internal users' expectations regarding promptness, price, and quality. One means of doing this is through this educational newsletter, which provides quarterly articles about "Best Practices" in procurement. Contact us at **www.StrategicProcurementSolutions.com** for more information about our services, or if you do not wish to receive this newsletter in the future.