"Best Practices" Newsletter
Volume 22, October 2004

About This Issue - This October 2004 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 advanced Strategic Sourcing, Training, and Organizational services. Robert Dunn, C.P.M. & Mark Trowbridge, C.P.M. are principals in the firm who lead teams of professionals in supporting leading procurement organizations. More information can be found at **www.StrategicProcurementSolutions.com**.

Mark Your Calendars –

- Tuesday October 19th and Wednesday October 20th, Bob Dunn and Mark Trowbridge will lead a workshop in "Advanced Procurement Negotiations" for the N.A.P.M. of Maryland (Baltimore-Washington International Airport Location). Wednesday night, we're also the featured speakers at the chapter's monthly dinner meeting. Our topic will be "Building Internal Customer Relationships". To attend either event, please contact Donald Johnson at donald.johnson@perkinelmer.com .

- December 17th, we're the featured speakers for Lorman Education Services at a San Francisco seminar. The day-long seminar is titled "Best Practices in Strategic Procurement in California". To register, phone (888) 678-5565.

When to Use a Reverse Auction, by Mark Trowbridge, C.P.M.

eSourcing technology has brought great value to Strategic Sourcing organizations. The ability to conduct competitive events electronically (eRFI, eRFQ, eRFP, and Reverse Auctions) is providing efficient structure to the solicitation of well-formatted supplier offers.

Much confusion exists, however, about when to conduct a Reverse Auction. This article will provide guidelines for when this particular form of solicitation will generate optimal benefits.

Reverse Auctions are a powerful tool to be used in the sourcing process <u>when a number of factors are present</u>. *Without these factors being present, however, the use of an auction may <u>worsen</u> the buying organization's competitive position related to the targeted spend category.*

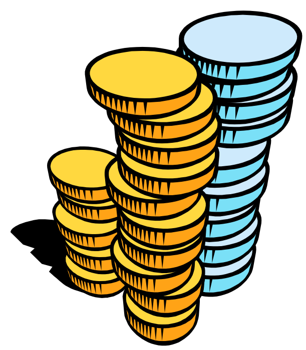
The following questions should be answered affirmatively before utilizing a Reverse Auction:

Question 1 - Do three or more competitive & qualified suppliers exist in this marketplace?	Reverse auctions <u>don't work without competition</u>…and no auction event should be conducted if multiple suppliers don't have a good chance to win. If the answer is "No", then other sourcing methods should be considered…such as (A) Soliciting a formatted proposal from a qualified provider and subsequent negotiation; (B) Expanding an existing relationship with a strategic alliance supplier; or (C) Developing alternative sources of supply.
Question 2 - Is the desired product or service clearly defined?	Reverse auctions require that the bidding suppliers clearly understand what they are bidding upon. Latitude in specification makes accurate comparisons difficult, if not impossible. An auction is a poor format to understand the qualitative benefits that one or more suppliers may bring to the buyer. Consider… (A) Using traditional or eRFPs to solicit supplier proposals containing qualitative options, (B) Staggering solicitations into sequential events that expand and refine the specifications to accomplish a desired outcome, or (C) Negotiating directly with a supplier having expertise in developing the needed product.
Question 3 – Has this commodity been successfully sourced through a Reverse Auction in the past?	Don't be the first kid on the block to launch a reverse auction upon an industry sector. You'll not recover soon from the black eye you may receive, because if you then approach the marketplace with another form of solicitation…it will be from a position of weakness. Let someone else be the test case. Once success has been proven, then join in.
Question 4 - Are there particular factors that make this product or service unsuitable for a Reverse Auction?	Marketplace factors have a large impact upon the sourcing methodology to be used. For example, an auction may not work when a short-supply condition exists. We are now working with a manufacturing firm whose production needs may require up to a 1/4 of the global availability of a particular raw material already in short supply. They need to be nurturing long-term alliance relationships with the leading sources for that material…not thinking an auction will help.

Question 5 – Are there price reductions still available through an auction?	A while ago, we were asked to benchmark a large banking company's pricing on paper, office supplies & computer supplies. As part of our due diligence, we asked their procurement team about the history of that commodity…and learned they had bid it out 5 times in the last decade (the last two times using their reverse auction technology). They were quite smug about this, and were skeptical that Strategic Procurement Solutions could make any improvement in their $3.5 Million program. As we reviewed their program, however, we learned that they were buying mostly OEM consumables…rather than quality alternative products. They had also structured their requirements in a manner that made the supplier handle their account differently than their typical customer. We were able to document how an additional 17% could be saved through our process of installing product optimization choices and managing demand.

Is Reverse Auction technology a great tool? Absolutely. But it is just <u>one</u> of <u>several</u> techniques that must be regularly-employed by the Supply Management profession. Asking the questions above can help us to use auctions in a beneficial way.

<u>Using "Total Cost Modeling" As a Negotiation Tool</u>… Robert Dunn, M.B.A., C.P.M.



Skilled negotiators can often break through a "positional" deadlock by identifying the real needs of both parties. Often these needs can be addressed by exploring the various elements of Total Cost of Ownership ("TCO").

In most cases, TCO elements are negotiable, and once they are identified, both parties can reach consensus on need fulfillment.

The Total Cost of Ownership (TCO) can be defined as ***"The sum of all costs, direct & indirect, associated with the life cycle of a product or service."***

Note that the TCO model applies equally to services as well as products, although the various cost elements may differ.

In determining TCO, one must use a comprehensive system approach to analyzing the life-cycle cost of Acquisition, Inventory, and the Product/Service itself. This includes such factors as price, service requirements, and associated costs. An analysis of total cost provides a clear picture of the financial implications; as illustrated in the following chart reflecting Total Cost elements *for a product*:

AC Acquisition Cost + **IC** Inventory Cost + **CC** Commodity Cost = **Total Cost**

These TCO elements can be further described as:

AC
Acquisition Cost

These are all costs associated with processing an order, from request through payment…i.e. "Procure-to-Pay" or "Req to Check". Acquisition costs can be further identified by isolating the overhead expense incurred by both Buyer and Supplier in conducting a transaction; including but not limited to:

- Personnel costs
- Computer/equipment costs
- Ancillary expenses (i.e. transactional communication expenses, office space…)
- Systems support
- Requisition preparation costs
- Order preparation costs
- Supplier or Buyer order entry expenses
- Payment processing costs

IC
Inventory Cost

These are costs related to receiving, holding, and moving inventory. For a product, they include:

- Cost of money (i.e. cost of funds or lost opportunity)
- Warehouse/Storage expense
- Insurance
- Property taxes
- Obsolescence
- Loss/damage
- Distribution/logistics
- (Note: it is helpful here to understand "inventory" as *anything not actively in use*…not just that which is stored in a warehouse. There is a cost associated with any purchased product that is not immediately put into use)

CC
Commodity Cost

The last part of the equation is represented as “Commodity Cost”; i.e. what is actually paid to the supplier and incurred for the products received.

Commodity Cost = Price <u>Plus</u>…

- **Inbound transportation/shipping**
- **Site installation**
- **Site modification**
- **Set up & testing**
- **Maintenance costs**
- **Repair parts**
- **Operating costs**
- **Energy costs**
- **Support materials**
- **User training**
- **Consumable supplies**
- **Remaining surplus value**
- **Environmental expenses**
- **Safety costs**

As mentioned before, the above TCO elements are reflective of a “product”. **But the TCO concept applies equally to services too, where factors like the following can be used in negotiations:**

TCO = AC + Supplier Fees <u>Plus</u>…

- **Reimbursable travel expenses (airfares, lodging, car rental, meals)**
- **Vehicular expenses**
- **Other reimbursable supplier expenses (materials used in the performance of services, etc.)**
- **Performance incentives**
- **Resources necessary to manage supplier performance**
- **Onsite equipment, communication, and space requirements**
- **Etc.**

Based on the multitude of cost elements to consider when negotiating a given acquisition, it is important to construct a TCO model that fits the proposed exchange.

6 Key Principles for Cost Modeling are as follows:

#1

Capture Cost Drivers, Not Just Cost Elements – Negotiations are more successful when "elements" are dissected and re-engineered to lower the cost of that element.

#2

Build Custom TCO Models That Highlight the Unique Cost Elements – The same TCO model won't work for different products or services. Each is unique in the various components of cost, and the relative values ascribed to each. While similarities may appear to exist, take time to break down the various components before the negotiation.

#3

Consider the Full TCO Impact – Don't make the mistake of evaluating just pieces of the TCO model. Partial understanding of the cost elements can be dangerous when negotiations begin, similar to pulling on just one strand of a spider's web…because all the other strands change shape. Failure to address all elements can allow the supplier to concede on one element, but increase the TCO by fudging the other elements.

#4

Start With a Simple TCO Model & Add Complexity Only as Needed – Sometimes, addressing too many layers of cost can open a door for the supplier to increase TCO. Some supply management consultants [but not us, of course…] have mistakenly-worsened their clients' position by forcing suppliers to ascribe a price to cost elements that wouldn't normally be part of their normal pricing model.

#5

Make Sure to Evaluate Total Value Received – Although TCO evaluations rightly-target costing factors, remember that "cost" is only a part of the complete "value" picture. Aspects like Quality, Timeliness, Professionalism, and Value Received must all be considered**.**

#6

Continue to Improve Accuracy & Confidence in the Model – Once you have prepared the initial TCO model, continue to clarify and improve the information that comprises each element. **Refine & Improve.**

The time & effort needed to develop an accurate Total Cost Model can be considerable, based upon the complexity of the commodity category. The benefits listed below, however, can far exceed the development effort. A Total Cost Modeling analysis helps procurement professionals to…

- Make comparisons between suppliers based upon factors other than price;
- Negotiate "value-added" agreements rather than limiting the scope of negotiations to price-related;

- Identify activities in the particular commodity supply-chain that add little or no value;
- Maximize saving opportunities.

It has often been said that "Knowledge is the foundation to a successful negotiation". Total Cost of Ownership (TCO) analysis is a powerful tool when developing our cost reduction strategy.

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 bi-monthly 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.